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## Watching Insider Trading Law Wobble: *Obus, Newman, Salman, Two Martomas*, and a *Blaszczak*

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# WATCHING INSIDER TRADING LAW WOBBLE: *OBUS, NEWMAN, SALMAN, TWO MARTOMAS, AND A BLASZCZAK*

Donald C. Langevoort\*

The crime of insider trading is a straightforward concept that some courts have somehow managed to complicate.

—Judge Jed S. Rakoff<sup>1</sup>

## INTRODUCTION

No subject in insider trading law has wobbled more than the standards for tipper-tippee liability. After setting a fiduciary duty-based framework for insider trading liability under § 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934<sup>2</sup> in *Chiarella v. United States*<sup>3</sup> in 1980, the U.S. Supreme Court ruled in *Dirks v. SEC*<sup>4</sup> three years later that tipper-tippee liability requires proof that the tipper is breaching a fiduciary-like duty in passing on the information to the tippee for the *tipper's* own personal benefit and that the tippee knows or should know of that breach.<sup>5</sup> A host of bothersome issues arose, mostly left for future litigation over what has turned out to be decades of refinement. Judge Jed S. Rakoff has decided more than a few such cases and, far more candidly than most, expressed frustration via occasional lamentations to his readers (or the law gods) about the wobbles. His thoughts and frustrations will guide what follows, from a judge whose involvement in insider trading enforcement goes back to the *Chiarella* prosecution.<sup>6</sup>

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1. *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287, 295 (S.D.N.Y. 2018).  
2. 15 U.S.C. §§ 78a–78qq.  
3. 445 U.S. 222 (1980).  
4. 463 U.S. 646 (1983).  
5. *Id.* at 667.  
6. See *Rakoff's Roots Run Deep in Insider Trading Law*, LAW360 (May 29, 2015), <https://www.law360.com/articles/660987/rakoff-s-roots-run-deep-in-insider-trading-law> [<https://perma.cc/FGS5-2KVN>].

For two decades after *Dirks*, the law evolved incrementally in a way that made the personal benefit requirement easy for enforcers to satisfy.<sup>7</sup> Two kinds of benefits became standard: quid pro quos with some pecuniary payoffs (e.g., kickbacks to the tipper) and “gifts” of information to family members and friends. That increasingly relaxed approach emboldened both criminal prosecutors and the Securities and Exchange Commission (SEC). In a 2012 civil case, *SEC v. Obus*,<sup>8</sup> the Second Circuit offered a sweeping restatement of all the elements of tipper-tippee liability;<sup>9</sup> Judge Rakoff famously called the decision “Delphic” in his first opportunity to apply its teachings,<sup>10</sup> not in a good way. Among other things, the *Obus* framework allowed tippees to be held liable without knowledge of the tipper’s alleged benefit.<sup>11</sup>

Soon thereafter, in *United States v. Newman*,<sup>12</sup> a panel of the Second Circuit addressed personal benefit more strictly, seemingly—but without explicit language—rejecting *Obus* in the criminal context.<sup>13</sup> The court sought to connect gift-giving and benefit by demanding proof of a sufficiently close relationship between the tipper and the tippee “that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature” and insists that the tippee have actual knowledge of the breach and benefit.<sup>14</sup> *Newman* was a rare godsend for the defense side, destabilizing the doctrine on which many prior and ongoing cases were founded. But then, on review of a Ninth Circuit decision that rejected the most demanding aspects of the *Newman* approach as to gifts in family settings, the Supreme Court agreed that *Newman* went too far in its retrenchment.<sup>15</sup> Precisely how much too far was unclear, however, so the wobbling was not over.

Next came *United States v. Martoma*.<sup>16</sup> The main legal question presented on appeal in this highly publicized prosecution was whether the gift benefit prong under *Dirks* and *Salman v. United States*<sup>17</sup> requires a preexisting family relationship or friendship. Or, is there a personal gift benefit in any intentional conveyance given with the purpose or expectation that the tippee

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7. See Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1, 5–6 (2016).

8. 693 F.3d 276 (2d Cir. 2012); see also Donald C. Langevoort, “*Fine Distinctions*” in *the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 449–58.

9. *Obus*, 693 F.3d at 286.

10. See *United States v. Whitman*, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012), *aff’d*, 555 F. App’x 98 (2d Cir. 2014).

11. *Obus*, 693 F.3d at 287–88.

12. 773 F.3d 438 (2d Cir. 2014).

13. See *id.* at 455 (vacating the criminal convictions “[b]ecause the Government failed to demonstrate . . . the intent to commit insider trading”).

14. *Id.* at 452.

15. See *Salman v. United States*, 137 S. Ct. 420, 428 (2016). The court of appeals decision was written by the peripatetic visiting Judge Rakoff. See *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), *aff’d*, 137 S. Ct. 420 (2016).

16. 894 F.3d 64 (2d Cir. 2018).

17. 137 S. Ct. 420 (2016).

will trade? In its first *Martoma*<sup>18</sup> opinion, a divided Second Circuit panel said the expectation is enough, regardless of to whom, and abrogated *Newman* to the extent that it indicated otherwise by its reference to a meaningfully close relationship.<sup>19</sup> There was a petition for rehearing en banc claiming that, among other things, the panel had no authority to overturn that holding in *Newman* absent direct Supreme Court direction. Nearly a year later, in June 2018, the panel substituted a completely new opinion,<sup>20</sup> reinterpreting *Newman* rather than abrogating it, but still making the tipper's specific purpose to confer a benefit on the tippee sufficient and potentially dispositive.<sup>21</sup> Much of *Newman*'s own precious gift to Wall Street and the defense side was thus repossessed.<sup>22</sup>

None of this is news. Nearly everyone who writes much about insider trading (and a few interlopers as well<sup>23</sup>) has had something to say about this remarkable sequence of decisions. As to the panel's authority to abrogate *Newman*, for example, a case comment in the *Harvard Law Review* treats *Martoma* as a "stealth overruling" of *Newman*<sup>24</sup> but then concedes that *Newman* was a stealth overruling of *Obus* (and so on).<sup>25</sup>

Finally, at the very end of 2019, the Second Circuit sent the insider trading ball spinning yet again, holding that when a tipper-tippee case is brought as either mail/wire fraud or under a (until now) rarely utilized public company securities fraud statute, personal benefit has no place at all in the analysis. The case, *United States v. Blaszczyk*,<sup>26</sup> seemingly provides the means for criminal prosecutors, but not the SEC (or private plaintiffs), to pursue tippees

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18. 869 F.3d 58 (2d Cir. 2017), *amended* by United States v. Martoma, 894 F.3d 64 (2d Cir. 2018).

19. *Id.* at 70 & n.4.

20. *Martoma*, 894 F.3d 64. Any reference to *Martoma* throughout this Article refers to the amended opinion.

21. *Id.* at 79 (finding it appropriate to infer "that [the] corporate insider receives a personal benefit . . . from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it"); *see also* Marshall v. United States, 368 F. Supp. 3d 674, 677 (S.D.N.Y. 2019). As addressed in both the withdrawn and final opinions, this gift argument was not necessarily crucial to the outcome of the case because there was evidence of pecuniary benefit as well. Dr. Gilman, the main tipper, was being paid considerable consulting fees for his meetings with Martoma to discuss the clinical drug trials in which Gilman was involved. The disagreement between the majority and Judge Rosemary Pooler was about the correctness of the charge to the jury on the theory of gift benefit (which they both agreed was flawed) and whether it was harmless error in light of the pecuniary benefit. *Compare Martoma*, 894 F.3d at 79–80, with *id.* at 87–88 (Pooler, J., dissenting).

22. Courts in the Second Circuit have noted the effect of *Martoma* on *Newman*. *See, e.g.*, Gupta v. United States, 913 F.3d 81 (2d Cir. 2019); United States v. Pinto-Thomaz, 352 F. Supp. 3d 287, 300 (S.D.N.Y. 2018) ("What remains of *Newman* therefore applies in only the rarest of cases.")

23. Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482 (2016).

24. Recent Case, United States v. Martoma, 894 F.3d 64 (2d Cir. 2018), 132 HARV. L. REV. 1730, 1734 (2019).

25. *Id.* at 1734–35.

26. 947 F.3d 19 (2d Cir. 2019), *petition for cert. filed*, 89 U.S.L.W. 3071 (U.S. Sept. 3, 2020) (No. 20-306).

simply on their awareness that the inside information constitutes misappropriated property.<sup>27</sup>

#### I. READING *DIRKS* LITERALLY: BENEFIT TO THE TIPPER

The issue of gratuitous tipping addressed in the two *Martoma* opinions might not seem practically important but instead more of a legal brain teaser. The withdrawn opinion posed a hypothetical about a well-heeled apartment dweller giving a holiday gift to his doorman in the form of a stock tip in place of the usual cash.<sup>28</sup> But valuable tips to doormen can be seen as an effort to buy superior service for the forthcoming year, a quid pro quo. So, the substituted opinion strips this down to a gift of a stock tip to someone simply with the statement that he (the tippee) can make money by trading on the information.<sup>29</sup> Joan Heminway's article on the subject uses a more compelling "Robin Hood" hypothetical about tips meant to take from the rich and give to the poor.<sup>30</sup> All these are simplistically entertaining, but the fact that some version of the question presented itself in both *Newman* and *Martoma*, each a big-time hedge fund-related prosecution, shows how closely it lies to the subject of what constitutes a legitimate trading edge for securities professionals and where the line is that they cannot safely cross. Big money turns on the answer. Seeing why requires some background.

##### A. History, Text, and Structure

Historically, insider trading law is very much the product of a particular and now long gone historical period during which courts construed federal statutes and rules "not technically and restrictively, but flexibly."<sup>31</sup> The Second Circuit's seminal case, *SEC v. Texas Gulf Sulphur Co.*,<sup>32</sup> was an exemplary product of this kind of thinking. Even though open-market insider trading is hard to see as deceptive (the insider trader communicates nothing false or misleading simply by submitting an anonymous bona fide order to buy or sell), the word "fraud" was taken to be sufficiently elastic to

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27. See *id.* at 36–37.

28. *United States v. Martoma*, 869 F.3d 58, 70 (2d Cir. 2017), amended by 894 F.3d 64 (2d Cir. 2018).

29. *Martoma*, 894 F.3d at 75.

30. Joan McLeod Heminway, *Tipper/Tippee Insider Trading as Unlawful Deceptive Conduct: Insider Gifts of Material Nonpublic Information to Strangers*, 56 WASH. U. J.L. & POL'Y 65, 68–69 (2018).

31. See A. C. Pritchard & Robert B. Thompson, *Securities Law in the Sixties: The Supreme Court, the Second Circuit, and the Triumph of Purpose over Text*, 94 NOTRE DAME L. REV. 371, 395 (2018) (quoting *SEC v. Cap. Gains Rsch. Bureau, Inc.*, 375 U.S. 180, 195 (1963)) (identifying the Supreme Court's determination of how Congress intended courts to interpret the Investment Advisers Act of 1940).

32. 401 F.2d 833 (2d Cir. 1968) (en banc).

encompass it.<sup>33</sup> Duties seemingly reach as far as need be to inspire investor faith in market integrity.<sup>34</sup> Or so it was thought.

That generous approach to securities law was trashed by the Burger Court starting in the mid-1970s. The surprise, perhaps, is that insider trading regulation under Rule 10b-5 somehow survived this retrenchment at all. In *Chiarella*, the Supreme Court scolded the Second Circuit for its failure to restrain the overbreadth of “abstain or disclose” but then plastered together its own doctrinal edifice under the revisionist banner of fiduciary responsibility.<sup>35</sup> That naturally raised concerns about tippers and tippees, because the latter were outsiders, not fiduciaries. Even though there was no tipping at issue in *Chiarella*, Justice Lewis F. Powell Jr. dropped a footnote saying that tippees may inherit the tipper’s fiduciary duty by becoming “participant[s] after the fact” in the tipper’s fiduciary breach, i.e., *co-venturers* with the insider.<sup>36</sup>

So, when *Dirks* came to the Court three years later, Justice Powell once again got to write the opinion and, not surprisingly, turned his *Chiarella* footnote from dicta into holding. Raymond Dirks had received material nonpublic information about a massive fraud at a well-known issuer from some whistleblowers and helped them publicly expose the fraud, though not before causing his clients to dump the stock before its collapse.<sup>37</sup> Still feeling some sting from *Chiarella*, the SEC (unwisely) took aim against Dirks, insisting that the fiduciary duty of the source runs to all who came in possession of the secret with knowledge of its confidential origins. A divided D.C. Circuit affirmed.<sup>38</sup>

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33. 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION § 2:2 (2020); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 6–7 (1982).

34. See Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, 71 SMU L. REV. 835, 839 (2018).

35. *Id.* at 842, 845–49.

36. *Chiarella v. United States*, 445 U.S. 222, 231 n.12 (1980). This footnote itself has an interesting history. The co-venturer concept, which stresses that tippee culpability is entirely derivative of the tipper’s fiduciary duty, was used in a Second Circuit decision construing insider liability under Florida’s state corporation law. See *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973). But that decision was vacated by the U.S. Supreme Court on the grounds that the issue of first impression was for the Florida Supreme Court to decide. *Lehman Brothers v. Schein*, 416 U.S. 386, 390–92 (1974). The Second Circuit decision is interesting because it draws a clear distinction between the right approach to liability under state corporation law and under Rule 10b-5, the latter being more expansive. Presumably because the Second Circuit decision was formally vacated, it was not cited directly in the *Chiarella* footnote—just a reference to an American Bar Association committee letter, which cited *Schein*. *Chiarella*, 445 U.S. at 230 n.12. What the court in *Schein* was describing was a form of civil conspiracy (or more precisely, a conspiracy to breach a fiduciary duty) arising from the formation of a “common enterprise” to exploit a fiduciary obligation. *Schein*, 478 F.2d at 822. Making this connection, the court also drew from the *Restatement (Second) of Agency*, which provides for third party liability for intentionally causing or assisting a fiduciary breach. RESTATEMENT (SECOND) OF AGENCY § 312 (AM. L. INST. 1958).

37. See *Dirks v. SEC*, 681 F.2d 824, 830–33 (D.C. Cir. 1982), *rev’d*, 463 U.S. 646 (1983).

38. See *id.* at 828.

Justice Powell was not impressed. His thinking is now well known not simply because of the *Dirks* opinion itself<sup>39</sup> but because of some remarkable documents that Adam Pritchard found some time ago in Justice Powell's archived materials—opinion drafts, marginal notes, and interchamber correspondence.<sup>40</sup> From these materials, the rationale behind the *Dirks* opinion can be pieced together.<sup>41</sup> From the earliest memoranda and drafts, Justice Powell had two clear objectives: to tether the test for tipper-tippee liability to his *Chiarella* footnote and to assure that the test would not unduly chill the bona fide interactions between insiders and market analysts that he saw as necessary to market efficiency.<sup>42</sup> The first drafts of the opinion were straightforward, simply requiring a court to find that the tipper's *purpose* in passing on the information involved disloyalty to the issuer and its shareholders, which would not be the case, for example, if the insider was merely careless in divulging some bit of material information to an analyst, thinking it immaterial or already public. To this, Justice Powell and his clerk added contrasting illustrations of liability-creating motivations: quid pro quo tips for the pecuniary benefit of the tipper and “gift” tips specifically intended by the tipper to benefit the tippee.<sup>43</sup> This duality would stay largely unchanged throughout the drafting of the opinion.

This subjective approach to personal benefit was apparently pleasing to Powell—in essence, he was simply saying that the breach of duty on which tipper liability is premised is the duty of loyalty, as opposed to the duty of care. There was nothing about making the test particularly demanding

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39. See generally *Dirks*, 463 U.S. 646 (reversing the D.C. Circuit's ruling).

40. See generally *Powell Papers*, *Dirks v. Securities and Exchange Commission* (10-1982) (1983) [hereinafter *Dirks File*] (on file with the Lewis F. Powell Jr. Archives). The entire *Powell Papers* collection is available via Washington and Lee School of Law's Lewis F. Powell Jr. Archives, at <https://scholarlycommons.law.wlu.edu/powellpapers> [<https://perma.cc/X2KF-2XMG>].

41. See A. C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 859 n.13 (2015).

42. First Draft: *Dirks v. SEC*, No. 82-276 (Apr. 30, 1983), in *Dirks File*, *supra* note 40, at 172. His clerk assigned to the case, Jim Browning (now a federal judge), was much more aggressive at the outset, trying to get Justice Powell to at least consider either no tippee liability at all or even no Rule 10b-5 insider trading liability at all, *Chiarella* notwithstanding. Bobtail Bench Memorandum from Jim Browning to Justice Powell, *Dirks v. SEC*, No. 82-276 (Mar. 21, 1983), in *Dirks File*, *supra* note 40, at 2, 7–11. Browning, in turn, drew heavily in his memos and drafts from the scholarship of Michael Dooley and Frank Easterbrook. See *id.* at 8. Browning graduated from the University of Virginia School of Law, where Dooley taught.

43. In the first internal draft of the opinion, reflecting Powell's handwritten edits, the tipper prong of what would become the *Dirks* test required a purpose to benefit or “to make a gift of the information to the recipient to enable him to gain a market advantage over other traders.” First Draft: *Dirks v. SEC*, No. 82-276 (Apr. 20, 1983), in *Dirks File*, *supra* note 40, at 172, 195. A subsequent memo from Justice Powell to his clerk expressed the same idea. Memorandum from Justice Powell to Clerks (May 5, 1983), in *Dirks File*, *supra* note 40, at 59, 60. The specific reference to friends and family following these sentences appeared in a subsequent internal draft and then in the draft opinion circulated to the other Justices, as what clearly seems to be an illustration of the gift benefit, saying that “certainly” there would be a personal benefit in that situation. Fourth Draft: *Dirks v. SEC*, No. 82-276 (May 20, 1983), in *Dirks File*, *supra* note 40, at 231, 253; Chambers Draft (May 22, 1983), in *Dirks File*, *supra* note 40, at 259, 274.

beyond this, even with respect to analysts. When the first draft opinion was circulated among the Justices, he quickly got three votes to overturn the SEC. Somewhat resistant was Justice Sandra Day O'Connor, who sent Justice Powell a memo saying that she objected to his focus on the tipper's purpose, which she thought much too subjective.<sup>44</sup> She wanted him to substitute a requirement that the SEC or prosecutors prove up an actual benefit to the tipper, an objective test.<sup>45</sup>

From his notes, Justice Powell seems reluctant; as a former corporate lawyer, it would be natural for him to think of fiduciary duty in terms of an attitude of loyalty and good faith.<sup>46</sup> And fiduciary duty law has never required an actual benefit to the fiduciary or harm to the beneficiary—quite the opposite. Justice O'Connor, the former Arizona trial judge, was coming from another place entirely, concerned about evidence. Compromise ensued,<sup>47</sup> which produced a semantic mess. To preserve the thrust of his initial approach, Powell kept most of his language about purpose, along with all his illustrations.<sup>48</sup> But he also inserted the requested language about objective proof of actual benefit without much effort to reconcile the two, which, if anything, suggests (as Pritchard argues) that *both* motivation and benefit in fact may be required, even though neither Justice was advocating that particular dualism.<sup>49</sup>

### B. *Martoma and the Mighty Comma*

Back to the question: under *Dirks*, is the intent to make a gift of the information disloyal per se, or is that category limited to meaningfully close relationships with family and friends, for which it may be said—as was later repeatedly emphasized by the Supreme Court in *Salman*—that tipping someone close to you is like the tipper trading on his own and then giving the proceeds to a loved one?<sup>50</sup> I will come back to this simile in a bit.

Chief Judge Robert A. Katzmann's majority opinion in *Martoma* is a hyperclose reading of *Dirks*'s text in support of a stand-alone “intent to benefit the tippee” route to tipper-tippee liability.<sup>51</sup> In so doing, *Martoma*

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44. See Pritchard, *supra* note 41, at 865–66.

45. See *id.*

46. See Stephen Galoob & Ethan Leib, *Fiduciary Loyalty, Inside and Out*, 92 S. CAL. L. REV. 69, 86–118 (2018) (emphasizing the cognitive dimension to fiduciary loyalty). At first glance, Justice Powell may be read to welcome Justice O'Connor's suggestion (he writes back about her “quite constructive” memo), but his notes on her memo twice say “no” to what she is pushing. Pritchard, *supra* note 41, at 866; Memorandum from Justice O'Connor to Justice Powell, *Dirks v. SEC*, No. 82-726 (June 7, 1983), in *Dirks* File, *supra* note 40, at 70, 71–72.

47. The draft with Justice O'Connor's revisions can be found in the *Dirks* File. Second Draft (June 9, 1983), in *Dirks* File, *supra* note 40, at 371, 371–88. Two heavily marked up pages show how hard Powell was trying to keep as much of his approach as possible. *Id.* at 385–86.

48. *Id.*

49. Pritchard, *supra* note 41, at 870.

50. See *Salman v. United States*, 137 S. Ct. 420, 428 (2016).

51. See *United States v. Martoma*, 894 F.3d 64, 75–76 (2d Cir. 2018). The discussion here is entirely about the substituted (i.e., the authoritative) opinion, though the withdrawn one had a similar emphasis.

seizes on language in *Dirks* that had been in plain sight but largely ignored in tipping jurisprudence up until then.<sup>52</sup> The analytical progression in the key paragraph in *Dirks* says, as discussed above, that while purpose may be the ultimate question, objective proof as to the benefit is required.<sup>53</sup> It then refers to pecuniary and reputational benefit as two ways to do this (oddly using “i.e.” rather than “e.g.”).<sup>54</sup> After a citation on that point to some secondary authority, it gives examples for when the inference of such benefit is proper: “there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, *or an intention to benefit the particular recipient.*”<sup>55</sup> *Martoma* seizes on the comma in the middle of this sentence to claim that the Supreme Court is offering two distinct routes to proving a tip, the latter being a demonstrable intention to benefit the tippee without the need for any quid pro quo.<sup>56</sup> Only in the *next* sentence—with the word “also” to suggest that this is additional, not defining or limiting—is there any specific reference to friends or family or (in the sentence that follows that one) the foggy point about such tips being the equivalent of trading followed by a gift of the proceeds.<sup>57</sup>

From this textual exegesis, Katzmann concludes that intent to benefit the tippee—regardless of any preexisting relationship—suffices for personal benefit; the subsequent reference to friends and family simply illustrates that those sorts of gifts can have an element of quid pro quo, too. The panel majority in *Martoma* is thus clinging tightly to Justice Powell’s original focus on the tipper’s purpose. As noted earlier, the particular words and phrases after the comma that are crucial to Judge Katzmann are ones that appeared in Justice Powell’s drafts early on, well before Justice O’Connor’s input. As seen in the archives, the distinct idea that an intentional tip to give someone a marketplace advantage is a clear breach of loyalty is stated in the first internal draft and Justice Powell’s accompanying notes, initially without any reference to family or friends.<sup>58</sup> With all the subsequent changes that went on elsewhere in the drafting, this distinctive language about the purposeful tip in contrast to the quid pro quo remained unchanged. In dissent, however,

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52. Not surprisingly, *Martoma* claims this language was put to use in *SEC v. Warde* and even *Newman*. See *id.* at 74 (citing *SEC v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998)); *id.* at 76–77 (citing *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014)). But, in neither case does the court put much, if any, weight on this language as a distinct route to liability. See generally *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014); *SEC v. Warde*, 151 F.3d 42 (2d Cir. 1998).

53. See *Dirks v. SEC*, 463 U.S. 646, 663–64 (1983).

54. *Id.* at 663.

55. *Id.* at 664 (emphasis added).

56. See *Martoma*, 894 F.3d at 74. This reading makes the reference to relationships at the beginning of the sentence applicable only to what comes before the comma. See *Dirks*, 463 U.S. at 664.

57. See *Dirks*, 463 U.S. at 664 (“The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.”).

58. See Memorandum from Justice Powell to Clerks (May 5, 1983), in *Dirks* File, *supra* note 40, at 59, 60; First Draft: *Dirks v. SEC*, No. 82-176 (Apr. 30, 1983), in *Dirks* File, *supra* note 40, at 172, 195; see also *supra* note 43.

Judge Rosemary Pooler does just the opposite, seizing on the handful of Justice O'Connor-inspired snippets that reject purpose in favor of actual benefit, objectively demonstrated.<sup>59</sup> Judge Pooler is insistent that gift benefit arguments be accompanied by a convincing (if perhaps circumstantial) story about the potential for some kind of gain, such as the inference that giving a tip to a close family member or friend will naturally enrich all those in the relationship. She wants nothing to do with purpose as such.

The *Dirks* Court's failure to reconcile the two inconsistent ideas explains much about *Martoma*'s difficulty. It comes down to whether one can fairly read the insistence on benefit in fact as evidentiary in assessing the presence of disloyalty or something more dispositive. In other words, how much did Justice Powell give away to Justice O'Connor? Different sentences or fragments suggest different answers to this question, which is not surprising given that Justice Powell was trying to satisfy Justice O'Connor without silencing his own strong views about the motivational nature of fiduciary duty and good faith.<sup>60</sup>

Textualism aside, does it make sense to proscribe deliberate gift tips outside the circle of family and friends as breaches of loyalty? Commenting on *Obus* and *Newman*, Pritchard says no.<sup>61</sup> In contrast, Donna Nagy and Joan Heminway both say yes, in part by reference to recent Delaware fiduciary duty case law,<sup>62</sup> which puts in the category of disloyalty and bad faith actions deliberately taken without regard for the interests of the corporation. I agree with them; even without such resort, I think that there is a benefit whenever fiduciaries take something valuable as their own to do with as they please without serving their principal (the issuer or source), regardless of what they ultimately choose to do. *The secretive exercise of dominion is itself a form of (unjust) enrichment.*<sup>63</sup> Judge Rakoff seems to agree, stating in *United States v. Pinto-Thomaz*<sup>64</sup> that the "use of the term

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59. See *Martoma*, 894 F.3d at 81–83 (Pooler, J., dissenting).

60. I see little in the Supreme Court's *Salman* opinion to resolve any of this confusion. *Salman* quotes *Dirks* extensively, including sentences inspired by both Justices Powell and O'Connor as if there is no tension. See *Salman v. United States*, 137 S. Ct. 420, 427–28 (2016). Curiously, the Court puts the distinct intent to benefit the tippee language in italics, without explanation. See *id.* at 427 (identifying the Court's statement in *Dirks* that it was not the tipper's "purpose to make a gift of valuable information to *Dirks*" (quoting *Dirks*, 463 U.S. at 667)). Judge Pooler in the withdrawn *Martoma* opinion notes that the government in *Salman* made broad arguments about the meaning of tip and the role of personal benefit, which the Court sets forth. See *United States v. Martoma*, 869 F.3d 58, 86–87 (2d Cir. 2017), amended by 894 F.3d 64 (2d Cir. 2018). The opinion then immediately says that the case can be resolved on narrow grounds—the nature of gifts in a family setting. See *id.* at 87. She suggests that this is an implicit repudiation of the government's argument. See *id.* I do not see it as such but, rather, the common approach of not seeking to resolve doctrinal issues beyond what is necessary to answer the question posed by the grant of certiorari. The *Salman* Court gave no reasons why it would reject the government's position.

61. See Pritchard, *supra* note 41, at 869–74.

62. See Heminway, *supra* note 30, at 90–91; Nagy, *supra* note 7, at 42.

63. Jill Fisch seems to be making a similar point about the tipper's increase in utility. See Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, 69 STAN. L. REV. ONLINE 46, 51 (2016).

64. 352 F. Supp. 3d 287 (S.D.N.Y. 2018).

‘personal purpose’ or ‘personal advantage’ [in *Dirks*] . . . could perhaps have averted subsequent confusion.”<sup>65</sup> In other words, the stand-alone inference coheres well enough with the *Dirks* Court’s intent.

Reputational benefit—the most undertheorized form of personal benefit—is also probative here. Justice Powell adds it to the *Dirks* opinion relatively late, as part of Justice O’Connor’s edits, perhaps to make clear (in opposition to what Justice O’Connor was pushing) that personal benefit does not have to involve an immediate or certain payoff to the tipper; it is enough to reasonably hope that something good may come as payback later on. We are doubling back to purpose, in other words. No prior relationship is necessary here: consider a hypothetical where a young investment banker brazenly seeks out a big-name hedge fund manager whom he has never met and simply delivers a valuable tip with the words “you’re welcome.” Given how the favor bank works on Wall Street, this might be characterized as seeking a reputational benefit and, given the cronyism involved, certainly should be.<sup>66</sup> On the other hand, hoping for something of significant value in return may seem delusional, failing Judge Pooler’s reasonable expectations approach. So, while a sensibly broad approach to reputational benefit would obviate the need to address my hypothetical as a form of gift-giving, I think the stand-alone intent-to-benefit standard is better aligned with what animates the inclusion of reputation in the personal benefit analysis. Gratuitous tips may be good conversation starters, with the relationship coming later.

There is one more textual clue in *Dirks* that bolsters the *Martoma* conclusion, though Judge Katzmman’s opinion does not stress it. Toward the very end of the Supreme Court’s opinion, in concluding that there was no breach for personal benefit by the whistleblowing insiders—which resolves the case—it says “nor was their purpose to make a gift of valuable information to *Dirks*.”<sup>67</sup> If a meaningfully close personal relationship was essential to gift-giving, the Court presumably would have noted that, because there was no such relationship. This language, which seems to admit the possibility of a gift benefit in a tip to an investment professional with whom the tipper had no prior relationship, much less a close personal one, also fits better with *Martoma*’s reading.

This, however, brings us to the two “friends and family” sentences in *Dirks*, which explain that tipping friends and family members “resembles” the insider trading and then giving the proceeds to them.<sup>68</sup> The analogy is

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65. *Id.* at 299.

66. See Donald C. Langevoort, *Informational Cronyism*, 69 STAN. L. REV. ONLINE 37, 39 (2016). For a corruption-based theory of insider trading, see Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014).

67. *Dirks v. SEC*, 463 U.S. 646, 667 (1983).

68. *Id.* at 664. In the evolution of the *Dirks* opinion, the idea and language about friends and family, including the simile, is taken almost verbatim from an opinion piece by Leonard Chazen that appeared roughly at the time the case was being argued. See First Draft: *Dirks v. SEC*, No. 82-176 (Apr. 30, 1983), in *Dirks* File, *supra* note 40, at 172, 196–97 (citing Leonard Chazen, *Dirks Presents Unique Corporate, Social Issues*, LEGAL TIMES, Mar. 14, 1983, at 14, 18). For a while, the draft opinion gave Chazen credit for the concept with an extensive quotation, *see id.*, but Justice Powell later directed his clerk to remove the citation on grounds

only superficially helpful, because the same thing could be said about many tips; indeed, in early drafts this form of “indirect benefit” was invoked to justify the entire idea behind the personal benefit test, not just the gift prong. If the idea is that the gains to the tippee will somehow come back to enrich the tipper because of the close relationship, that seems both speculative and poorly defined. Think of the many cases that could not easily be categorized: for example, a tip to the portfolio manager of the endowment fund of one’s alma mater. There are just too many forms the relationship between tipper and tippee can take for the analogy to bear much weight in disposing of cases.

That said, the two sentences have come to be part of the canon of tipper-tippee law and not so easily bypassed. The *Salman* court used them to conclude that the gift-giving language in *Dirks* needs no further elaboration, making the sentences the rationale for rejecting *Newman*’s tightening.<sup>69</sup> And as Jack Coffee points out, taking the facts in *Martoma* (ignoring the pecuniary quid pro quo), it is very hard to see what Dr. Gilman did as “resembling” trading massively for his own account and gifting the proceeds to a hedge fund by way of Mathew Martoma.<sup>70</sup> The friends and family qualifier to gift benefit has been around, used, and quoted long enough for it to have taken on a life of its own, predating *Newman* and its gloss. So, while I have been persuaded that *Martoma*’s reading probably makes better sense of the law of fiduciary responsibility on which insider trading theory is grounded, the more conventional reading of gift benefit—bolstered by *Salman*’s fascination with the simile—may be the more likely reading, at least outside the Second Circuit or until the next stealth overruling.

## II. TWO THEORIES, CONFLICTING PRINCIPLES

Essentially, insider trading is a variation of the species of fraud known as embezzlement, which is defined in Black’s Law Dictionary as “[t]he fraudulent taking of personal property with which one has been entrusted, especially as a fiduciary.” . . . If the embezzler, instead of trading on the information himself, passes on the information to someone who knows it is misappropriated information but still intends to use it in connection with the purchase or sale of securities, that “tippee” is likewise liable, just as any knowing receiver of stolen goods would be.

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that reliance on such media commentary might not be appropriate. Second Draft: *Dirks v. SEC*, No. 82-276 (May 10, 1983), in *Dirks File*, *supra* note 40, at 204, 225. Much the same idea was also expressed in the American Bar Association letter cited in the *Chiarella* footnote with reference to friends, family, “or others.” See *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980) (citing American Bar Association Section of Corporation, Banking, and Business Law, Comment Letter on Material, Non-public Information (Oct. 15, 1973)). This cite was eliminated in editing as well. Second Draft (May 10, 1983), in *Dirks File*, *supra* note 40, at 204, 216.

69. *Salman v. United States*, 137 S. Ct. 420, 427–28 (2016).

70. John C. Coffee Jr., *Tippees and Tippers: The Impact of Martoma II*, THE CLS BLUE SKY BLOG (July 23, 2018), <http://clsbluesky.law.columbia.edu/2018/07/23/tippees-and-tippers---the-impact-of-martoma-ii> [<https://perma.cc/8HN7-JZUE>].

—Judge Jed S. Rakoff<sup>71</sup>

Judge Rakoff has for some time now expressed the wish that insider trading law be more thoroughly grounded in misappropriation, from which a simpler “stolen goods” approach to tipper-tippee liability would naturally follow. He has expressed no affection for the classical theory from which the *Dirks* test was derived. Yet today, *Dirks* controls under both theories. Again, it is helpful to go back in time.

#### A. More Doctrinal History

The federal securities law of insider trading through (and including) the retrenchment in *Chiarella* and *Dirks* was entirely about the duties to abstain or disclose that traders with an informational advantage owe to others trading contemporaneously in the securities markets. The Supreme Court held that such a duty exists when the defendant is a fiduciary who trades or tips, because others trading contemporaneously in the marketplace can be seen as the beneficiaries of that trust. This is the classical theory, for which *Dirks* sets the rule for tipper-tippee liability.

When *Chiarella* was being briefed and argued before the Supreme Court, the U.S. Solicitor General’s Office abandoned the more expansive conceptions of duty that flourished in the aftermath of the Second Circuit’s *Texas Gulf Sulphur* decision and tried to get the Court to buy into a narrower framework, which it presumably thought had a better chance before an increasingly conservative lineup of Justices.<sup>72</sup> The solicitor general’s approach made the law turn on misappropriation, which was presented in two distinct versions in the government’s brief.<sup>73</sup> One version retained the focus on protecting contemporaneous marketplace traders by imposing a duty to abstain or disclose to the market anytime the information has been misappropriated, whether by breach of fiduciary duty or mere theft. The other found deception in the breach of entrustment itself, where the trader is pretending to be a faithful fiduciary to the source of the information but in fact acting disloyally. In *Chiarella*, the majority accepted neither argument on the merits, finding them insufficiently charged below, therefore leaving both for future consideration if and when properly pled and charged. For the

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71. *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287, 295–96 (S.D.N.Y. 2018) (first alteration in original) (quoting *Embezzlement*, BLACK’S LAW DICTIONARY (10th ed. 2014)); see also *SEC v. Payton*, 97 F. Supp. 3d 558, 559 (S.D.N.Y. 2015) (containing Judge Rakoff’s statement that insider trading “is a form of cheating, of using purloined or embezzled information to gain an unfair trading advantage”), *aff’d*, 726 F. App’x 832 (2d Cir. 2018).

72. See *Langevoort*, *supra* note 34, at 846. Until shortly before briefing and argument, Frank Easterbrook was the deputy solicitor general to whom those who eventually handled the case for the Solicitor General’s Office reported. Before leaving and thereafter, Easterbrook took the lead in urging a property-based approach to insider trading. See Interview by Kenneth Durr with Frank Easterbrook, Chief Judge, U.S. Ct. Appeals for the Seventh Cir., in Chicago, Ill. (Jan. 13, 2011), [http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/oral-histories/20110113\\_Easterbrook\\_Frank\\_T.pdf](http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/oral-histories/20110113_Easterbrook_Frank_T.pdf) [https://perma.cc/H5K7-Q5Y9].

73. See generally Brief for the United States, *Chiarella v. United States*, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 213521.

time being, at least, fiduciary duty was it.<sup>74</sup> In dissent, Chief Justice Warren E. Burger said he would apply the market-facing disclosure approach to misappropriation to sustain Chiarella's conviction.<sup>75</sup> In a concurring opinion, Justice John Paul Stevens agreed with the majority but said encouraging things about the fraud-on-the-source argument for future cases.<sup>76</sup>

The Supreme Court eventually embraced the misappropriation theory a decade and a half later in *United States v. O'Hagan*.<sup>77</sup> But which version? The Second Circuit's early cases supporting misappropriation were somewhat ambiguous on this, not seeming to put much weight on—or even noticing—much in the way of substantive distinction.<sup>78</sup> Since then, however, it has become clear that it was not Chief Justice Burger's conception<sup>79</sup> but rather the argument that Justice Stevens liked. By feigning fidelity, the misappropriator deceives the source of the information, taking advantage of misplaced trust. To experts in white collar crime, this version of misappropriation bears a close family resemblance to the “honest services” idea that for so long drove many high-profile mail and wire fraud prosecutions, which would explain its quick take-up among prosecutors and judges at the time.<sup>80</sup> The biggest practical difference between the two theories has to do with the “mere theft” of information. The Burger approach readily includes all purloined information within the duty to disclose, while the fraud-on-the-source theory only kicks in when the theft takes a deceptive form, like embezzlement.<sup>81</sup> As the quotes from Judge Rakoff show, it is tempting today to treat misappropriation as *the* theory of insider trading, expressing the first principles from which insider trading doctrine should follow. After all, almost all classical cases are also misappropriation cases (though not vice versa). Indeed, Judge Rakoff seems anxious to throw the classical theory into the trash.<sup>82</sup>

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74. *Chiarella*, 445 U.S. at 236–37.

75. *Id.* at 241–43.

76. *Id.* at 237–38.

77. 521 U.S. 642, 650 (1997).

78. In the first Second Circuit decisions applying the misappropriation theory, the “Burger” and “Stevens” approaches to the theory were intermingled. For example, consider *United States v. Carpenter*, 791 F.2d 1024, 1032–33 (2d Cir. 1986), which Judge Rakoff argued on the defense side. It appears that Justice Powell considered the misappropriation theory an invalid application of § 10(b) but left the Court shortly before he would have been able to reject it in *Carpenter*. A. C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 33–34 (1998).

79. Contrary to Judge Rakoff's attribution, see *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287, 297 (S.D.N.Y. 2018).

80. About the same time as *Chiarella* was decided, Judge Rakoff, though not yet a judge, wrote an extensive survey of the history and use of the mail and wire fraud statutes. Jed S. Rakoff, *The Federal Mail Fraud Statute (Part I)*, 18 DUQ. L. REV. 771 (1980).

81. See *SEC v. Dorozhko*, 574 F.3d 42, 49–50 (2d Cir. 2009) (involving insider trading via hacking).

82. *Pinto-Thomaz*, 352 F. Supp. 3d at 297 n.3 (“While the ‘classical theory’ may still be occasionally employed even today, it is hard to imagine an insider trading case that does not fit comfortably within the confines of the misappropriation theory.”).

It is tempting to speak of misappropriation solely in property-like terms,<sup>83</sup> but this is intellectual quicksand. The resemblance to embezzlement has been noted in the case law for decades (pointedly made in the government's brief in *Chiarella*<sup>84</sup>), but, of course, embezzlement takes money or property away from its rightful owner; insider trading is merely the unauthorized use of the information, often without any measurable harm to its owner.<sup>85</sup> The misappropriation theory is more about the abuse of trust in the sharing of secrets, applicable to settings where the "owner" of the information has invested in the gathering of valuable information that has been entrusted to agents of the firm but extending well beyond. It is more contract than property and, even then, can be as much in the hands of the courts as a matter of law (fiduciary duty) than the expressed intent of the parties. Yet, the embezzlement and stolen goods rhetoric persists.<sup>86</sup> It appeals especially to conservative-leaning academics and judges because it appears to privatize the interests at stake, reducing the purview of judicial discretion to the identification of preexisting protectable economic interests rather than searching promiscuously for more public-regarding duties.

The case law on tipper-tippee liability under the misappropriation theory took a sharp turn in this direction in the 1990s. Both the SEC and criminal prosecutors took the litigation position that personal benefit was required only in classical cases, which found some (though not clear) support.<sup>87</sup> This distinction came to matter more and more as misappropriation grew in reach. The pivotal case was *United States v. Libera*,<sup>88</sup> involving "tipsters" who worked at the plant where *Business Week* magazine was printed and distributed and who—for very little, if any, compensation—delivered advance copies to recipients who used the advantage to buy and sell stocks

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83. Judge Ralph Winter played a considerable judicial role in translating an academic theory to doctrine. See his concurring and dissenting opinion on the application of the misappropriation theory in *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) (en banc). He sought to draw a line between business-related misappropriation and more informal settings in a case involving a family-controlled business.

84. See Brief for the United States, *supra* note 73, at \*16.

85. Rational insider traders take pains to conceal their trading from all but a close circle, if that, because leakage erodes the trading advantage.

86. There is also a conceptual difference. The Burger-endorsed misappropriation theory was grounded in investor protection and avoiding marketplace abuse by embezzlers and thieves. By contrast, the theory underlying fraud on the source in its pure form is the protection of the owner's property interest in exclusive use of the secrets from embezzlement and deceptive thievery. The first makes insider trading a matter of public law; the second smacks of private law. I suspect that many judges who apply the misappropriation theory as we know it today instinctively think of it as grounded in investor protection, in the spirit of Chief Justice Burger. Justice Ruth Bader Ginsburg tries hard in *O'Hagan* to make this connection, though formally adhering to the victimization of the source alone. See Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1273–74 (1998). Judge Rakoff can be read as doing so as well.

87. See, e.g., SEC v. Willis, 777 F. Supp. 1165 (S.D.N.Y. 1991); SEC v. Musella, 748 F. Supp. 1028 (S.D.N.Y. 1989). A few years later, the First Circuit read Second Circuit law as not requiring a personal benefit. See generally SEC v. Sargent, 229 F.3d 68 (1st Cir. 2000).

88. 989 F.2d 596 (2d Cir. 1993).

mentioned favorably in the investment column. The Second Circuit affirmed Rule 10b-5 liability in a striking opinion written by Judge Ralph Winter, rejecting the defendants' main argument that the workers did not actually know what the recipients intended to do with the information (i.e., it was not obviously a tip to facilitate trading because the recipients could have had many reasons for wanting an advance look). Judge Winter anticipated Judge Rakoff with repeated references to embezzlement and stolen information and firmly embraced a property rights approach.<sup>89</sup> Misuse of someone else's information was enough, apparently, and as far as what was in it for the workers, the panel said simply that "it may be presumed that the tippee's interest in the information is, in contemporary jargon, not for nothing."<sup>90</sup> *Dirks* is cited, but reference to personal benefit was conspicuously absent.<sup>91</sup> A few years later, in *United States v. Falcone*,<sup>92</sup> the Second Circuit reaffirmed *Libera* in concluding that nothing in the Supreme Court's intervening *O'Hagan* decision in any way undercut its reasoning.<sup>93</sup> The exclusion of personal benefit from the analysis was even more palpable in *Falcone*.<sup>94</sup> Misappropriation law was heading in its own direction, in other words, hastening *Dirks*'s further demise. Trial judges in the Southern District of New York were confused.<sup>95</sup>

That turn in the maze led to a dead end. *Obus*, *Newman*, and *Martoma* now all say without qualification that the *Dirks* test for tipper-tippee liability applies equally to classical and misappropriation insider trading cases, as if the stolen goods line of cases never happened. Amazingly, *Obus* (which *Newman* and *Martoma* simply follow on this point) cites *Falcone* alone for this proposition,<sup>96</sup> even though *Falcone* reads as just the opposite. In this

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89. *Id.* at 600. The court did insist on a fiduciary breach by the insider and that the tippee must know or have reason to know of the breach. In that sense, *Dirks* has an influence, but personal benefit is not part of it.

90. *Id.*

91. *See id.*

92. 257 F.3d 226 (2d Cir. 2001). *Falcone* (written by now Justice Sotomayor) makes clear that there are separate and distinct tests for tipper-tippee liability for classical and misappropriation cases, with personal benefit relegated to the former. *Id.* at 231–32.

93. *Id.* at 232–33.

94. In contrast to *Libera*, *Falcone*, and other cases distancing misappropriation cases from *Dirks*, an Eleventh Circuit case squarely adopting a unified standard noted that *Dirks* could be rendered moot simply by avoiding the lesser-included classical theory in a charge, and it seemed too consequential a holding to allow that to happen. *SEC v. Yun*, 327 F.3d 1263, 1279 (11th Cir. 2003).

95. For an expression of angst about the direction the Second Circuit law was taking at that time, see, for example, *SEC v. Smath*, 277 F. Supp.2d 186 (E.D.N.Y. 2003).

96. *SEC v. Obus*, 693 F.3d 276, 285–86 (2d Cir. 2012). Neither *Falcone* nor *Libera* states explicitly that they are rejecting personal benefit. But both (especially *Falcone*) subdivide the discussion of tippee liability with personal benefit playing a significant role in the classical context, while there is no mention of it in the separate articulation of tipper-tippee liability for misappropriation. An SEC administrative law judge took the implausible view that the latter omission is only because it was not something that needed to be mentioned by the court of appeals. *See Bolan Jr.*, Initial Decision Release No. 877, 2015 WL 5316569 (Sept. 14, 2015). On review, an equally divided commission affirmed the administrative law judge's dismissal of the SEC's case. *See Joseph C. Ruggieri*, Securities Act Release No. 10389, Exchange Act Release No. 81143, 2017 WL 2984863 (July 13, 2017).

sense, *Obus* put a sudden stop to one wobble in the tipper-tippee case law but set another in motion as district court judges faced up to the challenges of applying the personal benefit test in the wave of hedge fund trader prosecutions that were cresting at the time, including the prosecutions leading to *Newman* and *Martoma*.

### B. Dirks as a Workhorse

Anyone who thinks that the stock market is a level playing field obviously has no contact with reality.

—Judge Jed S. Rakoff<sup>97</sup>

Judge Rakoff is right, of course. But insider trading law has never really promised a level playing field. There was a brief period of time after *Texas Gulf Sulphur* when it might have been so read, but that passed surprisingly quickly. By the mid-1970s, even the SEC had rejected strict egalitarianism as bad law and bad policy. The courts in the Second Circuit distanced themselves from its unrealistic implications as well. As I have written elsewhere recently in tracing this history, by the time of *Chiarella*, the equality principle had mainly become a bogeyman for Wall Street to use in pushing back against insider trading law's reach.<sup>98</sup>

Since that time, insider trading law has been read mainly for the work it does. Most courts and commentators seem to treat the Supreme Court's decision as straightforward and (assuming they take it seriously) functional in design—about sorting the circumstances in which outsiders gain an informational advantage into the good and the bad. As courts up through *Obus* made light of personal benefit, critics saw this as a perversion of the Court's original intent that could undermine the work it is supposed to be doing, although for most of that time neither the SEC nor prosecutors were targeting market professionals in a way that pushed hard on these efficiency concerns. With the hedge fund cases, that changed: *Newman* and its enthusiasts were resurrecting *Dirks* not only in form but in function. Two recent empirical studies of stock trading by market professionals found that the *Newman* decision was followed immediately by a noticeable step-up in aggressive trading.<sup>99</sup>

The common story is that *Dirks* is all about market efficiency and (to some at least) protecting property rights in private information. As to the former,

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97. Thomas A. Zaccaro, Nick Morgan & Lily Lysle, *The Insider Trading Mess Congress Is Trying to Fix*, LEXOLOGY (May 16, 2019) (quoting an April 16, 2019, bench ruling by Judge Rakoff on a pretrial motion in *Pinto-Thomaz*), <https://www.lexology.com/library/detail.aspx?g=266c1283-c920-4b56-a508-667e53e518c9> [<https://perma.cc/J9W5-ALKL>].

98. See Langevoort, *supra* note 34, at 840–43, 846.

99. See Manesh S. Patel, *Does Insider Trading Law Change Behavior?: An Empirical Analysis*, 53 U.C. DAVIS L. REV. 447, 479–84 (2019); Marcin Kacperczyk & Emiliano Pagnotta, *Becker Meets Kyle: Inside Insider Trading* (Nov. 30, 2019) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3142006](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3142006) [<https://perma.cc/GPC7-ZR8A>]. The latter authors also show that in the few years before *Newman*, with the arrival of Preet Bharara as U.S. attorney for the Southern District of New York, there were more cautious trading patterns. *Id.* at 5.

legitimate information searching should not be chilled by the threat of liability; the elements of tipper-tippee liability should thus work to protect analysts and professional traders. As discussed, this idea gets prominence in both *Chiarella* and (especially) *Dirks*, so there is no doubt it was important to Justice Powell and his colleagues in the majority of those two cases.

Deciding doctrinal issues by reference to first principles is hard without a clear theory of what those principles should be, however. A fairness-based, level playing field principle is sometimes put forth in favor of aggressive regulation (which almost automatically signals disdain for *Dirks* and *Newman*) but is notoriously difficult to substantiate via hard evidence. More sophisticated versions focus on market liquidity and the cost of capital.<sup>100</sup> The “alt” theory in insider trading, as noted, is that it is solely to protect the property rights belonging to the owner of the information from embezzlement or its equivalents. Judge Winter’s opinions in *United States v. Chestman*<sup>101</sup> and *Libera* took this on as their mission, as previously discussed. A fundamental implication of the property rights idea is that the owner gets to do with the information as they wish, free of government meddling at least so far as the securities laws are concerned. While an early version of this idea implied that there was no need for federal regulation at all—owners can protect themselves using common-law agency, fiduciary, tort, contract, and property principles—that seems to have faded in favor of seeing insider trading law as a useful federal law tool for sanctioning informational embezzlers.

But recall that Judge Winter still wanted no place for personal benefit. By contrast, in his commentary on *Newman* and the withdrawn *Martoma* opinion, Professor Jon Macey argues that a personal benefit requirement is crucial to cement a strict property rights/private ordering approach.<sup>102</sup> He thus treats the *Dirks* test (including personal benefit strictly applied) as a necessary protection for dissemination of information that serves the owner’s private self-interest.<sup>103</sup> If we are reasoning from first principles, however, it is unclear why personal benefit is a better test than what Macey really seems to want to get at—*business purpose*, which the majority emphasized in *Martoma*. The standard reading of *Dirks* from the beginning is that a tip genuinely motivated by a belief that the tip is in the issuer’s best interest does not violate Rule 10b-5. A handful of courts in the Second Circuit have suggested that looking for business purpose is indeed a sound way to apply

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100. See Merritt B. Fox et al., *Informed Trading and its Regulation*, 43 J. CORP. L. 817, 833–35 (2018); see also Merritt B. Fox & George Tepe, *Personal Benefit Has No Place in Misappropriation Tipping Cases*, 71 SMU L. REV. 767, 776–77 (2018) (arguing that the law is not so clear that further change could not take place to restore the view that the *Dirks* test be confined to classical cases). In many ways Fox and Tepe anticipate the *Blaszczak* case. See *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019), *petition for cert. filed*, 89 U.S.L.W. 3071 (U.S. Sept. 3, 2020) (No. 20-306).

101. 947 F.2d 551 (2d Cir. 1991) (en banc).

102. See generally Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018).

103. See *id.* at 876; see also Jonathan Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE 64, 66–67 (2016).

*Dirks*: if no plausible business purpose can be gleaned from the facts, the presumption is of personal benefit.<sup>104</sup> Indeed, this follows from the reading of *Dirks* given earlier, requiring objective evidence from which to infer subjective (selfish) purpose.

However this particular issue is resolved, I worry that it concedes too much authority to the “owner” of the information. This is inevitable under the fraud-on-the-source approach to misappropriation, where it is clear that the owner can license others to trade on the information for any reasons it wishes, regardless of any adverse effects on the marketplace. The law is far less clear under the classical theory, which makes me less inclined to put it in deep storage the way Judge Rakoff seems willing to do.

Suppose an independent, disinterested board of directors authorizes the CEO and CFO (and others, perhaps) to trade with abandon on any inside information they possess. (A more realistic example might be to allow senior executives to trade without restriction for forty-eight hours after the latest 10-K or 10-Q.) Would that provide a complete defense to an insider trading charge brought by the SEC, assuming that the defendant possessed material, nonpublic information at the time of the trade? Property rights advocates would argue, with some force, that the issuer owns the information so that, assuming proper corporate governance principles are satisfied, those in authority can waive the fiduciary obligations that would otherwise attach, just as under the misappropriation theory. But if we see the classical theory as a federally created duty owed to marketplace traders, it is far from clear that such absolution would work simply by operation of the state law principles of corporate governance.<sup>105</sup> Precedent favors treating trading by the issuer itself (stock buybacks in particular) as unlawful under Rule 10b-5 if the issuer is in possession of undisclosed material facts.<sup>106</sup> But if the issuer cannot trade based on inside information, why is *Dirks* commonly read to say that selective disclosure (tipping to an analyst or active shareholder) is

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104. See LANGEVOORT, *supra* note 33, § 4:7 (citing SEC v. Rubin, No. 91 CIV. 6531, 1993 WL 405428 (S.D.N.Y. Oct. 8, 1993)); see also SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995). The government made this argument to the Supreme Court in *Salman*, but the Court affirmed on narrower grounds.

105. Both *Chiarella* and *Dirks* triggered some debate about “issuer-authorized” insider trading. For an extensive discussion with citations as to the pros and cons of insider trading as a default rule, see Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225, 1263–67 (2017). For an argument in favor, see John P. Anderson, *What’s the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIA. L. REV. 795 (2015).

106. See LANGEVOORT, *supra* note 33, § 3:6 (discussing cases); see also Mark J. Loewenstein & William K. S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45 (2005). The SEC agrees. See Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, 47 Fed. Reg. 53,333, 53,334 n.5 (Nov. 26, 1982) (to be codified at 17 C.F.R. pt. 240); Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,953 n.5 (Nov. 17, 2003) (to be codified at pts. 228–29, 240, 249, 270, and 274). On the policy importance of this, see Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801 (2014). The adoption of Regulation FD, see *infra* note 125, is an even more dramatic rejection of issuer control over “its” information.

permissible so long as intended to carry out company policy, which is *Newman's* high ground?<sup>107</sup>

### III. NEVER MIND: THE *BLASZCZAK* DETOUR

And so we come to the Second Circuit's most recent wobble on personal benefit, *Blaszczak*, holding that the *Dirks* personal benefit test only applies to claims of securities fraud within the confines of Rule 10b-5 (or more precisely, the Securities Exchange Act of 1934), not to mail or wire fraud prosecutions or the "new" Sarbanes-Oxley criminal securities fraud statute.<sup>108</sup> Judge Richard J. Sullivan's opinion is an embrace of embezzlement as the touchstone for these Title 18 statutes, which does connect it to all the foregoing in this Article. He is channeling (with attribution via multiple citations) what both Judges Winter<sup>109</sup> and Rakoff<sup>110</sup> have said: when insider trading is thought of as misappropriation akin to embezzlement, a stolen goods approach to the liability of those who receive tips makes sense without any personal benefit gloss. As noted, until *Obus*, that was arguably the Rule 10b-5 law in the Second Circuit, and so—albeit only in the criminal context—*Blaszczak* may just be correcting the wobble from *Obus's* earlier apparent mischaracterization of *Libera* and *Falcone*. This makes it at least a partial stealth overruling, without even touching Rule 10b-5.<sup>111</sup>

The law of mail and wire fraud is massive, even as to the specific issue of misappropriation of intangible property, and certainly as to the "honest services" jurisprudence that went into its own wobble and has not ever, so far as I can tell, found stability.<sup>112</sup> In its decision in *Carpenter v. United States*,<sup>113</sup> the Supreme Court explicitly accepted the possibility that mail and

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107. Other academics and I have posed some version of this question for some time. See, e.g., Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023 (1990); see also LANGEVOORT, *supra* note 33, § 4:7. More recently, with reference to *Newman* and *Martoma*, see Fox & Tepe, *supra* note 100, at 773–74; Michael Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519, 542–43 (2017).

108. *United States v. Blaszczak*, 947 F.3d 19, 34–37 (2d Cir. 2019), *petition for cert. filed*, 89 U.S.L.W. 3071 (U.S. Sept. 3, 2020) (No. 20-306); see also 18 U.S.C. § 1348.

109. In his concurring opinion in *Chestman*, Judge Winter explicitly addressed the relationship between Rule 10b-5 and mail fraud doctrine as to personal benefit, acknowledging that it was a hard question he was not ready to answer. *United States v. Chestman*, 947 F.2d 551, 581 (2d Cir. 1991).

110. See *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287, 298 (S.D.N.Y. 2018); *United States v. Whitman*, 904 F. Supp. 2d 363, 370–71 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).

111. Judge Sullivan was the trial judge in the *Newman* case, taking *Obus* at its word about having no need for awareness of personal benefit, and was then famously reversed. See *United States v. Newman*, 773 F.3d 438, 443–44 (2d Cir. 2014) (describing proceedings below).

112. Illustrated most notably by the Supreme Court decision in *United States v. Skilling*, 561 U.S. 358 (2010). See also Brette M. Tannenbaum, Note, *Reframing the Right: Using Theories of Intangible Property to Target Honest Services Fraud After Skilling*, 112 COLUM. L. REV. 359 (2012).

113. 484 U.S. 19 (1987).

wire fraud can reach insider trading even when Rule 10b-5 might not;<sup>114</sup> starting immediately in the aftermath of its decision (which made many securities law types uncomfortable<sup>115</sup>), commentators and judges asked whether *Dirks*'s personal benefit test should have any continuing place with respect to crimes akin to embezzlement.<sup>116</sup> Whatever the preferred answer, the issue was always in plain sight but of little import so long as personal benefit was easily found, which only changed after *Newman*. Judge Rakoff has long been a mail/wire fraud exceptionalist (once calling mail fraud the prosecutors' "Stradivarius"<sup>117</sup>), wanting to treat securities fraud as a mere "specialized subspecies" of the more fundamental mail and wire fraud prohibition.<sup>118</sup> In *Blaszczak*, the Stradivarius came out of its case.<sup>119</sup>

Being no fan of the personal benefit test, I am not bothered by the new music. If *Martoma* is right that it can easily be satisfied by any deliberate tip, the test is doing little more than distinguishing between breaches of loyalty and care. *Blaszczak* insists on a taking for personal use (i.e., a misappropriation), so the practical impact of the ruling is small.

However, the shift in emphasis from civil to criminal that *Blaszczak* invites raises two conjoined concerns that can produce collateral damage in SEC cases. Criminalization invites judges to get on their high horses about

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114. *See id.* at 28; *see also* United States v. O'Hagan, 521 U.S. 642, 678 n.25 (1997) (indicating that it was not the Court's job to decide whether this kind of result was good enforcement policy). In *Blaszczak*, the Court puzzlingly also sought to bolster the case for allowing mail fraud to have a broader reach than Rule 10b-5 by reference to Justice Thomas's dissenting opinion in *O'Hagan*, United States v. Blaszczak, 947 F.3d 19, 36 (2d Cir. 2019) (citing *O'Hagan*, 521 U.S. at 682 n.1 (Thomas, J., dissenting)), and *United States v. Bryan*, *id.* (citing United States v. Bryan, 58 F.3d 933, 953 (4th Cir. 1995)), both of which were efforts to strike down the misappropriation theory under Rule 10b-5—which the majority of the Court rejected.

115. *See generally* John C. Coffee Jr., *Hush!: The Criminal Status of Confidential Information After McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 AM. CRIM. L. REV. 121 (1988).

116. *See, e.g.*, Michael R. Dreeben, *Insider Trading and Intangible Rights: The Redefinition of the Mail Fraud Statute*, 26 AM. CRIM. L. REV. 181, 214 (1988). More recently, Bill Wang gave this issue substantial coverage in *Application of the Federal Mail and Wire Fraud Statutes to Criminal Liability for Stock Market Insider Trading and Tipping*, 70 U. MIA. L. REV. 220 (2015).

117. Rakoff, *supra* note 80, at 771.

118. United States v. Whitman, 904 F. Supp. 2d 363, 373 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x 98 (2d Cir. 2014).

119. The court's point about personal benefit makes more sense in terms of mail and wire fraud. Section 1348 is meant for the world of public company securities fraud, though characterized by immense confusion about why it was needed and what it does differently from § 32(a) of the 1934 Act, whether as to insider trading or more generally. *See* Wendy Gerwick Couture, *Criminal Securities Fraud and the Lower Materiality Standard*, 41 SEC. REGUL. L.J. 77 (2013); Karen E. Woody, *The New Insider Trading*, 52 ARIZ. ST. L.J. 594 (2020); *see also* LANGEVOORT, *supra* note 33, § 8:13. A principal proponent in Congress was Senator Patrick Leahy, who indicated the need to create a mechanism for prosecution not bound by technical limitations. That is odd, because that is precisely why § 10(b) was created. *See* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990). Perhaps Leahy would point to the decision by Enron prosecutors to charge a margin violation to avoid a more complicated route to convictions. *See* William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961 (2003).

embezzlement and common thievery; at the same time, there is the impulse to rein in the laws' application in the name of notice and lenity.<sup>120</sup> The former can inadvertently pulverize the more nuanced equitable principles that underlay insider trading policy; the latter can spillover to the civil context where they lose most of their punch.

We see this in the part of *Newman* that survives today: the insistence that the tippee have knowledge of both the tipper's breach and the personal benefit. The phrase *Dirks* used—"should know"—has seemingly been lost in translation.<sup>121</sup> Consider the facts of *Newman* if brought in a civil enforcement context. The defendants were third- and fourth-level tippees of earnings-related information from Dell and NVIDIA, which came from mid-level insiders at the issuers.<sup>122</sup> The "gift" part of the case arose because it was not obvious why they leaked the information; there were casual relationships between the insiders and the analyst/acquaintances who were the first-level tippees, not known down the chain of other tippees.<sup>123</sup> However, the leaks were high quality and repeated, suggesting deliberateness from within the companies.<sup>124</sup> The court stressed that these leaks might well have been designed to serve the issuer's interests, but if these particular tippers were acting with authorization, it would seem to be a gross violation of the SEC's Regulation FD.<sup>125</sup> My sense is that, had *Newman* been a civil enforcement proceeding, liability under Rule 10b-5 could be sustained.

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120. Judge Rakoff notes this in *SEC v. Payton*, 97 F. Supp. 3d 558, 559 (S.D.N.Y. 2015), but finds sufficient evidence of knowledge or avoidance. The finding of liability in *Payton* was subsequently affirmed, 726 F. App'x 832 (2d Cir. 2018). At roughly the same time as Judge Rakoff, another judge in the Southern District of New York moved in the same direction by suggesting that the standard for tippee liability in civil cases should still be drawn from *Obus*. See *SEC v. Jafar*, No. 13-cv-4645, 2015 WL 3604228 (S.D.N.Y. June 8, 2015).

121. I read *Newman* as limited to criminal prosecutions, where the requirement of willfulness might explain why it ignored the *Dirks* phrase. Arguably, that would leave *Obus* standing in SEC actions. But the case nowhere says that or invokes the criminal willfulness requirement as explaining the derivation of a knowledge test. In *Dirks*, Justice Powell did not see his test (which for him was all about the tipper's disloyal purpose) as addressing the scienter requirement. See Pritchard, *supra* note 41, at 867–68. Justice Powell's clerk at the time vaguely recalls that this was just an effort to conform to language in pre-*Chiarella* precedent. *Id.* at 864–65, 865 n.43. This makes some sense in that the more expansive formulation could be found in two authorities cited at around this point in the opinion, Professor Louis Loss and former SEC Commissioner Richard Smith, whose concurring opinion in an SEC administrative proceeding in many ways gave Justice Powell a roadmap for (and was repeatedly cited in) *Chiarella* and *Dirks*. See *Invs. Mgmt. Co.*, Exchange Act Release No. 9267, 1971 WL 120502 (July 29, 1971).

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

123. See *id.* at 443, 453–454.

124. See *id.* at 454.

125. Regulation FD is an SEC disclosure rule requiring that if material nonpublic information is to be given to analysts or active shareholders, it must simultaneously be disclosed to the public. See LANGEVOORT, *supra* note 33, § 12:12. By all accounts, it was adopted by the SEC because of concern that, under *Dirks*, selective disclosure is hard to sanction. The category of persons whose disclosure triggers the Regulation FD obligation include lower or mid-level personnel authorized by higher-ups to convey such information; unauthorized personnel are presumed to be acting for personal benefit. I agree with Donna Nagy that Regulation FD ought to play a role in fashioning insider trading rules, even though it explicitly is not an insider trading rule itself. See Nagy, *supra* note 7, at 39–41. An

Also, by defending the counterintuitive result that the SEC's burden in civil enforcement can be more stringent than in criminal prosecutions, *Blaszczak* may inadvertently become self-fulfilling, blowing the personal benefit requirement back out of proportion. Defendants will insist that the distinction between the presence of personal benefit (civil) and its absence (criminal) be respected. That may be the next wobble to watch.

#### CONCLUSION

Lamentations aside, the best animating rhetoric for insider trading regulation today can be found in Judge Rakoff's own words: the promise to fight against a playing field that is tilted in favor of cheaters, i.e., those who would wrongfully exploit their access to secrets.<sup>126</sup> His insider trading jurisprudence (holdings, dicta, and asides) harkens back to Chief Justice Burger in *Chiarella*, who had the good idea of building a more expansive source of wrongful access or use while avoiding the unrealism of equal access.<sup>127</sup> Going back a number of years now, Judge Rakoff has been calling for Congress to replant the garden maze of doctrine that has too many circles and dead ends by writing a clear statutory definition of insider trading.<sup>128</sup> Putting aside his claim (with which I disagree) that insider trading is a straightforward concept, he is right about the unnecessary complications some courts have caused. Surely there is a better way going forward.

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intentional violation of a law (Regulation FD) is, under contemporary corporate law, a breach of loyalty.

126. *SEC v. Payton*, 97 F. Supp. 3d 558, 559 (S.D.N.Y. 2015) (“The United States securities markets—the comparative honesty of which is one of our nation’s great business assets—cannot tolerate such cheating if those markets are to retain the confidence of investors and the public alike.”), *aff’d*, 726 F. App’x 832 (2d Cir. 2018).

127. See Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella’s History, Central Bank’s Future*, 20 DEL. J. CORP. L. 865, 883–84 (1995). Donna Nagy has long championed Chief Justice Burger’s view of misappropriation as well. I read Chief Justice Burger as grounding the case against *Chiarella* in terms of embezzlement or theft but not confining the Rule 10b-5 duty to violations of positive criminal law. His approach presumably takes in all wrongful ways of obtaining or using inside information.

128. See *United States v. Whitman*, 904 F. Supp. 2d 363, 367 n.1 (S.D.N.Y. 2012), *aff’d*, 555 F. App’x 98 (2d Cir. 2014); see also *Payton*, 97 F. Supp. 3d at 559. Many others agree. See, e.g., Roberta S. Karmel, *The Fiduciary Principle of Insider Trading Needs Revision*, 56 WASH. U. J.L. & POL’Y 121 (2018). Judge Rakoff is currently taking part in the revisionist effort. See THE BHARARA TASK FORCE ON INSIDER TRADING, REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING (2020), <https://static1.squarespace.com/static/5e1f2462d354fa5f5bac2699/t/5e2a1e9d12e0c33aefc41303/1579818654541/Report+of+the+Bharara+Task+Force+on+Insider+Trading.pdf> [<https://perma.cc/C5US-9KW2>].