NEWMAN/*MARTOMA*: THE INSIDER TRADING LAW'S IMPASSE AND THE PROMISE OF CONGRESSIONAL ACTION

By Tai H. Park[*]

ABSTRACT

The prohibition against insider trading is a judge-made law that has evolved for over fifty years, and has reached a critical impasse in two recent decisions in the Second Circuit Court of Appeals: *United States v. Newman* and *United States v. Martoma*. Judges of the Second Circuit are sharply divided over what conduct constitutes improper trading on material nonpublic information ("MNPI"), leaving the law in profound disarray. At bottom, the disagreement stems from a decades-old split within the judiciary about how to (1) ensure a fair securities marketplace, while (2) enabling institutional analysts to probe for corporate information in furtherance of efficient market valuation of securities.

In 1983, the U.S. Supreme Court in *SEC v. Dirks* sought to strike a balance between these two interests by holding that trading on MNPI is not illegal unless the information was disclosed in exchange for a personal benefit. But the effort to balance these two competing economic and moral interests should never have been the province of the judiciary, nor did its formulation ever win uniform consensus among the judges. After decades of struggle, the *Newman*/*Martoma* empasse is the consequence. Congress may finally be ready to pass a law of insider trading that would break the deadlock, but the bill under consideration ignores the market efficiency interests that undergirded the personal benefit element of insider trading. This Article suggests that before passing any law, Congress must undertake an empirical review of the impact that the insider trading bill would have on an efficient market to ensure that the final law is not only clear, but beneficial to the health of the capital markets.

---

[*] Tai H. Park is a partner at the law firm White & Case LLP. The views expressed here are his own and not necessarily those of the law firm. He is grateful for the thoughtful suggestions of his colleague, Tami Stark, as well as the insightful analysis and commentary of Professor Daniel Richman to an earlier draft of this Article.

TABLE OF CONTENTS

INTRODUCTION

In the late 2000s, when federal prosecutors in New York turned their sights to the hedge fund investor community, it was like shooting fish in a barrel. Within a few years, they had won insider trading convictions or guilty pleas from dozens of securities professionals.[1] They then watched, however, as key prosecutions unraveled. In *United States v. Newman*, the Second Circuit determined that some of the defendants who had been convicted after a hard-fought trial were not guilty of any crime.[2] The Court's ruling and interpretation of the law led to reversals of other convictions and other charges being dismissed, even as to some defendants who had pleaded guilty to insider trading.[3]

Three years later, a different panel of the Second Circuit in *United States v. Martoma* issued a ruling that flatly contradicted *Newman*.[4] A dissenting judge disagreed, declaring that the majority's mistaken rule should be ignored as dicta.[5] These concerning events have caught the attention of Congress. While Congress had in previous years considered, then abandoned, legislation, Congress may now enact a statute that defines the insider trading prohibition.[6] The current draft of the House bill offers much needed clarity, but also seems incomplete. It remains to be seen how the Senate will react to it.

This Article suggests that the merits of the current bill cannot be understood without examining the evolution of the judge-made rule of insider trading, which culminated in the *Newman/Martoma* impasse. This Article will examine the judiciary's decades-long effort to define an insider trading law that only Congress had the power to enact under the separation of powers doctrine. It argues that the result has been a hopelessly vague law that violates the notice requirements of the Due

---

1. *Timeline: A History of Insider Trading*, N.Y. TIMES: DEALBOOK (Dec. 6, 2016), https://www.nytimes.com/interactive/2016/12/06/business/dealbook/insider-trading-timeline.html [https://perma.cc/LY6L-NUDZ].

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

3. *See, e.g.*, United States. v. Conradt, 2015 U.S. Dist. LEXIS 16263, at *3 (S.D.N.Y. Jan. 22, 2015).

4. United States v. Martoma, 869 F.3d 55, 61 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017).

5. *See Martoma*, 869 F.3d at 74 (Pooler, J., dissenting)).

6. *See* Insider Trading Prohibition Act, H.R. 2534, 116th Cong. § 16A (as approved by H.R. Fin. Serv. Comm., May 8, 2019, and committed to the H. Comm. of the Whole, Sept. 27, 2019).

Process clause. While Congress is now considering a bill that offers much needed clarity, this Article contends that the current draft may be problematic. It strongly embraces a "parity of information" vision for the securities market by prohibiting any trades while in possession of material nonpublic information ("MNPI") obtained through a breach of a confidentiality obligation. In so doing, the bill gives too little regard for the competing interest of market efficiency. It is the conflict between these two important interests that mired the courts in debate for decades. If passed, the bill's blanket prohibition could materially impact institutional investors' ability to investigate corporate information, a task that is vital to accurate securities valuations. This Article supports a deeper analysis in the Senate that may lead to a more balanced law regulating the flow of corporate information in the financial markets.

Part I summarizes the origin and evolution of the judge-made law of insider trading. While at its very inception, the law was heavily criticized for analytic flaws as well as its nature as a judge-made criminal law, Congress declined to act. Thus, after decades of the law evolving on a case-by-case basis in a "topsy turvy" fashion, the sharp disagreement between *Newman* and *Martoma* suggests that even judges of the Second Circuit cannot decide what precisely the law prohibits and why.[7] The root cause of this ambiguity is disagreement about a policy question of great importance to the U.S. securities market: to what extent our interest in market efficiency should trump the competing interest in parity of market information.

In *Dirks v. SEC*, Justice Lewis Powell, writing for the majority, triggered this debate when he sought to prohibit abusive conduct in the securities market while simultaneously offering institutional analysts a "safe harbor" so they could continue to seek out nonpublic corporate information.[8] Such activity was viewed as vital to the efficient and accurate pricing of securities. Thus, *Dirks* held insider trading to be fraudulent only if the insider engages in an intentional breach of its fiduciary duty, which in turn requires a personal benefit to the insider in exchange for disclosing MNPI.[9]

---

7. *See* United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012) (Rakoff, J.) (remarking on "the topsy-turvy way the law of insider trading has developed in the courts") *aff'd*, 555 F. App'x 98 (2d Cir. 2014).

8. Dirks v. SEC, 463 U.S. 646, 659 n.17 (1983); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1034 (1990).

9. *Dirks*, 463 U.S. at 654.

On the other side of the debate, Justice Harry Blackmun's dissent expressed the demand for information parity.[10] Compelled by the instinct for fairness and equity of opportunity, he argued for a more comprehensive ban on any trading based on confidential information.[11] He challenged the majority to explain why, exactly, personal benefit should be an element and what, precisely, that even means.[12] This challenge was not answered; he was simply outvoted.[13]

Though Blackmun lost that debate, in subsequent years, securities regulators and prosecutors took positions that had the effect of diluting *Dirks*' core doctrine, earning Second Circuit judges' support along the way.[14] The law began with confusion, evolved in uncertain directions, and led to the startling *Newman/Martoma* impasse we now see within the Second Circuit.[15] While centered on the meaning of *Dirks*, the two circuit court cases continue the policy debate that Powell and Blackmun engaged in over 35 years ago.[16] In *Newman*, the Second Circuit sought to reinvigorate *Dirks'* protection of the work of investment analysts, while *Martoma's* majority applied reasoning consistent with Blackmun's insistence on information parity.[17]

Part II argues that, when viewed through the lens of an institutional investor, the judicial doctrine is too vague and imprecise and thus fails the due process standards of notice. Both the Due Process clause and the related separation of powers doctrine demand that Congress finally follow through and finish the job of legislating a coherent law.

In the wake of *Newman/Martoma*, the House appears to recognize that Congress must act, and has taken steps toward legislation.[18] But as Part III suggests, the draft bill fails to account for the market efficiency interests promoted by *Dirks* and *Newman*. The current bill fully embraces the information parity vision of the marketplace by effectively precluding

---

10. *See id.* at 679 (Blackmun, J., dissenting).
11. *See id.*
12. *Id.* at 674.
13. *Id.* at 667.
14. *See* United States v. Martoma, 869 F.3d 58, 72 (2d Cir. 2017).
15. *See* United States v. Newman, 773 F.3d 438 (2d Cir. 2014); *Martoma*, 869 F.3d at 72.
16. *See Newman*, 773 F.3d at 438; *Martoma*, 869 F.3d at 72.
17. *See Newman*, 773 F.3d at 438; *Martoma*, 869 F.3d at 72.
18. *See Insider Trading Prohibition Act*, H.R. 2534, 116th Cong. § 16A (as approved by H.R. Fin. Serv. Comm., May 8, 2019).

any trades on the basis of confidential corporate information.[19] Though the bill has the benefit of clarity, it may discourage institutional analysts from seeking out nonpublic information that illuminate the true condition of companies they analyze. If that happens, the market's ability to value securities may become less reliable—instead, a company's public representations about itself may become the predominant basis of its stock price. The consequences of such events on the efficiency of the marketplace are unclear.

Part III suggests that the Senate should engage in a more probing and expansive evaluation of the analysts' role in the marketplace than the House appears to have conducted. This is the work that should have been done in the early 1980s, and that neither Powell nor Blackmun were in a position to do.

Whatever happens, the law will benefit from the democratic process of establishing a rule or set of rules that regulates the flow of corporate information. Not only will it be a law issued by Congress, accountable to the citizens of this country, it will hopefully be a clear one. Ideally, it will also be beneficial to the health of the securities market.

I. The Origin and History of a Judge-Made Law

A. The Sustained Criticism of Insider Trading Law

The law of insider trading is judge-made, not statutory.[20] In *Salman v. United States*—the U.S. Supreme Court's most recent decision on insider trading—the Court opened with the following description of the law:

> Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b-5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage.[21]

In this succinct statement, the Court cites to certain language in the referenced statute and rule, as well as to *United States v. O'Hagan*.[22] The

19. *See id.*
20. *See generally* United States v. Whitman, 904 F. Supp. 2d. 372 (S.D.N.Y. 2012).
21. Salman v. United States, 580 U.S. 420, 423 (2016).
22. *Id.* (citing United States v. O'Hagan, 521 U.S. 642, 650–52 (1997)).

elegance of *Salman's* description of the law, however, belies its true nature. In fact, neither section 10(b) nor the SEC's Rule 10b-5 contains a prohibition on insider trading.[23] The statutory anti-fraud language, to which the Court cites, contains no reference to "undisclosed trading," "inside corporate information," the "duty of trust and confidence," or the secret use of "information for their personal advantage."[24] Each of those terms is a construct of caselaw and each is fraught with uncertainty.

The Court's key citation was to *O'Hagan*, which in turn relies on controversial reasoning contained in *Chiarella v. United States* and *Dirks v. SEC*, and expanded on them with more controversial reasoning.[25] To muddy the waters further, *Salman's* definition of the prohibition omitted the key element of "materiality," another notoriously ambiguous concept that has never been defined by either Congress or the U.S. Securities and Exchange Commission ("SEC").[26] And *Salman's* description refers only to what the insider can or cannot do, but is silent regarding what a tippee, such as defendant Salman, can do and under what circumstances.[27]

Far from a succinctly-stated law neatly tied to a statute, insider trading is a common law edifice, hand-built over the past five decades through myriad judicial decisions, each presenting highly fact-intensive disputes.[28] This jurisprudence violates the separation of powers doctrine,

---

23. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catch-all clause to prevent fraudulent practices. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of § 10(b)"); *see also* Newman v. United States, 773 F.3d 438, 445 (2d Cir. 2014) ("[N]either [section 10(b)] nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading").

24. *Salman*, 580 U.S. at 423 (citing 48 Stat. 891, as amended, 15 U.S.C. § 78j(b)(2012)) (prohibiting the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance in contravention of such rules as the [SEC] may prescribe"); 17 C.F.R. § 240.10b–5 (2016) (forbidding the use, "in connection with the sale or purchase of any security," of "any device, scheme or artifice to defraud," or any "act, practice, or course of business which operates . . . as a fraud or deceit").

25. *Chiarella*, 445 U.S. at 222.

26. *See infra* discussion at note 610.

27. *See Salman*, 580 U.S. at 423.

28. *See* Paul A. Engelmayer, *Congress: U.S. Needs an Insider Trading Law*, N.Y.L.J. (Oct. 23, 2015), *http://www.newyorklawjournal.com/id=1202740459962* ("[T]he development of U.S. insider trading law has been left to the federal courts. The U.S. Supreme Court and the Second Circuit have developed this body of law, *ad hoc*, case by case, essentially from scratch, effectively as a matter of federal common law.").

democratic norms, and Supreme Court jurisprudence since *United States v. Hudson* in 1812,[29] which all require congressional action.[30] Thus, scholars,[31] practitioners,[32] and even judges[33] have criticized the judicial source of this law by the droves.

Congress itself recognized its duty, as it sought to legislate a comprehensive insider trading law over the past several decades in fits and starts.[34] But each time, Congress was dissuaded from doing so due to the SEC's resistance to any definitive legislation.[35] As one commentator explains: "The SEC, preferring a case-by-case construction, has

29. *See United States v. Hudson*, 11 U.S. (7 Cranch) 32, 34 (1812); *see also infra* discussion at Part II.B.

30. As discussed *infra* at notes 577 and 578, insider trading is not alone in having grown out of federal common law, but as a means of regulating the flow of information in the nation's securities market, its unsuitability to judicial craftsmanship is unique.

31. *See, e.g.*, Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J. FORUM 129, 149 (2017) ("The larger problem for *Salman* is that the Supreme Court let Congress off the hook. And by doing so, it foreclosed the corollary benefits that arise when a legislature sets itself to the task not only of defining crimes, but of differentiating them as well."); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1212 (1997) ("Many commentators have expressed concern over the absence of a statutory definition") (citing James D. Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading*, 39 ALA. L. REV. 381, 381 (1988) ("[I]t is imperative that Congress define insider trading."); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 251 (1991) ("Congress should replace the current regime with a statute that is clear and predictable."); Donald C. Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 ALA. L. REV. 399, 409–13 (1988) (calling for reform); Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 71 (1984) (citing the need for legislation)).

32. *See, e.g.*, Harvey L. Pitt & Karen L. Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415, 416 (1988); Hervé Gouraige, *Do Federal Courts Have Constitutional Authority to Adjudicate Criminal Insider-Trading Cases?*, 69 RUTGERS U.L. REV. 47, 118 (2016) ("They all point in the direction of statutory enactment and away from judicial development of legal rules based on case-by-case adjudication.").

33. *See*, *e.g.*, Engelmayer *supra*, note 28; Jed S. Rakoff, *A Statutory Solution to Insider Trading*, 27 A.B.A. SEC. LITIG. 2 (Winter 2017).

34. See Rakoff, *supra* note 33.

35. *See id.* ("[S]uch bills have been vigorously, and successfully, opposed by the SEC on the ground that they were too narrow or created loopholes through which insider traders could escape.").

discouraged efforts by Congress to legislate the parameters of section 10(b) and insider trading."[36] With respect to a 1984 bill introduced by Senator Al D'Amato, "the agency ultimately opposed the legislation because defining insider trading might 'reduce the Commission's flexibility to prosecute evolving types of conduct.' After all, the SEC noted that the existing anti-fraud provisions worked so well because of the adaptability inherent in the case-by-case treatment."[37] In other contexts, the SEC has given the same need-for-flexibility reasoning for its refusal to provide a clear definition of "materiality."[38]

Flexibility for the SEC has meant protean unpredictability of the law. Complaints about its vagueness came soon and often, from all quarters.[39]

---

36. Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1167 (1997) [hereinafter "Swanson, *Reinventing Insider Trading*"].

37. *Id.* at 1167–68 (citing to Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 1, 37 (Apr. 3, 1984) (statement of John Fedders, Director of the SEC's Division of Enforcement)).

38. *See infra* discussion at note 610.

39. For examples of scholarly criticism, see, e.g., Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 376–77 (1982) ("This is not a Supreme Court construing a complicated federal statutory scheme with wisdom, craft, and candor; this is a first-year Torts class on a bad day."); Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984) ("The more one ponders the reasoning in *Chiarella v. United States* and *Dirks v. SEC*, the less one is satisfied with the Supreme Court's explanation of when and why Rule 10b-5 prohibits trading in securities on the basis of material nonpublic information."); Swanson, *Reinventing Insider Trading*, *supra* note 36 at 1160 ("[I]nsider trading regulation will struggle forward, ill-defined and inefficient, into the next century."); Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1088–89, 1095 (2011) (arguing that "[t]he law of insider trading is hardly an example of clarity, and its fiduciary foundation is unstable," and that the source and the contours of a "federal fiduciary duty" remain cloaked in ambiguity); A.C. Pritchard, *Insider Trading and the Ambiguous Quest for Edge*, 116 MICH. L. REV. 945, 946 (2018) ("[T]he legal prohibition against insider dealing is beset by murky lines, the product of its essentially common law origins. Courts have made it up as they go along because Congress and the SEC have refused to define insider trading by statute or rule.").
For examples of judicial criticism, see United States v. Chestman (*Chestman II*), 947 F.2d 551, 572 (2d Cir. 1991) (Winter, J., concurring) (noting that the legal rules governing insider trading under section 10(b) are based solely on administrative and judicial caselaw and that "[t]his caselaw establishes that some trading on material nonpublic information is illegal and some is not. The line between the two is less than clear"); *id.* at 575

Most recently, in the wake of *Newman*, it was the Government telling the Supreme Court (1) that "market participants and analysts who seek to comply with the law will lack clear guidance about the legal limits of their conduct,"[40] and (2) that *Newman's* reading "blurs the line between legitimate and prohibited activity,"[41] and creates "uncertainty in the financial community about the boundaries of legitimate conduct."[42] The Government used even more emphatic language in its bid for a rehearing and rehearing *en banc*, as it told the Second Circuit that *Newman's* definition of personal benefit is "deeply confounding" and "certain to engender confusion among market participants, parties, judges, and juries."[43]

For all the urgency expressed by the Government, neither the *en banc* Second Circuit nor the Supreme Court granted the Government's pleas for review of *Newman*.[44] As discussed *infra* at Part I.E, *Martoma I and II* followed. In supporting Martoma's bid for *en banc* review, the New York Council of Defense Lawyers, and the National Association of Criminal Defense Lawyers chimed in on the law's uncertainty, as they filed an amicus brief claiming that *Martoma II* "creates great uncertainty in the

(referring to the *Chiarella* opinion as "an enigma"); *id.* at 576 (stating that the *Dirks* "rationale is obscure, and, as a result, so is the scope of the rule. Notwithstanding the ambiguities surrounding section 10(b)'s impact on insider trading—including its very definition—Congress has increased the penalties for violations of that prohibition"); *see also Whitman*, 904 F. Supp. 2d at 372 (remarking on "the topsy-turvy way the law of insider trading has developed in the courts").

40. Petition for a Writ of Certiorari, United States v. Newman, No. 15-137 (U.S. July 30, 2015), 2015 WL 4572753, *33 [hereinafter *Petition for Certiorari, Newman*].

41. *Id.* at *26.

42. *Id.* at *32.

43. Petition of the United States of America for Rehearing and Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2015) (No. 13-1837), 2015 WL 1064423, at *2 [hereinafter *Petition for Rehearing En Banc, Newman*].

44. In the wake of the *Newman* reversal, Congressman Jim Hines of the House of Representatives drafted a bill that is nearly identical to the ITPA discussed *infra* Part III, that would have codified the insider trading law to eliminate the personal benefit element because "there exists a fundamental disadvantage in prosecuting a crime that has never been properly defined." *See* Press Release, Jim Himes, Himes Introduces Bipartisan Bill to Define and Prohibit Illegal Insider Trading (Mar. 25, 2015), https://himes.house.gov/media-center/press-releases/himes-introduces-bipartisan-bill-define-and-prohibit-illegal-insider [https://perma.cc/68F7-U49W]. It is unclear why this bill was abandoned.

law of insider trading. . . ."[45] The defense bar's suggestion of *en banc* review of *Martoma* was also denied.[46]

To understand how confounding this "uncertainty" is, one need only consider the dissenting opinion of Judge Rosemary Pooler in *Martoma*:

> [The majority asks] us to imagine a situation where a tipper "discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this." Wouldn't it be absurd if this perfect stranger could not be held liable for insider trading if he went ahead and traded on this information? *No, it would not be*.[47]

Pooler explained why, under *Dirks*, the majority's hypothetical would not amount to a crime. Her dissent was entirely consistent with the *Newman* decision just two years earlier.

B. The Original and Unresolved Policy Debate

To understand the Gordian knot of *Newman*/*Martoma*, it is necessary to summarize the tortuous, half-century path of the caselaw that brought us here.

1. The Origin of Insider Trading Law: The SEC's Push for Information Parity

In 1961, in an administrative decision, *Cady, Roberts & Co.*,[48] the SEC espoused the view that market regulation should protect parity of information or information access ("information parity").[49] The SEC held

---

45. Brief of N.Y.C. Council of Def. Law. and Nat'l Ass'n of Crim. Def. Law. as Amici Curiae in Support of Defendant-Appellant's Petition for Rehearing *En Banc* at 6, United States v. Martoma, 894 F.3d 64 (2d Cir. 2017) (No. 14-3599), 2018 WL 4075999 [hereinafter *Amici Curiae Brief, Martoma*].

46. Order Denying Defendant's Petition for Rehearing *En Banc, United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 27, 2018) [hereinafter *Order Denying Rehearing, Martoma*].

47. *Id.* at 86 (Pooler, J., dissenting) (emphasis added).

48. Matter of Cady, Roberts & Co., 40 SEC 907 (1961).

49. It is, of course, not possible for market participants to always have the same or equal information. As a general matter, as described below, regulators have sought to ensure that all market participants have roughly the same access to information. If one already has MNPI, however, in a seller/buyer relationship, the information parity theory requires that the person in possession either disclose it to the trade counterparty or abstain from trading.

that insider trading violates section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act").[50] No language in the statute references insider trading, but the SEC reasoned that pursuant to the anti-fraud provisions of the statute, a "special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders."[51] Under that obligation, "any sales by the insider must await disclosure of the information"[52] whether made to a current shareholder or a new shareholder, and whether made face-to-face or over the exchange.[53] In finding this obligation, the SEC stated:

> Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[54]

As Second Circuit Judge Ralph Winter later explained, "[u]nder the theory of *Cady, Roberts & Co.*, the second element furnishes the fraud or deception that links the prohibition on insider trading to [s]ection 10(b)."[55]

Several years later, in 1968, the Second Circuit's decision in *SEC v. Texas Gulf Sulphur Co.*[56] essentially endorsed the SEC's approach in *Cady, Roberts & Co*. The Court held that "anyone in possession of material inside information must either disclose it to the investing public,

---

50. Section 10(b) of the 1934 Act, 15 U.S.C. § 78j (2018) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Pursuant to this section, the SEC promulgated Rule 10b-5, which provides in pertinent part: "[i]t 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, [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." 17 C.F.R. § 240.10b–5 (1979).

51. *Cady, Roberts*, 40 SEC at 912.

52. *Id.* at 914.

53. *Id.* at 913–14.

54. *Id.* at 912.

55. United States v. Chestman, 947 F.2d 551, 574 (2d Cir. 1991) (*Chestman II*) (Winter, J., concurring).

56. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.1968), *cert. denied*, 394 U.S. 976 (1969).

or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[57] In embracing the notion of information parity, the Court stated that Congress had intended investors to "be subject to identical market risks,"[58] and that the law sought to remove "inequities based upon unequal access to knowledge."[59]

A decade later, in 1978, the Second Circuit relied on the same rationale in *United States v. Chiarella*,[60] as it affirmed the criminal conviction of a defendant charged with insider trading. This appeared to be the first criminal prosecution for such conduct under the securities laws.[61] The defendant was an employee of a printing company who used client documents to determine the identity of target companies and bought stock in those companies.[62] Consistent with previous caselaw regarding information parity, the Second Circuit held that "[a]*nyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."[63] On this theory, Chiarella, a lowly employee of a printing company—who owed no duties to the target companies—was found guilty of "insider" trading.[64]

2. Chiarella—the Court's Rejection of Information Parity

With Justice Lewis Powell writing for the majority, the U.S. Supreme Court reversed Chiarella's conviction.[65] The decision effectively rejected the interest in information parity as a basis for insider trading prohibitions, but the case yielded five separate opinions from the splintered Supreme Court.[66] While *Chiarella* articulates insider trading

---

57. *Id.* at 848.
58. *Id.* at 852.
59. *Id.*
60. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), *rev'd,* 445 U.S. 222 (1980).
61. Chiarella v. United States, 445 U.S. 222, 235 n.20 (1980).
62. *Id.* at 224.
63. *Chiarella*, 588 F.2d at 1365.
64. *Id.* at 1362.
65. *Chiarella*, 445 U.S. at 225.
66. *Id.* at 223.

law, it did so largely by way of limiting the law that had developed prior to reaching the Court.

Research into Powell's thinking helps to explain the limitations imposed by *Chiarella*. Professor A.C. Pritchard, who studied Powell's papers, explains that the Justice had misgivings about the doctrine as he found it.[67] He viewed "Rule 10b-5's jurisprudence as a species of 'federal common law,'"[68] and thought "that the SEC should have gone to Congress long ago. Rather, it has elected to write expansive Rules (*e.g.*, Rule 10b-5, drafted by Louis Loss one morning), and then undertake to extend the vague language of the Rule to the edge of rationality."[69] The common law perspective gave courts "wide latitude for policy concerns."[70] Powell also "worried that prohibitions against insider trading could chill incentives for analysts and other market professionals to uncover information about publicly traded companies."[71] It was not until *Dirks v. SEC* that Powell squarely confronted the policy disagreement.

Rather than acting on these very real concerns and declaring the law an unconstitutional exercise of judicial power, Powell set about trying to limit its reach by imposing his own "policy concerns" onto the law.[72] It may be that by then, the "federal common law" of securities jurisprudence was so far along that he felt it was too late. Five years earlier, in *Blue Chip Stamps v. Manor Drug Stores*, Justice Rehnquist bemoaned the fact that:

> When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.[73]

Given this history, Powell may have concluded the Court had no choice but to create yet a new branch to the expanding "judicial oak." The

67. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 929 (2003).

68. *Id.* at 930.

69. *Id.* (quoting from Powell letter to Michael P. Dooley, Professor of Law, University of Virginia 1 (Oct. 25, 1980)).

70. *Id.* at 930–31.

71. *Id.* at 931.

72. *Id.* at 846, 869.

73. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

best he could do was attempt to limit its reach by tightly mooring insider trading liability to the statute it was supposedly based upon. Thus, the Court's opinion begins and ends by reference to section 10(b) of the Exchange Act.[74] It emphasized that "neither the legislative history nor the statute itself affords specific guidance for the resolution of this case."[75] And at the end of its analysis of the law, the Court concluded by reminding the Government that "the [Exchange] Act cannot be read more broadly than its language and the statutory scheme reasonably permit[s]. . . . Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[76] To reach this conclusion, the Court sought the aid of the common law of fraud:

> At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[77]

In a passage that would take greater importance later in *Dirks*, the Court suggested that the "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[78] While Chiarella acted for personal profit, he had no duty to the company whose

---

74. *See Chiarella*, 445 U.S. at 224–37.

75. *Id.* at 226 ("Although the starting point of our inquiry is the language of the statute . . . 10(b) does not state whether silence may constitute a manipulative or deceptive device. Section 10(b) was designed as a catch-all clause to prevent fraudulent practices . . . . But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of 10(b).") (citations omitted).

76. *Id.* at 234–35 (citations omitted).

77. *Id.* at 227–28 n.9 (citing, *inter alia*, RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976); as well as the American Law Institute's comment that "silence when there is a duty to . . . speak may be a fraudulent act." ALI, Federal Securities Code § 262(b) (Prop. Off. Draft 1978)).

78. *Id.* at 230.

stock he traded or to its shareholders, and thus could not be convicted of insider trading.[79]

In so holding, the Court expressly rejected the Second Circuit's ruling that "*[a]nyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[80] The reasoning violated two precepts of securities law: "First not every instance of financial unfairness constitutes fraudulent activity under [section] 10(b),"[81] and second, it would eliminate "the element required to make silence fraudulent—a duty to disclose."[82] The principle espoused by the Second Circuit incorrectly assumed a "general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[83] According to the Court, "such a broad duty . . . departs radically from the established doctrine that duty arises from a specific relationship between two parties [and] should not be undertaken absent some explicit evidence of congressional intent."[84]

The Court then added that "neither the Congress nor the Commission ever has adopted a parity-of-information rule."[85] This was a puzzling assertion, because the parity of information rule was effectively the rationale underlying both *Cady, Roberts & Co.* and the SEC's litigation position before the Second Circuit in *Texas Gulf*.[86] It is perplexing that the Court would acknowledge and even appear to rely on *Cady, Roberts & Co.*,[87] but then steer it in a direction that was decidedly off-course from the SEC's pathway. To do this, the Court cited with approval the two elements that gave rise to an obligation to disclose or abstain from trading described in *Cady, Roberts & Co.*: "the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading

79. *Id.* at 231.
80. *Id.* at 235 n.20.
81. *Id.* at 232.
82. *Id.*
83. *Id.* at 233.
84. *Id.*
85. *Id.*
86. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Matter of Cady, Roberts & Co., 40 SEC 907, 912 (1961).
87. Chiarella v. United States, 445 U.S. 222, 226–29 (1980).

without disclosure."[88] But instead of acknowledging that the SEC had stressed the second of the two elements—"unfairness" resulting from information disparity—*Chiarella* appeared to seize on the first element, the "relationship," as the core foundation of a fraud prosecution.[89] The second factor appeared to be relevant only because of its reference to the improper "advantage" sought by the insider. Thus, immediately after citing to the two *Cady, Roberts & Co.* factors, the Court shifted to a detailed discussion about the element of "duty" under the common law of fraud.[90]

The Court also cited to *Texas Gulf*, but only for the proposition that "[t]he federal courts have found violations of [section] 10(b) where corporate insiders used undisclosed information for their own benefit."[91] The Court did not even acknowledge, much less address the Second Circuit's conclusion in *Texas Gulf* that "anyone in possession of material inside information" must either disclose or abstain from trading.[92] Nor did the Court address the Second Circuit's contention in *Texas Gulf* that Congress had intended investors to "be subject to identical market risks,"[93] and that the law sought to remove "inequities based upon unequal access to knowledge."[94] Instead, the Court moved back seamlessly to a discussion—in the civil securities context—of the duty to disclose under common law, citing Second Circuit precedent.[95]

Thus, the Court managed to reject the information parity rule, while at the same time relying on SEC and Second Circuit case law that effectively relied on that same doctrine.[96] In any event, the Court concluded that "a duty to disclose under [section] 10(b) does not arise from the mere possession of nonpublic market information."[97]

---

88. *Id.* at 227.
89. *Id.*
90. *Id.* at 227–29
91. *Id.* at 229 (*citing Texas Gulf*, 401 F.2d at 833).
92. *See id.*; *cf. Texas Gulf*, 401 F.2d at 848.
93. *See Chiarella*, 445 U.S. 222; *cf. Texas Gulf* at 852.
94. *See Chiarella*, 445 U.S. 222; *cf. Texas Gulf* at 852.
95. *Chiarella*, 445 U.S. at 222.
96. Oddly, in *Dirks v. SEC*, Justice Powell's majority opinion states that the *Chiarella* majority "accepted" the SEC's formulation of both elements of *Cady, Roberts*. *Dirks*, 681 F.2d 824 at 834.
97. *Chiarella*, 445 U.S. at 235 (citations omitted). Seeking to salvage the conviction, the Government argued Chiarella was guilty because he had breached a duty to his employer printer's clients, the acquiring corporations, by misusing their information for his personal trading gain. *Id.* The Court declined to affirm the conviction on this basis

The dissent, written by Justice Blackmun and joined by Justice Marshall, squarely championed a contrary vision for the marketplace and sharply disagreed that the "failure to disclose violates the Rule [10b-5] only when the responsibilities of a [fiduciary-like] relationship . . . have been breached."[98] Blackmun noted that the "common law of actionable misrepresentation long has treated the possession of 'special facts' as a key ingredient in the duty to disclose,"[99] and that in fact, "there has been a trend away from strict adherence to the harsh maxim *caveat emptor* and toward a more flexible, less formalistic understanding of the duty to disclose."[100] Emphasizing the need for "fairness" in market interactions, he noted that the Court previously "observed that the securities laws were not intended to replicate the law of fiduciary relations[,]"[101] and that, instead, "their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate."[102] He cited to an opinion he had authored for the Court in *Affiliated Ute Citizens v. United States*,[103] which he "believe[d], and surely thought, [recognized and approved] . . . this broad understanding of the duty to disclose under Rule 10b-5 . . . ."[104]

Arguing for information parity, Blackmun continued: "[a]s I now read my opinion," it "lends strong support to the principle that a structural disparity in access to material information is a critical factor under Rule 10b-5 in establishing a duty either to disclose the information or to abstain from trading."[105] Blackmun also cited to section 10(b)'s legislative history for the proposition that "Congress itself has recognized [that] it is integral to this purpose 'to assure that dealing in securities is fair and without undue preferences or advantages among investors.'"[106] Blackmun then

because that theory had not been offered during jury instructions at trial. *Id.* at 236. This theory has come to be known as the misappropriation theory, which the Court would not adopt until United States v. O'Hagan, 521 U.S. 642 (1997) discussed *infra* pp. 45–51.

98. *Chiarella*, 445 U.S. at 247 (Blackmun, J., dissenting).

99. *Id.*

100. *Id.* at 247–48 (citing W. Page Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 31 (1936)).

101. *Id.* at 248 (citing Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 474–76 (1977)).

102. *Id.* (citing United States v. Naftalin, 441 U.S. 768, 775 (1979)).

103. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

104. *Chiarella*, 445 U.S. at 250.

105. *Id.* at 251.

106. *Id.* at 248 (citing H.R. Conf. Rep. No. 94–229, at p. 91, (1975), as reprinted in 1975 U.S.C.C.A.N, p. 323).

cited to *Cady, Roberts & Co.*, describing its import in a more straightforward fashion than the majority had.[107] Quoting in full the two factors that "defined the category of 'insiders' subject to a disclose-or-abstain obligation," Blackmun concluded that the SEC was focused on "access to nonpublic information, and not merely in terms of the presence of a common-law fiduciary duty or the like."[108] In the SEC's view, the "duty to abstain or disclose arose, not merely as an incident of fiduciary responsibility, but as a result of the 'inherent unfairness' of turning secret information to account for personal profit."[109]

The dissent concluded that Chiarella was guilty of insider trading because "[h]e occupied a relationship to the takeover companies giving him intimate access to concededly material information that was sedulously guarded from public access . . . . By any reasonable definition, his trading was 'inherent[ly] unfai[r].'"[110]

While Powell's majority opinion took pains to respond to many of the dissent's objections, it did not address Blackmun's most basic claim, which is that section 10(b) should be enforced to ensure fair access to information—a position that has been embraced by the SEC and the Second Circuit.[111] It would not be until *Dirks v. SEC* that Powell took this fundamental disagreement on squarely.

a. Government's Resistance to *Chiarella*

Not surprisingly, *Chiarella* drew sharp scholarly criticism for its internal analytic inconsistencies.[112] Moreover, the SEC did not relent in its effort to enforce its own conflicting vision for how to regulate the

---

107. *Id.* at 249.
108. *Id.* (emphasis omitted).
109. *Id.*
110. *Id.* at 252.
111. *See id.* (*Compare* Powell, J., Majority at 224–37 *with* Blackmun, J., dissenting at 246–52).
112. *See, e.g.*, Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 376–77 (1982) ("The Court appears simply to be playing games with doctrine in order to limit liability without articulating the reasons why liability should be limited in just that way. This is not a Supreme Court construing a complicated federal statutory scheme with wisdom, craft, and candor; this is a first-year Torts class on a bad day.").

securities market.[113] The SEC's next chance to convince the Court of its wisdom came only three years later in *Dirks v. SEC*[114]

Its pursuit of Dirks had actually begun in 1973, long before *Chiarella* was decided.[115] Dirks was employed by a broker-dealer that provided investment analysis to institutional investors.[116] He caused his clients to trade on MNPI that Ronald Secrist, a former insider at a company called Equity Funding, tipped to Dirks.[117] Secrist was apparently motivated to provide Dirks this information to help expose a fraud that Secrist believed was occurring at his company.[118] In other words, Secrist did not tip Dirks expecting any personal benefit in return.

Nevertheless, the SEC pursued Dirks in an administrative proceeding on the theory that he had engaged in a form of insider trading as a tippee of Secrist's improper disclosure of MNPI.[119] For the regulator, it was as if *Chiarella's* fiduciary duty element was an annoying inconvenience, readily ignored.[120] The SEC prevailed before the administrative judge and then again before the Commission itself.[121] Dirks appealed to the D.C. Circuit Court of Appeals but lost there as well.[122]

In affirming the judgment, the D.C. Circuit struggled to distinguish *Chiarella*. Among other arguments, the court appeared to make a distinction between "market information" and "inside information,"[123] and then suggested that *Chiarella* should be applied only to "market information" fraud: "the narrowness of the holding in *Chiarella* cautions against applying the majority's rationale rigidly or exclusively to contexts involving information other than 'market' information."[124] The Circuit Court also held, contrary to the thrust of *Chiarella*, that "[t]he *Chiarella* majority focused on the existence of a set of fiduciary obligations as a

---

113. *See, e.g.*, *Dirks*, 463 U.S. at 646.
114. *Id.*
115. *See id.* at 648, 650–51.
116. *See id.* at 648.
117. *See id.* at 649.
118. *Cf. id.*
119. *See id.* at 650–51.
120. *Cf. id.* at 651–52.
121. *See id.* at 650.
122. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982) (dismissing petition), *rev'd*, 463 U.S. 646 (1983).
123. *Id.* at 835.
124. *Id.* at 837.

prerequisite to the addition of a disclosure-or-refrain duty, but it did not hold that breach of the fiduciary obligations was required to bring Rule 10b-5 to bear on a case, nor did it hold that state fiduciary law was the sole source of the duty to disclose-or-refrain."[125]

Lastly, the D.C. Circuit deferred to the SEC, as the agency is "charged with administering the nation's securities laws . . . . It has decided to censure Dirks under Rule 10b-5, and we cannot say that the SEC's disposition is 'inconsistent with the statutory mandate' behind Rule 10b-5 or that it 'frustrate(s) the policy that Congress sought to implement.'"[126]

3. Dirks' "Safe Harbor" for Institutional Analysts

The Supreme Court promptly reversed, with Justice Powell once again writing for the majority.[127] The Court again rejected the information parity goal underlying the SEC's position because it "differs little from the view that we rejected as inconsistent with congressional intent in *Chiarella* . . . .[128] In effect, the SEC's theory of tippee liability in both cases appears rooted in the idea that the anti-fraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information."[129] Citing *Chiarella*, the Court held "[w]e reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.'"[130]

Crucially, the Court explained why the idea of "equal information among traders" could not form the basis of insider trading law:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," 21 SEC [Docket 1401], at 1406

125. *Id.* at 838–39.
126. *Id.* at 839–40 (citations omitted).
127. Dirks v. SEC, 463 U.S. 646, 648, 667 (1983).
128. *Id.* at 656.
129. *Id.* at 657 (footnote omitted).
130. *Id.* at 657–58 (quoting *Chiarella*, 445 U.S. at 231–32, n.14).

> [1981], and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.[131]

Put another way, demand for information parity is, first, not realistic in an industry where investment professionals are expected to "ferret out" information that is not readily accessible to the public. Second, it would undermine the critical role that such professionals play to the health of the capital markets.[132]

On this latter point, the Court used the SEC's own discussions about market efficiency to underscore the need to avoid chilling analyst activities.[133] "The SEC expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'"[134] Moreover, responding to the SEC's contention that their enforcement action would not impinge on the analysts' lawful activities because they would "remain free to obtain from management corporate information for purposes of filling in the 'interstices in analysis,'"[135] the Court stated:

> But this rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed.[136]

This was a critical concern for Justice Powell.[137] As Professor Pritchard reports, "Powell . . . worried that regulation could impair market

---

131. *Id.* at 658–59 (footnotes omitted).
132. *Id.*
133. *See id.*
134. *Id.* at 658 n.17.
135. *Id.*
136. *Id.* (citation omitted).
137. Pritchard, *supra* note 67, at 931.

efficiency. He saw the SEC's efforts to impose a 'parity of information' rule as undermining 'incentives to perform market research in order to discover undervalued stocks and thereby bring about a more efficient allocation of resources.'"[138] Powell was concerned that supporting the SEC's position would have the opposite result, "securities analysts will be far less liable to 'ferret out' information. They will be concerned constantly with the uncertainty of lawsuits, with juries determining whether the information circulated was confidential and should not have been disclosed."[139] Drawing on his substantial prior practice as a securities lawyer, Powell described the special access analysts had to inside information, including:

> The more difficult type of information gathering—difficult in terms of line drawing for our purposes—is where the analysts will visit corporate headquarters and confer with senior officers. The analyst is likely to be a specialist in the particular business. When he returns to his firm, often he will circulate "buy" or "sell" recommendations to clients and person[s] whom the firm would like to have as clients. These recommendations are backed up by a report on the interview.[140] The line drawing problem is one that impacts directly on both the corporate officers and the analysts. Neither can be quite sure when the "line" is crossed.[141]

---

138. *Id.* (quoting from bench memorandum to Powell in *Chiarella* and his handwritten notes).

139. *Id.* at 938–39 (quoting Powell's Memorandum for Conference, Dirks v. SEC, 2–3 (Mar. 23, 1983)).

140. The term "analyst" refers to the securities professionals who are hired to analyze companies. In market parlance, they are commonly divided into "sell-side" analysts who work for major financial institutions that have broad trading platforms, and "buy-side" analysts who work for institutional investors such as managers of mutual funds or hedge funds. The sell-side analyst will prepare reports that are offered to the "buy-side," the institutional investors, and such reports can often be accessed by a broader group of industry professionals. The sell-side analysts hope to attract investors to trade through their respective banks. Buy-side analysts on the other hand work within the institutional investor firms and will use the sell-side reports but also engage in more in-depth analysis. Their reports are kept within their respective firms. *See Buy Side vs Sell Side: The role of an analyst on the buy side and the sell side*, CORPORATE FINANCE INSTITUTE, https://corporatefinanceinstitute.com/resources/careers/jobs/buy-side-vs-sell-side/ [https://perma.cc/SZK4-TPWQ].

141. Pritchard, *supra* note 67, at 940 (quoting from memorandum from Powell to his law clerk Jim Browning 3 (May 2, 1983)).

In short, based on his practical knowledge of the securities market, Powell wanted to protect the analyst process of finding nonpublic information and to ensure that such players had clear guidance as to where the prohibited line of insider trading is drawn.

The bright line drawn by *Dirks* was personal benefit: "[insiders are] forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[142] As for the tippee, like Dirks, he "assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[143] And how would the tippee know there has been a breach? "[T]he test is whether the insider 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 [by the tippee]."[144]

This significantly narrowed the reach of insider trading, in favor of more robust analyst research.[145] In *Chiarella*, the Court had referred to personal benefit as an evil that would be prevented by enforcing the disclose or abstain rule: "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[146] But under *Dirks*, personal benefit became itself an element necessary to finding breach of duty.[147]

In response to the SEC's argument that any rule premised on the "purpose" of the insider in disclosing the information would lead to difficulty in prosecutions, the Court said: "the SEC and the courts are not required to read the parties' minds."[148] Instead, it should look for "objective criteria":

---

142. Dirks v. SEC, 463 U.S. 646, 659 (1983) (citing 15 U.S.C. § 78t(b)).
143. *Id.* at 660 (emphasis added).
144. *Id.* at 662.
145. *Cf. id.* at 662–63.
146. Chiarella v. United States, 445 U.S. 222, 230 (1980).
147. *Dirks*, 463 U.S. at 662.
148. *Id.* at 663.

> [T]he initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i.e.,* whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings . . . . There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient. [149]

Applying this reasoning, the Court concluded that Dirks did not violate the insider trading law.[150] He had no relationship to the company whose shares were traded by Dirks' customers.[151] And the insiders, Secrist and others, did not tip the corporate information for "monetary or personal benefit . . . nor was their purpose to make a gift of valuable information to Dirks."[152] Rather, it was to expose the fraud at the company.[153]

In trying to draw as clear a line as possible "for those whose daily activities must be limited and instructed by the SEC's inside-trading rules,"[154] Powell's majority opinion—largely at the urging of Justice Sandra Day O'Connor—required "objective criteria."[155] But this line was blurry at best, as it is unclear exactly what personal benefit means. Indeed, the Court acknowledged that "[d]etermining whether an insider

149. *Id.* at 663–64.
150. *Id.* at 665.
151. *Id.*
152. *Id.* at 667.
153. *Id.*
154. *Id.* at 664.
155. Based upon a review of Powell's papers, Professor Pritchard reports that Justice O'Connor was concerned about a draft opinion discussing the insider's purpose, and she "suggested omitting the discussion of purpose, a change that Powell was not willing to make. More promising was her proposed alternative, which looked to whether the insider derives a direct or indirect benefit from his disclosure, and that benefit is primarily of a pecuniary nature . . . . Justice O'Connor shrewdly couched her suggested change as 'more objective' and based on her 'past experience on the bench.' These factors were well calculated to persuade Powell, who favored predictability and respected the practical wisdom of experience. The opinion accordingly was revised to reflect Justice O'Connor's 'quite constructive' suggestions." Pritchard, *supra* note 67, at 941–42.

personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."[156]

Imperfect as it was, the decision clearly was intended to, and did, offer institutional analysts—and hence their trading clients—some legal protection as they plied their trade in ferreting out even MNPI.[157] Professor Donald Langevoort characterized the decision as providing for a "deep safe harbor" for securities analysts,[158] while Professor John Coffee later said the decision was a "virtual paean" to the work of securities analysts and offered them a "Magna Carta."[159]

Justice Blackmun again wrote the dissent, arguing that the Court did not offer any guidance at all: "The Court acknowledges the burdens and difficulties of this approach, but asserts that a principle is needed to guide market participants. I fail to see how the Court's rule has any practical advantage over the SEC's presumption." [160] To him, "[i]t makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of nonpublic information."[161]

Unwilling to cede this policy debate, the *Dirks* majority avidly engaged with the dissent as it disputed the idea of any "losses" to the informationally disadvantaged trader:

> The dissenting opinion focuses on shareholder "losses," "injury," and "damages," but in many cases there may be no clear causal connection between inside trading and outsiders' losses. In one sense, as market values fluctuate and investors act on inevitably incomplete or incorrect information, there always are winners and losers; but those who have "lost" have not necessarily been defrauded. On the other hand, inside trading for personal gain is fraudulent, and is a violation of the federal securities laws. Thus, there is little legal significance to the dissent's argument that Secrist and Dirks created new "victims" by disclosing the information to persons who traded.[162]

To this, Justice Blackmun retorted that such a view was:

---

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

157. *See generally id.*

158. Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1034 (1990).

159. John C. Coffee, *The SEC and the Securities Analyst; Corporate Update; Corporate Securities*, N.Y.L.J., May 30, 1991 at 41.

160. *Dirks*, 463 U.S. at 676 n.13 (Blackmun, J., dissenting) (citations omitted).

161. *Id.* at 674.

162. *Id.* at 667 n.27 (citation omitted).

> [L]ittle different from the theory that insider trading should be permitted because it brings relevant information to the market . . . . The Court also seems to embrace a variant of that extreme theory, which postulates that insider trading causes no harm at all to those who purchase from the insider. *Ante*, at 666-667, [sic] n. 27. Both the theory and its variant sit at the opposite end of the theoretical spectrum from the much maligned equality-of-information theory, and never have been adopted by Congress or ratified by this Court . . . . The theory rejects the existence of any enforceable principle of fairness between market participants.[163]

Then, sounding more like a congressman than a judge, Justice Blackmun concluded that Dirks should be held liable, as "[a]ny other result is a disservice to this country's attempt to provide fair and efficient capital markets.[164]

Though Blackmun's preferred approach to demand information parity may have been a simpler one to follow, it gave little weight to Powell's concern of avoiding an "inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[165] To this, Blackmun dismissively responded, "I fail to understand how imposing liability on Dirks will affect legitimate insider-analyst contacts."[166] This was a superficial response to an important policy concern that Powell had laid out in detailed, practical terms.

Put simply, if institutional analysts could be liable for insider trading merely because they passed MNPI on to their investing clients, they will naturally fear any contact with corporate representatives. And if that happens, their analysis of a company's true merits will not be reflected in the pricing of its stock in the securities market. The way to avoid this deleterious impact of an insider trading rule was to require, as an element, the exchange of information by the insider for a personal benefit. Blackmun may have had no meaningful response to this reasoning because he had no empirical basis for challenging Powell's experienced-based concerns about how an efficient market works.[167]

Blackmun did, however, have his own, common sense-based concerns about Powell's new personal benefit test, and to this, Powell had

---

163. *Id.* at 677 n.14.
164. *Id.* at 678–79.
165. *See id.* at 658; *cf. id.* at 674 n.11 (Blackmun, J., dissenting).
166. *Id.* at 674 n.11.
167. *See generally Dirks*, 463 U.S. at 667–79 (Blackmun, J., dissenting).

no response.[168] Blackmun accurately exposed a serious flaw in *Dirks*'s analysis:

> The Court does not explain why the benefit Secrist obtained—the good feeling of exposing a fraud and his enhanced reputation—is any different from the benefit to an insider who gives the information as a gift to a friend or relative. Under the Court's somewhat cynical view, gifts involve personal gain. Secrist surely gave Dirks a gift of the commissions Dirks made on the deal in order to induce him to disseminate the information. The distinction between pure altruism and self-interest has puzzled philosophers for centuries; there is no reason to believe that courts and administrative law judges will have an easier time with it.[169]

This criticism was unanswered by the majority, and as we shall see, the Second Circuit, in *Newman*, sought to close this doctrinal gap thirty-two years later by requiring that even gifts to close friends involve some potential substantial benefit to the tipper.[170] This effort was later rebuffed by the Supreme Court in *Salman*.[171]

a. *Dirks'* Fundamental Ambiguity

The problem, of course, is that neither Justice Powell and his allies in the *Dirks* opinion, nor Justice Blackmun were legislators. Neither side had the benefit of congressional hearings to mull over the complex issues of economics, market behavior, norms of information flow, speed of information getting impounded into stock prices, or the like. What would be the true impact on analyst investigative activities if the law contained a blanket prohibition on trading on MNPI? Was Powell's concern empirically grounded? And even if it was, did the positives of having a personal benefit test outweigh the inherent ambiguities in the law that would be invited by that test? No congressional hearings examined these important questions.

Professor Langevoort predicted the significant legal problems that might follow.[172] Arguably, his prediction was realized in the form of the

168. *See generally id.* (Blackmun J., dissenting).
169. *Id.* at 676 n.13 (Blackmun, J., dissenting) (citations omitted).
170. United States v. Newman, 773 F.3d 438, 455 (2d Cir. 2014).
171. *See* discussion *infra* at Part I.D.
172. *See generally* Langevoort, *supra* note 8, at 1023.

Newman/*Martoma* impasse.[173] Writing in 1990, Langevoort engaged in a detailed analysis of the economic and policy arguments for and against the efficient market/information parity debate.[174] He then centered in on the element of personal benefit that the *Dirks* Court required before finding a breach of fiduciary duty.[175] Noting that *Dirks*' definition of personal benefit included a reputational benefit that will translate into future earnings, among others, he asked "what is the difference if the form of currency [for an insider to share information to an institutional investor] is a favorable analyst's recommendation instead of cash? Yet this seems to be what *Dirks* permits."[176]

He predicted that a court may later "declar[e] that the *Dirks* safe-harbor is available only with respect to unintentional disclosures, such as slips of the tongue or good faith misappreciations of materiality, not conscious tips. The notion of personal benefit might thereupon grow to include all corporate 'gifts' of information—any situation where officials of the issuer consciously prefer the interests of one group of shareholders to another."[177]

But if this were to occur, he predicted, it "would effectively destroy the meaningfulness of the personal/business distinction that the Supreme Court so clearly considered the linchpin of its analysis. The analyst's safe-harbor would accordingly disappear."[178]

Langevoort concluded that, if the courts continue to look favorably upon the role of institutional analysts, "there is little reason to expect such revisionism will occur beyond the random case."[179] But if courts were to "[t]ak[e] a more critical view of the argument for the analyst . . . a doctrinal shift would be both foreseeable and unsurprising."[180]

As discussed *infra* at Part I.A.4, the *Newman* court can be viewed as supporting the role of securities professionals and refusing to accept such a radical "revisionism" of *Dirks*, thus keeping the safe harbor intact, while the *Martoma* majority can be viewed as taking the opposite view, all but ensuring the "doctrinal shift" that Langevoort considered to be "both

173. *Compare id.* at 1053–54 *with Newman*, 773 F.3d at 448. *Compare* Langevoort, *supra* note 8, at 1053–54 *with* United States v. Martoma, 869 F.3d 58, 71 (2d Cir. 2017).
174. Langevoort, *supra* note 8, at 1044–50.
175. *Id.* at 1051.
176. *Id.* at 1052.
177. *Id.* at 1053 (citations omitted).
178. *Id.* at 1053–54.
179. *Id.* at 1054.
180. *Id.* (footnote omitted).

foreseeable and unsurprising."[181] The *Martoma* majority appears to accept the idea that breaches of fiduciary duty "include all corporate 'gifts' of information-any situation where officials of the issuer consciously prefer the interests of one group of shareholders to another."[182] The safe-harbor "accordingly disappear[s]."[183]

The SEC and federal prosecutors inexorably pushed the law to that position.[184] Indeed, after the *Dirks* decision, its former Chairman declared, "[t]he fact is that the SEC does not accept *Dirks*."[185] This would have been the time for the Commission to seek a legislative response, overruling the decision.[186] Instead, the SEC actually persuaded Congress not to pass legislation.[187] It was more focused on protecting its flexibility in policing the securities market.[188] Perhaps it was also concerned that Congress may agree with Justice Powell when all relevant information about the workings of the securities market were duly considered. Whatever its strategy, the SEC chose instead to continue to prosecute individuals with expanding theories on a case-by-case basis.[189] In so doing, the Government often found a supportive audience in the Second Circuit.

---

181. *See generally*, United States v. Martoma, 869 F.3d 58 (2d Cir. 2017); United States v. Newman, 773 F.3d 773 (2d Cir. 2014); Langevoort, *supra* note 8.

182. Langevoort, *supra* note 8, at 1053.

183. *Id.* at 1053–54.

184. *See generally* Edward Fleischman, Commissioner, SEC, Presentation to the University of California, San Diego, Eighteenth Annual Securities Regulation Institute: Ferreting in the Interstices of SEC Attitudes to Securities Analysts (Jan. 24, 1991) [hereinafter *Fleischman Presentation*].

185. *Id.*

186. Prosecutorial authorities have, in other contexts, moved swiftly for legislative reaction to an adverse Supreme Court decision, persuading Congress to make legislative changes to shore up a gap that the Supreme Court identified. Thus, for example, in 1994, in the wake of United States v. Ratzlaf, 510 U.S. 135 (1994), wherein the Supreme Court construed the "willfulness" element in the statute as requiring proof that the defendant knew it was unlawful to "structure" cash transactions with a bank to avoid the currency reporting requirement to the IRS, Congress swiftly amended the statute to adjust the language of the prohibition so that such specific intent was not necessary for a prosecution. *See* 31 U.S.C. § 5324(c) (2012).

187. *Cf. Fleischman Presentation*, *supra* note 184, at 4.

188. *Cf. id.* at 3.

189. *See* United States v. Whitman, 904 F. Supp. 2d 363, 366–67 (S.D.N.Y. 2012) (collecting cases of expansion of doctrine).

4. The Misappropriation Theory—Government's Continued Expansion of the Law in the Second Circuit

One promising avenue of expansion that the SEC and criminal authorities pursued was the theory of misappropriation. As early as *Chiarella*, the Justices' multiple opinions had presaged a theory that if someone takes confidential information belonging to someone else, without the owner's consent, the misappropriator may not use that information for personal gain.[190] Chiarella, the printing company's employee, took corporate information that had been entrusted to the company and used it to trade in the corporate client's stock for personal profit.[191] The jury in that case had not been instructed about a theory of misuse of stolen information, and thus the conviction could not be affirmed on that basis.[192] But both Justice Stevens' concurring and Justice Burger's dissenting opinions noted the possibility of basing a conviction on such a theory.[193]

One year after *Chiarella*—but before *Dirks*—the Second Circuit embraced the misappropriation theory in a criminal prosecution captioned *United States v. Newman* (*Newman I*).[194] The Court noted Justice Stevens' concurring opinion in *Chiarella* reserving this issue "for another day," then said, "[f]or this Court, that day has now come."[195] Newman was a trader at a brokerage firm who received MNPI about proposed mergers and acquisitions from two employees of investment banks.[196] He caused his associates at foreign locations to use secret bank and trust accounts to effectuate trading on the information, reaping substantial profits.[197] Newman then shared the profits with the investment bank insiders.[198] They were charged under section 10(b) on a misappropriation theory, as well as under the separate mail and wire fraud statutes.[199]

---

190. Chiarella v. United States, 445 U.S. 222, 238, 250 (1980).
191. *Id.* at 224.
192. *Id.* at 235–36.
193. *Id.* at 238 (Stevens, J., concurring) (noting that the Court "wisely leaves the resolution of this issue for another day."); *see also id.* at 245 (Burger, C.J., dissenting).
194. United States v. Newman, 664 F.2d 12 (2d Cir. 1981).
195. *Id.* at 16.
196. *Id.* at 15.
197. *Id.*
198. *Id.*
199. *Id.* at 14.

The district court, however, dismissed the charges on the basis that securities law prior to the charged conduct was insufficiently clear and that the mail fraud allegations failed as a matter of law.[200] In reversing, the majority held that Newman's "conduct as alleged in the indictment could be found to constitute a criminal violation of section 10(b) and Rule 10b-5 despite the fact that neither [of the investment banks] nor their clients was at the time a purchaser or seller of the target company securities in any transaction with any of the defendants."[201]

The majority canvassed the state of securities law—largely in the civil context—but made almost no effort to address the limitations of the law described in the *Chiarella* decision.[202] Instead, the majority cited to the dissenting opinions, including Chief Justice Burger's statement that Chiarella "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."[203] For the *Newman I* majority, "[t]hat characterization aptly describes the conduct of the connivers in the instant case."[204]

Judge Dumbauld dissented from this portion of the opinion, noting that *Chiarella* and *Blue Chip Stamps v. Manor Drug Stores* "evince a trend to confine the scope of [section] 10(b) to practices harmful to participants in actual purchase-sale transactions."[205] He noted that Justice Stevens's concurring view was merely that "respectable arguments could be made in support of either position."[206] Judge Dumbauld would have reversed on the more limited and "solid ground that [defendant] has clearly violated the Mail Fraud statute, 18 U.S.C. [section] 1341."[207]

If there was any doubt as to how the Second Circuit would have come out had *Newman I* been decided after the *Dirks* decision in 1983, the Court put it to rest in *SEC v. Materia*.[208] There, just a little over a year after *Dirks*, a unanimous panel of Second Circuit judges again applied the misappropriation theory to affirm the district court's finding of liability

200. *Id.*
201. *Id.* at 16.
202. *Id.* at 16.
203. *Id.* at 17.
204. *Id.* at 17 (quoting from *Chiarella*, 445 U.S. at 245) (Burger, C.J., dissenting).
205. *Id.* at 20.
206. *Id.* (citing *Chiarella*, 445 U.S. at 238).
207. *Id.* at 20–21.
208. *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984).

against the defendant.[209] Like Chiarella, Materia had been an employee at a printing company who had determined the identity of target companies and traded in those companies.[210] This time, the SEC squarely presented the misappropriation theory to the court, and the Second Circuit had no problem concluding that the defendant's conduct violated section 10(b) of the Exchange Act.[211] Materia defrauded his employer "[b]y purloining and trading on confidences entrusted to Bowne [his employer, and thereby] . . . undermined his employer's integrity."[212]

In so holding, the court gave no attention to the limiting language of *Chiarella* or *Dirks*.[213] Indeed, it did not even acknowledge *Dirks*.[214] It cited to *Chiarella* for the limited purpose of quoting the same "misappropriated—stole to put it bluntly" language from Justice Burger's dissent that the *Newman* court had quoted[215] and to note that the misappropriation theory had not been "disavow[ed]" by *Chiarella*.[216]

Commentators were divided on the soundness of the misappropriation theory. Professor Barbara Aldave argued that neither *Chiarella* nor *Dirks* provided a satisfactory explanation for why Rule 10b-5 prohibits insider trading, and that misappropriation was a better conceptual basis for the prohibition.[217] Others argued that the theory ran directly counter to the limitations set by *Dirks* and in any event did not make sense since "[t]he employee's duty to his employer, . . . has nothing to do with a duty to speak. . . . Disclosure by the employee would aggravate the breach of duty to the employer, not cure it."[218]

In the meantime, the Second Circuit continued to cement the misappropriation theory into insider trading law with ever expanding reach. In *United States v. Carpenter*,[219] the Court affirmed the conviction

---

209. *Id.* at 199.
210. *Id.*
211. *Id.* at 203.
212. *Id.* at 202.
213. *Id.* at 203.
214. *See generally id.*
215. *Id.* at 201.
216. *Materia*, 745 F.2d at 203.
217. Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 124 (1984) ("The misappropriation theory provides a logical and coherent framework for the continuing development of the law regarding trading on nonpublic information.").
218. Richard M. Phillips, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 91 (1984) [hereinafter *The Insider Trading Doctrine*].
219. *See* United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

of a Wall Street Journal ("WSJ") reporter, a former clerk, and a stockbroker, who traded ahead of upcoming, highly influential news articles issued by the WSJ about company performance.[220] Relying on *Dirks*, the defendants argued that "the misappropriation theory may be applied only where the information is misappropriated by corporate insiders or so-called quasi-insiders, who owe to the corporation and its shareholders a fiduciary duty of abstention or disclosure."[221] The Court rejected the argument because, in *Materia*, it had applied the misappropriation theory to "proscribe[] the conversion by 'insiders' *or others* of material non-public information in connection with the purchase or sale of securities."[222]

In his dissent, Judge Miner expressed two concerns about the majority's application of the misappropriation theory.[223] First, unlike prior cases, this one involved the use of journal articles rather than insider "*securities-related* information by those who obtain that information through special relationships with their sources of knowledge."[224] Second, the harm to the owner of the information, the WSJ, was tenuous: "[w]hile the proscription of fraudulent and deceptive practices in connection with the purchase and sale of securities is a broad one, it never was intended to protect the reputation, or enforce the ethical standards, of a financial newspaper."[225]

As one commentator observed, even before the *Carpenter* decision, the misappropriation theory "entirely ignores the tippee liability test articulated by *Dirks* which requires that an insider receive some personal benefit from the disclosure of inside information to a tippee."[226] *Carpenter's* material expansion of that theory to conduct where the corporate insider is nowhere in sight fell even farther from the *Dirks* test.

5. Carpenter—An Impasse as Powell Departs the Bench

But for fortuitous timing, the misappropriation theory would have likely been rejected. Justice Powell, however, retired before the appeal

220. *Id.* at 1027.
221. *Id.* at 1028–29.
222. *Id.* at 1029 (citing *Materia*, 745 F.2d at 203).
223. *Id.* at 1036–37.
224. *Id.* at 1036 (Miner, J., dissenting).
225. *Id.* at 1037 (Miner, J., dissenting).
226. *See* Phillips, *The Insider Trading Doctrine*, *supra* note 218, at 91.

could be heard.[227] Professor Pritchard reports that the Court initially voted to deny the defendants' petition for *certiorari*, and Powell drafted a dissent from the denial, "ma[king] it clear that he would have rejected the misappropriation theory altogether" because it conflicted with the Court's insider trading decisions.[228]

Under *Chiarella*, Powell argued, "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[229] In *Dirks*, as well, "the relevant disclosure duty was between the parties to the securities transaction."[230] In *Carpenter*, there was no fiduciary relationship between the defendants and those who had sold them securities.[231] Because "the inquiry under Rule 10b-5 'must focus on the petitioner's relationship with the sellers of . . . securities,' and because there was no such relationship, Powell concluded that the petitioners' conduct did not violate Rule 10b-5."[232]

This dissent was never published because the Court ultimately agreed to grant *certiorari*.[233] With Powell's retirement and his successor, Anthony Kennedy, not confirmed until after the argument,[234] the "Court split 4-4 on the misappropriation theory, automatically affirming the conviction as a consequence."[235] As Professor Pritchard predicted: "[g]iven Powell's rejection of the misappropriation theory in his draft dissent, it is reasonable to conclude that if Powell had not retired when he did, the Supreme Court would have rejected the misappropriation theory in 1987."[236]

227. Pritchard, *supra* note 67, at 945.
228. *Id.* at 943–44.
229. *Id.* at 944.
230. *Id.*
231. *Carpenter*, 484 U.S. at 24.
232. Pritchard, *supra* note 67, at 945.
233. *Id.*
234. *Id.*
235. *Id.* As to the second basis for conviction—the mail and wire fraud statutes under Title 18—the Court overwhelmingly affirmed the conviction, as it accepted the theory that the defendants had deprived the Wall Street Journal of "its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter." *Carpenter*, 484 U.S. at 25–28.
236. Pritchard, *supra* note 67, at 945.

6. Chestman—A Splintered Second Circuit

Notwithstanding its considerable tension with *Chiarella* and *Dirks*, the misappropriation theory was pursued aggressively by the SEC and criminal authorities, and the lower courts largely supported their efforts.[237] A rare but limited setback for the Government in the Second Circuit occurred in *United States v. Chestman*,[238] when the court, sitting *en banc*, reversed the conviction of a defendant charged with misappropriation among other charges.[239]

The case, which yielded seven separate conflicting opinions,[240] illustrates how deeply mired in doctrinal uncertainty the law had become in just over a decade. It also demonstrated how the SEC and the Government's unabated efforts to impose information parity on the marketplace, notwithstanding the Supreme Court's twice rejection of that policy, embroiled lower courts in conflicting views about the law of insider trading.

In *Chestman*, a corporate insider of Waldbaum, Inc. was a Waldbaum family member who told his sister and other immediate family members about plans to make a tender offer to another large company.[241] The sister told her daughter, Susan Loeb, who in turn told her husband, Keith Loeb.[242] Loeb then tipped his stockbroker, Robert Chestman.[243] Chestman used that information to buy stock for himself and his clients—including Loeb—and sold the shares at a profit after the takeover became public.[244] Chestman was charged with fraudulent trading in connection with a tender offer in violation of Rule 14e–3(a), securities fraud in violation of Rule 10b-5 under a misappropriation theory, mail fraud, and

237. *See* Swanson, *Reinventing Insider Trading*, *supra* note 36, at 1173–75 (collecting cases) ("Second Circuit courts continued to apply the misappropriation theory in the context of employment relationships and other settings . . . . In addition to the influential Second Circuit, courts in other jurisdictions, including the Third, Seventh, and Ninth Circuits, followed suit.").

238. United States v. Chestman (*Chestman II*), 947 F.2d 551 (2d Cir. 1991) (*en banc* panel, yielding four separate opinions), *cert. denied*, 503 U.S. 1004 (1992).

239. *Id.* at 551.

240. United States v. Chestman (*Chestman I)*, 903 F.2d 75 (2d Cir. 1990) (original panel, yielding three separate opinions); *Chestman II*, 947 F.2d at 551.

241. *Chestman I*, 903 F.2d at 77.

242. *Id.* at 77.

243. *Id.*

244. *Chestman II*, 947 F.2d at 555–56.

one count of perjury in connection with his testimony before the SEC.[245] "After a jury trial, Chestman was convicted on all counts."[246]

In his original appeal to the Second Circuit, the Court reversed the convictions.[247] It was unanimous in reversing the conviction as to the 10b-5 and perjury counts,[248] but split on the Rule 14e-3(a) conviction, with a majority voting—in two separate opinions—to reverse that conviction on the basis that the SEC did not have authority to issue that rule.[249] The Court then granted the Government's application for *en banc* review.[250] The dispute in the resulting four opinions centered—as it would again in *Newman*/*Martoma*, decades later—on what exactly constitutes insider trading.[251]

Dealing first with Rule 14e-3(a), the Court noted that it was promulgated by the SEC pursuant to Section 14(e),[252] and essentially

---

245. *Id.* at 551.
246. *Id.* at 556.
247. *Id.* at 551.
248. *Chestman I*, 903 F.2d at 82, 84.
249. *Id.* at 84–88.
250. *See* United States v. Chestman, 1990 WL 134249 (2d Cir. Aug. 24, 1990).
251. *Chestman II*, 947 F.2d 551–52.
252. 15 U.S.C. § 78n(e) (2012). Section 14(e) provides:

> It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (2012). Congress enacted Section 14(e) as part of the Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968). Pursuant to the authority granted by section 14(e), the SEC promulgated Rule 14e-3 in 1980. Rule 14e-3(a) provides:

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which

precludes any trading on MNPI in connection with a tender offer, without regard to whether the insider breached any fiduciary duty.[253] Once it was established that Chestman knew the tip about a tender offer he received was MNPI, he was required to disclose or abstain from trading. In challenging his conviction on this count, Chestman argued that, under *Chiarella*, the Commission did not have the power to define fraud without also requiring breach of duty.[254] Two members of the original Second Circuit panel to hear his appeal had agreed with him and voted to reverse the section 14(e) conviction.[255] Nevertheless, applying *Chevron* deference to an agency's determination,[256] the majority of the *en banc* panel rejected the challenge on the basis that the language and legislative history of Section 14(e) was materially different from that of section 10(b) and that the SEC had authority to issue a broad prohibition in the tender offer context, one that "deserves special regulation."[257] Thus, Chestman's

---

> information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> > (1) The offering person,
> >
> > (2) The issuer of the securities sought or to be sought by such tender offer, or
> >
> > (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise. 17 C.F.R. § 240.14e–3(a) (2019).

253. *Chestman II*, 947 F.2d at 557.

254. *Id.* at 556.

255. *Chestman I*, 903 F.2d at 84–88.

256. *Chestman II*, 947 F.2d at 557 ("In reviewing this claim, our scope of review is limited.") (citing Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843–44 (1984)).

257. *Id.* at 560 (unlike the general anti-fraud provision of section 10(b), "section 14(e) is an anti-fraud provision specifically tailored to the field of tender offers, an area of the securities industry that, the Williams Act makes clear, deserves special regulation.").

convictions on the Rule 14e charges were affirmed, vacating the original panel's reversal of those convictions.[258]

Judge Mahoney wrote a comprehensive dissent, arguing that the SEC's effort to excise the fiduciary duty element from insider trading prosecutions contravened the Supreme Court's rulings in *Chiarella* and *Dirks*.[259] In his view, this was "an obvious effort by the SEC to circumvent" *Chiarella*,[260] and the rule was designed "to avoid the impact of *Dirks*."[261] Judge Mahoney doubted the SEC's authority "to impose a limited equal-access rule in the aftermath of *Chiarella* [and] *Dirks*."[262]

The Government's victory, however, was only partial. With respect to the misappropriation counts of conviction under Rule 10b-5, the majority concluded that the Government had failed to prove any breach of "a fiduciary or similar relationship of trust and confidence" by Keith Loeb "owed to the Waldbaum family or [his wife]."[263] The Court began by painstakingly retracing the history of insider trading law.[264] It identified the "Traditional Theory of Rule 10b-5 Liability," stemming from *Chiarella* and *Dirks*, pursuant to which a person possessing MNPI owes a duty "to disclose or abstain" from trading and that this duty arises

---

The Court also noted that section 14(e) was part of the Williams Act, whose "sole purpose . . . was the protection of investors who are confronted with a tender offer." *Id.* at 558–59 (quoting Piper v. Chris–Craft Indus., Inc., 430 U.S. 1, 35 (1977)). Moreover, section 14(e) expressly directed the SEC to "define" fraudulent practices and to "prescribe means reasonably designed to prevent" such practices. *Id.* at 558.

The legislative history also shows that the SEC specifically identified for the legislators the danger of trading by the "person who has become aware that a tender bid is to be made . . . [who] may fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made." *Id.* at 559 (quoting from Hearings on S.3431 before the Subcomm. on Securities of the Senate S. Comm. on Banking and Currency, 91st Cong., 2nd Sess. 2, 12 (1970)). Thus, the Court concluded: "Recognizing the highly sensitive nature of tender offer information, its susceptibility to misuse, and the often-difficult task of ferreting out and proving fraud, Congress sensibly delegated to the SEC broad authority to delineate a penumbra around the fuzzy subject of tender offer fraud." *Id.* at 559.

258. *Id.* at 571.

259. *Id.* at 583–84.

260. *See id.* at 587 (Mahoney, J., dissenting).

261. *Id.*

262. *Id.* at 586 (citing to and quoting from American Bar Association Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW. 223, 252 (1985)).

263. *Id.* at 564.

264. *Id.*

only from a fiduciary or other similar relationship of trust and confidence between the parties to the transaction.[265] The Supreme Court "rejected a parity of information theory of Rule 10b-5 liability," requiring instead "a specific relationship between the shareholders and the individual trading on inside information."[266]

The Court then described the rise of the "Misappropriation Theory," which it called the "second general theory of Rule 10b-5 liability,"[267] one that had not yet been adopted by the Supreme Court but accepted by several Circuit Courts, including the Second Circuit.[268] "Under this theory, a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction."[269] Here, the victim is not the buyer or seller of securities, but rather "the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities."[270] The Court called this a "fraud-on-the-source" theory.[271]

The Court then turned to the question presented by the Government's newly evolved iteration of insider trading law: how does the breach of duty element apply in a family setting. The Court engaged in a detailed review of fiduciary law, including in the context of family relationships, as well as the question of what is meant by a "similar relationship of trust and confidence."[272] The Court held that such a relationship "must be the functional equivalent of a fiduciary relationship."[273] That meant having elements of reliance on one side and "de facto control and dominance" or "superiority and influence on the other."[274] The test, then, was "dependency and influence."[275] Applying the dependency-influence test to the evidence adduced against Chestman, the Court concluded that "the evidence [did] not support a finding that Keith Loeb shared either a

---

265. *Id.* at 564–65.
266. *Id.* at 565.
267. *Id.* at 566.
268. *Id.*
269. *Id.*
270. *Id.*
271. *Id.* at 567.
272. *Id.* at 568.
273. *Id.*
274. *Id.*
275. *Id.* at 569.

fiduciary relation or its functional equivalent."[276] His wife's "disclosure . . . served no [business] purpose" and she simply gave him the information "unprompted."[277] As Loeb breached no fiduciary duty, Chestman "could not be derivatively liable".[278]

Judge Ralph Winter issued an opinion, concurring in part and dissenting in part, which was joined by a number of his colleagues.[279] If the majority's review of the evolution of insider trading law was detailed, it paled in comparison to the archeology Judge Winter performed, as he explained "[t]he difficulty this court finds in resolving the issues raised by this appeal stems largely from the history of the development of the law concerning insider trading.[280] For that reason, I begin by tracing that history in [a] somewhat tiresome fashion."[281]

Judge Winter then set about describing the many problems with the law.[282] He started with the observation that the law is "based solely on administrative and judicial caselaw. This caselaw establishes that some trading on material nonpublic information is illegal and some is not. The line between the two is less than clear."[283] He labeled *Chiarella* "an enigma" in that "[i]t appears to state that [s]ection 10(b) bars some kinds of insider trading. However, it rejects the element of *Cady, Roberts & Co.* that provided the fraud or deception linking the conduct to the provisions of [s]ection 10(b)."[284] As to *Dirks*, Judge Winter opined that "the Court's rationale is obscure, and, as a result, so is the scope of the rule."[285] Yet, "[n]otwithstanding the ambiguities surrounding [s]ection 10(b)'s impact on insider trading—including its very definition—Congress has increased the penalties for violations of that prohibition. . . . The SEC in turn has failed to promulgate rules outside the area of tender offers but its decisions have continued to march, in the eyes of one commentator, to the beat of its own drummer."[286] Under these circumstances, Judge Winter

---

276. *Id.* at 570–71.
277. *Id.* at 571.
278. *Id.*
279. *Id.*
280. *Id.* at 572 (Winter, J., concurring in part, dissenting in part).
281. *Id.*
282. *Id.*
283. *Id.*
284. *Id.* at 575.
285. *Id.* at 576.
286. *Id.*

noted "[i]t is hardly surprising that disagreement exists within an *en banc* court of appeals as to the import of present caselaw."[287]

With palpable reluctance, Judge Winter nevertheless proceeded to analyze the facts against the hazy doctrine of insider trading, noting that "the law is far enough down this road—indeed, the Insider Trading Sanctions Act seems premised on [s]ection 10(b)'s applicability—that a court of appeals has no option but to continue the route."[288]

His disagreement with the majority regarding Loeb's relationship to his wife and her family members was largely practical, and he would have found a breach of duty because Waldbaum Inc. was a family-controlled business.[289] Acknowledging "the difficulty of drawing lines in this area,"[290] he would have found that a "family member in possession of "confidential corporate information through ordinary family interactions, and . . . who knows that under the circumstances both the corporation and the family desire confidentiality, has a duty not to use information so obtained for personal profit where the use risks disclosure."[291] Under this test, Judge Winter concluded that Loeb breached his duty and that "Chestman knew" that.[292]

Judge Miner agreed entirely with the majority opinion but issued his own concurring opinion, to respond expressly to Judge Winter's dissent on the scope of the misappropriation theory, which he called the "'familial relationship' rule of insider trading."[293] Concerned that the Government may seek to utilize the concept in future prosecutions, Judge Miner warned "[t]he difficulty of identifying those who would be covered by the proposed familial rule adds an additional element of uncertainty to what already are uncertain crimes."[294] He worried that "[t]he net would be spread wider than appropriate in a criminal context"[295] and that "to further extend the concept of confidential duty would be to take the courts into

287. *Id.* (emphasis in original).
288. *Id.* at 578.
289. *Id.* at 579.
290. *Id.* at 580.
291. *Id.*
292. *Id.* at 581.
293. *Id.* at 582 (Miner, J., concurring).
294. *Id.*
295. *Id.* at 582–83 (citing Cantwell v. Connecticut, 310 U.S. 296, 308 (1940) ("Here we have a situation analogous to a conviction under a statute sweeping in a great variety of conduct under a general and indefinite characterization, and leaving to the executive and judicial branches too wide a discretion in its application.").

an area of securities regulation not yet entered by Congress. It would give the wrong signal to prosecutors in their continuing efforts to push against existing boundaries in the prosecution of securities fraud cases."[296] Judge Miner suggested "await[ing] further instructions from Congress before sailing into this unchartered area."[297]

Almost two decades later, Congress has offered nothing of the kind. Instead, nine years after *Chestman*, the SEC took it upon itself to shore up the gap identified by the Court to issue a new rule, Rule 10b5-2, imposing a duty of trust or confidence between spouses, parent and their children, and siblings when they share MNPI.[298]

7. O'Hagan and the Misappropriation Theory

Judge Winter's misgivings about the origin and evolution of the law and Judge Miner's plea that the courts await congressional action had no discernible impact on the Government as it continued its push for expansion of the law. Its next significant opportunity came in *United States v. O'Hagan*.[299] Ten years after its deadlock in *Carpenter*, the Supreme Court was presented once again with the misappropriation theory of insider trading.[300] This time—with Justice Powell long since retired from the bench—the Court approved the theory, but not without drawing a penetrating dissent by Justice Thomas, joined by Chief Justice Rehnquist.[301]

Unlike *Secrist*, the insider in *Dirks* who was motivated by a conscientious desire to expose fraud—O'Hagan—was a defendant whom the Government could easily portray as a greedy lawyer who violated the duties of client confidentiality for personal gain. Yet, it bears noting that even here the Eighth Circuit found the defendant's conduct not criminal.

O'Hagan was a partner at the law firm Dorsey & Whitney.[302] The firm was engaged for a brief period by Grand Metropolitan PLC ("Grand Met") in connection with a potential tender offer for the Pillsbury Company's common stock.[303] O'Hagan was not involved in the

296. *Id.* at 583.
297. *Id.*
298. *See* 17 C.F.R. § 240.10b5-2(b) (3) (2019).
299. *See* United States v. O'Hagan, 521 U.S. 642 (1997).
300. *Id.* at 643; *see* Carpenter v. United States, 484 U.S. 19 (1987).
301. *O'Hagan*, 521 U.S. at 680.
302. *Id.* at 642.
303. *Id.*

engagement but learned of it and decided to buy call options for, as well as shares in, Pillsbury stock.[304] "When Grand Met [later] announced its tender offer, . . . the price of Pillsbury stock rose [and] O'Hagan sold his Pillsbury call options and common stock, making a profit of more than $4.3 million."[305] He was later criminally charged under both [section] 10(b) and § 14(e) of the Exchange Act.[306]

As in *Chestman*, the two core issues before the Court were the viability of the misappropriation theory and the SEC's authority to issue Rule 14e–3(a).[307] As to the first issue, the Court adopted the misappropriation theory pressed by the Government:

> [A] fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.[308]

The Court noted that section 10(b) "requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller."[309] Thus, according to the Court, it should not matter that the deception or fraud was perpetrated on the client company, Grand Met, while the party that traded with O'Hagan was a shareholder of Pillsbury.[310]

In so holding, the Court made an observation that pulled in a policy direction away from *Chiarella/Dirks's* rejection of information parity, as it declared: "an animating purpose of the Exchange Act [was] to insure honest securities markets and thereby promote investor confidence."[311] While acknowledging that "informational disparity is inevitable in the

304. *Id.* at 647.
305. *Id.* at 648.
306. *Id.* at 648–49.
307. *Id.* at 647.
308. *Id.* at 652.
309. *Id.* at 658.
310. *See id.*
311. *Id.* at 644.

securities markets," the Court embraced the view that any such disparity must be the product of "luck," "research or skill," not "contrivance."[312]

Section 10(b), however, requires not only fraud, but fraud "in connection with the purchase or sale of any security," and on this point, the Court concluded that "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.[313] The securities transaction and the breach of duty thus coincide."[314]

Three Justices disagreed and instead sided with the majority of judges in the Eighth Circuit panel, that O'Hagan should not be held criminally liable under section 10(b) and Rule 10b-5.[315] In their view, because the fraud or deception had to be "in connection with" a securities transaction, the fraud has to be perpetrated on the investors with whom one trades.[316] Here, O'Hagan misappropriated or "defrauded" Grand Met, the potential acquirer, rather than the shareholders of Pillsbury, the acquisition target.[317] Justice Scalia believed "the principle of lenity we apply to criminal statutes" should lead to the conclusion that "the unelaborated statutory language: '[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance,' [section] 10(b), must be construed to require the manipulation or deception of a party to a securities transaction," i.e., Pillsbury stock transactions.[318]

In Justice Thomas's dissent—where he was joined by Chief Justice Rehnquist—there was no need to resort to the rule of lenity; the language of the statute was plain enough: "I cannot accept the Commission's interpretation of when a deceptive device is 'use[d] . . . in connection

312. *Id.* at 658–59. While the distinction is intuitively appealing, on closer examination, it may be hard to distinguish "luck" from "contrivance." For example, O'Hagan's access (by virtue of his membership in a law firm that briefly represented the potential acquirer) to information about a potential tender offer was apparently viewed as less "luck" and more "contrivance," but it is unclear why that was so. Moreover, the "contrivance" only occurred when O'Hagan traded on the information in violation of a duty of confidentiality, not in the manner he obtained the information.

313. *Id.* at 656.

314. *Id.*

315. *Id.* at 649.

316. *Id.* at 679.

317. *Id.* at 648.

318. *Id.* at 679 (Scalia, J., concurring in part and dissenting in part).

with' a securities transaction."[319] As he explained, if O'Hagan had stolen money rather than information from company A and used it to trade with company B, even the SEC agreed that would not be securities fraud. There has to be "a more integral connection between the fraud and the securities transaction."[320] But if so, what is it?

The Government argued "that the misappropriation theory satisfies the 'in connection with' requirement because it 'depends on an *inherent* connection between the deceptive conduct and the purchase or sale of a security.'"[321] Recognizing that this may go too far, however, the majority did not adopt the reasoning and instead required that the fraudulently-obtained property is one that "'misappropriators *ordinarily* capitalize upon to gain no-risk profits through the purchase or sale of securities.'"[322]

Justice Thomas criticized this approach as a judge-imposed expansion of the law that had not even been advanced by the Government:

> There are no findings regarding the 'ordinary' use of misappropriated information much less regarding the 'ordinary' use of other forms of embezzled property . . . . [P]ersons subject to this new theory, such as respondent here, surely could not and cannot regulate their behavior to comply with the new theory because, until today, the theory has never existed.[323]

The dissent also crucially exposed the majority's effort to protect the fairness or integrity of the securities market through a form of information parity:

> [T]he supposed threat to fair and honest markets, investor confidence, and market integrity comes not from the supposed fraud in this case, but from the mere fact that the information used by O'Hagan was nonpublic. As the majority concedes, because "the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses *to the source* that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no [section] 10(b) violation." Indeed, were the source expressly to authorize its agents to trade on the confidential information—as a perk or bonus, perhaps—there would likewise be no [section] 10(b)

319. *Id.* at 680 (Thomas, J., dissenting).
320. *Id.* at 681.
321. *Id.* at 687 (citing Brief for United States at 21, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842)).
322. *Id.* at 681 (cross-reference omitted).
323. *Id.* at 688–89.

> violation. Yet in either case—disclosed misuse or authorized use—the hypothesized "inhibiting impact on market participation," would be identical to that from behavior violating the misappropriation theory: "Outsiders" would still be trading based on nonpublic information that the average investor has no hope of obtaining through his own diligence . . . Even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of the source of the information.[324]

The dissent went on to remind the parties that, "as we have repeatedly held, use of nonpublic information to trade is not itself a violation of [section] 10(b)."[325] The fraud has to be "in connection with" a securities transaction itself.[326]

In other words, the harm to the unwitting buyer of Pillsbury stock from O'Hagan, resulted from information disparity, not the means by which O'Hagan acquired information superiority. The "fraud" on the source, Grand Met, could have been remedied by O'Hagan's disclosure to it of his intent to trade Pillsbury stock. That would not remove the harm to the Pillsbury shareholders. By tying the fraud to the trade, the majority was "[c]onflating causation and correlation."[327] The use of MNPI, "even for securities trading, is not illegal, and the consequential deception of the source follows an entirely divergent branch of causation than does the harm to the public. The trader thus 'gains his advantageous market position *through*' the use of nonpublic information, whether or not deception is involved; the deception has no effect on the existence or extent of his advantage."[328]

While one could certainly criticize the dissent for taking an overly restrictive reading of the phrase "in connection with," it is likely Powell would have agreed with the dissent's direction. It sought to contain the scope of insider trading laws within the lines drawn by *Chiarella*/*Dirks*. In contrast, the misappropriation theory was effectively expanding the law to protect any shareholder who has unequal information because of a violation of some duty somewhere in the extended chain of information sharing. Such a theory expanded the zone of danger for an institutional investor and would undoubtedly diminish the safe harbor that *Dirks* intended.

---

324. *Id.* at 689–90 (citations and cross-references omitted).
325. *Id.* at 690–91 (citing Chiarella v. United States, 445 U.S. 222, 232–33 (1980)).
326. *Id.* at 691.
327. *Id.* at 690 n.7.
328. *Id.* at 690–91 n.7.

In also dissenting from the majority's conclusion that the SEC had authority to issue Rule 14e-3(a) respecting tender offers,[329] Justice Thomas pointed out that Section 14(e), like section 10(b), is addressed to fraud, and there was no fraud in the absence of a breach of fiduciary duty.[330] Citing *Chiarella*, the dissent again reminded the Government and the majority that

> [T]here is no general duty between all participants in market transactions to forgo actions based on material, nonpublic information, and such duty only arises from a specific relationship between two parties . . . . Unfair disparities in market information, and the potential 'stampede effect' of leaks, do not necessarily involve a breach of any duty to anyone, and thus are not proper objects for regulation in the name of 'fraud' under [section] 14(e) . . . . As we have held in the context of [section] 10(b), not every instance of financial unfairness constitutes fraudulent activity.[331]

Professor Carol Swanson claimed the *O'Hagan* Court "squandered a rare chance to clarify one of the most difficult and frustrating topics in business law."[332] She accurately predicted that "insider trading regulation will struggle forward, ill-defined and inefficient, into the next century."[333] Noting that "[t]he policy concerns underlying insider trading litigation have essentially run between fairness and economic efficiency," she believed the "misappropriation theory itself embodies and heightens these tensions as a doctrine not directly supported by statutory language, yet born of a desire to regulate traders who benefit more remotely from inside information."[334] She lamented that "[b]efore *O'Hagan*, insider trading law was in confused disarray, the misappropriation theory was alive, but possessed an ill-defined scope, and an army of commentators demanded legislation that would provide clarity and predictability. After *O'Hagan*, the world looks very much the same."[335]

---

329. *Id.* at 666–78. The Court largely applied the same reasoning as appears in *Chestman*, discussed *supra* at note 257.
330. *Id.* at 680 (Thomas, J., dissenting).
331. *Id.* at 699–700 (quotation marks and citations omitted).
332. Swanson, *Reinventing Insider Trading*, *supra* note 36, at 1160.
333. *Id.*
334. *Id.*
335. *Id.* at 1212.

8. The "Confused Disarray" and the Dilution of the Personal Benefit Element

The years following *O'Hagan* did not improve the clarity of the law. Its "confused disarray" became further baked into the law of insider trading, as the Government continued to advocate legal positions in pursuit of a more "level playing field" of market information.[336] Wittingly or not, the Government's arguments further weakened the connection between breach of fiduciary duty and prohibited trading.

For example, in 1998, the Second Circuit applied *Dirks'* "personal benefit" test in the context of tipper liability involving two close friends.[337] In *SEC v. Warde*,[338] an insider—Downe—tipped his close friend—Warde—who then traded for a profit.[339] There was no evidence that Downe received any pecuniary benefit from Warde.[340] Applying *Dirks*, however, the Court held that

> the SEC need not show that the tipper expected or received a specific or tangible benefit in exchange for the tip . . . . Rather, the 'benefit' element of [section] 10(b) is satisfied when the tipper 'intend[s] to benefit the . . . recipient' or 'makes a gift of confidential information to a trading relative or friend.'[341]

Thus, Warde's trades "resemble[d] trading by the insider himself followed by a gift of the profits to the recipient. The close friendship between Downe and Warde suggests that Downe's tip was 'inten[ded] to benefit' Warde, and therefore allows a jury finding that Downe's tip breached a duty under [section] 10(b)."[342]

But what about Warde's knowledge that Downe violated his fiduciary duty? Here, the Court appears to make a subtle but significant shift from *Dirks* that the *Newman* Court would struggle to undo nearly fifteen years later. In *Dirks*, the personal benefit element was a *condition* for finding a breach of fiduciary duty; put another way, one violates a fiduciary duty when one tips for the purpose of obtaining a personal

---

336. *Id.* at 1191 n. 286.
337. SEC v. Warde, 151 F.3d 42 (2d Cir. 1998).
338. *Id.*
339. *Id.*
340. *Id.*
341. *Id.* at 48 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).
342. *Id.* at 48–49.

benefit.[343] The *Warde* Court, however, appeared to decouple personal benefit from the breach of fiduciary duty element, with the tippee's knowledge going to the breach of trust and not necessarily knowledge of a personal benefit: "[t]o affirm Warde's liability as a tippee under [section] 10(b), we must find sufficient evidence to permit a reasonable finding that . . . (4) Warde knew or should have known that Downe violated a relationship of trust by relaying Kidde information; and (5) Downe benefitted by the disclosure to Warde."[344] Missing was the requirement that Warde, the tippee defendant, knew that the insider Downe received some benefit from tipping Warde.[345] Having found that Downe sought to gift information to Warde, the Court determined that Warde was liable as a tippee without a separate analysis of whether Warde knew that Downes had obtained a personal benefit; it was sufficient that Warde knew Downe had violated the company's confidentiality requirement.[346]

This distinction was not momentous in *Warde* because Warde presumably would have understood that Downe benefited by gifting valuable information to his close friend.[347] Yet, the Court's discussion of the elements that effectively decoupled the personal benefit element from the fiduciary duty breach would have adverse consequences in subsequent cases.

In *United States v. Falcone*,[348] the Second Circuit affirmed the conviction of a second level tippee, Falcone, without commenting on whether the Government had proven the tippee knew whether the insider had obtained a personal benefit. The Court also approved a misappropriation theory against a tippee who traded on misappropriated information—unlike *O'Hagan*, where the temporary insider was himself the trader.[349] The core issue on appeal was whether *O'Hagan* precluded his conviction on a misappropriation theory because the insider's act of misappropriation was not "in connection with" the securities trading that

343. *See Dirks*, 463 U.S. at 662 ("[T]he test is whether the insider 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 [by the tippee]").

344. *Warde*, 151 F.3d at 47.

345. *Id.* at 48.

346. *Id.*

347. *Id.*

348. United States v. Falcone, 257 F.3d 226 (2d Cir. 2001).

349. *Id.*; *see* United States v. O'Hagan, 521 U.S. 642, 657 (1997).

he, a tippee, subsequently engaged in.[350] The Court affirmed the conviction, noting that the facts of *O'Hagan* were not "the sole combination of factors necessary to establish the requisite connection in all contexts," and that the Court could apply the broader *O'Hagan* "requirement that the misappropriated information 'ordinarily' be valuable due to 'its utility in securities trading,' . . . [because it] appears to be a more generally applicable factor in determining whether section 10(b)'s 'in connection with' requirement is satisfied."[351]

With respect to the defendant second level tippee's knowledge about a breach of fiduciary duty by the insider, the Court analyzed the issue without any reference to personal benefit.[352] For the Court, "the key factor was the tipper's intent in providing the information."[353] The Court noted that the insider was aware of the confidentiality requirements of his company and subsequent breach of it.[354] It is possible that, as in *Warde*, the Court was prepared to find breach of fiduciary duty regardless of whether a personal benefit was shown. Its decision could also simply reflect that the appellant did not raise personal benefit because it would have been a futile argument. There was clear evidence in the record that the insider newspaper employee was paid $200 in cash for each column he shared with the first level tippee,[355] who testified at trial that he told Falcone about the scheme and Falcone paid the first level tippee the $200 per column.[356]

In any event, in the wake of *Warde* and *Falcone*, there was now an open question as to whether the fiduciary duty element—under either the traditional or misappropriation theories—could be satisfied by showing a knowing violation of the duty of confidentiality without showing knowledge of the personal benefit.

In *SEC v. Obus*,[357] the Second Circuit offered mixed signals on this question.[358] As in *Falcone*, the case involved two levels of tipping.

---

350. *Id.* at 227.
351. *Id.* at 233.
352. *Id.* at 230.
353. *Id.*
354. *Id.* at 234–35.
355. *See* Government Brief at 10, United States v. Falcone, 257 F.3d 226 (2d Cir. 2001) (No. 00-1768), 2001 WL 34106997, at *9.
356. *Falcone*, 257 F.3d at 235.
357. SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).
358. One judge later called the decision "somewhat Delphic." United States v. Whitman, 904 F. Supp. 2d 363, 371 n. 6 (S.D.N.Y. 2012) (Rakoff, J.).

Strickland, the insider, tipped his college friend, Black, and Black tipped his boss, Obus, who traded on the information.[359] With respect to the insider's liability, the Court returned to the personal benefit requirement and held, as in *Warde*, that where a tipper and tippee are good friends, the information can be viewed as a gift.[360] "*Dirks* defined 'personal benefit' to include making a gift of information to a friend."[361] With respect to the second level tippee trader Obus's liability, however, the Court focused exclusively on his awareness of the tipper, Strickland's, breach of confidentiality, and did not discuss his awareness of Strickland's intent to gift information to Black.[362] Obus's knowledge of the personal benefit to the insider appeared to be dropped from the analysis of the fiduciary duty breach altogether.[363]

C. *United States v. Newman* and the Return to *Dirks'* "Safe Harbor"

That was the confused state of insider trading law when, during the financial crisis that began in 2008, the SEC and the U.S. Attorney's Office for the Southern District of New York began unspooling a series of prosecutions that targeted institutional investors—specifically, the hedge fund industry.[364] By this point, the class of institutional investors comprised of lightly-regulated hedge funds had mushroomed.[365] In this exceedingly-competitive industry, each portfolio manager sought an

---

359. *Obus*, 693 F.3d at 280–81.
360. *Id.* at 291.
361. *Id.* (citing *Dirks*, 463 U.S. at 664; *Warde*, 151 F.3d at 48–49 ("[T]he 'close friendship' between the alleged tipper and tippee was sufficient to allow the jury to find that the tip benefitted the tipper").
362. *Id.* at 292–93.
363. *Id.* ("[T]he SEC must show that Obus knew or had reason to know that the [corporate] information was obtained through a breach of fiduciary duty . . . . [A] jury could infer (1) that Obus believed Black's information was credible and thus knew that it originated from someone entrusted with confidential information; and (2) that Obus recognized that Strickland might lose his job as a result of the information he had conveyed to Black, demonstrating Obus's knowledge that Strickland had acted inappropriately.")
364. *See* Sheelah Kolhatkar, *Black Edge*, Random House, 2017 (reporting that the investigation began with Rajat Rajaratnam and his fund the Galleon Group, before focusing on one of the most successful hedge fund traders on Wall Street, Steve Cohen, who ran SAC Capital).
365. *See id.* at XVII.

"edge," an informational advantage that would distinguish one's trading ideas over another.[366] With enormous financial resources, the most successful hedge funds could engage in highly sophisticated research and analysis of corporate performance.[367] To accommodate their appetite, an industry of expert consultants had also sprung up to provide the hedge funds with expert opinions about a product or company.[368] Hedge funds often engaged consultants who were working on a product for a company that they were interested in trading.[369]

When enforcement agents began peering into this industry, they quickly identified certain firms that they believed were engaged in exceptionally aggressive behavior and targeted them.[370] These investigations were not focused on the "one-off" opportunistic trader who obtained access to confidential corporate information through corrupt payments or gifts of information from friends.[371] Rather, they centered on the core practice of institutional investors who sought out inside information for a crucial edge for their trading strategies.[372] In a legal environment where the key element of the insider's personal benefit had been eroded, the institutional investors' systematic use of nonpublic information struck the investigators as patently wrong.[373] Using intensive investigative techniques that had previously been reserved for narcotics and organized crime figures, the Government executed search warrants on offices and obtained wiretap orders enabling them to intercept vast numbers of electronic communications.[374]

These efforts yielded an extraordinary number of defendants. By the end of 2015, a number of hedge funds were shuttered, and 86 defendants

---

366. Patrick Radden Keefe, *The Empire of Edge*, THE NEW YORKER (Oct. 13, 2014), https://www.newyorker.com/magazine/2014/10/13/empire-edge [https://perma.cc/7ZQC-P8HG].

367. *Id.* (describing physical surveillance of corporate operations to determine whether workers were doing one or two shifts, and use of former CIA operatives to determine if corporate representatives were being truthful).

368. *Id.*

369. Laurie P. Cohen, *Seeking an Edge, Big Investors Turn to Network of Informants*, WALL ST. J. (Nov. 27, 2006), https://www.wsj.com/articles/SB116459881353833275 [perma.cc/5MQH-ZHAP].

370. *See* Kolhatkar, *supra* note 364, at XIII.

371. *Id.*

372. *Id.* at XIX.

373. *Id.*

374. *Id.*

were reportedly convicted after trial or the entry of guilty pleas.[375] Only a few challenged the Government at trial; Todd Newman and co-defendant Anthony Chiasson were two such defendants.[376]

Although the Government prevailed before a jury, they then saw their case reversed and dismissed in the Second Circuit, as the panel, which included Judge Winter—the author of the comprehensive dissent and concurring opinion in *Chestman*—reprised the crucial element of personal benefit.[377] In so doing, the Court sharply returned the caselaw to the letter and the spirit of *Dirks*, as it effectively reminded the Government that *Dirks* raised the hurdle for insider trading prosecution of institutional analysts and related investors.[378] Indeed, the Court took the unusual step of broadly criticizing the Government's "recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders."[379]

There were a number of unusual features to this case, not least of which was that the Government did not charge the "corporate insiders," that is, those who are the principal violators of their fiduciary duties with any crimes,[380] and they did not even testify as cooperating witnesses.[381] In light of the *Warde* and *Obus* line of cases, prosecutors may have reasonably concluded such charges and testimony were not essential to a sound prosecution. Second, the defendant portfolio managers were a number of steps removed from communications with insiders.[382]

Newman was a portfolio manager at Diamondback Capital Management, LLC ("Diamondback"), and Chiasson was a portfolio manager at Level Global Investors, L.P. ("Level Global").[383] The case involved two separate insider tippers at two companies: Rob Ray at Dell, and Chris Choi of Nvidia.[384] As to Dell securities, Ray tipped Dell's

---

375. *See* Nate Raymond, *U.S. Prosecutors to Drop Insider Trading Charges Over IBM Deal*, REUTERS (Jan. 29, 2015), https://www.reuters.com/article/us-usa-insidertrading-ibm/u-s-prosecutor-to-drop-insider-trading-charges-over-ibm-deal-idUSKBN0L21J420150129 [perma.cc/TX4A-TTBQ].

376. *United States v. Newman*, 773 F.3d 438, 442 (2d Cir. 2014).

377. *Id.* at 451.

378. *Id.* at 454.

379. *Id.* at 448.

380. *Id.* at 442.

381. *Id.* at 453.

382. *Id.* at 455.

383. *Id.* at 442.

384. *Id.* at 443.

earnings results, pre-public announcement, to Sandy Goyal, an analyst at an investment firm Neuberger Berman.[385] Goyal in turn tipped Diamondback analyst Jesse Tortora who then tipped his manager, defendant Newman.[386] In short, as to Dell, Newman was three steps removed from the insider. There was no evidence that he was aware of Ray as the source of the insider information.[387] Tortora also tipped the Dell information to Level Global analyst, Spyridon Adondakis.[388] "Adondakis then passed along the Dell information to [defendant] Chiasson," his manager.[389] Thus, Chiasson was four steps removed from the insider and, as with Newman, there was no evidence Chiasson was aware of Ray as the source.[390]

As to Nvidia securities, insider Choi tipped an acquaintance from church, Hyun Lim, about Nvidia's quarterly earnings information pre-public announcement.[391] Lim tipped Danny Kuo, an analyst at investment firm Whittier Trust, and "Kuo circulated the information to the group of analyst friends, including Tortora and Adondakis, who in turn gave the information to Newman and Chiasson. This made Newman and Chiasson four levels removed from the [Nvidia] inside tippers."[392]

Unlike *Warde*, *Falcone*, and *Obus*, the Second Circuit squarely addressed the ultimate defendant tippee's required level of knowledge. Reconnecting the personal benefit to the violation of duty element, the Court made clear that the Government had to prove that the ultimate tippee was aware of the insider tipper's personal benefit, because

> *Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b-5. For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the

385. *Id.*
386. *Id.*
387. *Id.*
388. *Id.*
389. *Id.*
390. *Id.*
391. *Id.*
392. *Id.*

> Government cannot meet its burden of showing that the tippee knew of a breach.[393]

Understandably, the Government protested because this rule seemed to run counter to *Warde*, *Falcone*, and *Obus*, discussed *supra*, Part I.B.8, but the Court dismissed the objections as "overreliance on our prior dicta."[394] It characterized the prior cases as ones that "generally involved tippees who directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit) or tippees who were explicitly apprised of the tipper's gain by an intermediary tippee."[395] In contrast, the Court said it was unaware of "a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading."[396]

The Court then directly addressed the theory of insider trading that "the Government might like the law to be," as it reminded litigants that the Supreme Court had long since repudiated the theory of information parity in a fair marketplace.[397] "[N]ot every instance of financial unfairness constitutes fraudulent activity under [section] 10(b)."[398] Instead, it noted, as Judge Winter wrote in Chestman, "[e]fficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate . . . . "[399] The Supreme Court made clear that "insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nation's securities markets."[400]

In marching through the logic of *Dirks* to the current case, the *Newman* Court gave scant attention to the considerable tension between *Dirks* and the line of intervening Second Circuit cases that blurred *Dirks'*

393. *Id.* at 448.
394. *Id.*
395. *Id.*
396. *Id.*
397. *Id.* at 448–49.
398. *Id.* at 449 (citing *Dirks*, 445 U.S. at 232; *Chestman*, 947 F.2d at 578 (Winter, J., concurring)).
399. *Id.*
400. *Id.* at 449.

personal benefit requirement.[401] It likewise failed to account for *O'Hagan's* seeming embrace of "fair market" policy arguments in its adoption of the misappropriation theory.[402]

Instead, the *Newman* Court strongly reaffirmed *Dirks* by holding that a "corporate insider breache[s] his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; [and] the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit."[403] Applying these standards, the jury instruction below was flawed because the jury could have found "that a defendant could be criminally liable for insider trading merely if such defendant knew that an insider had divulged information that was required to be kept confidential. But a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper 'is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself.'"[404]

So far, while *Newman* could be viewed as having put the brakes on the Government, its reasoning closely adhered to *Dirks* and reclaimed the safe harbor for institutional analysts that Justice Powell intended.[405] But, in the next part of its opinion, as the Court addressed what "personal benefit" means, it inserted a new requirement, a stronger safeguard, not expressly contained in *Dirks*:

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.[406]

401. *Id.* at 455.
402. *Id.* at 455–56.
403. *Id.* at 450.
404. *Id.* (citing *Dirks*, 463 U.S. at 664).
405. *Dirks*, 463 U.S. at 658–59.
406. *Id.* at 452 (citations omitted).

To defend this increased restriction on insider trading prosecutions, the Court relied on other cases that happened to involve facts pertaining to potentially pecuniary benefits in addition to friendship.[407]

Because the evidence of the insiders' personal benefit in tipping involved nothing more than "career advice" or membership in the same church, without any expectation of a quid pro quo, the Government had adduced insufficient evidence of a violation of fiduciary duty and the convictions had to be reversed.[408] Moreover, according to the Court, "the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts."[409]

In reaching this conclusion, the Court recited the evidence demonstrating what institutional investors do on a routine basis as they probe and analyze corporate information that are accessible without resort to fiduciary duty violations.[410] If Justice Powell only vaguely outlined their work as he emphasized their importance to efficient markets, the *Newman* Court's description of the evidence detailed what that activity entails.[411]

The evidence demonstrated that "analysts at hedge funds routinely estimate metrics such as revenue, gross margin, operating margin, and earnings per share through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends."[412] "[A]nalysts routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements."[413] And in response, "investor relations departments routinely assisted analysts with developing their models."[414] In fact, investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings and other financial information "to

407. *Id.* at 452–53 (citing SEC v. Yun, 327 F.3d 1263, 1280 (11th Cir. 2003); SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000).
408. *Id.* at 453.
409. *Id.*
410. *Id.* at 454.
411. *Id.*
412. *Id.* at 454.
413. *Id.*
414. *Id.*

establish relationships with financial firms who might be in a position to buy" their stock.[415]

As a consequence, the convictions of Newman and Chiasson were reversed on all counts, with instructions to dismiss the indictment with prejudice.[416] The Government sought *en banc* review. When denied,[417] it then sought *certiorari* relief from the Supreme Court but was again denied.[418] Nearly four years had passed from the date the defendants were first indicted in January 2012, and their ordeal was finally over.

In its effort at a rehearing, the Government claimed that the *Newman* Court imposed a new definition of personal benefit that was "deeply confounding and, contrary to the Panel's express intention of supplying clarity, is certain to engender confusion among market participants, parties, judges, and juries."[419] In its *certiorari* petition, the Government promised the Supreme Court that "market participants and analysts who seek to comply with the law will lack clear guidance about the legal limits of their conduct,"[420] that *Newman's* reading "blurs the line between legitimate and prohibited activity,"[421] and would engender "uncertainty in the financial community about the boundaries of legitimate conduct."[422] The Government added that this "is particularly intolerable in the circuit that is home to the financial capital of the Nation, if not the world."[423]

Particularly troubling to the Government was *Newman's* new rule: "To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, . . . such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that *generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature*."[424] The Government complained that "[t]his is

415. *Id.* at 455.
416. *Id.* at 443.
417. United States v. Newman, 773 F.3d 438 (2d Cir. 2015), *rehearing denied en banc*, No. 13-1837 (Apr. 3, 2015).
418. United States v. Newman, 773 F.3d 438 (2d Cir. 2015), *cert. denied*, 136 S.Ct. 242 (2015).
419. *See Petition for Rehearing En Banc, Newman*, *supra* note 43, at *2.
420. *See Petition for Certiorari, Newman*, *supra* note 40, at *33.
421. *Id.* at *26.
422. *Id.* at *32.
423. *Id.* at *33.
424. United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2015) (emphasis added).

flatly inconsistent with *Dirks*, as well as cases in this Circuit and others," including *Warde*.[425]

That was only partially true. While the new requirement was certainly inconsistent with the trend of the Second Circuit law, it was arguably fully consistent with the policy judgment underlying *Dirks*. *Dirks* sought to provide a zone of safety for institutional analysts because of their importance to the securities market by insisting on proof of the insider's breach of fiduciary duty.[426] Yet, as Professor Langevoort noted in 1990, the Court added language about reputational benefit and gifting that would open the door to future interpretive challenges.[427] Justice Blackmun rightly assailed the personal benefit test, and in particular the gift theory. "[T]he Court does not explain why the benefit Secrist obtained—the good feeling of exposing a fraud and his enhanced reputation—is any different from the benefit to an insider who gives the information as a gift to a friend or relative."[428]

The *Newman* decision effectively offered to shore up a gap that *Dirks* had left open and to save it from Justice Blackmun's unanswered challenge.[429] Even where friends are involved, the *Newman* Court held the information must be in exchange for something meaningful; it cannot be a matter of mere good personal feelings.[430] There has to be a discernible line for tippees to observe and act on—if gifts among "friends" were enough, the personal benefit requirement could become illusory. Thus, if *Dirks'* requirement of an "objective" test means anything, there must be a showing that the insider actually benefited from disclosing the information not merely because he felt good about it. This is the necessary implication of concluding that Secrist did not personally benefit. Lacking pertinent statutory language or legislative history as a guide, the *Newman* Court's new requirement reinforced *Dirks'* effort to protect institutional analysts' activity.[431]

The impact of *Newman* was quickly felt in other cases.[432] In *United States v. Steinberg*, where a portfolio manager for SAC Capital had been

---

425. *See Petition for Rehearing En Banc, Newman*, *supra* note 43, at *13.
426. Dirks v. SEC, 463 U.S. 646, 658 (1983).
427. *See supra* text accompanying notes 190–98.
428. *Dirks*, 463 U.S. at 676 n.13 (1983) (Blackmun, J., dissenting).
429. United States v. Newman, 773 F.3d 438, 438 (2d Cir. 2015).
430. *Id.*
431. *Id.*
432. Matthew Goldstein, *U.S. Prosecutors to Drop Insider Trading Cases Against Seven*, N.Y. TIMES (Oct. 22, 2015), https://www.nytimes.com/2015/10/23/

separately tried and convicted of insider trading, the Government agreed to vacate his conviction in the wake of *Newman*, as well as the convictions on the basis of guilty pleas of six cooperating witnesses.[433] In *United States v. Conradt*,[434] four defendants who had pleaded guilty to insider trading were permitted by the Government and the district court to withdraw their guilty pleas after the *Newman* decision because the Government conceded that it had no proof any of them was aware of the insider obtaining any personal benefit in exchange for information.[435]

This outcome was so troubling that it almost spurred Congress into action, as U.S. House Representative Jim Himes drafted a bill that received bipartisan support in the House.[436] The bill, which was nearly identical to the Insider Trading Protection Act, would have codified the insider trading law to eliminate the personal benefit element.[437] Himes claimed the bill was necessary because "there exists a fundamental disadvantage in prosecuting a crime that has never been properly defined."[438] John Coffee, a securities law professor at Columbia Law and acknowledged expert in the area, applauded the bill but characterized its impact differently, stating that it "closes the loophole created by the *Newman* decision."[439] That bill however was never advanced to a vote.

D. The Supreme Court Reacts in *Salman v. United States*

While the Supreme Court denied *certiorari* review in *Newman*, it later granted *certiorari* to a defendant convicted of insider trading in the Ninth Circuit. *Salman v. United States* squarely presented a dispute about

---

business/dealbook/us-prosecutor-to-drop-insider-trading-cases-against-seven.html [https://perma.cc/3LN9-G89R].

433. *Id.*

434. United States v. Conradt, No. 12 Cr. 887(ALC), 2015 WL 480419, at *1 (S.D.N.Y. Jan. 22, 2015).

435. Christopher M. Matthews, *Insider Trading Charges to be Dropped*, WALL ST. J. (Jan. 29, 2015), https://www.wsj.com/articles/justice-department-drops-insider-trading-charges-14.22571552 [https://perma.cc/Q7ND-EKGW].

436. Press Release, Jim Himes, *Himes Introduces Bipartisan Bill to Define and Prohibit Illegal Insider Trading* (Mar. 25, 2015), https://himes.house.gov/media-center/press-releases/himes-introduces-bipartisan-bill-define-and-prohibit-illegal-insider [https://perma.cc/YB8E-B8WH].

437. *Id.*

438. *Id.*

439. *Id.*

the gift theory of the personal benefit element under *Dirks*.[440] In *Salman*, the insider was the brother of the first level tippee, and that tippee in turn tipped Salman, the defendant, who traded on the information.[441] In affirming the conviction, the Court noted—without adopting—the Government's expansive view of the gift theory: "that a gift of confidential information to anyone, not just a 'trading relative or friend,' is enough to prove securities fraud . . . . Under the Government's view, . . . a gift to a friend, a family member, or anyone else would support the inference that the tipper exploited the trading value of inside information for personal purposes and thus personally benefited from the disclosure."[442] The Court did not expressly adopt nor reject the Government's construction of personal benefit.[443] Instead, the Court merely retraced the origin of the gift theory to *Dirks's* discussion[444] and held that it applied squarely to support the conviction of Salman.[445]

With respect to *Newman*, the Court essentially split the baby.[446] It first quoted, with apparent approval, the portion of *Newman's* holding that the inference of a personal benefit from a gift "'is impermissible in the absence of proof of a meaningfully close personal relationship.'"[447] But the Court rejected the part of the holding regarding a gain of "pecuniary or similarly valuable nature" even when making a gift to relatives or friends: "To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends . . . this requirement is inconsistent with *Dirks*."[448] In short, "when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift."[449] There need not be an additional showing, as *Newman* held, that the tipper expected to receive something of "a pecuniary or similarly valuable nature."[450]

440. Salman v. United States, 137 S. Ct. 420 (2016).
441. *Id.*
442. *Id.* at 426.
443. *Id.* at 429.
444. *Id.* at 427.
445. *Id.* at 429.
446. *Id.*
447. *Id.* at 425 (quoting United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)).
448. *Id.* at 428.
449. *Id.*
450. *Id.*

The Court went on to acknowledge, in something of an understatement, that: "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts . . . . But there is no need for us to address those difficult cases today, because this case involves precisely the gift of confidential information to a trading relative that *Dirks* envisioned."[451]

This was a punt. It is not easy for the courts to determine whether the personal benefit test has been met, even after a close examination at trial with 20/20 hindsight, but institutional investors reacting in real time are expected to make those perilous judgments on a daily basis.[452] The peril was deepened when the Second Circuit issued its decision in *Martoma*.

E. *United States v. Martoma* and the Second Circuit's Impasse

The *Martoma* decision revealed the deep fracture within the Second Circuit. The two opinions in *United States v. Martoma*[453] demonstrated that the policy battle that Justices Powell and Blackmun waged in 1983, between information parity and market efficiency, continues to be waged among fair-minded judges.[454]

Martoma was a portfolio manager at a hedge fund SAC Capital, who traded the stock of Elan Corporation and Wyeth Pharmaceuticals after he had a series of communications with Dr. Stanley Gilman, the alleged tipper.[455] Elan and Wyeth were jointly developing an experimental drug called bapineuzumab to treat Alzheimer's disease.[456] To learn more about this drug, Martoma sought the help of expert networking firms and arranged paid consultations with doctors knowledgeable about Alzheimer's disease.[457] Through this network, Martoma was put in touch with two doctors who were working on the bapineuzumab clinical trial, Joel Ross and Dr. Gilman.[458] Gilman was in fact chairman of the safety monitoring committee for the bapineuzumab clinical trial.[459]

451. *Id.* at 429 (citations omitted).

452. *Id.*

453. United States v. Martoma, 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017).

454. *Martoma*, 869 F.3d at 58.

455. *Id.* at 61.

456. *Id.*

457. *Id.*

458. *Id.*

459. *Id.*

Notwithstanding the confidentiality obligations Gilman and Ross owed to the companies and to the expert consulting network, they both disclosed confidential updates on the progress of the trial to Martoma.[460] As in *Newman*, the principal "insider," Dr. Gilman, was not charged, but did testify against Martoma under a non-prosecution agreement with the Government.[461] Martoma was convicted of insider trading after a jury trial.[462] On appeal, he argued that the evidence was insufficient to support the conviction and that the district court had not properly instructed the jury in compliance with the legal standards articulated in *Newman*.[463]

More specifically, Martoma argued that he and Dr. Gilman did not have a "meaningfully close personal relationship" and that Dr. Gilman had not received any "objective, consequential . . . gain of a pecuniary or similarly valuable nature" in exchange for providing Martoma with confidential information.[464] Even if the evidence might be viewed as satisfying these standards, Martoma argued, the jury was not properly instructed and thus, a retrial was necessary.[465]

In rejecting these claims, the majority of the three-judge panel in *Martoma*, Chief Judge Robert Katzmann and Judge Denny Chin, issued two separate opinions, each time over the dissent of Judge Rosemary Pooler.[466] Both majority opinions departed sharply from *Newman*.[467] If the *Newman* Court sought to rein in the Government, *Martoma* loosened the leash, and then some.[468]

1. *Martoma I*

The majority in *Martoma* held that the evidence was in fact sufficient to prove the tippers obtained a personal benefit in sharing the confidential

---

460. *Id.* at 62.

461. Brian Jacobs, *Non-Prosecution Agreements: Reserved for VIPs?*, FORBES (Feb. 9, 2016), https://www.forbes.com/sites/insider/2016/02/09/non-prosecution-agreements-reserved-for-vips/#684b1e572bdd [https://perma.cc/B6CG-XQT7].

462. Alexandra Stevenson and Matthew Goldstein, *Ex-SAC Trade Convicted of Securities Fraud*, N.Y. TIMES (Feb. 6, 2014), https://dealbook.nytimes.com/2014/02/06/former-sac-trader-found-guilty-of-insider-trading/ [https://perma.cc/ED3R-U95V].

463. *Martoma*, 869 F.3d at 61.

464. *Id.* at 64–65.

465. *Id.*

466. United States v. Martoma, 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017).

467. *Martoma*, 869 F.3d at 67; *Martoma*, 894 F.3d at 77–78.

468. *Martoma*, 869 F.3d at 73.

information with Martoma.[469] With respect to the jury instruction, *Salman* abrogated *Newman* and held that its "meaningfully close personal relationship' requirement can no longer be sustained."[470] To reach this conclusion, the majority expanded the *Dirks* definition of gift and personal benefit, embracing the view espoused by the Government in *Salman*, a view that the Supreme Court had not adopted:

> [T]he ultimate inquiry under *Dirks* is whether a tipper has personally benefitted from a disclosure of inside information such that he has violated his fiduciary duty, and it is not apparent that the examples in *Dirks* support a categorical rule that an insider can never benefit personally from gifting inside information to people other than 'meaningfully close' friends or family members—especially because the justification for construing gifts as involving a personal benefit is that '[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient,' an observation that holds true even if the tipper and tippee were, for example, business school classmates who "had known each other for years" rather than close friends."[471]

Thus, the *Martoma* majority found an insider could obtain a personal benefit by gifting information to someone who was not a friend or relative.[472] As to *Newman*, the majority argued that "a three-judge panel may issue an opinion that overrules Circuit precedent . . . where an intervening Supreme Court decision casts doubt on the prior ruling . . . . We respectfully conclude that *Salman* fundamentally altered the analysis underlying *Newman*'s 'meaningfully close personal relationship' requirement such that the 'meaningfully close personal relationship' requirement is no longer good law."[473]

Salman, however, had not impaired the requirement described in *Newman*—it merely abrogated the portion requiring a pecuniary benefit even where gifts among friends or relatives were involved.[474] Nevertheless, the majority reasoned that under *Dirks* and *Salman* there should be no "distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship'—a term left

---

469. *Id.* at 58.
470. *Id.* at 67.
471. *Id.* at 68 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).
472. *Id.* at 63.
473. *Id.* at 68–69 (citation omitted).
474. Salman v. United States, 137 S.Ct. 420, 428 (2018).

undefined in *Newman*, but which apparently did not reach two people who 'had known each other for years, having both attended business school and worked . . . together,'—and gifts to those with whom a tipper does not share such a relationship."[475] Thus, the jury instruction was not erroneous when it stated that a "gift [given] with the goal of maintaining or developing a personal friendship or a useful networking contact" constitutes a personal benefit.[476] Whether an existing friend or a potential future friend, "a tipper personally benefits by giving inside information in lieu of a cash gift."[477]

The *Martoma* majority went on to hold that in any event, the evidence was sufficient to convict Martoma even under the traditional personal benefit theory of a *quid pro quo*: "Dr. Gilman, the tipper, received substantial financial benefit in exchange for providing confidential information to Martoma. As discussed above, Dr. Gilman, over the course of approximately 18 months and 43 paid consultation sessions for which he billed $1,000 an hour, regularly and *intentionally* provided Martoma with confidential information from the bapineuzumab clinical trial."[478]

2. *Martoma I Dissent*

In a lengthy dissent, Judge Pooler explained why the majority view was directly at odds with *Dirks*: the "personal benefit" rule is "a limiting principle of liability. The rule allows many people—including reporters and stock analysts—not to worry that they will become felons or face civil liability for telling information to others who later happen to trade on it . . . . In holding that someone who gives a gift *always* receives a personal benefit from doing so, the majority strips the long-standing personal benefit rule of its limiting power. What counts as a 'gift' is vague and subjective. Juries, and, more dangerously, prosecutors, can now seize on this vagueness and subjectivity. The result will be liability in many cases where it could not previously lie."[479]

For Judge Pooler, *Newman* "attempted to specify what *Dirks* had left unclear—how close persons must be for a gift between them to count as

475. *Martoma*, 869 F.3d at 69.
476. *Id.* at 73.
477. *Id.*
478. *Id.*
479. *Id.* at 74–75 (Pooler, J., dissenting).

a benefit to the gift-giver."[480] There has to be a "meaningfully close personal relationship" in addition to a gift made "in the context of a relationship that 'generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.'"[481] While the *Salman* Court overturned the "pecuniary or similarly valuable nature" portion of *Newman*, it "left *Newman*'s first holding [regarding meaningfully close personal relationship] untouched."[482]

Judge Pooler further noted that the majority's new rule "exactly mirrors the government's view pressed in *Salman*: that 'a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove securities fraud.'"[483] The Supreme Court, however, did not adopt that view.[484] It is curious indeed that the majority would understand *Salman* to require us to take a position that the Supreme Court explicitly considered but did not adopt."[485]

The dissent would have found the jury instruction to be erroneous[486] and argued that properly instructed, the jury could have rationally found that the Government failed to prove Martoma had a close personal relationship with Dr. Gilman[487] or that Gilman received any pecuniary benefit from sharing confidential information with Martoma.[488]

3. *Martoma II*

Martoma petitioned for rehearing or reconsideration *en banc*, and in light of Judge Pooler's vigorous dissent and the majority's mistaken analysis of *Salman's* impact on *Newman*, *en banc* might have been granted.[489] But the majority issued an amended opinion, from which Judge Pooler again dissented.[490] The majority retreated from its position that *Salman* had effectively abrogated the *Newman* holding that a gift theory

480. *Id.* at 79.
481. *Id.* (citing United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)).
482. *Id.* at 80.
483. *Id.* at 86.
484. *Id.*
485. *Id.* at 86–87.
486. *Id.* at 88–89.
487. *Id.* at 90.
488. *Id.* at 90–91.
489. United States v. Martoma, 894 F.3d 64 (2d Cir. 2017).
490. *Id.* at 65.

could only be applied in the context of a "meaningfully close personal relationship."[491] It nevertheless maintained that personal benefit could be proven solely with evidence that the tipper intended to benefit the tippee, even if the tippee was a total stranger.[492]

The majority held that the jury instructions were erroneous "because they allowed the jury to find a personal benefit in the form of a 'gift of confidential information to a trading relative or friend' without requiring the jury to find either that tipper and tippee shared a relationship suggesting a *quid pro quo* or that the tipper gifted confidential information with the intention to benefit the tippee."[493] The majority went on to conclude, however, that the error was harmless because one insider tipper received $70,000 in consulting fees, which "establishes the existence of a relationship suggesting a *quid pro quo* between the tipper and tippee."[494] The conviction could also be affirmed because "at least one tipper received a personal benefit by disclosing inside information with the intention to benefit Martoma."[495]

The majority found support in the *Warde* decision to find the principle that "the personal benefit element is satisfied where there is evidence that the tipper "intend[ed] to benefit the . . . recipient."[496] But *Warde* involved two close friends who were tipper and tippee, and the Court did not address whether the "intent to benefit" test would be applicable even in the absence of a close friendship.[497] Thus, the *Warde* Court held "[t]he close friendship between Downe and Warde suggests that Downe's tip was 'inten[ded] to benefit' Warde, and therefore allows a jury finding that Downe's tip breached a duty under [section] 10(b)."[498]

The basis for the *Martoma* majority's finding that "intent to benefit" is sufficient, without regard to relationships, is the grammar used in the *Dirks* decision: "For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient."[499] Recognizing that this "key sentence of *Dirks* is admittedly ambiguous," the *Martoma* majority

491. *Id.* at 68.
492. *Id.*
493. *Id.*
494. *Id.*
495. *Id.*
496. *Id.* at 74 (quoting SEC v. Warde, 151 F.3d 42, 48 (2d Cir. 1998)).
497. *Warde*, 151 F.3d at 44.
498. *Id.* at 48–49.
499. *Dirks*, 463 U.S. at 664.

held that the "comma separating the 'intention to benefit' and 'relationship . . . suggesting a *quid pro quo*' phrases can be read to sever any connection between them.[500] The sentence, so understood, effectively reads, "there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or there may be an intention to benefit the particular recipient."[501] The *Martoma* majority then read *Warde* as adopting this reading, before stating matter-of-factly, "[w]e adhere to *Warde*."[502]

The majority argued that their analysis was also: "more consonant with *Dirks* as a whole. Because the existence of a breach 'depends in large part on the purpose of the disclosure,' [. . .] it makes perfect sense to permit the government to prove a personal benefit with objective evidence of the tipper's intent, without requiring in every case some additional evidence of the tipper-tippee relationship."[503]

To press their point, the majority posits a hypothetical scenario that starkly revealed the disconnect from the reasoning of *Newman* and Judge Pooler:

> [S]uppose a tipper discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this. Under the dissent's approach, this plain evidence that the tipper intended to benefit the tippee would be insufficient to show a breach of the tipper's fiduciary duty to the firm due to the lack of a personal relationship. *Dirks* and *Warde* do not demand such a result. Rather, the statement "you can make a lot of money by trading on this," following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the insider's fiduciary duty.[504]

For the majority, it was obvious that an intention to benefit a tippee "proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose."[505]

The majority went further to argue that its analysis was consistent even with *Newman* because "[i]mmediately after introducing the

---

500. *Martoma*, 894 F.3d at 74.
501. *Id.* (quoting *Dirks*, 463 U.S. at 662).
502. *Id.*
503. *Id.* at 75 (citation omitted).
504. *Id.*
505. *Id.*

'meaningfully close personal relationship' concept, *Newman* held that it 'requires evidence of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'"[506] Thus, relying on *Newman*'s quoting the *Dirks* language that the majority determined to evidence a disjunctive approach to finding personal benefit, the majority suggested that *Newman* itself agreed with its reasoning: "We do no more than read literally *Newman's* own explanation of its novel standard in light of these decisions, thereby fulfilling our legitimate function to construe and give effect to prior panel decisions."[507]

From this, the majority concluded that the jury instructions were in fact erroneous but not for the reasons Martoma suggested.[508] Instead, "a properly instructed jury would have been informed that it could find a personal benefit based on a 'gift of confidential information to a trading relative or friend' only if it also found that Dr. Gilman and Martoma shared a relationship suggesting a *quid pro quo* or that Dr. Gilman intended to benefit Martoma with the inside information."[509] The inaccurate instructions were harmless, however, because the government "produced compelling evidence that Dr. Gilman, the tipper, 'entered into a relationship of *quid pro quo*' with Martoma" when he was paid for his consulting services.[510] And, even if the evidence could not be viewed as quid pro quo "because Dr. Gilman did not bill Martoma for two key sessions, a rational jury could nonetheless find that Dr. Gilman personally benefited by disclosing inside information with the 'intention to benefit' Martoma."[511]

4. Martoma II Dissent

The dissent characterized the *Martoma II* majority opinion as offering cosmetic changes to the flawed *Martoma I* opinion.[512] Judge Pooler described the vanishingly small difference between *Martoma I and II*: "In their now withdrawn opinion, they held that a gratuitous tip could be understood as beneficial to the tipper so long as a jury were to conclude

---

506. *Id.* at 77 (quoting *Newman*, 773 F.3d at 452) (citation omitted).
507. *Id.*
508. *Id.* at 77–78.
509. *Id.* at 78.
510. *Id.* at 78–79.
511. *Id.* at 79.
512. *Id.* at 80 (Pooler, J., dissenting).

that a tipper expected the tippee to trade on it. Now they hold that an uncompensated tip can be found to personally benefit the tipper so long as the jury were to conclude that the tipper intended to benefit the tippee."[513] The dissent stressed that such an interpretation of *Dirks* would undermine its crucial demand for objective facts.[514] "The only objective facts the government would have to prove would be the communication of material non-public information. All of the protections of the personal benefit rule—a clear guide for conduct, preventing liability for slip ups and other innocent disclosures—would erode."[515]

It is difficult to read the full text of *Dirks* without concluding that the dissent had the better of that particular argument. Objective evidence of personal benefit was a key mechanism for preventing unjust prosecutions in Justice Powell's mind. Pooler took pains to reiterate that *Dirks* sought to provide "a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules so that participants in securities markets are not left to the whims of prosecutorial enforcement priorities."[516] In particular, she noted the need to protect "persons outside the company such as an analyst or reporter who learns of inside information from the threat of prosecution for uncovering information about securities issuers just because they also traded on it."[517]

If objective criteria for finding personal benefit were replaced by mere "intent" or purpose of the tipper, Pooler argued, "[t]he difference between guilty and innocent conduct would be a matter of speculation into what a tippee knew or should have known about the tipper's intent."[518] Here, the dissent channeled Justice Powell as she explained:

> A trader, journalist, or analyst attempting to avoid running afoul of criminal law would have little to guide her behavior. The conservative thing to do would be to avoid seeking inside information too aggressively, even if the whole market could benefit from such investigation. Those who decided to cultivate insider sources would risk prosecution in any case, so they might have fewer scruples about

513. *Id.* at 83.
514. *Id.* at 84.
515. *Id.*
516. *Id.* at 81 (quoting *Dirks*, 463 U.S. at 664).
517. *Id.* (quoting *Dirks*, 463 U.S. at 664 n.24).
518. *Id.*

> compensating their sources and trading on the information they purchased.[519]

Either way, the dissent suggests, the market loses.[520] Where the line blurs, legitimate players fear to "ferret out" the information necessary for efficient pricing, and unscrupulous players become more brazen.[521]

Contrary to the majority's holding, Judge Pooler argued, neither *Dirks* nor any Second Circuit precedent ever held that the tipper's intent to benefit was in and of itself sufficient to satisfy the personal benefit element. "The only time *Dirks* refers to an 'intention to benefit' is when it discusses the need to prove 'a *relationship* between the insider and the recipient *that suggests* . . . an intention to benefit the particular recipient.'"[522]

She also argued that the majority's effort to disconnect the two concepts is deeply flawed.[523] Where *Dirks* sought to provide examples of "objective facts and circumstances," why would the Court "have mentioned an intention to benefit, which is a subjective fact, as an example of a personal benefit, which is an objective fact"?[524] Moreover, why would the Court "have provided an intention to benefit a *tippee* as an example of a benefit to the *tipper*[?] Intending to benefit somebody is not in itself a benefit. That is, not unless one has reason to believe that the person with the intention to benefit benefits from the beneficiary's benefit or one adopts the trivializing view of human psychology wherein everything any individual does is to benefit herself."[525] And, if the majority's standalone "intent to benefit" test is all it takes to prove the tipper's personal benefit, why would the *Dirks* Court "have adopted the personal benefit test in the first place"?[526] As for the majority's reliance on *Warde*, Judge Pooler retorted: "We found that the '*close friendship* between Downe and Warde *suggests* that Downe's tip was "inten[ded] to benefit" Warde' . . . . Thus, we did not find that a freestanding 'intention

---

519. *Id.* at 81–82.
520. *Id.* at 82.
521. *Id.*
522. *Id.* (quoting *Dirks*, 463 U.S. at 664).
523. *Id.* at 80.
524. *Id.* at 85.
525. *Id.*
526. *Id.*

to benefit' would have been sufficient to prove Downe's personal benefit."[527]

With respect to the majority's hypothetical tipper who tips a "perfect stranger," Judge Pooler had this blunt retort:

> The [majority] ask[s] us to imagine a situation where a tipper "discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this." [*Martoma*, 894 F.3d at 75].[528] Wouldn't it be absurd if this perfect stranger could not be held liable for insider trading if he went ahead and traded on this information? *No, it would not be*.[529]

Dirks requires that the tipper receive a personal benefit. "That is the law whether we like or not."[530] Judge Pooler went on to remind the majority that "[e]ven assuming arguendo that there was any ambiguity on the topic in our precedents, *Newman* removed it by requiring a 'meaningfully close personal relationship' in order to prove personal benefit via the gift theory."[531]

In conclusion, Judge Pooler's dissent characterized the majority's rule as "non-binding dicta,"[532] and "[i]t is good news, then, that binding precedent stands for the opposite principle."[533] She then declared that "*Newman* remains good law."[534]

---

527. *Id.* at 84 (quoting *Warde*, 151 F.3d at 49).
528. *Id.* at 86 (quoting majority opinion at 75).
529. *Id.* (emphasis added).
530. *Id.*
531. *Id.* (quoting *Newman*, 773 F. 3d at 452).
532. *Id.* at 86–87.
533. *Id.* at 84.
534. *Id.* at 87.

While Judge Pooler's dissent did not make this point, one could also argue that the SEC's issuance of Regulation Fair Disclosure (Reg FD) casts further doubt on *Martoma II*'s view that mere intent to benefit the tippee suffices for the personal benefit element of insider trading liability under *Dirks*. That rule, embodied in 17 C.F.R. § 243.100, prohibits senior corporate insiders from making "selective disclosures" to analysts and institutional investors.

The SEC issued this rule in 2000 in an effort to stem the practice of corporate insiders regularly disclosing MNPI to their favorite analysts. As one commentator explained, the rule was "conceptually [] a brilliant end-run around *Dirks*" because that case held "a company official disclosing material nonpublic information to an analyst violates his/her fiduciary duty to the shareholders and Rule 10b-5 *only* if s/he 'receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.' This does not permit insiders

One would have thought that this impasse between the *Newman* panel and Judge Pooler on the one hand and Chief Judge Katzman and Judge Chin on the other was an intolerable condition to leave the law of insider trading. Yet, the Court refused defendant Martoma's petition for rehearing *en banc*.[535] All the cries of legal "uncertainty" coming from the Government[536] and the defense[537] remain unanswered.[538]

F. *MARTOMA'S* IMPACT

Insider trading prosecutions continue unabated, and Judge Pooler's characterization of the *Martoma* majority's rule as "non-binding dicta" has proven to be mistaken.[539] Instead, accepting the majority's invitation, the Government has argued that under *Martoma II*, personal benefit to the insider can be proven by merely showing that the insider intended to

---

to make a 'gift' of such information to friends or family, but does permit considerable latitude in what insiders disclose to securities analysts absent a quid pro quo." BLOOMENTHAL & WOLFF, INTRODUCTION TO SELECTIVE DISCLOSURE AND REGULATION FD, 2 SEC. LAW HANDBOOK § 33:46 (June 2019) (emphasis added).

The SEC appeared to admit as much, as it responded to opponents of Reg FD who urged the SEC to simply "use existing tools (namely, the law of insider trading) to bring individual enforcement actions in those cases that appear to involve significant selective disclosures." The SEC claimed it considered this avenue but did "not agree that this is the appropriate response to the legal uncertainties posed by current insider trading law." Selective Disclosure and Insider Trading, 65 FR 51716-01, at 51718. Put more plainly, in 2000, the SEC did not view *Dirks* as reaching intentional selective disclosure by insiders in the absence of proof of a personal benefit. *Martoma II* now effectively suggests that *Dirks* did intend to reach that conduct: any insider (classic or temporary, like Dr. Gilman) who discloses information with intent that the tippee investor would trade on it violates her fiduciary duty and is liable for insider trading. If this were so, it would seem the SEC went through a lot of trouble for nothing to issue Reg FD.

Moreover, if *Martoma II* is a correct statement of *Dirks*' personal benefit requirement, what is one to make of the fact that Reg FD's prohibition only applies to specified members of senior management and those in investor relations departments who regularly communicate with analysts and not more generally to all corporate representatives? *See* 17 C.F.R. §§ 243.101(c) and (f). Not only would Reg FD have been redundant, it was incomplete.

535. *See Order Denying Rehearing*, *Martoma*, *supra* note 46.

536. *See Petition for a Writ of Certiorari*, *Newman*, *supra* note 40, at *33.

537. See *Amici Curiae Brief, Martoma*, *supra* note 45, *5.

538. Martoma filed a petition for *certiorari* to the Supreme Court, which was denied in June 2019. *See* Petition for Writ of Certiorari, United States v. Martoma, No. 18-972 (U.S. Jan. 24, 2019), 2019 WL 480568, *cert. denied*, 139 S.Ct. 2665 (2019).

539. *Martoma*, 894 F.3d at 86–87.

benefit the tippee regardless of the nature of their relationship with each other. Thus, in *United States v. Pinto-Thomaz*, the district court applied the *Martoma II* reasoning to hold that personal benefit can be proven by showing intent to benefit the tippee.[540] The Court rejected a defendant's motion to dismiss the indictment for failure to allege a close personal relationship between the tipper and tippee or a tipper's personal benefit.[541] After all, the district court noted that *Dirks* itself says there may be "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient."[542] The court did not address Judge Pooler's argument that *Martoma II's* reliance on the grammatical structure of the *Dirks* passage could not be squared with *Dirks* read as a whole.

Separately, the Second Circuit issued a summary order in *Rajat Gupta v. United States*,[543] which contained dicta indicating that the judges on that panel might also be inclined to adopt the *Martoma* majority's view that mere intent to tip is enough for *Dirks's* personal benefit test.[544] The Court relied on a variety of bases to reject a collateral habeas challenge to an insider trading conviction after trial.[545] But in so doing, the Court noted that *Dirks* "suggests varying sets of circumstances *each* of which would warrant a finding of the tipper's illegal purpose."[546] It then cited *Martoma*'s holding that "The tipper's intention to benefit the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose."[547] The Court, however, stopped short of expressly adopting this rationale as another basis for rejecting Gupta's challenge.[548]

It remains to be seen what the next panel of Second Circuit judges will do when a new significant insider trading appeal squarely confronts the conflict between *Newman* and *Martoma*. That case may be *Pinto-Thomaz*, and if it is not, another case will surely present a powerful

540. *See* United States v. Pinto-Thomaz, 352 F. Supp. 3d 287, 300–01 (S.D.N.Y. 2018).
541. *Id.*
542. *Id.* at 299 (citing Dirks v. SEC, 463 U.S. 646, 663–64 (1983)).
543. *See* Rajat Gupta v. United States, 913 F.3d 81, 86–87 (2d Cir. 2019).
544. *Id.* at 86.
545. *Id.* at 84–85.
546. *Id.* at 86 (emphasis added).
547. *Id.* (citing United States v. Martoma, 894 F.3d 64, 75 (2d Cir. 2017)).
548. *Id.*

challenge to *Martoma*, invoking *Newman*. It is easy to foresee another panel comprised of Judges Parker, Winter, Pooler, or anyone else who reads *Dirks* as they did, wanting to find a way to limit the reach of *Martoma*. Pooler's dissent offers myriad bases for concluding that a gratuitous disclosure of corporate information to a "perfect stranger" cannot suffice for fraud under *Dirks*.[549]

One thing is certain: when the next insider trading appeal is filed, the defense and the Government will take extraordinary interest in which three judges are assigned to the appeal.[550]

II. A Vague Law That Violates The Due Process Clause

When the Government lost its case in *Newman*, it declared that the law was left unclear,[551] and when, two years later, the Court in *Martoma* issued its decision, the defense bar stated the same.[552] They are both correct. An appraisal of the case law reveals there is in fact no clarity, under either *Newman* or *Martoma,* and certainly not under both. It may be that Congress will actually pass a law this time, ending the uncertainty, but this would not be the first time it has considered legislation only to abandon the effort.[553] If so, it will leave an insider trading law that is unconstitutionally vague and thus void for vagueness. Two related constitutional doctrines support this conclusion: the Due Process Clause and the separation of powers doctrine.

A. The Due Process Requirement of Notice of the Law

Constitutional and Anglo-American common law jurisprudence agree that in order to follow the law, one must be able to understand it. This principle is a prerequisite of ordered liberty. In *Kolender v. Lawson*, the Supreme Court said: "Our Constitution is designed to maximize individual freedoms within a framework of ordered liberty. Statutory

549. *See* United States v. Martoma, 894 F.3d 64, 86 (2d Cir. 2017).

550. Of course, if the next criminal appeal involves conduct and a conviction that occurred after Congress passes an insider trading law—as the current draft of the Insider Trading Prohibition Act promises—the *Newman*/*Martoma* uncertainty will no longer be an issue. If the conduct precedes any legislation, however, the viability of the conviction may turn, again, on how the new panel of judges views the scope of *Dirks*.

551. *See supra* text accompanying note 43.

552. *See supra* text accompanying note 45.

553. *See supra* note 436 and accompanying text.

limitations on those freedoms are examined for substantive authority and content as well as for definiteness or certainty of expression."[554] In *Baggett v. Bullitt*, the Court said that where statutes are vague, people "steer far wider of the unlawful zone than if the boundaries of the forbidden areas were clearly marked," causing them to "restrict[] their conduct to that which is unquestionably safe."[555] Justice Holmes expressed the requirement of fair notice succinctly in *McBoyle v. United States*:

> Although it is not likely that a criminal will carefully consider the text of the law before he murders or steals, it is reasonable that a fair warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed. To make the warning fair, so far as possible the line should be clear.[556]

The Court has variously located the fair notice requirement in the common law's long legal tradition or the Due Process Clause. In *Collins v. Commonwealth of Kentucky*,[557] the Court held that a vague penal statute "violated the fundamental principles of justice embraced in the conception of due process of law in compelling men, on peril of indictment to guess" whether their conduct would later be deemed illegal.[558] In a subsequent case, *Connally v. Gen. Const. Co.*, the Court said the principle of clear notice was consistent with: "ordinary notions of fair play and the settled rules of law," as well as "the first essential of due process of law."[559] "The crime, and the elements constituting it, must be so clearly expressed that the ordinary person can intelligently choose, in advance, what course it is lawful for him to pursue. Penal statutes prohibiting the doing of certain things, and providing a punishment for their violation, should not admit of such a double meaning that the citizen may act upon the one conception of its requirements and the courts upon

554. Kolender v. Lawson, 461 U.S. 352, 357 (1983) (citing M. Bassiouni, *Substantive Criminal Law* 53 (1978)).
555. Baggett v. Bullitt, 377 U.S. 360, 372 (1964) (quoting Speiser v. Randall, 357 U.S. 513, 526 (1958)).
556. McBoyle v. United States, 283 U.S. 25, 27 (1931).
557. Collins v. Commonwealth of Kentucky, 234 U.S. 634 (1914) (construing Int'l Harvester Co. v. Kentucky, 234 U.S. 216, 221 (1914), decided earlier that term).
558. *Id.* at 638.
559. Connally v. Gen. Const. Co., 269 U.S. 385, 391 (1926).

another."[560] Subsequent Supreme Court decisions repeat similar expressions about why the fair notice rule is critical.[561]

The "void-for-vagueness" doctrine enforces this rule. As the Court explained in *Grayned v. City of Rockford*, "[i]t is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined. Vague laws offend several important values. First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning."[562] The doctrine also prevents discriminatory enforcement by "policemen, judges, and juries for resolution on an ad hoc and subjective basis."[563] The Court has in recent years cited to this doctrine as it reversed convictions after high profile and hard-fought trials on the basis that the Government's interpretations of the penal offenses swept too broadly, in violation of the Due Process clause.[564]

---

560. *Id.* at 393 (quoting United States v. Cap. Traction Co., 34 App. D.C. 592, 598 (D.C. Cir. 1910)).

561. *See, e.g.*, Lanzetta v. New Jersey, 306 U.S. 451, 453 (1939) ("No one may be required at peril of life, liberty or property to speculate as to the meaning of penal statutes. All are entitled to be informed as to what the State commands or forbids."); Papachristou v. City of Jacksonville, 405 U.S. 156, 162 (1972) ("Living under a rule of law entails various suppositions, one of which is that '(all persons) are entitled to be informed as to what the State commands or forbids.'") (quoting *Lanzetta*, 306 U.S. at 453).

562. Grayned v. City of Rockford, 408 U.S. 104, 108 (1972).

563. *Id.* at 109.

564. *See e.g.*, McDonnell v. United States, 136 S. Ct. 2355, 2373 (2016) (reversing conviction of former governor of Virginia accused of accepting bribes on grounds, *inter alia*, that Government's interpretation of term "official act" is not defined "with sufficient definiteness that ordinary people can understand what conduct is prohibited," or "in a manner that does not encourage arbitrary and discriminatory enforcement."); Skilling v. United States, 561 U.S. 358, 402–03 (2010) (reversing conviction of former CEO of Enron on grounds that honest services theory of mail fraud is not void for vagueness as long as it is properly understood as prohibiting only kickbacks and bribery, and Skilling was not accused of such misconduct); *Skilling*, 561 U.S. at 415–16 (Scalia, J., concurring) (arguing that the statute should be stricken as unconstitutionally vague); *see also* Johnson v. United States, 135 S. Ct. 2551, 2555–63 (2015) (holding 18 U.S.C. § 924(e)(2)(B)—defining "violent felony" as any felony that "otherwise involves conduct that presents a serious potential risk of physical injury to another" void for vagueness under the Fifth Amendment's Due Process Clause); Sessions v. Dimaya, 138 S. Ct. 1204, 1207 (2018) (applying void for vagueness doctrine to strike down as unconstitutional an immigration law that required deportation of any alien convicted of an "aggravated felony," defined

It is hard to imagine a law that is more unconstitutionally vague than one that can deadlock the Second Circuit as to what constitutes illegal conduct. The meaning of the personal benefit element is not a transient question for institutional investors searching for legal technicalities. It is the difference between whether *Newman* was right or wrong in adjudging two portfolio managers not guilty of insider trading.[565]

---

as "a crime of violence."); *cf.* Marinello v. United States, 138 S. Ct. 1101, 1106 (2018) (reversing conviction as obstruction statute is read narrowly: "[W]e 'have traditionally exercised restraint in assessing the reach of a federal criminal statute, both out of deference to the prerogatives of Congress and out of concern that a fair warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed.'") (citations omitted).

565. One might argue that, in light of the Government's ability to charge insider trading under Title 18's anti-fraud statutes, the uncertainties in section 10(b) case law are largely immaterial. That would be wrong, however, as the Title 18 bases for insider trading prosecutions actually make the landscape more, not less, confusing. Indeed, *Martoma* can be read as making it easier to prosecute securities professionals for insider trading under section 10(b) than under Title 18's anti-fraud statutes, sections 1341, 1343 and 1348. Even before section 1348 was enacted in 2002, the Government successfully prosecuted insider trading on a misappropriation theory under the traditional mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, respectively. *See, e.g.*, United States v. Carpenter, 484 U.S. 19 (1987).

Tellingly, the Government did not prosecute the hedge fund professionals Newman or Martoma under the fraud statutes. This was probably because the theory of information theft that fits more naturally in a straightforward fraud statute is ill-suited for prosecuting the conduct of securities professionals who are expected to seek out nonpublic corporate information. The defendants in *Carpenter*, in contrast, worked for the WSJ, whose confidential information was stolen so that the employee and his cohorts could financially benefit on the advance information. *Carpenter*, 484 U.S. at 22–23. This theory of fraud offers little guidance to the institutional investor who seeks a clear line between legal probing (and trading for profit) and illegal conduct.

Moreover, the *Newman*/*Martoma* disagreement about the meaning of "personal benefit" is not avoided by a Title 18-based prosecution of insider trading, because *Carpenter's* embrace of the fraud-based theory of misappropriation itself assumed a scheme for personal pecuniary benefit. *See id.* at 27–28 (embezzlement is "'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another'" (quoting Grin v. Shine, 187 U.S. 181, 189 (1902)). *Id.* ("It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.").

Put simply, information is stolen to obtain a personal benefit. One could argue that Title 18 fraud-based insider trading prosecutions may be harder now than section 10(b) prosecutions under the *Martoma* majority's construction because *Martoma* appears

B. THE SEPARATION OF POWERS DOCTRINE

As previously noted, under the separation of powers doctrine, it is Congress, not the courts, that has the constitutional power to define federal crimes.[566] Had the insider trading law been subjected to the legislative process at its inception, the warring policy goals of market regulation would presumably have been resolved at the outset, enabling the law-makers to issue clearer rules.

There is an intimate connection between the due process requirement that laws be clear and the separation of powers doctrine.[567] In the context of discussing the rule of lenity, Justice Scalia said that providing "fair notice" is "not the only function performed by the rule of lenity; equally important, it vindicates the principle that only the *legislature* may define crimes and fix punishments. Congress cannot, through ambiguity, effectively leave that function to the courts, much less to the administrative bureaucracy."[568]

Justice Gorsuch elaborated on this same principle. The "void for vagueness doctrine, at least properly conceived, serves as a faithful expression of ancient due process and separation of powers principles the framers recognized as vital to ordered liberty under our Constitution."[569] He explained "[i]t is for the people, through their elected representatives, to choose the rules that will govern their future conduct."[570] Judges cannot

---

to remove the personal pecuniary benefit element, while arguably Title 18 fraud still requires it. It is difficult to imagine a *Carpenter*-endorsed fraud prosecution of a tippee who received confidential information from an insider who simply sought to gift it to the tippee for no other reason than a feeling of good will.

566. *See* United States v. Hudson, 11 U.S. 32, 34 (1812); Daniel C. Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 761 n.13 (1999) (citing United States v. Lanier, 520 U.S. 259, 267 (1997) ("Federal crimes are defined by Congress, not the courts . . . ."); *see also* Whalen v. United States, 445 U.S. 684, 689 (1980) ("[W]ithin our federal constitutional framework . . ., the power to define criminal offenses and to prescribe the punishments to be imposed upon those found guilty of them, resides wholly with the Congress.").

567. *See generally* Nathan S. Chapman & Michael W. McConnell, *Due Process as Separation of Powers*, 121 YALE L.J. 1672, 1679 (2012) ("The meaning of 'due process of law' and the related term 'law of the land' evolved over a several-hundred-year period, driven, we argue, by the increasing institutional separation of lawmaking from law enforcing and law interpreting.").

568. Whitman v. United States, 135 S. Ct. 352, 354 (2014) (Scalia, J., concurring) (citing United States v. Wiltberger, 18 U.S. 76, 95 (1820)).

569. Sessions v. Dimaya, 138 S. Ct. 1204, 1224 (2018) (Gorsuch, J., concurring).

570. *Id.* at 1227.

"craft new laws to govern future conduct, but only to 'discer[n] the course prescribed by law' as it currently exists and to 'follow it' in resolving disputes between the people over past events."[571] Under the constitutional structure, "legislators may not 'abdicate their responsibilities for setting the standards of the criminal law,' . . . by leaving to judges the power to decide 'the various crimes includable in [a] vague phrase,' . . . For 'if the legislature could set a net large enough to catch all possible offenders, and leave it to the courts to step inside and say who could be rightfully detained, and who should be set at large[,][t]his would, to some extent, substitute the judicial for the legislative department of government.'"[572]

Gorsuch observed: "Nor is the worry only that vague laws risk allowing judges to assume legislative power. Vague laws also threaten to transfer legislative power to police and prosecutors, leaving to them the job of shaping a vague statute's contours through their enforcement decisions."[573]

Grayned prohibited precisely what the common law origins of insider trading law permitted. It employs vague language and concepts that continue to evolve based on fact-intensive disputes. The federal law enforcement apparatus determines which cases to bring in its effort to "shap[e] a vague [law's] contours through their enforcement decisions." And vital, "basic policy matters," pertaining to regulation of information flow in the capital markets is "delegate[d] . . . to policemen, judges and juries for resolution on an *ad hoc* and subjective basis."[574] The congressional abdication is particularly troubling where, as discussed *supra* p. 6, it was the "prosecutor," in the form of the SEC, who repeatedly persuaded Congress to leave them flexibility to bring enforcement actions on a case-by-case basis.[575] The Government has succeeded in protecting its flexibility, but this has come at the expense of the law's integrity. This is the kind of outcome Justice Jackson feared when the law is so vague it leaves prosecutors and judges the freedom to "condem[n] all that [they] personally disapprove [] for no better reason than [they] disapprove it."[576]

Insider trading law, of course, is not alone as a species of federal common law. Prodded by inventive prosecutions, courts regularly engage

---

571. *Id.* (quoting Osborn v. Bank of U.S., 22 U.S. 738, 866 (1824)).

572. *Id.*

573. *Id.* at 1227–28 (citing Grayned v. City of Rockford, 408 U.S. 104, 108–09 (1972)).

574. *Id.*

575. *See supra* note 35 and accompanying text.

576. Jordan v. De George, 341 U.S. 223, 242 (1951) (Jackson, J., dissenting).

in such elaborate interpretation of ambiguous or open-ended statutory language and they effectively create new bodies of law.[577] In particular, the Government has for many decades persuaded the courts to evolve the meaning of "fraud" to encompass the latest instance of conduct it deems harmful and thus worthy of punishment.[578]

Insider trading law, however, is unique in that it is premised more on policy judgments about a highly specialized activity vital to our national economy than on any words in a statute. The conceptual gap between the word "fraud" in section 10(b) and trading on information others do not have is not resolved by studying the language of the Exchange Act. Justice Powell claimed there must be an exchange of information for personal benefit while Justice Blackmun disagreed.[579] The key to this debate is not linguistic, but rather, policy. It is this same policy debate that led to an impasse between the *Newman* panel and Judge Pooler, who construed *Dirks* in a manner that sought to enlarge its protection of the institutional analyst's work, and the *Martoma* majority judges who condemned the conduct that such interpretation might condone in the marketplace. As the

---

577. For an extensive discussion of the ways in which the federal courts have engaged in common law-making in the field of federal criminal law through elaborate interpretation of broad statutory terms, see Daniel C. Richman et al., *Defining Federal Crimes*, 181–265 (discussing evolution of theories of mail and wire fraud), 265–335 (discussing evolution of extortion theories), 429–502 (discussing criminal civil rights law enforcement) (1st ed. 2014).

578. Before 1987, the Government had persuaded the courts to interpret the mail and wire fraud statutes so as to prohibit deprivations of "intangible rights" such as honest services. When the Supreme Court in United States v. McNally held that the statutory language could not be stretched so far and should be construed to apply only to tangible property rights, Congress enacted 18 U.S.C. § 1346, to expressly prohibit schemes to deprive one of honest services. 483 U.S. 350 (1987).

But the Government pushed the limits of that language as well, winning the conviction of Enron's CEO Jeffrey Skilling in part on the basis of an honest services fraud theory, with the lower courts approving the Government's expensive reading. The Supreme Court rejected the defendant's constitutional challenge to the statute as applied to his case but nevertheless reined in the Government, declaring that honest services fraud should be read to mean only bribes and kickbacks. Skilling v. United States, 561 U.S. 358 (2010).

In his concurrence, Justice Scalia opined that he would have declared the statute unconstitutional rather than trying to save the statute by redefining its limits: "in transforming the prohibition of 'honest-services fraud' into a prohibition of 'bribery and kick-backs,' [the Court] is wielding a power we long ago abjured: the power to define new federal crimes." *Skilling*, 561 U.S. at 415 (Scalia, J., concurring).

579. *See* Dirks v. SEC, 463 U.S. 646, 647, 676 (1983).

latest, but not last, word, the *Martoma* majority supported Blackmun's effort to prevent a marketplace where trading on confidential information is permitted.

The separation of powers doctrine would suggest it is irrelevant whether every judge to entertain an insider trading prosecution agrees with the *Martoma* majority. Neither the *Dirks* nor the *Martoma* courts had constitutional authority—or expertise—to decide this difficult policy issue.[580] In the past, Congress may have acceded to the SEC's desire for maximum flexibility in law enforcement discretion,[581] but that abdication to the regulators led to the judiciary's decades-long, futile struggle to make sense of this law.

In light of the implications of insider trading law to the country's securities market, few laws demand congressional attention more than this one.

III. CONGRESSIONAL ACTION AT LAST?

By recently taking up the bill, dubbed the Insider Trading Prohibition Act (ITPA),[582] the House of Representatives appears to recognize the pressing need for clarity and its own duty to undertake the process of legislation. History offers a cautionary warning, however, that the ITPA may yet become mired in indecision so that the Senate will ultimately decline to act. As discussed, a nearly identical version of the ITPA was drafted in 2015 in the wake of *Newman* and then abandoned.[583] One hopes that is not the fate of this initiative, but the current draft of the ITPA

580. *See generally id.*; *see also* United States v. Martoma, 894 F.3d 64 (2d Cir. 2018).

581. Some might argue that Congress effectively ratified the law of insider trading by, for example, passing 18 U.S.C. § 1348 in 2002, which the Government has sometimes relied on to bring insider trading charges. *See, e.g.*, United States v. Blaszczak, 308 F. Supp. 3d 736 (S.D.N.Y. 2018), *appeal docketed*, No. 18-2811 (2d Cir. Sept. 24, 2018); United States v. Mahaffey, 693 F.3d 113 (2d Cir. 2012). But that would be inaccurate. Section 1348 was passed as part of the Sarbanes-Oxley Act in the wake of the Enron scandal and there is no indication in the legislative history that Congress had insider trading in mind. *See, e.g.*, S. REP. NO. 107-146, at 2–6 (2002) (discussing "shortcomings in current law" that Enron exposed, with no reference to insider trading cases). Its recent drafting of the ITPA further suggests that the current state of the judge-made law is inadequate.

582. *See* Insider Trading Prohibition Act, H.R. 2534, 116th Cong. § 16A (as approved by H.R. Fin. Serv. Comm., May 8, 2019, and committed to the H. Comm. of the Whole, Sept. 27, 2019) [hereinafter *ITPA*].

583. *See supra* note 436 and accompanying text.

suggests that there is much work still left to be done in the Senate. It seemingly fails to account for market efficiency interests and, if passed, might have deleterious impacts on the securities market.

A. THE TERMS OF THE ITPA

The ITPA supports Justice Blackmun's vision of information parity in pursuit of a fairer and more equitable marketplace.[584] It proposes to amend Section 16 of the Exchange Act by adding Section 16A, which would prohibit trading while in possession of MNPI "if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information."[585] The "wrongful" criteria would apply "only if the information has been obtained by, or its communication or use would constitute, directly or indirectly," acts such as theft, bribery, misrepresentation, conversion, misappropriation (or similar "deceptive taking" of information), a breach of a fiduciary duty, confidentiality agreement, or breach of a contract, as well as a "breach of any other personal or other relationship of trust and confidence."[586] As for the level of knowledge of the trader relating to how the MNPI was obtained, the law would provide:

> It shall not be necessary that the person trading while in possession of such information . . . . knows the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while in possession of such information or making the communication, as the case may be, was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained or communicated.[587]

The effect of the ITPA would be to prohibit any trading while in possession of any confidential material information. Whether the insider gave the information for a personal benefit would be irrelevant. As long as that person did so in violation of some agreement or duty to keep the

---

584. *See generally Dirks*, 463 U.S. 674–79 (Blackmun, J., dissenting).
585. ITPA, H.R. 2534 § 16A(a).
586. *Id.* at §§ 16(A)(c)(1)(A)–(D).
587. *Id.* at § 16(A)(c)(2). After this Article went to print, the House modified the bill to include a personal benefit element. *See* discussion *infra* at footnote 620.

information confidential, trading while in possession of it would be "wrongful" and illegal.

B. *Dirks'* Concern for Market Efficiency Is Unaddressed

The ITPA is an obvious departure from the 35-plus years of judge-made law. It removes the personal benefit element altogether and also prohibits not only trading "on the basis of" MNPI, but any trading "while in possession of" such information. In effect, if an investor has the information, that person cannot trade, even if the bases for the trade are unrelated and properly acquired information.

While the blanket rule surely provides greater clarity, it does not appear to accommodate the efficient market interest in giving institutional analysts room to probe aggressively for information so that their investor clients can trade on such information. Thus, the ITPA raises the obvious question of whether Justice Powell and the other members of the *Dirks* majority, as well as Judge Winter in *Chestman*, the *Newman* panel, and Judge Pooler were all mistaken when they feared the potential chilling effect a blanket prohibition on MNPI would have on the important work of analysts.

Dirks' "safe harbor" for analysts was premised on the belief that a pure "disclose or abstain" rule "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to 'ferret out and analyze information,' . . . and this often is done by meeting with and questioning corporate officers and others who are insiders."[588] "[M]arket efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."[589]

Similarly, in *Newman*, the Court echoed Judge Winter's observation in *Chestman* that: "[e]fficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate . . . ."[590] Thus, "insider trading liability

588. *Dirks*, 463 U.S. at 658–59.

589. *Id.* at 658 n.17 (citation omitted).

590. United States v. Newman, 773 F.3d 438, 448–49 (2d Cir. 2014) (citing *Dirks*, 463 U.S. at 662 and United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring)).

is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nation's securities markets."[591]

The Court thus examined the evidence at trial relating to analysts' legitimate functions, including the fact that "analysts routinely solicited information from companies,"[592] and in response, "investor relations departments routinely assisted analysts with developing their models."[593] In fact, investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings and other financial information "to establish relationships with financial firms who might be in a position to buy" their stock.[594]

Similarly, in her dissent in *Martoma*, Judge Pooler discussed the need to protect "persons outside the company such as an analyst or reporter who learns of inside information from the threat of prosecution for uncovering information about securities issuers just because they also traded on it."[595] If objective evidence of personal benefit were no longer an element of insider trading, she warned, analysts and traders may be fear to engage in aggressive probing for information "even if the whole market could benefit from such investigation."[596]

These concerns did not arise in a vacuum. Long before *Chiarella* or *Dirks*, scholars argued that insider trading should not be illegal at all, and that the activity actually speeds up the dissemination of relevant information to the marketplace.[597] Professor Carol Swanson outlined such historic views among scholars and economists who "have rebutted fairness concerns, arguing that an emotional approach too often glosses over the underlying economics."[598] "In essence, deregulation advocates asserted that if insider trading is economically efficient, there remains no

591. *Id.* at 449.
592. *Id.*
593. *Id.*
594. *Id.* at 454–55.
595. *Martoma*, 894 F.3d at 81 (quoting *Dirks*, 463 U.S. at 664).
596. *Id.* at 81–82.
597. *See* Henry G. Manne, *Insider Trading and the Stock Market*, THE FREE PRESS 59–76, 111–46 (1966); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565–576 (1970).
598. Swanson, *Reinventing Insider Trading*, *supra* note 36, at 1163.

compelling independent basis for asserting unfairness" because "stock prices already reflect the risk of insider trading."[599]

Consistent with this thinking, Professor Daniel Fischel made the argument, in effect, that *Dirks's* protection of institutional investors did not go far enough and that such investors should be exempt from insider trading restrictions altogether. He first chided fairness advocates arguing, "without some understanding of the economic consequences of different kinds of actions . . . legal analysis is reduced to a vacuous recitation of clichés and talismanic phrases devoid of analytical content. If insider trading is beneficial to investors because it increases their wealth, for example, it would be irrational to interpret the fiduciary duty owed to investors, the supposed beneficiaries of fiduciary duties, as prohibiting the practice."[600] He then proceeded to extol the role of investment analysts, as he explained, "These market professionals create social benefits by reducing problems of asymmetric information faced by competing sellers of securities and by monitoring the actions of corporate managers. They may also provide private benefits to investors who rely on their recommendations in an attempt to earn abnormal positive returns. Because of these social and private benefits . . . legal rules should act to increase, not decrease, the private returns of information acquisition, and analysts should be free of legal rules restricting the use of inside information."[601]

Such an approach disregards the gravitational pull of our desire for equity, but it is not irrational. The efficient market thesis suggests that all available information about a company's value is promptly reflected in its price.[602] If the goal is the swiftest impoundment of corporate information in the price of its stock, the theory goes, the sooner people trade on the information, the better. According to this view, information disparity is a necessary condition for efficient trading by profit-motivated trading. After all, in every trade, one party wishes to sell, thinking of profiting, while the other party buys thinking it is a fair price. As Justice Powell put it, "as market values fluctuate and investors act on inevitably

---

599. *Id.*

600. Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127, 129 (1984).

601. *Id.* at 130.

602. *See* Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988) (noting that fraud on the market theory assumes that widely-followed securities of the larger corporations are "efficiently" priced: the market price of stocks reflects all available public information).

incomplete or incorrect information, there always are winners and losers."[603] Indeed, "in many cases there may be no clear causal connection between inside trading and outsiders' losses."[604] Market efficiency purists would use this point to say that if someone has MNPI about a company, the sooner that person trades on it, the sooner the true value of the stock will be attained.[605]

Understandably, Justice Powell and the majority in *Dirks* would not go quite so far, as his "sense of propriety abhorred the abuse of trust that insider trading represented."[606] He condemned abusive behavior where the insider is given access to confidential information by virtue of the trusted position with the company and then acts to enrich himself with that information to the detriment of a corporate shareholder.[607] Under that specific circumstance, *Dirks* would say, the insider defrauded, acted immorally, and cheated. Absent the violation of duty motivated by an intent to reap a personal benefit, however, there would appear to be no basis for censure.

C. Potential Impact of ITPA on Securities Market

What happens to the efficiency of the market if one cannot trade while in possession of MNPI derived from a breach of some confidentiality obligation? Here, it may help to review what the proponent of an efficient market might say about the risk/reward analysis of a hypothetical portfolio manager (the "PM") at an institutional investment firm:

The PM is highly motivated to make money for the fund but also to abide by the law, and he has dutifully attended all the compliance-training programs and understood the outlines of the law, though he is not a lawyer. He understands that meetings or calls with insiders pose risks, but the law does not prohibit such interactions and, indeed, he believes it is not possible to do the job without testing the accuracy of the company's public statements or getting more "color" and nuance about what those public representations really mean. This is important because a company's public statements can be self-serving and incomplete. Under

603. Dirks v. SEC, 463 U.S. 646, 666 n.27 (1983).
604. *Id.*
605. *See generally id.*
606. Pritchard, *supra* note 67, at 936.
607. *Id.* at 937.

the law, the companies are not required to disclose unfavorable information, unless the omission of that information will make the rest of the company's statements materially misleading.[608] As an experienced PM, he recognizes that one of the most helpful tools to testing the reliability of public corporate representations is through one-on-one meetings with key corporate employees.

Moreover, he understands that the law recognizes that part of the job is to build, and trade on the basis of, a "mosaic" of information regarding a company. The Second Circuit noted that "[a] skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information" for that analyst.[609] He has to be careful that the information learned during a one-on-one meeting with a corporate representative is not, in and of itself "material," as opposed to merely important to the mosaic of information.[610] He has never

---

608. *See* Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 45 (2011).

609. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980).

610. The element of materiality is notoriously elusive. The common definition is "information regarding an undisclosed fact is material when there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

As the Second Circuit acknowledged more than 40 years ago, "since the importance of a particular piece of information depends on the context in which it is given, materiality has become one of the most unpredictable and elusive concepts of the federal securities laws." SEC v. Bausch & Lomb Inc., 565 F.2d 8, 10 (2d Cir. 1977); *see also* SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005).

The concept has spawned a wealth of criticism for decades. *See, e.g.*, Dale A. Oesterle, *The Overused and Under-Defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 168 n.8 and articles cited therein (2011) (noting that "academics have long been critical of the vagueness" of the materiality standard); Wendy Gerwick Couture, *Materiality and a Theory of Legal Circularity,* 17 U. PA. J. BUS. L. 543 (2015); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call For Action*, 52 AM. U. L. REV. 1131 (2003). To make matters worse for institutional investors, what exactly is the difference between a material fact that a reasonable investor would consider important and data that is a key determinant when fit into an analyst's mosaic? While the investing community has made persistent calls for the SEC to provide a clear, workable definition of materiality, the regulator has consistently demurred, once again preferring to reserve for itself enforcement flexibility on a case-by-case basis. Thus, for example, in justifying its refusal to define materiality in promulgating Reg FD, the SEC declared: "the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case." Selective Disclosure and Insider Trading, 65 FR 51716-01, at 51735; *see also* SEC v. Bausch & Lomb Inc., 565 F.2d 8, 10 n.2 (2d Cir. 1977) ("The SEC itself has despaired of providing gotten a clear explanation for how to make that distinction in a consistent and reliable way, but he tries. He must also consider whether the key piece of information from the insider that is valued was nonpublic.[611] He thinks pieces of it are in the public realm, but he is not positive, and time is short.

This is a lot to think about and, unfortunately, not a single factor is all that clear. The risk of a regulator second-guessing the PM later as to any one of them is always there. But before *Martoma* and the ITPA, one key factor provided substantial comfort: there is no known personal benefit to the insider. The PM is unaware of any payments to the insider for the information the PM learns from a meeting with her. He would never engage in paying the insider, nor would he permit his analysts to do so. Neither he nor his analyst is a relative of the insider's or a close friend such that the information could reasonably be considered a "gift" of trading information to her.

The PM also recognizes that there is additional gray area when, as the *Newman* Court recognized, insiders leak information because they seek to maintain a favorable relationship with an important investor or analyst—either sell side or buy side.[612] This is not a "personal benefit" for the insider as the motivation is to benefit the company, not the corporate representative.

---

written guidelines to advise wary corporate management of the distinctions between material and non-material information, and instead has chosen to rely on an after-the-fact, case-by-case approach, seeking injunctive relief when it believes that the appropriate boundaries have been breached.") (citing address by Ray Garrett, Jr., Chairman of the SEC, "An Inside Look at Rule 10b-5," ALI-ABA Conference, April 10, 1975). This rationale serves judgment in hindsight, when all relevant information can be studied and pored over at the leisure of the SEC or the courts. But "necessary flexibility" for the SEC does nothing to aid the trader who must make real time judgments about whether he or she can legally trade on nonmaterial information.

611. This too can be a tricky concept. Information is "nonpublic" if it "has not been disseminated in a manner sufficient to ensure its availability to the investing public." SEC v. Seibel Systems, Inc., 384 F. Supp. 2d 694, 703 (S.D.N.Y. 2005) (citing SEC v. Texas Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968)). The difficulty of applying this element in the real world was demonstrated in *Seibel Systems*, where the SEC pursued the CFO of the company for Reg FD violations, as it claimed he made material disclosures of nonpublic information to securities analysts. After a detailed examination of the SEC's claim that seven separate material disclosures had been made and comparing the statements to publicly available information at the time of the disclosures, the court concluded that the information had already been in the public realm. The court dismissed the SEC's complaint.

612. United States v. Newman, 773 F.3d 438, 455 (2d Cir. 2014).

The tendency of insiders to do this, however, led to the SEC's Reg FD in 2000, which is meant to prevent selective disclosure to favored analysts.[613] However, it still occurs, as *Newman* recognized in 2015.[614] Even when that happens, Reg FD does not prohibit him from trading because its purpose was to prevent the insider's conduct. Reg FD says nothing about the investor's obligation. Moreover, the insiders his analysts meet with are often not senior management of a company or a representative of the investor relations department, and Reg FD only applies to such corporate employees. Often, the PM or his firm learns helpful information from lower level employees in the sales channel or in the finance departments.

In the absence of any bribe or personal relationship, the investor thinks, the uncertainties about materiality or nonpublic status pose risks in any one-on-one meeting with an insider, but they are relatively manageable. That was the intent of *Dirks* and was clearly reinforced in *Newman*.

Those are the "risks" of meetings with an insider; now, what about the rewards? What can the PM hope to gain from the meetings? After all, he has access to publicly issued, detailed statements from the company, including detailed financial information. He has access to full market and industry information. He can participate in large conference calls with management and many other analysts and investors. Why risk any legal exposure by having one-on-one meetings?

The answer is that a well-placed and knowledgeable set of probing questions can elicit answers from the insider that provide key insights for the PM. Sometimes, the tone and body language signal how much confidence this corporate employee really has in the official projections and factual representations. Small inconsistencies in responses can mean a great deal. They can confirm the PM's thesis about the company built from a variety of sources suggesting the company's public statements are not accurate. Sometimes, the insiders inadvertently make statements that are in themselves highly revealing, possibly even material on their own. The PM can use the information to make a profitable or loss-avoidance trade that others may not make.

Based on his modeling of the company, influenced by the information he learned from the insider, the PM believes the company's projections are inflated and overly optimistic. He decides to sell a large

---

613. *See supra* note 534.

614. *See* Newman, 773 F.3d at 455.

block of shares to protect his position. He and his fund effect trades that are significant enough in size to affect the price of stock because it can influence other large investors to trade in his same direction. This happens because he is respected for his disciplined approach to company analysis; his modeling is said to be rigorous and his substantive expertise in the products sold in the industry he covers is formidable. He also has an excellent track record. If the block trade is large enough, some may even suspect he obtained MNPI and avidly trade in the same direction as he. His trades of large blocks will cause the price of the stock to decrease.

Assuming his assessment was correct and the company's official projections were too optimistic, the price reached as a result of his activity will be the fairer value.

If the ITPA is passed, however, such efforts at fair valuation may be deterred. The absence of any personal benefit to the insider will no longer protect the PM from an insider trading prosecution. Where the disclosure of information in breach of any confidentiality obligation is considered "wrongfully" obtained information leading to criminal liability for those who trade while in possession of it, the PM may reasonably consider terminating the practice of having any individualized meetings or calls with insiders (or permitting his analysts to have such interactions). After all, who can say with certainty if even innocuous comments by the insider breached some confidentiality obligation? Even if the PM did not believe there was a breach, the risk of a regulator later claiming that the PM "recklessly disregarded" the confidential nature of the information is substantial.[615] Moreover, while the PM may have believed he received nonmaterial information that was nevertheless important to the investment mosaic he had created on the company, the regulator could easily disagree and claim he traded on material information. In theory, if one of the PM's analysts becomes aware of confidential information that could be considered material, the PM may be forced to freeze any trades in the subject company even if he would have traded in the stock without regard to the analyst's new information. The risk/reward calculation is thus altered. The risk to him personally may far outweigh the benefit to his fund of trying to learn more from the insider.

If this calculus causes a PM to forego any meetings with insiders, he will lose a traditional and important tool for analyzing the companies he follows. Profit-driven, incentivized investigations for accurate information may be chilled. To be sure, he will still have other tools

615. *See* ITPA, H.R. 2534 § 16A(a).

available to him, based on publicly available information and the information equally available to all investors, retail and institutional. But his trades may look the same as those of all other investors. If the same risk/reward calculus is made by the entire class of institutional analysts and investors, the impact could be market-wide. Important pricing adjustments that might have occurred where institutional investors engaged in profit-incentivized investigations may be lost as a consequence. This is the outcome the *Dirks* Court sought to avoid.[616]

Perhaps House members already examined this possibility and concluded that the impact would actually be minimal. For example, proponents of the bill could argue that the ITPA's elimination of the personal benefit element should not deter the law-abiding analyst from one-on-one meetings because most such analysts already steer clear from any disclosed information that was in and of itself material. And if they did encounter such information, compliance and legal departments of well-run institutional investors did not rely on whether the personal benefit test was satisfied. Instead, they have long taken the prudent course to put a stock on the restricted list if they became aware of any MNPI, however obtained. Thus, they would argue, we should not expect the ITPA to impact the current efficiency of the market.

This theory would suggest that the rigorous, profit-driven trading *Dirks* envisioned has not been the reality for some time now, and that the conduct of portfolio managers like Newman or Chiasson reflects an undesirable fringe that the market is better off prohibiting in clear terms. Perhaps the House concluded that while there might be some marginal delay or inaccuracy in pricing, the cost of that is outweighed by the benefit of a clear-cut rule that eliminates the use of confidential information from the marketplace.

If the Democratic Majority members of the House Finance Committee came to this conclusion, the Minority Republicans did not. In voicing their nonsupport for the bill, they stated:

> Reading the personal benefit test out of the law could have real implications; for example, absent a personal benefit test, corporate insiders who share information with the full expectation of confidentiality would become subject to prosecution simply because that confidentiality was violated . . . . At worst, [the bill] is overbroad

616. *See generally* Dirks v. SEC, 463 U.S. 646 (1983).

> and will criminalize beneficial trading as well as chill the productive flow of information within the marketplace.[617]

It is not clear whether economists or other market experts are able to quantify the loss of market efficiency, if any, from the ITPA's rule. The *Dirks* Court assumed a deleterious impact, and its concerns were not unreasonable given basic market efficiency principles. But the Court, of course, was structurally incapable of conducting an examination of the empirical support for its concerns.[618] There is no evidence that the House made that examination when drafting the ITPA. One would expect the Senate to undertake this important review.

Given that the health of the securities market is at issue, one hopes for comprehensive deliberation, complete with detailed hearings at which the perspectives of securities experts, economists, institutional investors, issuers (represented by senior management and investor relations departments), individual investors, and regulators, among others, would be carefully evaluated. This may require examination of the extent to which the institutional investor community still relies on one-on-one meetings, for what purposes, and how any bill would either deter or encourage such activities. After such examination, the legislators may conclude that, in fact, market valuation would be materially impacted and that some other clear rule must be added to avoid such impact.

The judiciary struggled to find some balance between the competing interests in information parity and market efficiency. Congress has the opportunity to legislate that balance based on a factual study.

CONCLUSION

Whatever the outcome, if Congress acts as it now appears poised to do, the democratic process will finally have worked as designed. The legislature will have decided upon a clear statute putting institutional analysts and investors on notice of where the legal line is drawn. To reach that goal, there may be more legislative work to do and it may prove to be difficult. But as Justice Gorsuch put it: "[u]nder the Constitution, the adoption of new laws restricting liberty is supposed to be a hard business,

617. *See* Insider Trading Prohibition Act, H.R. 2534, 116th Cong. § 16A (as approved by H.R. Fin. Serv. Comm., May 8, 2019, and committed to the H. Comm. of the Whole, Sept. 27, 2019) (report of Rep. Waters, Minority Views, at 27).
618. *Dirks*, 463 U.S. at 678 (Blackmun, J., dissenting).

the product of an open and public debate among a large and diverse number of elected representatives."[619]

After fifty years of the "evolving" judge-made law of insider trading, the *Newman*/*Martoma* impasse may have finally driven Congress to undertake the difficult task of defining the law of insider trading. One can only hope the solution is clear as well as consistent with the nation's interest in a robust securities market.[620]

619. Sessions v. Dimaya, 138 S. Ct. 1204, 1228 (2018) (Gorsuch, J., concurring).

620. After this Article went to print, the House passed the ITPA. But in the final voice vote on December 5, 2019, the bill was amended to insert a personal benefit element, at the request of Republican Representative Patrick McHenry of North Carolina. The version that passed provides that trading is wrongful if information was obtained in breach of a fiduciary duty, confidentiality agreement, or breach of a contract "for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)." ITPA, H.R. 2534, 116th Cong. § 2 at 16A(c)(1)(D) (2019). This last-minute amendment was added without any additional fact-finding hearing or analysis. While the final bill offers greater weight to market efficiency interests than the prior drafts, it incorporated the same language about personal benefit that has bedeviled the courts, without offering any clarification about what the term means. By using the word "including," does the bill mean to suggest that "personal benefits" is not necessarily limited to pecuniary gain, reputational benefit, or gift to a relative or friend, and might include merely a charitable desire to gift information to a perfect stranger as *Martoma II's* majority concluded? That reading likely is not one Congressman McHenry would agree with since it tends to dilute the force of a personal benefit element. But it is a fair reading of the language. Moreover, what constitutes a "friend" to whom a gifting of confidential information constitutes a crime? Must the person be very close, as Newman suggested or is a casual friendly relationship enough? One of the proponents of the original draft, Professor John Coffee of Columbia Law School, understandably expressed disappointment with this eleventh-hour amendment, stating that the change eliminated the "key element" which was meant to clarify the convoluted state of the law and that the change "makes it less of a reform bill." Andrew Kragie & Jody Godoy, *House Passes 1st Explicit Ban on Insider Trading*, LAW360 (Dec. 5, 2019), https://www.law360.com/whitecollar/articles/1225615/house-passes-1st-explicit-ban-on-insider-trading?nl_pk=1a4a648a-a128-4d8c-aea8-9685d2247633&utm_source=newsletter&utm_medium=email&utm_campaign=whitecollar. The challenge of legislating an insider trading law cannot be addressed by simply adopting the language with which courts have struggled. An empirical study of what kind of marketplace the country needs may lead to clearer language about the scope of prohibition on trading.