

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

Cindy A. Schipani

Stephen M. Ross School of Business
University of Michigan

H. Nejat Seyhun

Stephen M. Ross School of Business
University of Michigan

Ross School of Business Working Paper
Working Paper No. 1287
September 2015

Forthcoming in the *‘Fordham Journal of Corporate and Financial Law’*

This work cannot be used without the author's permission.

This paper can be downloaded without charge from the
Social Sciences Research Network Electronic Paper Collection:
<http://ssrn.com/abstract=2668162>

FORTHCOMING: *FORDHAM JOURNAL OF*
CORPORATE AND FINANCIAL LAW

Defining “Material, Nonpublic:”

What Should Constitute Illegal Insider Information?*

Cindy A. Schipani and H. Nejat Seyhun*****

Abstract

The courts, the SEC, and the U.S. Congress should take up the recent opportunity presented by the Second Circuit decision in *United States v. Newman* (773 F.3d 438 (2014)) to define what material, nonpublic insider trading information means and in this spirit, we offer a new approach. Our approach is simple, easy to implement and difficult to circumvent by insiders.

* Copyright 2015. Cindy A. Schipani and H. Nejat Seyhun. All rights reserved. We thank Alina Charnianskaya, Ivana Mrazova, Jacob Styburski, and Julia Xin for excellent research assistantship.

** Merwin H. Waterman Collegiate Professor of Business Administration and Professor of Business Law, University of Michigan, Ann Arbor, Michigan.

*** Jerome B. & Eilene M York Professor of Business Administration and Professor of Finance, University of Michigan, Ann Arbor, Michigan.

The statutory penalties for illegal insider trading are almost as severe as first-degree murder, yet we see insiders make tens of thousands of lucrative transactions every year. Moreover, the increase in penalties over time has done little to slow down insider trading.¹ What is the explanation for this paradox?

Even though more than 80 years have passed since the Securities and Exchange Act of 1934, which prohibits fraud in the purchase or sale of any security and more than 50 years have passed since the 1961 decision in *In re Cady, Roberts & Co.*² holding trading by insiders on material, nonpublic information illegal, neither the U.S. Congress nor the U.S. Securities and Exchange Commission (SEC) has defined what the phrase material, nonpublic information means. In the absence of any definition, courts typically find insider trades made immediately prior to disclosure of corporate takeovers, earnings announcements, and dividend announcements as unlawful.³ Immediately usually means within days or hours of an announcement by the firm. What is much less clear is whether trading on a takeover or earnings information one month before the announcement is legal. What is also not clear is the legality of trading on other types of valuable information such as corporate structuring, new security issues, corporate borrowing decisions, and personnel changes, etc., all of which can significantly impact stock prices.⁴ We argue that it is this ambiguity about what is and is not allowed under the law that enables corporate insiders to engage in profitable transactions.

¹ See Mirela V. Hristova, *The Case for Insider-Trading Criminalization and Sentencing Reform*, 13 TENN. J. BUS. L. 267, 279-80 (2012). See generally Patrick Augustin, Menachem Brenner & Marti G. Subrahmanyam, *Informed Options Trading Prior to M&A Announcements: Insider Trading?*, Working Paper (2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2441606.

² 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5; 40 S.E.C. 907 (1961).

³ Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1680 (1992) (noting that insider trading is associated with immediate price movements and quick price discovery”).

⁴ See e.g., Karl-Adam Bonnier and Robert F. Bruner, *An Analysis of Stock Price Reaction to Management Change in Distressed Firms*, J. OF ACCOUNTING AND ECONOMICS, 95 (1989); Steven Davidoff Solomon, *In Corporate Disclosure, a Murky Definition of Material*, N.Y. TIMES, APRIL 5, 2011.

Over the past 30 years, as public concern about illegal insider trading has increased, Congress has responded by passing legislation that has repeatedly increased the penalties upon conviction. In 1984, Congress passed the Insider Trading Sanctions Act (ITSA),⁵ followed by the Insider Trading and Securities Fraud Enforcement Act (ITSFEA)⁶ in 1988 and followed by the Sarbanes Oxley Act (SOX)⁷ in 2002, all without defining what constitutes illegal insider information. Currently, the penalties from insider trading can reach up to 20 years in prison and up to one million dollars in penalties for each offense.⁸

Yet, while the penalties have increased over time, the definition of illegal insider information has become even more ambiguous. To further complicate this matter, through a strict interpretation of the Supreme Court's holding in *Dirks v. S.E.C.*,⁹ the U.S. Court of Appeals for the Second Circuit recently required a showing of personal benefit to insider-tippers before attaching liability to tippees.¹⁰ In particular, in order to establish tippee liability, the Second Circuit now requires the government "prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit."¹¹ This ruling significantly raises the bar for establishing liability because this requirement can easily be avoided by traders who add additional layers between the original tipper and the eventual tippee. Moreover, the U.S. Solicitor General has requested that the Supreme Court review the decision; and, if certiorari is granted, the Court may apply the Second

⁵ Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

⁶ Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

⁸ Hristova *supra*, note 1, at 279-80.

⁹ See *Dirks v. S.E.C.*, 463 U.S. 646, 662 (1983) (holding that derivative (tippee) liability can only be found where the insider-tipper "personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."). In *Dirks*, the insider-tipper shared personal information with an analyst (the defendant) in order to expose an insurance scam being perpetrated by the tipper's company. *Id.*

¹⁰ *United States v. Newman*, 773 F.3d 438, 442 (2d Cir. 2014).

¹¹ *Newman*, 773 F.3d at 442.

Circuit's personal benefit requirement nationwide.¹² We argue that the additional ambiguity created by the *Newman* ruling will lead to fewer insider trading prosecutions, increased frequency and profitability of insider trading, thereby causing detriment to the investing public and its confidence in public markets.¹³

Therefore, the courts, the SEC and Congress should reverse course and define insider trading more precisely. Increasing civil and criminal penalties does not work as a successful deterrent if there is substantial ambiguity about what is illegal insider trading. This ambiguity allows insiders to not only trade successfully but also to fend off attempts by the SEC and the U.S. Justice Department to discipline them after the fact. The evidence we present in this paper is consistent with our hypothesis. Our evidence shows that insiders have been able to engage in hundreds of thousands of lucrative transactions over the past 40 years without ever worrying about sanctions.

We thus urge the courts, the SEC, and Congress to take this opportunity to define the phrase “material, nonpublic” and in this spirit, we offer an evidentiary presumption. Our presumption is simple, easy to implement, and difficult to circumvent by insiders. We propose that the a prima facie case of trading on material, nonpublic information be found upon proof that: (1) the information giving rise to the trade is of the type that requires an 8-K filing by the corporation, (2) its announcement must lead to statistically significant abnormal stock returns, and (3) the insider trading must have occurred within two months prior to the announcement of the information. Given that corporations file 10-Q and 10-K reports every three months, these

¹² *U.S. Asks Justices to Review 'Newman' Insider Case*, SECURITIES LAW DAILY, Aug. 3, 2015, <http://www.bna.com/us-asks-justices-n17179934226/>; see also <http://www.scotusblog.com/wp-content/uploads/2015/07/Newman-petition-by-SG-7-29-15.pdf>.

¹³ Beeson, Ed, SEC Loses Insider Trading case on Home Court”, Law360, September 14, 2015. See, http://www.law360.com/securities/articles/702227?nl_pk=b7cedb18-41f7-4adf-baa2-177ef5398f80&utm_source=newsletter&utm_medium=email&utm_campaign=securities

conditions in effect require that all insider trading based on 10-Q/K information to be confined to approximately one-month window after each earnings announcement.¹⁴ If all three conditions are satisfied, then the burden of proof must shift to the insiders to show that the particular transaction does not meet the material, nonpublic information requirement. Furthermore, any tipping by insiders of any information satisfying these three conditions above must again shift the burden of proof to defendants to show that their tip(s) should be exempted.

There is evidence that information disclosed in 8-K filings provides new and material information to the public. Recent research shows that 15,419 transactions executed by insiders during the four-business-days prior to the filing of 8-K reports exhibit statistically significant abnormal trading profits of 42 basis points.¹⁵ This finding indicates that insiders can and do exploit the new information contained in 8-K reports.

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

We expect additional clarity will allow all insiders who want to be on the safe side of the law to ensure that their transactions do not meet any of the conditions set forth above. Insiders

¹⁴ Typically, one week after earnings announcements is also considered a black-out period to allow to markets to fully digest the earnings information. This in effect confines insider trading to one and four weeks between each earnings announcement.

¹⁵ See Alma Cohen, Robert Jackson & Joshua Mills, "The 8-K Trading Gap," Columbia University working paper. available at <http://bj1.law.columbia.edu/8kgap>.

already know which events trigger an 8-K filing. By not trading or tipping during the two-month window preceding an upcoming 8-K filing, insiders can easily ensure that at least two of the three conditions will not be satisfied. The benefit of this additional clarity should enable courts to separate routine insider trading from opportunistic trading and increase the confidence in the public equity markets.

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

I. The Development of Insider Trading Law

Insider trading is not defined in federal securities laws, thus the courts are left to interpret whether insider trading is fraudulent and, more specifically to define material, nonpublic insider information.¹⁶ The lack of statutory or regulatory definition in this respect is troublesome and out of line with many jurisdictions across the Atlantic.¹⁷ In the U.S., the offense is based on

¹⁶ See 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5.

¹⁷ Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 424 (2013). In the European Union (EU) for example, the offense is defined in a statutory directive, the Market Abuse Directive. The Directive is detailed and the crime is premised on the concept of parity of information without a requirement of deception or misleading conduct, or breach of a fiduciary duty or any similar relationship of trust and/or confidence. *Id.* at 369. The SEC lobbied for a similar parity-of-information approach, but this approach was rejected in *Chiarella v. United States*, 445 U.S. 222 (1980), where the Supreme Court found it too broad in scope, since Rule

interpretations, both judicial and administrative, of the antifraud provisions in Section 10(b) of the Securities and Exchange Act and Rule 10b-5 of the SEC.¹⁸ While state causes of action and liability for securities fraud had existed long before,¹⁹ serious federal involvement did not begin until 1961, when the SEC argued in *In re Cady, Roberts & Co.*,²⁰ that federal antifraud provisions should extend to cover insider trading.²¹ The crime is either criminal or civil and has been interpreted by the courts as requiring intent.²²

Today, according to the SEC, insider trading “generally occurs when a security is bought or sold in breach of a fiduciary duty or other relationship of trust and confidence while in possession of material, nonpublic information.”²³ “Inside information” is generally understood to be “nonpublic information about events or circumstances related to a company’s assets or earning power known only to corporate management and its confidants, and which can reasonably be expected to have a material effect on the company’s share price.”²⁴ Not all insider trading cases involve this type of information, however. Some concern trading by professionals on nonpublic market information, and others include “tipping” this information to others. The SEC defines information as being material “if its release could affect the company’s stock price.” The SEC definitions and rules are generally broader than the limited rulings of the courts.

A. Lack of Statutory Clarity

10b-5 is based on fraud. The parity-of-information approach is focused on the information, not how the person obtains it from his or her source, and does not involve criminal intent. The U.S. has not adopted this approach and continues to suffer from lack of clear definitions of insider trading.

¹⁸ 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5.

¹⁹ Robert B. Thompson, *Insider Trading, Investor Harm, and Executive Compensation*, 50 CASE W. RES. L. REV. 291, 293 (1999).

²⁰ *Id.*

²¹ Securities Exchange Act of 1934 Release No. 8-3925, 40 S.E.C. 907 (Nov. 8, 1961); see Thompson, *supra* note 17, at 293.

²² See, e.g., *Chiarella*, 445 U.S. 222.

²³ *SEC Enforcement Actions: Insider Trading Cases*, U.S. Securities and Exchange Commission, available at <http://www.sec.gov/spotlight/insidertrading/cases.shtml>.

²⁴ Roberta S. Karmel, *The Law on Insider Trading Lacks Needed Definition*, Brooklyn Law School Legal Studies, Research Paper No. 413, at 2 (May 2015), available at <http://ssrn.com/abstract=2607693> (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968)).

Section 10(b) of the 1934 Securities Exchange Act (the “Exchange Act”) provides:

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

...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.²⁵

SEC Rule 10(b)(5) similarly states:

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

(a) To employ any device, scheme, or artifice to defraud,

(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.²⁶

It is notable that neither the statute nor the regulatory rule even utilize the phrase “insider trading” let alone define it. Instead, insider trading has been considered fraud, covered by the above statute and rule, through court interpretation.²⁷

Historically, the SEC and the U.S. government did not agree on the definition of insider trading. The SEC resisted defining insider trading in fear that a definition would enable more fraud.²⁸ Therefore, it has passed rules to clarify the borders of what the crime constitutes based

²⁵ 15 U.S.C. § 78j(b).

²⁶ 17 C.F.R. 240.10b-5.

²⁷ Securities Exchange Act of 1934 Release No. 8-3925, 40 S.E.C. 907 (Nov. 8, 1961) (the first decision to hold that section 10(b) of the 1934 Exchange Act and SEC rule 10(b)(5) apply to insider trading); *Chiarella*, 445 U.S. 222 (the first Supreme Court case to hold that section 10(b) and rule 10(b)(5) cover insider trading).

²⁸ See e.g., Jed S. Rakoff, Keynote Address at the PLI Securities Regulation Institute: Is the S.E.C. Becoming a Law Unto Itself? (noting that the S.E.C. “has repeatedly resisted any effort by Congress to statutorily define insider trading, preferring to leave the concept sufficiently flexible as to be able to adjust to new developments”) Nov. 5,

on the court decisions on the matter throughout the years. When the U.S. Senate²⁹ and the U.S. House of Representatives³⁰ attempted to define insider trading with proposed bills in 1987, the SEC proposed its own bill.³¹ These bills, however, adopted different approaches. Whereas the Senate and SEC gave contemporaneous traders the ability to recover damages, the House put forward a criminal statute.³²

The Senate bill would have considered “information ... [to have been] used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.”³³ The SEC, on the other hand, wanted to outlaw trading while in possession of material, nonpublic information only if this information “has been obtained by, or its communication would constitute, directly or indirectly (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.”³⁴ This change from “possession” to “use” resulted in no action being taken until the ITSFEA³⁵ which, while increasing sanctions for the crime, was not any more helpful in defining insider trading.³⁶

B. Defining Insider Trading through Case Law

2014; *The Muddle of Insider Trading Regulation*, N.Y. TIMES, Nov. 24, 1991, available at <http://www.nytimes.com/1991/11/24/business/1-the-muddle-of-insider-trading-regulation-101791.html>.

²⁹ S. 1380, 100th Cong. (1987).

³⁰ H.R. 1238, 100th Cong. (1987).

³¹ Insider Trading Act of 1987, 19 Sec. Reg. & L. Rep. (BNA) 1284 (1987).

³² S. 1380, 100th Cong. (1987); H.R. 1238, 100th Cong. (1987); Insider Trading Act of 1987, 19 Sec. Reg. & L. Rep. (BNA) 1284 (1987).

³³ S. 1380, at 2.

³⁴ Accompanying Letter, and Analysis by Ad hoc Legislation Committee, 19 Sec. Reg. & L. Rep. (BNA) 1817 (1987).

³⁵ Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in subsections of 15 U.S.C. § 78 & 80b-4a).

³⁶ Karmel, *supra* note 22, at 9.

In large part due to the lack of statutory clarity, the courts find it necessary to shape the boundaries of what constitutes illegal insider information through case law. *In re Cady, Roberts & Co.*,³⁷ the first insider trading case under Rule 10b-5, a broker-dealer's liability derived from the conduct of one of its principals, a director of a corporation that decided to make a dividend cut.³⁸ The SEC found the director had violated Rule 10b-5 when, soon after leaving the board meeting, he sold securities in customer accounts of the broker-dealer, including those in which he had a beneficial interest.³⁹ The SEC emphasized the existence of a relationship, which gave the director access to inside information only intended for a corporate purpose and the unfairness of allowing him to take advantage of this information by trading without disclosure.⁴⁰

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

In *In re Investors Management Co.*, investment advisers and mutual fund managers sold stock in a company because of a selective disclosure from the underwriter of the company's debentures of a reduction in its earnings.⁴⁴ The SEC held that anyone who obtains insider information, "which he has reason to know emanates from a corporate source and which places

³⁷ 40 S.E.C. 907 (1961).

³⁸ *Id.* at 909.

³⁹ *Id.*

⁴⁰ *Id.* at 911-13.

⁴¹ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

⁴² *Id.* at 849.

⁴³ Karmel, *supra* note 22, at 3.

⁴⁴ *In re Investors Management Co.*, 44 S.E.C. 633, 636-37 (1971).

him in a position superior to other investors, acquires a relationship with respect to that information giving rise to a legal duty under Rule 10b-5.”⁴⁵ Commissioner Smith’s concurring opinion further stated that the tippee “must know that the information was given to him in breach of a duty by a person having a special relationship to the issuer” and the information must also have substantially contributed to the trading at hand.⁴⁶ The case exemplifies the two main questions in the debate: first, whether possession of insider information is enough for a violation or if it also has to be traded or used and, second, must the tippee trading on the information know that it was given in breach of a duty by someone with a special relationship with the company in question in which he or she cannot disclose this information?⁴⁷ This concurring opinion would resonate in a later ruling of the Court.

Almost a decade later in *Chiarella v. United States*,⁴⁸ the Supreme Court rejected this parity of information theory stating that not every case of financial unfairness is in violation of Rule 10b-5.⁴⁹ In this case, the Court reversed the conviction of an employee of a printing company who, upon learning of upcoming tender offers for a few target companies, purchased shares in those companies in order to sell them at a profit after the tender offer was announced.⁵⁰ Because the names of the companies were not well disguised, the employee was able to ascertain their names on his own and, thus, was not tipped. Noting this, the Court held that “silence in connection with a purchase or sale constitutes fraud only if liability is premised on a duty to disclose arising from a relationship of trust and confidence.”⁵¹

⁴⁵ Karmel, *supra* note 22, at 3 (citing *Chiarella*, 445 U.S. at 240).

⁴⁶ *Id.*

⁴⁷ Karmel, *supra* note 22, at 3.

⁴⁸ 445 U.S. 222 (1980).

⁴⁹ *Id.* at 231-32.

⁵⁰ *Id.* at 222.

⁵¹ *Id.* at 230.

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

permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.⁵²

In the 5-4 decision, the majority of the Justices presumably supported the misappropriation doctrine.⁵³

Sidestepping this limited understanding of insider trading violations, the SEC passed Rule 14e-3.⁵⁴ Rule 14-e-3 creates a “disclose or abstain” from trading requirement for anyone who (1) possesses material information concerning a tender offer and (2) knows or has reason to know the information is nonpublic and derived from the offeror or target company. The SEC regards this as a prophylactic rule and argues that neither scienter nor breach-of-duty is required to trigger a violation.⁵⁵ This rule proved to be useful in its prosecutions involving advance knowledge of tender offers, and both the SEC and the DOJ prosecuted a number of cases under this rule, on the basis of misappropriation theory.⁵⁶

⁵² *Id.* at 239-40.

⁵³ Karmel, *supra* note 22, at 4 (citing Chiarella, 445 U.S. 222).

⁵⁴ 17 C.F.R. §240.14e-3 (2014).

⁵⁵ Karmel, *supra* note 22, at 4 n. 33 (citing Tender Offers, Exchange Act Release No. 17120, 45 Fed. Reg. 60,410 (Sept. 4, 1980)).

⁵⁶ Karmel, *supra* note 22, at 4; *see* SEC v. Jacobs, No. 13-CV-1289 (N.D. Ohio June 11, 2013) (denying defendants' motion for judgment as a matter of law where downstream tippees allegedly traded on information concerning a planned tender offer); Steginsky v. Xcelera Inc., Nos. 13-cv-1327, 13-cv-1892 (2d Cir. Jan. 27, 2014) (reversing the trial court's dismissal of insider trading charges where defendants allegedly traded on information concerning a planned tender offer).

Explicitly rejecting the equal access or parity of information theory, the Supreme Court in *Dirks v. SEC*, overturned the SEC's sanctions against Dirks finding that a tippee's liability is derivative.⁵⁷ Dirks, an insurance company analyst, received information from a former officer of a company and began an independent investigation resulting in a finding that the company was engaging in large scale fraud.⁵⁸ After Dirks told his clients and potential clients about his findings, many sold their shares of the company. The Court rejected SEC's argument that when tippees come into knowledge of material information they know is confidential, they must publicly disclose it or abstain from trading.⁵⁹ Instead, in order for a tippee to be held liable for trading on material, nonpublic information, the tipper must have breached her duty "before the tippee inherits the duty to disclose or abstain."⁶⁰ As the *Dirks* Court explained, because there are many legitimate reasons why an insider might disclose material nonpublic information,⁶¹ the test for insider breach "is whether the insider personally will benefit, directly or indirectly, from his disclosure."⁶² According to *Dirks*, personal benefit may be satisfied in many ways, e.g., by proof of pecuniary benefits, reputational benefits that will promote future earnings, the benefit associated with "mak[ing] a gift of confidential information to a trading relative or friend," or even the mere existence of a relationship between the insider and tippee that suggests a *quid pro quo* arrangement;⁶³ and the federal courts have typically imposed little burden on prosecutors in

⁵⁷ *Dirks*, 463 U.S. at 647.

⁵⁸ *Id.* at 646.

⁵⁹ *Id.* at 647.

⁶⁰ *Id.*

⁶¹ In *Dirks*, for example, the insider-tipper was acting as a whistleblower and disclosed information to the defendant in order to expose an insurance scam occurring at his company.

⁶² *Id.* at 662.

⁶³ *Id.*

proving this element.⁶⁴ 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.⁶⁵

Hence, a tippee is not liable unless the use of the information breaches a fiduciary duty that she owed to either her clients or organization and the insider realized a personal benefit. The ruling thus endorsed Commissioner Smith's aforementioned opinion in *Investors Management*.⁶⁶

Following the ruling, the SEC attempted to distinguish the case of *SEC v. Stevens*⁶⁷ from *Dirks*. In *Stevens*, a CEO made a number of unsolicited calls to some securities analysts to tell them the soon-to-be announced quarterly results would be lower than expected.⁶⁸ The SEC argued that through his selective disclosure the CEO attempted to benefit from enhancing his reputation and managerial status.⁶⁹ Following a settlement in the case, the SEC adopted Regulation FD, which imposed a duty on public companies that disclose insider information to analysts or others in the industry to simultaneously disclose it publicly.⁷⁰

The courts and the SEC also do not agree on the interpretation of situations involving the tipping of family members by insiders. For example, in *United States v. Chestman*,⁷¹ a husband tipped a stockbroker based on information he had received from his wife, who had received it

⁶⁴ *Second Circuit Redefines "personal benefit" in Insider Trading Case*, LATHAM & WATKINS CLIENT ALERT COMMENTARY 1175, <http://www.lw.com/thoughtLeadership/lw-personal-benefit-decision-insider-trading> (2014); *see, e.g.*, *S.E.C. v. Yun*, 327 F.3d 1263, Fed. Sec. L. Rep. (CCH) ¶ 92408 (11th Cir. 2003) (finding sufficient evidence to support a "reputational" benefit where the tipper and tippee had worked together for several years and split commissions on various real estate deals, indicating that disclosure was made in order to strengthen a beneficial relationship); *S.E.C. v. Sargent*, 329 F.3d 34 (1st Cir. 2003) (finding evidence of personal benefit when the tipper allegedly passed on the information in order to "effect a reconciliation with his friend and to maintain a useful networking contact").

⁶⁵ *Dirks*, 463 U.S. at 647.

⁶⁶ Karmel, *supra* note 22, at 5. *See generally*, *Investors Mgmt. Co.*, 44 S.E.C. 633.

⁶⁷ *SEC v. Stevens*, 559 U.S. 460 (2010).

⁶⁸ Litigation Release No. 12813, 48 SEC Docket no. 9 at 739 (Mar. 19, 1991).

⁶⁹ *Id.*

⁷⁰ 17 C.F.R. § 243.100 (2014). Regulation FD cannot lead to private damages suits or criminal prosecution as it is not promulgated under Section 10(b) or 14 of the Securities Exchange Act. Regulation FD provides in pertinent part, that "[w]henver an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to [a broker, dealer, investment adviser, investment company, or holder of the issuer's securities], the issuer shall make public disclosure of that information: (1) [s]imultaneously, in the case of an intentional disclosure; and (2) [p]romptly, in the case of a non-intentional disclosure."

⁷¹ *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

through a line of family members, starting with a family member who was a corporate insider.⁷² The stockbroker was prosecuted in the matter, but the Second Circuit overturned the conviction under Section 10(b),⁷³ arguing that a family relationship is not a sufficient basis to establish the fiduciary relationship necessary based on *Chiarella*⁷⁴ and *Dirks*.⁷⁵ Following this holding, the SEC passed Rule 10b5-2, which establishes that “(3) whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child or sibling: provided however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information” he or she has a duty of trust and confidence under the misappropriation theory.⁷⁶

The causal connection between a trader’s possession of insider information and her trading is unclear in the case law, and the circuits currently disagree on its proper interpretation. For example, the Second Circuit held in *United States v. Teicher* that “knowing possession” is sufficient to establish insider trading liability.⁷⁷ Yet, in *SEC v. Adler*, the Eleventh Circuit found that “use” is required.⁷⁸ In *United States v. Smith*, the Ninth Circuit required a proof of “use” in a criminal case, since criminal intent cannot be based on a legal presumption.⁷⁹ The SEC again answered the question by passing Rule 10b5-1, which establishes that trading “on the basis” of insider information means the trader “was aware of” the information when the trade was made.⁸⁰

The next Supreme Court case to deal with insider trading was *United States v. O’Hagan*, in which the Court reinstated a criminal conviction under Rule 10b-5 and 14e-3 of a lawyer who

⁷² *Id.* at 555.

⁷³ He was convicted under Rule 14e-3, however. *Id.* at 571.

⁷⁴ *Chiarella*, 445 U.S. 222 (1980).

⁷⁵ *Dirks*, 947 F.2d at 568.

⁷⁶ 17 C.F.R. §240.10b5-2.

⁷⁷ *United States v. Teicher*, 987 F.2d 112, 119 (2d Cir. 1993).

⁷⁸ *SEC v. Adler*, 137 F.3d 1325, 1336 (11th Cir. 1998).

⁷⁹ *United States v. Smith*, 155 F.3d 1051, 1069 (9th Cir. 1998).

⁸⁰ 17 C.F.R. §240.10b5-1.

traded in the securities of a target company when the bidder was a client of the defendant's law firm.⁸¹ The holding further advanced the Court's agreement with the misappropriation theory and found that SEC can regulate non-deceptive activities "as a reasonably designed means of preventing manipulative acts" under § 14(e).⁸²

Following many victories for the SEC and the DOJ, both have prosecuted insider trading robustly. The SEC alone has prosecuted almost 600 defendants in civil insider trading cases over the past five years.⁸³

C. The Ambiguity of Defining "Material, Nonpublic" in the Case Law

There is no clear answer to what constitutes "material, nonpublic information" in the case law. In general, "material" information is information that fits into one or more of the following categories: (1) there is a *substantial likelihood* that a *reasonable investor* would consider the information as important in making his or her investment decisions,⁸⁴ (2) the disclosure of such information would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available,"⁸⁵ or (3) the disclosure of that information is "reasonably certain to have a substantial effect on the market price of the security."⁸⁶

The SEC defines information as "nonpublic" when investors "may not lawfully acquire [it] without the consent of the source," or when the information may be lawfully disseminated

⁸¹ United States v. O'Hagan, 521 U.S. 642, 647-48 (1997).

⁸² *Id.* at 666-673.

⁸³ Oversight of the SEC's Division of Enforcement: Testimony Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the H. Comm. On Capital Markets and Government Sponsored Enterprises (2015) (testimony of Andrew Ceresney, Director Division of Enforcement), available at http://www.sec.gov/news/testimony/031915-test.html#.VQ2lt_nF_Tq.

⁸⁴ Joint Market Practices Forum, Statements of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participation, ISDA (Oct. 2003).

⁸⁵ Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-448-49 (1976)).

⁸⁶ *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2nd Cir. 1980).

but has not been made available to investors generally.⁸⁷ According to the SEC, insiders must wait a “reasonable” amount of time after disclosure before trading. What constitutes a “reasonable” amount of time depends on the circumstances of the disclosure.⁸⁸

The courts, in contrast, have focused more on the “material” portion of the test. The basic test for materiality was established in *List v. Fashion Park, Inc.*,⁸⁹ in which the court held that the materiality of the information rests on “whether a reasonable man would attach importance [to the information] in determining his choice of action in the transaction in question.” This includes any information that “in reasonable and objective contemplation might affect the value of the corporation’s stock or securities.”⁹⁰ Material information also encompasses “those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company’s securities.”⁹¹

The determination of materiality is fact-specific; hence, depending on the circumstances, the same information may be material or non-material.⁹² In practice, certain factors seem to easily satisfy the materiality test. For example, the Chartered Financial Analyst (CFA) guidelines generally include the following information as material: dividend increase, decrease, or omission; quarterly earnings of sales considerably different from consensus; gain or loss of a major client; changes in management; important development within the industry; government reports of economic trends; large acquisition or divestiture; and when an offer is made to tender

⁸⁷ Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (Dec. 1979).

⁸⁸ Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51721, Release Nos. 33-7881, 34-43154, IC-24599 (Aug. 24, 2000)(adopting release for Regulation FD and Rules 10b5-1 and 10b5-2).

⁸⁹ *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2nd Cir. 1974).

⁹⁰ *Id.* at 462 (quoting *Kohler v. Kohler Co.*, 319 F.2d 634, 642, 7 A.L.3d 486 (7th Cir. 1963); *see also* *Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 731 (2nd Cir. 1987).

⁹¹ *Texas Gulf Sulphur Co.*, 401 F.2d at 849).

⁹² *Basic*, 485 U.S. at 236.

shares.⁹³ Courts often cite the market price impact of the information and the source of the information in support of a finding of materiality. A court is more likely to find the information material when the source of the information is reliable.⁹⁴

On numerous occasions, the courts have found that confidential information about tender offers can be material, nonpublic information. In *Chestman*, the Second Circuit Court stated “[o]ne violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired ‘directly or indirectly’ from an insider of the offeror or issuer, or someone working on their behalf.”⁹⁵ As discussed previously, in this case a husband tipped a stockbroker based on information that his wife received from her family members.⁹⁶ The court did not dispute that the husband’s statement to the broker that the corporation would be sold at a “substantially higher” price than its market value was material, nonpublic information.⁹⁷

In *SEC v. Maio*,⁹⁸ the Seventh Circuit found that an executive in the process of an acquisition was in possession of material, nonpublic information when he allegedly disclosed this information in a series of phone calls to his friend. The friend discussed this information with a third individual, who then bought and sold various securities prior to the acquisition being made public.⁹⁹ The Court held that Rule 14e-3 establishes a “duty to disclose material nonpublic information or abstain from trading in stocks implicated by an impending tender offer.”¹⁰⁰

⁹³ CFA Level I, Investopedia, available at <http://www.investopedia.com/exam-guide/cfa-level-1/ethics-standards/standard-nonpublic-information.asp>.

⁹⁴ *Id.*

⁹⁵ *Chestman*, 947 F.2d at 557.

⁹⁶ *Id.* at 555.

⁹⁷ *Id.*

⁹⁸ *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995)

⁹⁹ *Id.*

¹⁰⁰ *Id.*

In *O'Hagan*, discussed above, the Supreme Court held that a lawyer who had knowledge of a tender offer through his connection to the legal counsel of the corporation was in possession of material, nonpublic information.¹⁰¹ James O'Hagan was a partner in a law firm that was retained as local counsel to represent Grant Metropolitan PLC (Grant Met) in a potential tender offer for the common stock of the Pillsbury Company. O'Hagan did not do any work on the representation of the company and the firm withdrew from representing the company less than a month before the tender offer became public.

While the firm was still representing Grand Met, O'Hagan began to purchase call options of Pillsbury stock giving him rights to purchase additional shares. By the time the tender offer became public, he had owned 2,500 unexpired options, more than any other individual investor.¹⁰² When the tender offer became public and the stock prices shot up, O'Hagan sold his call options and common stock, with a profit of more than \$4.3 million.¹⁰³

The SEC began an investigation into these transactions alleging that O'Hagan defrauded his law firm and its client, Grand Met, when using material, nonpublic information about the planned tender offer for personal trading purposes.¹⁰⁴ A jury convicted O'Hagan on all 57 counts, but a divided panel of the Eighth Circuit reversed these convictions.¹⁰⁵

The Supreme Court reversed the ruling of the Court of Appeals and held that under Rule 14e-3(a) trading based on material, nonpublic information “that concerns a tender offer and that the person knows or should know has been acquired from an insider of the offeror or issuer, or

¹⁰¹ *O'Hagan*, 521 U.S. at 645.

¹⁰² *Id.* at 647

¹⁰³ *Id.* at. 648.

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 649.

someone working on their behalf, unless within a reasonable time before any purchase or sale such information and its source are publicly disclosed” is unlawful.¹⁰⁶

In *Chiarella*,¹⁰⁷ also previously discussed, the Supreme Court held that an employee of financial printer that printed takeover bids was in possession of material, nonpublic information when he deduced the names of the target companies (based on the information contained in documents delivered to the printer) and purchased stock in the target companies. In this case, however, the individual did not have a duty to disclose because he had no fiduciary duties to or specific relationships with the shareholders in the corporation.¹⁰⁸

Knowledge of confidential facts that could have a significant impact on the price of the company’s stock can also constitute material, nonpublic information. In *Texas Gulf Sulphur Co.*,¹⁰⁹ the defendants had knowledge of confidential information regarding the results of TGS drilling in Timmins, Ontario when such information was not publicly available, and a few defendants disclosed this information to others for use.¹¹⁰ The court disagreed with the trial judge and found that the knowledge of the discovery hole would have been important to a reasonable investor and could have affected the price of stock; therefore, it was material information. Furthermore, the Court stated that an important factor in determining whether this information was material was “the importance attached to the drilling results by those who knew about it.”¹¹¹

Similarly, in *SEC v. Adler*, the Eleventh Circuit held that an executive and board member of a company was in possession of material, nonpublic information when he was told at a board meeting that the company would be receiving fewer orders from one of its largest customers.¹¹²

¹⁰⁶ *Id.* at 645.

¹⁰⁷ *Chiarella*, 445 U.S. at 222.

¹⁰⁸ *Id.*

¹⁰⁹ *Texas Gulf Sulphur Co.*, 401 F.2d at 848.

¹¹⁰ *Id.* at 840.

¹¹¹ *Id.* at 851.

¹¹² *Adler*, 137 F.3d at 1328.

In addition, the Second Circuit held in *Teicher*¹¹³ that the defendant, a principal of a securities firm, possessed material, nonpublic information when he received the names of the companies on the Drexel “phantom list.” The list contained the names of companies Drexel would not be able to trade in because the firm was working on transactions involving these companies.¹¹⁴

The information can be ‘soft’ and still be found material. The Ninth Circuit Court of Appeals found that “‘soft,’ forward-looking information may be material in the meaning of Rule 10b-5” in *United States v. Smith*.¹¹⁵ In this case, the court held that “forecasts of future sales and revenue” may be understood as “soft” information, but can still be material under specific circumstances.¹¹⁶

Information about fraudulent corporate practices can also be material information. In *Dirks*,¹¹⁷ the officer of the New York broker-dealer firm that received information from a former officer of a corporation that the corporation had overstated its assets due to fraudulent corporate practices.¹¹⁸ He urged Dirks to verify the alleged fraud and to disclose it publicly. Dirks began an investigation and discussed his findings with investors and clients, which resulted in a number of large investment advisers to liquidating their holdings of more than \$16 million in the company’s stock. As a result, the corporation’s stock fell dramatically. The Court found that the information of fraud shared by Dirks was material, nonpublic information.¹¹⁹

D. Tippee Derivative Liability, “Personal Benefit” and Newman

As discussed above, the Court in *Dirks* rejected the view (of the SEC) that a tippee has a duty to abstain from trading simply because he has received material, nonpublic information

¹¹³ *Teicher*, 987 F.2d at 119.

¹¹⁴ *Id.* at 115-16.

¹¹⁵ *Smith*, 155 F.3d at 1069.

¹¹⁶ *Id.* at 1064.

¹¹⁷ *Dirks*, 463 U.S. at 646.

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 649.

from an insider.¹²⁰ Moreover, because the antifraud provisions of Section 10(b) and Rule 10b-5 require *scienter*,¹²¹ in order for tippee liability to exist, a tippee must also know or have reason to know that the tipper has disclosed in breach of a duty of confidence.¹²² Negligent disclosure of information, however, is not sufficient.¹²³ Whether recklessness is sufficient remains open to debate; the circuits are split on this question and the Supreme Court has yet to address it.¹²⁴

The federal courts also remain divided as to whether (and the extent to which) a tippee-violator must be aware of a personal benefit received by the tipper. As noted above, some courts are content to infer that a tippee was complicit in the tipper's breach simply on the basis of a preexisting relationship between the two. Others, however, like the Second Circuit in *Newman*, appear to require much more.¹²⁵

In December of 2012, Newman and Chiasson were found guilty of committing securities fraud in violation of sections 10(b) and 32 of the Securities Exchange Act and SEC Rules 10b-5 and 10b5-2, as well as of conspiring to commit securities fraud under 18 U.S.C. § 371.¹²⁶ Todd Newman and Anthony Chiasson who were convicted of insider trading in December 2012 for trading on material, nonpublic information received third and fourth hand from an insider at Dell and NVIDIA. Newman and Chiasson argued that neither knew the identity of the original source

¹²⁰ *Id.* at 646.

¹²¹ Liability for securities fraud requires proof of *scienter*, defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1991).

¹²² *Dirks*, 463 U.S. at 646.

¹²³ *Id.*

¹²⁴ *See Obus*, 693 F.3d at 286 ("[w]hile the Supreme Court has yet to decide whether recklessness satisfies section 10(b)'s *scienter* requirement . . . we have held that *scienter* "may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care").

¹²⁵ *See Newman* 773 F.3d at 450 (requiring proof beyond a reasonable doubt that "(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit").

¹²⁶ *See Newman* 773 F.3d at 442. 18 U.S.C. § 371 is the conspiracy statute.

of information, nor that this source violated a duty of confidentiality or received a personal benefit.¹²⁷

On appeal to the Second Circuit, Newman and Chiasson argued that the district court erred in failing to instruct the jury that it must find that a tippee knew the insider had disclosed inside information in exchange for a personal benefit.¹²⁸ Because there was no evidence that Newman or Chiasson possessed such knowledge, the defendants argued, the government had failed to establish tippee liability under *Dirks*.¹²⁹ In response, the government claimed that *Dirks* only required that the “tippee know that the tipper disclosed information in *breach of a duty*,” not a requirement that the tippee also know that the insider received a personal benefit in exchange for information.¹³⁰

The government further contended that the defendants were “sophisticated traders,” and therefore, should have known that such information was disclosed by insiders in breach of a fiduciary duty and not for a legitimate business purpose.¹³¹ The district court agreed with this assessment and instructed the jury that the government had to only prove that the defendants “must have known that [the insider information] was originally disclosed by the insider in violation of a duty of confidentiality.”¹³² After being convicted by the jury on all counts, both defendants appealed the decision on the grounds that the government needed to prove that they had the knowledge of the personal benefit provided to the tippers under *Dirks*. They further claimed that there was insufficient evidence to prove the tippers received a personal benefit in exchange for the disclosed information.

¹²⁷ *Id.* at 444.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 447.

¹³¹ *Id.* at 443-44.

¹³² *Id.* at 444.

In December, 2014, the Second Circuit Court of Appeals found that, under *Dirks*, it was necessary for the government to prove that the tippees knew the breach of duty was for a personal benefit. The court reached this conclusion as follows: a tippee's liability is derivative;¹³³ therefore, a tippee cannot be held liable unless use of the information breaches a fiduciary duty owed by the tipper to his clients or organization and, the insider must have realized a personal benefit.¹³⁴ The court further interpreted the language in *Dirks* as requiring the tippee to know about the personal benefit to be liable.¹³⁵ As the court explained, "insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries."¹³⁶ Hence, the test established in *Newman* necessitates a showing of proof beyond a reasonable doubt that:

(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee; (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.¹³⁷

The court also held that the benefit must be objective, consequential, and represent a potential gain of a pecuniary or similarly valuable nature, hence, a mere friendship was insufficient to constitute personal benefit.¹³⁸

The 2014 decision vacated the convictions and ordered the district court to dismiss the indictment with prejudice because it found insufficient evidence to support a pecuniary benefit. The Court of Appeals found that the district court incorrectly instructed the jury regarding the government's need to prove that the defendants were aware of a personal benefit and the government failed to establish that the defendants willfully engaged in insider trading.

¹³³ *Id.* at 450.

¹³⁴ *Dirks*, 463 U.S. at 647.

¹³⁵ *Newman*, 773 F.3d at 450.

¹³⁶ *Id.* at 449.

¹³⁷ *Id.* at 450.

¹³⁸ *Id.* at 452-53.

The *Newman* court found that a “tippee’s liability derives *only* from the tipper’s breach of a fiduciary duty, *not* from trading on material, nonpublic information”:¹³⁹ “in both *Chiarella* and *Dirks*, the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries.”¹⁴⁰ The court further noted that the “Supreme Court rejected the SEC’s theory that a recipient of confidential information (*i.e.* the tippee) must refrain from trading whenever he received inside information from an insider.”¹⁴¹

The *Newman* court pointed out that, according to *Dirks*, there can be no insider breach of fiduciary duty unless the insider receives a personal benefit “in exchange for disclosure.”¹⁴² Hence, the Second Circuit concluded that, even if a tipper has breached his or her fiduciary duty, a tippee is liable only if he or she knows or should have known of the personal benefit.¹⁴³ According to the court, tippee knowledge of a breach of the duty of confidentiality, without tippee knowledge of tipper personal benefit, is insufficient to impose criminal liability.¹⁴⁴

E. The Limits of Newman

Newman leaves a large gap in its interpretation for potential inside traders to escape liability. The *Newman* decision reaffirmed the personal benefit requirement for insider trading convictions and illuminated the high evidentiary burden necessary for downstream tippees.¹⁴⁵ Prior to the holding in *Newman*, the government had worked to limit the *Dirks* benefit test. For example, it found the test to be satisfied when the tip was made in exchange for “maintaining a useful networking contact,”¹⁴⁶ or when it simply entailed “making a gift of information to a

¹³⁹ *Id.* at 447.

¹⁴⁰ *Id.* at 449.

¹⁴¹ *Id.* at 446.

¹⁴² *Id.*

¹⁴³ *Id.* at 449.

¹⁴⁴ *See id.* at 450.

¹⁴⁵ *United States v. Newman: Second Circuit Ruling Portends Choppier Waters for Insider Trading Charges Against Downstream Tippees*, Gibson Dunn, Publications (Dec. 15, 2014), available at aspx [hereafter “Gibson Dunn”].

¹⁴⁶ *United States v. Whitman*, 904 F. Supp. 2d 363, 372 n.7 (S.D.N.Y. 2012)

friend.”¹⁴⁷ The *Newman* decision makes it more difficult for the government to win in cases where evidence of a pecuniary benefit is not easy to prove. Reputational benefits, for example, may not be sufficient to prove insider trading.

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

1. The nature of tippee/tipper relations

The *Newman* court held that the government had presented insufficient evidence of “personal benefit,” in part, because insider tippers, Ray and Choi, “were not ‘close’ friends” and “were merely casual acquaintances” with the first level tippees, Sandy Goyal and Hyung Lim.¹⁴⁸ The court, for instance, found the evidence that Goyal advised Ray on a variety of career decisions and edited Ray’s resume insufficient to show the two had the kind of strong relationship that would have supported an inference of a *quid pro quo* arrangement.¹⁴⁹ Nevertheless, the court apparently entertained the idea that such a showing could be made with different evidence. Hence, personal benefit can still—and indeed should under *Dirks*—be inferred where a preexisting relationship between tippee and tipper is sufficiently strong. And there is no reason why the same evidence, which would support a jury inference beyond a reasonable doubt

¹⁴⁷ *Obus*, 693 F.3d at 291.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

would not also be sufficient to establish that a tippee knew or should have known the tipper disclosed information in order to gain a personal benefit.

The court establishes that one must have knowledge of the personal benefit to the tipper and know that the trading is based on material, nonpublic information. Thereby, the ruling “raises the bar” for the remote-tippee prosecutions.¹⁵⁰ Still, the holding does not clarify whether the showing of the remote tippee consciously avoiding learning of the personal benefit would meet the standard. Therefore, the *Newman* standard may lead to more illicit insider trading behavior aimed at escaping liability.

2. Legitimate reasons for breach

Similarly, the *Newman* court also discusses how the investor relations departments at NVIDIA and Dell had a habit of disclosing material, nonpublic earnings data in advance of quarterly earnings.¹⁵¹ Because insiders at these companies engaged in this practice for the good of the company, the court found it unreasonable to infer that the circumstances under which Newman and Chiasson received their tips were enough to support an inference beyond a reasonable doubt that the original insider had disclosed in breach of her fiduciary duty.¹⁵² But in the absence of these special circumstances, such an inference might very well have been warranted. And, were this the case, the same evidence used to support a jury inference of tipper personal benefit may also support a jury inference that the tippee knew or should have known of the personal benefit.

3. What Newman changes

In *Newman*, the Second Circuit raises the bar significantly regarding the kind of relationship that will support an inference of a *quid pro quo* arrangement. In the Second Circuit,

¹⁵⁰ Gibson Dunn, *supra* note 152.

¹⁵¹ *See id.*; *Newman*, 773 F.3d at 454-55

¹⁵² Gibson Dunn, *supra* note 152.

the government will need to provide “proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”¹⁵³ Examples that meet the new standard include tangible gifts, access to an investment club where stock tips and insight are routinely discussed, close working relationship on real estate deals in which parties commonly split commissions on transactions, and business referral relationships, such as dental work.¹⁵⁴ In many other federal courts, the kinds of relationships evidenced in *Newman* might well have sufficed.¹⁵⁵

F. The Purpose of the Dirks Requirement

The *Newman* court’s rigid adherence to the personal benefit requirement as a necessary element of breach may overlook the reasons behind the requirement articulated in *Dirks*. As noted above, the Court in *Dirks* presented the personal benefit requirement as a test that would allow the judiciary to overcome a particular problem. Because there are legitimate (reasonable doubt-creating) reasons for insider disclosure of material, nonpublic information—e.g., stimulating the interest of potential new financiers/stock purchasers or, as in *Dirks*, whistleblower tipping—the fact of disclosure alone is not enough to establish breach. For this reason, the Court introduced the personal benefit requirement as a proxy for assaying disclosure (il)legitimacy. Where a personal benefit exists, disclosure is presumptively illegitimate, and thus deceptive under Section 10(b) and Rule 10b-5. Where there is no personal benefit, the disclosure must have

¹⁵³ *Newman*, 773 F.3d at 452.

¹⁵⁴ *Id.*

¹⁵⁵ See, e.g., *S.E.C. v. Ingram*, 694 F. Supp. 1437, Fed. Sec. L. Rep. (CCH) ¶93788 (C.D. Cal. 1988) (discussing how intent to personally benefit can, in the absence of another reasonable explanation, be inferred based on a strong showing of the materiality of the information); *SEC v. Blackwell*, 291 F. Supp.2d 673 (S.D. Ohio 2003) (citing *S.E.C. v. Blackman*, 2000 WL 868770 (M.D. Tenn. 2000)) (“A mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement.”).

been made (a) in the interest of the principal or (b) negligently—neither of which satisfies the Section 10(b) and Rule 10b-5’s *scienter* requirement.¹⁵⁶

This being the case, if the government can adduce compelling evidence that the insider-tipper tipped knowingly (not accidentally) *and* that there is no reasonable explanation as to how tipping might promote the best interests of the principal, it seems unnecessary to insist upon evidence of a specific personal benefit. Rather, it would be logical under these circumstances to allow a jury to draw the inference that disclosure must have been made for personal benefit. This analysis would be particularly well-supported by *Dirks*, which allows similar inferences to be drawn on the basis of pre-tipping tipper/tippee relationships and which includes the benefit of making a gift of insider information to a trading friend or relative as a “personal benefit.”¹⁵⁷ If a tippee knows the insider is not tipping negligently, and she knows there is no reason to think the tipper’s disclosure will benefit the principal, then a jury should be permitted to draw the same inference about the tippee—i.e., that she knew or should have known that the tipper was disclosing information in exchange for a personal benefit (either to benefit herself or to benefit a friend or relative).¹⁵⁸

For example, consider the case where a major stockholder tips investment analysts in order to spur favorable reports by the analysts, and to thus exert an upward influence on the price of his stock.¹⁵⁹ In this situation, if the tippee knows there is no reason to think that the disclosure is in the best interest of the principal, he knows what he is doing is wrong, just not precisely how it is wrong. This wrongdoer should not escape justice simply because of his perplexity as to how the insider expects to benefit from disclosure.

¹⁵⁶ 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5.

¹⁵⁷ *Dirks*, 463 U.S. at 647.

¹⁵⁸ See *Ingram*, 694 F. Supp. at 1437; *Blackwell*, 291 F. Supp. 2d at 673.

¹⁵⁹ <http://www.sec.gov/investor/pubs/analysts.htm>.

G. Reform Proposals

As a pushback against the 2014 *Newman* decision, there are now bills pending in Congress to define insider trading. The House proposal would amend Section 10 of the Securities Exchange Act to outlaw the purchasing or selling of “any security, or any securities-based swap agreement, based on information that the person knows or, considering factors including financial sophistication, knowledge of and experience in financial matters, position in a company, and amount of assets under management, should know is material information or inside information.”¹⁶⁰ The proposed legislation defines inside information as nonpublic, and obtained illegally, “directly or indirectly from an issue with an expectation of confidentiality or that such information will only be used for a legitimate business purpose or in violation of a fiduciary duty.”¹⁶¹

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

(A) ...purchase, sell or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available, (B) To knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of subparagraph (A).¹⁶²

The bill does not include “information that the person has independently developed from publicly available resources” under the “not publicly available” category.¹⁶³

III. The Paradox: Penalties for the Undefined Insider Trading Offense

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

¹⁶⁰ Ban Insider Trading Act, H.R. 1173, 114th Cong. § 2(a) (2015).

¹⁶¹ H.R. 1173 § 2(a)(3)(A)(i-ii).

¹⁶² Stop Illegal Insider Trading Act, S. 702, 114th Cong. §2 (d)(1)(A)(2015).

¹⁶³ S.702 § 2(2).

A. Civil Penalties

Prior to 1984, federal legislation did not impose civil penalties on insider trading. The SEC had to rely on federal court injunctions against future violations, as well as disgorgements of profits, to enforce securities fraud prohibitions.¹⁶⁴ Although insider trading is not statutorily defined, in 1984, Congress enacted the ITSA¹⁶⁵ to remedy the “inadequate deterrent provided by enforcement remedies for insider trading,” noting that neither injunctions nor disgorgement sufficiently penalized defendants for insider trading.¹⁶⁶ The ITSA amended Section 21 of the Securities Exchange Act to include, in relevant part, that the SEC:

may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty . . . [the amount of which] shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States.¹⁶⁷

Among the numerous changes implemented by ITSFEA,¹⁶⁸ was expansion of the scope of civil penalties on insider trading to “controlling” persons—those “who, at the time of the violation, directly or indirectly controlled the person who committed such violation.”¹⁶⁹ Civil penalties for a controlling person are limited to the greater of \$1,000,000 or treble damages.¹⁷⁰ If the “controlled person's violation was a violation by communication, the [damages] . . . [are] deemed to be limited to the profit gained or loss avoided by the person[s] to whom the controlled person directed such communication.”¹⁷¹

¹⁶⁴ See Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 983-84 (1985).

¹⁶⁵ Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264.

¹⁶⁶ See SEC v. Downe, 969 F. Supp. 149, 159 (S.D.N.Y. 1997) (quoting H.R. Rep. No.98-355, at 7-8 (1983), reprinted in 1984 U.S.C.C.A.N. 2274, 2280-81).

¹⁶⁷ Pub. L. No. 98-376, 98 Stat. 1264.

¹⁶⁸ Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100- 704, 102 Stat. 4677.

¹⁶⁹ Pub. L. No. 100-704, 102 Stat. 4677.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

Empirical evidence provided by Professor Seyhun shows that neither ITSA nor ITSFEA was effective in reducing either the volume or profitability of insider trading.¹⁷² In fact, following these legislative changes, the volume of insider trading increased four-fold, while abnormal profitability of insider trading doubled.¹⁷³ Insiders did not reduce their trading even on a temporary basis in response to these legislative initiatives.¹⁷⁴ Seyhun concludes that among the possible reasons for the ineffectiveness of the increased sanctions are the highly stringent requirements for the legally material information.¹⁷⁵

The Securities Act and the Exchange Act also provide for civil penalties in other securities fraud contexts. Section 20(d)(1) of the Securities Act and Section 21(d)(3) of the Exchange Act permit the SEC to impose monetary penalties against persons who violate the Securities Act and the Exchange Act, respectively, “other than by committing a violation subject to a penalty pursuant to [section 21A of the Exchange Act].”¹⁷⁶ Both Section 20(d)(1) of the Securities Act and 21(d)(3) of the Exchange Act provide three-tier penalty systems, where the maximum penalty increases with the severity of the violation.¹⁷⁷ The Second Circuit Court of Appeals recently held that Section 21(a) of the Exchange Act is the only basis for ordering civil penalties in insider trading cases brought in federal court.¹⁷⁸ The court, however, did not have cause to address the expanded scope of the Commission’s powers under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”).¹⁷⁹

The Dodd-Frank Act significantly enhanced the SEC’s enforcement powers by 1) granting the SEC the ability to obtain monetary penalties in administrative proceedings against

¹⁷² See H. Nejat Seyhun, *The Effectiveness of Insider Trading Sanctions*, J. LAW & ECON. 35, 149-182 (1992).

¹⁷³ *Id.* at 150.

¹⁷⁴ *Id.* at 169.

¹⁷⁵ *Id.* at 177.

¹⁷⁶ 15 U.S.C. §§ 77t(d)(1), 78u(a)(3)(A).

¹⁷⁷ 15 U.S.C. §§ 77t(d)(2), 78u(a)(3)(B).

¹⁷⁸ *SEC v. Rosenthal*, No. 10-CV-01204, 2011 BL 152965 (2d Cir. June 9, 2011).

¹⁷⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, 124 Stat. 1376 (2010).

all individuals, not just those associated with regulated entities, and 2) increasing the civil penalties that the SEC can seek in administrative cases.¹⁸⁰ Section 21B as amended states, in part:

In any proceeding instituted pursuant to sections 15(b)(4), 15(b)(6), 15D, 15B, 15C, 15E, or 17A of this title against any person, the [SEC] or the appropriate regulatory agency may impose a civil penalty if it finds . . . that such penalty is in the public interest and that such person—

(A) has willfully violated any provision of the Securities Act of 1933, the Investment Company Act of 1940, the Investment Advisers Act of 1940, or this title, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

(C) has willfully made or caused to be made in any application for registration or report required to be filed with . . . any . . . appropriate regulatory agency under this title, or in any proceeding before the [SEC] with respect to registration, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or (D) has failed reasonably to supervise, within the meaning of section 15(b)(4)(E) of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision.¹⁸¹

Section 21(b) contains civil penalty provisions applicable in administrative proceedings similar to those in Section 21(d)(3) for judicial proceedings, except notably, 21B does not contain the “21(a)” exemption found in Section 21(d)(3).¹⁸² The three-tier penalty structure under Section 21(b) also imposes the same maximum penalties as the penalty structure of Section 21(d)(3).¹⁸³ While the applicability of Section 21B to insider trading is still the subject of debate,¹⁸⁴ the SEC

¹⁸⁰ *Id.* at § 929P(a) (2010) (codified at 15 U.S.C. § 78u–2).

¹⁸¹ *Id.*

¹⁸² *See id.*

¹⁸³ *See id.*; 15 U.S.C. § 78u(a)(3)(b).

¹⁸⁴ Larry P. Ellsworth, *SEC Overreaching In Applying Penalty Act to Insider Trading*, BLOOMBERG, https://jenner.com/system/assets/publications/39/original/SEC_Overreaching_In_Applying_Penalty_Act_to_Insider_Trading.pdf?1319655869 (2011).

has continued using this section to impose civil penalties for insider trading in their administrative forum.¹⁸⁵

Additionally, Section 753 of the Dodd-Frank Act expanded the “anti-manipulation” authority of the Commodity Futures Trading Commission (“CFTC”) by amending Section 6 of the Commodity Exchange Act.¹⁸⁶ The amended Section 6(c)(1) is closely modeled after Section 10(b) of the Securities Exchange Act, and CFTC Regulation 180.1, promulgated in accordance with Section 6(c)(1), is the functional analog of Rule 10b-5.¹⁸⁷ However, the CFTC has recognized that unlike securities markets, “derivatives markets have long operated in a way that allows for market participants to trade on the basis of lawfully-obtained, material nonpublic information,”¹⁸⁸ and therefore has limited the scope of CFTC Regulation 180.1 with regard to insider trading. CFTC Regulation 180.1 only prohibits trading based on misappropriated information obtained or used in breach of a pre-existing duty.¹⁸⁹ Furthermore, the Commission has noted that CFTC Regulation 180.1 does not create an affirmative duty of disclosure (except such disclosure that may be required “as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect”).¹⁹⁰ The CFTC may assess in any case of manipulation or attempted manipulation a civil penalty of not more than \$1 million or triple the monetary gain to the person for each violation.¹⁹¹

B. Criminal Penalties

¹⁸⁵ See, e.g., *In the Matter of Michael S. Geist*, Adm. Proc. File No. 3-16269 (Nov. 12, 2014).

¹⁸⁶ Pub. L. No. 111-203, § 753 (2010) (codified at 7 U.S.C. § 9, 15).

¹⁸⁷ See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41403 (July 14, 2011).

¹⁸⁸ *Id.*

¹⁸⁹ “Depending on the facts and circumstances, a person who engages in deceptive or manipulative conduct in connection with any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity, for example by trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), or by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of final Rule 180.1.” *Id.*

¹⁹⁰ 7 U.S.C. § 9(1) (2010).

¹⁹¹ *Id.* § 9(10)(C)(ii) (2010).

Most criminal prosecutions for violations of the federal securities laws, including the insider trading provisions, are brought under Section 24 of the Securities Act and Section 32(a) of the Exchange Act.¹⁹² Other bases for criminal liability in the insider trading context include the federal mail and wire fraud statutes,¹⁹³ as well as the federal criminal offense of securities fraud (enacted as part of SOX).¹⁹⁴ Section 24 of the Securities Act¹⁹⁵ and Section 32(a) of the Exchange Act¹⁹⁶ generally authorize criminal prosecutions for “willful violations” of provisions, rules, or regulations under the respective acts. In the insider trading context, the most common bases for criminal liability are violations of Section 10(b) of the Exchange Act and Rule 10b-5, although Rule 14e-3 and Section 17(a) of the Securities Act are also frequently used.¹⁹⁷

Section 24 of the Exchange Act provides that “any person who willfully” (1) violates any of the provisions or related rules and regulations of the Act or (2) provides materially false or misleading information on a registration statement under the Act, is subject to a maximum fine of \$10,000, a maximum prison term of five years, or both.¹⁹⁸ Section 32(a) of the Exchange Act provides that any natural person who willfully violates any provision of the Act, other than Section 30,¹⁹⁹ may be subject to a maximum penalty of \$5,000,000, a maximum prison term of 20 years, or both.²⁰⁰ A corporation may be subject to a fine not exceeding \$25,000,000.²⁰¹

One of the primary contributions that SOX made to the insider trading statutory scheme was the new criminal securities fraud offense.²⁰² Among other things, the provision makes it

¹⁹² See WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 7.2.1 (3rd. ed. 2010).

¹⁹³ See generally 18 U.S.C. §§ 1341-51 (2012).

¹⁹⁴ 18 U.S.C. § 1348 (2012).

¹⁹⁵ 15 U.S.C. § 77x (2012).

¹⁹⁶ *Id.* at § 78ff(a).

¹⁹⁷ Karmel, *supra* note 22, at 2-7.

¹⁹⁸ 15 U.S.C. § 77x.

¹⁹⁹ Section 30 of the Exchange Act, codified as 15 U.S.C. § 78dd-I, contains anti-bribery provisions.

²⁰⁰ 15 U.S.C. § 78ff(a) (2012).

²⁰¹ *Id.*

²⁰² Pub. L. No. 107-204, § 807 (2002) (codified at 18 U.S.C. § 1348).

unlawful to execute or attempt to execute a scheme or artifice to defraud a person in connection with any security.²⁰³ The statute provides for a fine, a term of imprisonment of not more than 25 years, or both.²⁰⁴ In 2009, the provision was amended by the Fraud Enforcement and Recovery Act of 2009 to extend the criminal penalties to commodities fraud.²⁰⁵

The DOJ has often relied on the federal mail and wire fraud statutes in criminal prosecutions by alleging Rule 10b-5 violations, including insider trading cases.²⁰⁶ The federal mail and wire fraud statutes prohibit the use of mail or wire, radio, or television communications “for the purpose of executing any scheme or artifice to defraud.”²⁰⁷ Although these statutes may lack teeth in most securities fraud prosecutions, in insider trading cases, the wire and mail fraud statutes may enable prosecutors to reach conduct outside of the scope of Section 10(b).²⁰⁸ For example, under a wire or mail fraud theory, a crime is complete once a company is defrauded of its confidential information regardless of whether the information is used by anyone for purposes of trading. Also, the “materiality” required for wire and mail fraud may be easier to meet than that of securities fraud.²⁰⁹ Wire and mail fraud carry the same statutory penalties as a violation of

²⁰³ 18 U.S.C. § 1348 (2009).

²⁰⁴ *Id.*

²⁰⁵ See The Fraud Enforcement and Recovery Act of 2009, Pub. L. 111–21, 123 Stat. 1617, § 2(e)(1)(A)-(C) (2009) (inserting “and commodities” before “fraud” in section catch line, and “any commodity for future delivery, or any option on a commodity for future delivery, or” before “any security”).

²⁰⁶ Peter J. Henning, *Insider Trading Case Could Push Congress to Define a Murky World*, N.Y. TIMES, Feb. 23, 2015, http://www.nytimes.com/2015/02/24/business/dealbook/insider-trading-case-could-push-congress-to-define-a-murky-world.html?_r=0.

²⁰⁷ See 18 U.S.C. §§ 1341, 1343 (2008).

²⁰⁸ See *U.S. v. Autuori*, 1998 WL 774232, at *22, n. 9 (D. Conn. Aug. 28, 1998), *aff’d in part, rev’d in part* by U.S. v. Autuori, 212 F.3d 105 (2d Cir. 2000).

²⁰⁹ *Compare Basic*, 485 U.S. at 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) (information is material in the federal securities law context if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”) *with Autuori*, 1998 WL 774232, at *22 (information is material under the mail fraud statute when it “would be important to a reasonable person in deciding whether to engage in a particular transaction or to engage in certain conduct”).

Section 10(b) (with a few exceptions – notably if “the violation affects a financial institution”).²¹⁰

Although federal judges have the right to impose any sentence for insider trading convictions, they are required to keep in mind the criminal sentencing guidelines. In the Dodd-Frank Act, Congress issued directives to the U.S Sentencing Commission to “review and, if appropriate, amend” various sentencing guidelines and policy statements applicable to fraud offenses.²¹¹ The Sentencing Commission promulgated amendments to the federal sentencing guidelines for securities fraud, which took effect in 2012.²¹²

First, the Sentencing Commission adopted a new minimum offense level of 14 (which equates to a recommended prison range of 15-21 months for defendants with no criminal record)²¹³ for any “organized scheme to engage in insider trading.”²¹⁴ The commentary lists factors that courts may consider in determining whether an insider trading scheme is “organized”—whether it involved “considered, calculated, systemic, or repeated efforts to . . . trade on insider information, as distinguished from . . . opportunistic instances of insider trading.”²¹⁵ For cases where there is minimal gain from insider trading, this will mean an automatic increase of six offense levels for all participants in the offense.²¹⁶ As the profitability

²¹⁰ Both the wire and mail fraud statutes provide that “[i]f the violation affects a financial institution, such person shall be fined not more than \$1,000,000 or imprisoned not more than 30 years, or both.” 18 U.S.C. §§ 1341, 1343. The mail fraud statute also provides for this increased penalty if the violation involves “a Presidential declared major disaster or emergency.” 18 U.S.C. §§ 1341.

²¹¹ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

²¹² See Sentencing Guidelines For United States Courts, 77 Fed. Reg. 28225 (May 11, 2011), available at http://www.ussc.gov/sites/default/files/pdf/amendment-process/federal-register-notices/20120511_FR_Sub_to_Congress_Amendments.pdf.

²¹³ U.S. SENTENCING GUIDELINES MANUAL, ch. 5, pt. A (2014).

²¹⁴ *Id.* at § 2B1.4.

²¹⁵ See *id.* cmt. n.1.

²¹⁶ An offense level of 8, for criminals with 0 or 1 criminal history points under the Sentencing Guidelines chart, equates to a recommended prison term of 0-6 months.

of a scheme increases, however, the effect of this new provision diminishes, disappearing entirely when the overall gain from the scheme reaches \$30,000.²¹⁷

The amendments to the insider trading guideline also broadened the applicability of the "abuse of trust" enhancement. Previously, defendants received increased punishment under the guidelines if their abuse of a position of public or private trust significantly facilitated the crime; this provision was not triggered unless the defendant's position was characterized by "substantial discretionary judgment that is ordinarily given considerable deference."²¹⁸ The amendment loosened that requirement, specifying that the enhancement applies if "the position of public or private trust . . . contributed in some significant way to facilitating the commission or concealment of the offense."²¹⁹

The Sentencing Commission also added a special rule for determining loss in cases involving fraudulent inflation or deflation in the value of publicly traded securities or commodities.²²⁰ The amended commentary directs use of what has become known as the "modified rescissory method" for determining actual loss.²²¹ The commentary also directs the court to presume that the modified rescissory method has accurately calculated the actual loss, but a party may rebut that presumption and persuade the court that it is not a "reasonable estimate of the actual loss."²²² The court may consider, among other factors, the extent to which the amount so determined includes significant changes in value not resulting from the offense (e.g., changes caused by external market forces, such as changed economic circumstances,

²¹⁷ Both the pre-2012 amendment and post-2012 amendment guidelines recommend a base offense level of 8 for insider trading.

²¹⁸ U.S. SENTENCING GUIDELINES MANUAL, § 3B1.3 cmt. n.1 (2010).

²¹⁹ U.S. SENTENCING GUIDELINES MANUAL, § 3B1.3 cmt. n.1 (2014).

²²⁰ *Id.* § 2B1.1 cmt. n.3(F)(ix).

²²¹ First, calculate the difference between (i) the average share price during the fraud period; and (ii) the average share price during the 90-day period after the fraud was disclosed to the market. Second, multiply the difference by the number of shares outstanding. *See id.*

²²² *Id.*

changed investor expectations, and new industry-specific or firm-specific facts, conditions, or events).²²³

Finally, the Sentencing Commission expanded the provisions in the fraud guideline that govern when a judge may depart above or below the recommended guideline range.²²⁴ First, the Commission noted that an upward departure may be warranted if the offense created a risk of substantial loss beyond the loss determined under the guideline, “such as a risk of a significant disruption of a national financial market.”²²⁵ Second, the Commission provided new guidance on downward departures, adding the example of a securities fraud where fraudulent misrepresentations inflate the price of a stock in a manner that produces “an aggregate loss amount that is substantial but diffuse, with relatively small loss amounts suffered by a relatively large number of victims.”²²⁶

III. Our Proposal: A New Evidentiary Standard

Many scholars²²⁷ agree that a clear statutory definition of illegal insider trading should be established, arguing that it is preferable to further judicial interpretation.²²⁸ Our proposal for reform follows below.

A. Requirements

We propose that the government be allowed to establish a prima facie case of illegal insider trading on the basis of material, nonpublic information when it can prove the following three elements: (1) the information giving rise to the trade is of the type that requires an 8-K

²²³ *Id.*

²²⁴ *Id.* § 2B1.1 cmt. n.20.

²²⁵ *Id.* § 2B1.1 cmt. n.20(A).

²²⁶ *Id.* § 2B1.1 cmt. n.20(C).

²²⁷ Former Commissioner of the Securities and Exchange Commission and Centennial Professor of Law at Brooklyn Law School.

²²⁸ *See, e.g.,* Karmel, *supra* note 22, at 2.

filing by the corporation; (2) its announcement must lead to statistically significant, abnormal stock returns; and (3) the putative insider trading must have occurred within two months prior to the announcement of the information.

The first and third requirements are factual and can easily be satisfied. The second requirement can be satisfied by following a similar procedure as we described in Section IV. Given that corporations file 10-Q and 10-K reports every three months, these conditions in effect require that all insider trading to be confined to approximately one-month window after each earnings announcement.²²⁹ If all three conditions are satisfied, then the burden of proof must be on insiders to show that their particular transaction does not meet the material, nonpublic information requirement. Similarly, any trades made by individuals receiving tips from insiders (of any information satisfying the three conditions above) must also shift the burden of proof, in this case, to the tippee(s) accused of committing securities fraud.

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

B. 8-K Filing Requirements

²²⁹ Typically, one week after earnings announcements is also considered an additional black-out period to allow to markets to fully digest the earnings information. This in effect confines insider trading (on information contained in the forms) to between weeks one and four after each earnings announcement.

Form 8-K (“Form”) is a broad form used to notify investors of any material event that is important to shareholders or the SEC. The SEC usually considers an event to be material when “there is a substantial likelihood that a reasonable investor would consider the information important to making an investment decision.”²³⁰ It is one of the most common forms filed with the SEC and supplements the public companies’ annual reports on Form 10-K and quarterly reports on Form 10-Q. Public companies are required to file the Form under the Securities Exchange Act. These reports are available to the public on the SEC’s EDGAR website.²³¹

The Form is used for reports under Section 13 or 15(d) of the Securities Exchange Act and filed pursuant to Rule 13a-11 or Rule 15d-11, as well as for reports of nonpublic information required to be disclosed by Regulation FD (17 CFR 243.100 and 243.101).²³² The Form may be used to satisfy the filing obligations under (1) Rule 425 of the Securities Exchange Act (17 CFR 230.425) for written communications relating to business combination transactions; (2) Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12) for soliciting materials and pre-commencement communications for tender offers; (3) for pre-commencement communications under Rule 14d-2(b); and (4) for pre-commencement communication under Rule 13e-4(c) under the Exchange Act (17 CFR 240.14d-2(b) and 240.13e-4(c)).²³³

Triggering events apply to registrants and subsidiaries.²³⁴ The Form consists of nine sections. Under Section 1,²³⁵ a company is required to file the Form when there is (1) an entry into a material definitive agreement; (2) termination of such agreement; (3) bankruptcy or receivership; as well as (4) reporting of shutdowns and patterns of violations in mine safety.

²³⁰ Investor Bulletin: How to Read an 8-K, SEC, (May 2012) at 1, available at <http://www.sec.gov/investor/pubs/readan8k.pdf>.

²³¹ Available at www.sec.gov/edgar/searchedgar/companysearch.html.

²³² Form 8-K, U.S. SEC, may be accessed at <https://www.sec.gov/about/forms/form8-k.pdf>.

²³³ *Id.*

²³⁴ Division of Corporate Finance: Current Report on Form 8-K, Frequently Asked Questions (Nov. 23, 2004), available at <http://www.sec.gov/divisions/corpfin/form8kfaq.htm> [*hereafter* FAQ].

²³⁵ Form 8-K, Fast Answers, SEC, access at <http://www.sec.gov/answers/form8k.htm> [*hereafter* Fast Answers].

Item 1.01 requires a disclosure of material agreements not made in the ordinary course of business, or any material amendments to those. A material definitive agreement can be both written and oral.²³⁶ Taking out a loan with a bank or signing a long-term lease would require this disclosure, but signing a lease for an additional store when the retailer already has a chain does not. If the agreement was not material at the time the registrant entered into it, but becomes material at a later time, the registrant does not need to file Form 8-K. In either case, the registrant is required to file the agreement as an exhibit to the periodic report in the period in which the agreement became material.²³⁷ Furthermore, the registrant must file the Form if an agreement is not “immaterial in amount or significance” within the meaning of Item 601(b)(10)(iii)(A) of Regulation S-K, unless it is not required to be disclosed under Item 601(b)(10)(iii)(C). This issue is considered from the perspective of a reasonable investor and within established standards of materiality.²³⁸

Item 1.02 requires disclosure of a termination of an agreement prior to the established expiration, but not an agreement that expires under its terms. Once notice of termination is received, the Form is required, even if the registrant intends to negotiate and in good faith believes that the agreement has not been terminated.²³⁹ Importantly, the triggering event is the notice, not the termination of the agreement.²⁴⁰ Under Items 1.03 and 1.04, the registrant may include the company’s plan for Chapter 11 reorganization or Chapter 7 liquidation, and the court’s confirmation of the plan.²⁴¹

²³⁶ FAQ, *supra* note 241.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ Investor Bulletin, *supra* note 237, at 1.

Under Section 2, a company must report in Form 8-K: (1) the completion of acquisition or disposition of assets; (2) results of operations and financial condition; (3) creation of a direct financial obligation or an obligation under an off-balance sheet arrangement of a registrant; (4) triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement; (5) costs associated with exit or disposal activities; or (6) material impairments.²⁴²

Item 2.01 requires a company to disclose any time a significant amount of assets are acquired or disposed, such as when a company buys or merges with another company, or sells a business unit. If a merger results in a “shell company”²⁴³ becoming a company in its own right, the registrant would provide investors with information about this company under this item. Under Item 2.02, the company usually summarizes the full financial statement, which often appears later in the company’s quarterly report or annual report. The company often announces these results in a press release and a Form 8-K simultaneously. Item 2.03 requires the basic terms of material financial obligations, including long-term debt, capital or operating lease, as well as short-term debt beyond ordinary course of business, to be disclosed. Any material financial obligations arising out of off-balance sheet arrangements, whether direct or contingent, must also be disclosed.²⁴⁴ The materiality of the financial obligation is “a facts and circumstances determination.”²⁴⁵

Item 2.04 requires the disclosure of any event that triggers the acceleration or increase of a financial obligation as long as the event is material, such as defaults on loans. In the case of a loan default where the company must pay the entire amount owed, the company must disclose

²⁴² FAQ, *supra* note 241.

²⁴³ The SEC defines a “shell company” as “a company that either has little or no operations or has little or no assets other than cash and cash equivalents.” Investor Bulletin, *supra* note 237, at 2.

²⁴⁴ *Id.* at 2.

²⁴⁵ See FAQ, *supra* note 241.

the amount to be repaid, the terms of such repayment and other financial obligations that may have to be repaid on different terms as result of the initial default. Item 2.05 requires disclosure of restructuring plans where the company would incur material charges, such as the decision to close some of its stores, or lay off workers. Under this provision, the company must also disclose the costs estimates when it is able to determine them.²⁴⁶

Lastly, under Item 2.06, a company must disclose write-downs, otherwise known as impairments. These occur when a company significantly lowers its estimates of the value of some assets.²⁴⁷ If the impairment is determined routinely as the company prepares its financial statements for its periodic report, then the company may make the disclosure in the periodic report, and not Form 8-K.²⁴⁸

Under Section 3, a company must file Form 8-K when there is: (1) a notice of delisting or failure to satisfy a continued listing rule or standard or transfer of listing, (2) unregistered sales of equity securities, or (3) material modification to rights of security holders. Under Item 3.01, a company must disclose if the stock exchange notifies it that it can no longer be listed. If the company has a grace period to return to compliance, it must disclose any steps it will take to avoid delisting. Item 3.02 mandates public companies to disclose private sales of securities above 1 percent of its outstanding shares of that class (or five percent for smaller reporting companies). Public offerings registered with the SEC, however, do not need to be disclosed. Under Item 3.03, companies are required to disclose material changes to instruments that define the rights of shareholders or material restrictions on the rights of security holders resulting from

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ Investor Bulletin, *supra* note 237, at 2-3.

the issuance or modification of another class of securities, such as loan term restricting dividend payments, adoption of an antitakeover device, or issuance of preferred stock.²⁴⁹

Under Section 4, matters related to accountants and financial statements, such as (1) changes in the registrant's certifying accountant or (2) non-reliance on previously issued financial statements or a related audit report or completed interim review, must also be filed.

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

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

²⁴⁹ *Id.* at 3.

²⁵⁰ Investor Bulletin, *supra* note 237, at 3.

²⁵¹ *Id.*

auditor believes that the previously issued audit reports or interim reviews of these statements should not be relied upon. The company must demonstrate whether its audit committee, full board or authorized executive officer has discussed the issue with the auditor.²⁵²

Section 5 discusses corporate governance and management. A company must file Form 8-K when: (1) there are changes in control of registrant; (2) there is departure of directors or certain officers; election of directors; appointment of certain officers; compensatory arrangements of certain officers; (3) there are amendments to articles of incorporation or bylaws or change in fiscal year; (4) temporary suspension of trading under registrant's employee benefit plans; (5) amendments to registrant's Code of Ethics, or waiver of a provision of the Code of Ethics; (6) change in shell company status; (7) submission of matters to a vote of security holders; and lastly, (8) shareholder director nominations.

Under Item 5.01, the company must disclose an event where there is a change of control of the company, including identifying the persons acquiring the control and the percentage of voting securities they now possess, any arrangements between the previous and new control groups relating to election of directors or other important issues.²⁵³ In the event that a board member resigns or will not stand for re-election due to disagreement with the company in regards to its operations, policies, or practices, or a director is removed for cause from the board, the company has an obligation to disclose the circumstances of the disagreement under the Item 5.02.²⁵⁴ If there is a letter from the director to this effect, the letter must be filed as an exhibit. In the event that a high-level executive officer retires, resigns, or is terminated, or alternatively, a new officer is appointed, the company must disclose this fact along with any related

²⁵² *Id.* at 4.

²⁵³ *Id.*

²⁵⁴ Investor Bulletin, *supra* note 237, at 5.

compensation arrangements. Any changes to the compensation of the current high-level officers must also be disclosed.²⁵⁵

Unless the company already disclosed the proposed amendments or fiscal year change in a proxy or information statement, the company must disclose any amendments to its articles of incorporation or bylaws, or changes to its fiscal year under Item 5.03. It should be noted that companies that issue only debt securities are usually exempted from this item.²⁵⁶

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

Under Section 6, a public company must disclose any: (1) asset-backed securities (ABS) informational and computational material, (2) change of servicer or trustee, (3) change in credit enhancement or other external support, (4) failure to make a required distribution, or (5) Securities Act Updating Disclosure.²⁵⁹

Section 7 discusses Regulation FD Disclosure. The purpose of this regulation is to “prevent companies from selectively disclosing material, nonpublic information.” Generally,

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ *Id.*

²⁵⁹ The Securities Act Updating Disclosure requires that, with respect to offerings of asset-backed securities, “any material pool characteristic of the actual asset pool at the time of issuance of the asset-backed securities [that] differs by 5% or more . . . from the description of the asset pool in the prospectus” requires a disclosure regarding the characteristics of the actual asset pool.

companies are required to disclose material information to the public at the same time as it is provided to others, including securities market professionals. Companies may submit an 8-K under this Item or Item 8.01 to comply with the Regulation FD's public disclosure requirement. Disclosures include announcements of dividends, quarterly sales of figures, etc.²⁶⁰

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

A report must be filed or furnished within four business days²⁶¹ of the occurrence of the event for items in Sections 1-6, and 9. If the form is being furnished only to satisfy its obligation under Regulation FD, the due date may be earlier.²⁶² If a triggering event occurs within four business days before the registrant's filing of a periodic report, it may be disclosed in that periodic report instead of filing of Form 8-K, unless it is required under Item 4.01 or Item 4.02.²⁶³

IV. Exploitation of Vagueness in Standards: Profitability of Insiders' Transactions

Given the vagueness of the insider trading laws, insiders have been able to exploit their material, nonpublic information by buying and selling the shares of their firms prior to the public dissemination of this information through 8-K filings, without facing legal consequences. To test our hypothesis, we obtained stock price information from the Center for Research in Security Prices (CRSP). The insider trading data come from the union of the Thomson Reuters Insider

²⁶⁰ Investor Bulletin, *supra* note 237, at 7.

²⁶¹ Day one is the first business day after the occurrence.

²⁶² Fast Answers, *supra* note 242.

²⁶³ FAQ, *supra* note 241.

Filing Data Feed (1996 to 2013) and backward extensions using archived annual purchases from the National Archives (1975 to 1995). We henceforth refer to this database as the “Back-Extended Thomson Reuters” Database or simply the combined insider trading database. Our sample includes U.S. common stocks (CRSP share codes of 10 or 11) that are covered by all three databases. The time period is from January 1975 through December 2013. We restrict attention to this interval due to the availability of insider trading data, which first became available in January of 1975. We include observations beginning only from the time when the firms first appear in the combined insider trading database. Following Shumway (1997), we adjust stock returns for delistings using the CRSP delisting file. Our final dataset has over 20,000 unique CUSIPs and over 3,500,000 observations.

The combined Insider Filing Database includes all trades reported to the SEC-Ownership Reporting System. The data contains all open market purchases and sales by officers, directors, and beneficial owners (direct or indirect owners of more than 10% of any equity class of securities) of publicly traded firms.²⁶⁴ Shares acquired through exercise of options, stock awards, and trades with corporations are excluded. The final sample is limited to firms for which stock return data are available in CRSP. Finally, in order to deal with potential misreports and incorrect outliers, three filters are used. On the insider transaction date, (1) the insider transaction price must be less than twice the closing price of the stock, (2) the number of shares of the insider transactions will be less than the daily volume of trade of the stock, and (3) the

²⁶⁴ For most of the sample period analyzed here (prior to August 29, 2002), Section 16(a) of the Securities and Exchange Act requires that insider transactions be disclosed within the first 10 days of the month following the month of the trade. Section 16(b) prohibits insiders from profiting from short-term price movements defined as profitable offsetting pairs of transactions within 6 months of each other, while Section 16(c) prohibits profiting from short-sales. Sarbanes- Oxley Act of 2002 (effective August 29, 2002) has modified insider trading regulations in many significant ways. First, the new reporting requirement states that insider transactions must be reported electronically by the end of the second business day following the day on which the transaction is executed both through EDGAR and corporate public websites. Sarbanes-Oxley also prohibits purchase and sale of securities during black-out periods.

number of shares of the insider transaction will be less than the outstanding number of shares for the stock.²⁶⁵

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

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

where $H_{i,t}$ takes the value 1 for insider purchases and -1 for insider sales. Thus, we define an insider purchase to be abnormally profitable if the stock price outperforms the general stock market after the purchase. Similarly, we define an insider sale to be abnormally profitable if the stock price underperforms the general stock market after the sale. The variable $r_{i,t}$ is the cum-dividend return to stock i for day t , and $r_{m,t}$ is the cum-dividend return to the CRSP equally-weighted portfolio of all New York Stock Exchange, American Stock Exchange and NASDAQ stocks for day t . We examine the profitability of insider trades for $T=5, 10, 20, 30, 40$ and 50 days following insiders' transactions.

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

Our evidence shows that a significant portion of insider transactions exhibit immediate profitability. During the decade of 1975-1984, over 60,000 transactions showed almost immediate abnormal profitability by beating the general stock market more than 5% during the first five days after the trade date. Given the quick stock price reaction and immediate

²⁶⁵ Qualitative results do not change if these filters were not enforced. Results are available upon request.

profitability, these translations are likely to be based on material, nonpublic insider information. By day 50, the proportion of highly profitable transactions rises to about 40% of all trades by insiders.

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

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

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

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

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

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

Conclusion

The 40 year time period from 1975 to 2014 that we investigated has seen a number of changes in insider trading laws. While Congress kept increasing civil and criminal penalties for criminal insider trading, it kept the definition of what is material, nonpublic information purposefully vague. The 1984 ITSA established a civil penalty up to three times the profit or loss avoided for both insiders as well as tippers.²⁶⁶ The 1988 ITSEA provided for private right of action for contemporaneous trading, a bounty program to collect up to 10% of the insiders' illegal profits, while also increasing the maximum penalties for violations of insider trading laws to \$1 million in fines and 10 years in prison.²⁶⁷ Finally, the 2002 Sarbanes-Oxley Act further increased the penalties for purposeful violations of the insider trading laws to \$5 million in fines

²⁶⁶ Pub. L. No. 98-376, 98 Stat. 1264.

²⁶⁷ Pub. L. No. 100-704, 102 Stat. 4677.

and prison sentence up to 20 years.²⁶⁸ Clearly, none of these increases in penalties have been successful in even slowing down profitable insider trading.

The recent Second Circuit decision in *Newman* represents a step backward in clarifying what is material, nonpublic information and should be reversed. According to *Newman*, establishing tippee liability under Section 10b of the Securities Exchange Act²⁶⁹ and Rule 10b-5 of the SEC²⁷⁰ requires tippee knowledge of tipper personal benefit. The Second Circuit interprets the Supreme Court's decision in *Dirks* stringently,²⁷¹ reversing the trend in the federal judiciary over the past 30 years of allowing the *Dirks* personal benefit requirement to be satisfied by proof that (1) the tippee knew the insider-tipper breached a fiduciary-like duty²⁷² in disclosing confidential information and (2) that the insider expected to obtain a personal benefit in exchange for disclosure.²⁷³ Moreover, apart from expounding this strict interpretation of the elements needed to establish tippee liability, the *Newman* court also set surprisingly high evidentiary standards for proving these elements.

²⁶⁸ 18 U.S.C. § 1348.

²⁶⁹ 15 U.S.C. § 78j(b).

²⁷⁰ 17 C.F.R. 240.10b-5.

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

²⁷² See *Chiarella* 445 U.S. at 228 (describing the relevant duty as a “fiduciary or other similar relation of trust and confidence”); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1337-1340 (2009) (discussing the tendency among courts to base insider trading liability on breaches of duties that fall outside the (typically) more narrow confines of traditional fiduciary duties).

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

The combination of these legal and evidentiary adjustments to the *Dirks* test could have serious implications for the government’s efforts to deter insider trading. The reason for this is quite simple. When potential tippees know they can trade on confidential information without recourse—just so long as they are careful to receive that information from “a friend of a friend of [a friend]”²⁷⁴—this easily circumvented liability rule should be expected to give rise to informal information sharing networks.²⁷⁵ By habitually sharing inside information with friends and associates, insiders could easily engage in indirect, mutual-back-scratching relationships, disclosing valuable information to the network in the hope that similarly situated individuals “three and four levels removed from the inside tipper”²⁷⁶ will reciprocate. Such arrangements could lead to significant increases in insider trading activity, and thus exacerbate the practice’s primary consequences: the unfair transfer of wealth from ordinary investors to insider traders and the diminution of the public’s confidence and participation in securities markets²⁷⁷ (which, in turn, would likely promote less efficient allocations of investor capital and reduced liquidity in the financial sector).²⁷⁸ Considering these negative consequences, it is imperative that the legal community find ways to circumvent the constraints *Newman* imposes on prosecutors.

This article puts forth a solution, identifying evidence that could demonstrate a tippee’s knowledge of tipper benefit without requiring actual knowledge of the confidential information’s source. By using the 8-K filing as a proxy for tippee knowledge of tipper breach of duty and

²⁷⁴ *Id.* at 453.

²⁷⁵ See *Why Insider Trading Is Hard to Define, Prove and Prevent*, KNOWLEDGE@WHARTON, Nov. 11, 2009; see also Weitzman, *supra* note 283, at 3 (explaining how previous insider trading cases considered the ability to maintain networking contacts by disclosing inside information to be a considerable “reputational benefit,” a benefit that typically satisfied the *Dirks* personal benefit requirement).

²⁷⁶ *Newman*, 773 F.3d at 443.

²⁷⁷ See *O’Hagan*, 521 U.S. at 658 (noting that, where insider trading goes unregulated, “investors likely would hesitate to venture their capital [into the] market”).

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

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

Table 1: The number and percentage of highly profitable insider transactions exceeding 5% in abnormal profits

Decade	Total number of open market trades	After 5 Days	After 10 Days	After 20 Days	After 30 Days	After 40 Days	After 50 Days
1975-1984	380,315	61,759	93,072	123,375	139,147	149,452	156,731
		16.2%	24.5%	32.4%	36.6%	39.3%	41.2%
1985-1994	428,432	70,652	102,463	137,748	156,942	170,001	177,843
		16.5%	23.9%	32.2%	36.6%	39.7%	41.5%
1995-2004	1,134,154	215,859	300,885	387,741	435,868	462,386	483,736
		19.0%	26.5%	34.2%	38.4%	40.8%	42.7%
2005-2014	1,578,253	204,042	309,572	418,712	477,534	528,742	563,082
		12.9%	19.6%	26.5%	30.3%	33.5%	35.7%
1975-2014	3,521,154	552,312	805,992	1,067,576	1,209,491	1,310,581	1,381,392
		15.7%	22.9%	30.3%	34.3%	37.2%	39.2%

Table 2: The number and percentage of highly profitable insider transactions exceeding 10% in abnormal profits.

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

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

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