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Insider Trading Prosecution Under Section 10b and Rule 10b-5: Balancing Newman and Salman

Porter L. Strickler

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INTRODUCTION

Two recent cases from different federal circuit courts have recently come to very different conclusions with respect to defining the requirements of an insider trading conviction. The Second Circuit's *Newman* decision was decided on December 10, 2014 and within just seven months the Ninth Circuit issued its *Salman* decision that rejected *Newman's* narrow conception of insider trading. The Ninth Circuit and the Second Circuit have created a contentious split with their differing interpretations of Supreme Court precedent, which could have tremendous impact on the prosecution and defense of financial services insiders and financial analysts.[2] This is especially true as the Second Circuit hears a very large number of financial trading cases.[3] Insider trading prosecutions are myriad in the modern financial world. In addition to the vast quantity of insider trading that occurs within Wall Street, a large number of these instances have been brought to the public's attention and prosecuted by the U.S. Attorney for the Southern District of New York, Preet Bharara. As U.S. Attorney he has applied

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[1] * J.D. Candidate, 2017, Seton Hall University School of Law; B.A., Villanova University.

[2] Bartlett, Talarides & Blair, *The Ripple Effects of U.S. v. Newman*, http://blogs.orrick.com/securities-litigation/2016/03/02/the-ripple-effects-of-u-s-v-newman-continue-sec-lifts-administrative-bar-on-downstream-insider-trading-tippee-and-tipper-requests-that-third-circuit-vacate-sec-settlement/ (April 18, 2016).

[3] *Salman*, 792 F.3d 1087, 1092 (9th Cir. 2015) ("Of course, *Newman* is not binding on us, and our own reading of *Dirks* is guided by the clearly applicable language italicized above. But we would not lightly ignore the most recent ruling of our sister circuit in an area of law that it has frequently encountered.")

a renewed focus on prosecuting financial fraud.[4] From the amount of insider trading cases he has brought and won during his appointment it seems to be a hallmark of his term.[5]

In *Dirks v. SEC* the Supreme Court held that "not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[6] The fact that a personal gain is required by the test set forth in *Dirks* left no doubt as to its necessity, but it and its progeny have left uncertain of what is sufficient to satisfy the standard of a personal benefit or evidence such a gain.

In *Newman* two hedge fund managers Todd Newman and Anthony Chiasson, were charged with insider trading in Dell and NVIDIA stock. It was alleged that, "a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies."[7] The government was able to prove that Newman and Chiasson had received and traded on inside information that they received through an extenuated tipping chain from their respective funds' analysts. The government argued that the social relationship between the tipper and tippees, including career advice and attending church together, should be a sufficient personal benefit. The Second Circuit disagreed holding that to the extent a personal benefit may be inferred from a

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[4] *Meet the U.S. Attorney Preet Bharara*, U.S. Attor. SDNY, https://www.justice.gov/usao-sdny/meet-us-attorney (April 18, 2016).
[5] Jonathan Marino, *Preet Bharara was the undefeated top cop of Wall Street – but now his legacy is in question*, Business Insider (April 18, 2016) http://www.businessinsider.com/preet-bharara-was-once-the-undefeated-top-cop-of-wall-street-but-that-has-all-changed-2015-10
[6] *Dirks v. SEC*, 463 U.S. 646, 659 (1983).
[7] *United States v. Newman*, 773 F.3d 438, 442 (2d Cir. 2014).

relationship, "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."[8] The Second Circuit's holding indicates that the tippee must know of the personal benefit to the tipper, no matter how far removed in the tipping chain. The results of the trades in Dell and NVIDIA stock were huge, with Newman earning four million dollars in profit for his fund Level Global, and Chiasson earning sixty-eight million dollars in profit for his fund Diamondback.

In *Salman* the case arose from an alleged insider trading chain which involved members of an extended family. The tipper Maher Kara, worked for an investment bank and provided confidential information to his brother about the upcoming mergers and acquisitions of the bank's clients. His brother then went on to tip Salman because his sister was engaged to Maher Kara. Kara testified at trial that the information had been given to benefit the tippee and that the tipper and tippee shared a close mutually beneficial relationship. The district court then went on to convict Salman of insider trading. On appeal the Ninth Circuit rejected Salman's request that they adopt the *Newman* rule, instead they regarded the close personal relationship as a sufficient personal benefit. The Ninth Circuit rejected Salman's argument as construing *Newman* too narrowly, and affirmed the district court's judgement. The Court reasoned that liability exists where, "the insider makes a gift of confidential information to a trading relative or friend."[9] They also expressed concern that if Salman's argument prevailed, insiders could disclose confidential information to whomever they chose, as long as they did not ask for "tangible" compensation in return.[10]

[8] *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).
[9] *United States v. Salman*, 792 F.3d 1087, 1093 (quoting *Dirks*, 463 U.S. at 664).
[10] *Id*. at 1094.

The Ninth Circuit rejected the Second Circuit's interpretation of *Dirks* in the *Newman* case. The crux of the disagreement lies within their definition of the personal-benefit requirement. *Newman* appears to contradict its past precedent in cases such as *Jiau*, and also to have severely limited future insider trading prosecutions in the Second Circuit.[11] The Ninth Circuit's approach seeks to keep a broad scope of liability for insider trading enforcement under Section 10(b). Their holding was crafted with the fears that insiders could trade to benefit relatives or friends with only pre-textual reasons and escape liability. A very simple trick to obviate the the law's prohibitions would be all that was required to entirely circumvent liability by simply asking for nothing pecuniary or tangible in return.[12]

The possible implications of the *Newman* decision have been predicted to be tremendous with the government acknowledging that the decision, "will dramatically limit the Government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading" and "arguably represents one of the most significant developments in insider trading law in a generation."[13] The fear that insiders will be able to benefit their relatives, friends, and really anyone they wish with impunity smacks in the face of our common notions of fairness and how to properly achieve the 'American Dream'. That insiders and financial experts will be able to "game the system" at the expense of the American public threatens the entire financial system's integrity. The outcome of the petition to the Supreme Court could have broader societal implications in addition to financial regulation concerns, such as exacerbating or escalating

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[11] *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013) ('"Personal benefit" is "broadly defined . . . [to] include[] not only 'pecuniary gain,'" Obus, 693 F.3d at 285(quoting Dirks, 463 U.S. at 663), but also, inter alia, any "reputational benefit that will translate into future earnings," Dirks, 463 U.S. at 663, and "the benefit one would obtain from simply 'mak[ing] a gift of confidential information to a trading relative or friend.'" Obus, 693 F.3d at 285 (quoting Dirks, 463 U.S. at 664). The existence of "a relationship between the insider and the recipient that suggests a quid pro quofrom the latter, or an intention to benefit the [latter]" may be sufficient to justify an inference of personal benefit. Id. at 664.')

[12] *Salman*, 792 F.3d 1087, 1094 (2015).

[13] Petition of U.S. for Rehearing and Rehearing *En Banc* in *United States v. Newman* at 3 (Jan. 23, 2015).

tensions surrounding wealth disparity in the United States. How this split is resolved, by either the Supreme Court or Congress will define how the American securities markets are regulated. The Court is scheduled to hear the decision in Fall of 2016, during a contentious presidential election season and with an increasingly disparate wealth structure between the different classes in the United States.[14]

In Part I, I will briefly describe the development of the history of tipper-tippee insider trading liability. This will include a discussion of early state law regulations which have developed into the present regime where the federal securities laws predominate. The interpretations of the Securities Exchange Act of 1934[15], by the Supreme Court will be explained, encompassing the waves of expansion and retraction of its scope of liability. Part II will start by giving a detailed explanation of the progression of these cases. It will provide an understanding of the Court's reasoning in the *Dirks* decision, and how the recent *Newman* and *Salman* cases have culminated in the Circuit Split, for which this paper now seeks to present a solution. Part III will develop the current understanding of insider trading liability with respect to tippers and tippees. This section will examine the competing views of what is the proper requirement for a personal benefit, and will also discuss how this requirement interacts with the scienter requirement. The section will end with a discussion providing the basis for my solution to balance the competing aims of the government, the public, the commission, financial professionals, and investors.

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[14] For further discussion of this issue *See*, G. William Domhoff, *Wealth, Income, and Power*, http://www2.ucsc.edu/whorulesamerica/power/wealth.html (April 18, 2016); Chad Stone, *A Guide to Statistics on Historical Trends in Income Inequality*, http://www.cbpp.org/research/poverty-and-inequality/a-guide-to-statistics-on-historical-trends-in-income-inequality (April 18, 2016).

[15] *The Securities Exchange Act of 1934*, 15 U.S.C. § 78a et seq.

I. BACKGROUND – BRIEF HISTORY of INSIDER TRADING LAW

Insider trading has not always been regulated as extensively as it is today.[16] Like many other aspects of business in the 19th century, insider trading was completely regulated under state laws, which proved to be ineffective, and that some commentators believe contributed to the decline of the economy leading to the Great Depression.[17] Starting in the early 20th century prosecution of fraud was entirely done through the common law of fraud by the states.[18] The original intent of state securities laws was to protect consumers from being misled or swindled by unscrupulous securities sellers, especially as securities' regulation among the states had only recent origins in Kansas in 1911.[19] The law of fraud was applied to prevent fraud in the sale of securities just as it had been applied previously under other common law doctrine to prevent fraud in contracts for other goods and services.[20] Yet, these efforts proved to be inadequate as

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[16] JAMES D. COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW, 288-290 (3d. ed. 2011); See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385 (1990); *See, e.g., Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 170-71 (1994) (stating that the Securities Act of 1933 and the Securities Exchange Act of 1934 "embrace a fundamental purpose … to substitute a philosophy of full disclosure for the philosophy of caveat emptor.")

[17] SYMPOSIUM: CURRENT ISSUES IN SECURITIES REGULATION: Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934., 49 Ohio St. L.J. 329, 332 (1988) (Many states boasted of great success with their blue sky legislation, but there was little documented proof as to their effectiveness. In reality, the laws proved quite ineffective for several reasons. First, responsibility for the enforcement of these laws was delegated to "unspecialized attorneys working for state officials as disparate as the railroad commission or the state auditor. When political administrations changed, responsibility for blue sky law enforcement frequently also was reassigned." In addition to the lack of expertise among the enforcers, state funding was generally inadequate to support the fulltime manpower needed to investigate the securities and to take remedial or prosecutorial action. Also, many states were deliberately lax in the regulation of securities traffic in order to attract outside industry and to prevent the exodus of industry to more lenient states.)

[18] *See United States v. Watkins*, 278 F.3d 961, 966-69 (9th Cir. 2002) ("Unlike fraud with its [common law] history in torts as a cause of action and term of art defined by its elements, 'intent to mislead' does not necessarily enjoy such a clear or distinguished pedigree.").

[19] Mindy Olson, *The Securities Fraud Deterrence and Investor Restitution Act: More Effective Than Current Regulation?*, 30 Iowa J. Corp. L. 425, 426 (2005). ("Many states then enacted securities laws called blue-sky laws. Kansas was the first state to adopt "blue-sky" laws in 1911, and forty-seven states adopted them before 1931. These laws attempted to stop the sale of fraudulent securities.") *See also*, Larry E. Ribstein, *Commentary: Bubble Laws*, 40 Hous. L. Rev. 77, 91 (2003) (After state regulation was thought to have failed, the first enactment of Federal Securities laws occurred after the 1929 market crash.)

[20] *Id*. at 426-427 (Kansas state statute was based on broad criteria, "such as if the issues does not intend to do a fair and honest business or does not promise a fair return." Additionally, the New York state statute requires the New York Attorney General to, "show that the perpetrators, which may include corporations, individuals, investment banks or other third parties, have committed an intentional act that constitutes fraud."); *Watkins,* 278 F.3d 961, 965

the complexity of securities markets grew and the state laws were inconsistently enforced.[21] Securities sales often spanned multiple states, and could encompass many buyers and sellers before the fraud was brought to the attention of law enforcement.[22] Additionally, before the passage of the federal securities acts, most of what we think of today as classic illegal insider trading transactions were commonly accepted.[23] Which forms of insider trading were considered fraudulent varied from state to state.[24] In the 1909 case of *Strong v. Repide*, the Supreme Court acknowledged the common law rule of fraud as a cause of action in the securities market for the first time, but held that it was unnecessary to create a separate cause of action for securities fraud in this case as there was fraud in procuring the contracts from the plaintiffs for the sale of their land.[25] Therefore the securities had to be rescinded under the common law of contracts.[26] In response to cases like *Strong*, and the hesitancy of the Court to apply fraud to securities sales, Congress enacted section 10 (b) of the '34 Act which focused primarily on fraud in securities transactions.[27] However, the only provision of the Act which explicitly addressed insider trading was Section 16 (b) that prohibited insider short-swing speculative profits.[28] Congress passed the SEC Rule 14(e-3) in the 1980s, in conjunction with section 14(e) from the 1960s to outright

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(9th Cir. 2002) ("Where Congress uses terms such as defraud that have accumulated settled meaning under the . . . common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of those terms.").

[21] *SYMPOSIUM*, 49 Ohio St. L.J. 329 (1988). Shalini M. Aggarwal, *From the Individual to the Institution: The SEC's Evolving Strategy for Regulating the Capital Markets*, 2003 Colum. Bus. L. Rev. 581, 585 (describing the reasons for ineffectiveness of the state laws as leading to the passage of federal legislation to provide "additional protections to investors").

[22] *Id*. at 331.

[23] Jeanne F. Doyle, *The Fraud on the Market Theory: A Unified Concept of Causation in Rule 10b-5 Open Market Actions*, 12 Loy. U. Chi. L. J. 727, 730 (1981) ("This judicially-created private cause of action, on the other hand, enabled victims of past fraudulent activities to be compensated for their injuries and substantially improved the effective enforcement of the 1934 Act.") *See also, Stock Exchange Practices,* S. REP. No. 1455, 73d Cong., 2d Sess. (1934).

[24] *Id.* at 334-337; Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171 (1933).

[25] *Strong v. Repide*, 213 U.S. 419 (1909).

[26] 7-28 Corbin on Contracts § 28.13 (2015).

[27] Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982).

[28] 78 U.S.C. § 78n(d), 17 C.F.R. § 240.14e-1; 78 U.S.C. § 78p(b), 17 C.F.R. § 240.16b-3.

prohibit insider trading on tender offers.[29] Both sections are fairly straightforward because they pertain to only a specific, limited set of transactions and have strict liability for trading on the information, as no proof of scienter is required.[30] Largely because of these characteristics section 14 (e) and 16 (b) are rarely contested by defendants other than as to the establishment of the predicate facts of a particular case.[31]

An essential element of a fraud claim is to demonstrate that the defendant acted with scienter.[32] Scienter in the context of fraud litigation means the defendant acted specifically with the "intent to deceive", as the Supreme Court decided in *Ernst & Ernst*.[33] Lower courts applying the standard, have ruled that recklessness is sufficient for fraud convictions, but the Supreme Court has not yet decided this issue. Rule 10b–5 describes the type of conduct proscribed, but it does not detail the appropriate standard of culpability.[34] Twenty years of conflicting cases over whether scienter was even required elapsed, and then finally in 1976 the Supreme Court held in *Ernst & Ernst v. Hochfelder,* that under Rule 10b-5 it must be proven that the defendant acted with scienter.[35] In the context of a criminal prosecution of insider trading, the prosecutor also

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[29] WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTIARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 618 (Vicki Been et al. eds., 4th ed. 2012).
[30] *Id.* at 620.
[31] Id. at 625. But see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston,* 566 F.2d 1119, 1123 (9th Cir. 1978) (Reversing the District Court's interpretation of what type of information is captured in Section 16(b). The court reasoned that the lower court was incorrect in its application of the Act, 15 U.S.C.S. § 78p (1971). "Insider information within the meaning of Section 16(b) encompasses that kind of confidential information about a company's affairs that would help the particular employee make decisions affecting market transactions in his employer's securities." Holding, "[Defendant] did not receive insider information within the meaning of Section 16(b)."; *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973). e.g. 17 C.F.R. § 240.14e-3 (Sept. 12, 1980).
[32] 7-28 *Corbin on Contracts* § 28.13 (2015) ("Tortious fraud—the action of deceit—involves five elements, each of them, although tersely stated, is quite complex: (1) representation; (2) falsity; (3) scienter; (4) deception; and (5) injury.").
[33] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)
[34] 17 C.F.R. § 240.10b-5.
[35] *United States v. Stewart*, 305 F.Supp.2d 368, 371 (S.D.N.Y. 2004) (quoting *Hochfelder* supra n.32, at 193 ("The Supreme Court has held that scienter or intent in the civil securities fraud context, indicates a 'mental state embracing intent to deceive, manipulate, or defraud' and is a required element of any claim of securities fraud.")

must establish that the defendant acted willfully, which means that the defendant acted with the realization that the acts are wrongful.[36]

Although intentional deceit and fraud are definitely encompassed in the prohibitions of the rule, it is less clear if recklessness is sufficient to satisfy the scienter requirement. Conduct that falls short of a willful misrepresentation were no presented in the Supreme Court's *Hochfelder* and *Aaron* decisions.[37] While the recklessness question remains unresolved at the Supreme Court level, the vast majority of the circuit and district court decisions have found that recklessness is sufficient to state a claim under 10b–5.[38]

Section 10 (b) has been interpreted broadly, and has been the main tool for the SEC and the Department of Justice in prosecuting insider trading.[39] The SEC Rule 10(b)-5, similarly enacts the provisions of section 10(b) but in more specific terms. To better clarify, section 10b is the antifraud provision of the Exchange Act, while Rule 10b-5 is the rule the SEC promulgated under that section. The modern era of insider trading prosecutions began with the SEC's application of Rule 10 (b)-5 in the case, *In re Cady, Roberts & Co.*[40] This interpretation was

[36] *Id.* at 372.
[37] *Aaron v. SEC,* 446 U.S. 680, 690 (1980) ("To premise civil liability under § 10 (b) on merely negligent conduct, the Court concluded, would run counter to the fact that wherever Congress intended to accomplish that result, it said so expressly and subjected such actions to significant procedural restraints not applicable to § 10 (b) ... In fact, since *Hochfelder* involved an implied cause of action that was not within the contemplation of the Congress that enacted § 10 (b), *id*., at 196, it would be quite anomalous in a case like the present one, involving as it does the express remedy Congress created for § 10 (b) violations, not to attach at least as much significance to the fact that the statutory language and its legislative history support a scienter requirement.").
[38] The stringent recklessness standard adopted by the Ninth Circuit has been phrased in terms of deliberate or conscious recklessness. See, e.g., *Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co.,* 353 F.3d 1125, 1134 (9th Cir. 2004). As other courts have put it: ''[a]n egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of recklessness.'' *MBI Acquisition Partners v. Chronical Publishing Co.,* 301 F.Supp.2d 873 (W.D. Wis. 2002), (quoting *Rehm v. Eagle Fin. Corp.,* 954 F.Supp. 1246, 1255 (N.D.Ill. 1997) and *Goldman v. McMahan, Brafman, Morgan & Co*., 706 F.Supp. 256, 259 (S.D.N.Y.1989)).
[39] Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 Ohio St. L.J. 353, Pages (1988)
[40] *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961*).* David Cowan Bayne, *Insider Trading: The Demise of the Misappropriation Theory--and Thereafter*, 41 St. Louis L.J. 625, 652 (Thus in 1961 in "a case of first impression" for the SEC, the talented Chairman Cary wrote, for a unanimous Commission, the vanguard *Cady,Roberts & Co. Cady, Roberts* has endured as the ideal paradigm: 'Insider Gintel's direct privity trade on the NYSE with hundreds of anonymous victims posed a narrow insider-trading question for the Commission, uncluttered and perfect as "a

perhaps the strictest form of insider trading liability to date. The case was an SEC administrative ruling, and even though it did not ultimately become the law, it laid the basis for how section 10(b) would be interpreted later by the federal courts.[41] In *Cady*, the Curtiss-Wright Corporation's board of directors decided to reduce the company's quarterly dividend.[42] Cheever Cowdin, a member of the board of directors at Curtiss-Wright also served as a partner at the stock brokerage firm of Cady, Roberts & Company. Cowdin privately leaked information about the Curtiss-Wright dividend cut to another partner at Cady, Roberts before the news was publicly announced.[43] Relying on the information, the partner at the brokerage firm sold several thousand shares of Curtiss-Wright stock that had been held in customer accounts before the announcement, and consequently before the company's stock declined in value. This case fell into the tipper-tippee liability category of insider trading as well as the traditional theory. It was novel at the time for the fact that it took place over an impersonal stock exchange which was a new technology transitioning from solely face-to-face transactions.[44] In *Cady, Roberts* which was an administrative opinion by the SEC, it was decided that the information belonged to the corporation, and therefore that any use of it by an individual for personal profit fell within the

case of first impression."') (quoting David Cowan Bayne, *The Insider's Natural-Law Duty: Chiarella and the Fiduciary Fallacy*, 19 J. Corp. L. 681 (1994)).

[41] *Id*.

[42] *Id*. at 909. ("Sometime after the dividend decision, there was a recess of the Curtiss-Wright directors' meeting, during which Cowdin telephoned registrant's office and left a message for Gintel that the dividend had been cut. Upon receiving this information, Gintel entered two sell orders for execution on the Exchange, one to sell 2,000 shares of Curtiss-Wright stock for ten accounts, and the other to sell short 5,000 shares for 11 accounts. Four hundred of the 5,000 shares were sold for three of Cowdin's customers. According to Cowdin, pursuant to directions from his clients, he had given instructions to Gintel to take profits on these 400 shares if the stock took a "run-up." These orders were executed at 11:15 and 11:18 a.m. at 40-1/4 and 40-3/8, respectively.")

[43] Michael H. Dessent, *Joe Six-Pack, United States v. O'Hagan, and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 Ariz. L. Rev. 1137, 1159 (1998) (David Cowdin, an investment banker with Cady and a director at Curtiss-Wright, attended a board meeting of Curtiss-Wright. There he learned of the decision to reduce the dividend. Cowdin left the board room to call a Cady partner to inform him of the new information before it was publicly released. Relying on this information the firm sold Curtiss-Wright stock in all of its customers' accounts. It also sold borrowed stock at the current market price in anticipation of a price decline after public disclosure of the dividend cut, when it would then purchase an equivalent number of shares, effectively selling short.)

[44] Jerry W. Markham and Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 Iowa J. Corp. L. 865, 874 (2008).

prohibitions of Rule 10b-5.[45] The SEC argued that when a corporate insider has material non-public information (MNPI) regarding the corporation, they have a duty to disclose the information publicly or to abstain from trading on it all together.[46] The duty was very broad and included within its scope anyone who held material non-public information regardless of the source, or extent of the knowledge of the possessor.[47] Therefore, an individual with MNPI would either have to disclose it to the market publicly, thereby eliminating any possible trade advantage resulting from the information, or abstain from any trading in the company's stock.[48] The "disclose or abstain rule" was based on an equality of information principle, where a pure equality of information amongst traders was to be thought to be desired and enforced.[49] To enforce the equality standard required a flat and complete prohibition that forbade any trading using MNPI if it was not disclosed publicly.[50] The SEC was soon forced to realize by later judicial opinions that the *Cady, Roberts* rationale was completely untenable, as information asymmetries can arise from purely benign reasons not related to insiders of a company, and these asymmetries could possibly be to the benefit of a corporation or simply the result of probability alone.[51]

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[45] *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).
[46] Dessent, *Joe Six-Pack,* 40 Ariz. L. Rev. 1137 (1998).
[47] *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).
[48] *Id.* at 914.
[49] *Id.* at 913 ("We cannot accept respondents' contention that an insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. This approach is too narrow. It ignores the plight of the buying public -- wholly unprotected from the misuse of special information.").
[50] *Id.*
[51] Dessent, *Joe Six-Pack*, 40 Ariz. L. Rev. 1137, 1160 ("Cady, Roberts gave the courts a starting point to evolve § 10(b) on the new rationale that it gave the outsider-investor a more level playing field in the stock market. Its assumption, of course, was that outsiders are innocent parties whom the law should be expected to protect. Events in the next few decades explored this question more carefully and offered quite a different answer.").

In *SEC v. Texas Gulf Sulphur Co.* the second circuit relied on the equality of information theory to develop the "disclose or abstain" rule suggested in *Cady, Roberts*.[52] In effect this rule virtually required there to be a parity of information among all traders of a company's stock implicitly endorsing this part of *Cady, Roberts* as well. Whereas later this standard would be narrowed by the second circuit in *Chiarella* to an 'equality of access' from the realization that a complete parity of information was impossible.[53] The directors and officers of the mining company traded in its stock after a vast discovery of mineral deposits, in territory the company was set to acquire. They did so while in possession of material information and affirmatively misrepresenting publicly that no such discovery had been made.[54] The Court held that corporate insiders had no duty to disclose the information, if they had not traded in the stock themselves. The reasoning was that companies have a right to decide to keep information secret or as here keep the discoveries secret for business reasons, such in order to obtain a favorable price for the land that still needed to be purchased for the mining site.[55] Because they traded on the stock however, the Second Circuit found that while in possession of the MNPI, even if the directors did not owe a duty to disclose the information to the public, that if they trade while possessing the information they must disclose it publicly before doing so or abstain from trading in the stock

[52] *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) ("Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.")

[53] Francisco A. Loayza, *The Remote Tippee Dilemma: Resolving Tippee Liability More Than Thirty Years After Dirks v. SEC*, 52 Cal. W. L. Rev. 109, 119 (2015) ("It would not be until several years later that the Supreme Court severely limited Texas Gulf by narrowing the right to a private cause of action under 10b-5 to purchasers or sellers. Yet, because the Supreme Court did not directly reject the equal access theory, the Second Circuit would again implement it to uphold a conviction in *U.S. v. Chiarella*.")

[54] *Supra* note 51 at 846.

[55] *Id*. at 843. ("This visual estimate convinced TGS that it was desirable to acquire the remainder of the Kidd 55 segment, and in order to facilitate this acquisition TGS President Stephens instructed the exploration group to keep the results of K-55-1 confidential and undisclosed even as to other officers, directors, and employees of TGS. The hole was concealed and a barren core was intentionally drilled off the anomaly.")

altogether.[56] The SEC proposed an aggressive stance towards insider trading, and the Second Circuit agreed that, "any possession of relevant, material, nonpublic information gives rise to a duty to disclose or abstain from trading."[57] This was intended to assure that all investors trading on an impersonal stock exchange have equal access to material information.[58] Before the Supreme Court weighed in on insider trading in *Chiarella,* a case to be discussed later in the paper, the lower federal courts largely followed this interpretation of section 10 (b) without much guidance from the legislature or the Supreme Court.[59]

In a case occurring just a few years after *Texas Gulph*, but before *Chiarella,* the Supreme Court signaled an intent to preserve state law regulation of internal corporate affairs, and to delimit Rule 10 (b-5) from extending too far into state corporate governance matters.[60] A notable case in this area was *Santa Fe Industries Inc. v. Green*, where the court limited a director's breach of fiduciary duty, only to minority shareholders in a cash-out merger and only to state law appraisal rights in accordance with the law of states' fraud provisions.[61] In *Santa Fe* minority shareholders objected to a short-form cash-out merger in order to get what they believed to be a fair price for their shares.[62] However, in place of their appraisal rights they decided to pursue their case under Rule 10 (b-5).[63] The Court clearly set forth that this type of

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[56] *Id.* at 848. ("So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchasethe land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished." Cady, Roberts.)
[57] *Id.*
[58] *Id.* at 864.
[59] *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1973); *United States v. Gleason*, 616 F.2d 2, 28 (2d Cir. 1979).
[60] Joseph Urgese, *United States v. O'Hagan : Rule 10b-5, the "Judicial Oak Which Has Grown From Little More Than a Legislative Acorn," and the Antifraud Legislation of the Securities and Exchange Act of 1934*, 31 Akron L. Rev. 431, 432. (In each of these cases the Supreme Court was charged with interpreting the scope of § 10(b) of the Exchange Act and Securities and Exchange Commission ("SEC") Rule 10b-5.)
[61] *Santa Fe Indus. v. Green*, 430 U.S. 462, 466 (1977).
[62] *Id*. at 467.
[63] *Id*.

claim was not permissible even under the broad anti-fraud language of Rule 10 (b-5) because it was not a manipulation or deception required under the federal law.[64]

A. Federal Case Law Surrounding Section 10b and Rule 10b-5

The disclose or abstain theory primarily dominated the federal prosecutions of insider trading until 1980 when the Supreme Court decided *Chiarella v. United States*.[65] The Supreme Court attempted to confine the SEC's broad view of insider trading liability in two cases the year before *Chiarella*.[66] The case did not rule on the misappropriation theory as it was not presented in the court below, but it did set the groundwork for modern day misappropriation liability.[67] In later opinions applying the misappropriation theory mentioned *Chiarella* it also confined all Section 10 (b) violations to those where a breach of duty of some sort can be found, and that a conviction cannot rest on mere possession of MNPI.[68] Therefore, the court was able to clarify the traditional theory of insider trading by demonstrating that Chiarella did not fall under its proscriptions. Chiarella was acquitted because he had no fiduciary duty to the acquiring or target companies.[69] He only would have been guilty under the misappropriation theory which was not

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[64] *Id*. at 474. (It is our judgment that the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5.)

[65] STEPHEN M. BAINBRIDGE, CORPORATE LAW, 85 (2d ed. 2009).

[66] *Chiarella v. United States*, 445 U.S. 222, 234 (1980) ("As we have emphasized before, the 1934 Act cannot be read "'more broadly than its language and the statutory scheme reasonably permit."' *Touche Ross & Co*. v. *Redington*, 442 U.S. 560, 578 (1979), quoting *SEC* v. *Sloan*, 436 U.S. 103, 116 (1978).).

[67] *Id.* at 236 ("The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-public information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury…we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10 (b).").

[68] *United States v. O'Hagan*, 521 U.S. 642, 647 (1997) ("In particular, we address and these issues: (1) Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10 (b) and Rule 10b-5? … Our answer to the first question is yes.")

[69] *Chiarella*, 445 U.S. 222, 224 (1980).

before the court. *Chiarella* established an insider trading fiduciary duty requirement in place of the equality of access to information theory that the SEC had been advocating.[70]

The facts of Chiarella were unusual compared to what had traditionally been considered insider trading. He was an employee of Pandick Press, which was a company that prepared and printed tender offer disclosure materials.[71] The acquiring company, and the target company Pandick, had redacted their names in the disclosure materials to preserve confidentiality, but Chiarella was able to deduce the companies' names from the surrounding words and information.[72] The Supreme Court reversed his conviction, squarely rejecting the equal access to information notion.[73] The Court's problem with his conviction in the lower court was that he was said to have violated section 10 (b), but he was not a corporate insider nor did he receive any confidential information from the acquiring or target company. Instead of being a corporate insider he was only in the confidence of Pandick Press not the target company whom the information belonged to.[74] The court suggested that he may have owed some duty to the printing company to keep the information confidential, thus suggesting that the misappropriations theory might be applicable, but it could not decide the issue under that framework as it had not been raised or presented to the jury below.[75] The Court went on to acquit Chiarella holding that, "when the defendant is charged with non-disclosure, there can be no fraud absent a duty to speak."[76] A 'duty to speak' means that the possessor of the inside information have a duty to

[70] *Id*. at 236.
[71] *Id*. at 222.
[72] *Id.* at 225.
[73] *Id*.
[74] *Id*. at 243-244. (The jury was charged that "[in] simple terms, the charge is that Chiarella wrongfully took advantage of information he acquired *in the course of his confidential position at Pandick Press* and secretly used that information when he knew other people trading in the securities market did not have access to the same information that he had at a time when he knew that that information was material to the value of the stock.")
[75] *Id*. at 236. ("We need not decide whether this theory has merit for it was not submitted to the jury.")
[76] *Id*.

disclose the material information to the public.[77] An affirmative duty can arise when an insider, a tippee, or another entrusted in a confidential relationship must disclose the information publicly before he is able to trade while in possession of the information to avoid 10(b) liability. The fiduciary has the duty to not disadvantage the principal for personal gain. The duty does not arise from the mere fact of possession of MNPI, but instead must be based on a relationship of trust or confidentiality.[78] Thus, there must be some connection between the possessor and the source of the information. However, this does not need to be a direct connection, but can be derivative of another's duty as in tipper, tippee liability.[79]

Another seminal case that followed three years later was *Dirks v. SEC,* where the Court set the modern standard of tipper-tippee liability insider trading.[80] The Supreme Court helped to define the standards for insider trading in conjunction with the new fiduciary relationship requirement held to be necessary in *Chiarella*.[81] In *Dirks* the defendant was an officer of a New York broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors.[82] A former officer of Equity Funding of America gave Dirks information that the company's assets were vastly overstated as a result of fraudulent corporate practices.[83] Dirks commenced an independent investigation and found that there was a substantial basis for the allegations of fraud based on this tip.[84] Dirks contacted a Los Angeles

[77] *Id*. at 237 ("There can be no fraud absent a duty to speak when an allegation of fraud is based upon nondisclosure, and a duty to disclose under 10(b) does not arise from the mere possession of nonpublic market information, such duty arising, rather, from a specific relationship between parties.")
[78] *Id*.
[79] *Dirks v. SEC*, 463 U.S. 646, 666 (1983). ("In the absence of a breach of duty to the shareholders by the insiders, there was no derivative breach by Dirks.")
[80] *Id.* at 649.
[81] *Id*. at 657. ("In effect, the SEC's theory of tippee liability in both cases [*Chiarella and Dirks*] appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.").
[82] *Id*. at 649.
[83] *Id*.
[84] *Id.*

newspaper to publish the story, however the newspaper did not believe his story and did not publish it allegedly for fear of being liable for slander or defamation.[85] Dirks then openly discussed the information with a number of clients and investors, some of whom sold their holdings in Equity Funding securities.[86] When the fraud was finally revealed Equity Securities immediately went into receivership. Afterwards the SEC then brought a section 10 (b) violation against Dirks for giving the information to his clients.[87] The SEC claimed that Dirks had a duty to refrain from trading on the MNPI because tippees must either publicly disclose the information or refrain from trading altogether.[88] The Supreme Court reaffirmed the *Chiarella* holding and reiterated that there is no general duty to disclose before trading on material nonpublic information, and that such a duty arises only from the existence of a fiduciary relationship.[89] *Dirks* applied *Chiarella*'s conception of duty-first liability, to the context of the tipper-tippee relationship.[90] The Court also attempted to narrow the concept of what constitutes an improper tip to include only certain relationships where the tipper expects to receive some type of gain.[91] In contrast to the policy implications of the zealous draconian equal access regime that can be inferred from some of the Court's earlier jurisprudence, *Dirks* represented an

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[85] *Id*. at 650. ("William Blundell, the Wall Street Journal's Los Angeles bureau chief. Dirks urged Blundell to write a story on the fraud allegations. Blundell did not believe, however, that such a massive fraud could go undetected and declined to write the story. He feared that publishing such damaging hearsay might be libelous.")
[86] *Id*. at 649. ("Neither Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors. Some of these persons sold their holdings of Equity Funding securities, including five investment advisers who liquidated holdings of more than $ 16 million.")
[87] *Id*.
[88] *Id*.
[89] *Id*. at 659.
[90] *Id.* ("As we noted in *Chiarella*, '[the] tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty.'")
[91] *Id*.

appreciation for the possible chilling effect that over prosecution of insider trading and possession of inside information may have on financial analysts and traders generally.[92]

The Supreme Court then went on to define insider trading further, specifically in the context of the tipper-tippee relationship. The Court held that there are two essential elements that compose a breach of the fiduciary duty claim, as the liability arises not from mere possession of MNPI, but from the desire to stop a corporate insider from vicariously achieve through a tippee what he himself would be prohibited from doing.[93] The prohibition the Court decided extends to a corporate insider personally profiting from information that was only intended to be used for the corporation's benefit and entrusted to him under a fiduciary relationship of trust and confidence.[94] Thus the liability to the tippee is an extension of the original duty of the insider turned tipper, to the corporation. This follows because there is essentially no substantive difference in the harm that results to a corporation from a tippee doing what the tipper could not. The Supreme Court described the scenario like this:

> 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.[95]

This relationship does not have to be proved by direct evidence as, "There are objective facts and circumstances that often justify such an inference."[96] In such a case, "a relationship between the

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[92] WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTIARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS, 620 (Vicki Been et al. eds., 4th ed. 2012).
[93] *Dirks v. SEC*, 463 U.S. 646 (1983).
[94] *Id*. at 659. ("Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.")
[95] *Id.* at 663.
[96] *Id.* at 664.

insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient" can be sufficient to warrant the inference.[97] Additionally, "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.", with the main idea being that these tip and trade schemes are almost identical to, "trading by the insider himself followed by a gift of the profits to the recipient."[98] The Court made clear that not all insiders' tips constitute a breach of an insider's fiduciary duty.[99] In order for there to be a breach of a fiduciary duty, the disclosure must be either directly or indirectly intended to benefit the individual rather than the company. To decipher the intent to benefit, one must consider the presence of scienter for the tipper, relating to why the information was revealed and also whether the insider will personally benefit directly or indirectly from the disclosure.[100] Both the scienter and the personal benefit test are intended to achieve a more exact definition of the breach of fiduciary duty by an insider.[101] The Supreme Court ultimately left the interpretation open for additional categories of what defines a benefit, but gave a rough outline that it must be a pecuniary gain, or at least a reputational benefit that will translate into future earnings.[102] The Supreme Court held that a relationship that suggests a quid pro quo from the latter, or an intention to benefit a particular recipient is sufficient for an insider trading conviction.[103] Exploitation of nonpublic information

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[97] *Id*.
[98] *Id.*
[99] *Id*. at 661-662 ("In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders.")

[100] *Id*.
[101] *Id*.
[102] *Id*. at 666. ("The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate the tippers were motivated by a desire to expose fraud.")
[103] *Id*.

also exists when an insider makes gifts of the information to a trading relative or friend. The 'gifts' rule is then qualified by the following sentence that, "the tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[104] These various mandates of the definition of the personal benefit seem to be at odds with one another, where one requires a seemingly monetary gain while the other sets a much lower bar that a mere gift will suffice.[105] *Dirks* attempts to apply the fiduciary duty language set forth in *Chiarella* to the tipper- tippee relationship, but it does not define it clearly enough for courts to easily apply it to the attenuated tipping chains and the plethora of various relationships that have arisen in modern practice between tippees and their tippers.[106]

II. INTERPRETING *DIRKS* IN *NEWMAN* AND *SALMAN*

Since the *Chiarella* and *Dirks* cases, where the Supreme Court limited the SEC's previous interpretations of insider trading under section 10 (b) and Rule 10b-5, most of the cases to date have been prosecuted under the misappropriation theory of liability, so there has not been much new case law for the tipper-tippee category until *Newman* was decided in 2014.[107] Prosecution via the misappropriation theory appeared to be the SEC's preferable method until

[104] *Id*.
[105] *Id*.
[106] Elizabeth Williams, *Recipients of Corporate Information Other than Directors, Officers, Substantial Shareholders, or Associated Professionals as Subject to Liability for Trading on Material, Nonpublic Information, Sometimes Referred to as "Insider Trading," Within § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) -- and SEC Rule 10b-5 Promulgated Thereunder -- Making Unlawful Corporate Insider's Nondisclosure or Manipulation of Information to Seller or Purchaser of Corporation's Stock*, 14 A.L.R. Fed. 2d 401, 2 ("Courts have thus determined or discussed the liability of various persons, not traditionally thought of as corporate insiders, for trading on inside corporate information in violation of 15 U.S.C.A. § 78j(b) and SEC Rule 10b-5 promulgated thereunder, including insiders' spouses (§§ 5, 6) or other relatives (§ 7) or friends (§§ 8, 9), employees of the corporation other than traditional insiders (§§ 10, 11), business associates (§ 12) and prospective business combination associates (§ 15) of the corporation, journalists or other writers and printers (§§ 13, 14), stockbrokers and financial advisors (§§ 16, 17) as well as underwriters (§ 18) and finders (§ 19), and the tippees of any of these "quasi-insiders." The courts have also considered the potential liability under these same provisions of persons in other relationship to the corporation in question other than the groups mentioned above (§ 20).")
[107] *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *United States v. Scop*, 8846 F.2d 135 (2d Cir. 1988) (Cases decided under the misappropriation theory in the intervening time between *Dirks* and the 2014 *Newman*.).

the renewed campaign against insider trading began in 2009.[108] The SEC and the DOJ had a large streak of successes and won 80 insider trading cases.[109] The Supreme Court has not decided an insider trading case dealing with remote tippee liability and the personal benefit requirement in the thirty-three years that has elapsed since *Dirks* was decided. This is true even though the securities markets have drastically changed and the economy has had enormous developments since that time.[110] *Newman* was actually a relatively standard case out of the many that were brought and won by U.S. Attorney Preet Bharara since 2009 as part of his campaign against insider trading on Wall Street.[111] The Second Circuit where *Newman* was litigated, hears many financial cases as it encompasses New York City and thus Wall Street, and had decided many previous insider trading cases.[112] *Newman* is a case with much complexity however, and it brought to the forefront all of the holes that the Supreme Court left undecided surrounding issues of insider trading and demonstrated the disconnect between a greater than thirty year old judge made insider trading law regime, and the complex modern securities market.[113] *Dirks* was a case

[108] Roberta S. Karmel, *A Critical Look at SEC Insider Trading Policies; Second Circuit Ruling Raises Questions about Future Prosecutions*, (Jan. 31, 2016, 1:22 AM), http://www.ctlawtribune.com/id=1202719893299/A-Critical-Look-at-SEC-Insider-Trading-Policies?slreturn=20160031012315.

[109] Walter Pavlo, *Chiasson / Newman Appeal Heard On Insider Trading Conviction* (Jan. 31, 2016, 1:22AM), http://www.forbes.com/sites/walterpavlo/2014/04/23/chiasson-newman-appeal-heard-on-insider-trading-conviction/#721a7b976c14 ("Preet Bharara's victory lap on insider trading cases seems like a distant memory now. His 80-0 winning record on insider trading prosecutions started with the big bust on October 16, 2009 with the arrest of Galleon Group's co-founder Raj Rajaratnam.").

[110] Markham & Harty, ECNs, 33 Iowa J. Corp. L. 865 (2008).

[111] DealBook, *Preet Bharara's Key Insider Trading* Cases, http://www.nytimes.com/interactive/2014/07/09/business/dealbook/09insider-timeline.html#/#time337_8872 (Moffat, Ex-I.B.M. Executive, Given 6 Months in Galleon Case; Longueuil, Ex-SAC Manager, Given 2 and Half Years; Jiau, Ex-Technology Consultant, Given 4 Years; Rajaratnam, Galleon Fund Chief, Given 11 Years; Skowron, Hedge Fund Manager, Given 5 Years; Brownstein, Fund Manager, Gets 366 Days; et. al.).

[112] *Salman*, 792 F.3d 1087, 1092 (9th Cir. 2015) (Infra footnote 1).

[113] Speech Fisher: The Extraordinary Events in Credit Markets Over the Last Sixty Days https://www.newyorkfed.org/newsevents/speeches/1998/pf981015.
Robin Greenwood and David Scharfstein, *The Growth of Finance*, 27 J. of Econ. Perspectives 2, 7 http://www.people.hbs.edu/dscharfstein/Growth_of_Finance_JEP.pdf (In particular, the securities industry grew from 0.4 percent of GDP in 1980 to 1.7 percent of GDP in 2007, having peaked at 2.0 percent of GDP in 2001 during the Internet boom. Demonstrating an increase of 500% from 1980, when *Dirks* was decided, to 2001 which was immediately after the technology surge of the 90s.)

with a defendant whose plight was sympathetic, who tried to report the information of massive fraud at a company to a newspaper first, did not trade on the information himself but only for his clients, and was apparently only avoiding losses that were due to the expected imminent disclosure of the fraud. The corporate tipper in that case was retired and received no benefit whatsoever, other than possibly a feeling of doing the right thing. Additionally, his relationship to Dirks was not suspect because he too was only trying to reveal fraud within the company. Because of the special facts of *Dirks* it is not a good fit for, other than fraud exposing insider trading cases, and thus because "great cases like hard cases make bad law"[114] we arrive at the problem of *Newman* where the Second Circuit is forced to apply vague statutory language that has been interpreted in a narrow highly specific context by the Supreme Court, to a case whose facts do not resemble *Dirks* in the least. As mentioned, the prosecutorial streak of success in the Second Circuit continued until *United States v. Newman,* which brought the streak to a grinding halt when the Second Circuit dismissed a high profile case against two hedge fund managers, proclaiming a new heightened standard of what the interpretation of a breach of fiduciary duty by a corporate insider entailed.[115] This ruling was interpreted by some to be a complete overhaul of insider trading prosecutions that were cracking down on fund managers over the last seven years. Some commentators have even suggested that they are worried that it will lead to rampant abuse by Wall Street insiders until it is fixed.[116] The requirements in order to sustain an insider trading conviction as articulated in *Dirks* had been found easily satisfied until this case. Prior to the *Newman* decision a corporate insider who was entrusted with a fiduciary duty, breached said

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[114] *Northern Securities Co. v. United States*, 193 U.S. 197, 400 (1904) (Homes dissenting).
[115] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[116] Patricia Hurtado, *Prosecutor Fears Insider Leak 'Bonanza', http://www.bloomberg.com/news/articles/2015-10-05/top-prosecutor-warns-of-insider-leak-bonanza-as-ruling-stands.* ("With that increased benefit requirement now the law, an entire class of tippers who knowingly traffic in inside information are shielded from prosecution," said John Zach, a former federal prosecutor who worked on the Newman and Chiasson case for the government and is now a partner at Boies, Schiller & Flexner.")

duty by (a) disclosing confidential information to a tippee, (b) in exchange for a personal benefit, and (c) the tippee knew or should have known of the tipper's breach, that is, he knew the information was confidential and divulged it for personal benefit, and then still used that information to trade in a security or tip another individual for personal benefit.[117]

A. The Second Circuit Interprets Dirks

The Second Circuit interpreted *Dirks* to require that the tippee know of the breach by the tipper, as an extension of the reasoning that possession of MNPI in itself is not illegal.[118] The chain of tippers and tippees that ultimately ended with the two hedge fund manager defendants Todd Newman and Anthony Chiasson, were extensive. Newman was three persons removed from the original source and Chiasson was four persons removed.[119] The tippees were thus multi-person removed and allegedly because of this did not know that the original corporate insiders had tipped the information.[120] The Second Circuit made it clear that the defendant had to know that one of the tippers had breached a fiduciary duty to the corporation to be liable. The only way that one of the tippers could have breached their duty was by receiving a pecuniary benefit or having, "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.", thereby selectively choosing only this language from *Dirks* to interpret what was meant by the legislature to be a broad rule.[121] This holding makes the pecuniary

[117] *Id.*; *Dirks* 463 U.S. 646 (1983). ("Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation 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.")
[118] *Newman*, 773 F.3d 438 (2d Circ. 2014).
[119] Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 Yale L.J. 1482, 1487 (2016).
[120] *Newman* at 445.
[121] *Id.* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 Stan. L. Rev. 385, 385-386 (1990) (This article recounts the events that led up to the enactment of section 10(b) and argues that the provision was intended to empower the Securities and Exchange Commission (SEC) to regulate any practice that might contribute to speculation in securities or tend to move security prices away from investment value, save

requirement necessary to satisfy the test, whereas in *Dirks* it was merely sufficient. At the same time the decision limits the *Dirks* holding of what satisfies the requirement of a personal pecuniary benefit.[122] The Court concluded in Newman that there was no substantial exchange that represented at least the "potential gain of pecuniary or similarly valuable nature."[123] The Second Circuit seemed to feel that the government's case was too speculative. Holding, that (1) the tippers from Dell and NVIDIA did not know that Newman and Chiasson were trading on the information, (2) Newman and Chiasson did not know that the information was from an insider, and (3) that even if there was a satisfactory benefit to the insider from the original tippees who were close business colleagues, fellow church members, and even family friends, it was possible that the defendants did not have the requisite knowledge of the breach to support a conviction.[124] They did not ultimately decide that question however, because there was found to be no breach of duty because no sufficient personal benefit was exchanged.[125]

B. The Ninth Circuit's Differing Interpretation of Dirks

Within the following year after Newman, the Ninth Circuit also decided an insider trading case involving tipper-tippee liability based on the *Dirks* framework.[126] The Ninth Circuit convicted the tippee defendant and disavowed *Newman's* reading of *Dirks* by saying, "To the extent that *Newman* can be read to go so far, we decline to follow it. Doing so would require us

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perhaps those Congress subjected to explicit controls in other parts of the Exchange Act." Drawn from legislative history and historical context at the time of drafting.)

[122] Jon Eisenberg, *"Friends"* Who Trade on Inside Information: How United States v. Newman Changes the Law, K&L Gates. (April 20, 2015) http://www.klgates.com/friends-who-trade-on-inside-information-how-united-states-v-newman-changes-the-law-04-20-2015/.

[123] *Newman* at 442.

[124] *Id.* at 442.

[125] *Id.* ("We hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons. *First*, the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive. *Second*, even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, 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.")

[126] *United States v. Salman*, 792 F.3d 1087 (9^{th} Cir. 2015).

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.'"[127] This was particularly interesting as District Court Judge Jed S. Rakoff of the Southern District of New York who was sitting by designation in the Ninth Circuit wrote the opinion. Judge Rakoff had also previously issued other district court opinions highlighting the complexity of the *Newman* holding.[128] Judge Rakoff has challenged the Second Circuit in the past, such as in 2009 when he rejected a high profile settlement between the SEC and Bank of America, and also again rejecting a settlement between the SEC and Citigroup.[129] He rejected the settlements because they lacked admissions by the defendant.[130] The Second Circuit sharply rebuked him, vacating and remanding the case.[131] Whereas the Second Circuit could force Judge Rakoff to follow their mandate in the Southern District, by sitting in the Ninth Circuit he was able to express freely his thoughts on how *Newman* should have interpreted *Dirks*.

The defendants petitioned for a Writ of Certiorari from the Supreme Court for review of the Ninth Circuit decision by asking the following question,

> Does the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, 463 U.S. 646 (1983), require proof of "an exchange that is objective, consequential, and represents at least a potential gain of a

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[127] *Id.* at 1093.
[128] *See, SEC v. Payton*, 97 F. Supp. 3d 558 (S.D.N.Y. 2015); *United States v. Gupta*, 111 F. Supp. 3d 557 (S.D.N.Y. 2015) (Both cases by Judge Jed S. Rakoff convicting the insider trading defendants even under the *Newman* standard.) *e.g.* David I. Miller and Nathan J. Hochman, *Putting the Brakes on Newman: 3 Recent Rakoff Decisions*, Law360 http://www.law360.com/articles/684440/putting-the-brakes-on-newman-3-recent-rakoff-decisions ("While Judge Rakoff may have been unable to create a circuit split from his position as a Southern District jurist, sitting by designation in the Ninth Circuit, he may have just achieved that result…. Until the courts offer further guidance, federal prosecutors and the U.S. Securities and Exchange Commission may seek to use Payton, Gupta and/or Salman as a response to the growing number of insider trading defendants seeking to use Newman as an escape hatch.").
[129] *United States SEC v. Citigroup Glob. Mkts. Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).
[130] *Id.* at 329.
[131] *SEC v. Citigroup Global Markets, Inc.*, 752 F.3d 285 (2d Circ. 2014).

> pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), cert. denied, No. 15-137 (U.S. Oct. 5, 2015), or is it enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case?[132]

In *United States v. Salman* the defendant was alleged to have traded on information received from his future brother-in-law who received the information previously from a corporate insider at Citigroup's healthcare investment banking group.[133] Salman and his brother-in-law used the corporate information to execute nearly identical trades in securities issued by Citigroup clients shortly before the announcement of major transactions.[134] Unlike in *Newman* the first prong of the analysis involving knowledge of the breach was clearly satisfied here.[135] The cases differed as Salman knew that the information was coming from a corporate insider and it was also suggested that he felt it was wrong to trade on this information.[136] The two cases were the same in one respect however, because as in *Newman* the primary tippee to the corporate tipper had provided simple career advice and intangible benefits, that were nearly identical to those benefits at issue in *Salman*.[137] Defendant Salman's brother-in-law, Michael Kara, provided his brother Maher Kara with occasional help with his work by helping him understand scientific concepts due to the fact that Michael possessed an undergraduate degree in chemistry.[138] Where the two

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[132] Petition for a Writ of Certiorari, *Salman v. United States*, No. 15-628 (U.S. Nov. 10, 2015).
[133] *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).
[134] *Id.* at 1088.
[135] *Id.* at 1089. ("Meanwhile, in 2003, Maher Kara became engaged to Salman's sister, Saswan ("Suzie") Salman. Over the course of the engagement, the Kara family and the Salman family grew close. In particular, Salman and Michael Kara became fast friends. In the fall of 2004, Michael began to share with Salman the inside information that he had learned from Maher, encouraging Salman to "mirror-imag[e]" his trading activity."; "Michael testified that Salman agreed that they had to "protect" Maher and promised to shred all of the papers.")
[136] *Id.* at 1092. ("Thus, there can be no question that, under *Dirks*, the evidence was sufficient for the jury to find that Maher disclosed the information in breach of his fiduciary duties and that Salman knew as much.")
[137] *Id.* at 1089.
[138] *Id.*

cases' holdings diverge is that the Ninth Circuit found the requisite personal benefit to be satisfied from these various relationship intangibles whereas *Newman* found them irrelevant.[139]

C. The Key Differences Between Newman and Salman

The Second Circuit's *Newman* decision in contrast to the Ninth Circuit's *Salman* decision adopted a much narrower view of *Dirks* than prior courts.[140] The requirement for establishing insider trading can only be met they said, when there is proof that the tipper and tippee had a "meaningfully close personal relationship" and the insider received or might receive a monetary benefit or some other kind of valuable gain.[141] The Second Circuit disagreed with the jury that the facts were sufficient to prove that the tippers derived some benefit from the tip and held that, "if this was a 'benefit' practically anything would qualify."[142] Thus the court felt that the tipper must receive something more than the, "ephemeral benefit of the value of the tippee's friendship."[143] The Ninth Circuit in *Salman* disagreed with *Newman* that insider trading liability requires the tipper to receive a tangible benefit. The court's view was that requiring a tangible benefit would cause courts, "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.'"[144] The court thus concluded that disclosing MNPI "with the intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element of insider trading."[145] Following the Second Circuit's reading of what is required for the personal benefit of *Dirks* would create a nonsensical loophole where insiders could trade to benefit a

[139] *Id.*
[140] *Ferrara on Insider Trading and the Wall*, Section 2.02.
[141] *Newman* at 442.
[142] *Newman* at 445.
[143] *Id.*
[144] *Salman*, at 1093 (quoting *Dirks*, at 663).
[145] *Id*. at 1094

relative or friend, to the detriment of the company, or for their personal gain as long as they did not receive any tangible compensation. Although citing the same standard from *Dirks*, both courts put emphasis on different portions of the opinion's language. The *Salman* court focused on the line in *Dirks* where it states that 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.[146] The Ninth Circuit used this line with an expansive interpretation of what is encompassed in the term gift.[147] The Ninth Circuit's conclusion of what constitutes a gift includes essentially what is meant in the standard dictionary definition of the word with the additional element required of a relationship between friends or family.[148] *Salman's* interpretation holds that evidence of a friendship or familial relationship between the tipper and tippee by itself, is sufficient to demonstrate that the tipper received a benefit.[149] *Newman*, however, interpreted the term "gift" as something akin to certain tangible things and that intangibles as a reputational benefit must have potential to materialize into physical future earnings or something of similarly pecuniary value.[150]

Although the *Salman* decision has slightly different facts and thus was decided by an issue that *Newman* did not expressly reach, the holding does adopt a standard which would decide Newman's facts differently than the Second Circuit did. This creates a split among the two Circuits as to their interpretation of *Dirk's* core holding on insider trading prohibition.[151]

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[146] *Id.*
[147] *Id.*
[148] *Id.* Gift. n. (*"*something given voluntarily without payment in return, as to show favor toward someone, honor an occasion, or make a gesture of assistance.") WEBSTER'S ELEVENTH NEW COLLEGIATE DICTIONARY, 68 (2007).
[149] *Salman*, 792 F.3d 1087 (9th Cir. 2015).
[150] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[151] Petition for a Writ of Certiorari, *Salman v. United States*, No. 15-628 (U.S. Nov. 10, 2015). (Supreme Court has decided to hear the case to address the split between the circuits in its Fall, 2016 Term.); Lathrop B. Nelson, III, *Supreme Court Takes on Insider Trading "Personal Benefit" After All*, (Jan. 19, 2016) https://whitecollarblog.mmwr.com/2016/01/19/supreme-court-takes-on-insider-trading-personal-benefit-after-all/.

The two cases' facts provide telling examples of how cases will be decided in each Circuits' framework for the time being. In *Newman* the relationship between Newman and Chiasson with the original tipper was attenuated. This appeared to weigh heavily on the Court's analysis rather than focusing on the original tippee's relationship to the original tipper of attending the same church and providing career advice. Whereas, in *Salman,* the Ninth Circuit stressed the original tippee's brotherly relationship to the original tipper.[152] The two cases seemingly could have been decided on the issue of the knowledge of the defendants because *Newman* and *Salman* did not directly disagree on this point as *Salman* conceded knowledge of trading. However, the holding that interpreted the same tipper-tippee relationship differently even though they consisted of almost identical relationship facts. The relationships in terms of benefits received by the original tipper for purposes of finding a close personal relationship ship were ostensibly the same. Whether there can be some cohesion in the decisions depends on the exclusivity of the holding in Newman of how it would be applied to cases where the relationship between the tipper and tippee is stronger or separately where the tippee's knowledge is more assured.

Once an identical case is placed before each court, based on the dicta of each decision the split will show itself to be deeper than it appears by just looking at its primary holdings because the pecuniary benefit aspect of the test would be more visible if the tipping chain was not as extensive as in *Newman* or if the relationship was stronger and thus familial as in *Salman*.[153] A question that subsequently arises is whether these two parts of the test are not so much an "or" as they are two parts of a larger balancing test. Based on the Second Circuit's denial to re-hear the case and that the Supreme Court refused to grant certiorari, the holding in Newman stands

[152] *Salman*, 792 F.3d 1087 (9th Cir. 2015).
[153] Jonathan E. Richman, *9th Circ. Rebuffs Newman* (Jan. 31, 2:08AM) http://www.law360.com/articles/676604/9th-circ-rebuffs-newman.

definitive in the Second Circuit. From the court's certitude in acquitting the defendants on all charges, it is unlikely that they would ever find a non-pecuniary benefit by itself sufficient for an insider trading conviction.[154] This therefore calls for a deeper look at what the Supreme Court meant in *Dirks*, by examining the policy goals found in preventing insider trading and what the current trajectory of insider trading litigation is and should be.

The Ninth Circuit does not suggest that just any type of relationship, such as a casual friendship would be sufficient to infer a personal benefit under *Dirks,* but that a close personal relationship, such as that of a family member or close friend is required. This is more in line with the intent of *Dirks,* which was intended to prohibit insiders from profiting on information that they do not own. This reasoning thus extends to *Newman* type relationships between a funds' analyst and their family friends that later gave the information to their bosses Newman and Chiasson. *Newman* itself goes seemingly is contradictory in application the Second Circuit's prior interpretation that it gave for what is a personal benefit in *United States v. Jiau,*

> Personal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, … the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.

Jiau.[155] In *Dirks* the Supreme Court properly did not focus on the relationship between Dirks and the former insider who provided him with information, solely because there was no relationship between the two to categorize as close or casual.[156] The rough logic

[154] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014); Matthew Goldstein, *U.S. Prosecutor to Drop Insider Trading Cases Against Seven*, http://www.nytimes.com/2015/10/23/business/dealbook/us-prosecutor-to-drop-insider-trading-cases-against-seven.html ("The impact of a landmark decision that made it harder to prosecute insider trading was amply demonstrated on Thursday as the top federal prosecutor in Manhattan moved to dismiss the charges and convictions of seven people.").
[155] *Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).
[156] Adam Pritchard, *History Says Newman Is Faithful to Dirks*, Law 360 (August 14, 2015) (I conclude that *Newman* is not faithful to *Dirks,* but the fact that there was no relationship between Dirks and the tipper from Equity Funding is valid.); Epstein, 125 Yale L.J. 1482, 1504 ("On this question, the seminal Supreme Court decision in Dirks v.

underlying the *Dirks* holding rings true under the broader standard of liability announced in *Salman*, that if the insider is getting a kickback for giving out the information, he is not doing it on behalf of the company. Also by maintaining the prohibition of the same type of trading that *Dirks* meant to prohibit, specifically the type where an individual gets a tip from their shady business friend to profit for their own advantage, allows preservation of the positive market analysts' research to analyze communications that are in line with the company's business purposes rather than the individual's interests. The impropriety of giving information to family or close friends, is too likely to be biased with self-interest when it occurs to be considered a business decision profitable for the company. The presumption of impropriety is too strong for a distinction to be made as *Newman* does between tangible and intangible payments, which leaves a loophole for insiders to benefit from insider trading through their tippees.[157]

III. SALMAN CAPTURES THE PRACTICAL REALITIES OF INSIDER TRADING

The Ninth Circuit's interpretation of when a personal benefit satisfies the *Dirks* standard is more tenable and is more in line with the practical realities of the marketplace. To express it differently the Ninth and Second Circuits concur on the idea that the fiduciary breach and receipt of a personal benefit by the tipper are the inextricably intertwined. I agree with the Ninth Circuit where it disagrees with the Second Circuit's holding in *Newman* that a personal benefit can only

SEC lays down an underinclusive rule that insider liability extends to any outsiders who "have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." But the Court in Dirks then qualified this proposition by invoking its earlier decision in Chiarella v. United States to say that "there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, … was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence."' Therefore, as the former officer of Equity Funding, Ronald Secrist had no duty to not disclose fraud in the company, there was no relationship to analyze for its sufficiency.).

[157] Matt Levine, *Justices Will Know Insider Trading When They See It*, http://www.bloombergview.com/articles/2016-01-19/justices-will-know-insider-trading-when-they-see-it. (Jan. 19, 2016). (Describing a rough layperson's view of where the line is to be drawn between impermissible insider trading and benign or beneficial business activity.)

be found when pecuniary gain is involved, as this rationale flies in the face of the realities of modern day contracting and business principles. A broader rule than *Newman's* similar to the holding in *Salman*, is necessary for adequate policing and enforcement of insider trading. Without such a broader definition practices that essentially achieve the detrimental effects of reducing market integrity, violating notions of fairness, and decreasing economic efficiency would be achieved through virtually the same proscribed means simply because they were in a different form. The repercussions of *Newman* will most likely affect all types of insider trading, not just tipper-tippee liability. An instance of the holdings of *Newman* influencing other areas of insider trading law can already be seen in the recent case of *United States v. Conradt, et al.*, where a temporary insider-attorney, working on the IBM/SPSS deal told his friend Trent Martin, an analyst, about the deal.[158] Martin told his roommate Thomas Conradt, a Euro-Pacific trader and a lawyer, who passed it along to three of his Euro-Pacific co-workers. The government's allegation rested on the theory that the traders had received the information in violation of a duty of trust. The government argued that *Newman* applied only to classical insider trading cases and not misappropriation. However, the district court cited *Newman* as being the applicable standard of personal benefit for both misappropriation tipping and classical tipping cases.[159]

The *Newman* and *Salman* cases both try to home in on defining a remote tippee's liability under the relatively unclear *Dirks* mandate for the panoply of possible situations that have arisen under its purview.[160] The only ambiguity left by *Salman*'s reasoning that could allow the

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[158] *United States v. Conradt*, 2015 U.S. Dist. LEXIS 16263, at *3 (S.D.N.Y. 2015) (Specifically, this Court finds that, as indicated in *Newman*, the controlling rule of law in the Second Circuit is that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." 773 F.3d 438, 2014 WL 6911278, at *4 (citing *SEC v. Obus*, 693 F.3d 276, 285-86 (2d Cir. 2012)).
[159] *Id*.
[160] J. Kelly Strader, *Conceptualizing Insider Trading: United States v. Newman and the Intent to Defraud*, 80 Brooklyn L. Rev. 1419, 1432 (2015) ("In sum, in any insider trading case under Section 10b and Rule 10b-5, liability rests upon theft of material nonpublic information in breach of a duty. The person can be a corporate insider who buys or sells corporate securities, or can be a corporate outsider who has misappropriated the information.")

Supreme Court to side-step the issue is that it is questionable whether it will apply in a more remote tipping situation as seen in *Newman*.[161] Said another way, is *Salman* really contradicting *Newman* or is it just a more pronounced level of insider trading? *Newman* has its own problems of vagueness however, because the substantial value and pecuniary benefit language leave too much to be decided on a case by case basis in order for it to provide a workable and consistent standard for the district courts to apply.[162]

As a result of this opacity in the standard, analysts, investors, and insiders are left to guess in most scenarios, aside from the prototypical tipper-tippee insider trades, whether their trading on the fringe of these two extreme cases will result in enormous liability or not.[163] This realistically could lead to a problem of adverse selection, where the market will be left in the situation where the most unscrupulous analysts and insiders survive, pushing out the still productive to the markets but less risky analysts. In this scenario the first category are encouraged to gamble big for the bigger profit because the loss due to insider trading conviction is largely unpredictable whereas the second is encouraged to leave the business altogether.[164] The dangers are real and the investing public will become ever more hesitant to invest in funds that have questionably high returns, and will err on the side of underinvestment because of the difficulty in deciphering which fund is an succeeding on an illegal type of insider trading and thus has an unbeatable advantage, to those who succeed from complex and innovative financial analysis .[165]

[161] *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).
[162] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[163] Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 Gonz. L. Rev. 181 (2005).
[164] *Id.*
[165] Alexandre Padilla, *Insider Trading Symposium – January 27, 2007: How Do We Think About Insider Trading? An Economist's Perspective on the Insider Trading Debate and Its Impact*, 4 J.L. Econ. & Pol'y 239 (2008).

The two tests set forth in *Salman* and *Newman* can and need to be reconciled, as recent applications by the lower courts show the potential for pecuniary gain or substantial value standard has a wide spectrum interpretations. The Supreme Court should rule on this issue to clarify and define explicitly what the test of insider trading liability is. The ambiguous and all-encompassing anti-fraud provision of section 10 (b) has survived under the auspices of the SEC's 10 (b-5) rule since *Dirks* and *Chiarella*, largely because of the clarifications that the Supreme Court has provided to it in the past.[166] Without this clarity in the nuanced area of tipper-tippee liability as was given to the other requirements, the amorphous section 10 (b) standard will not live up to the needs of supporting the markets and its investors.[167]

The Supreme Court could provide clarification to these two decisions without overruling either holding completely. This would be the best way for them to achieve a comprehensive reading of *Dirks* while also limiting the definition of insider trading, so as not to return to the impractical equality of information standard of *Cady, Roberts*. Neither the government nor the defendants would like to go back to the equality of information standard, as this would produce too much litigation for the government to possibly manage, would prosecute completely innocent conduct, and would eliminate any incentive for stock market analysts. The *Dirks* standard instead should be read as a balancing test rather than as a strict checklist. Insider trading can pervade any industry and all types of relationships.[168] Therefore, the remedy to illegal insider trading must also be as flexible and pervasive as it is. It also must be clear enough that it is not overreaching in its scope or unpredictable. The main fear from overzealous insider trading

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[166] Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 Va. L. Rev. 153, Pages (1998); *United States v. O'Hagan*, 521 U.S. 642 (1997); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).
[167] J. Kelly Strader, *Conceptualizing Insider Trading: United States v. Newman and the Intent to Defraud*, 80 Brooklyn L. Rev. 1419 (2015).
[168] *SEC Enforcement Actions* (January 2016 2:28 AM) http://www.sec.gov/spotlight/insidertrading/cases.shtml (Listing the various types of relationships that have resulted in prosecutions and convictions.).

prosecution is that it will inhibits the functioning of market trading too much, and discourage individual work product by discovering new information through analysis, such as pricing the stock through a new formula or computer algorithm. With the appropriate balancing test and encouragement of legitimately productive activity the Supreme Court's interpretation of these proposed standards must include the pecuniary benefit and relationships tests, but also augment them to allow for full circumstantial evidence to be submitted in order to reflect reality. That it will be the rare case rather than the common one, where inside information is accidentally exposed in a non-public format to a closely connected tippee. This will give the much needed explanation of *Dirks* that it was meant to be inclusive rather than exclusive and to cover the exceptional situations such as the exposure of fraud.[169] This would allow greater flexibility for the courts, allowing more circumstantial evidence and common sense through a lens of a threshold breach of duty to factor into the considerations of the extent of the relationship will help to prove intent more accurately .[170]

A high court ruling would however be limited to the specific contours of enforcement under section 10 (b), which is now an eighty two year old provision, that did not explicitly purport to govern insider trading, yet is the primary enforcement mechanism of it.[171] Since the limitation of its current language applying to the complexities of how the stock markets have developed since 1934 will exist regardless of what the high court decides the better and more comprehensive approach can only be accomplished by the legislature.[172] Although another Supreme Court decision would help to clarify this issue and would definitely help to sure up

[169] *Dirks v. SEC*, 463 U.S. 646, 648 (1983).
[170] *Id*.
[171] WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTIARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS (Vicki Been et al. eds., 4th ed. 2012).
[172] Paul Engelmayer, *Congress: U.S. Needs an Insider Trading Law* (January 31 2016, 2:32AM) http://www.newyorklawjournal.com/id=1202740459962/Congress-US-Needs-an-Insider-Trading-Law.

insider trading law in part, in order for there to be a fully comprehensive system of prosecution there needs to be a legislative enactment. Insider trading deals with social networks within financial networks that are invariably complex. The current state of the law leaves very little guidance for the myriad ways that insider trading can arise. Each Court opinion will clarify some aspect of the problem to be fixed, but it will not provide the foundational principles needed. Congressional action is needed for the most efficient solution, because the securities markets' insider trading has too many variations to be governed only with such a blunt tool as section 10(b) and Rule 10(b-5). One of the key determinants for the outcome of *Dirks* was that the Court crafted a standard for personal benefit around a circumstance that is only present in a small minority of insider trading cases.[173] The reason that the Court searched so extensively for this solution was because of the seeming injustice that would have resulted from convicting an insider who was simply revealing fraud within a company, and an analyst who was in good-faith trying to make the fraud publicly known.[174] Instead of circumscribing this as an exception to the rule, and walling it off from the rest of insider trading, the Court used a broader principle of fiduciary duty and thus had to define how such a duty could be breached in this specific context while hiding the real reasons for the decision.[175]

A fundamental step for reform of this area of securities law is to define the underlying policy rationale that decides why insider trading is wrong, which is primarily the province of the legislature.[176] This can only be done through debate by Congress, the need for clarity and exaction in insider trading law can best be accomplished through a new set of legislation with

[173] *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015); *Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).
[174] *Dirks v. SEC*, 463 U.S. 646, 653 (1983).
[175] *Id*.
[176] Henry G. Manne, *Insider Trading and the Stock Market* (Free Press 1966). (The argument of the writer of this seminal work arguing that insider trading is not bad for the free market, but actually beneficial for it must be addressed and put to rest.)

these specific idiosyncrasies of how insider trading occurs in mind.[177] The way that this could be done is Congress could cast a net that is specific to insider trading, not simply under the guise of a general anti-fraud provision. The legislation would finally provide an exact definition of insider trading as laid out in the balancing test described above by using a combination of the *Newman* and *Salman* standards. The balancing test would also have certain 'market productive' exceptions allowed where it is determined that the benefit of select insider trading outweighs the costs.[178] Thus, with a proper legislative debate and explanation, any fear of deterioration in the public's confidence about the integrity of the securities markets would be allayed, or if still persisting to some extent would be to a lesser degree and would be limited in scope to the certain easily identifiable to investors promulgated circumstances not the market as a whole.[179] Thus, Supreme Court clarification is much needed because Congress is very unlikely to legislate on this issue that it has refused to fix for nearly ninety years. Despite the unwillingness of Congress to address this matter it would still be the ideal solution instead of the seeming unfairness to both defendants and the public, because of the hallmarks of legislative debate including the interests of the public, the decisions of which exemptions to allow, and what situations are the most responsive to public fears and perceptions.[180]

With the new reformulated *Dirks* balancing test codified as the main text of the enactment, and with a clear definition of insider trading the exceptions then would be listed in its subsections. A prominent exception would arise from the *Dirks* scenario itself.[181] This would be an exception for the exposure of fraud.[182] This exception would be based on the reasoning that

[177] Paul Engelmayer, *Congress: U.S. Needs an Insider Trading Law* (January 31 2016, 2:32AM) http://www.newyorklawjournal.com/id=1202740459962/Congress-US-Needs-an-Insider-Trading-Law.
[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] *Dirks v. SEC*, 463 U.S. 646, 649 (1983).
[182] *Id*.

revelation of fraud is productive for the market and investors as a whole.[183] It would be illogical to burden corporate insiders with the choice of choosing between leaving the company or revealing the fraud with the possibility of being convicted of insider trading in the near future.[184] Society can easily justify the personal gains to a tippee and a tipper who benefit from exposing the fraud as a necessary consequence for the revelation.[185] Whistleblowers in companies are rewarded for coming forward already, and in a fraud case, the role of the tipper is very similar. In this particular case the tip about the fraud will almost certainly be an avoidance of loss in trading on a fraudulently inflated stock, rather than a profitable capital gain, which limits the likelihood of abuse.[186] This is because it is much less risky to sell stock believed to be fraudulently inflated, than to bet with borrowed money by shorting the stock. None of the investors in *Dirks* shorted the stock after the fraud was made known to them, and they included many large investors. Thus these exceptions, such as the reporting fraud exception that Congress knows are beneficial or benign could be stated explicitly. In analogizing to section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[187], instead of awarding a percentage of the fine the plaintiff recovers going to the whistleblower, the insider-whistleblower would be allowed to keep a portion of the insider trading profits. There could be limitations set, such as only so long as exposure of one of the specially delineated activities was made known publicly within a reasonable time after the trades. A standard to govern the conduct of the tipper

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[183] *Id*.
[184] *Id*. at 666.
[185] *Id*.
[186] 15 U.S.C.S § 78u-6
[187] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 922 (2010). (Which states "In any covered judicial or administrative action, or related action, the Commission…shall pay an award or awards to 1 or more whistleblowers who voluntarily provided original information to the Commission that led to the successful enforcement of the covered judicial or administrative action, or related action, in an aggregate amount equal to – (A) not less than 10 percent, in total, of what has been collected of the monetary sanctions imposed in the action or related actions;")

and the tippee in these situations would not turn on the benefit captured by them, thus eliminating the specious debate surrounding what a 'personal benefit' means. It would be the same type of insider trading formerly illegal, but in a statutorily allowable form of it. The easily decipherable threshold question would be whether a good faith effort was made to expose the fraud in a timely manner, and whether the fraud was actually exposed.[188] Under these exemptions as explicitly defined in such categories, the SEC could formulate rules in its implementation to provide for beneficial insider information being made public and moving insiders out of the precarious position of uncertainty. There should not however be a comprehensive exception for all analysts as some commentators may suggest.[189] The argument for allowing analysts to trade on MNPI is that it causes efficiency in the markets by more accurately pricing stock through greater access to information.[190] This is one of the primary reasons for the argument of complete deregulation of insider trading. It is also partly responsible for the narrowing of the scope of insider trading in the case law because of the underlying policy rationale that analysts with inside information benefit the market by making this information public.[191] While I do not disagree with the benefits of increased market information there must be a properly delineated set of acceptable ways to achieve this objective. With proper legislative debate the core foundations of complete deregulation would be discredited. With legislative debate this net gain to the efficiency of securities' markets from inside trades would be disproven and demonstrated that it could be achieved in the same proportion and be more equitably shared through other means. For further guidance, specific prohibitions of settings likely to lead to insider tips would be another helpful subsection. Such settings in need of more regulation are

[188] *Id*.
[189] Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 Va. L. Rev. 1023 (1990).
[190] *Id*.
[191] *Id*.

special one-on-one meetings or phone calls with analysts.[192] These sessions invite exposing information, that under a fair approach would be made available by the most dedicated and most skilled analysts instead of the ones the insider likes the most. By proscribing these 'likely to result in insider trading scenarios' it would align our capitalist system's goal of free enterprise with the true goals of insider trading law.

It can be said that the average investor buys securities for several reasons including in order to capture long term capital gains, preservation of buying power that an active market provides, and investment in favorable companies.[193] This is a sustainable long-term strategy of growing one's wealth. Short sales for example, only prove valuable for a limited time as there is a lower bound on profits that can be made unlike stock growth which theoretically has no upper bound limit.[194] Shorting also is not practiced by most unsophisticated investors, as it is generally riskier and requires quick and cheap access to buying and selling stocks.[195] The price of a stock can be predicted in various ways, and generally represents market consensus of current earnings and earnings potential of the company.[196] Efficiency of pricing is a beneficial aspect of a well-

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[192] *Id*.

[193] Why do people buy stocks? https://www.investor.gov/investing-basics/investment-products/stocks; Jeff Schwartz, Fairness, Utility, and Market Risk, 89 Or. L. Rev. 175, 178 (2010); F. Hodge O'Neal, Corporate and Securities Law Symposium: Markets and Information Gathering in an Electronic Age: Securities Regulation in the 21st Century: What Causes New Securities Regulation? 300 Years of Evidence, 75 Wash. U. L. Q. 849, 851(1997) (As long as the market has been rising or at least holding steady, however, these strands of thought have been kept in check by the simple fact that too many people have been making too much money to favor regulation restricting trading. But when prices drop, much of that opposition to regulation is removed. People who were proponents of securities trading in good times become critics in bad.) Compare with, SEC, *Day Trading: Your Dollars at Risk*, https://www.sec.gov/investor/pubs/daytips.htm.

[194] Sunil Parameswaran, *Fundamentals of Financial Instruments: An Introduction to Stocks, Bonds, Foreign Exchange, and Derivatives*, 161 (ISBN 978-0-470-82490-0)(John Wiley & Sons 2011) ("Because of the limited liability feature, the price of a share has a lower bound of zero. In the case of a short sale, however, what has been loaned is a stock. Although stocks have a lower bound, they do not have an upper bound. In other words, there is no limit on how high the share price can rise. Because the short seller is required to acquire the stock at the prevailing market value, in principle, at the time of covering the short sale the maximum possible loss is infinite.")

[195] *Id*. at 163 (A long position resulting from the limited liability feature entails finite losses and potentially infinite profits. Short sales, however, entail finite profits and infinite losses. Although profits are capped at 100 percent, potential losses cannot be capped.).

[196] *Why do People buy Stocks?* (January 31, 2016 3:33AM) https://www.investor.gov/investing-basics/investment-products/stocks#Buy stocks.

functioning market, but correct pricing is a function of investor expectations and is inherently subjective rather than having an underlying objective value. This is true because of the general proposition that it is impossible to ever know beforehand, exactly what will occur in the future, especially what the price of a stock will be. With current reporting requirements and government oversight[197] the likely gains of information reaching the market by a trader informed by an insider is only one of timing. The information will not be entirely excluded from the market, but will reach the market eventually anyway. Additionally, the gain from the insider, trading earlier on this information, simply does not add anything to the market, but only acts as a transfer of the gain from the original holder of the securities to the insider-informed trader or transfer of loss from the insider holder of the securities to the new holder. What the Supreme Court said in *O'Hagan* describing the unfairness that makes up the misappropriation theory's prohibition rings true to all forms of illegal insider trading that, "An investor's informational disadvantage vis á vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill."[198] Thus, efficient pricing seems primarily appealing to a corporation who wishes to have a lower cost of capital sooner.[199] But the problem with this reasoning is that it is not only achievable by releasing the information to a particular trader or analyst, but is entirely possible to achieve the same reduction of the cost of capital and sooner, for the firm who makes the information disclosure publicly. The only remaining alleged benefit to the company is most likely secondary to the cost of capital benefit and anyways is entirely unquantifiable in value, namely winning the favor of the insider-informed trader be it a hedge fund or a single family member investor. Do we really want

[197] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 922 (2010); Sarbanes-Oxley Act of 2002, 107 P.L. 204, 116 Stat. 745 (2002); 1934 Act; 1933 Act
[198] *United States v. O'Hagan*, 521 U.S. 642 (1997).
[199] Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 Va. L. Rev. 1023 (1990).

companies trying to curry favor with high profile investors, instead of increasing their stock price through higher earnings and productivity? However, it is also hard if not impossible to justify that the release of information through select disclosures is necessary to make firms better off in terms of borrowing interest rates. A release of more information by a firm affects the stock price the same if not more efficiently by public disclosures rather than selective analyst disclosures.[200] Thus, even if there were firm specific reasons for early tips to analysts they seem universally hard to justify for most types of information which will come to be known eventually, such as all the information contained in earnings reports.[201] More information in the market generally benefits society, by allowing the productive and profitable firms to receive a lower cost of capital, appreciation of stock prices, and thereby more investment. However, selective disclosures of information are gains solely to the favored trader and shifts the wealth gains or loss that occurs when the information is incorporated into the stock's market price. In most cases, basically absent a never ending fraud, the information inevitably will reach the market. With the modern reporting requirements of the national exchanges it will not be released any sooner by private placement of the information to the favored analysts than to all capable investors. The only difference would be on how we want these gains to be distributed. Either based on performance and merit, or favoritism and discrimination.[202] As a result of these selective analysts' disclosures, when the information eventually reaches the average investor in most cases its possible utility to them has been virtually stripped from it completely.

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[200] Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking Regulation of Analysts, 88 Iowa L. Rev. 1035, 1091 (2003).
[201] *Why do People buy Stocks?* (January 31, 2016 3:33AM) https://www.investor.gov/investing-basics/investment-products/stocks#Buy stocks.
[202] Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970); see also Myron S. Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J. BES. 179 (1972). (Suggesting that information effects are more important than price pressure in moving prices toward efficient levels in security markets).

The requirements of a friendship or familial relationship should be abandoned as an exclusionary feature, but still should captured in the law to a lesser degree of importance.[203] There is no reason why giving information to a stranger, if only less likely to occur, is less invidious and corrosive to the confidence in the markets and sense of fairness than giving it to a family member or close friend.[204] Nor do the markets have to be so strictly enforced as to require a parity of information among all investors, as *Dirks* and experience have proved this to be harmful and also impossible to maintain. Inequality of information among traders should not be decided by corporate insiders playing favorites.[205] There is a marked difference of effect between autonomous discovery and a sneaky tip from an insider, on the public's perception and its effect on corporate practices.[206] As the misappropriation theory adopted a standard that incorporated a vast amount of confidential relationships anytime a person owed a duty not misuse the information entrusted to them[207], unless authorized to do so with the consent of whom the information belongs to. So too should tipper-tippee liability adopt a similar standard based on approval of the public through their Congressional representatives tailored to the intricacies of tipper-tippee situations.

CONCLUSION

With the current political intrigue surrounding the broader implications of insider trading, a large amount of prosecutions brought by the U.S. Attorney's Office in the Second Circuit under Preet Bharara, and the current split between the Second and Ninth Circuits this is an ideal time to define what insider trading means and providing the much needed clarity to both traders

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[203] *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).
[204] Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 Ohio St. L.J. 353, Pages (1988); MARC STEINBERG, UNDERSTANDING SECURITIES LAW PAGE CITED, (2001).
[205] *Dirks v. SEC*, 463 U.S. 646, Page (1983).
[206] Jill Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 Ga. L. Rev. 179 (1991).
[207] *United States v. O'Hagan*, 521 U.S. 642 (1997);

and the government.[208] Solving the discrepancies in section 10(b) and Rule 10(b-5) litigation is most important for creating a more efficient capital market to stimulate business development in such a tumultuous economic climate. Tipper-tippee liability is the biggest obstacle to achieving this goal because it is the most uncertain and most insidious expression of the growing rift between the economic social classes in the United States. The current state of confusion leaves one with the paradox of how it could be wrong for someone's brother who was given a tip for no tangible benefit to give that information to another tippee to benefit them both, while it is not wrong for a tipper who gives information to a close family friend to benefit them, who then gives it to another tippee is not. The confusion creates many problems in the investment industry, such as a seeming impropriety of giving hedge funds preferential treatment over other investors, while creating a hesitancy for currently legal good faith disclosures by corporations to analysts, and an easily exploited loophole for future tippers and tippees. This loophole allows the tipper to reap numerous intangible benefits worth considerable sums as long as it does not actually turn into a pecuniary gain of just a penny. The Supreme Court should uphold the ultimate outcome of the *Salman* decision, but describe the balancing framework described above by defining a substantial personal benefit broader than solely as pecuniary gains. The holding in *Dirks* and the legislative intent of Section 10(b) clearly demonstrate that the gain by the insider whether pecuniary or not are indicative proof of the harm to the corporation's property rights, integrity of the markets, and individual investors that was meant to be prevented by Section 10(b) and the SEC Rule 10(b-5). The Supreme Court should elaborate on the intricacies of the current standing of tipper-tippee liability as it has developed through the courts precedent, to refine what they meant in *Dirks*.

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[208] *SEC Enforcement Actions* (January 2016 2:28 AM) http://www.sec.gov/spotlight/insidertrading/cases.shtml; Stephanie Russell-Kraft, *DOJ Appeals Insider Trading Ruling to High Court* (January 31, 2016 4:00AM) http://www.law360.com/articles/685289/doj-appeals-insider-trading-ruling-to-high-court.

This would be the first step in the road to recovery from the current vagaries. Defining it at least more broadly to encompass more activity than the Second Circuit did in *Newman*, but also not so broad as to be without any practical limits. The rule of *Salman* itself is a good start, and the Supreme Court should affirm this case. However, affirming *Salman* will not resolve the myriad of other scenarios where certain market-beneficent exceptions should be excluded from prosecution. It would take too long, and be a drain on the Supreme Court's resources and time for it to decide all of these possible scenarios. If the Supreme Court does not decide all these scenarios it will fall back to the lower courts to sort through the chaos, which will be ineffective as many of the courts disagree with each other on fundamental tenets of insider trading prosecution. A prime example of this can be seen from the fact that the main author of the Ninth Circuit opinion was a District Court Judge from the Second Circuit sitting by designation. If Congress decided to clarify this issue with new legislation it would reduce the issues that the Court would have to decide in future cases and create a sustainable federal insider trading enforcement regime for the future. With the current appeal to the Supreme Court in *Salman* the court should do its best to explain what they meant the present law to be under *Dirks*, to help Congress build a more stable structure from the existing insider trading laws. Legislative action is the best way to achieve reform in insider trading law because it will give courts the proper tools to craft sustainable interpretations. Setting an explicit standard, and not just a general anti-fraud provision written eighty-two years ago, would allow companies to properly evaluate whether particular trading of securities with material non-public information is permitted, allowing businesses to plan ahead, and also to allot more concrete predictions of the risk involved with certain strategies of trading.[209] With a specific allocation of what qualifies as

[209] Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking Regulation of Analysts, 88 Iowa L. Rev. 1035, 1091 (2003).

beneficial insider trading, and a specific prohibition against invidious tips, the goal of a free market will be better realized by all investors. It will provide reassurance that any gains from disparity of information will be earned and not cheated from them.[210]

[210] Melissa A. Robertson, *Insider Trading – A U.S. Perspective* (January 31, 2016 4:05 AM) https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.