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INSIDER TRADING LAW THAT WORKS: USING *NEWMAN* AND *SALMAN* TO UPDATE *DIRKS*'S PERSONAL BENEFIT STANDARD

*Mark Hayden Adams**

I. INTRODUCTION

Wall Street corruption, particularly insider trading, has captured the imagination of the American public since the 1980s.[1] While the most egregious cases of insider trading often grab headlines,[2] there is confusion and disagreement about exactly what constitutes illegal insider trading.[3] Imagine this: a prosecutor has solid evidence that an investment banker tipped inside information[4] to his brother, who, in turn tipped his brother-in-law, who traded on the information and pocketed a cool $1.7 million.[5] In addition, the evidence shows that

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1. Hollywood studios produced a string of popular movies based on Wall Street manipulations starting in the 1980s, including most notably *Wall Street* (1987) (insider trading), but also *Trading Places* (1983) (commodities future trading), *Working Girl* (1988) (mergers and acquisitions), *Other People's Money* (1991) (corporate takeover), *Barbarians at the Gate* (1993) (leveraged buyout), *Boiler Room* (2000) (securities fraud), *Margin Call* (2007) (financial recklessness), and coming back full circle to *Wall Street: Money Never Sleeps* (2011) (moral hazard). Usman Hayat, *Top 20 Films About Finance: From Crisis to Con Men*, CFA INST. (Sept. 20, 2013), https://blogs.cfainstitute.org/investor/2013/09/20/20-finance-films-for-entertainment-and-education.

2. *See, e.g.*, Anita Raghavan, *Lust for Zeros*, N.Y. TIMES MAG., May 17, 2013, at MM30 (discussing United States v. Gupta, 747 F.3d 111 (2d Cir. 2014), *cert. denied*, 135 S. Ct. 1841 (2015)).

3. *See, e.g.*, Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014) ("Deep confusion reigns over federal insider trading law, even over the essential elements of an insider trading violation.").

4. While it is often referred to simply as "inside information," the accurate term is "material nonpublic information" and courts often examine whether the information tipped was indeed "material." *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848–51 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

5. United States v. Salman, 792 F.3d 1087, 1088–89 (9th Cir. 2015).

all parties were fully aware that the activity was illegal.[6] The brother-in-law even tried to hide the trades in a friend's account.[7] The prosecutor handily wins the case, but the defendant appeals all the way to the Supreme Court, claiming to be innocent because the government did not prove that the investment banker received a pecuniary benefit when he tipped his brother *and* that the defendant knew of such a benefit.[8] To many laypersons, this may sound like further proof that "the law is an ass."[9]

Unlike many other countries, the United States has no federal statute defining and prohibiting insider trading.[10] Instead, insider-trading prohibitions have been developed through common law interpretations of Section 10(b) of the 1934 Exchange Act, and of SEC Rule 10b-5, one of the regulations issued pursuant to it, which was adopted in 1942.[11] The results have been uneven, particularly in recent years.[12] At issue lately has been the question of the "personal benefit" received by the insider who tips the information, also known as the "tipper." (The person who receives the tip is known as the "tippee.") The tipper's personal benefit is a required element of a violation.[13]

In 2012 in *SEC v. Obus*,[14] the Second Circuit reversed a summary judgment order against the SEC, holding that evidence of a college friendship between the tipper and the tippee was a sufficient inference to send to the jury the question of whether the tipper received a personal benefit from the tip.[15] But in 2014 in *United*

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6. *Id.* at 1089.

7. *Id.*

8. *Id.* at 1090.

9. These words were uttered (more or less) by Mr. Bumble in Charles Dickens's *Oliver Twist*. But the notion was not new to Dickensian characters. In 1654, the phrase "the law is such an ass" was found in *Revenge for Honour*, published by George Chapman, and possibly written by playwright Henry Glapthorne. *The Law Is an Ass*, PHRASE FINDER, http://www.phrases.org.uk/meanings/the-law-is-an-ass.html (last visited Feb. 7, 2016).

10. Richard W. Painter, *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 211–12 (1998).

11. Kim, *supra* note 3, at 935. The "SEC" is the commonly used acronym for the Securities and Exchange Commission.

12. *Compare* SEC v. Obus, 693 F.3d 276 (2d Cir. 2012) and United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), *with* United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

13. Dirks v. SEC, 463 U.S. 646 (1983) (holding that the prohibition against insider trading is based on the insider's breach of fiduciary duty in tipping the information, which generally includes some kind of personal benefit obtained by the insider/tipper).

14. 693 F.3d 276 (2d Cir. 2012).

15. *Obus*, 693 F.3d at 279.

States v. Newman,[16] the Second Circuit seemed to reverse itself—although it did not state that it was doing so—by holding that a personal benefit *cannot be inferred* "by the mere fact of a friendship," but must be established through "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[17] In addition, the *Newman* Court held that the government must prove both that the tipper received a personal benefit and that the tippee *knew* that the tipper received the benefit.[18] These requirements have made it much more difficult for prosecutors to bring cases forward and to win them.[19] Consequently, the government petitioned the Second Circuit to review the case en banc, but was denied.[20] Subsequently, the government petitioned the Supreme Court to review the case, but again, the Court denied the request.[21]

In 2015, Judge Jed Rakoff of the Southern District of New York sat by designation on the Ninth Circuit in *Salman*, the case in which the insider tipped his brother, who tipped his brother-in-law.[22] No longer bound by the Second Circuit's decision in *Newman*, Judge Rakoff held that *Newman* did not intend to overturn the landmark Supreme Court insider trading case, *Dirks v. SEC*.[23] Indeed, the Second Circuit was required to follow the Supreme Court, and therefore any interpretation of *Newman* must be in concert with *Dirks*.[24] *Dirks* held that insider trading violations are based on the breach of fiduciary duty by the original tipper (the "insider"), and that this breach of duty is met where an "insider makes a gift of confidential information to a trading relative or friend."[25] Judge Rakoff therefore rejected Salman's argument that the government needed to prove that the investment banker received a personal

16. 773 F.3d 438 (2d Cir. 2014).
17. *Newman*, 773 F.3d at 452.
18. *Id.* at 453.
19. David I. Miller, *Putting the Brakes on Newman: 3 Recent Rakoff Decisions*, LAW360 (July 30, 2015, 3:46 PM ET), http://www.law360.com/articles/684440/putting-the-brakes-on-newman-3-recent-rakoff-decisions.
20. Brief of Petitioner-Appellee at 1, United States v. Newman, No. 13-1837(L), 13-1917(CON), 2015 WL 1064423 (2d Cir. Jan. 23, 2015).
21. United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).
22. United States v. Salman, 792 F.3d 1087, 1088 (9th Cir. 2015).
23. *Id.* at 1093.
24. *Id.*
25. *Id.* at 1093 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

benefit—it was enough that he tipped inside information to his brother as a gift.[26]

After the Supreme Court denied certiorari in *Newman*, some commentators predicted that the Court would find *Salman* a better case to determine the issue of a personal benefit.[27] In fact, in 2014 Justice Scalia welcomed the opportunity to hear an insider trading case so that the Court could clarify this area of law.[28] On January 19, 2016, the Supreme Court granted certiorari to hear *Salman*.[29] Less than one month later, on February 13, 2016, Justice Scalia died, and his absence will likely significantly change the dynamics of the Court and create an opportunity to revisit earlier holdings.[30] The Court should take this opportunity to reverse *Dirks*'s holding that a personal benefit is required to show a breach of fiduciary duty.[31] While a personal benefit examination is often useful, by making it a required element, the Court made it too difficult for the judicial framework of insider trading to comport with congressional intent as expressed through the creation of the SEC.[32] In addition, the Court should eliminate the *Newman* requirement that the tippee must have knowledge of the tipper's personal benefit.[33] There is much at stake in the Court's upcoming decision. On one side, there is a world of Wall Street market analysts who routinely talk with corporate insiders to "ferret out" information about a company to determine the value of its stock.[34] These analysts' findings quickly filter down to traders, resulting in much more accurate pricing of securities.[35] As such, they provide information that is integral to the proper

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26. *Id.* at 1094.

27. Walter Pavlo, *The Insider Trading Case the Supreme Court Wants to Hear*, FORBES (Jan. 25, 2016, 9:24 AM), http://www.forbes.com/sites/walterpavlo/2016/01/25/the-insider-trading-case-the-supreme-court-wants-to-hear/#222220562788; Stephen Bainbridge, *Insider Trading at the Supreme Court: With Newman Down, Will Salman Go?*, PROFESSORBAINBRIDGE.COM (Oct. 9, 2015), http://www.professorbainbridge.com/professorbainbridgecom/2015/10/insider-trading-at-the-supreme-court-with-newman-down-will-salman-go.html.

28. Whitman v. United States, 135 S. Ct. 352, 354 (2014).

29. Ed Beeson, *High Court Takes on Insider Trading Benefits Case*, LAW360 (Jan. 19, 2016, 10:18 AM ET), http://www.law360.com/articles/747762/high-court-takes-on-insider-trading-benefits-case.

30. Adam Liptak, *Antonin Scalia, Justice on the Supreme Court, Dies at 79*, N.Y. TIMES (Feb. 13, 2016), http://www.nytimes.com/2016/02/14/us/antonin-scalia-death.html.

31. Dirks v. SEC, 463 U.S. 646, 662 (1983).

32. *See infra* Part II.

33. Unites States v. Newman, 773 F.3d 438, 449 (2d Cir. 2014).

34. *Dirks*, 463 U.S. at 658.

35. *Id.* at 658–59.

functioning of the market, and they need to be able to perform their work without fear of breaking the law.[36] On the other side, the government must have tools to prosecute those, like Salman, who willfully trade on inside information.

This Note proceeds as follows: Part II chronicles the development of insider trading law, from the Great Depression through today, including the policy issues that have guided both legislators and judges. Part III examines in detail the policy problems with recent judicial decisions, as well as the inherent conflict between the mission of the Securities Exchange Commission and the Supreme Court's holding in *Dirks*. Part IV proposes solutions to the current problem with insider trading liability and demonstrates how the solutions would solve the problem. Part V justifies the proposal. Part VI concludes.

II. STATEMENT OF EXISTING LAW

A. *Brief History of the Securities and Exchange Act*

After World War I, there was little appetite for a federal system of market regulation.[37] The roaring '20s were full of promises of "rags to riches" transformations by investing in the stock market, and most investors failed to consider the systemic risk that came from widespread abuse of margin financing (investing borrowed money) and unreliable information about the securities in which they were investing.[38]

When the stock market crashed in October 1929, however, public confidence in the markets crashed as well.[39] Both large and small investors, and even the banks that had loaned to them, lost massive amounts of money in the Great Depression that followed.[40] For the economy to recover, the public would need renewed faith in the markets, and Congress held hearings in search of a solution.[41] Based on its findings, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934 ("Exchange Act"), which

36. *Id.* at 658; *see also* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 936 (2003).

37. *What We Do*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/about/whatwedo.shtml (last modified June 10, 2013).

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

created the Securities and Exchange Commission ("SEC").[42] The acts were intended to restore investor confidence in the capital markets by ensuring that investors would have access to reliable information and that there were clear rules of honest dealing.[43]

Most insider trading prosecutions are based on violations of two laws: Section 10(b) of the Exchange Act and SEC Rule 10b-5. In § 10(b), Congress made it unlawful "[t]o use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention" of rules promulgated by the SEC.[44] In Rule 10b-5, the SEC made it unlawful to "engage in any act, practice, or course of business which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[45] Interestingly, although § 10(b) was intended as a "catch-all" clause to prevent fraudulent practices, neither the statute nor the pursuant regulations expressly prohibits insider trading.[46]

B. The Seminal Insider Trading Cases

1. Straightforward Insider Trading: *Texas Gulf Sulphur Co.* in 1969

The first insider trading case in modern judicial history, *SEC v. Texas Gulf Sulphur Co.*,[47] was relatively simple.[48] Corporate insiders knew the company had just discovered a huge deposit of copper, zinc and silver, but released a press statement that essentially denied it.[49] Secretly, they purchased stock and options in their company and sold it at a great profit after the news became public and the share price rose.[50] The Second Circuit found that the insiders violated § 10(b) and SEC Rule 10b-5, noting that "[i]t was the intent of Congress that all members of the investing public should be subject to identical

42. *Id.*
43. *Id.*
44. 15 U.S.C. § 78j(b) (2006).
45. 17 C.F.R. § 240.10b–5(c) (2016).
46. Unites States v. Newman, 773 F.3d 438, 445 (2d Cir. 2014) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202–06 (1976)).
47. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).
48. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). This is widely considered a seminal case, even though it is from the Second Circuit, not the Supreme Court. The Second Circuit handles a large portion of securities related cases because it covers New York City.
49. *Id.* at 845.
50. *Id.* at 847.

market risks."[51] Specifically, the court found that because the insiders had access to inside information, they "were not trading on an equal footing with the outside investors," and Congress intended to prevent this kind of inequity.[52]

By contrast, subsequent cases that have shaped the law of insider trading have dealt with situations that were far more complicated.[53] More importantly, the idea that Congress intended that "all members of the investing public should be subject to identical market risks"[54] was rejected in subsequent cases, most notably by Justice Powell in *Chiarella v. United States*.[55]

2. The Classical Theory: *Chiarella* in 1980

The second major insider trading case was *Chiarella v. United States*, which established what became known as the "classical theory" of insider trading.[56] Vincent Chiarella worked at a financial printer, where he handled documents announcing corporate takeover bids.[57] Although the identities of the acquiring and target corporations were withheld until the last minute, often Chiarella was able to deduce them.[58] Without disclosing his knowledge, he purchased stock in the companies and sold his shares immediately after the takeovers occurred, making a profit in excess of $30,000.[59] He was convicted of violating § 10(b) and SEC Rule 10b-5.[60] The Second Circuit affirmed the conviction.[61]

The Supreme Court granted certiorari and began by examining the trial court's jury instruction, which allowed a conviction if the

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51. *Id.* at 852.
52. *Id.*
53. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 224–25 (1980) (where the inside information was deduced by a man who worked at a Wall Street print shop); *see also* Dirks v. SEC, 463 U.S. 646, 648–49 (1983) (where the insider revealed information to a broker-dealer for the purpose of exposing corporate fraud).
54. Tex. Gulf Sulphur Co., 401 F.2d at 851–52.
55. 445 U.S. at 232 (rejecting the Second Circuit's reasoning that the federal securities laws "created a system providing equal access to information necessary for reasoned and intelligent investment decisions.").
56. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) ("Under the 'traditional' or 'classical theory' of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.").
57. *Chiarella*, 445 U.S. at 224.
58. *Id.*
59. *Id.*
60. *Id.* at 225.
61. *Id.*

jury found that Chiarella "willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable."[62] The Court observed that § 10(b) did not address whether silence may constitute a "manipulative or deceptive device."[63]

Next, the Court turned for guidance to an earlier influential case at the SEC, *In re Cady, Roberts & Co.*,[64] where the SEC held that a broker-dealer's duty to abstain from trading or disclosing the inside information arose from "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[65] Under this test, Chiarella could not be held liable because neither the Second Circuit nor the trial court identified a fiduciary relationship between Chiarella and the sellers of the stock.[66] Instead, the Court reasoned the SEC's decision was based on the belief that federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions," and therefore, any trading using material nonpublic information was fraudulent.[67]

The Court rejected the "equal access" theory, also known as the "fairness" theory.[68] In fact, the Court held that to formulate such a broad duty would "depart radically" from the "established doctrine that duty arises from a specific relationship between two parties" and should not be undertaken "absent some explicit evidence of congressional intent."[69]

The Supreme Court is free to overturn lower court decisions, but

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62. *Id.* at 226.

63. *Id.*

64. 40 S.E.C. 907 (1961).

65. *Id.* at 227 (citing *Cady*, 40 S.E.C. at 912).

66. *Id.* at 231–32. Although Chiarella was a stranger to the companies whose shares he purchased, he was arguably an agent for the printing company. The SEC never advanced that theory, and thus, the court declined to address it. In his dissent, Chief Justice Burger stated that Chiarella was not operating in an arm's-length transaction, because he had essentially stolen inside information. *Id.* at 239–40 (Burger, C. J., dissenting). Justice Burger would read § 10(b) and Rule 10b-5 to mean that a person who has "misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* (Brennan, J., concurring). It would take 20 years for the Supreme Court to recognize the misappropriation theory in United States v. O'Hagan, 521 U.S. 642 (1997).

67. *Chiarella*, 445 U.S. at 232 (1980).

68. *Id.*

69. *Id.* at 233.

here, the Court did not even acknowledge the Second Circuit's finding in *Texas Gulf Sulphur Co.* that Congress did indeed intend to ensure equal access to information when it passed the Securities and Exchange Act.[70] Considering the Second Circuit generally handles most of the insider trading cases, it was odd to ignore a finding regarding insider trading as clear as this: "[s]uch inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected."[71] Nevertheless, the Court found Chiarella had violated no law and thus, reversed his conviction.

The *Chiarella* opinion was written by Justice Powell, who was appointed to the bench in 1972 when he was sixty-four, and was already a prominent corporate lawyer, as well as a former director of eleven major corporations.[72] Shortly before his appointment, he had written a letter to the U.S. Chamber of Commerce, entitled "Attack of the American Free Enterprise System," in which he warned of the "present assault" on the enterprise system by communists, leftists, and even voices "from the perfectly respectable elements of society: the college campus, the pulpit, the media, the intellectual and literary journals, the arts and sciences, and from politicians."[73] As a fierce advocate of free enterprise, Powell likely considered "fairness theory" to be in conflict with the free market ideals he championed.

3. *Dirks v. SEC*: Creating the Standard for Tipper/Tippee Liability

The third major insider trading case, and widely considered the landmark decision in this area, was *Dirks v. SEC*, also written by Justice Powell. The facts in *Dirks* were extremely unusual because they involved massive corporate fraud.[74] In 1973, Raymond Dirks, a market analyst, received material nonpublic information from Ronald Secrist, a former officer of Equity Funding of America ("Equity"),

70. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 851–52 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

71. *Id.*

72. Linda Greenhouse, *Lewis Powell, Crucial Centrist Justice, Dies at 90*, N.Y. TIMES (Aug. 26, 1998), http://www.nytimes.com/1998/08/26/us/lewis-powell-crucial-centrist-justice-dies-at-90.html?pagewanted=all.

73. Lewis F. Powell, Jr., *Confidential Memorandum: Attack of American Free Enterprise Systems*, PBS (Aug. 23, 1971), http://www.pbs.org/wnet/supremecourt/personality/sources_document13.html ("The memo was written two months before President Nixon nominated him to the Supreme Court. The memo is credited with inspiring the founding of many conservative think tanks, including the Heritage Foundation, the Cato Institute and the Manhattan Institute.").

74. Dirks v. SEC, 463 U.S. 646, 649 (1983).

that Equity's assets were vastly overstated due to widespread fraud within the company.[75] Secrist stated that various regulatory agencies had failed to act, despite charges made by other employees, and he wanted Dirks both to verify the fraud and to disclose it publicly.[76]

Dirks investigated Equity and found lower level employees who admitted the fraud.[77] Although neither Dirks nor his firm owned any shares of Equity, some of his firm's clients did. Dirks discussed his findings openly with them, and they sold their shares worth more than $16 million, thereby avoiding substantial losses.[78]

Dirks urged the Wall Street Journal to write a story on the fraud allegations, but the bureau chief did not believe such massive fraud was possible and feared publishing a story that might be libelous.[79] Shortly thereafter, Equity's share price fell from $26 to $15, and California insurance authorities discovered the fraud.[80]

The SEC found that Dirks had aided and abetted violations of § 10(b) and Rule 10b-5 by repeating the allegations of fraud to members of the investment community who later sold their shares.[81] Although Dirks played an important role in exposing the fraud,[82] the SEC censured him because he gave material nonpublic information about Equity to his clients, knowing that they would trade on it.[83]

The Court of Appeals for the District of Columbia Circuit affirmed. Judge J. Skelly Wright held that anyone who receives material nonpublic information from an insider retains the fiduciary duty to disclose before trading.[84] Alternatively, Judge Wright found that, as an employee of a broker-dealer, Dirks had violated his obligations to the SEC and to the public, which were completely independent of any obligations he acquired from Secrist's tip.[85]

But at the Supreme Court, Justice Powell rejected Judge Wright's reasoning as essentially the same arguments the Court had

75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 649–50.
80. *Id.* at 650.
81. *Id.* at 651.
82. Dirks v. SEC, 681 F.2d 824, 829 (1982) ("Largely thanks to Dirks, one of the most infamous cases of fraud in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding.").
83. *Dirks*, 463 U.S. at 651.
84. *Id*. at 652 (citing *Dirks*, 681 F.2d at 839).
85. *Id.*

previously rejected in *Chiarella*.[86] The Court again rejected the SEC's theory that the antifraud provisions of the Securities Act require "equal information" among all traders.[87] In fact, Powell intended to establish a carve-out for market analysts,[88] claiming that imposing a duty on analysts to disclose or abstain could inhibit them, and that even the SEC recognized that analysts were necessary for a healthy market.[89] According to Powell, analysts routinely "ferret out" and evaluate information they receive by meeting with corporate officers and other insiders, and then determine the value of a corporation's security.[90] The analysts' judgments are then made available to clients of the firm through newsletters, but, given the nature of the information and the markets themselves, it would be impossible to make the information available simultaneously to all of the stockholders or the general public.[91]

At the same time, Powell knew a ban on insider trading was essential; without it, corporate insiders would trade information for cash or give it to the "stereotypical golfing buddy."[92] But he did not trust the SEC to create the legal boundaries.[93] He contended that the duty to disclose advocated by the SEC would have no limiting principle, and in a footnote he observed "[w]ithout legal limitations,

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86. *Id.* at 656.

87. *Id.* at 657.

88. Professor Adam Pritchard has researched Justice Powell's life and writings extensively, including unpublished notes and dictations to his clerks, to better understand the Justice's internal process. Pritchard stated: "Powell's experience as a corporate lawyer had left him with definite views on the direction that the securities laws should take. In contrast to his reputation as a swing vote in constitutional cases, Powell had profoundly conservative views on the proper scope of the federal securities laws, and he pushed the Court toward holdings consistent with those views." A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 845 (2003).

89. *Dirks*, 463 U.S. at 658.

90. *Id.*

91. *Id.* at 658–59. One can't help but wonder how applicable that assessment is today, when information is released to the public with the click of a mouse, let alone in light of high-frequency trading that occurs within microseconds, literally millionths of a second. In addition, Professor Langevoort has questioned the value of analysts as applied to different investors in the market: "[I]ntuition suggests that information generated by such multiservice firms will first find its way to the firm's own trading desks and its institutional clients, and only be filtered along to retail customers after most of the opportunity for an informational trading advantage has disappeared." Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1026 (1990). In fact, in 2000 the SEC promulgated Regulation FD, which requires simultaneous disclosure of information. 17 C.F.R. § 243.100 (2016).

92. A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 861 (2015). Professor Pritchard's insight comes from Justice Powell's notes to his clerk, James Browning, regarding drafting the opinion, as well as memoranda for meetings with other justices.

93. *Id.*

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."[94]

In the end, Justice Powell held that liability for insider trading must be based on the insider's (tipper's) breach of fiduciary duty, which required that the tipper receive a "personal benefit," either directly or indirectly, from the disclosure.[95] Further, because a tippee's liability was derivative of the tipper's liability, there would be no liability for the tippee if the tipper received no personal benefit.[96] Lower courts were instructed to focus on objective criteria, such as a pecuniary gain or a reputational benefit that would translate into future earnings, which could be inferred by objective facts and circumstances.[97] In addition to these quid pro quo types of relationships, a breach of duty could arise when an insider "makes a gift" of material nonpublic information to a "trading relative or friend."[98] There, it would "resemble trading by the insider himself followed by a gift of the profits to the recipient."[99] Because Secrist, the insider who tipped Dirks, was motivated by the desire to expose the fraud and received no personal benefit, Dirks inherited no liability, and thus, his conviction was reversed.[100]

4. *United States v. O'Hagan*: The Misappropriation Theory

The fourth major insider trading case was *United States v. O'Hagan*, 521 U.S. 642 (1997). This case established the "misappropriation theory" that Justice Burger had contemplated in *Chiarella*.[101] O'Hagan was a partner at a law firm that was hired to represent Grand Metropolitan for a potential tender offer for the common stock of the Pillsbury Company.[102] Although O'Hagan did not work on the offer, he was aware of it, and he used material nonpublic information he acquired through his firm to trade in call

94. *Dirks*, 463 U.S. at 664 n.24. Powell no doubt valued Dirks' investigation into the alleged fraud, and likely considered the SEC's action to be misguided, because he believed Dirks' goal was to expose fraud, not to profit from inside information.
95. *Id.* at 662.
96. *Id.* at 664.
97. *Id.* at 663–64.
98. *Id.* at 664.
99. *Id.*
100. *Id.* at 667.
101. *See* United States v. Chiarella, 445 U.S. 222, 240 (1980) (Burger, J., dissenting).
102. United States v. O'Hagan, 521 U.S. 642, 647 (1997).

options and shares, making a profit of more than $4.3 million.[103]

The SEC indicted O'Hagan for defrauding his law firm and its client by using material nonpublic information for his own trading purposes.[104] In addition, O'Hagan used the profits to conceal his previous embezzlement and conversion of unrelated client trust funds.[105] O'Hagan was convicted of violations of § 10(b) and Rule 10b-5.[106]

The Eighth Circuit Court of Appeals reversed all of the convictions, holding that liability under § 10(b) and Rule 10b-5 could not be grounded on the basis of misappropriating material nonpublic information he received through his firm, effectively rejecting the "misappropriation theory."[107]

The Supreme Court reversed the Eighth Circuit and held that criminal liability under § 10(b) could indeed be based on the misappropriation theory.[108] It reasoned that because the statute proscribed using any deceptive device in connection with the purchase or sale of securities in contravention of SEC Rules, it did not confine its coverage merely to deception of a purchaser or seller of securities.[109] While the classical theory of a Rule 10b-5 violation is based on the fiduciary duty that corporate insiders owe to their shareholders,[110] the misappropriation theory holds that a person commits securities fraud when he "misappropriates" material nonpublic information for trading purposes, "in breach of a duty *owed to the source of the information*."[111]

The court explained that under this theory, when a fiduciary breaches a duty of loyalty and confidentiality to the principal by trading on material nonpublic information for his own self-interest without disclosing it, he "defrauds the principal of the exclusive use

103. *Id.* at 648.

104. *Id.*

105. *Id.*

106. *Id.* at 648–49.

107. *Id.* at 649.

108. *Id*. at 649–50. The Court observed in a footnote that twice before it had been presented with the same question: first, in *Chiarella*, where the jury had not received instructions regarding misappropriation, thus the court declined to address it; and second, in United States v. Carpenter, 484 U.S. 19, 24 (1987), where the court was evenly divided on misappropriation theory, partly because it was such an unusual case—the misappropriated information did not come from a company dealing in securities, but from the Wall Street Journal. *O'Hagan*, 521 U.S. at 650 n.4.

109. *Id.* at 651.

110. *Id.* at 651–52 (citing *Chiarella*, 445 U.S. at 228).

111. *Id.* at 652 (emphasis added).

of that information."[112] The court reasoned that the two theories were complementary, as each addressed efforts to capitalize on nonpublic information through securities trading.[113]

Commentators have noted that Powell's opinions in *Chiarella* and *Dirks* were based on the common law of deceit, whereas Ginsburg's opinion in *O'Hagan* drew on the common law of agency.[114] But the broad scope of the misappropriation theory filled a gap left by the classical theory, which otherwise would have "severely undermine[d] the policy interests served by prohibitions against insider trading."[115]

C. Recent Cases: Interpreting the Dirks Standard

1. *SEC v. Obus*: Expanding Tipper/Tippee Liability

In 2012, the Second Circuit arguably expanded insider trading liability in *SEC v. Obus* when it reversed a summary judgment ruling against the SEC.[116] Strickland then had a conversation with his college friend, Peter Black, a hedge fund analyst, about SunSource.[117] Black told his boss, Nelson Obus, about the pending acquisition, and Obus later purchased about five percent of SunSource's outstanding common stock for $4.75 per share.[118] Eleven days later, the acquisition was publicly announced and the price jumped to $9.50, representing a profit of $1.3 million for

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112. *Id.*

113. *Id.*

114. A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 17 (1998).

115. *Id.* Professor Pritchard further observed that Justice Powell petitioned his fellow justices to grant certiorari in United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), the earlier case based the misappropriation theory. *Id.* at 32. The Second Circuit had been developing the theory through three cases, and Powell wanted to invalidate it, but by the time *Carpenter* reached the court, he had retired, and the decision resulted in a 4-4 split. *O'Hagan*, written by Justice Ginsberg, settled the matter in favor of the misappropriation theory. Unlike Justice Powell, Justice Ginsburg had no corporate law experience. Before becoming a Circuit Judge, Justice Ginsburg "was the director of the Women's Rights Project for the ACLU and won five of the six major cases on gender equality she argued before the Supreme Court including Reed v. Reed (1973)." John Fox, *Biographies of the Robes: Ruth Bader Ginsburg*, PBS, http://www.pbs.org/wnet/supremecourt/future/robes_ginsburg.html (last visited Mar. 14, 2016).

116. SEC v. Obus, 693 F.3d 276, 293 (2d Cir. 2012).

117. *Id.* at 280. The contents of the conversation were disputed. *Id.* The defendants maintained that Strickland asked Black about Sunsource's management as part of his due diligence, whereas the SEC alleged that Strickland tipped Black with material nonpublic information regarding the pending acquisition. *Id.* The Second Circuit deemed the disputed conversations "genuine questions of fact," that warranted reversal of the summary judgment. *Id.* at 293.

118. *Id.* at 280–82.

Obus's fund.[119]

The Second Circuit held that the District Court erred when it relied on an internal investigation at Strickland's firm to determine whether he had tipped Black in breach of a fiduciary duty, because the investigation's conclusions were contradicted by other evidence, making it unreliable.[120] It was a factual dispute, which therefore required a jury to make a finding of fact.[121] Further, the court held that the undisputed fact that Strickland and Black were college friends was sufficient to "send to the jury the question of whether Strickland received a benefit from tipping Black."[122] The same evidence created a question of fact as to "whether Strickland intentionally tipped Black."[123] Moreover, the court held that it was sufficient for a jury to conclude that Strickland "intentionally or recklessly revealed material non-public information to Black, knowing that he was making a gift of information Black was likely to use for securities trading purposes."[124]

Taken together, the court's holdings regarding the college friendship between Strickland and Black may have led prosecutors to believe that evidence of a friendship, college or otherwise, would satisfy the "personal benefit" element required for tipper liability.

2. *United States v. Newman*: Reducing Exposure

In 2014, the Second Circuit took another look at tipper/tippee liability in *United States v. Newman*, and rejected the notion that a tipper's personal benefit could be inferred from a personal relationship between the tipper and tippee, without more proof.

The facts of this case were complicated because they involved several degrees of tipping from insiders at Dell and NVIDIA regarding earnings numbers in advance of their public release.[125] The information came through a tipping chain of three to four analysts, who then passed the information on to hedge fund managers Newman and Chiasson.[126] They both traded on the tips and made $4

119. *Id.*

120. *Id.* at 291.

121. *Id.*

122. *Id.* This line of the opinion was likely the most troubling for those working on Wall Street. It could be interpreted to mean that *any* conversation among friends regarding *any* security could lead to liability on the ground that one party made a gift of inside information.

123. *Id.*

124. *Id.*

125. United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).

126. *Id.*

million and $68 million, respectively, in profits for their funds.[127] Notably, because Newman and Chiasson were several steps removed from the tippers, there was no evidence that either was aware of the source of the inside information.[128] Nevertheless, the Government argued that Newman and Chiasson were criminally liable for insider trading because, "as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose."[129] They were convicted and sentenced to fifty-four months in prison, followed by a year of supervised release, in addition to fines and forfeitures of up to $5 million.[130]

On appeal, Newman and Chiasson argued that the jury instructions were erroneous and, further, that there was insufficient evidence to support their convictions.[131] The court noted that although the Government conceded that tippee liability required proof of a personal benefit to the tipper, it claimed that it was not required to prove that the appellants *knew* that insiders at Dell and NVIDIA received a personal benefit in order to be found guilty of insider trading.[132] Instead, "consistent with the district court's instruction," it claimed it merely needed to prove that the "defendants traded on material nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality . . . ."[133] In support, the Government cited *Dirks* for the "proposition that the Supreme Court only required that the 'tippee know that the tipper disclosed information in *breach of a duty*.'"[134] In addition, the Government cited dicta in other cases where the court described elements of tippee liability "without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit."[135]

The court rejected the Government's argument. It explained, "[b]y selectively parsing this dictum, the Government seeks to revive

127. *Id.*
128. *Id.*
129. *Id.* at 443–44.
130. *Id.* at 444–45.
131. *Id.* at 445.
132. *Id.* at 447 (emphasis added).
133. *Id.*
134. *Id.* (citing *Dirks*, 463 U.S. at 600).
135. *Id.*

the absolute bar on tippee trading that the Supreme Court explicitly rejected in *Dirks*."[136] The court observed that the Government's "overreliance" on the court's prior dicta merely highlighted the "doctrinal novelty" of its recent insider trading prosecutions, which were "increasingly targeted at remote tippees many levels removed from corporate insiders."[137] Prior cases, by contrast, generally involved tippees who "directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit)" or tippees who were "explicitly apprised of the tipper's gain by an intermediary tippee."[138] The court could not find a single case in which tippees "as remote as" the appellants had been held criminally liable for insider trading.[139]

The court acknowledged it had "not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit," but stated that the answer "follows naturally from *Dirks*."[140] For insider trading liability, the insider's disclosure of confidential information alone is not a breach.[141] Therefore, without establishing that "the tippee knows of the personal benefit received by the insider in exchange for the disclosure," the Government cannot meet its burden of showing that the tippee knew of a breach.[142] Specifically addressing the issue of the benefit that may be inferred from a personal relationship, the court stated, "such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[143]

Thus, the court reversed the convictions. The Government petitioned for an en banc review, but the Circuit denied it.[144] The Government then filed a writ of certiorari to the Supreme Court, but was again denied.[145]

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136. *Id.*
137. *Id.* at 448.
138. *Id.*
139. *Id.*
140. *Id.* at 447.
141. *Id.* at 448.
142. *Id.*
143. *Id.* at 452.
144. United States v. Newman, Nos. 13-1837(L), 13-1917(Con), 2015 U.S. App. LEXIS 5788, at *4 (2d Cir. Apr. 3, 2015).
145. United States v. Newman, No. 15-137, 2015 U.S. LEXIS 6104, at *1 (Oct. 5, 2015).

D. Post Newman *Circuit Split*

Before the Supreme Court took up *Salman*, some commentators speculated that there may have been a circuit split created by the opinions of Judge Jed Rakoff.[146] Although he regularly sits in the District Court of the Second Circuit, he recently sat by designation on the Ninth Circuit and he alone may have created a circuit split.[147] In the Second Circuit, Judge Rakoff was bound by *Newman*, but in the Ninth Circuit he was not.

1. S.D.N.Y.: *United States v. Gupta* July 2015

Here, Rajat Gupta moved to vacate his sentence and the judgment against him arising from his 2012 conviction of conspiracy and securities fraud, based on the recent decision in *Newman*.[148] Gupta had been on the board of directors of Goldman Sachs, and there was ample evidence he had tipped his close business associate with material nonpublic information on several occasions, following which, his associate traded on the information.[149] Gupta had argued that *Newman* required that a tipper (here Gupta) receive from his tippee a "quid pro quo" in the form of "a potential gain of a pecuniary or similarly valuable nature."[150] The court first distinguished *Newman*, noting that Newman was a remote tippee, whereas Gupta was a tipper.[151] Next, the court reiterated the standard it had repeatedly made clear: "a tipper is liable for securities fraud if he takes sensitive market information provided to him in a fiduciary capacity and exploits it for some personal benefit."[152] The court noted that this was "precisely how the jury was instructed" in his case, and *Newman* "in no way purports to change this fundamental concept."[153]

Then Judge Rakoff addressed the second holding in *Newman*, upon which Gupta primarily relied:[154]

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and

146. Miller, *supra* note 19.
147. *Id.*
148. United States v. Gupta, 111 F. Supp. 3d 557 (S.D.N.Y. 2015).
149. *Id.* at 560–61.
150. *Id.* at 559.
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.* at 560.

> tippee, where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, as Judge Walker noted in *Jiau*, this requires evidence of "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the latter.[155]

Judge Rakoff pointed out that the use of the word "or" in the last sentence indicated that "a tipper's intention to benefit the tippee is sufficient to satisfy the benefit requirement so far as the tipper is concerned, and no quid pro quo is required."[156] On the other hand, Judge Rakoff clarified, "so far as a remote tippee's knowledge of that intent is concerned, the jury, according to the *Newman* court, cannot infer such knowledge from the mere fact that the remote tippee knew that the tipper and direct tippee were friends."[157] Rather, he explained, "to warrant such an inference in such circumstances, there must be evidence of a 'meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.'"[158] Judge Rakoff concluded that, in any event, the proof at trial easily satisfied "even Gupta's view of *Newman*."[159] Thus, Gupta's motion was denied in its entirety.[160]

2. Ninth Circuit: *United States v. Salman* July 2015

Here again, the element of personal benefit was the crucial factor in deciding the case. In 2003, Bassam Yacoub Salman's sister Susan became engaged to Maher Kara, an investment banker in

155. *Id.* (internal citations omitted).
156. *Id.*
157. *Id.* The "friendship from college" argument was put forth by the Government in *Newman*, perhaps based on success of that argument in *Obus*, but the *Newman* court invalidated it as insufficient. The standard the *Newman* court set forth was more rigorous, as it added the requirement that the tippee, no matter how remote, know of the personal benefit received by the original tipper.
158. *Id.*
159. *Id.* at 561.
160. *Id.*

Citigroup's healthcare group.[161] Over the course of the engagement, the Kara family and the Salman family became very close.[162] In particular, Salman and Michael Kara, Maher's older brother, became close friends.[163] Michael had an undergraduate degree in chemistry and often helped his younger brother, Maher, understand scientific concepts relevant to his work in the healthcare and biotechnology sectors.[164] Between 2004 and 2007, Maher regularly and knowingly disclosed to Michael material nonpublic information about upcoming mergers and acquisitions, on which Michael traded.[165] At the same time, Michael shared the information with Salman and encouraged him to "mirror-image" his trading activity.[166] Salman did so, but instead of trading through his own account, he arranged for a series of transfers, ultimately into the account of his wife's sister and her husband, Bayyouk, and Salman would split the profits with them.[167] From 2004 to 2007, the account grew from $396,000 to $2.1 million.[168]

Salman, like Newman, was a remote tippee. Under the *Newman* standard of the Second Circuit, in order to prosecute Salman, the Government would need to prove that Salman (1) knew that Maher was the tipper and that he breached his fiduciary duty to Citigroup, (2) knew that Maher received a personal benefit from doing so, and (3) traded on the information anyway.[169]

The Government had presented evidence that Salman knew that Maher was the tipper and had breached his fiduciary duty in tipping the information.[170] In addition, the Government had presented evidence that Maher and Michael Kara "enjoyed a close and mutually beneficial relationship," which would satisfy the *Newman* requirements.[171] For instance, Michael helped pay for Maher's

161. United States v. Salman, 792 F.3d 1087, 1088–89 (9th Cir. 2015).
162. *Id.* at 1089.
163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.*
169. United States v. Newman, 773 F.3d 438, 447 (2d Cir. 2014).
170. *Salman*, 792 F.3d at 1089. In fact, Michael pleaded guilty and testified for the government that he told Salman, directly, that the information was coming from Maher. *Id.* On another occasion, when Michael saw papers regarding their trades strewn about Salman's office, Michael became angry, and Salman agreed that they had to "protect" Maher and promised to shred the papers. *Id.*
171. *Id.*

college, stood in for their deceased father at Maher's wedding, and coached Maher on science, so that he could succeed at Citigroup.[172] Maher loved his brother Michael and gave him information "to benefit him" and "fulfill whatever needs he had."[173] On one occasion when Michael asked for inside information because he "owed somebody," Maher initially offered cash, but when Michael refused it, he eventually "gave him a tip about an upcoming acquisition instead."[174]

Moreover, the Government presented evidence that Salman was aware of the Kara brothers' close relationship, such as when Salman attended Maher's wedding and saw him weep when Michael gave a toast, describing Maher as his "mentor" and "one of the most generous human beings he knows."[175] Lastly, there was ample evidence that Salman traded on the information.[176]

Salman had argued that under *Newman*, "evidence of a friendship or familial relationship between a tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit."[177] Salman focused on the language "indicating that the exchange of information must include 'at least a potential gain of a pecuniary or similarly valuable nature,'" which Salman interpreted as referring to the benefit received by the tipper.[178] Salman argued that because there was no evidence that Maher received "any such tangible benefit in exchange for the inside information" or that Salman "knew of any such benefit," the Government failed to "carry its burden."[179]

The court responded firmly: "To the extent *Newman* can be read to go so far, we decline to follow it."[180] Although at first blush, these

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.* at 1090.

176. *Id.* at 1089.

177. *Id.* at 1093.

178. *Id.* (quoting United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)).

179. *Id.*

180. *Id.* In what might be considered a jab at the *Newman* court, Judge Rakoff began with the same three words, "to the extent," the *Newman* court used when it arguably added an evidentiary requirement to the *Dirks* holding: "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' *see* Dirks v. SEC, 463 U.S. 646, 664 (1983), we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014).

may sound like fighting words (and the Supreme Court must have thought so when it granted certiorari), Judge Rakoff followed that sentence with the weight of binding precedent: "Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend.'"[181] If Salman's theory were accepted and the evidence found to be insufficient, Rakoff continued, then an insider would be free to disclose material nonpublic information to her relatives, and they would be free to trade on it, as long as she asked for no tangible compensation in return.[182] As evidenced by Justice Powell's internal notes, this was not the result intended by *Dirks*.[183] The court held that the evidence was more than sufficient to convict Salman.[184]

III. CRITIQUE OF EXISTING LAW

A. Is Market Efficiency Still a Valid Argument?

Justice Powell was concerned with protecting market analysts from overzealous SEC prosecution.[185] He argued that even the SEC agreed that analysts provided a valuable service to the efficient functioning of the markets.[186] According to the SEC paper Justice Powell was referencing, the "value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."[187]

But in light of modern technology, where nearly unlimited information is readily available to anyone with an internet connection, it is worth asking if analysts' contributions continue to

181. *Salman*, 792 F.3d at 1093 (quoting *Dirks*, 463 U.S. at 664).

182. *Id.* at 1094.

183. Pritchard, *supra* note 92, at 861 (noting that Justice Powell, who wrote *Dirks*, wanted to prevent insiders from tipping the "stereotypical golfing buddy").

184. *Salman*, 792 F.3d at 1094.

185. *Dirks*, 463 U.S. at 664 n.24 (1983) ("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.").

186. *Id.* at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.").

187. *Id.* at 658 n.17.

provide a benefit to all investors.[188]

In exchange for this benefit, the Court essentially created a carve-out for market analysts.[189] But this policy has meant that analysts (and their firms and clients) can reap the benefits of trading on material nonpublic information, as long as the government cannot prove that the tipper obtained a personal benefit and that the tippee knew of the benefit. For example, the remote tippees in *Newman* arguably knew that they had inside information regarding corporate earnings before they were publicly released in a report.[190] Newman and others traded on the insiders' tips and made over $70 million for their hedge funds.[191] Their convictions were reversed because the government did not prove that the tippers received a personal benefit or that the tippees knew of such a benefit.[192] It would seem that the lesson from this case is quite simple: the legal way to beat the market and succeed in the financial sector is to obtain material nonpublic information from corporate executives, share the information within a circle of friends without telling them the source, and ensure that the friends do the same. As long as each person trades on information obtained by someone else, no one can be prosecuted. Considering the current debate on income inequality, it is worth asking if this policy is still consistent with our society's values.

If, on the other hand, a market analyst conducts extensive research, arrives at certain conclusions about a company's financial health, and profits handsomely by trading on those conclusions without receiving material nonpublic information from an insider, such actions are consistent with the core American ideal that hard work will be rewarded. In such a case, it would be considered unthinkable (or worse, communist) to expect the analyst to hand over the fruits of the research to a trading counterparty in order to achieve information parity. Market analysts are constantly striving for an informational advantage over their counterparties by collecting and analyzing publicly available data to "take advantage of pricing

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188. It should be noted that even when the SEC gave credit to market analysts, seemingly endorsing the efficiency theory, it continued to support the SEC's overarching goal of fairness for all investors.

189. Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1033–34 (1990) (regarding *Dirks*: "The investment analyst was obviously meant to have a deep safe-harbor.").

190. United States v. Newman, 773 F.3d 438, 443–44 (2d Cir. 2014).

191. *Id.* at 443.

192. *Id.* at 455.

inefficiencies in [a] company's securities."[193]

One technique used to gather information is "channel checking", which can take many forms, such as conversations with supply-side sources or franchise outlets, aggregation of shipping data, or even counting the cars in a Best Buy parking lot.[194] Analysts can run into a gray area, however, when they combine channel checks with nonpublic information obtained from insiders that is ostensibly non-material.[195] Because the definition of materiality is so broad as to include any information a reasonable investor would consider before choosing to invest, analysts' conversations with corporate insiders can easily reveal information that later turns out to be "material."[196] This could leave the analyst with the dilemma of either scrapping all of their research or running the risk of being prosecuted. Perhaps it is unrealistic to expect analysts to conduct vigorous research and never receive material nonpublic information, and thus the carve-out is an appropriate protective measure.

B. The SEC Pursues Fairness, Despite the Supreme Court's Explicit Fiduciary Requirement

As a general rule, from the beginning of the SEC, its regulations have been designed to promote full disclosure to all investors.[197] This policy played out in 2000 with the passage of SEC Regulation FD (Fair Disclosure), which requires that issuers of securities who disclose any material nonpublic information to *one person*, must *publicly disclose* the information "simultaneously, in the case of an intentional disclosure," or "promptly, in the case of a non-intentional disclosure."[198] With full disclosure, market participants should be fully informed, and therefore, the pricing of securities should reflect all of the publicly available information.[199] Given this basic premise, a companion theory has arisen that investors should have equal access to information,[200] Under this theory of equal access, "[t]rading

193. Marron C. Doherty, Note, *Regulating Channel Checks: Clarifying the Legality of Supply-Chain Research*, 8 BROOK. J. CORP. FIN. & COM. L. 470, 477 (2014).

194. *Id.* at 478.

195. *Id.* at 479–80.

196. *See id.*

197. Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 882 (2010).

198. 17 C.F.R. § 243.100 (2016).

199. Hazen, *supra* note 193, at 882.

200. *Id.* at 883, citing, *inter alia*, 65 Fed. Reg. 51716-01 (Aug. 15, 2000) (discussing the SEC's rationale for the need for equal access).

securities on the basis of material nonpublic information gives the trader an unfair advantage over other investors that runs counter to the premise of federal securities law."[201]

Although this theory of equal access and fairness dates back (at least) to *In re Cady, Roberts & Co.*,[202] it also appears to have motivated many of the SEC's recent actions, despite the Supreme Court's "explicit dicta that fiduciary principles underlie the offense of insider trading."[203] An increasing number of lower courts ignored the fiduciary dicta "when it foreclose[d] liability against a defendant who ha[d] traded securities based on wrongfully obtained information."[204] Indeed, lower courts may have been emboldened by observing the Supreme Court's willingness to stretch fiduciary principles in order to obtain policy goals, as some contend occurred in *Chiarella*, *Dirks*, and *O'Hagan*.[205] Given that lower courts discard fiduciary principles with increasing regularity, the current framework of insider trading liability is producing inconsistent results.

Professor Nagy has recommended that when examining gratuitous tipping, courts go beyond *Dirks* and consider the misappropriation theory, Regulation FD, and state court decisions that "construe breaches of the duty of loyalty to include not only self-dealing but also other actions taken in bad faith."[206] Professor Kim suggested that considering insider trading as a form of private corruption would be an improvement on the fiduciary duty model.[207] When deciding *Salman*, the Court should consider revisiting the fiduciary test created in *Dirks*.

C. Beware the Ambitious, Aggressive Prosecutor

While some government prosecutions may be motivated by the

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201. *Id.*

202. 40 S.E.C. 907, 912 (1961) ("Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the *inherent unfairness* involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." (emphasis added) (citation omitted)).

203. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1319 (2009).

204. *Id.* at 1340.

205. *Id.* at 1339–40.

206. Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, Indiana Legal Studies Research Paper No. 327 (Oct. 22, 2015), http://ssrn.com/abstract=2665820.

207. Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 932–33 (2014).

equal access theory, which the Supreme Court has explicitly rejected,[208] others may be motivated by personal recognition and career advancement. For example, in 2012, U.S. Attorney Preet Bharara, whose office prosecuted *Newman*, among many other high profile cases, was named by *Time* magazine as one of "The 100 Most Influential People in the World."[209] In 2011, Reed Brodsky rose to prominence as the lead prosecutor in the trial of former Goldman Sachs Director Rajat Gupta, and in 2016 he is making headlines for joining the defense team for Kaye Scholer LLP partner Evan Greebal, who is charged with securities fraud along with "pharma bad boy" Martin Shkreli.[210]

Many celebrated Attorney Generals have parlayed their position into powerful elected posts, including New York Governors Andrew Cuomo, Elliot Spitzer and Thomas Dewey and California Governors Jerry Brown, George Deukmejian, Pat Brown and Earl Warren. It is not unreasonable to surmise that an aspiring government prosecutor might bend the law to take down a high profile Wall Street player. In the new Showtime television series *Billions*, where a federal prosecutor pursues his nemesis, a hedge fund manager, both characters are equally motivated by personal gain.[211] The concern of prosecutorial overreach in part led to Justice Powell's formulation of the fiduciary duty requirement in *Dirks*.[212] In reviewing *Salman*, the court should clarify the law so that prosecutors cannot stretch the law to achieve a desirable outcome.

IV. PROPOSAL: REVISIT *DIRKS* AND *NEWMAN*

While it might be tempting to suggest that the Court create an entirely new standard for insider trading violations when it decides *Salman*, it is unlikely the Court would do so. Instead, the Court could keep the basic framework, which is based on fiduciary duty, but reduce one of the necessary elements to a factor to be considered and

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208. United States v. Chiarella, 445 U.S. 222, 232–33 (1980).

209. Viet Dinh, *Time 100: The List: Preet Bharara*, TIME (Apr. 18, 2012), http://content.time.com/time/specials/packages/article/0,28804,2111975_2111976_2112129,00.html.

210. Y. Peter Kang, *Kaye Scholer Atty Taps Gupta Prosecutor in Shkreli Case*, LAW360 (Feb. 8, 2016, 10:44 PM ET), http://www.law360.com/securities/articles/756862.

211. Kai Ryssdal, *Showtime's "Billions" Pits Wealth Against Power*, MARKETPLACE (Jan. 14, 2016, 9:52 PM), http://www.marketplace.org/2016/01/12/life/billions. The show's creators based the prosecutor on interviews with current AUSAs, one of whom gloated over his unbridled power. *Id.*

212. Dirks v. SEC, 463 U.S. 646, 664 n.24 (1983); *see supra* note 185.

eliminate another element entirely. First, the Court should change the personal benefit requirement established in *Dirks* to a personal benefit factor. The Court has done this before, when it rejected the strict two-pronged Aguilar-Spinelli test for assessing the value of an anonymous tip regarding criminal activity, and instead adopted a totality-of-the-circumstances test.[213]

Second, the Court should eliminate the requirement established in *Newman* that the tippee must know of the tipper's personal benefit. Instead, the Court should return to the fiduciary duty requirement before *Dirks*, where liability stemmed from the insider's breach of fiduciary duty to the corporation, *regardless of whether the insider obtained a personal benefit*.[214] While it is understandable that Justice Powell examined the personal benefit of the tipper to determine whether a tip constituted a breach of duty, it should be considered as an important factor in assessing a breach of duty, *but not a dispositive one*. This interpretation is arguably consistent with parts of *Dirks*, because Justice Powell gave such an open-ended, non-exclusive set of examples of breach of fiduciary duty.[215] To highlight the non-exclusive nature of the list of examples, certain words have been underlined:

> [T]o determine whether the disclosure itself "[deceives], [manipulates], or [defrauds]" shareholders, the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct *or* indirect personal benefit from the disclosure, *such as* a pecuniary gain *or* a reputational benefit that will translate into future earnings. There are objective facts and circumstances that *often* justify an *inference*. For example, there *may be* a relationship between the insider and the recipient that *suggests* a *quid pro quo* from the latter, *or* an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information *also* exist when an insider makes a gift of confidential information to a trading relative *or* friend. The tip and trade *resemble*

213. Illinois v. Gates, 462 U.S. 213, 230–31, (1983) ("This totality-of-the-circumstances approach is far more consistent with our prior treatment of probable cause than is any rigid demand that specific "tests" be satisfied by every informant's tip.")

214. *Dirks*, 463 U.S. at 672–73 (Blackmun, J., dissenting).

215. *Id.* at 663.

> trading by the insider himself followed by a gift of the profits to the recipient.[216]

The facts of Dirks were extremely unusual and Justice Powell created a test that yielded the result he desired in that case, but the result was inconsistent with the SEC's goal of fairness. As Justice Blackmun wrote in his dissent in *Dirks*, "[i]t makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of nonpublic information."[217] Blackmun stated that the majority engrafted a "special motivational requirement" on the fiduciary duty doctrine.[218] Further, Blackmun disagreed with Powell's "efficiency theory," in which "the benefit conferred on society by Secrist's and Dirks' activities may be paid for with the losses caused to shareholders trading with Dirks' clients."[219]

Blackmun interpreted the Court's opinion to impose liability on tippees when they know or have reason to know that the information is material and nonpublic and was obtained through a breach of duty.[220] Justice Brennan perhaps phrased the standard better in his concurrence in *Chiarella*: "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."[221] As demonstrated below, this standard would yield results that align more closely with the SEC's goal of fairness for all investors, without punishing analysts who work diligently and honestly to gain an informational advantage.

Applying this standard to *Dirks*, Dirks' censure would have been upheld. Dirks received material nonpublic information from Secrist regarding Equity's fraud, and Dirks surely knew or should have known that Secrist, a former officer of the company, breached his duty in tipping the information.[222] Dirks should have kept the information confident, but instead he shared it with his clients who immediately sold their shares, thereby avoiding great losses.[223] Other

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216. *Id.* (citations omitted).
217. *Id.* at 674.
218. *Id.* at 668.
219. *Id.* at 676–77.
220. *Id.* at 671 n.5.
221. United States v. Chiarella, 445 U.S. 222, 239 (1980) (Brennan, J., concurring).
222. *See Dirks*, 463 U.S. at 649.
223. *Id.* at 648–49.

investors who did not have access to such inside information were not so lucky. This is precisely the kind of unfair advantage that led to the creation of the SEC.[224] While it may be honorable that Dirks also helped to expose the fraud, it should not exempt him from liability for using inside information for personal gain.[225]

Applying the standard to *Chiarella*, the "insider" who owed a duty to the company was Chiarella himself. As an employee of the print shop, he owed a duty to the print shop and its customers to keep confidential any information he learned in the course of his work. Without such a duty, every outside vendor from the cleaning staff to the lawyers structuring the acquisition would be free to use inside information for personal gain. The fact that Chiarella was clever enough to deduce the identities of the corporations involved in acquisitions should not have exempted him from liability. In addition, this standard would yield the same result in *O'Hagan*, because O'Hagan owed a duty to his law firm and to its client to keep the acquisition information confidential and not to use it for personal gain.

Looking to *Salman*, Mr. Salman would certainly be liable under this standard because he clearly knew that he was receiving information about corporate acquisitions in advance of public announcements in breach of his brother-in-law's brother's duty to Citigroup to keep the information confidential.[226]

Perhaps the most difficult application of this standard would be to *Newman*. The liability of all the tippees, no matter how remote, would depend on whether they knew or should have known that the information was material, nonpublic and obtained through a breach of duty. As mentioned in the discussion of the efficiency theory in the previous section, it is conceivable that an analyst would conduct research by speaking with corporate insiders, and in the course of the conversation, the insider might reveal material nonpublic information. Liability would then depend on whether the information

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224. *See* U.S. SEC. & EXCHANGE COMM'N, *supra* note 37.

225. *Dirks*, 463 U.S. at 669 n.4 (Blackmun, J., dissenting). Although the majority implied Dirks did not gain from disclosing the information, Dirks's firm generated approximately $25,000 in commissions as a result of the tips, as well as an enhanced reputation for "looking after" its clients. *Id.*

226. United States v. Salman, 2013 WL 6655176, at *1 (N.D. Cal. Dec. 17, 2013), *aff'd*, 792 F.3d 1087 (9th Cir. 2015) ("From 2004 through 2007, Maher Kara provided his brother, Mounir "Michael" Kara with material, non-public information relating to a number of companies Citigroup was advising in the context of potential acquisitions.").

was tipped in breach of a duty.

Evidence presented in *Newman* established that investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings.[227] For instance, the head of Investor Relations at Dell selectively disclosed financial information "to establish relationships with financial firms who might be in a position to buy Dell's stock."[228] In such an example, the disclosure would be for the benefit of the corporation, and therefore it would not be a breach of duty, nor would it be improper for the tippee to obtain it. On the other hand, selectively leaking inside information, even to establish relationships with powerful finance firms, is in violation of Regulation FD, and it would be a breach of duty to the corporation to intentionally break a federal securities law.

Additional evidence in *Newman* established that analysts "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."[229] Further evidence showed that analysts "routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements."[230] For example, one of the tippees in the tipping chain testified that he frequently ran his model past internal relations departments and asked whether his assumptions were "too high or too low" or in the "ball park," which suggested analysts routinely updated figures in advance of earnings announcements.[231] If it is determined that such information was passed to analysts for a corporate benefit and did not constitute a breach of fiduciary duty, there would be no tippee liability.

Newman would be an ideal case to consider a personal benefit factor in determining whether there was a breach of fiduciary duty. If a corporate insider received a personal benefit such as a payback or a job offer for disclosing information, then it would tend to be more likely it was a breach. But if the benefit accrued to the corporation, it would tend not to be a breach, especially if the insider revealed the information publicly in accordance with Regulation FD.

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227. United States v. Newman, 773 F.3d 438, 454 (2d Cir. 2014).
228. *Id.* at 454–55.
229. *Id.* at 454.
230. *Id.*
231. *Id.*

In applying the pre-*Dirks* standard to *Newman*, the result would be unclear. Because there was evidence on both sides of the question of whether there was a breach of duty when the information was tipped, it would require the jury to determine the facts, using the personal benefit as a factor, not a required element.

V. JUSTIFICATION FOR THE PROPOSAL

The problem with the current standard under *Dirks* and *Newman* is that it is making it unreasonably difficult for the government to prosecute those who willfully use material nonpublic information obtained improperly. Mr. Salman, for instance, blatantly broke the law and attempted to hide his actions in another person's brokerage account, but now he claims innocence and has appealed to the Supreme Court, based on *Newman*'s holding that the government must prove that the insider/tipper received a benefit from the tip and that he, as the remote tippee, knew of the benefit.[232] By eliminating the personal benefit requirement from *Dirks* as well as *Newman*'s requirement that the tippee know of the tipper's personal benefit, and instead using the personal benefit as a factor, not a requirement, the Court will align the judicial framework with the objective of the SEC to ensure fairness in the market system. In addition, this standard would not result in absolute information parity, which would punish market analysts for honest work.

Further, this standard would comport with what lower courts are already doing, in terms of disregarding the fiduciary duty requirement. Courts are likely doing this because the current standard is unreasonably difficult for prosecutors to succeed, even when facts demonstrate obvious violations. By using the proposed standard, lower courts would be more likely to follow precedent, because they could successfully convict violators. This would result in more consistent application of the law throughout the country.

Under the current standard, courts in the Second Circuit are bound by the stringent requirements of *Newman*, while courts elsewhere are not. Defendants with identical facts prosecuted in different circuits are subject to different interpretations of federal law, which is untenable. The current situation also makes it difficult for counsel to advise clients, and makes it easy for potential violators to craft defense strategies.

232. United States v. Salman, 792 F.3d 1087, 1090 (9th Cir. 2015).

By implementing the new standard, the investing public would be encouraged to participate more fully in the markets, because there would be less concern that insiders can trade using an unfair advantage. This would lead to greater financial rewards for all market participants.

VI. CONCLUSION

When the Supreme Court reviews *United States v. Salman* this year, it should take the opportunity to revisit the personal benefit requirement created in the landmark insider trading case *SEC v. Dirks*, as well as the *United States v. Newman* requirement that the tippee must know of the tipper's personal benefit. The Court should eliminate the knowledge requirement of *Newman* and change the personal benefit requirement of *Dirks* to a personal benefit factor. While it is a valuable factor for determining an insider's breach of duty, it is not dispositive, and therefore, it should not be a required element of a fiduciary breach.