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Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?

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Cindy A. Schipani and H. Nejat Seyhun

Abstract

It has been over fifty years since the United States Securities and Exchange Commission held that insider trading on material, nonpublic information is illegal, and despite the passage of the Insider Trading Sanctions Act in 1984, Insider Trading and Securities Fraud Enforcement Act in 1988, and the Sarbanes-Oxley Act of 2002, there is still no clear definition of "material, nonpublic information." This Article argues that the ambiguity of what constitutes illegal insider information enables corporate insiders to engage in profitable transactions without legal consequences. Furthermore, we argue and provide evidence that the necessity of showing a tipper's personal benefit creates evidentiary difficulties, which, along with the ambiguity of "material, nonpublic information," has made the recent increased penalties against insider traders ineffective. In response, this Article proposes a new evidentiary standard that is simple, easy to implement, and difficult to circumvent by insiders.

KEYWORDS: Insider Trading, Corporate Law

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Cindy A. Schipani[*] *& H. Nejat Seyhun*[**]

ABSTRACT

It has been over fifty years since the United States Securities and Exchange Commission held that insider trading on material, nonpublic information is illegal, and despite the passage of the Insider Trading Sanctions Act in 1984, Insider Trading and Securities Fraud Enforcement Act in 1988, and the Sarbanes-Oxley Act of 2002, there is still no clear definition of "material, nonpublic information." This Article argues that the ambiguity of what constitutes illegal insider information enables corporate insiders to engage in profitable transactions without legal consequences. Furthermore, we argue and provide evidence that the necessity of showing a tipper's personal benefit creates evidentiary difficulties, which, along with the ambiguity of "material, nonpublic information," has made the recent increased penalties against insider traders ineffective. In response, this Article proposes a new evidentiary standard that is simple, easy to implement, and difficult to circumvent by insiders.

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INTRODUCTION

A crackdown on financial fraud over the past fifteen years has led to the passage of the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, and significant increases in insider-trading prosecution.[1] The statutory penalties for illegal insider trading are almost as severe as those for first degree murder, yet some estimate that insiders profit more than $6 billion on transactions every year.[2] The increase in penalties over this time has done little to deter insider trading.[3] What is the explanation for this paradox?

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1. *See* Mirela V. Hristova, *The Case for Insider-Trading Criminalization and Sentencing Reform*, 13 TRANSACTIONS: TENN. J. BUS. L. 267, 276-80 (2012)

2. Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801 (2014).

3. *See* Hristova, *supra* note 1, at 276-80 (2012); *see also* Patrick Augustin, Menachem Brenner & Marti G. Subrahmanyam, Informed Options Trading Prior to

Even though more than eighty years have passed since the enactment of the Securities Exchange Act of 1934 (the "Exchange Act"), prohibiting fraud in the purchase or sale of any security,[4] and more than fifty years have passed since *Cady, Roberts* held that insider trading on material, nonpublic information is illegal,[5] neither the United States Congress nor the United States Securities and Exchange Commission (the "SEC") has provided a clear definition of the phrase "material, nonpublic information." In the case of litigation, courts have typically found insider trades made immediately prior to the disclosure of corporate takeovers, earnings announcements, or dividend announcements to be unlawful.[6] Immediately is generally interpreted as meaning within days or hours of an announcement by the firm. However, it is much less clear whether trading one month before an announcement is legal. Equally unclear is the legality of trading on other types of valuable information, such as corporate structuring, new security issues, corporate borrowing decisions, or personnel changes, all of which can significantly impact stock prices.[7] We argue that the ambiguity of the term "material, nonpublic information" enables corporate insiders to engage in problematic, profitable transactions without legal consequence.

Over the past thirty years, Congress has responded to public concern over increased insider trading by passing legislation that has repeatedly increased the penalties upon conviction. In 1984, Congress passed the Insider Trading Sanctions Act ("ITSA"),[8] followed by the

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M&A Announcements: Insider Trading? (Oct. 26, 2015) (unpublished working paper), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2441606 [http://perma.cc/7H6R-QNLM].

4. *See* Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012); *see also* 17 C.F.R. § 240.10b-5 (2015).

5. *See* Cady, Roberts & Co., 40 S.E.C. 907 (1961), 1961 WL 60638.

6. *See* Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1663 (1992) (noting that insider trading is associated with immediate price movements and quick price discovery).

7. *See e.g.*, Karl-Adam Bonnier & Robert F. Bruner, *An Analysis of Stock Price Reaction to Management Change in Distressed Firms*, 11 J. ACCT. & ECON. 95 (1989); Steven Davidoff Solomon, *In Corporate Disclosure, a Murky Definition of Material*, N.Y. TIMES: DEALBOOK (Apr. 5, 2011, 5:57 PM), http://dealbook.nytimes.com/2011/04/05/in-corporate-disclosure-a-murky-definition-of-material/?_r=0 [http://perma.cc/4TB3-GYS9].

8. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

Insider Trading and Securities Fraud Enforcement Act ("ITSFEA")[9] in 1988, and the Sarbanes Oxley Act ("SOX")[10] in 2002. Currently, the penalties from insider trading can reach up to twenty years in prison and up to $1 million in fines for each offense.[11] Despite increased congressional action to address issues stemming from insider trading, the legislature has yet to define clearly what exactly constitutes illegal insider information.

This matter is further complicated by *Newman*,[12] a recent decision by the Second Circuit that endorses a strict interpretation of the Supreme Court's holding in *Dirks v. SEC* requiring a showing of personal benefit to insider-tippers before attaching liability to tippees.[13] More specifically, in order to establish tippee liability, the Second Circuit now requires the government to "prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."[14] This ruling significantly raises the bar for establishing liability because traders can evade the requirement by adding additional layers between the original tipper and the eventual tippee. We argue that the additional ambiguity created by *Newman*, which was recently denied certiorari,[15] will lead to an increased frequency and profitability of insider trading to the detriment of the investing public and its confidence in public markets.

We therefore advocate for a clearer definition of "material, nonpublic information." Increasing civil and criminal penalties does not

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9. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100- 704, 102 Stat. 4677.

10. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

11. *See* Hristova *supra* note 1, at 279-80.

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

13. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983) (holding that derivative (tippee) liability can only be found where the insider-tipper "personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."). In *Dirks*, the insider-tipper shared personal information with an analyst (the defendant) in order to expose an insurance scam being perpetrated by the tipper's company. *Id.* at 648-49.

14. *See Newman*, 773 F.3d at 442.

15. United States v. Newman, 136 S. Ct. 242 (2015) (denying certiorari); *see also* Ed Beeson, *SEC Loses Insider Trading Case on Home Court*, LAW360 (Sept. 14, 2015, 3:44 PM), http://www.law360.com/articles/702227/sec-loses-insider-trading-case-on-home-court [http://perma.cc/7TKY-CB2V].

work as a successful deterrent if there is substantial ambiguity about what constitutes illegal insider trading. This ambiguity allows insiders to not only trade successfully, but also to fend off attempts by private litigants, the SEC, and the U.S. Department of Justice (the "DOJ") to discipline them after the fact. The evidence presented in this Article confirms our hypothesis and shows that insider trading has become increasingly prevalent while the threat of sanctions continues to weaken.

To achieve a clearer definition, we urge the courts, the SEC, and Congress to adopt an evidentiary presumption. Our proposed presumption is simple, easy to implement, and difficult for insiders to circumvent. It provides that a prima facie case of trading on material, nonpublic information be found upon proof that (1) the information giving rise to the trade is of the type that requires an 8-K filing by the corporation, (2) its announcement leads to statistically significant abnormal stock returns,[16] and (3) the insider trading has occurred within two months prior to the announcement of the information. Given that corporations file 10-Q and 10-K reports every three months, these conditions, in effect, require that all insider trading based on 10-Q and 10-K information be confined to approximately a one-month window after each earnings announcement.[17] If all three conditions are satisfied, then the burden of proof must shift to the insiders to show that the particular transaction does not meet the material, nonpublic information requirement. Furthermore, any tipping by insiders of any information satisfying these three conditions must again shift the burden of proof to defendants to show that their tip should be exempted.[18]

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16. Standard deviation of stock returns for a typical publically listed company is about 50% per year or about 3.3% per day. This means that to be statistically significant at the 5% level, the announcement must lead to a stock price change of 7% or greater on the announcement day.

17. Typically, two to three days after earnings announcements is also considered a black-out period to allow markets to fully digest the earnings information. This, in effect, confines insider trading to the four-week period after each earnings announcement.

18. This proposal is based, in part, on evidence that information disclosed in Form 8-K filings provides new and material information to the public. Recent research shows that 15,419 transactions executed by insiders during the four business days prior to the filing of Form 8-K reports exhibit statistically significant abnormal trading profits of 42 basis points. This finding indicates that insiders can and do exploit the new information contained in 8-K reports. *See* Alma Cohen, Robert J. Jackson, Jr. & Joshua R. Mitts, *The 8-K Trading Gap* (Sept. 7, 2015) (Columbia Law & Econ., Working Paper No. 524, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2657877 [http://perma.

Of course, this evidentiary presumption does not cover all possible instances of insider trading, as it is not intended to be comprehensive. For instance, insiders may trade on material, nonpublic information, but still end up losing money due to unexpected circumstances. Insiders may also exploit long-lived information beyond two months. Our objective is to provide a prima facie presumption of what is always considered material, nonpublic information, similar to Rule 14e-3 (described below), which declares takeover-related information to always be material and nonpublic. We recognize that other types of trading may still fall in a gray area, which will need to be resolved through a fact-finding process.

We expect additional clarity will allow all insiders who want to be on the safe side of the law to ensure that their transactions do not meet any of the conditions set forth above. Insiders already know which events trigger an 8-K filing. By not trading or tipping during the two-month window preceding an upcoming 8-K filing, insiders can easily ensure that at least two of the three conditions will not be satisfied. The benefit of this additional clarity should enable courts to separate routine insider trading from opportunistic trading and increase the confidence in the public equity markets.

The remainder of this Article is organized as follows. Part I discusses the development of insider trading law, and recent developments in materiality of insider trading information, including the role of the *Newman* decision. Part II outlines the numerous criminal and civil penalties imposed upon the undefined offense of insider trading. Part III describes our proposal for a new evidentiary presumption, and discusses the potential effects of the *Newman* decision in establishing liability under insider trading laws. In Part IV, we argue that insiders exploit the vagueness in the statutes to engage in profitable transactions, and as a result, the profitability of insiders' transactions is itself a measure of the ineffectiveness of the insider trading laws. We also present evidence on time-series profitability of historical insider trading to gauge the deterrence effect of the insider trading laws. This Article then sums up our findings and presents our conclusions.

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I. THE DEVELOPMENT OF INSIDER TRADING LAW

Insider trading is not defined in federal securities laws. Therefore, the courts are left to interpret whether a trade is fraudulent, which requires a determination of whether the information used was material and nonpublic. The lack of a statutory or regulatory definition in this respect is troublesome and out of line with many jurisdictions across the Atlantic.[19] In the United States, the offense is based on interpretations, both judicial and administrative, of the antifraud provisions in Section 10(b) of the Exchange Act and SEC Rule 10b-5.[20] While state causes of action and liability for securities fraud existed long before either was enacted,[21] serious federal involvement did not begin until 1961, when the SEC argued in *Cady, Roberts* that federal antifraud provisions should extend to cover insider trading.[22] The crime is either criminal or civil, and has been interpreted by the courts as requiring intent.[23]

According to the SEC, insider trading "generally occurs when a security is bought or sold in breach of a fiduciary duty or other relationship of trust and confidence while in possession of material, nonpublic information."[24] "Inside information" is generally understood to be "nonpublic information about events or circumstances related to a

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19. *See* Edward Greene & Olivia Schmid, *Duty Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 372, 424 (2013). In the European Union, for example, the offense is defined in a statutory directive, the Market Abuse Directive. The Directive is detailed and the crime is premised on the concept of parity of information without a requirement of deception or misleading conduct, or breach of a fiduciary duty or any similar relationship of trust and/or confidence. *Id.* at 372. The SEC lobbied for a similar parity-of-information approach, but this approach was rejected in *Chiarella*, where the Supreme Court found it too broad in scope because Rule 10b-5 is based on fraud. *See* Chiarella v. United States, 445 U.S. 222, 233-34 (1980). The parity-of-information approach is focused on the information, not how the person obtains it from his or her source, and does not involve criminal intent. The United States has not adopted this approach and continues to suffer from lack of clear definitions of insider trading.

20. *See* Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2015).

21. *See, e.g.*, Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 293 (1999).

22. *See* Cady, Roberts & Co., 40 S.E.C. 907 (1961), 1961 WL 60638; Thompson, *supra* note 21, at 293.

23. *See, e.g.*, *Chiarella*, 445 U.S. at 227-28.

24. *See SEC Enforcement Actions: Insider Trading Cases*, SEC, http://www.sec.gov/spotlight/insidertrading/cases.shtml [http://perma.cc/B6B3-WRR2] (last modified Jan. 28, 2015).

company's assets or earning power known only to corporate management and its confidants, and which can reasonably be expected to have a material effect on the company's share price."[25]

Not all insider trading cases involve this type of information, however. Some concern trading by professionals on nonpublic market information, and others include "tipping" this information to others. The SEC defines information as being material if its release could affect the company's stock price. The SEC definitions and rules are generally broader than the limited rulings of the courts. This part will describe in detail how the legal landscape for insider trading has developed through both regulation and caselaw.

A. Lack of Statutory Clarity

Section 10(b) of the Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement[,] 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.[26]

SEC Rule 10b-5 similarly states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

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25. Roberta S. Karmel, *The Law on Insider Trading Lacks Needed Definition*, 68 SMU L. REV. 757 (2015).
26. Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2012).

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To 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.[27]

It is notable that neither the statute nor the regulatory rule even utilize the phrase "insider trading," let alone define it. Instead, insider trading has been considered fraud, covered by the above statute and rule, through court interpretation.[28]

Historically, the SEC and Congress have not agreed on the definition of insider trading. The SEC resisted defining insider trading in fear that a definition would enable more fraud.[29] Therefore, it has passed rules to clarify the borders of what the crime constitutes based on the court decisions on the matter throughout the years. When the United States Senate[30] and the United States House of Representatives[31] attempted to define insider trading with proposed bills in 1987, the SEC proposed its own bill.[32] These bills, however, adopted different approaches. Whereas the Senate and SEC gave contemporaneous traders the ability to recover damages, the House put forward a criminal statute.[33]

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27. 17 C.F.R. § 240.10b-5 (2015).

28. *See, e.g.,* Cady, Roberts & Co., 40 S.E.C. 907 (1961), 1961 WL 60638 (the first decision to hold that Section 10(b) of the Exchange Act and SEC Rule 10b-5 apply to insider trading); *Chiarella*, 445 U.S. at 230 (1980) (the first Supreme Court case to hold that Section 10(b) and Rule 10b-5 cover insider trading).

29. *See, e.g.*, Jed S. Rakoff, Judge, PLI Securities Regulation Institute Keynote Address: Is the S.E.C. Becoming a Law unto Itself? (Nov. 5, 2014), http://securitiesdiary.files.wordpress.com/2014/11/rakoff-pli-speech.pdf [http://perma.cc/XMW3-Z5GD] (noting that the SEC "has repeatedly resisted any effort by Congress to statutorily define insider trading, preferring to leave the concept sufficiently flexible as to be able to adjust to new developments"); Jill E. Fisch, Letter to the Editor, *The Muddle of Insider Trading Regulation*, N.Y. TIMES (Nov. 24, 1991), http://www.nytimes.com/1991/11/24/business/l-the-muddle-of-insider-trading-regulation-101791.html [http://perma.cc/RQC8-TFAH].

30. S. 1380, 100th Cong. (1987).

31. H.R. 1238, 100th Cong. (1987).

32. *See* Karmel, *supra* note 25, at 766.

33. H.R. 1238.

The Senate bill would have considered "information [to have been] used or obtained wrongfully only if it [had] been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence."[34] The SEC, on the other hand, wanted to outlaw trading while in possession of material, nonpublic information if that information "has been obtained by, or its communication would constitute, directly or indirectly (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship."[35] This change to "possession" without an accompanying "use" resulted in no action being taken by Congress until the ITSFEA,[36] which increased the sanctions for the crime, but failed to provide any help in defining insider trading.[37]

B. DEFINING INSIDER TRADING THROUGH THE COURTS

In large part due to the lack of statutory clarity, the courts have found it necessary to shape the boundaries of what constitutes illegal insider information through caselaw. In *Cady, Roberts*, the first insider trading case under Rule 10b-5, the SEC found that a broker-dealer's liability derived from the conduct of one of its principals, a director of a corporation that decided to make a dividend cut.[38] The SEC held that the director had violated Rule 10b-5 when, soon after leaving the board meeting where he had learned of the dividend cut, he sold the securities of that corporation held in customer accounts of the broker-dealer, including those in which he had a beneficial interest.[39] The SEC emphasized the existence of a relationship, which gave the director access to inside information only intended for a corporate purpose, and

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34. S. 1380, at 3.
35. *See* Karmel, *supra* note 25, at 766 (citing *Accompanying Letter, and Analysis by Ad Hoc Legislation Committee,* 19 Sec. Reg. & L. Rep. (BNA) 1817 (Nov. 27, 1987)).
36. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.
37. *See* Karmel, *supra* note 25, at 766.
38. *See* Cady, Roberts & Co., 40 S.E.C. 907 (1961), 1961 WL 60638, at *1.
39. *Id.* at *4.

the unfairness of allowing him to take advantage of this information by trading without disclosure.[40]

In *Texas Gulf Sulphur*, the Second Circuit adopted this view when it affirmed an injunction against an issuer, its officers, and its employees disallowing them from trading and tipping others to trade stocks and options based on insider information concerning a large copper strike by the issuer in Canada.[41] The court rooted its decision in the theory that investors trading on impersonal exchanges should have similar access to material information.[42] In this case, and in those following, the SEC would argue that in the public securities markets, Rule 10b-5 requires a parity of information among traders.[43]

In *Investors Management*, investment advisers and mutual fund managers sold stock in a company because of a selective disclosure from the underwriter of the company's debentures of a reduction in its earnings.[44] The SEC held that anyone who obtains insider information, "which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of [Rule 10b-5]."[45] Commissioner Smith's concurring opinion further stated that the tippee must know that "the information was given to him in breach of a duty by a person having a special relationship to the issuer" and the information must have substantially contributed to the trading at hand.[46] The case exemplifies the two main questions of the debate: (1) whether possession of insider information is enough for a violation, or if it also has to be used, and (2) whether the tippee trading on the information must know that it was given in breach of a duty by someone with a special relationship with the company in question in which he or she cannot disclose this information.[47] This concurring opinion would resonate in a later ruling of the Supreme Court.

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40. *Id.*
41. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).
42. *Id*. at 849.
43. Karmel, *supra* note 25, at 759.
44. *See* Investors Mgmt. Co., 44 S.E.C. 633 (1971), 1971 WL 120505, at *2-3.
45. *See* Karmel, *supra* note 25, at 760 (citing *Investors Mgmt.*, 1971 WL 120505, at *8).
46. *See* Karmel, *supra* note 25, at 760.
47. *See id.*

Almost a decade later in *Chiarella,* the Supreme Court rejected this parity of information theory, stating that not every case of financial unfairness violates Rule 10b-5.[48] In this case, the Court reversed the conviction of an employee of a financial printing house who, upon learning of upcoming tender offers for a few target companies, purchased shares in those companies in order to sell them at a profit after the tender offers were announced.[49] Because the names of the companies were not well disguised, the employee was able to ascertain their names on his own and, thus, was not tipped. Noting this, the Court held that "silence in connection with the purchase or sale of securities may operate as a fraud" only if "liability is premised upon a duty to disclose arising from a relationship of trust and confidence."[50]

Apart from its majority opinion, the case also generated an important dissent from Chief Justice Warren Burger, which helped to shape the development of insider trading law. In his dissent, he stated that the general rule that does not require parties to an arm's length business transaction to disclose information, in the absence of a confidential or fiduciary relation,

> permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.[51]

In the 5-4 decision, the majority of the Justices presumably supported the misappropriation doctrine.[52]

In response to their defeat in *Chiarella*, the SEC passed Rule 14e-3.[53] Rule 14e-3 creates a "disclose or abstain" from trading requirement for anyone who (1) possesses material information concerning a tender offer, and (2) knows or has reason to know the information is nonpublic

48. *See* Chiarella v. United States, 445 U.S. 222, 231-32 (1980).
49. *Id*. at 224-25.
50. *Id*. at 230.
51. *Id.* at 239-40 (Burger, J., dissenting).
52. *See* Karmel, *supra* note 25, at 760-61 (citing *Chiarella*, 445 U.S. 222).
53. 17 C.F.R. § 240.14e-3 (2015).

and derived from the offeror or target company.[54] The SEC regards this as a prophylactic rule and argues that neither scienter nor breach of duty is required to trigger a violation.[55] This rule proved to be useful in prosecutions involving advance knowledge of tender offers; in fact, both the SEC and the DOJ prosecuted a number of cases under this rule on the basis of the misappropriation theory.[56]

The courts have also been faced with determining how to define insider trading under the various theories within the context of tippees. The Supreme Court explicitly rejected the equal access or parity of information theory in *Dirks*, and overturned the SEC's sanctions against Raymond Dirks by finding that a tippee's liability is derivative.[57] Dirks, an insurance company analyst, received information from a former officer of a company and began an independent investigation whereby he discovered that the company was engaging in large-scale fraud.[58] After Dirks told his clients and other potential clients about his findings, many sold their shares of the company. The Court rejected the SEC's argument that when tippees come into knowledge of material information they know is confidential, they must publicly disclose it or abstain from trading.[59] Instead, the court held that a tippee is only liable if the tipper breached a fiduciary duty by receiving a personal benefit via the tip.[60]

Following the ruling, the SEC attempted to distinguish the case of *Stevens* from *Dirks*.[61] In *Stevens*, a CEO made a number of unsolicited calls to some securities analysts to tell them the soon-to-be announced quarterly results would be lower than expected.[62] The SEC argued that,

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54. *See id.*

55. *See* Karmel, *supra* note 25, at 761 n.33 (citing Tender Offers, 45 Fed. Reg. 60,410 (Sept. 4, 1980)).

56. *See* Karmel, *supra* note 25, at 761; *see also* Steginsky v. Xcelera Inc., 741 F.3d 365, 370 (2d Cir. 2014) (reversing the trial court's dismissal of insider trading charges where defendants allegedly traded on information concerning a planned tender offer); SEC v. Jacobs, No. 1:13-CV-1289 (N.D. Ohio June 11, 2013) (denying defendants' motion for judgment as a matter of law where downstream tippees allegedly traded on information concerning a planned tender offer).

57. *See* Dirks v. SEC, 463 U.S. 646, 659 (1983).

58. *See id.* at 648-50.

59. *See id.* at 653-54.

60. *See id.*

61. SEC v. Stevens, Litigation Release No. 12,813, 48 S.E.C. Docket 739, 1991 WL 296537, at *1 (Mar. 19, 1991).

62. *See id.*

through his selective disclosure, the CEO attempted to benefit by enhancing his reputation and managerial status.[63] Following a settlement in the case, the SEC adopted Regulation Fair Disclosure ("Regulation FD"), which imposes a duty on public companies that disclose insider information to analysts or others in the industry to simultaneously disclose that information publicly.[64]

The courts and the SEC also do not agree on the interpretation of situations involving the tipping of family members by insiders. For example, in *Chestman*, a husband tipped a stockbroker based on information he had received from his wife, who had received it through a line of family members, starting with a family member who was a corporate insider.[65] The stockbroker was prosecuted in the matter, but the Second Circuit overturned the conviction under Section 10(b),[66] arguing that a family relationship is not a sufficient basis to establish the fiduciary relationship necessary based on *Chiarella* and *Dirks*.[67] Following this holding, the SEC passed Rule 10b5-2, which establishes that "(3) whenever a person receives or obtains material, nonpublic information from his or her spouse, parent, child or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information," he or she has a duty of trust and confidence under the misappropriation theory.[68]

Disagreement among the circuit courts regarding the interpretation of the causal connection between a trader's possession of insider information and his or her trading has only contributed to the confusion. For example, the Second Circuit held in *Teicher* that "knowing

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63. *Id*.

64. *See* 17 C.F.R. § 243.100 (2015). Regulation FD cannot lead to private damages suits or criminal prosecution, as it is not promulgated under Sections 10(b) or 14 of the Exchange Act. Regulation FD provides in pertinent part, that "[w]henever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to [a broker, dealer, investment adviser, investment company, or holder of the issuer's securities], the issuer shall make public disclosure of that information: (1) [s]imultaneously, in the case of an intentional disclosure; and (2) [p]romptly, in the case of a non-intentional disclosure." *Id.* § 243.100(a), (b)(1).

65. *See* United States v. Chestman, 947 F.2d 551, 555 (2d Cir. 1991) (en banc).

66. He was convicted under Rule 14e-3, however. *Id*. at 554.

67. *See id.* at 571.

68. *See* 17 C.F.R. § 240.10b5-2.

possession" is sufficient to establish insider trading liability.[69] Yet, in *Adler*, the Eleventh Circuit found that "use" is required.[70] In *Smith*, the Ninth Circuit required a proof of "use" in a criminal case because criminal intent cannot be based on a legal presumption.[71] The SEC answered the question by passing Rule 10b5-1, which establishes that trading "on the basis" of insider information means the trader "was aware of" the information when the trade was made.[72]

The Supreme Court again dealt with insider trading in *O'Hagan*, where the Court reinstated a criminal conviction under Rules 10b-5 and 14e-3 of a lawyer who traded in the securities of a target company when the bidder was a client of the lawyer's firm.[73] This holding further advanced the Court's agreement with the misappropriation theory, and found that the SEC can "regulate nondeceptive activities as a reasonably designed means of preventing manipulative acts" under Section 14(e).[74] Following many victories for the SEC and the DOJ, both have prosecuted insider trading more robustly. The SEC alone has prosecuted almost 600 defendants in civil insider trading cases over the past five years.[75]

C. THE AMBIGUITY OF DEFINING "MATERIAL, NONPUBLIC INFORMATION"

In addition to the law's imprecision in detailing the acts that constitute insider trading, there is also no clear answer as to what constitutes "material, nonpublic information." In general, "material" information is information that fits into one or more of the following categories: (1) there is a *substantial likelihood* that a *reasonable investor* would consider the information as important in making his or her

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69. *See* United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993).
70. *See* SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998).
71. *See* United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998).
72. *See* 17 C.F.R. §240.10b5-1.
73. *See* United States v. O'Hagan, 521 U.S. 642, 647-48 (1997).
74. *Id*. at 666-73.
75. *See* Andrew Ceresney, Director, Division of Enforcement, SEC, *Testimony on "Oversight of the SEC's Division of Enforcement"* (Mar. 19, 2015), http://www.sec.gov/news/testimony/031915-test.html [http://perma.cc/8Z4L-VW2F].

investment decisions,[76] (2) the disclosure of such information would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available,"[77] or (3) the disclosure of the information is "reasonably certain to have a substantial effect on the market price of the security."[78]

The SEC defines information as "nonpublic" when investors "may not lawfully acquire [it] without the consent of the source," or when the information may be lawfully disseminated, but has not been made available to investors generally.[79] According to the SEC, insiders must wait a "reasonable" amount of time after disclosure before trading, and what constitutes a "reasonable" amount of time depends on the circumstances of the disclosure.[80]

The courts, in contrast, have focused more on the "material" portion of the test. The basic test for materiality was established in *List v. Fashion Park, Inc.*, in which the court held that the materiality of the information rests on "whether a reasonable man would attach importance [to the information] in determining his choice of action in the transaction in question."[81] This includes any information that "in reasonable and objective contemplation might affect the value of the corporation's stock or securities."[82] Material information also encompasses "those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."[83]

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76. *See* JOINT MARKET PRACTICES FORUM, STATEMENTS OF PRINCIPLES AND RECOMMENDATIONS REGARDING THE HANDLING OF MATERIAL NONPUBLIC INFORMATION BY CREDIT MARKET PARTICIPANTS 4 (2003), http://www.isda.org/c_and_a/pdf/jmpfStatement.pdf [http://perma.cc/B9MZ-65DA].

77. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

78. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980) (citing SEC v. Bausch & Lomb Inc., 565 F.2d 8, 15 (2d Cir. 1977)).

79. *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 322 n.2 (1979).

80. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,721 n.40 (Aug. 24, 2000) (citing Faberge, Inc., 45 S.E.C. 249 (1973), 1973 WL 149283, at *6) (adopting release for Regulation FD and Rules 10b5-1 and 10b5-2).

81. *See* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1974).

82. *Id*. at 462 (quoting Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); *see also* Kronfeld v. Trans World Airlines, Inc, 832 F.2d 726, 732 (2d Cir. 1987).

83. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

The determination of materiality is fact-specific; hence, the same information may be material or non-material depending on the circumstances.[84] In practice, certain factors seem to satisfy the materiality test easily. For example, the Chartered Financial Analyst ("CFA") guidelines generally include the following information as material: dividend increase, decrease, or omission; quarterly earnings of sales considerably different from consensus; gain or loss of a major client; changes in management; important developments within the industry; government reports of economic trends; large acquisition or divestiture; and when an offer is made to tender shares.[85] Courts often cite the market price impact of the information and the source of the information in support of a finding of materiality. A court is more likely to find the information material when the source of the information is reliable.[86]

On numerous occasions, the courts have found that confidential information about tender offers can be material, nonpublic information. The following cases were discussed in Part I.B in the context of how the act of insider trading has been interpreted. This discussion will highlight the aspects of those cases that relate to the courts' attempts to define "material, nonpublic information."

In *Chestman*, the Second Circuit held that "[o]ne violates Rule 14e-3(a) if he trades on the basis of material, nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf."[87] This case involved a husband who tipped a stockbroker based on information that his wife received from her family members.[88] The court found that the husband's statement to the broker that the corporation would be sold at a "substantially higher" price than its market value was material, nonpublic information.[89]

In *O'Hagan*, the Supreme Court held that a lawyer who had knowledge of a tender offer of the corporation his firm was representing was in possession of material, nonpublic information.[90] James O'Hagan

84. *See* Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988).
85. *See* CFA INST., STANDARDS OF PRACTICE HANDBOOK 59-61 (11th ed., 2014).
86. *Id*.
87. *See* United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (en banc).
88. *See id*. at 555.
89. *See id*. at 564.
90. *See* United States v. O'Hagan, 521 U.S. 642, 647 (1997).

was a partner in a law firm that was retained as local counsel to represent Grand Metropolitan PLC ("Grand Met") in a potential tender offer for the common stock of the Pillsbury Company.[91] O'Hagan did not do any work on the representation of the company and the firm withdrew from representing the company less than a month before the tender offer became public.[92] While the firm was still representing Grand Met, O'Hagan began to purchase call options of Pillsbury stock, giving him rights to purchase additional shares.[93] By the time the tender offer became public, he owned 2500 unexpired options, which was more than any other individual investor.[94] As the stock price shot up, O'Hagan sold his call options and common stock at a profit of more than $4.3 million.[95] Accordingly, the SEC began an investigation into these transactions alleging that O'Hagan defrauded his law firm and its client, Grand Met, by using material, nonpublic information regarding the planned tender offer for personal trading purposes.[96] A jury convicted O'Hagan on all fifty-seven counts, but a divided panel of the Eighth Circuit reversed these convictions.[97] The Supreme Court, however, reversed the ruling of the Eighth Circuit and held that under Rule 14e-3(a), it is unlawful to trade based on material, nonpublic information that concerns a tender offer where the person knows or should know that the information was acquired from an insider of the offeror or issuer, or someone working on their behalf, unless such information and its source are publicly disclosed within a reasonable time before any purchase or sale.[98]

In *Chiarella*, the Supreme Court held that an employee of a financial printing house that printed takeover bids was in possession of material, nonpublic information when he deduced the names of the target companies (based on the information contained in documents delivered to the printer) and purchased stock in the target companies.[99] In this case, however, the individual did not have a duty to disclose

91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id*. at 648.
96. *Id.*
97. *Id.* at 649.
98. *Id.* at 666-69.
99. *See* Chiarella v. United States, 445 U.S. 222, 231, 236 (1980).

because he had no fiduciary duties to, or specific relationships with, the shareholders in the corporation.[100] Nevertheless, the information he possessed was considered to be material and nonpublic despite the Court holding that he was not liable for trading on that information.[101]

Knowledge of confidential facts that could have a significant impact on the price of the company's stock can also constitute material, nonpublic information. In *Texas Gulf Sulphur*, the defendants had knowledge of confidential information regarding Texas Gulf Sulphur's ("TGS") drilling activities in Timmins, Ontario when such information was not publicly available, and a few of the defendants had disclosed this information to others for use.[102] TGS had discovered a very prosperous mining area where the discovery hole was referred to by one mining publication as "one of the most impressive drill holes completed in modern times."[103] The Second Circuit disagreed with the trial judge and found that the knowledge of TGS's discovery hole would have been important to a reasonable investor and could have affected the price of stock; therefore, it was material information.[104] Furthermore, the Court stated that an important factor in determining whether this information was material was "the importance attached to the drilling results by those who knew about it."[105]

Similarly, in *Adler*, the Eleventh Circuit held that an executive and board member of a company was in possession of material, nonpublic information when he was told at a board meeting that the company would be receiving fewer orders from one of its largest customers.[106] In addition, the Second Circuit held in *Teicher* that the defendant, a principal of Drexel, a securities firm, possessed material, nonpublic information when he received the names of the companies on the Drexel "phantom list."[107] The list contained the names of companies Drexel would not be able to trade in because the firm was working on transactions involving these companies.[108]

100. *Id.* at 232-33.
101. *Id.* at 235.
102. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 840-42 (2d Cir. 1968).
103. *See id.* at 850.
104. *See id.*
105. *Id.* at 851.
106. *See* SEC v. Adler, 137 F.3d 1325, 1328 (11th Cir. 1998).
107. *See* United States v. Teicher, 987 F.2d 112, 114, 119 (2d Cir. 1993).
108. *Id.* at 114-15.

The information can also be "soft," and still be found material. In *Smith,* the Ninth Circuit explained that "soft" information means forward-looking information such as the "forecasts of future sales and revenue."[109] The court held that "'soft' information can, under the proper circumstances, be 'material' within the meaning of Rule 10b-5."[110]

Lastly, information about fraudulent corporate practices can also be material information. In *Dirks*, the officer of a New York broker-dealer firm received information about a corporation from one of its former officers alleging that it had overstated its assets due to fraudulent corporate practices.[111] He urged Dirks to verify the alleged fraud and to disclose it publicly.[112] Dirks began an investigation and discussed his findings with investors and clients, which resulted in a number of large investment advisers liquidating their holdings of more than $16 million in the company's stock.[113] As a result, the corporation's stock fell dramatically.[114] The Court found that the information of fraud shared by Dirks was material, nonpublic information.[115]

D. TIPPEE DERIVATIVE LIABILITY, "PERSONAL BENEFIT," AND *NEWMAN*

Although it is clear that the ambiguity as to what type of acts and information constitute insider trading and give rise to liability is pervasive, the following section will discuss in more depth how this ambiguity has affected the development of tippee liability.

The Court in *Dirks* rejected the view of the SEC that a tippee has a duty to abstain from trading simply because he has received material, nonpublic information from an insider.[116] Instead, in order for a tippee to be held liable for trading on material, nonpublic information, the tipper must have breached her duty "before the tippee inherits the duty to disclose or abstain."[117] As the *Dirks* Court explained, because there are

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109. United States v. Smith, 155 F.3d 1051, 1064 (1988).
110. *Id.* at 1065.
111. *See* Dirks v. SEC, 463 U.S. 646, 648-49 (1983).
112. *Id.* at 649.
113. *Id.*
114. *Id.* at 650.
115. *Id.* at 649-51.
116. *Id.* at 656-58.
117. *See id*. at 664.

many legitimate reasons why an insider might disclose material, nonpublic information, the test for insider breach "is whether the insider personally will benefit, directly or indirectly, from his disclosure."[118] Accordingly, personal benefit may be satisfied in many ways, including by proof of pecuniary benefits, reputational benefits that will promote future earnings, the benefit associated with "mak[ing] a gift of confidential information to a trading relative or friend," or even the mere existence of a relationship between the insider and tippee that suggests a *quid pro quo* arrangement.[119] Absent some personal gain, there has been no breach of duty by the insider,[120] and absent a breach by the insider, there is no derivative breach.[121] Moreover, because the antifraud provisions of Section 10(b) and Rule 10b-5 require scienter,[122] in order for tippee liability to exist, a tippee must also know or have reason to know that the tipper has disclosed in breach of a duty of confidence.[123] Negligent disclosure of information, therefore, is not sufficient.[124] Whether recklessness is sufficient remains open to debate. The circuits are split on this question and the Supreme Court has yet to address it.[125]

The federal courts also remain divided as to whether, and the extent to which, a tippee-violator must be aware of a personal benefit received by the tipper. As noted above, some courts are content to infer that a tippee was complicit in the tipper's breach simply on the basis of a preexisting relationship between the two. Others, like the Second Circuit in *Newman,* appear to require much more.[126] In December of 2012, Todd

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118. *See id.* at 662.

119. *See id.* at 664.

120. *Id.* at 662.

121. *Id.*

122. Liability for securities fraud requires proof of scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud." *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

123. *See Dirks*, 463 U.S. at 660.

124. *Id.*

125. *See* SEC v. Obus, 693 F.3d 276, 286 (2d Cir. 2012) ("While the Supreme Court has yet to decide whether recklessness satisfies section 10(b)'s scienter requirement . . . we have held that scienter may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care.").

126. *See* United States v. Newman, 773 F.3d 438, 450 (2d Cir. 2014) (requiring proof beyond a reasonable doubt that "(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee

Newman and Anthony Chiasson were found guilty of committing securities fraud in violation of Sections 10(b) and 32 of the Exchange Act and SEC Rules 10b-5 and 10b5-2, as well as of conspiring to commit securities fraud under 18 U.S.C. § 371.[127] Newman and Chiasson traded on material, nonpublic information received third and fourth hand from insiders at Dell and NVIDIA.[128] Newman and Chiasson argued that neither knew the identity of the original source of information, nor did they know that this source violated a duty of confidentiality or received a personal benefit.[129]

At trial, the defendants argued that because there was no evidence that they had possessed such knowledge, the government had failed to establish tippee liability under *Dirks*.[130] In response, the government claimed that *Dirks* only required that the "tippee know that the tipper disclosed information in *breach of a duty*," not that the tippee also know that the insider received a personal benefit in exchange for information.[131] The government further contended that the defendants were "sophisticated traders," and therefore, should have known that such information was disclosed by insiders in breach of a fiduciary duty and not for a legitimate business purpose.[132] The district court agreed with this assessment and instructed the jury that the government only had to prove that the defendants "must have known that [the insider information] was originally disclosed by the insider in violation of a duty of confidentiality."[133] After being convicted by the jury on all counts, both defendants appealed the decision on the grounds that the government needed to prove that they had the knowledge of the personal benefit provided to the tippers under *Dirks*.[134] They further claimed that

knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit").

127. *See id.* at 442.
128. *Id.* at 445.
129. *See id.* at 444.
130. *Id.*
131. *Id.* at 447.
132. *Id.* at 443-44.
133. *Id.* at 444.
134. *Id.* at 442.

there was insufficient evidence to prove the tippers received a personal benefit in exchange for the disclosed information.[135]

On appeal, the Second Circuit held that, under *Dirks*, it was necessary for the government to prove that the tippees knew the breach of duty was for a personal benefit. The court reached this conclusion because a tippee's liability is derivative,[136] and therefore, a tippee cannot be held liable unless the insider breached a fiduciary duty owed to his or her clients or organization by receiving a personal benefit "in exchange for the disclosure." [137] The court agreed with the Supreme Court's rejection of "the SEC's theory that a recipient of confidential information (i.e., the tippee) must refrain from trading 'whenever he received inside information from an insider.'"[138] As the court explained, "insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries."[139] Hence, the test established in *Newman* necessitates a showing of proof beyond a reasonable doubt that:

> (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.[140]

The court also held that the benefit must be objective, consequential, and represent a potential gain of a pecuniary or similarly valuable nature; hence, a mere friendship is insufficient to constitute personal benefit.[141] The decision vacated the convictions and ordered the district court to dismiss the indictment with prejudice, in part, because it found insufficient evidence to support a pecuniary benefit.[142] According to the court, tippee knowledge of a breach of the duty of confidentiality,

135. *Id.*
136. *Id.* at 446.
137. *Id.* at 447.
138. *Id.* at 446.
139. *Id*. at 449.
140. *Id*. at 450.
141. *Id*. at 452.
142. *Id.* at 455.

without tippee knowledge of tipper personal benefit, is insufficient to impose criminal liability.[143]

E. THE LIMITS OF *NEWMAN*

Newman leaves a large gap in its interpretation for potential inside traders to escape liability. The *Newman* decision reaffirmed the personal benefit requirement for insider trading convictions and illuminated the high evidentiary burden necessary for downstream tippees.[144] Prior to the holding in *Newman*, the government had worked to limit the *Dirks* benefit test. For example, it found the test to be satisfied when the tip was made in exchange for "maintaining a useful networking contact,"[145] or when it simply entailed "making a gift of information to a friend."[146] The *Newman* decision makes it more difficult for the government to win in cases where evidence of a pecuniary benefit is not easy to prove, such as when reputational benefits are the alleged benefit the tipper received.

The *Newman* decision's tippee-liability formula diverges from common federal practice. Rather than allowing tippee knowledge of tipper breach of the duty of confidence to satisfy the scienter requirement, the Second Circuit requires that the tippee also know of a personal benefit that will accrue to the tipper as a result of disclosure. Whether this distinction makes any practical difference, however, remains somewhat unclear. This is because a court must rely on the *Dirks* objective bases for proving tipper personal benefit in assaying tippee knowledge of personal benefit—most notably, evidence of a relationship implying a *quid quo pro* arrangement.

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143. *See id.* at 450.

144. *United States v. Newman: Second Circuit Ruling Portends Choppier Waters for Insider Trading Charges Against Downstream Tippees*, GIBSON DUNN (Dec. 15, 2014) [hereinafter GIBSON DUNN], http://www.gibsondunn.com/publications/Documents/US-v-Newman—Second-Circuit-Ruling-Portends-Cho
ppier-Waters—Insider-Trading-Charges-Against-Downstream-Tippees.pdf [http://perm a.cc/R5AY-JHR6].

145. *See* United States v. Whitman, 904 F. Supp. 2d 363, 371 n.7 (S.D.N.Y. 2012).

146. *See* SEC v. Obus, 693 F.3d 276, 291 (2d Cir. 2012) (citing Dirks v. SEC, 463 U.S. 646, 664 (1983)).

1. Newman's Impact on the Personal Benefit Test

The *Newman* court held that the government had presented insufficient evidence of "personal benefit," in part because the insider tippers, Rob Ray and Chris Choi, "were not 'close' friends" and "were merely casual acquaintances" with the first level tippees, Sandy Goyal and Hyung Lim.[147] The court, for instance, found the evidence that Goyal advised Ray on a variety of career decisions and edited Ray's resume insufficient to show the two had the kind of strong relationship that would have supported an inference of a *quid pro quo* arrangement.[148] Nevertheless, the court apparently entertained the idea that such a showing could be made with different evidence. Hence, personal benefit can still—and indeed should under *Dirks*—be inferred where a preexisting relationship between tippee and tipper is sufficiently strong. And there is no reason why the same evidence, which would support a jury inference beyond a reasonable doubt, would not also be sufficient to establish that a tippee knew or should have known the tipper disclosed information in order to gain a personal benefit.

The court establishes that one must have knowledge of the personal benefit to the tipper, and know that the trading is based on material, nonpublic information. Thereby, the ruling "raises the bar" for the remote-tippee prosecutions.[149] Still, the holding does not clarify whether the showing of the remote tippee consciously avoiding learning of the personal benefit would meet the standard. Therefore, the *Newman* standard may lead to more illicit insider trading behavior aimed at escaping liability.

2. Newman's Impact on Excuses for Breach

Similarly, the *Newman* court also discusses how the investor relations departments at NVIDIA and Dell had a habit of disclosing material, nonpublic earnings data in advance of quarterly earnings.[150] Because insiders at these companies engaged in this practice for the good of the company, the court found it unreasonable to infer that the circumstances under which Newman and Chiasson received their tips

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147. *See Newman*, 773 F.3d at 452-53.
148. *Id.* at 453.
149. GIBSON DUNN, *supra* note 144, at 3.
150. *See Newman*, 773 F.3d at 454-55; *see also* GIBSON DUNN, *supra* note 144, at 1-2.

were enough to support an inference beyond a reasonable doubt that the original insider had disclosed in breach of her fiduciary duty.[151] But in the absence of these special circumstances, such an inference might very well have been warranted. In fact, the same evidence used to support a jury inference of tipper personal benefit may also support a jury inference that the tippee knew or should have known of the personal benefit.

3. *Newman's Impact on Tipper/Tippee Relationships*

Newman also significantly raises the bar for the kind of relationship that will support an inference of a *quid pro quo* arrangement. In the Second Circuit, the government will need to provide "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[152] Examples that meet the new standard include gifts, access to an investment club where stock tips and insight are routinely discussed, close working relationships on real estate deals in which parties commonly split commissions on transactions, and business referral relationships, such as dental work.[153] In many other federal courts, the kinds of relationships evidenced in *Newman* might well have sufficed.[154]

F. THE PURPOSE OF THE *DIRKS* REQUIREMENT

The *Newman* court's rigid adherence to the personal benefit requirement as a necessary element of breach may overlook the reasons behind the requirement articulated in *Dirks*. As noted above, the Court

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151. *See Newman*, 773 F.3d at 442, 451, 453-55; *see also* GIBSON DUNN, *supra* note 144, at 3.

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

153. *See id.* at 452-53.

154. *See, e.g.*, SEC v. Ingram, 694 F. Supp. 1437, 1441 n. 5 (C.D. Cal. 1988) (discussing how an intent to personally benefit may be inferred based on the materiality of the information being conferred); SEC v. Blackwell, 291 F. Supp. 2d 673 (S.D. Ohio 2003) ("A mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement.") (citing SEC v. Blackman, No. 3:99-1072, 2000 WL 868770, at *9 (M.D. Tenn. May 26, 2000)).

in *Dirks* presented the personal benefit requirement as a test that would allow the judiciary to overcome a particular problem. Because there are legitimate, reasonable doubt-creating reasons for insider disclosure of material, nonpublic information—for example, stimulating the interest of potential new financers or stock purchasers, or, as in *Dirks*, whistleblower tipping—the fact of disclosure alone is not enough to establish breach. For this reason, the Court introduced the personal benefit requirement as a proxy for assaying disclosure (il)legitimacy. Where a personal benefit exists, disclosure is presumptively illegitimate, and thus deceptive under Section 10(b) and Rule 10b-5. Where there is no personal benefit, the disclosure must have been made (a) in the interest of the principal or (b) negligently, neither of which satisfies the Section 10(b) and Rule 10b-5's scienter requirement.[155]

This being the case, if the government can adduce compelling evidence that the insider-tipper tipped knowingly (not accidentally) *and* that there is no reasonable explanation as to how tipping might promote the best interests of the principal, it then seems unnecessary to insist upon evidence of a specific personal benefit. Rather, it would be logical under these circumstances to allow a jury to draw the inference that disclosure must have been made for personal benefit. This analysis would be particularly well supported by *Dirks*, which allows similar inferences to be drawn on the basis of pre-tipping tipper/tippee relationships, and which includes the benefit of making a gift of insider information to a trading friend or relative as a personal benefit.[156] If a tippee knows the insider is not tipping negligently, and she knows there is no reason to think the tipper's disclosure will benefit the principal, then a jury should be permitted to draw the same inference about the tippee: that she knew or should have known that the tipper violated a relationship of trust by relaying the principal's information.[157] For example, consider the case where a major stockholder tips investment analysts in order to spur favorable reports by the analysts that will lead to an upward influence on the price of the stock.[158] In this situation, if the tippee knows there is no reason to think that the disclosure is in the

155. *See* Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983) ("Scienter . . . is an independent element of a Rule 10b-5 violation.").

156. *Id.* at 664.

157. *See Blackwell*, 291 F. Supp. 2d at 696-97.

158. *See Analyzing Analyst Recommendations*, SEC (Aug. 30, 2010), http://www.sec.gov/investor/pubs/analysts.htm [http://perma.cc/SE74-7MNM].

best interest of the principal, he knows what he is doing is wrong, just not precisely how it is wrong. This wrongdoer should not escape justice simply because of his perplexity as to how the insider expects to benefit from disclosure.

G. REFORM PROPOSALS

As a pushback against the *Newman* decision, there are now bills pending in Congress to define insider trading. The House proposal would amend Section 10 of the Exchange Act to outlaw the purchasing or selling of "any security, or any securities-based swap agreement, based on information that the person knows or, considering factors including financial sophistication, knowledge of and experience in financial matters, position in a company, and amount of assets under management, should know is material information or inside information."[159] The proposed legislation defines inside information as nonpublic, and obtained "(I) illegally; (II) directly or indirectly from an issuer with an expectation of confidentiality or that such information will only be used for a legitimate business purposes; or (III) in violation of a fiduciary duty."[160]

On the other hand, the Senate bill would amend Section 10(b) to make it illegal:

> (A) To purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available.
>
> (B) To knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of subparagraph (A).[161]

The bill does not include "information that the person has independently developed from publicly available sources" under the "not publicly available" category.[162]

159. Ban Insider Trading Act, H.R. 1173, 114th Cong. § 2(d)(1) (2015).
160. *Id.* § 2(d)(3)(A)(i)-(iii).
161. Stop Illegal Insider Trading Act, S. 702, 114th Cong. § 2 (d)(1)(A)-(B) (2015).
162. *Id.* § 2(2).

II. THE PARADOX: PENALTIES FOR THE UNDEFINED INSIDER TRADING OFFENSE

As discussed above, neither the SEC nor Congress has defined the term "insider trading." Yet, Congress has established both civil and criminal penalties, including fines and prison terms, for engaging in this behavior. The various penalties are described below.

A. CIVIL PENALTIES

Prior to 1984, federal legislation did not impose civil penalties on insider trading. The SEC had to rely on federal court injunctions against future violations, as well as disgorgements of profits, to enforce securities fraud prohibitions. [163] Although insider trading is not statutorily defined, in 1984, Congress enacted the ITSA[164] to remedy the "inadequate deterrent provided by enforcement remedies for insider trading," noting that neither injunctions nor disgorgement sufficiently penalized defendants for insider trading.[165] The ITSA amended Section 21 of the Exchange Act to include, in relevant part, that the SEC:

> may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty [the amount of which] shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States.[166]

Congress doubled down its efforts when it enacted ITSFEA in 1988, which expanded the scope of civil penalties on insider trading to "controlling" persons, defined as those "who, at the time of the violation, directly or indirectly controlled the person who committed such violation."[167] Civil penalties for a controlling person are limited to

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163. *See* Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 960 (1985).

164. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

165. *See* SEC v. Downe, 969 F. Supp. 149, 159 (S.D.N.Y. 1997) (quoting H.R. Rep. No. 98-355, at 7-8 (1983).

166. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264.

167. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4678.

the greater of $1,000,000 or treble damages.[168] If the "controlled person's violation was a violation by communication, the [damages are] deemed to be limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication."[169]

Empirical evidence provided by Professor Seyhun shows that neither ITSA nor ITSFEA was effective in reducing either the volume or profitability of insider trading.[170] In fact, following these legislative changes, the volume of insider trading increased four-fold, while abnormal profitability of insider trading doubled.[171] Insiders did not reduce their trading, even on a temporary basis, in response to these legislative initiatives.[172] Seyhun concludes that among the possible reasons for the ineffectiveness of the increased sanctions are the highly stringent requirements for the legally material information.[173]

The Securities Act and the Exchange Act also provide for civil penalties in other securities fraud contexts. Section 20(d)(1) of the Securities Act and Section 21(d)(3) of the Exchange Act permit the SEC to impose monetary penalties against persons who violate these acts "other than by committing a violation subject to a penalty pursuant to [Section 21A of the Exchange Act]."[174] Both Section 20(d)(1) of the Securities Act and Section 21(d)(3) of the Exchange Act provide three-tier penalty systems, where the maximum penalty increases with the severity of the violation.[175] The Second Circuit recently held that Section 21A of the Exchange Act is the only basis for ordering civil penalties in insider trading cases brought in federal court.[176] The court, however, did

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168. *Id.*
169. *Id.*
170. *See* H. Nejat Seyhun, *The Effectiveness of Insider Trading Sanctions*, 35 J. LAW & ECON. 149 (1992).
171. *Id.* at 150.
172. *Id.* at 176.
173. *Id.* at 177.
174. *See* Exchange Act § 21(d)(3)(A), 15 U.S.C. § 78u(d)(3)(A)(2012); Securities Act § 20(d)(1), 15 U.S.C. § 77t(d)(1).
175. *See* Exchange Act § 21(d)(3)(B), 15 U.S.C. § 78u(d)(3)(A); Securities Act § 20(d)(1), 15 U.S.C. § 77t(d)(1).
176. *See* SEC v. Rosenthal, 426 Fed. Appx. 1, 2-3 (2d Cir. 2011).

not have cause to address the expanded scope of the SEC's powers under the Dodd-Frank Act.[177]

The Dodd-Frank Act significantly enhanced the SEC's enforcement powers by (1) granting the SEC the ability to obtain monetary penalties in administrative proceedings against all individuals, not just those associated with regulated entities, and (2) increasing the civil penalties that the SEC can seek in administrative cases.[178] Section 21B, as amended, states, in part:

> In any proceeding instituted pursuant to sections [15(b)(4), 15(b)(6), 15D, 15B, 15C, 15E, or 17A] of this title against any person, the [SEC] or the appropriate regulatory agency may impose a civil penalty if it finds . . . that such penalty is in the public interest and that such person—
>
> (A) has willfully violated any provision of the Securities Act of 1933, the Investment Company Act of 1940, the Investment Advisers Act of 1940, or this chapter, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;
>
> (B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;
>
> (C) has willfully made or caused to be made in any application for registration or report required to be filed with . . . any . . . appropriate regulatory agency under this chapter, or in any proceeding before the [SEC] with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or
>
> (D) has failed reasonably to supervise, within the meaning of [section 15(b)(4)(E)] of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision.[179]

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177. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, 124 Stat. 1376 (2010).

178. *Id.* § 929, 124 Stat. at 1863.

179. 15 U.S.C. § 78u–2

Section 21B contains civil penalty provisions applicable in administrative proceedings similar to those in Section 21(d)(3) for judicial proceedings, except notably, Section 21B does not contain the "21A" exemption found in Section 21(d)(3).[180] The three-tier penalty structure under Section 21B also imposes the same maximum penalties as the penalty structure of Section 21(d)(3).[181] While the applicability of Section 21B to insider trading is still the subject of debate,[182] the SEC has continued using this section to impose civil penalties for insider trading in its administrative forum.[183]

Additionally, Section 753 of the Dodd-Frank Act expanded the "anti-manipulation" authority of the Commodity Futures Trading Commission ("CFTC") by amending Section 6 of the Commodity Exchange Act.[184] The amended Section 6(c)(1) is closely modeled after Section 10(b) of the Securities Exchange Act, and CFTC Regulation 180.1, promulgated in accordance with Section 6(c)(1), is the functional analog of Rule 10b-5.[185] However, the CFTC has recognized that unlike securities markets, "derivatives markets have long operated in a way that allows for market participants to trade on the basis of lawfully obtained material, nonpublic information,"[186] and therefore has limited the scope of CFTC Regulation 180.1 with regard to insider trading. CFTC Regulation 180.1 only prohibits trading based on misappropriated information obtained or used in breach of a pre-existing duty.[187]

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180. *See id.*

181. *See id.*; Exchange Act § 21(d)(3)(B), 15 U.S.C. § 78u(d)(3)(A).

182. *See e.g.*, Larry P. Ellsworth, *SEC Overreaching in Applying Penalty Act to Insider Trading*, 5 BLOOMBERG L. REP.—SEC. L., no. 27, 2011, http://jenner.com/system/assets/publications/39/original/SEC_Overreaching_In_Applying_Penalty_Act_to_Insider_Trading.pdf?1319655869 [http://perma.cc/MP8N-8MBN].

183. *See, e.g.*, Geist, Securities Act Release No. 9680, Exchange Release No. 73,581, 2014 WL 5842375 (Nov. 12, 2014).

184. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, § 753, 124 Stat. 1376 (2010).

185. *See* Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398 (July 14, 2011).

186. *Id.* at 41,403.

187. "Depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, for example by trading on the basis of material nonpublic

Furthermore, the Commission has noted that CFTC Regulation 180.1 does not create an affirmative duty of disclosure, except such disclosure that may be required "as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect."[188] The CFTC may assess a civil penalty of not more than $1 million or triple the monetary gain to the person for each violation in any case of manipulation or attempted manipulation.[189]

B. CRIMINAL PENALTIES

Most criminal prosecutions for violations of the federal securities laws, including the insider trading provisions, are brought under Section 24 of the Securities Act and Section 32(a) of the Exchange Act.[190] Other bases for criminal liability in the insider trading context include the federal mail and wire fraud statutes,[191] as well as the federal criminal offense of securities fraud (enacted as part of SOX).[192] Section 24 of the Securities Act[193] and Section 32(a) of the Exchange Act[194] generally authorize criminal prosecutions for "willful violations" of provisions, rules, or regulations under the respective acts. In the insider trading context, the most common bases for criminal liability are violations of Section 10(b) of the Exchange Act and Rule 10b-5, although Rule 14e-3 is also frequently used.[195]

Section 24 of the Securities Act provides that any person who willfully (1) violates any of the provisions or related rules and regulations of the Act, or (2) provides materially false or misleading information on a registration statement under the Act, is subject to a maximum fine of $10,000, a maximum prison term of five years, or

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information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of final Rule 180.1." *Id.*

188. 7 U.S.C. § 9(1) (2012).

189. *Id.* § 9(10)(C)(ii).

190. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING: LIABILITY AND COMPLIANCE § 7.02.1 (3d. ed. 2013).

191. *See* 18 U.S.C. §§ 1341-1351 (2012).

192. *See id.* § 1348.

193. *See* Securities Act § 24, 15 U.S.C. § 77x (2012).

194. *See* Exchange Act § 32(a), 15 U.S.C. § 78ff(a).

195. *See* 17 C.F.R. § 240.14e-3 (2015).

both.[196] Section 32(a) of the Exchange Act provides that any natural person who willfully violates any provision of the Act, other than Section 30(A),[197] may be subject to a maximum penalty of $5 million, a maximum prison term of twenty years, or both.[198] A corporation may be subject to a fine not exceeding $25 million.[199]

One of the primary contributions that SOX made to the insider trading statutory scheme was the new criminal securities fraud offense.[200] Among other things, the provision makes it unlawful to execute or attempt to execute a scheme or artifice to defraud a person in connection with any security.[201] The statute provides for a fine, a term of imprisonment of not more than twenty-five years, or both.[202] In 2009, the provision was amended by the Fraud Enforcement and Recovery Act of 2009 to extend the criminal penalties to commodities fraud.[203]

The DOJ has often relied on the federal mail and wire fraud statutes in criminal prosecutions by alleging Rule 10b-5 violations.[204] The federal mail and wire fraud statutes prohibit the use of mail or wire, radio, or television communications "for the purpose of executing [any] scheme or artifice" to defraud.[205] Although these statutes may lack teeth in most securities fraud prosecutions, in insider trading cases, the wire and mail fraud statutes may enable prosecutors to reach conduct outside of the scope of Section 10(b).[206] For example, under a wire or mail fraud

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196. *See* Securities Act § 24, 15 U.S.C. § 77x.

197. This section contains the anti-bribery provisions. *See* Exchange Act § 30, 15 U.S.C. § 78dd-1.

198. *See* Exchange Act § 32(a), 15 U.S.C. § 78ff(a).

199. *Id.*

200. *See* Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348 (2012).

201. *See id.*

202. *Id.*

203. *See* Fraud Enforcement and Recovery Act of 2009, Pub. L. 111–21, § 2(e), 123 Stat. 1617, 1618 (inserting "and commodities" before "fraud" in section caption, and "any commodity for future delivery, or any option on a commodity for future delivery, or" before "any security" in subsection (1)).

204. *See* Peter J. Henning, *Insider Trading Case Could Push Congress to Define a Murky World*, N.Y. TIMES: DEALBOOK (Feb. 23, 2015), http://www.nytimes.com/2015/02/24/business/dealbook/insider-trading-case-could-push-congress-to-define-a-murky-world.html?_r=0 [http://perma.cc/Z9E9-NWW6].

205. *See* 18 U.S.C. §§ 1341, 1343.

206. *See* United States v. Autuori, 1998 WL 774232, at *22 n.9 (D. Conn. Aug. 28, 1998), *aff'd in part, rev'd in part*, 212 F.3d 105 (2d Cir. 2000).

theory, a crime is complete once a company is defrauded of its confidential information regardless of whether the information is used by anyone for purposes of trading. Also, the "materiality" required for wire and mail fraud may be easier to meet than that of securities fraud.[207] Wire and mail fraud carry mostly the same statutory penalties as a violation of Section 10(b) (with a few exceptions, the most notable being if "the violation affects a financial institution").[208]

Although federal judges have the right to impose any sentence for insider trading convictions, they are required to keep in mind the criminal sentencing guidelines. In the Dodd-Frank Act, Congress issued directives to the U.S Sentencing Commission to "review and, if appropriate, amend" various sentencing guidelines and policy statements applicable to fraud offenses. [209] The Sentencing Commission promulgated amendments to the Federal Sentencing Guidelines for securities fraud, which took effect in 2012.[210]

The Sentencing Commission adopted a new minimum offense level of fourteen (which equates to a recommended prison range of fifteen to twenty-one months for defendants with no criminal record)[211] for any "organized scheme to engage in insider trading."[212] The commentary lists factors that courts may consider in determining whether an insider trading scheme is "organized" within the meaning of the Act: whether it

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207. *Compare* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (information is material in the federal securities law context if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"), *with Autuori*, 1998 WL 774232, at *22 (quoting United States v. Siegel, 717 F.2d 9, 15 (2d Cir. 1983) (information is material under the mail fraud statute when it "would be important to a reasonable person in deciding whether to engage in a particular transaction or to engage in certain conduct").

208. Both the wire and mail fraud statutes provide that "[i]f the violation . . . affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both." 18 U.S.C. §§ 1341, 1343. The mail fraud statute also provides for this increased penalty if the violation involves "a presidentially declared major disaster or emergency." *Id.* § 1341.

209. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, § 1079A(a)(1)(A), 124 Stat. 1376 (2010).

210. *See* Sentencing Guidelines for United States Courts, 77 Fed. Reg. 28,226 (May 11, 2011).

211. U.S. SENTENCING GUIDELINES MANUAL ch. 5, pt. A (U.S. SENTENCING COMM'N 2014).

212. *Id.* § 2B1.4.

involved "considered, calculated, systemic, or repeated efforts to . . . trade on insider information, as distinguished from . . . opportunistic instances of insider trading."[213] For cases where there is minimal gain from insider trading, this will mean an automatic increase of six offense levels for all participants in the offense.[214] As the profitability of a scheme increases, however, the effect of this new provision diminishes, disappearing entirely when the overall gain from the scheme reaches $30,000.[215]

The amendments to the insider trading guidelines also broadened the applicability of the "abuse of trust" enhancement. Previously, a defendant received increased punishment under the guidelines if the abuse of a position of public or private trust significantly facilitated the crime; this provision was not triggered unless the defendant's position was characterized by "substantial discretionary judgment that is ordinarily given considerable deference."[216] The amendment loosened that requirement by specifying that the enhancement applies if "the position of public or private trust . . . contributed in some significant way to facilitating the commission or concealment of the offense."[217]

The Sentencing Commission also added a special rule for determining loss in cases involving fraudulent inflation or deflation in the value of publicly traded securities or commodities.[218] The amended commentary directs the use of what has become known as the "modified rescissory method" for determining actual loss.[219] The commentary also directs the courts to presume that the modified rescissory method has accurately calculated the actual loss, but a party may rebut that presumption and persuade the court that it is not a "reasonable estimate

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213. *See id.* cmt. n.1.

214. An offense level of eight, for criminals with zero or one criminal history points under the Sentencing Guidelines chart, equates to a recommended prison term of zero to six months. *See id.* at ch. 5, pt. A.

215. Both the pre-2012 amendment and post-2012 amendment guidelines recommend a base offense level of 8 for insider trading. *See id.* at § 2B1.4.

216. U.S. SENTENCING GUIDELINES MANUAL § 3B1.3 cmt. n.1 (U.S. SENTENCING COMM'N 2010).

217. U.S. SENTENCING GUIDELINES MANUAL, *supra* note 211, at § 3B1.3 cmt. n.1.

218. *Id.* § 2B1.1 cmt. n.3(F)(ix).

219. First, calculate the difference between (i) the average share price during the fraud period; and (ii) the average share price during the 90-day period after the fraud was disclosed to the market. Second, multiply the difference by the number of shares outstanding. *See id.*

of the actual loss."[220] The court may consider, among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (e.g., changes caused by external market forces, such as changed economic circumstances, changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events).[221]

Finally, the Sentencing Commission expanded the provisions in the fraud guideline that govern when a judge may depart from the recommended guideline range.[222] First, the Commission noted that an upward departure might be warranted if the offense created a risk of substantial loss beyond the loss determined under the guideline, "such as a risk of a significant disruption of a national financial market."[223] Second, the Commission provided new guidance on downward departures, adding the example of a securities fraud where fraudulent misrepresentations inflate the price of a stock in a manner that produces "an aggregate loss amount that is substantial but diffuse, with relatively small loss amounts suffered by a relatively large number of victims."[224]

III. OUR PROPOSAL: A NEW EVIDENTIARY STANDARD

Many scholars agree that a clear statutory definition of illegal insider trading should be established, arguing that it is preferable to further judicial interpretation.[225] Our proposal for reform is outlined in this part.

A. REQUIREMENTS

We propose that the government be allowed to establish a prima facie case of illegal insider trading on the basis of material, nonpublic information when it can prove the following three elements: (1) the information giving rise to the trade is of the type that requires an 8-K filing by the corporation; (2) its announcement must lead to statistically significant, abnormal stock returns; and (3) the putative insider trading

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220. *Id.*
221. *Id.*
222. *Id.* § 2B1.1 cmt. n.20.
223. *Id.* § 2B1.1 cmt. n.20(A)(iv).
224. *Id.* § 2B1.1 cmt. n.20(C).
225. *See, e.g.*, Karmel, *supra* note 25.

must have occurred within two months prior to the announcement of the information.

The first and third requirements are factual and can easily be satisfied. The second requirement can be satisfied by following a similar procedure described in this part. Given that corporations file 10-Q and 10-K reports every three months, these conditions in effect require that all insider trading be confined to approximately a one-month window after each earnings announcement.[226] If all three conditions are satisfied, then the burden of proof must be on insiders to show that their particular transaction does not meet the material, nonpublic information requirement. Similarly, any trades made by individuals receiving tips from insiders (on any information satisfying the three conditions above) must also shift the burden of proof, in this case, to the tippee(s) accused of committing securities fraud.

We expect additional clarity will allow all insiders who want to be on the safe side of the law to ensure that their transactions do not meet any of the conditions set forth above. Insiders already know which events trigger an 8-K filing. By not trading or tipping during the two-month window preceding an upcoming 8-K filing, insiders can easily ensure that at least two of the three conditions will not be satisfied. The benefit of this additional clarity should enable courts to separate routine insider trading from opportunistic trading and increase the confidence in the public equity markets.

B. 8-K Filing Requirements

Form 8-K is a broad form used to notify investors of any material event that is important to shareholders or the SEC.[227] The SEC usually considers an event to be material when "there is a substantial likelihood that a reasonable investor would consider the information important to making an investment decision."[228] It is one of the most common forms

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226. Typically, one week after earnings announcements is also considered an additional black-out period to allow to markets to fully digest the earnings information. This in effect confines insider trading (on information contained in the forms) to between weeks one and four after each earnings announcement.

227. *Form 8-K*, SEC, http://www.sec.gov/about/forms/form8-k.pdf [http://perma.cc/4AQJ-HKAL].

228. *Investor Bulletin: How to Read an 8-K*, SEC, at 1 (May 2012) [hereinafter *Investor Bulletin*], http://www.sec.gov/investor/pubs/readan8k.pdf [http://perma.cc/53T

filed with the SEC and supplements the public companies' annual reports on Form 10-K and quarterly reports on Form 10-Q. Public companies are required to file the Form under the Exchange Act. These reports are available to the public on the SEC's EDGAR website.[229]

Form 8-K is used for reports under Section 13 or 15(d) of the Exchange Act and filed pursuant to Rule 13a-11 or Rule 15d-11, as well as for reports of nonpublic information required to be disclosed by Regulation FD.[230] Form 8-K may be used to satisfy the filing obligations under (1) Exchange Act Rule 230.425 for written communications relating to business combination transactions; (2) Exchange Act Rule 240.14a-12 for soliciting materials and pre-commencement communications for tender offers; (3) for pre-commencement communications under Rule 240.14d-2(b); or (4) for pre-commencement communications under Rule 240.13e-4(c).[231]

Triggering events apply to registrants and subsidiaries.[232] Form 8-K consists of nine sections. Under Section 1, a company is required to file the Form when it (1) enters a "material definitive agreement;" (2) terminates such an agreement; (3) is in bankruptcy or receivership; or (4) receives official reports of shutdowns and patterns of violations in mine safety.[233]

Item 1.01 requires a disclosure of material agreements not made in the ordinary course of business, or any material amendments to those. A material definitive agreement can be both written and oral.[234] Taking out a loan with a bank or signing a long-term lease would require this disclosure, but signing a lease for an additional store when the retailer already has a chain would not. If the agreement was not material at the time the registrant entered into it, but becomes material later, the registrant does not need to file Form 8-K. In either case, the registrant is required to file the agreement as an exhibit to the periodic report in the

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229. *EDGAR*, SEC, http://www.sec.gov/edgar/searchedgar/companysearch.html [http://perma.cc/CVK9-EUME].

230. *See Form 8-K*, *supra* note 227, at 1.

231. *Id.*

232. *Division of Corporate Finance: Current Report on Form 8-K Frequently Asked Questions*, SEC (Nov. 23, 2004) [hereinafter *FAQ*], http://www.sec.gov/divisions/corpfin/form8kfaq.htm [http://perma.cc/T5B6-CCYC].

233. *Fast Answers: Form 8-K*, SEC [hereinafter *Fast Answers*], http://www.sec.gov/answers/form8k.htm [http://perma.cc/GA48-4N73].

234. *See FAQ*, *supra* note 232.

period in which the agreement became material.[235] Furthermore, the registrant must file Form 8-K if an agreement is not "immaterial in amount or significance" within the meaning of Item 601(b)(10)(iii)(A) of Regulation S-K, unless it is not required to be disclosed under Item 601(b)(10)(iii)(C).[236] This issue is considered from the perspective of a reasonable investor and within established standards of materiality.[237]

Item 1.02 requires disclosure of a termination of an agreement prior to the established expiration, but not of an agreement that expires under its terms. Once notice of termination is received, Form 8-K is required, even if the registrant intends to negotiate and in good faith believes that the agreement has not been terminated.[238] Importantly, the triggering event is the notice, not the termination of the agreement.[239] Under Item 1.03, the registrant may include the company's plan for Chapter 11 reorganization or Chapter 7 liquidation, and the court's confirmation of the plan.[240]

Under Section 2, a company must report in Form 8-K when (1) it completes transactions acquiring or disposing of assets; (2) it makes public announcements of its operations and financial condition; (3) liabilities arise under a direct financial obligation or under an off-balance sheet arrangement; (4) triggering events occur that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement; (5) its executives commit the company to certain exit or disposal activities; and (6) its executives decide that material impairments to its assets are required.[241]

Item 2.01 requires a company to disclose any time a significant amount of assets are acquired or disposed, such as when a company buys or merges with another company, or sells a business unit.[242] If a merger results in a "shell company"[243] becoming a company in its own right, the registrant would provide investors with information about this

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235. *See Investor Bulletin*, *supra* note 228, at 1.
236. *Id.*
237. *Id.*
238. *See FAQ*, *supra* note 232.
239. *Id.*
240. *Investor Bulletin*, *supra* note 228, at 2.
241. *Id.* at 2-3.
242. *Id.*
243. The SEC defines a "shell company" as "a company that either has little or no operations or has little or no assets other than cash and cash equivalents." *Id.* at 2.

company under this item. Under Item 2.02, the company usually summarizes the full financial statement, which often appears later in the company's quarterly report or annual report. The company often simultaneously announces these results in a press release and a Form 8-K. Item 2.03 requires disclosure of the basic terms of material financial obligations, including long-term debt and capital or operating leases, as well as short-term debt beyond the ordinary course of business. Any material financial obligations arising out of off-balance sheet arrangements, whether direct or contingent, must also be disclosed.[244] The materiality of the financial obligation is "a facts and circumstances determination."[245]

Item 2.04 requires the disclosure of any event that triggers the acceleration or increase of a financial obligation as long as the event is material, such as defaults on loans. In the case of a loan default where the company must pay the entire amount owed, the company must disclose the amount to be repaid, the terms of such repayment, and other financial obligations that may have to be repaid on different terms as result of the initial default. Item 2.05 requires disclosure of restructuring plans where the company would incur material charges, such as the decision to close some of its stores or lay off workers. Under this provision, the company must also disclose cost estimates when it is able to determine them.[246] Lastly, under Item 2.06, a company must disclose write-downs, otherwise known as impairments. These occur when a company significantly lowers its estimates of the value of some assets.[247] If the impairment is determined routinely as the company prepares its financial statements for its periodic report, then the company may make the disclosure in the periodic report, and not in a Form 8-K.[248]

Under Section 3, a company must file Form 8-K when it (1) receives a notice of delisting, transfer of listing, or failure to meet listing rules or standards; (2) makes an unregistered sale of equity securities; or (3) materially modifies the rights of its security holders. Under Item 3.01, a company must disclose if the stock exchange notifies the company that it can no longer be listed. If the company has a grace period to return to compliance, it must disclose any steps it will take to

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244. *Id.*
245. *See FAQ*, *supra* note 232.
246. *See Investor Bulletin*, *supra* note 228, at 2.
247. *Id.* at 3.
248. *Id.* at 2-3.

avoid delisting. Item 3.02 mandates public companies to disclose private sales of securities above 1% of its outstanding shares of that class (or 5% for smaller reporting companies). Public offerings registered with the SEC, however, do not need to be disclosed. Under Item 3.03, companies are required to disclose material changes to instruments that define the rights of shareholders or material restrictions on the rights of security holders resulting from the issuance or modification of another class of securities, such as loan terms restricting dividend payments, adoption of an antitakeover device, or issuance of preferred stock.[249]

Under Section 4, matters related to accountants and financial statements, such as (1) changes in the company's certifying accountant, or (2) decisions to no longer rely on the company's previously issued financial statements, must also be filed. Public companies must disclose if they dismiss their independent auditor, if she resigns or declines to stand for re-appointment, or if the company hires a new auditor. As the SEC notes in its Investor Bulletin,[250] a change in auditors may be a red flag for investors. Therefore, companies must disclose three major events if they occurred in the previous two fiscal years. First, a company must disclose whether the departing auditor gave an adverse or qualified opinion on the company's statements. Second, it must disclose disagreements it had with the departing auditor over accounting principles or practices, financial statements, or the scope or procedure of the audit. Finally, it must disclose whether the former auditor advised the company that (a) "the necessary internal controls to prepare reliable financial statements do not exist;" (b) "the auditor can no longer rely on management's representations or is unwilling to be associated with the financial statements prepared by management;" (c) "the auditor believed it should further investigate a matter or significantly expand the scope of its audit, and the author did not do so;" or (d) "the auditor has found new information that materially impacts the fairness or reliability of current or prior financial statements, and the issue has not been resolved to the auditor's satisfaction."[251]

Item 4.02 requires a disclosure of any error in the previously issued financial statements to establish that these should not be relied upon. Additionally, a company must disclose if the auditor believes that the

249. *Id.* at 3.
250. *Id.*
251. *Id.*

previously-issued audit reports or interim reviews of these statements should not be relied upon. The company must demonstrate whether its audit committee, full board, or authorized executive officers have discussed the issue with the auditor.[252]

Section 5 discusses corporate governance and management. A company must file Form 8-K when there are (1) changes in control of the company; (2) departures of directors or certain officers, board elections, appointments of certain officers, and changes in compensatory arrangements of certain officers; (3) amendments to the company's articles of incorporation or bylaws, or changes in its fiscal year; (4) temporary suspensions of trading under the company's employee benefit plans; (5) amendments to the company's Code of Ethics, or waivers of any provisions of the Code of Ethics; (6) changes from shell-company to non-shell-company status; (7) submissions of issues to security-holder vote; and (8) shareholder nominations of directors.

Under Item 5.01, the company must disclose an event where there is a change of control of the company, by identifying the persons acquiring the control and the percentage of voting securities they now possess, any arrangements between the previous and new control groups relating to election of directors, or other important issues.[253] In the event that a board member resigns or will not stand for re-election due to disagreement with the company over its operations, policies, or practices, or a director is removed for cause from the board, the company has an obligation to disclose the circumstances of the disagreement under Item 5.02.[254] If there is a letter from the director to this effect, the letter must be filed as an exhibit. In the event that a high-level executive officer retires, resigns, or is terminated, or alternatively that a new officer is appointed, the company must disclose this fact along with any related compensation arrangements. Any changes to the compensation of the current high-level officers must also be disclosed.[255] Unless the company already disclosed the proposed amendments or fiscal year change in a proxy or information statement, the company must disclose any amendments to its articles of incorporation or bylaws, or changes to its fiscal year under Item 5.03. It

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252. *Id.* at 4.
253. *Id.*
254. *Id.*
255. *Id.*

should be noted that companies that issue only debt securities are usually exempted from this item.[256]

Under Item 5.05, companies are required to report any changes to their code of ethics or waivers that apply to the CEO, CFO, CAO, controller, or others performing similar duties. Companies may elect to disclose this information on their website instead of filing Form 8-K.[257] Under Item 5.07, companies are required to file the results of the shareholder votes in director elections and on all other issues put to a vote within four business days of the end of an annual or special meeting. If such results are unavailable at the time, companies are required to file preliminary results and an amended Form 8-K with final vote results within four business days of those results being available.[258]

Under Section 6, a public company must disclose any (1) asset-backed securities (ABS) "informational and computational material," (2) change in Regulation AB Item 1108(a)(2) servicer or trustee, (3) change in credit enhancement or other support as specified in Regulation AB, (4) failure to make any required distribution to holders of the ABS, or (5) "Securities Act Updating Disclosure."[259]

Section 7 discusses Regulation FD disclosure. The purpose of this regulation is to "prevent companies from selectively disclosing material, nonpublic information."[260] Generally, companies are required to disclose material information to the public at the same time as it is provided to others, including securities market professionals. Companies may submit Form 8-K under this Item or Item 8.01 to comply with the Regulation FD's public disclosure requirement. Disclosures include announcements of dividends, quarterly sales of figures, etc.[261]

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256. *Id.*

257. *Id.*

258. *Id.*

259. See *Form 8-K*, *supra* note 227, at 20. The Securities Act Updating Disclosure requires that, with respect to offerings of asset-backed securities, "any material pool characteristic of the actual asset pool at the time of issuance of the asset-backed securities [that] differs by 5% or more . . . from the description of the asset pool in the prospectus" requires a disclosure regarding the characteristics of the actual asset pool. *Id.*; *see also* JOHN ARNHOLZ, REED D. AUERBACH & EDWARD E. GAINOR, OFFERINGS OF ASSET-BACKED SECURITIES § 6.05 (3d ed. 2016).

260. *Investor Bulletin*, *supra* note 228, at 5.

261. *See id.* at 7.

Section 8 is a catchall section where the registrant company can report events that are not specifically called for by Form 8-K, but that it nevertheless considers important to security holders. Finally, Section 9 discusses financial statements and exhibits that a company may be required to furnish to supplement other parts of Form 8-K.

A report must be filed or furnished within four business days[262] of the occurrence of the event for items in Sections 1 through 6, and 9. If the form is furnished only to satisfy its obligation under Regulation FD, the due date may be earlier.[263] If a triggering event occurs within four business days before the company's filing of a periodic report, it may be disclosed in that periodic report instead of filing of Form 8-K, unless it is required under Item 4.01 or Item 4.02.[264]

IV. EXPLOITATION OF VAGUENESS IN STANDARDS: PROFITABILITY OF INSIDERS' TRANSACTIONS

Given the vagueness of the insider trading laws, insiders have been able to exploit material, nonpublic information by buying and selling the shares of their firms prior to the public dissemination of this information through Form 8-K filings, without facing legal consequences. To test our hypothesis, we obtained stock price information from the Center for Research in Security Prices ("CRSP"). The insider trading data comes from the union of the Thomson Reuters Insider Filing Data Feed (1996 to 2013) and backward extensions using archived annual purchases from the National Archives (1975 to 1995) (collectively, the "combined Insider Trading Database"). Our sample includes United States common stocks (CRSP share codes of 10 or 11) that are covered by all three databases. The period is from January 1975 through December 2013. We restrict attention to this interval due to the availability of insider trading data, which first became available in January of 1975. We include observations beginning only from the time when the firms first appear in the combined Insider Trading Database. Following Shumway,[265] we adjust stock returns for delistings using the CRSP delisting file. Our final dataset has over 20,000 unique CUSIPs and over 3,500,000 observations.

262. The first day is the first business day after the occurrence.
263. *Fast Answers*, *supra* note 233.
264. *See FAQ*, *supra* note 232.
265. Tyler Shumway, *The Delisting Bias in CRSP Data*, 52 J. OF FIN. 327 (1997).

The combined Insider Trading Database includes all trades reported to the SEC-Ownership Reporting System. The data contains all open market purchases and sales by officers, directors, and beneficial owners (direct or indirect owners of more than 10% of any equity class of securities) of publicly traded firms.[266] Shares acquired through exercise of options, stock awards, and trades with corporations are excluded. The final sample is limited to firms for which stock return data is available in CRSP. Finally, in order to deal with potential misreports and incorrect outliers, three filters are used. On the insider transaction date, (1) the insider transaction price must be less than twice the closing price of the stock, (2) the number of shares of the insider transactions must be less than the daily volume of trade of the stock, and (3) the number of shares of the insider transaction must be less than the outstanding number of shares for the stock.[267]

We measure the profitability of insider trades starting from the insider trade date. We measure abnormal stock return behavior using the cumulative market-adjusted abnormal daily stock returns (CAR) starting from the trade date (date 0) for a period of *T* days:

$$CAR_{i,T} = \sum_{t=0}^{T} H_{i,t}(r_{i,t} - r_{m.t})$$

where $H_{i,t}$ takes the value 1 for insider purchases and -1 for insider sales. Thus, we define an insider purchase to be abnormally profitable if the stock price outperforms the general stock market after the purchase. Similarly, we define an insider sale to be abnormally profitable if the

266. For most of the sample period analyzed here (prior to Aug. 29, 2002), Section 16(a) of the Securities and Exchange Act requires that insider transactions be disclosed within the first 10 days of the month following the month of the trade. Section 16(b) prohibits insiders from profiting from short-term price movements defined as profitable offsetting pairs of transactions within 6 months of each other, while Section 16(c) prohibits profiting from short sales. The Sarbanes-Oxley Act of 2002 (effective Aug. 29, 2002) has modified insider trading regulations in many significant ways. First, the new reporting requirement states that insider transactions must be reported electronically by the end of the second business day following the day on which the transaction is executed both through EDGAR and through corporate public websites. Sarbanes-Oxley also prohibits purchase and sale of securities during blackout periods.

267. Qualitative results do not change if these filters are not enforced (results on file with the authors).

stock price underperforms the general stock market after the sale. The variable $r_{i,t}$ is the cum-dividend return to stock i for day t, and $r_{m,t}$ is the cum-dividend return to the CRSP equally-weighted portfolio of all New York Stock Exchange, American Stock Exchange, and NASDAQ stocks for day t. We examine the profitability of insider trades for $T = 5$, 10, 20, 30, 40, and 50 days following insiders' transactions.

To focus on insider transactions that are likely to be based on material, nonpublic information, we first require that the abnormal profitability (CAR) of insiders' transactions exceed 5% by day 5, 10, 20, 30, 40 and 50. The results using insider trading data for the last 40 years are shown in Table 1.

Table 1: The Number and Percentage of Highly Profitable Insider Transactions Exceeding 5% in Abnormal Profits

Decade	Total Number of Open Market Trades	After 5 Days	After 10 Days	After 20 Days	After 30 Days	After 40 Days	After 50 Days
1975-1984	380,315	61,759	93,072	123,375	139,147	149,452	156,731
		16.2%	24.5%	32.4%	36.6%	39.3%	41.2%
1985-1994	428,432	70,652	102,463	137,748	156,942	170,001	177,843
		16.5%	23.9%	32.2%	36.6%	39.7%	41.5%
1996-2004	1,134,154	215,859	300,885	387,741	435,868	462,386	483,736
		19.0%	26.5%	34.2%	38.4%	40.8%	42.7%
2005-2014	1,578,253	204,042	309,572	418,712	477,534	528,742	563,082
		12.9%	19.6%	26.5%	30.3%	33.5%	35.7%
1975-2014	3,521,154	552,312	805,992	1,067,576	1,209,491	1,310,581	1,381,392
		15.7%	22.9%	30.3%	34.3%	37.2%	39.2%

Our evidence shows that a significant portion of insider transactions exhibits immediate profitability. During the decade of 1975 to 1984, over 60,000 transactions showed almost immediate abnormal profitability by beating the general stock market more than 5% during the first 5 days after the trade date. Given the quick stock price reaction and immediate profitability, these translations are likely to be based on material, nonpublic insider information. By day 50, the proportion of highly profitable transactions rises to about 40% of all trades by insiders.

Over the next three decades, the number of transactions with immediate abnormal profitability steadily rose. In the most recent decade of 2005 to 2014, over 200,000 large-volume transactions show immediate profitability by day 5. The number of transactions that showed significant abnormal profitability by day 50 exceeded 500,000 during this decade, again constituting about 35% of all trades by insiders.

As a second test of materiality, we require that profitability of insider trades exceed 10% within 5 days after trade. These results are shown in Table 2. The overall sample period shows that there were more than 190,000 such transactions. By day 50, the number of highly-profitable transactions approaches 1,000,000. These highly profitable transactions constitute about 27% of all insider trades.

Table 2: The Number and Percentage of Highly Profitable Insider Transactions Exceeding 10% in Abnormal Profits

Decade	Total Number of Open Market Trades	After 5 Days	After 10 Days	After 20 Days	After 30 Days	After 40 Days	After 50 days
1975-1984	380,315	19,399	38,054	65,928	84,540	97,537	108,743
		5.1%	10.0%	17.3%	22.2%	25.6%	28.6%
1985-1994	428,432	23,867	43,314	74,524	96,700	113,231	125,716
		5.6%	10.1%	17.4%	22.6%	26.4%	29.3%
1995-2004	1,134,154	86,822	146,557	228,735	289,818	328,642	357,715
		7.7%	12.9%	20.2%	25.6%	29.0%	31.5%
2005-2014	1,578,253	61,022	117,456	204,991	268,452	323,513	368,269
		3.9%	7.4%	13.0%	17.0%	20.5%	23.3%
1975-2014	3,521,154	191,110	345,381	574,178	739,510	862,923	960,443
		5.4%	9.8%	16.3%	21.0%	24.5%	27.3%

The average abnormal profitability of these selected insider transactions is shown in Table 3. Within 5 days after insiders' trade, insiders' average abnormal profit reaches about 17% for the entire sample period, and rising further to about 20% by day 50. The average abnormal profits for this highly profitable sample appear to be stable over the past four decades.

Table 3: Average Abnormal Profitability of Insider Trades Conditional on Exceeding 10% in 5 Days

Decade	Total Number of Open Market Trades	After 5 Days	After 10 Days	After 20 Days	After 30 Days	After 40 Days	After 50 days
1975-1984	19,399	16.6%	16.3%	15.9%	16.2%	16.4%	16.9%
1985-1994	23,867	16.6%	15.6%	16.1%	16.7%	17.6%	18.1%
1995-2004	86,822	18.4%	18.1%	19.4%	20.5%	21.5%	22.6%
2005-2014	61,022	17.1%	17.4%	17.1%	17.8%	17.5%	17.6%
1975-2014	191,110	17.6%	17.4%	17.9%	18.8%	19.2%	19.9%

To compute the statistical significance of our findings, we compared the statistical distribution of actual insiders' abnormal profits with the hypothetical distribution of insider transactions had insiders not traded on material, nonpublic information. To generate the hypothetical distribution, we took the actual insider transactions and then randomized the date of trade as well as the purchase/sale indicator using a random number generator. About 53% of actual insider transactions show abnormal profitability while exactly 50% of the randomly generated hypothetical trades show abnormal profitability. This difference is statistically significant at the 1% level and translates to over 100,000 transactions for our sample.

We also repeated this exercise for large transactions involving 10,000 or more shares. In this case, the difference grew to 4% (54% versus 50%), which is again statistically significant at the 1% level. Finally, we repeated this exercise for large transactions involving 10,000 or more shares by top executives. In this case, the difference grew to 4% to 6% for various holding periods (54% to 56% for actual trades versus 50% for hypothetical trades), which is again statistically significant at the 1% level.

The fact that tens of thousands to hundreds of thousands of additional trades exhibit high abnormal profitability demonstrates that the congressional approach of leaving the definition of illegal insider information purposefully vague is not working. To the contrary, our evidence indicates that insiders are taking advantage of this vagueness in the law to exploit their material, nonpublic information. We suggest that Congress take this opportunity to define the boundaries of what constitutes material, nonpublic and therefore illegal insider trading information.

CONCLUSION

The forty-year time period from 1975 to 2014 that we investigated has seen a number of changes in insider trading laws. While Congress continually increased civil and criminal penalties for insider trading, it kept the definition of material, nonpublic information purposefully vague. The 1984 ITSA established a civil penalty up to three times the profit or loss avoided for both insiders as well as tippers.[268] The 1988 ITSFA provided for private right of action for contemporaneous trading, a bounty program to collect up to 10% of the insiders' illegal profits, while also increasing the maximum penalties for violations of insider trading laws to $1 million in fines and ten years in prison.[269] Finally, SOX further increased the penalties for purposeful violations of the insider trading laws to $5 million in fines and prison sentences up to twenty years.[270] As our evidence establishes, none of these increases in penalties have been successful in even slowing down profitable insider trading.

The recent Second Circuit decision in *Newman* represents a step backward in clarifying what is material, nonpublic information and should be reversed. According to *Newman*, establishing tippee liability under Section 10b of the Exchange Act and Rule 10b-5 of the SEC requires tippee knowledge of tipper personal benefit. The Second Circuit interprets the Supreme Court's decision in *Dirks* stringently,[271] reversing the trend in the federal judiciary over the past 30 years of allowing the *Dirks* personal benefit requirement to be satisfied by proof that (1) the tippee knew the insider-tipper breached a fiduciary-like duty[272] in disclosing confidential information, and (2) that the insider expected to

268. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264.

269. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680-81.

270. Sarbanes-Oxley Act of 2002 § 1106, 15 U.S.C. 78ff(a) (2012).

271. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983) (holding that derivative (tippee) liability can only be found where the insider-tipper "personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."). In *Dirks*, the insider-tipper shared personal information with an analyst (the defendant) in order to expose an insurance scam being perpetrated by the tipper's company. *Id.*

272. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980) (describing the relevant duty as a "fiduciary or other similar relation of trust and confidence"); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1337-340 (2009) (discussing the tendency among courts to base insider trading liability on breaches of duties that fall outside the (typically) more narrow confines of traditional fiduciary duties).

obtain a personal benefit in exchange for disclosure.[273] Moreover, apart from expounding a strict interpretation of the elements needed to establish tippee liability, the *Newman* court also set surprisingly high evidentiary standards for proving these elements.

The combination of these legal and evidentiary adjustments to the *Dirks* test could have serious implications for the government's efforts to deter insider trading. The reason for this is quite simple: when potential tippees know they can trade on confidential information without recourse, so long as they are careful to receive that information from "a friend of a friend of [a friend],"[274] they can easily circumvent liability, which will give rise to informal information sharing networks.[275] By habitually sharing inside information with friends and associates, insiders could easily engage in indirect, mutual-back-scratching relationships, disclosing valuable information to the network in the hope that similarly situated individuals "three and four levels removed from the inside tipper"[276] will reciprocate. Such arrangements could lead to significant increases in insider trading activity, thereby exacerbating the practice's primary consequences: the unfair transfer of wealth from ordinary investors to insider traders and the diminution of the public's confidence and participation in securities markets.[277] This,

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273. *See* Avi Weitzman et al., *Second Circuit Injects New Life into Dirks Personal Benefit Test in United States v. Newman*, 29 CORP. & SEC. L. ADVISOR 1, 3 (2015) (outlining how the federal courts have generally "diminished the *Dirks* personal benefit test" over the past 30 years; "[e]ven absent any pecuniary benefit to the tipper, insider trading charges were brought against . . . downstream tippees who knew neither the identity of the individual tipper nor whether the tipper had personally benefitted from providing the tip. It was the rare case indeed for a court to dismiss insider trading cases for lack of a *Dirks* personal benefit to the tipper."); SEC v. Obus, 693 F.3d 276, 276 (2d Cir. 2012) (enumerating the elements of tippee liability without including knowledge of the tipper's expected personal benefit as a separate element).

274. United States v. Newman, 773 F.3d 438, 453 (2d Cir. 2014).

275. *See Why Insider Trading Is Hard to Define, Prove and Prevent*, KNOWLEDGE@WHARTON, Nov. 11, 2009, http://knowledge.wharton.upenn.edu/article/why-insider-trading-is-hard-to-define-prove-and-prevent/ [http://perma.cc/9AZR-BJRV]; *see also* Weitzman et al., *supra* note 273, at 3 (explaining how previous insider trading cases considered the ability to maintain networking contacts by disclosing inside information to be a considerable "reputational benefit," a benefit that typically satisfied the *Dirks* personal benefit requirement).

276. *See Newman*, 773 F.3d at 443.

277. *See* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (noting that, where insider trading goes unregulated, "investors likely would hesitate to venture their capital [into the] market").

in turn, would likely promote less efficient allocations of investor capital and reduced liquidity in the financial sector.[278] Considering these negative consequences, it is imperative that the legal community find ways to circumvent the constraints *Newman* imposes on prosecutors.

This Article puts forth a solution, identifying evidence that could demonstrate a tippee's knowledge of tipper benefit without requiring actual knowledge of the confidential information's source. By using the Form 8-K filing as a proxy for tippee knowledge of tipper breach of duty and personal benefit, this approach puts tippees on notice that the specific information has been disclosed contrary to law and in violation of fiduciary duties. Because there should be no legitimate business purpose for disclosing such information without filing a Form 8-K, the failure to file should also be strong enough circumstantial evidence to support an inference that the tipper has shared confidential information in order to secure a personal benefit. This is because no rational insider would assume the liability risk associated with such a disclosure if she did not expect to benefit from it. This evidentiary presumption is not only consistent with *Newman* and other insider trading cases, but it also promises to significantly expand the ability of prosecutors to bring cases against putative insider traders. Moreover, this approach exemplifies how similar evidentiary presumptions might be employed to bridge the "knowledge gap" that now makes it so difficult—and under *Newman* practically impossible—to establish downstream tippee liability.

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278. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 733-37 (2006) (discussing the harmful impact that insider trading and the market's perceptions of insider trading can have on market liquidity and overall market performance). *But see* Eric Engle, *Insider Trading: Incoherent in Theory, Inefficient in Practice*, 32 OKLA. CITY U. L. REV. 37, 60 (2007) (arguing that there is no evidence to suggest that insider trading leads to significant decreases in market liquidity).