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# (Beyond) Family Ties: Remote Tippees in a Post-*Salman* Era

Austin J. Green
*Fordham University School of Law*

# NOTES

# (BEYOND) FAMILY TIES: REMOTE TIPPEES IN A POST-*SALMAN* ERA

*Austin J. Green**

*In* Salman v. United States, *the U.S. Supreme Court reaffirmed* Dirks v. SEC, *holding that a personal benefit may be inferred where an insider discloses material nonpublic information to a "trading relative or friend." While the decision was viewed as a win for prosecutors, the Court's limited holding did little to address issues pertaining to more complex tipping chains, such as those raised by the Second Circuit's decision in* United States v. Newman *two years prior. Particularly, a remote tippee cannot always determine whether material nonpublic information was improperly disclosed at the time of receipt. Such a remote tippee could not know whether trading on the tip is lawful without further investigation, and in the fast-paced securities industry, time is money. These scenarios also raise issues in the courtroom, where prosecutors must prove that the remote tippee knew, or should have known, the information was improperly disclosed at time of the trade, and the Supreme Court has rejected the notion that a remote tippee presumptively knows that material nonpublic information was improperly disclosed. In response to these lingering uncertainties, this Note proposes that the SEC adopt Rule 10b5-D, a safe harbor rule that would encourage disclosure and promote timely decision making without condoning insider trading.*



* J.D. Candidate, 2018, Fordham University School of Law; B.A., 2015, Villanova University. I'd like to thank my advisor, Aditi Bagchi, as well the members of the *Fordham Law Review* for their guidance and oversight throughout this process. I'd also like to thank my friends, family, and loved ones for their unfettered love and support.

## INTRODUCTION

An analyst and a hedge fund manager walk into a bar. The analyst tells the manager that she heard X Corp stock is about to plunge. When asked about where this information originated, the analyst merely states that she received the tip from an old college friend but does not know how her friend obtained the information. If the manager then sells the fund's X Corp stock holdings, will she be liable for insider trading?[1] Will she go to jail? It depends.

The manager knows that whether she may lawfully trade on the analyst's tip depends on whether the information was originally disclosed in breach of a fiduciary duty.[2] Absent a breach, the manager is free to trade.[3] Regardless, the manager cannot know whether trading on the analyst's tip would be lawful without knowing more.[4] Time spent investigating the facts pertaining to the source of the information could be costly, however, as the information's value will decrease over time.[5] However, placing the trade

1. "'Insider trading' is a term of art that refers to unlawful trading in securities by persons who possess material nonpublic information about the company whose shares are traded or the market for its shares." 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 1:1 (2016).

2. *See* United States v. O'Hagan, 521 U.S. 642, 655–66 (1997); Dirks v. SEC, 463 U.S. 646, 662–64 (1983).

3. *See Dirks*, 463 U.S. at 662; 18 LANGEVOORT, *supra* note 1, § 4:10, at 4-34 n.3 ("[I]t is necessary that the notice of the breach (i.e., intent to benefit) relate back to the insider in order to create abstain or disclose liability.").

4. The U.S. Supreme Court has rejected the premise that a tipper who discloses material nonpublic information necessarily does so for a personal benefit. *See Dirks*, 463 U.S. at 661–62.

5. *See infra* Part II.A.1.

without performing a sufficient investigation could result in a court finding that she consciously avoided learning about the potential breach.[6] The manager is thus presented with a dilemma: either she abstains from trading with the chance of forgoing permissible profits, or she trades at the risk of facing criminal prosecution.[7]

This manager's dilemma illustrates the problem with the current insider trading laws, particularly as applied to "remote tippees."[8] A remote tippee commits insider trading when she purchases or sells securities on the basis of material nonpublic information that she knows, or reasonably should know, was disclosed in breach of a fiduciary duty owed to the source of the information.[9] A breach occurs where the information was originally disclosed in exchange for a personal benefit,[10] which, as the U.S. Supreme Court recently held in *Salman v. United States*,[11] may be inferred where the tipper discloses the information to a "trading relative or friend," even where nothing tangible or of pecuniary value is received in return.[12]

*Salman* was the Supreme Court's first insider trading case in almost two decades, but it did little to address recent issues within insider trading jurisprudence. Almost exactly two years before the Supreme Court decided *Salman*, the Second Circuit created waves when it handed down its decision in *United States v. Newman*.[13] In that case, the Second Circuit made two distinctions from the Supreme Court's landmark case, *United States v. Dirks*.[14] First, the court found that "the mere fact of a friendship, particularly of a casual or social nature," was insufficient to draw the inference of a personal benefit to the tipper.[15] Second, the court held that a

6. Even in a criminal case, the government contends that the requisite knowledge element may be satisfied if the court finds that the manager "consciously avoided" learning of the breach. *See* Transcript of Oral Argument at 36–37, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628). While the petition for writ of certiorari presented the question of whether failure to investigate suspicious circumstances alone can satisfy the knowledge requirement, *see* Petition for Writ of Certiorari, *Salman*, 137 S. Ct. 420 (No. 15-628), the Supreme Court declined to review that issue, *see* Salman v. United States, 136 S. Ct. 899 (2016).

7. *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 218 (2006) ("From the standpoint of the would-be trader who is several degrees removed from the source of information, this leads to the remote tippee's dilemma—whether to trade and risk the possibility that the original source, or primary tipper, breached a duty, or whether to refrain from trading and risk foregoing a profit or avoiding a loss in a transaction that would have been legal.").

8. A "remote tippee" is an actor who receives material nonpublic information indirectly. *Id.* at 184 n.18.

9. *See Dirks*, 463 U.S. at 662–64; *see also* United States v. O'Hagan, 521 U.S. 642, 555–66 (1997) (endorsing the misappropriation theory as a basis for establishing liability in insider trading cases).

10. *See Dirks*, 463 U.S. at 663.

11. 137 S. Ct. 420 (2016).

12. *Id.* at 428–29 (quoting *Dirks*, 463 U.S. at 664); *see also* 17 C.F.R. § 240.10b5-2 (2016) (providing a nonexhaustive list of relationships where the inference of a personal benefit to the tipper may be drawn).

13. 773 F.3d 438 (2d Cir. 2014).

14. 463 U.S. 646 (1983).

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

remote tippee's knowledge cannot be inferred "where the financial information is of a nature regularly and accurately predicted by analyst modeling."[16] The Supreme Court did not discuss these aspects of *Newman* in its recent opinion.[17] Thus, the legal significance of the distinctions identified by the Second Circuit may continue to carry weight in future cases.[18]

The minute distinctions identified in *Newman* may perpetuate the uncertainties faced by investors who seek to trade in accordance with the law.[19] Similarly, prosecutors may find it more difficult to establish the knowledge requirement in cases against remote tippees, and that difficulty will only increase when the remote tippee is further removed from the tipper.[20] This will burden the Securities and Exchange Commission (SEC) in particular, which must already be selective in choosing cases for its Enforcement Division to target.[21] Additionally, lower courts may find it difficult to consistently distinguish between types of relationships and information where the inference of a personal benefit may be drawn. This may exacerbate some courts' tendency to implicitly enforce a fairness-based regime[22]—a practice that directly contravenes explicit Supreme Court precedent.[23]

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16. *Id.* at 455.

17. *See generally Salman*, 137 S. Ct. 420. With regard to *Newman*, the Court simply stated, "To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift *to family or friends*, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*." *Id.* at 428 (emphasis added) (citation omitted).

18. The weight of *Newman* is reinforced by the Second Circuit's significant influence on securities law. *See* Karen Patton Seymour, *Securities and Financial Regulation in the Second Circuit*, 85 FORDHAM L. REV. 225, 225 (2016) (noting that the Second Circuit has decided one-third of securities decisions decided by appellate courts).

19. "[T]he remote tippee's apparent duty to inquire is further complicated by the necessity of determining when information is sufficiently specific and accurate so as to be material and raise suspicions that it emanated from a tainted source, not from general market-place rumors." Coles, *supra* note 7, at 216.

20. 18 LANGEVOORT, *supra* note 1, § 4:10 (noting that establishing "sufficient knowledge of the insider's personal benefit becomes considerably more difficult—especially in the criminal context—as the chain of tippees lengthens"); Coles, *supra* note 7, at 219 n.232 ("As the information moves down the chain of tippees . . . the evidence of a close relationship with the primary tipper typically attenuates and then disappears from the mix of circumstantial evidence."); *see also* United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012) ("[O]ne can imagine cases where a remote tippee's knowledge that the tipper was receiving some sort of benefit might be difficult to prove.").

21. "The typical insider trader is never caught or prosecuted, for the costs in manpower and resources of investigation and litigation are extremely high in this area." 18 LANGEVOORT, *supra* note 1, § 1:13 (noting that formal investigations were actually initiated in only 203 out of 83,000 business events in 1985 and 1986 where the possibility of insider trading was present).

22. Coles, *supra* note 7, at 208, 211 (noting that lower courts have tended to interpret the personal benefit requirement expansively and "ease[] the standards for both pleading and proving that the primary tipper relayed nonpublic information to a primary tippee for personal gain" (footnotes omitted)).

23. The Supreme Court has consistently rejected the fairness-based approach. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 657 n.16 (1983); Chiarella v. United States, 445 U.S. 222, 233 n.16 (1980). Nevertheless, the government continues to push for the Supreme Court to

Despite recent developments, compliance with the insider trading laws remains difficult and unpredictable.[24] While some have argued that the remote tippee's dilemma is easily resolved under a fairness-based approach,[25] such a rule would be inconsistent with congressional intent and Supreme Court precedent.[26] Alternatively, this Note proposes a solution to alleviate the uncertainties regarding remote tippees where it is not readily apparent whether the inference of a personal benefit to the tipper may be drawn. Part I analyzes the evolution of insider trading jurisprudence. Then, Part II addresses the arguments for and against the insider trading prohibition as well as various tests and approaches under which remote tippees may be held liable. Finally, Part III proposes the adoption of Rule 10b5-D, a safe harbor disclosure rule that encourages disclosure and promotes timely decision making without condoning or encouraging insider trading or requiring any substantive changes in existing law.[27]

## I. THE EVOLUTION OF INSIDER TRADING

The basis for insider trading liability is rooted in section 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act"). Section 10(b) prohibits the use of fraudulent or manipulative devices used "in connection with the purchase or sale of any security" and gives the SEC broad authority to define practices that constitute such devices.[28] Since the Exchange Act's enactment, the rules governing liability have been crafted and refined by the SEC and federal courts to conform the act of insider trading to section 10(b)'s fraud-prevention mandate.[29]

Insider trading is not explicitly mentioned anywhere in the Exchange Act[30] nor was it a practice that concerned Congress in 1934.[31] To better understand the distinction between lawful and unlawful trading on material nonpublic information, it is helpful to understand how insider trading compares to the practices that warranted reform. Part I.A discusses harmful

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endorse a fairness-based approach. *See* Transcript of Oral Argument at 23–27, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628).

24. *See* Coles, *supra* note 7, at 184; Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Insider Trading Information Is Untenable*, 59 BROOK. L. REV. 149, 151 (1993).

25. *See* Coles, *supra* note 7, at 235–36 (suggesting that a fairness-based approach would be easiest for average investors to comply with).

26. *See Dirks*, 463 U.S. at 657–63.

27. At least one other law review article has proposed the adoption of a safe harbor rule, though with a more limited scope. *See* Bernard Tsepelman, *A Safe Harbor for Communicating or Trading on Material Nonpublic Information Obtained Through "Replicable" Methods or Strategies: Proposed SEC Rule 10b5-SH*, 37 CARDOZO L. REV. 353 (2015).

28. 15 U.S.C. § 78j (2012). For further discussion on section 10(b), see *infra* notes 81–89.

29. *See infra* Part I.B–D.

30. *See* STEPHEN M. BAINBRIDGE, INSIDER TRADING 25–27 (2d ed. 2007); *see also* Anna Currier, Comment, *The Rule of Lenity and the Enforcement of the Federal Securities Laws*, 5 AM. U. BUS. L. REV. 79, 92 (2015).

31. Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343, 344 (1999).

practices in the securities industry that were prevalent in the years prior to the Great Depression. Part I.B then reviews the evolution of insider trading jurisprudence within the courts to show the development of the current rule governing remote tippee liability. Next, Part I.C highlights attempts by Congress and the SEC to reinforce the insider trading prohibition after *Dirks*. Finally, Part I.D analyzes the Second Circuit's opinion in *Newman* and compares that to the Supreme Court's recent *Salman* case.

### *A. The Boiling Pot*

Congress enacted the Exchange Act, in part, to prevent a recurrence of the Great Depression by prohibiting practices that posed a threat to investors and the integrity of the market.[32] However, insider trading is fundamentally different than the harmful practices that concerned Congress in the early 1930s.[33] Furthermore, some evidence suggests the early condemnation of insider trading may have been exaggerated to capitalize on political momentum at the time.[34]

To put the act of insider trading in perspective, Part I.A.1 briefly discusses two practices that concerned Congress and members of the public in the early twentieth century: price manipulation and uninformed speculation. Part I.A.2 discusses the government's denunciation of those practices in responding to the stock market crash of 1929.

#### 1. Price Manipulation and Uninformed Speculation

Price manipulation is a general term for practices whereby consumers are forced to pay a higher price for a given commodity.[35] For example, a group of investors might carry out a "corner" by purchasing a commodity's entire supply and thereafter charging monopolistic prices.[36] Speculation, meanwhile, is the act of "forecasting changes of value and buying or selling in order to take advantage of them."[37] While speculation "based on an intelligent forecast" is beneficial to the market and its participants,[38] speculation performed by those lacking means and experience is harmful.[39]

Such practices are by no means recent phenomena; "[h]istory is strewn with unsuccessful efforts by governments and organized religions to proscribe speculation and price manipulation and to control commodity

32. *Id.*

33. While modern market regulators are primarily concerned with insider trading, "the regulatory concern that prompted the Exchange Act was the prevention of manipulation, uninformed trading that artificially influences stock prices." *Id.*

34. *Id.* at 344–49.

35. For an interesting primer on several price manipulation "stratagems," see JERRY W. MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION 3–9 (2014).

36. *See id.* at 3–4.

37. STATE OF N.Y., REPORT OF GOVERNOR HUGHES'S COMMITTEE ON SPECULATION IN SECURITIES AND COMMODITIES 3 (1909) [hereinafter HUGHES COMMITTEE REPORT].

38. *See id.* at 4.

39. *See id.* This latter form of speculation will hereinafter be referred to as "uninformed speculation."

prices."[40] In the United States, price manipulation was prevalent early on,[41] and some manipulative tactics had appeared in the securities market by the early twentieth century.[42]

Securities manipulation was largely carried out by "crooked" stock pools—investor groups largely comprised of various corporate insiders.[43] Members of these crooked stock pools would use their privileged access to material nonpublic information to accurately value a given security.[44] Armed with substantial financial capital, crooked stock pools placed trades that altered market activity.[45] These pools manipulated market prices by purchasing the same securities that they were selling, thereby artificially inflating the stock's price by creating the appearance of increased demand.[46] In reaction to the increased market activity, other investors would purchase the security under the assumption that the increased trading activity was an accurate reflection of the market's valuation of the stock.[47] After the stock's market price had reached a certain height, the stock pools would sell their shares, thereby decreasing demand and deflating the stock's market price.[48] By collectively trading in a company's stock to generate the false appearance of increased activity, stock poolers profited by selling their holdings at inflated prices, while average investors lost money by overpaying for fraudulently overpriced stocks.[49]

Such manipulative tactics as those carried out by certain stock pools in the early twentieth century caused havoc and raised concern among government officials well before the Great Depression. For example, the "Panic of 1907"occurred when several New York banks collapsed after a

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40. MARKHAM, *supra* note 35, at 9.

41. *See id.* at 14–30.

42. *See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 393 (1990) ("If securities manipulation means anything in particular, it means conduct intended to induce people to trade a security or force its price to an artificial level.").

43. *See* COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 8 (7th ed. 2013); JOHN KENNETH GALBRAITH, THE GREAT CRASH 1929, at 12–13 (1954); Mahoney, *supra* note 31, at 346, 351.

44. GALBRAITH, *supra* note 43, at 12–13. This provided stock pool members with an advantage over uninformed investors because, at the time, investment banks rarely underwrote securities. *See* Mahoney, *supra* note 31, at 350.

45. *See* Thel, *supra* note 42, at 413 (suggesting that the pools relied on "the brute force of concentrated economic resources"); *see also* GALBRAITH, *supra* note 43, at 12–13 ("[E]ven the most devout Wall Streeter allow[ed] himself on occasion to believe that more personal influences have a hand in his destiny. Somewhere around there are big men who put stocks up and put them down.").

46. *See* GALBRAITH, *supra* note 43, at 79 ("During 1929 more than a hundred issues on the New York Stock Exchange were subject to manipulative operations, in which members of the Exchange or their partners had participated."). For an oft-cited description of a classic stock pool, see *id.*

47. *See id.*

48. *See id.*

49. *See* Mahoney, *supra* note 31, at 351 ("To the extent that pool participants were not merely informed, but company insiders, a modern commentator would condemn these pools for facilitating insider trading. While this is a current concern, it was not the Senate's concern in 1934. Congress condemned manipulation, not insider trading.").

group of investors failed "to corner the market in the stock of a copper mining company they controlled," causing a small recession.[50] Subsequently, a rumor circulated among the public that Wall Street had gone crooked; word had it that corporate insiders had fraudulently inflated stock prices to profit at the expense of unknowing investors.[51] While proposals for stock market reform failed to gain traction in Congress, New York Governor Charles Hughes appointed a committee ("the Hughes Committee") to conduct an investigation into practices at the New York Stock Exchange (NYSE).[52] The Hughes Committee's goal was to identify harmful practices and determine whether any specific regulations could efficiently deter such harmful behavior.[53]

The Hughes Committee report on its investigation was primarily concerned with "speculation," which it defined as "forecasting changes of value and buying or selling in order to take advantage of them."[54] The report distinguished between speculation carried on by "persons of means and experience, and based on intelligent forecast," which it found accomplished "an amount of good which offsets much of its cost," and speculation performed by persons without means or experience (uninformed speculation),[55] which the Hughes Committee found had the potential to cause "an almost incalculable amount of evil."[56] The Hughes Committee believed it was necessary to prevent uninformed speculation while preserving the benefits of informed speculation.[57] The Hughes Committee recommended against government intervention,[58] however, recognizing the "practical impossibility of distinguishing between what is virtually gambling from legitimate speculation."[59] Instead of enacting rigid statutes that might hamper proper transactions, the Hughes Committee believed that the NYSE could better address harmful practices.[60] Despite the Hughes Committee's caution, however, reformers used the critique of speculative practices to increase support for stock market reform.[61]

50. Thel, *supra* note 42, at 395–97. *See generally* ROBERT F. BRUNER & SEAN D. CAR, THE PANIC OF 1907 (2007).

51. *See* Thel, *supra* note 42, at 395 n.41.

52. *See id.* at 395.

53. HUGHES COMMITTEE REPORT, *supra* note 37, at 3.

54. *Id.*

55. *See supra* note 39.

56. HUGHES COMMITTEE REPORT, *supra* note 37, at 4.

57. "The most fruitful policy will be found in measures which will lessen speculation by persons not qualified to engage in it." *Id.*

58. "No law, the [Hughes] Committee argued, could clearly distinguish between appropriate and inappropriate transactions, and any effort to reform the exchanges by statute would hobble and eventually destroy the market." Thel, *supra* note 42, at 400.

59. *See* HUGHES COMMITTEE REPORT, *supra* note 37, at 4.

60. *See id.* at 5.

61. Thel, *supra* note 42, at 400–02 ("When stock market reform becomes a political issue, the public debate has historically brushed over the question of whether reforms are necessary and gone directly to their design: the question of what the reform should be.").

### 2. Reform Becomes Reality

The economic catastrophe that was the Great Depression saw the total value of all NYSE-listed securities drop by roughly 83 percent between 1929 and 1932.[62] While the exact cause of the Great Depression is still subject to debate,[63] many people at the time—whose memories of events like the Panic of 1907 were still fresh—generally blamed speculators and market makers for the stock market's collapse.[64] Despite knowing who to blame, average investors at that time lacked legal protection against crooked stock pools. Aside from asserting a state law fraud claim, there were no judicial remedies available for securities manipulation victims to pursue.[65] Thus, absent some duty to the corporation, the market, or its investors, crooked stock poolers could conduct fraudulent operations without incurring liability.[66] In the eyes of a recovering public, regulation of the nation's stock exchanges was necessary to prevent a relapse of the Great Depression.[67]

In 1932, the Senate's Banking and Currency Committee (SBCC) was directed to investigate and report on stock exchange practices.[68] The investigations piqued the public's interest once President Franklin D. Roosevelt appointed Ferdinand Pecora as the SBCC's chief counsel in 1933.[69] Prior to his appointment, Pecora had exposed "fabulous excesses in investment, commercial banking, and the financing of public utilities."[70] As chief counsel, Pecora hauled some of Wall Street's largest figures before

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62. *See* COX ET AL., *supra* note 43, at 7 (stating that the total value of all securities on the NYSE fell from $89 billion to $15 billion).

63. *Id.*

64. *See* Thel, *supra* note 42, at 408–11. "The public eventually concluded, just as it had after the panic of 1907, that speculators had pushed the market to unreasonable heights and that short sales had precipitated the collapse." *Id.* at 410–11; *see also* COX ET AL., *supra* note 43, at 7.

65. While state courts were successful in tackling deceptive statements and practices, they had not yet developed a solution to securities manipulation. *See* Thel, *supra* note 42, at 407 n.96 (citing Adolf A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 COLUM. L. REV. 264, 272–73 (1931)).

66. *See id.* Adolf Berle, who was considered one of the "most influential commentator[s] on corporate finance" at the time, hoped that American courts would follow English courts in curtailing securities manipulation "on the theory that it is somehow fraudulent to trade for the purpose of creating a market price that does not represent the trader's own appraisal of value." *Id.*

67. *See id.* at 409–11. "[I]n 1934 there was a widespread consensus that excessive stock market speculation and the collapse of the stock market had brought down the economy, and that those who enacted the Exchange Act were primarily concerned with preventing a recurrence." *See id.* at 409.

68. S. Res. 84, 72d Cong. (1932).

69. Thel, *supra* note 42, at 412. "[A]ny description of [the federal securities laws'] legislative history must begin with the dramatic hearings that Mr. Pecora conducted." *Id.* (alteration in original) (quoting 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at xiii–xiv (J. Ellenberger & E. Maher eds., 1973)). *But see* Mahoney, *supra* note 31, at 347–48 (suggesting that Pecora "treated the brokers and bankers who testified as accused criminals" and "presupposed the existence of wrongdoing" to capitalize on public animosity toward Wall Street and further his own political ambitions).

70. Thel, *supra* note 42, at 412.

the SBCC and repeatedly uncovered evidence that many NYSE members participated in stock pools.[71] By bringing these activities to light, Pecora sought to capitalize on the public's animosity toward Wall Street to promote the President's remedial agenda as well as his own political ambitions.[72]

The Pecora hearings have been criticized for demonstrating political bias against the witnesses[73] to capitalize on the public's infuriation with Wall Street at the time.[74] At least one scholar has argued that the SBCC's investigation would have been better served by hearing testimony from prominent academics of the time "who maintained the undesirability of the practice" rather than the bankers and executives involved.[75] Another criticism of the hearings is that the SBCC members apparently did not fully understand the mechanics for determining the prices of financial assets.[76]

Regardless, the Pecora hearings undoubtedly "colored the atmosphere in which the Exchange Act was proposed, considered, and adopted."[77] However, the harmful practices that the Pecora hearings targeted—price manipulation and uninformed speculation—were dissimilar to insider trading.[78] In contrast to price manipulation, insider trading does not require the creation of a false appearance of market activity. Rather, the act of insider trading entails the use of presumptively valid information to place the informed investor in a position to profit from the anticipation of some imminent market event.[79] Furthermore, given that informed investors are trading on credible information, insider trading more closely resembles informed speculation than uninformed speculation, which the Hughes Committee feared would bring harm to the market as a whole.[80] Simply put, insider trading today is fundamentally different from the harmful practices that concerned Congress in the years preceding the enactment of the Exchange Act.

### *B. Insider Trading as Fraud*

In 1934, Congress enacted the Securities Exchange Act,[81] in part to prevent manipulation.[82] Section 10(b)[83] was intended to serve as a catchall

71. *See id.* at 412–13.

72. *See* Mahoney, *supra* note 31, at 347.

73. *See id.*

74. *See* Thel, *supra* note 42, at 408–09.

75. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 9 (1966). By eliciting testimony from the wrongdoers as opposed to academics or learned reformers, the Pecora hearings seem to have been more of a trial than an attempt to ascertain the best means by which reform might be achieved.

76. Mahoney, *supra* note 31, at 348. For example, "[t]he Exchange Act was written on the assumption that the stock market is not rational," which is contrary to the modern conception. Thel, *supra* note 42, at 410.

77. Thel, *supra* note 42, at 413.

78. *See* Mahoney, *supra* note 31, at 344.

79. *See* MANNE, *supra* note 75, at 77–91.

80. *See supra* notes 54–57.

81. Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

provision to encapsulate manipulative practices not yet employed in the stock markets.[84] To accomplish this goal, section 10(b) afforded the SEC expansive authority to define fraud in connection with the purchase or sale of securities.[85] The SEC subsequently enacted Rule 10b-5, which makes it unlawful to

> employ any device, scheme or artifice to defraud, [t]o make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[86]

Thus, a claim brought under section 10(b) or Rule 10b-5 must allege that the claimant suffered a harm as a result of fraud in connection with the purchase or sale of a security.[87] Because insider trading is not explicitly mentioned, let alone prohibited, anywhere in the Exchange Act,[88] sustaining a claim for insider trading required a theory under which the act of trading on material nonpublic information constituted fraud within the meaning of section 10(b).[89]

In 1961, SEC Chairman William Cary proposed such a theory when the SEC decided *Cady, Roberts & Co.*[90] In that case, the SEC held that a person commits fraud under section 10(b) when she breaches a fiduciary duty owed to a corporation's shareholders by trading on material nonpublic information acquired by virtue of her position within the corporation.[91]

The SEC ruled that a corporate insider has a duty to disclose any material nonpublic information before trading in that corporation's securities.[92] Where disclosure prior to trading is impractical, the insider must abstain

82. Mahoney, *supra* note 31, at 346.

83. Under section 10(b) of the Exchange Act, it is unlawful

> [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j.

84. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).

85. Mahoney, *supra* note 31, at 344 ("The Exchange Act sought to curb manipulation by bans on specific practices such as reporting fictitious trades, by a general prohibition on 'raising or depressing the price of [any listed] security, for the purpose of inducing the purchase or sale of such security by others,' and by granting the SEC broad authority to define and prohibit manipulative devices." (alterations in original)).

86. 17 C.F.R. § 240.10b-5 (2016).

87. *See* COX ET AL., *supra* note 43, at 905–06. Even after Congress enacted the Exchange Act, insider trading actions were brought under state corporate law as common law fraud claims until the 1960s. *See* BAINBRIDGE, *supra* note 30, at 7.

88. *See* BAINBRIDGE, *supra* note 30, at 25–27; *see also* Currier, *supra* note 30, at 92.

89. *See* COX ET AL., *supra* note 43, at 906 ("Much of the conceptual difficulty in the law of insider trading is the product of a misfit between the broad fairness-based aim of the prohibition and the narrower statutory mechanism that must be used to combat it.").

90. 40 S.E.C. 907 (1961).

91. *Id.* at 911.

92. *See id.*

from trading.[93] Known as the "disclose or abstain rule," this ruling became the foundation for the insider trading prohibition under section 10(b).[94]

The Supreme Court endorsed the disclose or abstain rule nearly two decades later in *Chiarella v. United States*.[95] Vincent Chiarella traded on material nonpublic information he acquired from documents obtained in the course of his profession as a printer.[96] While the target corporation's identity had been explicitly concealed, Chiarella identified the target corporation using other information in the documents.[97]

Relying heavily on the SEC's *Cady, Roberts* decision, the Court held that a corporate insider commits fraud under section 10(b) by trading on material nonpublic information disclosed in breach of "a relationship of trust and confidence" owed to the corporation's shareholders.[98] The breach of such a fiduciary duty, the Court held, constituted the fraud required by section 10(b).[99] The Court's goal was to ensure that corporate insiders did not profit at the expense of minority shareholders.[100]

While endorsing the disclose or abstain rule, the Court ultimately held that, because Chiarella was not a corporate insider, he neither received "confidential information from the target company" nor relied on the target corporation's information.[101] Rather, Chiarella relied on "only the plans of the acquiring company," and he did not owe a duty of trust and confidence to the target corporation's stockholders.[102] The Court explained that "a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts."[103] Thus, Chiarella's conviction was improper because the jury instructions failed to specify whether the defendant was subject to an affirmative duty to disclose the information prior to trading.[104]

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93. *Id.* The decision in *Cady, Roberts* was "settled by consent and never reviewed by a court." MARKHAM, *supra* note 35, at 241.

94. *See infra* notes 95–100 and accompanying text.

95. 445 U.S. 222 (1980).

96. *See id.* at 224.

97. *See id.* The defendant realized a gain of $30,000 over the course of fourteen months. *Id.* Compared to some of the other insider trading defendants at the time, Chiarella's profits were meager. *See* BAINBRIDGE, *supra* note 30, at 52.

98. *Chiarella*, 445 U.S. at 228–29.

99. *Id.* at 230.

100. *Id.*

101. *Id.* at 231.

102. *Id.*

103. *Id.* at 229. *But see* United States v. O'Hagan, 521 U.S. 653, 555–66 (1997) (endorsing the "misappropriation theory," which expanded the list of persons who incur liability as corporate insiders to include those who owe a duty of trust and confidence to the source of the material nonpublic information by virtue of their professional relationship, such as lawyers and accountants). Under the misappropriation theory, Chiarella's conviction may have been upheld. *See* THOMAS LEE HAZEN, FED. JUDICIAL CTR., FEDERAL SECURITIES LAW 133–34 (3d ed. 2011) (suggesting that five of the Justices in *Chiarella* "would have upheld a conviction based on a theory that the defendant was given information in a position of trust and then wrongfully misappropriated the information to his advantage").

104. *Chiarella*, 445 U.S. at 229. The Court also suggested that tippees may incur liability when they use confidential information that they know originates from a corporate insider

Although the government advocated for the adoption of an "equal access to information" theory, the Court explicitly rejected this theory as a basis for the insider trading prohibition.[105] Financial unfairness does not always constitute fraud under section 10(b).[106] Rather, such unfairness is only fraudulent where there is a duty to disclose arising out of a fiduciary relationship with the corporation's shareholders.[107] Because Chiarella was not a fiduciary, but rather "a complete stranger," he was not under a duty to disclose or abstain from trading.[108]

The Supreme Court established in *Chiarella* that a claim for insider trading under section 10(b) or Rule 10b-5 requires a breach of a preexisting duty of trust and confidence. That holding clearly precluded corporate insiders from using their positions within their respective corporations from profiting off information acquired in the course of their professional responsibilities. Three years later, in *Dirks v. SEC*,[109] the Supreme Court discussed the application of the disclose or abstain rule to tippees—people who lack preexisting duties to a target corporation's stockholders but acquire information directly from someone with inside information.[110]

Raymond Dirks, an officer at a New York broker-dealer firm, received information from Ronald Secrist, a former officer at Equity Funding (EF), suggesting that EF's assets were vastly overstated due to fraudulent corporate practices.[111] Dirks then embarked on a two-week investigation, discussing the information openly with fellow investors,[112] clients, and the Los Angeles bureau chief for the *Wall Street Journal*.[113] Over the course of Dirks's two-week investigation, EF stock plummeted from twenty-six dollars per share to less than fifteen dollars per share.[114] The SEC

because the tippee has an obligation "arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." *See id.* at 230 n.12.

105. *See id.* at 232–33.

106. *See id.* at 232.

107. *See id.* The Court also rejected the "regular access to market information" test, which would impose liability on "*[a]nyone*—corporate insider or not—who regularly receives material nonpublic information" in connection with the purchase or sale of securities. *Id.* at 231 (quoting Chiarella v. United States, 588 F.2d 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222). In the case below, the Second Circuit believed a "regular access to market information" test would "create a workable rule embracing 'those who occupy . . . strategic places in the market mechanism.'" *Id.* at 231 n.14 (quoting *Chiarella*, 588 F.2d at 1365). However, the Court rejected this theory because it was "unrelated to the existence of a duty to disclose." *Id.* at 231.

108. *See id.* at 233–34. The idea that the "complete stranger" may escape liability has added to the confusion over who exactly may be charged under the federal securities laws. *See* Transcript of Oral Argument at 48–50, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628).

109. 463 U.S. 646 (1983).

110. *See supra* note 8.

111. *See Dirks*, 463 U.S. at 648–49.

112. Five investment advisors liquidated holdings exceeding $16 million. *Id.* at 649.

113. *Id.*

114. *Id.* at 650.

subsequently launched an investigation into trades in EF securities that occurred during Dirks's investigation.[115]

The Supreme Court reaffirmed its position that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[116] Thus, while identifying Congress's intent to exempt trading that "contribute[s] to a fair and orderly marketplace,"[117] the Court also recognized a need to ban tippee trading resulting from the exploitation of a corporate insider's privileged access to material nonpublic information.[118] The Court stated that

> [i]n holding that breaches of this duty to shareholders violated the Securities Exchange Act, the *Cady, Roberts* Commission recognized, and we agree, that "[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office."[119]

Holding otherwise "would open up opportunities for devious dealings in the name of others that the trustee could not conduct [on] his own."[120]

The Court explained that, under section 10(b) and Rule 10b-5, a tippee's liability derives from the insider's duty to the corporation's shareholders.[121] Therefore, the Court ruled that a tippee commits insider trading when she trades on material nonpublic information that was originally disclosed in breach of a fiduciary duty.[122] To determine whether a breach occurred, the Court stated that the test was "whether the insider will personally benefit, directly or indirectly, from his disclosure."[123] Without some personal benefit to the insider, the Court explained, there is no breach of fiduciary duty and thus no derivative breach by the tippee.[124] Therefore, a tippee's liability for insider trading turns on the tipper's intentions and the tippee's knowledge thereof.[125]

The Court overturned the judgment against Dirks because Secrist did not disclose the information for a personal benefit.[126] Rather, the Court concluded that Secrist was motivated by a desire to expose EF's fraudulent

115. While the *Wall Street Journal*'s Los Angeles bureau chief initially declined to publish a story on Dirks's information, the *Wall Street Journal* eventually released a front-page story after the SEC launched its investigation. *Id.* at 649–50.

116. *Id.* at 657–58 (alterations in original) (quoting Chiarella v. United States, 445 U.S. 222, 231 n.14 (1980)).

117. *See id.* at 657 n.16. The Court recognized that imposing a broad ban on trading on any material nonpublic information "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Id.* at 658.

118. *Id.* at 659.

119. *Id.* at 653 n.10 (quoting Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

120. *Id.* at 659 (quoting Mosser v. Darrow, 341 U.S. 267, 271 (1951)).

121. *Id.*

122. *Id.* at 660.

123. *Id.* at 662.

124. *Id.*

125. *See id.*

126. *Id.* at 665–67.

practices.[127] Therefore, Dirks did not incur liability as a tippee because Secrist had not disclosed the information in exchange for any personal benefit.[128]

While the *Dirks* personal benefit test limits tippee liability to circumstances in which information is disclosed in exchange for a personal benefit, the Court recognized that it will not always be clear whether a breach occurred.[129] As a guiding principle, the Court instructed lower 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."[130] A personal benefit to the tipper may be drawn where there is evidence of a quid pro quo relationship between the tipper and primary tippee.[131] Such an inference may also be drawn, the Court stated, where the insider intends "to benefit the *particular* recipient" or "makes a gift of confidential information to a *trading relative or friend*."[132] However, the Court did not precisely define what types of relationships may satisfy the "trading relative or friend" standard.[133] Thus, there may be some situations where, absent any clear, tangible benefit to the insider, it will be difficult to determine whether the person to whom the tipper originally discloses the information constitutes a "trading relative or friend," especially where that determination must be made by a remote tippee.

127. *Id.*

128. *Id. But see id.* at 670 (Blackmun, J., dissenting) ("The effect of Dirks' selective dissemination of Secrist's information was that Dirks' clients were able to shift the losses that were inevitable due to the Equity Funding fraud from themselves to uninformed market participants.").

129. *See id.* at 664 (majority opinion). As the Court recently recognized, that uncertainty lingers today. *See* Salman v. United States, 137 S. Ct. 420, 429 (2016) ("It remains the case that '[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.'" (quoting *Dirks*, 463 U.S. at 664)).

130. *Dirks*, 463 U.S. at 663 (emphasis omitted); *see also* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 348 (1979) ("The theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself . . . .").

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

132. *Id.* (emphasis added). "The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." *Id.*

133. Justice Harry Blackmun's dissent illustrates the difficulty of applying the personal benefit test:

> The Court's approach is particularly difficult to administer when the insider is not directly enriched monetarily by the trading he induces. For example, the Court does not explain why the benefit Secrist obtained—the good feeling of exposing a fraud and his enhanced reputation—is any different from the benefit to an insider who gives the information as a gift to a friend or relative. . . . Secrist surely gave Dirks a gift of the commissions Dirks made on the deal in order to induce him to disseminate the information. The distinction between pure altruism and self-interest has puzzled philosophers for centuries; there is no reason to believe that courts and administrative law judges will have an easier time with it.

*Id.* at 676 n.13 (Blackmun, J., dissenting).

### *C. Reinforcing* Dirks

While the justification for the ban on insider trading received the Supreme Court's endorsement, the range of conduct proscribed by the law was not as broad as the government had argued for.[134] Following *Dirks*, the government took several steps to further deter individuals from trading on material nonpublic information. First, Congress enacted the Insider Trading Sanctions Act of 1984[135] (ITSA), which increased both the civil and criminal penalties for insider trading.[136] While ITSA illustrated Congress's intent to increase the severity of punishment for insider trading, it did not alter the Supreme Court's definition of insider trading as established in *Chiarella* and *Dirks*.[137] Nonetheless, ITSA gave the SEC greater negotiating power in settlement talks, as evidenced by its ability to reach more lucrative settlements.[138]

The SEC also promulgated three major rules to better define some of the requisite elements of insider trading. First, the SEC promulgated Regulation Fair Disclosure ("Reg FD") in 2000, which sought to prevent corporate insiders from disclosing material nonpublic information to select shareholders and market professionals.[139] The SEC saw selective disclosure as a method that facilitated insider trading,[140] likely because it provides select investors with an informational advantage over the average investor. Reg FD prevents parties from attaining such an advantage by requiring all publicly traded companies to disclose material nonpublic information to all investors at the same time.[141]

Second, Rule 10b5-1 creates a presumption that an individual trades "on the basis of" material nonpublic information anytime that individual was aware of the material nonpublic information when she traded.[142] While this presumption may be rebutted by any of the affirmative defenses in subsection (c), those defenses are narrow, requiring the individual to have had some written commitment or plan to trade on the securities in question

134. *See supra* notes 105–07.

135. Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u (2012)).

136. *Id.* Specifically, the criminal penalty was increased tenfold, from $10,000 to $100,000. *Id.* § 3, 98 Stat. at 1265. The SEC may seek both disgorgement and damages amounting to three times the profit gained or loss avoided. *See* BAINBRIDGE, *supra* note 30, at 131. In practice, however, the SEC often varies the amount of punitive damages sought based on the severity of the infraction. *See* KIRKPATRICK & LOCKHART PRESTON GATES ELLIS LLP, THE SECURITIES ENFORCEMENT MANUAL 201–02 (2d ed. 2007).

137. *See* HAZEN, *supra* note 103, at 139 ("Thus, [ITSA] does not alter the availability of a cause of action, merely the penalties that may be imposed.").

138. *Id.*

139. 18 LANGEVOORT, *supra* note 1, § 1:1.

140. *See id.*

141. 17 C.F.R. § 243.100 (2016). However, some recent evidence suggests that similar, yet less explicit, practices still occur. *See* United States v. Newman, 773 F.3d 438, 454 (2d Cir. 2014) (indicating that "analysts routinely solicit[] information from companies in order to check assumptions in their models in advance of earnings announcements").

142. 17 C.F.R. § 240.10b5-1(b) (2016).

prior to receiving the information.[143] Thus, Rule 10b5-1 implicitly eases the pleading and proving standards in bringing an action for insider trading.[144]

Third, Rule 10b5-2 provides a nonexhaustive list of relationships in which a duty of trust or confidence exists.[145] These include situations where there is an agreement "to maintain information in confidence," where the parties have routinely shared confidences with each other, and where a person discloses information to a "spouse, parent, child, or sibling."[146] However, Rule 10b5-2's validity has been called into question.[147] While the Supreme Court's recent *Salman* decision was not inconsistent with Rule 10b5-2, the Supreme Court made no mention of the rule in its opinion.[148]

### *D. The Recent Controversy:* Newman *and* Salman

Since *Dirks*, lower courts have faced difficulty in applying the personal benefit test to cases involving remote tippees and more complex tipping chains.[149] As a result, lower courts have "eased the standards for both pleading and proving" the requisite elements in insider trading cases.[150] For example, some courts have not required "specific allegations of personal benefit in pleadings."[151] Additionally, courts have deemed circumstantial evidence sufficient to establish a tipper's intentions in disclosing information.[152] Furthermore, some "courts have downplayed the requirement of knowledge of breach of duty by repeating or emphasizing that information has been obtained 'improperly.'"[153] This approach could allow liability to be improperly imposed where no actual breach occurred.[154] These trends have implicitly imposed a fairness-based approach,[155] which directly contradicts explicit Supreme Court precedent.[156]

In December 2014, however, the Second Circuit's holding in *United States v. Newman*[157] curtailed the drifting jurisprudence.[158] Todd Newman

143. *See id.* § 240.10b5-1(c); HAZEN, *supra* note 103, at 137–38. The SEC had originally adopted a "possession test" but, after receiving comments from the public, later "reproposed the rule to adopt the use requirement plus a presumption of use." *Id.* at 137 n.609.

144. *See* HAZEN, *supra* note 103, at 137.

145. *See id.*; *see also* 17 C.F.R. § 240.10b5-2(b).

146. HAZEN, *supra* note 103, at 137.

147. *See id.* at 135 n.595 (citing United States v. Kim, 173 F. Supp. 2d 1035 (N.D. Cal. 2001)). "It remains difficult to define situations in which there is a sufficient duty that gives rise to Rule 10b-5's 'disclose or abstain from trading' obligation with regard to material nonpublic information." *Id.* at 134.

148. *See generally* Salman v. United States, 137 S. Ct. 420 (2016).

149. *See* Coles, *supra* note 7, at 184.

150. *Id.* at 208.

151. *Id.* at 208 n.166.

152. *Id.* at 208 n.167.

153. *Id.* at 210.

154. *Id.*

155. *Id.* at 211.

156. *See* Dirks v. SEC, 463 U.S. 646, 657 n.16 (1983); Chiarella v. United States, 445 U.S. 222, 233 n.16 (1980).

157. 773 F.3d 438 (2d Cir. 2014).

and Anthony Chiasson, hedge fund managers at Diamondback and Level Global, respectively, traded on information relayed to them by their analysts.[159] A group of analysts had shared material nonpublic information, including earnings reports, obtained from employees of technology companies Dell and NVIDIA.[160] Rob Ray, a member of Dell's investor relations department, had tipped Neuberger Berman analyst Sandy Goyal, who in turn tipped Diamondback analyst Jesse Tortora, who ultimately relayed the information to Newman.[161] Tortora also tipped Level Global analyst Spyridon "Sam" Adondakis, who passed the tip along to Chiasson.[162] The second tipping chain originated with Chris Choi, a member of NVIDIA's finance unit, who tipped fellow churchgoer Hyung Lim,[163] who then tipped Whittier Trust analyst Danny Kuo.[164] Kuo then provided the information to the group of analysts, including Tortora and Adondakis, who in turn relayed the information to Newman and Chiasson.[165] An illustration of the complex tipping chain is provided below.

158. *See* 18 LANGEVOORT, *supra* note 1, § 4:9.
159. *Newman*, 773 F.3d at 442.
160. *Id.* at 443.
161. *Id.* Newman was three levels removed from Ray. *Id.*
162. *Id.* Chiasson was four levels removed from Ray. *Id.*
163. *Id.* Lim was also a former Broadcom Corporation and Altera Corporation executive. *Id.*
164. *Id.*
165. *Id.* Newman and Chiasson were both four levels removed from Choi. *Id.*

*Figure 1: Dell Tipping Chain*

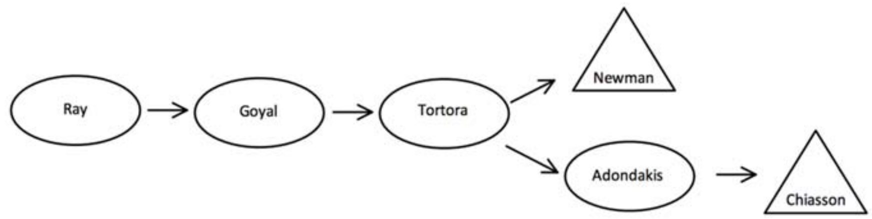
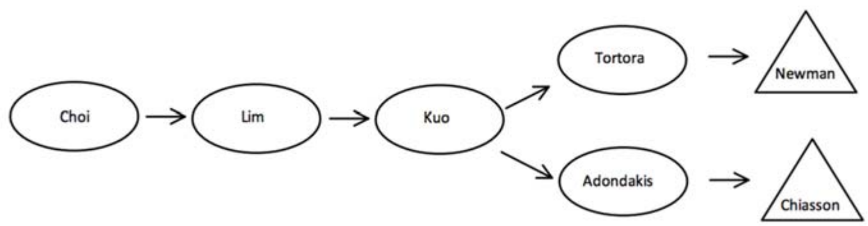



*Figure 2: NVIDIA Tipping Chain*




At the close of the government's case in chief, Newman and Chiasson argued that the government had failed to present any evidence that Ray or Choi received a personal benefit in exchange for the material nonpublic information or that either defendant knew of any such benefit.[166] Alternatively, Newman and Chiasson "requested that the court instruct the jury that it must find that Newman and Chiasson knew that the corporate insiders had disclosed confidential information *for personal benefit* in order to find them guilty."[167] Instead, the district court instructed the jury that, to return a guilty verdict, they must find that the defendants "knew that the material, nonpublic information had been disclosed by the insider *in breach of a duty of trust and confidence*."[168] The jury subsequently found both defendants guilty on all counts.[169]

On appeal, the Second Circuit reversed the convictions because the government presented no evidence that either defendant was aware of any personal benefit to Ray or Choi.[170] The court found that the jury instructions were inadequate because "a reasonable juror might have concluded that a defendant could be criminally liable for insider trading merely if such defendant knew that an insider had divulged information that

166. *Id.* at 444.
167. *Id.* (emphasis added).
168. *Id.* (emphasis added).
169. *Id.*
170. *See id.* at 451 (citing Neder v. United States, 527 U.S. 1, 17–18 (1999)).

was required to be kept confidential."[171] Thus, the Second Circuit deemed the convictions improper.[172]

The Second Circuit also stated that the inference of a personal benefit to either Ray or Choi was impermissible.[173] Both Ray and Choi were found to have social relationships with their respective primary tippees.[174] Ray and Goyal attended business school together and also had been colleagues at Dell.[175] Goyal had also given Ray career advice and helped him with his resume before Ray ever provided Goyal with any inside information.[176] With respect to the NVIDIA chain, Choi and Lim were fellow churchgoers who "occasionally socialized together."[177] While the Second Circuit acknowledged that an insider may receive a personal benefit "from simply making a gift of confidential information to a trading relative or friend,"[178] the court rejected the notion that a personal benefit could be inferred "by the mere fact of a friendship, *particularly of a casual or social nature*."[179] The Second Circuit feared that permitting the inference of a personal benefit under such circumstances could essentially nullify the personal benefit requirement.[180]

The Second Circuit also discussed whether knowledge of a breach could be inferred from the type of the material nonpublic information. The court acknowledged that, in general, knowledge may be inferred where the information traded on is of a certain specificity.[181] However, the evidence suggested that the investor relations departments at Dell and NVIDIA frequently aided analysts by affirming the accuracy of their models and by leaking information about their earnings reports in advance.[182] Accordingly, the Second Circuit held that knowledge of a breach could not be inferred "where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source."[183] The court further held that even where the specificity of the information would permit inferring knowledge regarding

171. *Id.* at 450; *see* Coles, *supra* note 7, at 210 ("[A] generalized focus on knowledge of 'improperly' obtained information could allow liability to be based on improper acts that involve no actual breach of duty by insiders.").

172. *Newman*, 773 F.3d at 451.

173. *Id.*

174. *See id.* at 452–53.

175. *Id.* at 452.

176. *See id.*

177. *See id.* "The evidence did not establish a history of loans or personal favors between the two." *Id.* at 453.

178. *Id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).

179. *Id.* (emphasis added).

180. *Id.* ("If this was a 'benefit,' practically anything would qualify."). The court also rejected the notion that the jury could have found that Newman and Chiasson "knew the insiders disclosed the information 'for some personal reason rather than for no reason at all'" because the *Dirks* Court "affirmatively rejected the premise that a tipper who discloses confidential information necessarily does so to receive a personal benefit." *Id.* at 454 (citing Dirks v. SEC, 463 U.S. 646, 661–62 (1983)).

181. *Id.* at 455.

182. *See id.* at 454–55.

183. *Id.* at 455.

the information's source, "it cannot, without more, permit an inference as to that source's improper *motive* for disclosure."[184]

The Second Circuit noted that it had never considered, nor had it found any cases where other courts had considered, a case involving tippees as far removed from the original tipper as Newman and Chiasson.[185] In stressing the significance of the knowledge requirement, the *Newman* decision illustrated the difficulty of establishing that a remote tippee several levels removed from the source knew that the information was improperly disclosed.[186] This created some concern that prosecutions against remote tippees would be virtually impossible to sustain.[187]

The Supreme Court denied certiorari in *Newman*,[188] and some scholars believe that the Second Circuit's holding signaled a change in insider trading jurisprudence.[189] A few months later in *Salman v. United States*,[190] the Ninth Circuit expressed its disapproval of *Newman* by declining to follow the Second Circuit's reasoning. The Supreme Court later took up the issue to resolve the apparent circuit split.[191]

Bassam Salman traded on material nonpublic information that originated with Maher Kara, a Citigroup employee who was also Salman's brother-in-law.[192] Maher conveyed material nonpublic information to his older brother Michael.[193] Without Maher's knowledge, Michael relayed the information to his friends, including Salman.[194] The evidence established that Maher intended the information to benefit his brother[195] and that Salman was well aware of Maher and Michael's close relationship.[196] At the close of trial, Salman was convicted on one count of conspiracy to commit securities fraud and four counts of securities fraud.[197]

On appeal, Salman pointed to *Newman*, arguing that he could not be held liable as a tippee because "there was no evidence that Maher received

184. *Id.*
185. *Id.* at 448.
186. *See* 18 LANGEVOORT, *supra* note 1, § 4:10.
187. *See id.*
188. *See* United States v. Newman, 136 S. Ct. 242 (2015).
189. *See* Elizabeth K. Friedrich, *Insider Trading After* Newman*: The Impact on Financial Institutions*, J. TAX'N & REG. FIN. INSTITUTIONS, Mar.–Apr. 2016, at 23, 26 ("The *Newman* court's [decision] thus narrowed the definition of the insider's personal benefit to be of a pecuniary nature.").
190. 792 F.3d 1087 (9th Cir. 2015), *aff'd*, 137 S. Ct. 420 (2016).
191. *See* Salman v. United States, 136 S. Ct. 899 (2016).
192. Salman, 137 S. Ct. at 424.
193. *Id.* The evidence suggests that, initially, Maher sought Michael's chemistry expertise to help him grasp concepts at his new job and that Maher did not even know that Michael was trading on the information they discussed. *See id.* Eventually, however, Maher not only discovered that Michael was trading on the information, but he also continued to provide the information to benefit Michael. *See id.*
194. *Id.* "Salman had made over $1.5 million in profits that he split with another relative." *Id.*
195. *Id.* at 424–25. Notably, Maher had first offered his brother money, "but Michael asked for information instead." *Id.* at 424.
196. *Id.* ("Michael was the best man at Maher's wedding to Salman's sister.").
197. *Id.* at 424–25.

anything of 'a pecuniary or similarly valuable nature' in exchange—or that Salman knew of any such benefit."[198] The Ninth Circuit disagreed; Salman could easily have inferred Maher's intent to benefit his brother due to the Kara brothers' close relationship.[199]

The Supreme Court affirmed the Ninth Circuit's ruling, finding that Maher breached his fiduciary duty to Citigroup and its clients and that Salman had full knowledge of that breach because he was well aware of the Kara brothers' relationship.[200] Thus, the Court easily determined that Salman incurred liability derivatively as a remote tippee.[201]

The Court upheld *Dirks*'s gift-giving standard, stating that the "gift of inside information to a relative like Michael is little different from trading on the information, obtaining the profits, and doling them out to the trading relative. The tipper benefits either way."[202] The Court did not overrule *Newman*, but did state that any requirement that the tipper "receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift *to family or friends* . . . is inconsistent with *Dirks*."[203] The Court did not comment on whether the relationships between the insiders and the primary tippees in *Newman* were sufficient to warrant the inference that the insider received a personal benefit in exchange for the information, nor did the Court provide a guiding principle to distinguish between relationships where an inference may properly be drawn from those where it may not. Thus, even where a remote tippee has full knowledge pertaining to the source of a tip, it will not always be clear whether a personal benefit accrued to the tipper. Further, in cases where a remote tippee is less acquainted with the tipper and primary tippee than Salman was with the Mara brothers, it is not clear when a remote tippee should be expected to have sufficient knowledge of their relationship to determine whether the tipper personally benefitted from the disclosure.

## II. REMOTE TIPPEES AFTER *SALMAN*

In light of the lingering uncertainties following *Newman* and *Salman*, an investor cannot always determine whether trading on a tip is lawful. Time spent investigating facts pertaining to the information's source could be costly, but the risk of trading on information that was improperly disclosed could result in jail time for the eager trader. To determine what courses of action may alleviate these concerns, Part II revisits the arguments for and against a ban on insider trading and considers various possible tests for determining a remote tippee's liability. Part II.A summarizes the relevant

198. *Id.* at 425.
199. United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015), *aff'd*, 137 S. Ct. 420.
200. *Salman*, 137 S. Ct. at 427.
201. *Id.*
202. *Id.* at 428. However, the fact that Michael rejected Maher's offer for money in favor of the information suggests that the information is more valuable than its cash equivalent. *See supra* note 195.
203. *Salman*, 137 S. Ct. at 428 (emphasis added).

arguments regarding insider trading to ascertain whether any deviation from the existing law is warranted. Part II.B then discusses various tests and approaches under which remote tippees could incur liability for insider trading, as well as possible supplemental rules that could alleviate the concerns presented by remote tippees.

### *A. Debating Insider Trading*

A discussion of various perspectives on the insider trading ban is helpful for understanding what goals and values a rule governing remote tippee liability should promote. Part II.A.1 addresses the argument that insider trading produces more efficient market prices. Part II.A.2 then presents the arguments supporting the prohibition on insider trading. Finally, Part II.A.3 discusses public choice theory as applied to insider trading.

#### 1. Insider Trading as an Efficient Pricing Mechanism

In 1966, law professor Henry G. Manne set forth the first major defense of insider trading, arguing that insider trading produces more accurate market prices.[204] In an efficient capital market, a stock's market value is a reflection of all material and publicly available information about that corporation and its activities.[205] However, not all material information relevant to a stock's value is always publicly available, and therefore a stock's market price may not always be an accurate reflection of its true value.[206] Manne suggested that insider trading essentially compensates for the information that is not available to the market and thereby increases demand for the stock.[207] This increase in demand causes the stock's market price to shift toward its true value: the stock's market value if all material information were publicly available.[208] Manne's theory assumes that the informed traders are the only investors affecting the security's demand and that the size of their trades, in relation to the number of outstanding securities, are significant enough to affect the stock's overall price.[209] To that point, at least one study surveying targets of SEC enforcement actions

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204. *See* MANNE, *supra* note 75, at 77–91. Manne also argued that insider trading could serve as a compensatory mechanism. *See id.* at 131–41.

205. *See* BAINBRIDGE, *supra* note 30, at 136. The efficient market capital hypothesis proposes that a security's "current price is an accurate reflection of the market's consensus as to the commodity's value." *Id.* at 141.

206. *See id.* at 136 ("The 'correct' price of a security is that which would be set by the market if all information relating to the security had been publicly disclosed.").

207. MANNE, *supra* note 75, at 82–83.

208. *Id.*

209. *See* BAINBRIDGE, *supra* note 30, at 139–44. Bainbridge argues that insider trading can only impact the security's market price derivatively, i.e., a significant price change will only occur after noninsiders become aware of the material nonpublic information and observant investors trade in accordance with the initial slight changes in price. *See id.* at 143–44.

during the 1980s suggests that insider trading does have an impact on a security's market price.[210]

Even where insider trading is completely unregulated, insiders will be naturally restrained by two factors: time and wealth.[211] As time goes on, a stock's value will gradually approach its true value because information will gradually leak to the public before any public announcement.[212] Thus, the prospective gain (or forgone loss) that a trader may incur decreases as time goes on.[213] Even if an informed investor is able to act immediately, the only way to realize the full value of the information is to purchase all of the corporation's outstanding stock.[214] Therefore, even if the law did not restrict investors from trading on material nonpublic information, investors typically would be limited to a fraction of the information's total value.

### 2. Justifications for the Ban

The mainstream argument in favor of prohibiting insider trading is rooted in fairness. Proponents of the prohibition argue that insider trading destroys the integrity of the stock markets by giving those with access to material nonpublic information an unfair advantage over average investors.[215] The fear is that allowing investors to profit from such an informational advantage at the expense of uninformed investors would ultimately discourage investor confidence.[216] However, the Supreme Court has consistently rejected the fairness justification for prohibiting insider trading because unfairness is not "fraudulent activity under [section] 10(b)."[217]

Stephen Bainbridge identifies two other types of fairness arguments in support of a prohibition.[218] First, fairness may be defined as the duty owed by the agent to her principal; an agent should not be permitted to use her position within a corporation for personal gain, especially at the expense of the principal—the shareholders.[219] However, this notion of fairness only justifies the insider trading prohibition if the principal is deprived of

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210. *See generally* Lisa Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661 (1992) (finding that inside traders who were the subject of SEC actions during the 1980s caused quick price changes by trading on material nonpublic information).

211. *See* MANNE, *supra* note 75, at 78–79.

212. *See id.* at 79.

213. *See id.* ("The time period that insiders have to capture the fresh information may occasionally be as small as minutes . . . .").

214. *See id.* at 78.

215. *See* BAINBRIDGE, *supra* note 30, at 4–5, 157–58; *see also* HAZEN, *supra* note 103, at 131 ("Trading on inside information destroys the integrity of the marketplace by giving an informational advantage to a select group of corporate insiders.").

216. Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982) ("[I]t is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"); *see also* Transcript of Oral Argument at 23–24, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628).

217. *See* Chiarella v. United States, 445 U.S. 222, 233–35 (1980).

218. *See* BAINBRIDGE, *supra* note 30, at 157 (citing Santa Fe Indus. v. Green, 430 U.S. 462, 474–77 (1977)); *see also Chiarella*, 445 U.S. at 227 ("That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law.").

219. *See* BAINBRIDGE, *supra* note 30, at 157.

something, which requires there to be an assignable property interest in material nonpublic information.[220] Alternatively, fairness may be premised on the notion that investors must not harm one another.[221] On an anonymous exchange, however, those who trade on material nonpublic information do not cause the transacting party to purchase or sell its shares. Thus, it is practically impossible to distinguish losses sustained or gains forgone as the result of insider trading from those resulting from poor investment decision making for purposes of imposing liability.[222]

Insider trading may also cause harm to the issuer in a variety of ways.[223] Some scholars argue that any insider trading prohibition must exist to ensure the proper maintenance of the mandatory disclosure system,[224] which is arguably the chief purpose of the Exchange Act.[225] Without mandatory disclosure, officers and managers might use confidential information for personal advantage[226] and, consequently, delay disclosure to their coworkers and the public to ensure their own profit.[227] While the time taken by one manager to trade on the information before relaying it to her superiors may be minimal, allowing all insiders to trade on the material nonpublic information could result in substantial delays.[228] This may also cause the corporation to incur greater administrative costs to ensure the efficient transition of information.[229] These costs would likely be magnified if insiders were permitted to disclose material nonpublic information to friends and family, as they would have to wait until each of those parties had traded before relaying the information to their colleagues.

Additionally, insider trading could interfere with corporate plans.[230] For example, in the context of a merger or acquisition, trading in the securities of the target company by insiders of the acquiring company before the offer is made public may increase the cost of the merger or acquisition as insiders drive up the target corporation's stock price.[231]

Even more dangerous is the possibility that managers may make decisions that will cause the greatest fluctuation in the corporation's stock price, allowing them to profit by purchasing or shorting the stock at the

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220. *See id.* Bainbridge argues that "the insider trading prohibition can be justified, but only by an economic argument that treats insider trading as theft of confidential information in which someone other than the inside trader has a property right superior to that of the inside trader." *Id.* at 135, 172–81.

221. *See id.* at 158–66.

222. *See id.* (suggesting that investors are not likely injured by insider trading).

223. *Id.* at 166–72. *But see* Dirks v. SEC, 463 U.S. 646, 672 n.7 (1983) ("[I]nsider trading generally does not injure the corporation itself.").

224. *See* Karmel, *supra* note 24, at 169–70.

225. BAINBRIDGE, *supra* note 30, at 154.

226. Karmel, *supra* note 24, at 170–71.

227. *See* BAINBRIDGE, *supra* note 30, at 156, 166–68.

228. *See id.* at 167.

229. *See id.* However, it is unclear whether corporate disclosures would be significantly delayed under a free-trading rule due to a lack of empirical evidence. *See id.*

230. *See id.* at 168–71.

231. *See id.* at 168; *see, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

right time.[232] This could cause managers to make decisions in accordance with their own interests, rather than decisions in the best interests of the shareholders. However, these concerns may be overstated because management often has a greater incentive to maximize the corporation's value, which favors choosing projects with a positive net present value.[233] This overriding incentive is also less likely to be outweighed by a manager's incentive to hamper corporate plans to benefit a remote tippee who is unrelated to the manager.

Finally, insider trading might harm a corporation's reputation.[234] Such reputational injury may result if prospective shareholders demand a premium for purchasing stock in a corporation in which managers trade on their own material nonpublic information.[235] However, Bainbridge argues that reputational harm will not materialize unless there is a "plausible shareholder injury story," which he asserts is difficult to create.[236]

### 3. Public Choice Theory

As applied to the insider trading ban, public choice theory suggests that the prohibition may serve the interests of special interest groups, such as the SEC and certain market professionals.[237] If the law were to cover a broader range of conduct, which has always captured the public's attention, the SEC could justifiably argue for a greater allocation of federal funds.[238] Thus, the SEC would benefit by increasing its budget to support its enforcement program.[239] Similarly, market professionals who set market prices benefit from a rule encompassing a broader range of conduct because informed investors profit from the market professionals' uninformed price setting.[240] However, informed investors would benefit from a narrow prohibition because they would have more freedom to trade on information garnered through their informational advantage.

The SEC was intended to be a neutral regulatory body, and Manne argues that the SEC should adopt a more neutral stance on insider trading in accordance with that role.[241] However, the SEC's numerous attempts to ease the pleading and proof standards for sustaining a claim for insider trading[242] suggest that its stance has been more one sided than its regulatory

232. *See* BAINBRIDGE, *supra* note 30, at 170–71 ("Allowing insider trading may encourage management to select negative net present value investments . . . because failure presents management with an opportunity for profit through short-selling."). *See generally* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.
233. *See* BAINBRIDGE, *supra* note 30, at 171.
234. *See id.* at 172.
235. *Id.*
236. *Id.*
237. *See id.* at 147–54.
238. *See id.* at 149–50.
239. *See id.*
240. *See id.* at 150–51.
241. *See* MANNE, *supra* note 75, at 45–46, 46 n.27.
242. *See supra* notes 139–46 and accompanying text.

role might call for. The Supreme Court has rejected a complete ban on trading on material nonpublic information, noting that such a ban would contravene congressional intent.[243] The SEC would benefit from adopting rules that accord with the Court's holdings because it would better reflect Congress's intent for the SEC to serve as a neutral regulatory authority.

### *B. The Various Proposals for Remote Tippee Liability*

The proper analysis for imposing liability on remote tippees is still open for debate. If the courts were to deviate from the *Dirks* personal benefit test, there are several possible replacements that offer varying standards for determining a remote tippee's liability. Part II.B.1 briefly addresses the mechanics of a fairness test. Next, Part II.B.2 discusses the implications of using the most restrictive reading of the personal benefit test. Part II.B.3 then addresses a slightly broader chain approach similar to the personal benefit test, which is discussed in Part II.B.4. Finally, Parts II.B.5 and II.B.6 discuss possible solutions that, coupled with the personal benefit test, may alleviate the issues faced by remote tippees and government regulators.

#### 1. Entire Fairness: A Rule Prohibiting Trading on Any and All Material Nonpublic Information

Under a fairness rule, a remote tippee would be barred from trading on material nonpublic information at any time. This rule would be the simplest for courts and regulators to implement and for remote tippees to follow.[244] This approach would still require a remote tippee to investigate whether the information in question is material and nonpublic, which is not always clear.[245] However, the Supreme Court has consistently rejected the entire fairness approach as being inconsistent with legislative intent.[246] Thus, Congress would need to enact legislation explicitly banning trading on material nonpublic information, but, as noted by both Congress and the Supreme Court, such a statute may hamper the role performed by many market professionals.[247]

#### 2. A Restrictive Reading of *Dirks*

Under a narrow reading of *Dirks*, a remote tippee would incur liability only where she knows that she is the intended beneficiary.[248] This approach would likely alleviate some of the issues faced in proving knowledge because, as the intended beneficiary, the remote tippee would likely know (or reasonably should know) that the information was disclosed to benefit her specifically. Such a rule would also limit liability for the

243. *See* Dirks v. SEC, 463 U.S. 646, 657 n.16 (1983); Chiarella v. United States, 445 U.S. 222, 233 n.16 (1980).
244. *See Chiarella*, 445 U.S. at 224–25.
245. *See id.* at 233.
246. *See Dirks*, 463 U.S. at 657 n.16; *Chiarella*, 445 U.S. at 233 n.16.
247. *See Chiarella*, 445 U.S. at 233 n.16.
248. *See* 18 LANGEVOORT, *supra* note 1, § 4:10.

tipper, who otherwise may be held liable for trades carried out by intermediary members of the tipping chain or subsequent remote tippees.[249] This reading of *Dirks* would permit intermediary tippees to tip other investors without incurring any liability,[250] and there is little reason to condone such trades that were similarly facilitated by the same improper disclosure.[251]

### 3. The Chain Approach

The chain approach is a slightly narrower version of the personal benefit test that would impose liability on remote tippees without the original tipper's intention or expectation to benefit from a tippee's trades.[252] Under the chain approach, each tippee is treated as owing a duty of trust and confidence to the source of the information, thus creating "a *chain* of persons with a duty to disclose."[253] Under this approach, each member of the chain would be deemed to owe a fiduciary duty to the source of the information, and liability would exist

> so long as it could be shown that each person in the chain (1) was given the information expressly for the purpose of facilitating trading based on inside information, (2) knew that the information was material and [nonpublic], and (3) knew or had reason to know that it came to him as a result of some breach of duty by an insider.[254]

While the chain approach focuses on the circumstances surrounding the tip to the remote tippee, it nonetheless requires that the original tipper breach a fiduciary duty for any of the subsequent members of the chain to incur liability.[255] Additionally, the chain approach would permit investors who know that information was improperly disclosed to lawfully trade merely because they were not affirmatively brought into the tipping scheme.[256] This result would not serve any important policy interests nor justify a modification in the current substantive law.

### 4. The Personal Benefit Test

Similar to the chain approach, the personal benefit test, established by the Supreme Court in *Dirks*,[257] imposes liability on a remote tippee who trades on material nonpublic information that she knows was disclosed in exchange for a personal benefit.[258] The personal benefit test best identifies

249. *See id.*
250. *Id.* In such cases, it may be necessary to show that the remote tippee owed a duty of trust and confidence to the primary tippee in order to be subject to liability. *See id.* § 4:10, at 4-34 n.2.
251. *See Dirks*, 463 U.S. at 659.
252. *See* 18 LANGEVOORT, *supra* note 1, § 4:10.
253. *See id.*
254. *Id.*
255. *See id.*
256. *Id.*
257. *See supra* notes 121–24 and accompanying text.
258. Dirks v. SEC, 463 U.S. 646, 662 (1983).

situations where insiders abuse their positions within the company for personal gain, which was the primary purpose of the SEC's original disclose or abstain rule.[259]

One interesting aspect of the personal benefit test is that success on the merits of an insider trading claim against a remote tippee depends on circumstances entirely outside of either party's control. For the unknowing investor, it does not matter whether the insider received a personal benefit for disclosing the material nonpublic information; the resulting harm from the remote tippee's trading is the same.[260] Whether the tip was disclosed in exchange for a personal benefit is entirely coincidental to the uninformed investor's decision to trade.[261] That this distinction is insignificant to the uninformed investor yet essential to determining a remote tippee's liability exacerbates the need for investors to know whether or not a particular tip was improperly disclosed at the time the investor acts on the information. Thus, the major problem with the personal benefit test is that investors may find it difficult to immediately comply with the law at the time they receive material nonpublic information if they do not know all the relevant information surrounding the initial disclosure. Solving this problem does not require a change in the substantive law. Rather, the solution lies in providing investors with all pertinent information to allow them to take advantage of a tip's time-sensitive value where trading is lawful.

### 5. A "Trading Relative or Friend" List

One tool that could aid investors in determining whether they may trade on a particular tip is an exhaustive list of circumstances where the inference of a personal benefit may be drawn. If Congress or the SEC set forth a list of relationships that satisfy the "trading relative or friend" standard, then the only issues for remote tippees and courts to discern would be the relationship between the tipper and primary tippee and whether that relationship is classified under the list.[262] However, the obvious problem with exhaustively defining every possible circumstance under which a remote tippee should infer a personal benefit to the insider is the potential for abuse: a creative trader could simply craft a scheme that does not involve a proscribed relationship. Additionally, even if a governing body—whether it be Congress, the SEC, or the courts—is able to clearly and definitively define what constitutes a "trading relative or friend," the question of whether the remote tippee had, or should have had, knowledge of the insider's breach will always be a factual issue—one that will be more

259. *See supra* notes 90–94 and accompanying text.

260. *See* BAINBRIDGE, *supra* note 30, at 158 ("It is purely fortuitous that an insider was on the other side of the transaction.").

261. *See id.* at 158–61.

262. Coles, *supra* note 7, at 235, nn.308–10 (arguing that clearer rules will become necessary as more ordinary citizens start to invest directly); *see also* United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (en banc); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1198 (1995).

difficult to prove the further the remote tippee is from the insider.[263] Without that information, an investor would still be unable to determine whether trading is lawful. Thus, enacting an exhaustive list of proscribed relationships would not sufficiently resolve the issues faced by investors.

#### 6. Rule 10b5-D, a Safe Harbor Disclosure Rule

Another mechanism that could alleviate the uncertainty faced by investors presented with material nonpublic information would be the adoption of a safe harbor disclosure rule, Rule 10b5-D. Consider the hedge fund manager from the introduction: under Rule 10b5-D, the manager would be permitted to trade on the analyst's tip upon receipt of the information so long as she files a preliminary report with the SEC within two days of trading. In the preliminary report, the manager would be required to provide a detailed account of all material facts pertaining to the trade known to the investor at that time, including the details of the tip, the number of shares purchased or sold, the amount at which the shares were purchased or sold, and any other facts regarding the source of the information. The investor would then be required to conduct a reasonable investigation to determine whether the information was disclosed in breach of a fiduciary duty. Subsequently, the manager would be required to file a report within a reasonable time period disclosing the results of the investigation.[264] If the investigation reasonably indicates that no breach occurred, no further action would be taken. If, however, the investor learns that the information was disclosed in breach of a fiduciary duty, she would be required to disgorge to the principal an amount equal to the profit gained or loss avoided. By obtaining the preliminary and investigative reports, the SEC would have oversight over the entire process, where it could determine whether there are any discrepancies between the two reports and whether a further SEC investigation is warranted. If the SEC were to find that either of the reports misrepresented material information, the investor may incur additional liability. This approach would retain the advantages of the personal benefit test, promote disclosure to the SEC, and alleviate the issues presented in situations involving remote tippees.

## III. ENACTING RULE 10b5-D WILL BEST ALLEVIATE CONCERNS UNDER CURRENT JURISPRUDENCE

The personal benefit test properly imposes liability on remote tippees where material nonpublic information is improperly disclosed. However, remote tippees cannot always be expected to know whether disclosure was improper at the time they receive a tip, and the speed at which securities are traded today makes preemptive investigation costly and practically

263. *See* 18 LANGEVOORT, *supra* note 1, § 4:10; Coles, *supra* note 7, at 219 n.232.

264. The time period allocated for the investigation should be flexible and determined on a case-by-case basis to account for tipping schemes that vary in length and complexity.

impossible.[265] Thus, while the substance of the personal benefit test is sound, compliance is arduous in practice.

Implementing a safe harbor disclosure rule is the most effective way to promote prompt, informed decision making without modifying substantive law. Where a remote tippee cannot reasonably know whether material nonpublic information was conveyed for a personal benefit, Rule 10b5-D would permit her to act quickly to realize the full value of the information. The safe harbor period would provide the investor time to investigate whether the information was the product of improper disclosure. Because the investor would not be permitted to retain any profits if her investigation, or a subsequent SEC investigation, revealed that the information was disclosed in breach of a duty of trust and confidence, Rule 10b5-D would not permit the investor to profit from any informational advantage.

Rule 10b5-D provides numerous benefits to various interested parties. First, investors will benefit from the ability to make timely investment decisions without the risk of incurring liability. Because investment information is time sensitive,[266] investors will be permitted to act decisively to realize the maximum possible value of a particular tip. By allowing investors to perform the investigation after the trade has been made, investors need not forgo time-sensitive profits by performing a potentially lengthy investigation so long as they notify the SEC within two days of placing the trade. If the investor later learns that the information was obtained in breach of a fiduciary duty, then disgorgement will put the investor back where she was before the trade, thereby depriving her of any informational advantage gained by her access to improperly gained material nonpublic information. Thus, investors would be permitted to make lawful trades free from the risk of criminal prosecution without the possibility of retaining illicit profits.

Additionally, investors presented with questionable tips will be incentivized to use the safe harbor in exchange for immunity from potential legal recourse. While the odds of being caught for insider trading are low,[267] the penalties are high.[268] Thus, it is reasonable to suggest that at least some investors will be incentivized to use the safe harbor disclosure rule to avoid regulatory action and criminal prosecution even if that means disgorging profits that they might have gotten away with otherwise.

A remote tippee's incentive to utilize Rule 10b5-D is strengthened by an inherent desire to avoid uncertainty in the courtroom. Because lower courts tend to implicitly impose a fairness-based rule contrary to Supreme Court precedent of *Dirks*, remote tippees could be found guilty of securities fraud

265. *See* Ian Domowitz & Benn Steil, *Automation, Trading Costs, and the Structure of the Securities Trading Industry*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 33, 38–39 (Robert E. Litan & Anthony M. Santomero eds., 1999) (noting that automated systems have become increasingly prevalent in practically all new market development efforts).

266. *See supra* notes 211–13 and accompanying text.

267. *See supra* note 21.

268. *See supra* note 136 and accompanying text.

absent any breach of fiduciary duty.[269] Rule 10b5-D would protect investors from these deviations and better ensure the results that the personal benefit test is intended to produce.

Further, Rule 10b5-D will serve the interests of corporations, which will benefit from acquiring funds disgorged by investors where an investigation reveals that information was disclosed in breach of a fiduciary duty. Corporations have an interest in their confidential information.[270] This theory is consistent with the theory that insider trading harms a corporation because it constitutes an abuse of a fiduciary duty owed to the corporation's shareholders.[271] Assuming the profits are disgorged to the corporation, the corporation may reinvest those funds in ways that may lead to an increase in that corporation's stock price, which would ultimately benefit the shareholders. Thus, requiring investors to disgorge improperly obtained profits to the corporation protects the corporation's property interest in its information, and recognizing a corporation's assignable property interest in its material nonpublic information is consistent with the original theory of insider trading.

Rule 10b5-D will also benefit the SEC in several ways. Because the investor performs the initial investigation, the SEC would externalize some of its investigative expenses and receive information to which it would not otherwise have access. This would, appropriately, place the burden on investors because they will likely receive the greatest benefit from the rule. The additional disclosure would also allow the SEC to police stock markets more efficiently, as the information provided by remote tippees may help the SEC better identify tipping chains serving as a conduit for improperly disclosed material nonpublic information. This will ultimately help the SEC to better identify specific individuals within those schemes, which may increase the prohibition's deterrent effect and stifle the flow of improperly disclosed material nonpublic information.

Additionally, adopting Rule 10b5-D would be consistent with the SEC's role as a regulatory agency. The political motivations for the insider trading prohibitions have been evident since the Exchange Act was enacted, as evidenced by the Pecora hearings.[272] Since then, the SEC has adopted rules that effectively make claims under section 10(b) and Rule 10b-5 easier to sustain.[273] By adopting Rule 10b5-D, the SEC would assume a more neutral position, in accordance with its regulatory mandate, without condoning insider trading. Indeed, enacting Rule 10b5-D would be consistent with the express intent of both Congress and the Supreme Court.[274]

Rule 10b5-D would also preserve the integrity of the market. Absent any breach of fiduciary duty, the corporation does not suffer a legally

269. *See supra* notes 149–55 and accompanying text.
270. *See supra* note 219 and accompanying text.
271. *See supra* notes 90–94 and accompanying text.
272. *See supra* notes 69–77 and accompanying text.
273. *See supra* notes 139–46 and accompanying text.
274. *See supra* note 247 and accompanying text.

cognizable harm, and the market may benefit from exposure to material nonpublic information before the corporation makes full disclosure.[275] However, where a tip is found to have been improperly disclosed, the integrity of the marketplace would remain intact because disgorgement protects the corporation's interest in its information and ensures the informed investor does not realize any advantage from improper disclosure.[276]

Rule 10b5-D would not be susceptible to abuse. Any attempt to deceive the SEC with inaccurate preliminary or investigative reports could result in additional liability under the federal securities laws. If the investor's investigation is either unreasonable or deceptive (e.g., the investigative report concludes that the information was not obtained in breach of a fiduciary duty, but a breach in fact occurred and the reporting party had reason to know about it), then the investor could later incur double liability; she may be held liable as a remote tippee under *Dirks* for the original trade, and she may also be held liable for a separate count of securities fraud for filing a fraudulent investigative report. This separate count of liability relies on the assumption that the fraudulent investigative report constitutes "a fraudulent or manipulative device in connection with the purchase or sale of a security" under section 10(b).[277] Additionally, the ability to perform a lengthy investigation after trading diminishes a remote tippee's ability to plead ignorance with regard to whether a breach occurred.[278]

## CONCLUSION

Despite the Supreme Court's recent decision in *Salman*, there remains a number of lingering uncertainties concerning the practical implications of remote tippee treatment under the federal securities laws. Where an investor lacks sufficient facts to determine whether material nonpublic information was improperly disclosed, fear of incurring liability for insider trading might prevent her from making a lawful trade. Time spent investigating the requisite facts is costly, and the law should not deter or prevent legally permissible conduct. Where trading on material nonpublic information is not prohibited under *Dirks*, investors should not have to forgo lawful profits, because they are uncertain of facts that are beyond their knowledge or control yet pivotal in their futures. Thus, the SEC should enact Rule 10b5-D to alleviate these concerns because it will promote prompt, informed decision making without permitting the exploitation of a corporation's confidential information.

Under Rule 10b5-D, investors will be able to better make investment decisions in compliance with the law without the risk of incurring liability as a remote tippee. By performing an investigation after trading, investors

275. *See supra* notes 204–09 and accompanying text.
276. *See supra* note 219 and accompanying text.
277. *See supra* notes 81–86 and accompanying text.
278. This would also alleviate concerns with regard to the government's contention that the knowledge requirement may be satisfied by showing that the remote tippee consciously avoided learning about any breach. *See supra* note 6.

will be able to realize the full value of a particular tip that they would otherwise be lawfully permitted to make if they knew that the information was not attributable to a breach of a relationship of trust and confidence. In the event that the investor later learns that the information was improperly disclosed, disgorgement will prevent the investor from retaining any illicit profits. The SEC's oversight of the investor's investigation will prevent the safe harbor from being abused, and the SEC will benefit by acquiring more information that it can use to identify other tipping chains and schemes that may otherwise go undetected. Finally, corporations that are found to have been harmed by disloyal fiduciaries will benefit from receiving unlawfully obtained profits through disgorgement.

Of course, this Note cannot predict how often this dilemma may arise or in how many situations Rule 10b5-D would be beneficial. This would present a pressing concern if Rule 10b5-D were subject to misuse. However, the potential for additional liability will likely serve as a sufficient deterrent against misusing the safe harbor, especially since filing the preliminary and investigative reports under Rule 10b5-D would only shine a spotlight on investors who might have otherwise gone undetected. Moreover, the potential benefits that Rule 10b5-D could bestow upon investors, corporations, the SEC, and the market in general are compelling enough to justify its adoption.