

THE TIPPING POINT: FEDERAL SECURITIES
LAW AND THE PRESERVATION
OF MARKET INTEGRITY

by
Anthony Micheli

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THE TIPPING POINT: FEDERAL SECURITIES
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Project Approved:

Paul Irvine, Ph.D.
Department of Finance

Robert Rhodes, J.D., LL.M.
Department of Management

Abstract

This study presents the issues inherent in the existing framework for evaluating alleged insider trading violations and proposes that the United States replace these rules and legal precedents with a statutory provision that both defines and expressly prohibits insider trading on the basis of an equality of access theory. To this end, the paper presents the origins of insider trading law, with particular emphasis on tipper-tippee liability, and ultimately seeks to demonstrate both philosophically and by example that an equality of access standard is more ethically sound and practical from an enforceability standpoint. It is meant to bear stylistic similarities to a law review article, with the goal of providing useful information and guidance for practitioners.

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I. Introduction

Insider trading cases have become increasingly high-profile, and numerous securities professionals have escaped conviction due to a lack evidence of a violation of the tests currently used in prosecuting insider trading cases. The more depraved members of the securities industry are hopeful that such loopholes will remain open, some of whom argue for the outright abolition of insider trading restrictions, asserting that anything so onerous discourages participation in the securities market and that insider trading is beneficial in that it allows securities to approach their fundamental values. As unconscionable as such a polarizing position may sound, existing insider trading laws are not much better at considering fairness and other values—rather, they are all but bereft of any semblance of good ethics.

This discussion ultimately concerns those losing confidence in the market's integrity and those who have exploited vague and loophole-laden rules. Consequently, the goal of this paper will be to present an alternative to the existing legal framework concerning insider trading, which ought to be replaced with a statutory provision that employs an equality of access standard. But to weigh in on this issue requires that one first form an understanding of the legal and regulatory pillars upon which the status quo stands. To do so requires tracing the chronology from the origin of federal regulation regarding the trading of securities following the Great Depression (if not earlier), with the Securities Exchange Act of 1933, through the modern day. Only then can one address the quagmire in which legal experts and market participants find themselves and ultimately advocate for a more common-sense and enforceable insider trading standard.

II. Methodology

The approach taken is to investigate legislation enacted and judiciary precedents set concerning insider trading more broadly as well as specific, more nuanced topics—primarily tipper-tippee liability and the personal gain (or quid pro quo) requirement popularized in 1983 in *Dirks v. SEC*, ultimately culminating in a discussion of how best to proceed post-*Salman v. United States*. This requires a comprehensive understanding of securities law as it related to insider trading and tipper-tippee liability. Foundational to this discussion are the Securities Exchange Acts of 1933 and 1934, both of which were a response to the excesses of Wall Street that gave rise to the Great Depression. The former of these has two basic objectives: (1) require that investors receive financial and other significant information concerning securities being offered for public sale, and (2) prohibit deceit, misrepresentation, and other fraud in the sale of securities.¹ The latter further concerns securities trading and is of particular importance, as it contains two provision directly applicable to the topic of insider trading, Sections 10(b), a general antifraud provision, and 16(b), regarding disclosure by beneficial owners of more than 10 percent of any class of any equity security, or who is a director or an officer of the issuer.²

These will necessitate a discussion of fiduciary duty, as this notion is inherent in the assertion that it is fraudulent for a corporate insider to look out for his or her own interest rather than those of his or her company, after which landmark and otherwise highly consequential court cases will be examined. Among these will be *Chiarella v. United States* (1980), which established the classical theory for insider trading—namely, trading in a corporation’s securities by an insider in possession of material, nonpublic information (“MNPI”) constitutes a breach of fiduciary duty. However, this addressed only the liability of the insider directly. The question

¹ SEC.gov. Fast Facts. The Laws That Govern the Securities Industry.

² Securities Exchange Act of 1934. SEC.gov.

remained whether personal use of this information alone was forbidden. *Dirks v. SEC* answered this question in 1983 by addressing the liability of both tipplers and tippees.

The misappropriation theory, then, established in *United States v. O'Hagan* (1997), asserts that one need not be an employee of an organization to qualify as an insider; rather, employees of certain agents to corporations assume “temporary insider” status and so are subjected to the same restrictions as corporate insiders. This doctrine is incorporated into SEC regulations in 2000 with the addition of Rule 10b5-2 to the Securities Exchange Act of 1934. A peculiar exception to the concept of tipper-tippee liability to be explored is found in both *SEC v. Switzer* and *United States v. Corbin*, which establish that it is possible for the tippee but not the tipper to be held liable. As recently as 2014, *United States v. Newman* asserted that in order to sustain a conviction of insider trading, it must be proven beyond a reasonable doubt that the tippee knew that an insider disclosed MNPI *and* that he did so in exchange for a personal benefit that is pecuniary or similarly valuable. However, this was very recently overruled in *Salman v. United States*, in which the Supreme Court cites language from *Dirks* that contradicts that of *Newman*, applying the former.

These pieces of literature will lay the groundwork for a more abstract exploration of a potential remedy to the deeply flawed U.S. securities laws that presently apply—namely, the equality of access theory, which has been implemented in the European Union through the Market Abuse Directive and is currently under review in the Senate as part of Senate Bill S.702.

III. Insider Trading Chronology

Statutes vs. Rules

A statute is “a written law passed by a legislature on the state or federal level.”³ The provisions within a bill, once signed into law (by the president at the federal level or governor at the state level), are considered statutes. A rule, then, is an “established standard, guide, or regulation governing conduct, procedure, or action” occurring once courts “have firmly established a standard for assessing an issue” which lays out in greater specificity how the law is to be interpreted.⁴ More specifically, “legislative power of administrative agencies”—their rule-making power, called delegated legislation—is “the power of agencies to enact binding rules through the power delegated to them by the legislator.”⁵

Fiduciary Duty

A fiduciary duty is the highest standard of care; it is the highest, most compelling duty the law recognizes.⁶ Circuit Judge Paul Hays wrote in his dissenting opinion in *Burg v. Horn*:

In an often quoted passage, the New York Court of Appeals laid down the principles of fiduciary conduct: “Many forms of conduct permissible in a workaday world for those acting at arm’s length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided

³ “Statute.” The Free Dictionary. Farlex.

⁴ “Rule.” The Free Dictionary. Farlex.

⁵ Yohannes, Aberham and Desta G. Michael. “Nature and Source of Power and Administrative Agencies.” AbyssiniaLaw. 2012.

⁶ Cornell University Law School. Legal Information Institute. “Fiduciary Duty.”

loyalty by the ‘disintegrating erosion’ of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”⁷

The Delaware Supreme Court described the concept of the duty of loyalty inherent in the notion of one’s fiduciary duty as early as 1939 in *Guth v. Loft*:

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its power.⁸

Hence, an act of fraud, manipulation, or deception, as broadly described in Section 10 of the Securities Exchange Act of 1934 would clearly be in breach of this fiduciary duty of loyalty owed by the fiduciary to the beneficiary / principal (i.e. the corporation).

The relationship between the fiduciary duty rule and Section 10(b) and Rule 10b-5 is made explicit in *Chiarella v. United States*: In negotiating a transaction, one commits fraud by failing to disclose material information only if he is “under a duty to do so.” This duty to disclose “arises when one party has information that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them.” Expounding upon this further, Chief Justice Burger, dissenting in this case, writes: “As a general rule, neither party to

⁷ *Burg v. Horn*, 380 F.2d 897 (1967).

⁸ *Supra*, note 6.

an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation." It is therefore intuitive that, as will later be shown, the tippee (or recipient of improper disclosure of information) assumes the fiduciary duty of his or her tipper, and thus is required to disclose that information (or abstain from trading on it).⁹

Robert A. Kutcher, in a paper entitled "Breach of Fiduciary Duties," while admitting the duties owed are vague, outlines corporate fiduciary duties. The duty owed by corporate officers and directors is, according to Kutcher, subdivided into the duty of care and duty of loyalty. These duties need not necessarily be "correct"—that is, there is no punishment for poor judgment that might lead to weak business performance. Rather, their actions must be taken in good faith, "with the care of ordinarily prudent persons in like positions and in a manner that they believe to be in the best interest of the corporation." This would constitute the duty of care, as has been defined in the Model Business Corporation Act (MBCA), observed by most states. Again, it need not be in the best interest of the organization, but they ought to think it so. The duty of loyalty, however, has not been prescribed via statute, but by jurisprudence. Corporate officers can be found in breach of their duty of loyalty when they are "interested" in transactions, meaning that they "appear on both sides of a transaction" and/or "expect to derive personal financial benefit," versus acting with the intention of benefiting only the corporation and its shareholders.¹⁰

Whereas the various fiduciary duties owed have been discussed at length, the concept of "materiality" is necessarily vague. While key earnings metrics such as revenue figures and profitability or major events such as M&A activity would undoubtedly be deemed material, there

⁹ *Chiarella v. United States*, 445 U.S. 222 (1980).

¹⁰ Kutcher, Robert A. "Breach of Fiduciary Duties." American Bar Association.

is significant gray area.¹¹ Based on precedent established in case law and then reflected in Regulation FD, information is considered material “if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision.”¹²¹³¹⁴

Insider trading is nearly as old as the public securities market itself, with the earliest such case recorded in the Philippine Islands in 1909 in *Strong v. Repide*. In this case, the “director of a corporation who knew that the value of the stock of his company was about to skyrocket [was found to have] committed fraud when he bought the company stock from an outsider without disclosing what he knew.”¹⁵

Securities Exchange Act of 1934

Section 10 of the Securities Exchange Act of 1934, which regulates the use of “manipulative and deceptive devices,” is the “principal source for the prohibition against insider trading.”¹⁶ The general antifraud provision states:

It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

¹¹ Garcia, Christopher L. and Boyd M. Johnson III. “Chapter 13: Defending Clients in Insider Trading Investigations and Enforcement Actions.” *Defending Corporations and Individuals in Government Investigations*. 2013.

¹² *Basic v. Levinson*, 485 U.S. 224 (1988).

¹³ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

¹⁴ Regulation FD, Securities and Exchange Commission (2000).

¹⁵ *Supra*, note 11.

¹⁶ *Id.*

prescribe as necessary or appropriate in the public interest or for the protection of investors.¹⁷

As Section 10b alone was viewed as overly broad, Rule 10b-5, effective May 21, 1942, “closed a loophole” through increased specificity by “prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.”¹⁸¹⁹ The rule follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
 - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person
- in connection with the purchase or sale of any security.²⁰

Circuit Judge Barrington D. Parker, a member of the U.S. Court of Appeals for the Second Circuit in the court’s 2013 *United States v. Newman* decision, succinctly noted that, “although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, neither the statute nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibits insider

¹⁷ *Supra*, note 2.

¹⁸ Ruder, David S. and Neil S. Cross. “Limitations on Civil Liability Under Rule 10b-5.” *Duke Law Journal*. Vol. 1972:1125.

¹⁹ Securities and Exchange Commission Release No. 3230. Securities Exchange Act of 1934. Philadelphia. 1942.

²⁰ *Id.*

trading.” One must instead make the assumption that “insider trading is a type of securities fraud proscribed by Section 10(b) and Rule 10b-5.”²¹ This would later become all the more explicit.

Sections 10b5-1, 10b5-2, and Regulation FD all came into effect at the same time, on October 23, 2000. These amendments to Rule 10b-5 were adopted largely in response to the misappropriation theory that was established in *United States v. O’Hagan* three years prior. Rule 10b5-1 asserts that “a trade is on the basis of material nonpublic information if the trader was aware of the material nonpublic information when the person made the purchase or sale.”²²

Rule 10b5-2 pertains to liability under the misappropriation theory resulting from breach of a family or other non-business relationship. The rule “sets forth a non-exclusive list of three situations in which a person has a duty of trust or confidence for purposes of the misappropriation theory. Accordingly, when one agrees to “maintain information in confidence,” a duty of trust or confidence is formed. Such duties also exist when people “have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information” expects the recipient to hold it in confidentiality. Lastly, “a duty of trust or confidence exists when a person receives or obtains MNPI from certain enumerated close family members: spouses, parents, children, and siblings.”²³

Regulation Fair Disclosure (popularly referred to as “Regulation FD,” or “Reg. FD”) is a regulatory action promulgated by the SEC in 2000 that sought to “terminate the practice by companies of selectively disclosing material nonpublic information to market professionals and

²¹ *United States v. Newman*. U.S. Court of Appeals for the Second Circuit (2013).

²² SEC Release Nos. 33-7881, 34-43154, IC-24599. Final Rule: Selective Disclosure and Insider Trading. SEC.gov.

²³ *Id.*

avored shareholders.”²⁴ This was deemed necessary, due to the frequency with which company management and investor relations speak with sell-side analysts and the investing public, specifically as relates to earnings results. And while providing such individuals with nonpublic information in an effort to personally benefit would constitute insider trading, Regulation FD addresses broader concerns. Regulation FD “requires that an issuer of securities publicly disclose any material, nonpublic information about the issuer or its securities if it discloses or has disclosed the same information to a holder of the issuer’s securities or to certain securities market professionals,” and that this be done “either (a) simultaneously (for intentional disclosures) or (b) promptly (for non-intentional disclosures).”²⁵

As aforementioned, Regulation FD also explicitly defines the terms “material” and “non-public,” borrowing from case law in so doing. Again, the SEC considers information material if “there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision”—and therefore that the potentially material fact in question “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available,” a characterization explicitly applied in *TSC Industries v. Northway*. Lastly, nonpublic information is that which “has not been disseminated in a manner making it available to investors generally,” as through an SEC filing, such as an 8-K, or a press release.^{26,27}

To round out the higher-level background information, it is worth noting the difference between civil and criminal insider trading cases. Although there is no official rule of thumb to

²⁴ Steinberg, Marc. “Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis.” *University of Pennsylvania Journal of International Law*. Vol. 22, Iss. 3. 2014.

²⁵ *Supra*, note 11.

²⁶ *Supra*, note 14.

²⁷ Steinberg, Marc. Personal Interview. 2 December 2016.

determining whether a charge will be criminal, such cases usually involve flagrant violations. Most insider trading cases are initially pursued by the SEC, but in the case of criminal cases, they may be referred to the U.S. Attorney's office, if they were not brought by the U.S. Attorney to begin with. One can face both civil and criminal suits simultaneously.²⁸ Determining which of the two will be brought is largely to do with the burden of proof. A legal expert writing for Forbes, named Walter Pavlo, outlines "the three primary factors that may trigger criminal insider trading charges: (1) Significance of wrongdoing; (2) corroboration of others to prove a criminal case and provide evidence of wrongdoing; and (3) recidivism of securities violations."²⁹ Sentencing can differ as well. Civil offenders are charged a fine, which can include treble damages (i.e. "up to three times the total profit gained or loss avoided"), and criminal cases are punished (for individuals) by "a maximum of \$5 million in fines" and "up to twenty years' imprisonment."³⁰

Classical Theory of Insider Trading

Foundational to the theory concerning tipper-tippee liability was *Chiarella v. United States*, in which the Supreme Court crafted the "classical theory" of inside trading. This case involved a defendant who was not an officer of the corporation but an employee of a printing company that had been hired to print announcements of takeover bids. Although the materials sent to the printer did not identify the firms by name, Chiarella successfully ascertained the targets, knowledge based on which he traded and profited; however, Chiarella was not found to have violated securities laws.³¹ Instead, one only violates 10b-5 if the fiduciary duty breached is

²⁸ SEC Law: Insider Trading. MyStockOptions.com. 2017.

²⁹ Pavlo, Walter. "Insider Trading: Civil or Criminal Crime?" Forbes. 24 Oct. 2013.

³⁰ Wallin & Klarich. Insider Trading.

³¹ Kaplan, Howard, Joseph Matteo, and Alan Pfeffer. "The Law of Insider Trading." 2012 Litigation Annual Conference, ABA Section. April 2012.

one owed to the corporation with whose shareholders one has traded, which Chiarella did not do. Under the classical theory as articulated in *Chiarella*, a corporate insider violates Section 10(b) and Rule 10b-5 when he or she trades in the corporation's securities "on the basis of material nonpublic information about the corporation."³²

The Court explains that there exists a "relationship of trust and confidence between the shareholders of a corporate and those insiders who have obtained confidential information by reason of their position within that corporation," thereby creating "a duty to disclose [or abstain from trading]," as the insider would otherwise be taking unfair advantage of the "uninformed" shareholders.³³ Such an act, therefore, constitutes a "deceptive device," in violation of the statutes.³⁵ In accepting this theory of insider trading, the Supreme Court explicitly rejected the notion of "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information," instead limiting "the scope of insider trading liability to situations where the insider had 'a duty to disclose arising from a relationship of trust and confidence between parties to a transaction,'" as apparently absent but described in the *Chiarella* decision, such as that between corporate officers and the shareholders.³⁶

Dirks v. SEC goes on to extend corporate insiders' obligation to abstain or disclose described in *Chiarella*'s classical theory to specifically apply to temporary insiders as well. Temporary insiders, the Court notes, include parties such as "underwriters, accountants, lawyers, and consultants," since "these outsiders 'have entered into a special confidential relationship in

³² *Id.*

³³ *Supra*, note 9.

³⁴ *Supra*, note 31.

³⁵ *United States v. O'Hagan*, 521 U.S. 642 (1997).

³⁶ *Supra*, note 31.

the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”³⁷³⁸

Misappropriation Theory of Insider Trading

The origins of the second key insider trading theory are found in the 1997 case *United States v. O’Hagan*, concerning an attorney who traded the stock of a potential takeover target.³⁹ He could not be found guilty on the grounds of *Chiarella*, because he was not an officer of the takeover target. However, “misappropriating” the confidential information from and belonging to his law firm, to whom he *did* owe a fiduciary duty, the Court ruled, did constitute insider trading, and thus he was found guilty.⁴⁰ That is, the outsider is breaching a fiduciary duty owed to the source of the information, “not to the persons with whom he has traded.”⁴¹ This is deemed a deceptive act, given that “the misappropriator” is “pretending loyalty to the principal while secretly converting the principal’s information for personal gain.”⁴² In other words, *O’Hagan* expands the scope of insider trading liability to outsiders without a fiduciary relationship to a publicly-traded corporation or its shareholders.⁴³ Rule 10b5-2 was subsequently promulgated in 2000 to enact as law the precedent set by the judiciary, as well as to further define what constitutes a misappropriation of confidential information.⁴⁴

To conclude the contrast between the classical and misappropriation theories, the former concerns the breach of an insider’s duty caused by the direct trading on that information or tipping of that information to another, whereas the latter has to do with an outsider’s

³⁷ *Dirks v. SEC*, 463 U.S. 646 (1983).

³⁸ *Supra*, note 31.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Supra*, note 21.

⁴³ *Id.*

⁴⁴ *Supra*, note 31.

misappropriation of MNPI from his employer or other source “in breach of a duty owed to the source of the information,” following which he or she “trades on it or, in return for a benefit, provides it for trading purposes to a tippee in breach of a duty to the source.”⁴⁵

Tipper-Tippee Liability

This tipper-tippee relationship arises when “the insider or misappropriator in possession of material nonpublic information (the ‘tipper’) does not himself trade but discloses the information to an outsider (the ‘tippee’) who then trades on the basis of the information before it is publicly disclosed.”⁴⁶ In both cases, tipping liability applies. The crux of the issue here is that the tippee’s fiduciary duty—and hence the duty to abstain or disclose—is derivative of that of the tipper, a chain which theoretically can be stretched out to include any number of tippees. The tippee’s liability for an insider trading violation occurs when the tippee “trades on such information knowing that his source’s disclosure of such information [i.e. that by the tipper] breaches a duty also violates the federal securities laws.”⁴⁷ Trading by a tippee on the tips is effectively a form of “participation after the fact” in the insider’s breach of his or her fiduciary duty.⁴⁸

Oddly enough, it is at times possible for the tippee, but not the tipper, to be held liable. This occurs in instances in which the tippee acted willfully, while the tipper had no intention of violating securities laws, as in *United States v. Corbin*. In this 2010 case, two day traders in Florida were regularly relayed material, nonpublic information from an acquaintance employed at a financial institution in New York City. However, the source of the MNPI was the New

⁴⁵ Eisenberg, Jon. “How *United States v. Newman* Changes the Law.” Harvard Law School Forum on Corporate Governance and Financial Regulation. 3 May 2015.

⁴⁶ *Supra*, note 21.

⁴⁷ *Supra*, note 31.

⁴⁸ *Supra*, note 9.

York-based acquaintance's wife, who worked for a communications firm that had access to nonpublic information concerning mergers and acquisitions and the like. The woman's husband betrayed the couple's "domestic confidentiality policy," unbeknownst to his wife, by providing his day-trading friends in Florida with information he received from his wife in confidence. This domestic confidentiality agreement existed on the grounds that, according to the recently established Rule 10b-5, the couple shared "a history, pattern, and practice of sharing and maintaining confidences such that Devlin knew and reasonably should have known that his wife expected that he would maintain the confidentiality of any material nonpublic information he obtained from her."⁴⁹

Rule 10b5-2, which further expounded upon the misappropriation theory that allowed for this assertion, also "imposed a 'duty of trust or confidence' that establishes a duty to abstain or disclose "[w]henver a person agrees to maintain information in confidence."⁵⁰ Lastly, under Rule 10b5-2, "a 'duty of trust or confidence' exists whenever a 'person receives or obtains material nonpublic information from his or her spouse."⁵¹ In addition, the court in *U.S. v. Corbin* applied *United States v. Chestman*, which predates *O'Hagan*, in which the court wrote that "the repeated disclosure of business secrets between family members" constitutes "the functional equivalent of a fiduciary relationship."⁵² Consequently, the misappropriation theory, as prescribed by the SEC in Rule 10b5-2, was directly applicable in *Corbin*, even though the original source of the MNPI (i.e. Devlin's wife), to whom Devlin owed a duty of trust and confidence, due to the nature of their relationship, was not found to be in breach of her duty.

⁴⁹ *United States v. Corbin*, 729 F. Supp. 2d 607 (2010).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

As Circuit Judge Barrington Parker reviews in *United States v. Newman, Dirks v. SEC* addressed “the liability of a tippee analyst [Dirks] who received material, nonpublic information about possible fraud at an insurance company from one of the insurance company’s former officers,” which the analyst then transmitted to a number of clients invested in the insurance company. Though it was not his intent, some clients sold their shares as a result of the tip, in response to which the SEC brought charges against Dirks. Perhaps surprisingly, because the Court determined that Dirks had “provided the confidential information in order to expose a fraud in the company and not for any personal gain,” he was not held liable as a tippee, as he was not in breach of his duty to the company’s shareholders⁵³.

As summarized by the Second Circuit in *United States v. Newman*, the requirements of tippee liability laid out in *Dirks* include the following:

“(1) The tippee’s liability derives *only* from the tipper’s breach of a fiduciary duty, *not* from trading on material, non-public information.

“(2) The corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure.

“(3) Even in the presence of a tipper’s breach, a tippee is liable only if he knows or should have known of the breach.”

Hence, there is nothing fraudulent about merely possessing material, nonpublic information; rather, only for making “secret profits” by trading on the information before first disclosing it.⁵⁴

It is the *improper* disclosure to the tippee by the insider which causes the tippee to assume the tipper’s fiduciary duty. So, if the disclosure is not improper, as Dirks’ disclosure was deemed not to be, then there is no breach, “and absent a breach by the insider, there is no derivative

⁵³ *Supra*, note 21.

⁵⁴ *Supra*, note 37.

breach.”⁵⁵ Moreover, it is required that the tippee know (or ought to have known) that “the insider disclosed confidential information in exchange for personal benefit.”⁵⁶ There must be evidence of an expected quid pro quo—i.e. the personal benefit requirement.

Importantly, the Court in *Dirks v. SEC* describes a “personal benefit” as not only pecuniary but also reputational. Further, the following declaration will be critical to the Supreme Court’s reading of *Dirks* in deciding *Salman v. United States* in 2016: “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.”⁵⁷

SEC v. Switzer, though troubling, given the questionability of the underlying facts, provides an answer to the question of what happens in the case of accidental disclosure by an insider. In *Switzer*, the events of which took place in 1981, former O.U. and Dallas Cowboys football coach Barry Switzer, while attending a track meet, overheard a conversation between executives of Texas International Co., who were discussing “the liquidation of Phoenix Resources, an Oklahoma City oil firm;” however, because it could not be shown that the tipper (George Platt, Texas International’s CEO) tipped in expectation of any personal gain, the case was dismissed.⁵⁸ The *Cady, Roberts* abstain-or-disclose requirement is derived by the tippee in the event of improper disclosure by an insider. Quite simply, though, this duty is only transmitted when an “improper disclosure” has taken place—which accidental disclosure is not.

Accordingly, accidental disclosure by a corporate insider (as George Platt does to Barry

⁵⁵ *Id.*

⁵⁶ *Supra*, note 21.

⁵⁷ *Supra*, note 37.

⁵⁸ Valenti, Catherine. “The Slippery Slope of Insider Trading.” ABC News.

Switzer's benefit in the case) is not a breach of one's fiduciary duty, and, further, one is not restricted from trading on the basis of information inadvertently revealed by an insider.

United States v. Newman and Chiasson involved two portfolio managers at separate hedge funds charged with insider trading violations. It was alleged that analysts below both Newman and Chiasson procured MNPI from employees at publicly-traded technology firms, and that information was eventually passed on to Newman and Chiasson. However, the guilty verdict at which a lower court arrived was declared erroneous because the court determined that "the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive" as well as that there was no evidence "that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties."⁵⁹

The precedent set by the reasoning behind the former conclusion is what proved problematic. Specifically, the court asserted that "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,'" they held "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."⁶⁰ Although the court would defend this by suggesting that this merely requires that the personal benefit "be of some consequence," this had the potential to considerably narrow judiciary capacity to combat insider trading violations among friends and other close trading relatives. They took issue with the assertion that a personal benefit can be broadly said to include

⁵⁹ *Supra*, note 21.

⁶⁰ *Id.*

“any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.”⁶¹ But indeed without such broad language, efforts to quell insider trading violations would be rendered impotent.

In their *Newman* decision, the Court of Appeals for the Second Circuit, as is pointed out in *Salman*, inadequately addressed a caveat found in *Dirks*: In the event of the gifting of confidential information by an insider 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.”⁶² This is repeatedly stated in *Salman*’s conviction. In *Newman*, however, the Court held 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.”⁶³ *Newman* and *Dirks* are therefore in disagreement with one another, and it is in *Salman* that the Court has the final word, acknowledging that the Ninth Circuit “declined to follow *Newman*,” in adherence to the previously noted solution offered by *Dirks*, thus declaring *Newman* “inconsistent with *Dirks*,” overruling it only two years following the decision.⁶⁴

Salman v. United States, brought before the Supreme Court in 2016, entailed the conviction of Bassam Salman, who traded on inside information received from a friend and “relative-by-marriage,” Michael Kara, who had himself received the information from his brother, Maher Kara, who formerly worked in Citigroup’s investment banking division and himself admitted to sharing the information with his brother Michael in order to benefit him

⁶¹ *Id.*

⁶² *Supra*, note 37.

⁶³ *Supra*, note 21.

⁶⁴ *Salman v. United States*, 137 S. Ct. 420 (2016).

financially. Michael, in turn, “testified to sharing that information with Salman, who knew it was from Maher,” though this was done without Maher’s knowledge.

Despite the fact that *Newman* states the tipper must receive (or have the potential to receive) something of a “pecuniary or similarly valuable nature” in return for the gift of the information to a trading relative, the Court concluded that “Salman’s conduct is in the heartland of *Dirks*’s rule concerning gifts,” indeed involving “precisely the gift of confidential information to a trading relative that *Dirks* envisioned.”⁶⁵ Again, “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.”⁶⁶ The tipper is said to personally benefit because the gift of the information is no different than the tipper trading on the information him or herself and then gifting the proceeds to the tippee.⁶⁷

However, the Court does not stop here, but goes on to contend that the personal benefit test “encompasses a gift of confidential information to anyone with the expectation that the information will be used for trading,” not for trading relatives and friends alone, thus providing grounds to convict Salman even absent that familial relationship.⁶⁸ As aforementioned, albeit less frankly, the tipper benefits where confidential information is disclosed for a non-corporate purpose—from there, the defendant’s liability as a tipper depends upon the tipper’s expecting “that the information disclosed would be used in securities trading,” as well as that the tippee knew or should reasonably have known that the tipper made the disclosure in exchange for a personal benefit and with the expectation the trading on the information would follow.⁶⁹ On

⁶⁵ *Id.*

⁶⁶ *Supra*, note 37.

⁶⁷ *Supra*, note 21.

⁶⁸ *Id.*

⁶⁹ *Id.*

December 6, 2016, Justice Samuel Alito delivered the decision to affirm Salman’s conviction for a unanimous court. And the Supreme Court in *Salman* was not alone in correcting *Newman*’s interpretation of *Dirks*—for instance, the U.S. District Court for the Southern District of New York argued in *United States v. Stewart* (in 2016, prior to SCOTUS’s *Salman* hearing) that “*Newman* erroneously departed from the *Dirks* standard with regard to gifts and that *Newman*’s standard would be impossible to apply and would harm markets by blurring the line between permissible and impermissible activity.”

As Peter Henning at *The New York Times* points out, “what is odd about the law is that the benefit requirement is far removed from what is considered wrongful about insider trading”—namely, the use of MNPI “for personal gain,” undermining confidence in the market. Henning would argue that the personal benefit is hardly applicable to whether there has occurred a fraudulent act. The fact that the tippee’s culpability depends upon his or her awareness of the tip’s origins, and whether the source received a personal benefit in exchange, is needlessly narrow in terms of enforceability.

IV. Equality of Access Theory

It is for the above stated reasons that academics and practitioners have advocated for the implementation of a statutory provision that would specifically define and prohibit insider trading and apply of an “equality of access” standard. The equality of access theory “comports with the fundamental dictates of ethics” in that it recognizes “the independent wrongfulness of trading on information that the trader knows or should know cannot be accessed by others through their own lawful and independent diligence.”⁷⁰ This starry-eyed pursuit should not suggest a naïve conception of a legal system founded solely in ethics—certainly legal principles and ethical norms do not always coincide. However, in this instance, existing law seems troublingly divorced from morality, neglecting to acknowledge the inherent unfairness in the act of insider trading—indeed, the fact that such behavior is nothing short of cheating. But to incorporate the notions of “fairness” and “cheating” into legislative statutes requires that the terms be philosophically explored and made practical and applicable to real-world scenarios.

A Moral Imperative

The need for an equality of access standard fundamentally has to do with the concept of fairness. In order for the securities markets to be fair, there must be equality of *access* to information. To be clear, this is not a call for a utopian world with “equality of information, skill, financial resources, or luck;” rather, *opportunities* to obtain information and form investment theses must be equal.⁷¹ This is not symmetry of information; it is symmetry of opportunity. Justices Blackmun and Marshall explained in their dissent in *Chiarella* that “there is a significant conceptual difference between parity of information and parity of access to material

⁷⁰ Klaw, Bruce W. “Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory.” *William & Mary Business Law Review*. March 2016.

⁷¹ *Id.*

information,” the latter of which is crucial to a fundamentally fair securities market.⁷² One should be rewarded for conducting superior due diligence. Insider trading deprives the savvy investor—and all market participants—of the opportunity to play on a level playing field. This would be considered “unfair.” In-depth due diligence and modeling conducted by the savvy analyst may result in superior information upon which to make investment decisions, and assuming the findings result solely from publicly available sources, this is absolutely fair, even if no other analyst had the mental acuity or luck to arrive at the same conclusion.

Oftentimes insider secrets are provided through “the good old boy network,” as Robert McGee writes, to which the vast majority of retail investors do not have access.⁷³ The argument sometimes posed by supporters of the abolition of insider trading restrictions that insider trading actually enhancing market efficiency by allowing securities to approach their fair values—and, hence, the select few with the means to obtain MNPI should be permitted to do so—is deeply flawed and un-empathetic, as Klaw passionately explains:

Most Americans are not current or former senior corporate officials . . . like the tipping insiders in *Cady, Roberts* and *Dirks*. Most Americans are not analysts able to command meetings with corporate insiders like the tippee in *Dirks*. Most Americans do not socialize with corporate insiders who are capable of providing meaningful tips like the two analysts in *Newman* . . . Most Americans do not have a close family relative that works as an investment banker, as in the *Salman* case . . . Such unfairness would not be remedied by simply allowing everyone to trade on the nonpublic information in *their* possession. For while such a rule could conceivably be fair with respect to those whose

⁷² *Supra*, note 9.

⁷³ *Supra*, note 70.

positions of access allow them to be in the know at least some of the time, it would not provide equality of opportunity to most retail investors.

In order to establish that insider trading is a form of cheating, it is necessary to first define “cheating.” Rutgers Law Professor Stuart Green proposes four requirements for an act to constitute cheating, which Klaw effectively applies to the issue of insider trading. First, “the rule broken must be fair and enforced in an even-handed manner and not subject to a justified exception”—ergo, unjustifiable—and, second, “the rule-breaking must be intentional” (not accidental).⁷⁴ The third requirement is that “the rule-breaker must be part of a cooperative rule-governed activity that involves another party,” a classification the publicly-traded securities market easily meets, particularly given that “without a counterparty to purchase what is being sold or sell what one wishes to purchase there can be no securities market,” and, as logically follows, “without a securities market, there can be scant capital accumulation for people or enterprises;” consequently, “all issuers and traders are involved in a mutually beneficial endeavor to raise capital, grow wealth, and develop economies.”⁷⁵ The fourth and final requirement is that “the rule-breaker must intend to gain an advantage through her rule-breaking.”⁷⁶ What other motive might there be? Conveniently, the SEC in 1961 stated (in *Cady, Roberts*) that from “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing” arises the duty to disclose or abstain.⁷⁷ It can, thus, be said that insider trading in all its forms qualifies as cheating.

The government acknowledged in the Writ of Certiorari in the *Newman* case that the precedent set in *Newman* “licenses trading by insiders’ favored tippees, thereby shifting losses to

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

investors who lack access to confidential corporate information and eroding public confidence in the integrity of securities markets,” and it therefore “disadvantages legitimate analysts who pursue research and modeling based on authorized information.”⁷⁸ Even though *Newman* has since been overturned by the Supreme Court in *Salman*, these assertions are nevertheless valid so long as U.S. insider trading laws remain narrow, which is inevitable when the underlying elements for establishing liability are breach of fiduciary duty or misappropriation, personal gain by the tipper, among other nebulous requirements. This, as will be explained, requires a dedicated statute that not only makes insider trading expressly illegal but “more squarely overlaps with all of the fundamental reasons why it is morally wrongful,” as has been done abroad.⁷⁹

Market Abuse Directive: Equality of Access Case Study

If the United States intends to transition to the more sensible equality of access theory, one need look no further than the European Union for an example of strong implementation of the standard. Under the E.U.’s Market Abuse Directive (M.A.D.), adopted in 2003, “trading by *anyone* ‘who possesses insider information while that person knows, or ought to have known, that it is inside information’” is prohibited, as is “disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession, or duties.”⁸⁰ In other words, this concisely addresses insider trading as a whole, including by temporary insiders and remote tippees, without invoking the concept of fiduciary duty or the receipt (or potential receipt) of a personal benefit.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

The laws make abundantly clear that exploitation or utilization of inside information by anyone by any means and for any reason is unlawful. They prohibit using material, nonpublic information “by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates.”⁸¹ This therefore applies not only to equities but to any instrument whose value or performance can be found to be derivative—even in the slightest—of the information in question. The law goes on to “expressly bar outsiders from trading on material information *regardless of how they received it.*”⁸²

Just the few excerpts from M.A.D. presented here constitute a more potent and enforceable prohibition of trading by insiders and their affiliates. Enforcement would be straightforward: “regulators would only need to prove that the defendant traded on material nonpublic information concerning an issuer or financial instrument that could not, in principle, have been available to others through independent and otherwise lawful due diligence.”⁸³ As it would happen, a bill has come before the Senate that could potentially do exactly that.

Senate Bill S.702

Senator Jack Reed of Rhode Island introduced Senate Bill S.702, or the “Stop Illegal Insider Act,” in March of 2015, which would amend the Securities Exchange Act of 1934 “to make it unlawful for any person to: (1) purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available; or (2) knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

circumstances in which it is reasonably foreseeable that the communication is likely to result in a violation of this prohibition.”⁸⁴ Importantly, the bill notes that “the term ‘not publicly available’ shall not include information that the person has independently developed from publicly available sources,” closely aligning it with much of what has previously been recommended.⁸⁵ Though introduced over two years ago, the bill still today sits with the Committee on Banking, Housing, and Urban Affairs in the introductory stage of the legislative process, unfortunately leading one to believe it has little in the way of momentum. The sooner a stoking of public support occurs, the better.

⁸⁴ S. Res. 702, 114th Cong. Congress.gov. March 2015.

⁸⁵ *Id.*

V. Conclusion

The tensions between the two polarized sides of the debate should by this point be clear: Whereas some fear for the market's integrity given the convoluted and difficult-to-enforce rules that prevail today, others have gained through exploitation of the vague and loophole-laden status quo. Any discussion that is sparked regarding this remarkably little understood topic would prove productive. Through this, previous, and subsequent research on the topic, the aim should be to better inform those affected by the flawed precedent that has been set and forge a path toward the implementation of a statutory provision that effectively combats insider trading and so aligns U.S. laws with what is morally upright and preserves the integrity of the securities market.

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