

The Future of Insider Trading after *Salman*: Perpetuation of a Flawed Analysis or a Return to Basics

CHARLES W. MURDOCK[†]

In large part due to two poorly reasoned decisions by Justice Powell in the early 1980s, Chiarella v. U. S. and Dirks v. SEC, the development of insider trading law has been constrained, enforcement has been hampered, and insider-trading has grown to the point where hundreds of millions of dollars are at stake. Moreover, Chiarella and Dirks were inconsistent with the Congressional policy that the purpose of the securities laws is to ensure a level playing field where one participant does not have an undue advantage over another participant.

A Second Circuit decision, U.S. v. Newman unnecessarily extended Dirks, notwithstanding Congress's caution to constrain the Dirks decision to its unique set of facts. Newman reversed the conviction of hedge fund portfolio managers who made millions of dollars by trading on inside information on the basis that they did not know the benefit that the tippees who provided that information had received in connection with their tips. Newman further cast doubt on whether a benefit can be relational, rather than pecuniary.

Recent insider trading prosecutions reflect the fact that insider trading today is big business. Hedge funds are under intense pressure to get an "edge" to enhance their returns, even if it means resorting to a "black edge." As Sheelah Kolhatkar, the author of Black Edge, a three-year study of the skulduggery that inheres in much of the hedge fund industry, noted the basic problem with Newman "is that it completely misunderstood the way the world actually works." For the Newman court, defendants' lack of culpability stemmed from the fact that "Newman and Chiasson were several steps removed from the corporate insiders and there was no evidence that either was aware of the source of the inside information."

The Newman court failed to realize that this is the way the game is played. The portfolio manager orders trades, which make millions for the organization and indirectly for the analysts and others who feed information to the portfolio manager. All of these people are aware of the risks of insider trading and, when a dark edge is employed, want to obfuscate insider trading as much as possible. The key for the portfolio manager is to inform the analysts that he wants the best possible information, but does not want to know how they get it.

Shortly after Newman, the Supreme Court decided Salman v. U.S., which involved a fairly pedestrian situation in which one family member tipped another. However, the Supreme Court declined to adopt the requirement in Newman that there must be something of a "pecuniary or valuable nature" in a gift to family or friends in order for the gift rationale in insider trading to apply.

Salman was then followed by U.S. v. Martoma, where SAC Capital Advisors realized \$80.3 million in gains and avoided \$194.6 million in losses by obtaining advance notice that the Alzheimer study was flawed. The portfolio manager who obtained the information from a participant in the study received a \$9 million bonus. Martoma, in first analyzing Salman, opined that Salman in effect also rejected Newman's requirement of a "meaningfully close personal relationship" in order to use the gift approach. The Martoma court later amended its opinion and looked at the basis for requiring a "meaningfully close personal relationship," namely, that there must be evidence of "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the latter."

This Article provides an extensive analysis of the history of insider trading, and the policies underlying the law, and demonstrates that the pre-Chiarella/Dirks law was much more consistent with the Congressional policy of a level playing field. Hopefully, Salman and Martoma reflect a more realistic approach to the law of insider trading. It is critical for courts to understand the pressures to receive illegal information, the chain through which it travels, where it must end in order to be operational, and the devices employed to disguise the illegal sources that are often used. Courts also need to understand that much of the world operates on networking and relationships, and that people are motivated by factors other than immediate pecuniary gain.

[†] Professor and Loyola Faculty Scholar, Loyola University Chicago School of Law.

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INTRODUCTION

The recent U.S. Supreme Court decision, *Salman v. United States*,¹ generated headlines like “Supreme Court Sides with Prosecutors”² and “Supreme Court Sets Tough Insider Trading Rule,”³ suggesting that *Salman* provided a substantial boost for the government in regulating insider trading. However, *Salman* was a minimalist decision and, at first glance, seemed to do little to define the scope of insider trading or to remedy or clarify the confusing and illogical jurisprudence in this area. The Court relied upon what was essentially an aside in *Dirks v. Securities*,⁴ a poorly reasoned decision that relied upon the equally poorly-reasoned decision in *Chiarella v. United States*.⁵

However, *Salman* did repudiate the part of the *United States v. Newman* holding that required that a tipper “must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends.”⁶ Building upon *Salman*’s repudiation of *Newman*, the Second Circuit in *United States v. Martoma* also constrained the requirement in *Newman* that there must be a “meaningfully close personal relationship” between the tipper and the tippee in a “gift” situation by focusing upon the underlying basis for the personal benefit requirement, namely, that there be either a *quid pro quo* or an intent to benefit, and by taking a broad view of personal benefit, in contradistinction to that taken by *Newman*.⁷ The position by the Second Circuit in *Martoma* could most likely have resulted in the conviction of the defendants in *Newman*.

To understand insider trading law and why the circuit courts in *Newman* and *Salman* could issue arguably conflicting opinions, leading to the Supreme Court’s decision in *Salman*, and also to understand why the Second Circuit backed off from *Newman* in *Martoma*, one needs a historical and policy perspective. This Article will first look at the reason why the securities laws were enacted and the early, liberal view of insider trading.⁸ It will then examine and critique the supposedly conservative but actually reactionary trilogy of decisions in this area that the Supreme Court handed down in the 1980s,⁹ and the aftermath of these decisions, including the dramatic uptick in insider

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

2. Adam Liptak, *Supreme Court Sides with Prosecutors in Insider Trading Case*, N.Y. TIMES (Dec. 6, 2016), <https://www.nytimes.com/2016/12/06/business/dealbook/supreme-court-insider-trading.html>.

3. Richard Wolf & Kevin McCoy, *Supreme Court Sets Tough Insider Trading Rule*, USA TODAY (Dec. 6, 2016), <https://www.usatoday.com/story/news/politics/2016/12/06/supreme-court-insider-trading/94567078/>.

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

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

6. *Salman*, 137 S.Ct at 428 (quoting *United States v. Newman*, 773 F.3d 438, 452 (2014)).

7. *United States v. Martoma*, 869 F.3d 58, 68 (2d Cir. 2017), amended 894 F.3d 64 (2d Cir. 2018) (quoting *Newman*, 773 F.3d at 452).

8. See Charles W. Murdock, *The Evolution of the Supreme Court’s Rule 10b-5 Jurisprudence: Protecting Fraud at the Expense of Investors* (Feb. 18, 2012) (unpublished paper) (on file with author).

9. See *Chiarella*, 445 U.S. 222; see also *Dirks*, 463 U.S. 646; *Carpenter v. United States*, 484 U.S. 19 (1987); Murdock, *supra* note 8.

trading,¹⁰ the congressional response,¹¹ and the relationship of the jurisprudential mischief between these trilogies to the *Newman/Salman/Martoma* conflict. This Article concludes that the “liberal” approach of the 1960s would create no more ambiguity and confusion than the course chosen by the Supreme Court in its decisions from the 1980s. Moreover, a liberal approach would be far more in line with the legislative policy preferences reflected in the securities laws enacted by Congress after the market excesses of the 1920s, and would stem the massive insider trading that followed these later decisions.

From a policy perspective, Congress has clearly stated the critical importance of fairness in our securities markets:

In order to raise the enormous sums of investment capital that will be needed in the years ahead and to assure that that capital is properly allocated among competing uses, these markets must continue to operate fairly and efficiently.¹²

For the securities markets to operate “fairly and efficiently,” Congress has recognized the following goals of the 1934 Securities Exchange Act:

The basic goals of the Exchange Act remain salutatory and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly.¹³

The Supreme Court itself has recognized that history teaches us “how essential it is that the highest ethical standards prevail in every facet of the securities industry.”¹⁴ However, to revert to a sound approach regarding insider trading, the Supreme Court will need to either abandon its personal benefit test in assessing whether a tipper has “sinned,” or follow the lead of the Second Circuit in *Martoma* that, in a situation where an insider makes a gift of material, non-public inside information to *anyone* when the purpose is to enable the tippee to trade, such conduct is illegal. If neither of these possibilities materialize, then either the Securities and Exchange Commission (SEC) or Congress should adopt a definition of insider trading akin to that proposed in the 1980s.

I. THE EARLY JURISPRUDENCE ON INSIDER TRADING

The leading insider trading case for a number of years was not a judicial decision, but rather a 1961 SEC decision: *In the Matter of Cady, Roberts & Co.*¹⁵

10. JAMES B. STEWART, DEN OF THIEVES 16 (1991).

11. Insider Trading Sanction Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered subsections of 15 U.S.C. § 78 (1988)); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.).

12. H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.).

13. *Id.*

14. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963).

15. In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

The significance of *Cady, Roberts* is attested to by the fact that the majorities in both *Chiarella* and *Dirks* relied upon the case as the leading one dealing with insider trading, but grossly misinterpreted that decision.¹⁶ Congress also viewed *Cady, Roberts* as seminal.¹⁷

A. THE *CADY, ROBERTS* DECISION—A SOUND RESULT BASED UPON SOUND POLICY AND JURISPRUDENCE

Both the *Chiarella* and *Dirks* majority opinions misunderstood the significance of the critically important facts of *Cady, Roberts*. First, *Cady, Roberts* was a “bad news” case; that is, the triggering event was a decision by the Board of Directors of Curtiss-Wright to cut the dividend.¹⁸ Such a negative development would typically result in a market price drop, which would then motivate unscrupulous “insiders” to sell their shares before the bad news became public.¹⁹

On the other hand, a “good news” situation, such as a dividend increase, or an incredible discovery of ore,²⁰ could raise the market price of the stock. In a “good news” situation, unscrupulous “insiders” could be expected to purchase company stock. However, the only persons from whom the insider could purchase stock would be existing shareholders to whom,²¹ arguably, the insider had a fiduciary duty.²²

Contrariwise, when an insider sells stock, there is a high likelihood that persons who previously did not hold the stock (that is, non-shareholders) would

16. *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

17. H.R. REP. NO. 98-355, at 2287 (1983).

18. *Cady, Roberts*, 40 S.E.C. at 908–09.

19. See generally *Diamond v. Oreamuno*, 24 N.Y.2d 494 (1969).

20. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (1968).

21. See, e.g., *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968) (in which insiders also purchased shares from the corporation).

22. *Strong v. Repide*, 213 U.S. 419, 434 (1909) (holding that defendant director and owner of stock and administrator general of the company had an obligation to make disclosures to the stockholder); *Oliver v. Oliver*, 118 Ga. 362, 368 (1903) (“If, however, the fact within the knowledge of the director is of a character calculated to affect the selling price, and can, without detriment to the interest of the company, be imparted to the shareholder, the director, before he buys, is bound to make a full disclosure. In a certain sense the information is a quasi asset of the company, and the shareholder is as much entitled to the advantage of that sort of an asset as to any other regularly entered on the list of the company’s holdings. If the officer should purposely conceal from a stockholder information as to the existence of valuable property belonging to the company, and take advantage of this concealment, the sale would necessarily be set aside.”); *Goodwin v. Agassiz*, 283 Mass. 358, 363 (1933) (“[W]here a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his particular knowledge and not within the reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances.”) (holding that defendants owed no duty to plaintiff shareholders because the identity of the sellers of the stock were unknown and could not be readily ascertained by defendant directors).

be among the purchasers.²³ Under the common law, there was no recognized duty of officers or directors to non-shareholders.²⁴

This is highly significant because the individual defendant in *Cady, Roberts* argued that “an insider’s responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders.”²⁵ In rejecting this argument, the SEC stated that “[t]his approach is too narrow. It ignores the plight of the buying public—wholly unprotected from the misuse of special information.”²⁶ The Court expanded upon this policy concern by stating:

There is no valid reason why persons who *purchase* stock from an officer, director or other person having the responsibilities of an ‘insider’ should not have the same protection afforded by disclosure of special information as persons who *sell* stock to them. *Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.*²⁷

At this time, case law took the same position. In *Gratz v. Claughton*, Judge Learned Hand, a highly regarded jurist, stated:

For many years a grave omission in our corporation law had been its indifference to dealings of directors or other corporate officers in the shares of their companies. When they bought shares, they came literally within the conventional prohibitions of the law of trusts; yet the decisions were strangely slack in so deciding. When they sold shares, it could indeed be argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one.²⁸

Refusing to let common law concepts determine results under securities laws makes preeminent sense because securities laws were enacted due to the common law’s inability to ensure fair and orderly securities markets.²⁹ The purpose of the securities laws was to “ensure the fair and honest functioning of impersonal national securities markets where common-law protections have

23. It is of course possible that an existing shareholder might increase his or her position.

24. Goodwin arguably determined that there is not a duty to shareholders in a publicly traded corporation where an insider purchases stock. A fortiori, there would not be a duty to non-shareholders. *Goodwin*, 283 Mass. at 361.

25. In re *Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).

26. *Id.*

27. *Id.* (third and fourth emphases added).

28. *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951).

29. See *supra* text accompanying notes 26–28; see also *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (the purpose of the securities laws was to “ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate.”) (Blackmun, J., dissenting).

proved inadequate.”³⁰ Congress itself stated that the purpose of securities laws was “to assure that dealing in securities is fair and without undue preferences or advantages among investors.”³¹ Professor Louis Loss, a noted scholar in the securities field, asserted that Congress, in enacting the 1934 Securities Exchange Act, sought to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted face-to-face, over-the-counter, or on an exchange.³² It makes little sense to rely upon common law jurisprudence to interpret securities laws when such jurisprudence was, in effect, rebuked by the enactment of the remedial jurisprudence embodied in the securities laws.

Cady, Roberts was significant in two other aspects. First, it recognized that the concept of “insider,” or one who has special duties under the securities laws, was not limited to “officers, directors and control shareholders,” but includes “those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.”³³ The Court pejoratively added that “[i]ntimacy demands restraint less the uninformed be exploited.”³⁴

The SEC opinion in *Cady, Roberts* proposed the following test to determine the persons upon whom a special obligation is imposed, which requires: (1) “the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone,” and (2) “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”³⁵

Second, and arguably more important, in the context of tipper/tippee, the tipper in *Cady, Roberts* was guiltless because he breached neither a common law duty, nor any special obligation imposed by the securities laws. Cowden, who was a director of Curtiss-Wright, was present at a board meeting in which a dividend cut was approved. The secretary of the company was instructed to make the appropriate disclosures to Dow Jones and the New York Stock Exchange and left the room to do so. Sometime later, the board took a break and it was then that Cowden telephoned Gintel, his colleague at *Cady, Roberts*, and mentioned the dividend cut.³⁶

The *Cady, Roberts* opinion noted that, “there was no evidence of a preconceived plan whereby Cowden was to ‘leak’ advance information [to] . . . Gintel,” and that “the evidence points to the conclusion that Cowden probably assumed, without thinking about it, that the dividend action was

30. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting).

31. *Id.* (Blackmun, J., dissenting) (citing H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.)).

32. LOUIS LOSS, *SECURITIES REGULATION* 1455-56 (2d ed. 1961).

33. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

34. *Id.*

35. *Id.*

36. *Id.* at 917.

already a matter of public information and further that he called registrant's office to find out the effect of the dividend news upon the market."³⁷

Thus, in *Cady, Roberts*, the tipper did not sin, that is, receive any sort of pecuniary benefit. Nonetheless, the tippee was found to have violated Rule 10b-5.³⁸ Contrast this approach to that taken by the Supreme Court in *Dirks*, where the Court held that a tippee does not "sin" unless the tipper sins, and that the tipper only sins when he or she obtains a pecuniary or other benefit.³⁹

B. *TEXAS GULF SULPHUR*—QUESTIONABLE ANALYSIS, BUT SOUND POLICY

The next significant decision in the development of insider trading was the Second Circuit's opinion in *Texas Gulf Sulphur*.⁴⁰ The case was arguably the apogee of the judicial expansion of Rule 10b-5 and much of its sloppy semantics have been rejected today.⁴¹ Its most problematic language was the use of the phrase "disclose or abstain,"⁴² instead of the more accurate phraseology, "abstain until disclosable." In almost every situation in which the phrase "disclose or abstain" has been used, suggesting that the insider has an option, there is invariably an obligation not to disclose; thus, there is not an option for alternative courses of action, but rather a duty not to trade while the information remains nonpublic. Nonetheless, *Texas Gulf Sulphur* has been cited positively by Congress and its result on the insider trading aspect is sound and would be followed today.⁴³

Texas Gulf Sulphur was actually a two-act play. The first act covered the period from November 12 to April 16, which involved insider trading by employees and officers of Texas Gulf Sulphur.⁴⁴ The second act covered the period from April 12 through April 16 and involved the company's disclosure obligations under the securities laws.⁴⁵

37. *Id.* at 908.

38. 17 C.F.R. § 240.10b-5 (2011).

39. *See infra* Subpart II.B.

40. SEC. v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

41. In discussing materiality, the court vacillated between using the word "may" and "would," and "possible" versus "probable." *Id.* at 848–50. ("[T]he materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors . . . Thus, material facts include not only information disclosing the earnings and distributions of a company but also 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.") *Id.* at 849. The Supreme Court, in *TSC Indus. v. Northway*, opted for the would/probable standard as opposed to the might/possible standard. 426 U.S. 438 (1976). With respect to scienter, the standard for liability in an SEC enforcement proceeding was merely whether the press release issued by the Corporation "resulted from a lack of due diligence." *Tex. Gulf Sulphur Co.*, 401 F.2d. at 863. This is, in effect, a negligence standard, whereas the Supreme Court, in *Ernst & Ernst v. Hochfelder*, required some degree of intentionality. 425 U.S. 185 (1976). Later, this has been interpreted as a recklessness standard. *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979).

42. *Tex. Gulf Sulphur Co.*, 401 F.2d at 848.

43. H.R. REP. NO. 98-355, at 2287 (1983).

44. *Tex. Gulf Sulphur Co.*, 401 F.2d at 841.

45. *Id.* at 857–64.

As a result of drilling operations in Timmins, Ontario, Canada, the company raised a core of ore that indicated a substantial, if not extraordinary, field of valuable metals.⁴⁶ However, management wanted to verify the mineral find with additional testing and acquire additional mineral leases in the area.⁴⁷ Drilling was suspended while the company obtained more definitive analyses and mineral leases.⁴⁸ The employees who were aware of the find were instructed not to disclose it, not even to other employees and officers of the company.⁴⁹

Nevertheless, several employees and officers bought Texas Gulf Sulphur stock during this period and the first act dealt with their liability for the alleged insider trading. Drilling was resumed on March 31, 1964.⁵⁰ An arguably misleading press release was issued on April 12, 1964,⁵¹ and the second act ended on April 16, 1964, when Texas Gulf Sulphur issued a corrective press release.⁵²

The individual defendants either purchased Texas Gulf Sulphur's stock, or called or tipped to others who did. Citing *Cady, Roberts*, the court set forth the following standard by which the individual defendants would be judged:

The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public.⁵³

The court added the following, which became known as the "disclose or abstain" rule:

Thus, anyone in possession of material inside information must either *disclose* it to the investing public, *or*, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must *abstain* from trading in or recommending the securities concerned while such inside information remains undisclosed.⁵⁴

46. *Id.* at 843.

47. *Id.*

48. *Id.*

49. *Id.* at 843.

50. *Tex. Gulf Sulphur Co.*, 401 F.2d. at 844.

51. The press release stated that reports and rumors of a substantial copper discovery were exaggerated by people not connected with Texas Gulf Sulphur (TGS) and that "[t]he work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading." *Id.* at 845. The trial court called the press release "gloomy or incomplete." *Tex. Gulf Sulphur Co.*, 258 F. Supp. 262, 296 (S.D.N.Y. 1966). The Second Circuit Court of Appeals held that "the release was issued in a manner reasonably calculated to affect the market price of TGS stock and influence the investing public" and remanded to the district court to determine whether the release was misleading such that the court should issue an injunction against TGS. *Tex. Gulf Sulphur Co.*, 401 F.2d at 864.

52. *Tex. Gulf Sulphur Co.*, 401 F.2d. at 850 n.13. It's unclear why TGS felt the need to issue the April 12 release and did not simply wait four days. Alternatively, TGS could have avoided a lot of trouble by issuing the April 16 release on the 12th, instead of the gloomy one.

53. *Id.* at 848.

54. *Id.* (emphasis added).

The court recognized that disclosure may be “forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site.”⁵⁵ In such a situation, “if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished.”⁵⁶ Consequently, as asserted above, the *Texas Gulf Sulfur* court should have described the obligation as “abstain until disclosable.” This latter phrasing would not have supported the plaintiff’s later argument that once the insider did not abstain, he or she had the obligation to disclose, and the failure to disclose caused plaintiffs’ loss.⁵⁷

While the language throughout the *Texas Gulf Sulfur* opinion could have been more precise, the legal standard was clear and unambiguous: if you receive material, non-public information because your “access” to information intended to be available only for a corporate purpose, you may not trade until such information is disclosed to other potential investors. This standard comports with the purpose of the securities laws, as stated by Congress, “to ensure that dealing in securities is fair and without undue preferences or advantages among investors.”⁵⁸ It also reflected the policy that the SEC later promulgated in Regulation Fair Disclosure (Reg FD),⁵⁹ requiring prompt disclosure of inside information that is intentionally or inadvertently selectively transmitted.

The *Texas Gulf Sulphur* standard would have foreclosed the subsequent argument about whether the source of information received a “benefit” in transmitting information. If the trader has scienter—that is, knows that the information is non-public—it is immaterial from a “fairness in trading” perspective whether the source of information “misappropriated” it,⁶⁰ sold it,⁶¹ or gifted it.⁶² If the tipper was duped into conveying the information,⁶³ the issue should be the scienter of the tippee, not the benefit of the tipper and the tippee, as in *Cady, Roberts*, which would violate the securities laws irrespective of the “sin,” or lack thereof, by the tipper.

C. EARLY OPPOSITION TO INSIDER TRADING ENFORCEMENT

The foregoing discussion is not to suggest that there was not some opposition to the early liberal development of insider trading. Henry Manne, originally at the University of Rochester and later the Dean of George Mason

55. *Id.*

56. *Id.*

57. *See Mitchell v. Tex. Gulf Sulphur Co.*, 446 F.2d 90, 106 (10th Cir. 1971) (awarding damages in the amount that it would have taken a reasonable person to reinvest in the market after the timely release of information in an action for recovery after investors sold stock as a result of a misleading press release).

58. *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (Burger, C.J., dissenting) (quoting H.R. REP. NO. 98-229, at 91 (1975) (Conf. Rep.)).

59. 17 C.F.R. § 243.100 (2012).

60. *Chiarella*, 445 U.S. at 241.

61. *Carpenter v. United States*, 484 U.S. 19, 27–28 (1987); PAULE CONSTANT, TRADING SECRETS (Betsy Wing trans., Univ. of Neb. Press 2001).

62. *Salman v. United States*, 137 S. Ct. 420, 429 (2016).

63. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 167–68 (2d Cir. 1980).

Law School,⁶⁴ is sometimes regarded as the father of law and economics,⁶⁵ and was an aggressive critic of insider trading enforcement.⁶⁶ According to Professor Manne, insider trading is a victimless crime, moves the market in the right direction, and constitutes a sound way to reward executives for outstanding performance.⁶⁷ While some economists shared his view, this was definitely a minority position.⁶⁸

First of all, Professor Manne is correct that insider trading pushes the market in the right direction. If an insider buys on positive information (good news) prior to the disclosure of such information, the additional buying pressure would move the price of the stock upward toward where it should be after the market absorbs the “good news.” Similarly, when an insider sells prior to the disclosure of adverse information (bad news), increasing the supply of securities offered for sale will decrease the price of the stock, and later disclosure will move the price toward a lower equilibrium.

For example, the stock in Curtiss-Wright, the company whose stock was traded in the *Cady, Roberts* case, was trending around 40 before the dividend cut was announced. Trading in the stock was suspended after the announcement because of the large number of sell orders and, after trading was resumed, the stock closed at just below 35.⁶⁹ However, moving the market in the right direction is not a justification for introducing inherent unfairness into the trading system.

According to Professor Manne, when the insider buys on undisclosed positive information, the seller on the other side of the transaction is advantaged because the purchase by the insider raises the price of the stock and the seller gets a higher price than would otherwise be the case. As a rough illustration, if a specialist or market maker were quoting 40 bid, 40½ asked, a seller at that point would receive 40. However, if the insider intervened to buy, the insider would buy at 40½, which could lead to a rise in the market to 40½ bid, 41 asked. The seller would then receive 40½, instead of 40.

64. Known today as the Antonin Scalia Law School.

65. *Henry G. Manne, '52, 1928-2015*, UNIV. OF CHI. L. SCH., <https://www.law.uchicago.edu/news/henry-g-manne-52-1928-2015> (last visited July 27, 2019).

66. Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 *CATO J.* 933 (1985).

67. *Id.*

68. The Insider Trading and Securities Fraud Enforcement Act of 1988 states:

A modest number of economists and academics defend the practice of insider trading as promoting an efficient market. Some free market economists even favor legalizing insider trading. They argue that the faster the market price reflects the nonpublic information, the more smoothly the market functions. But the far greater number of commentators support efforts to curb insider trading, viewing such efforts as crucial to the capital formation process that depends on investor confidence in the fairness and integrity of our securities markets. Insider trading damages the legitimacy of the capital market and diminishes the public's faith.

H.R. REP. NO. 100-910, at 6045 (1988). When I was enrolled in his Law & Economics professional program at Dartmouth, I offered to debate him on these issues, but he never responded. While it might be unfair to do this postmortem, his position is both simplistic and unsound.

69. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 908-10 (1961).

The fallacy in the argument that no one is injured from insider trading is that it assumes that any injury, if there be one, must be to the person on the opposite side of the transaction. This is a situation that would exist in a face-to-face transaction. For example, in *Kardon v. National Gypsum*,⁷⁰ two brothers bought stock at a low price without disclosing the favorable impending sale of assets, knowing of the opportunity to sell the assets of the company at a favorable price. Thus, the party on the other side was the injured one.

But with respect to a publicly traded stock, numerous investors may be trading at the same time and much of their stock would likely be held in street name, thus rendering it difficult to determine who on the other side of the transaction might be injured. Moreover, there is a serious problem with causation, in that the decision by the person on the other side of the transaction to trade could be based upon a multitude of factors.

However, paradoxically, in the public markets, the persons injured by the insider's trading arguably are the persons on the same side of the market. In a bad news situation, such as in *Cady, Roberts*, the insider always sells at a price that is higher than subsequent sellers receive after the adverse information is disclosed. Conversely, in a "good news" situation, the insider always buys ahead of the market, and the price the insider pays will be lower than the price after disclosure of the positive information. Unfortunately, this reality does not easily translate into a computation of damages for the sellers or buyers who come to the market after the insider trades.

Consequently, a private cause of action for insider trading in impersonal public markets is arguably neither feasible nor realistic and, consequently, enforcement falls to the U.S. Attorneys and the SEC in criminal and enforcement proceedings.⁷¹

The argument that insider trading is a form of executive compensation also fails. It is predicated on the notion that a rise in the price of stock reflects the quality of management. While that may be true in some instances, history has shown that there often is a negative correlation between a rise in stock prices and the quality of management. There are many instances of management hyping the price of the stock, bailing out, and leaving other shareholders to bear the subsequent drop in price.⁷²

Prescinding fraud situations, consider the situation of a corporation with three divisions, two of which are expecting an exceptional improvement in earnings, while a third division is poorly managed and has no earnings growth. The overall effect, companywide, is a substantial increase in the earnings of the

70. 73 F. Supp. 798 (E.D. Pa. 1947).

71. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) ("Private enforcement of proxy rules provides a necessary supplement to Commission action. . . . The Commission advises that it examines over 2,000 proxy statements annually and each of them must be necessarily expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value.").

72. Charles W. Murdock, *The Private Securities Litigation Reform Act and Particularity: Why Are Some Courts in an Alternate Universe?*, 45 *LOY. UNIV. CHI. L.J.* 615 (2014).

company. Assume that the chief operating officers of each division are privy to the company's financial information. If all three trade ahead of the release of earnings, all three will profit handsomely, but not even Professor Manne could argue that the poor manager deserved the benefits of his insider trading. Moreover, even Justice Powell, who wrote the restrictive opinions in *Chiarella* and *Dirks*, acknowledged that "[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office."⁷³

The situation would be all the more egregious in a bad news situation where all three executives are performing poorly, but liquidate their holdings before disclosure of the poor earnings and avoid a substantial loss.⁷⁴

Another criticism of the liberal development of insider trading in private damages flowed from the adoption of the "disclose or abstain" mantra in *Texas Gulf Sulphur* by other federal courts in private actions.⁷⁵ Under the "disclose or abstain" mantra, since the insider did not abstain, plaintiffs argued that he therefore had an obligation to disclose and, that by not disclosing, the insider caused injury to the other investors who traded in the market without the benefit of the undisclosed information.⁷⁶ *Texas Gulf Sulphur* was a "good news" case: when the insider bought at 29 without disclosing the extraordinary mineral find, sellers in the market would assert he or she would not have sold at 29, but rather at a price of 40, to which the stock rose after disclosure.⁷⁷

It soon became apparent that this theory of liability could have "draconian" consequences.⁷⁸ In *Fridrich*, two sets of plaintiffs brought suit against a defendant who purchased stock with knowledge of an impending merger that would increase the value of the company stock.⁷⁹ One set of plaintiffs, Woosley, purchased their stock in the company in 1967.⁸⁰ The defendant, Bradford, purchased 1225 shares of stock on April 27, 1972.⁸¹ The other set of plaintiffs, Fridrich, purchased stock in May 1972.⁸² Both sets of plaintiffs sold in June 1972 at a small profit, while Bradford sold his shares on July 27, 1972, realizing a profit of \$13,000 on the transaction.⁸³

The district court held that the plaintiffs were entitled to damages during the period of nondisclosure measured by "[t]he highest bid value reached by Old

73. *Dirks v. SEC.*, 463 U.S. 646, 654 n.10 (1983) (quoting *Cady, Roberts*, 40 S.E.C., at 912, n.15).

74. *See Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969).

75. *See, e.g., Mitchell v. Tex. Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971).

76. *Id.* at 95-96 ("Reynolds, Mitchell and the Stouts testified that they sold their TGS stock after hearing of the April 12th release but before becoming aware of the April 16th release. . . . Later that afternoon he learned of the favorable TGS report. He testified that had he known of the K-55-1 core results he would have doubled his holdings.").

77. *Id.* at 103 (explaining these rises in price and their effect on the market).

78. *Fridrich v. Bradford*, 542 F.2d 307, 309 (6th Cir. 1976).

79. *Id.* at 310.

80. *Id.* at 311.

81. *Id.* at 308.

82. *Id.* at 311.

83. *Id.* at 308.

Line stock within a period of 20 days following the SEC's [disclosure] action on November 10, 1972, disclosing the defendants' wrongful conduct."⁸⁴ Consequently, Bradford, who would realize a profit of only \$13,000, was nevertheless jointly and severally liable for a draconian judgment of \$361,186.75.⁸⁵

In beginning its analysis, the Sixth Circuit recognized that "[f]ew early cases brought under § 10(b) and Rule 10b-5 dealt with non-disclosure by insiders trading in the open market. Development of the law in this area is largely traceable to the "abstain or disclose rule" developed in *SEC v. Texas Gulf Sulphur*."⁸⁶ The Sixth Circuit also recognized that some courts had interpreted the "disclose or abstain" rule to require that once the insider traded, the insider had an obligation to disclose and a breach of that duty could give rise to a private cause of action without any more causation necessary.⁸⁷ In other words, it was the act of trading by the insider that supplied the necessary causation.

However, the Sixth Circuit did not accept that approach to causation:

We conclude that upon the facts of this case defendants' conduct caused no injury to plaintiffs and the judgment of the district court must be reversed. It is undisputed that defendants did not purchase any shares of stock from plaintiffs, and that defendants' acts of trading in no way affected plaintiffs' decision to sell.⁸⁸

In focusing upon causation, the court stated that "[d]efendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision."⁸⁹ Consequently, "defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider."⁹⁰

The logic of the Sixth Circuit is unassailable. Plaintiffs in *Fridrich* could have sold for many reasons: to close out a profit, to generate liquidity to pay for college tuition, or to diversify their holdings. The defendant had an obligation not to disclose, but this duty ran to the corporation. In fact, absent the law of insider trading, the disclosure obligation of either the insider or the corporation is limited under securities laws.⁹¹

84. *Id.* at 313.

85. *Id.* at 308.

86. *Id.* at 314 (footnote omitted).

87. *Id.* at 317.

88. *Id.* at 318.

89. *Id.*

90. *Id.* at 318–19.

91. Most of the litigation regarding disclosure involves not whether to disclose, but rather, whether the disclosure is false or misleading. Charles W. Murdock, *The Significance and Impact of Price Distortion in the Fraud-on-the-Market Theory After Halliburton II*, 46 *LOY. U. CHI. L.J.* 551, 577 (2015). 15 U.S.C. § 781(a)–(b) (2012); 15 U.S.C. § 78m (2012); 15 U.S.C. § 78n(a)–(c) (2012); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

II. THE SUPREME COURT'S 1980S MISADVENTURES IN INSIDER TRADING

The confusion and uncertainty in the present state of the law on insider trading is illustrated by the colloquy at oral argument in the current case of *Salman v. United States*.⁹² Both sides relied upon *Dirks* and *Chiarella*, the two poorly reasoned cases that marked the Supreme Court's turn from conservative to reactionary. If the foundation upon which a body of law is based is faulty, then the jurisprudence that follows will be equally flawed.

I now turn to the flawed reasoning embodied in the trilogy of insider trading decisions in the early 1980s, including *Chiarella*,⁹³ *Dirks*,⁹⁴ and *Carpenter*,⁹⁵ which dramatically changed the course of insider trading enforcement, led to an explosion in insider trading,⁹⁶ and triggered the enactment of the Insider Trading Sanctions Act in 1984 (ITSA)⁹⁷ and the Insider Trading Securities Fraud Enforcement Act in 1988 (ITSFEA).⁹⁸ Parenthetically, any reference to the Congressional response to the decisions is noticeably absent in subsequent Supreme Court decisions.

A. THE *CHIARELLA* DECISION—INTRODUCTION OF COMMON LAW DUTY

As stated above, both the defendant and government in *Salman* relied upon *Chiarella* and *Dirks*, thus illustrating that the “rules” set forth in these cases are not as clear and logical as supporters have argued.⁹⁹ *Chiarella* marked a radical departure from existing law, and *Dirks* made bad law worse. So, let us begin with *Chiarella*.

Chiarella worked for a financial printer, Pandich Press, and, in the days before computers (if anyone can remember that far back), type would be sent before the tender offer, with the names of the bidder and target left blank, as well as other clearly identifying material.¹⁰⁰ The night before the bid was to be made, the “blanks” would be filled in and the next morning, the bid would be publicized.¹⁰¹ *Chiarella* was sufficiently astute to discern the identity of the target, purchase the target stock at the pre-bid price, and make a substantial profit after the stock price rose when the bid was announced.¹⁰²

92. 137 S. Ct. 420 (2016).

93. 445 U.S. 222 (1980).

94. 463 U.S. 646 (1983).

95. 484 U.S. 19 (1987).

96. See H.R. REP. NO. 98-355, at 2287 (1983); H.R. REP. NO. 100-910, at 6044 (1988).

97. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered subsections of 15 U.S.C. § 78 (1988)).

98. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C.).

99. *Salman v. United States*, 137 S. Ct. 420, 426–29 (2016).

100. *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

101. *Id.*

102. *Id.*

If the purpose of the law was to reward industriousness, as Professor Manne has suggested,¹⁰³ Chiarella certainly was deserving. Unlike the defendants in *Newman* and *Salman*, Chiarella's profits came as a result of some creative effort on his part.¹⁰⁴ Contrariwise, the defendants in *Newman* and *Salman* were simply leeches, benefiting from the ill-gained knowledge of others.

However, Chief Justice Burger, a law and order conservative,¹⁰⁵ was not impressed with Chiarella's industriousness in his dissenting opinion and chastised Chiarella as follows:

[T]he evidence shows beyond all doubt that Chiarella, working literally in the shadows of the warning signs in the printshop, misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates § 10(b) and Rule 10b-5. Accordingly, I would affirm the judgment of the Court of Appeals.¹⁰⁶

Chiarella was tried by the U.S. Attorney essentially for violating the “disclose or abstain” duty articulated in *Texas Gulf Sulphur*. As stated above, this formulation by the *Texas Gulf Sulphur* court has always been problematic because, as here, Chiarella was under a duty not to disclose because he clearly owed a duty of confidentiality to his employer.

Moreover, the information he possessed was not “company specific” information relating to the “financials” of the bidder to whom he owed a duty of confidentiality, but rather “market information,” namely the plan of the bidder to make a forthcoming tender offer. Thus, the situation differed from the “traditional” insider trading situation where a corporate insider used company specific information and, in a “good news” situation, bought from existing shareholders to whom he may have had a common law fiduciary duty. Under the common law, Chiarella did not have a fiduciary duty to the persons trading on the other side of his transactions, namely, the shareholders of the target company.

Dealing with this somewhat unique situation in a point in time when tender offers were not as prevalent as today, the majority believed that it could not affirm Chiarella's conviction without recognizing a duty to the market as a whole.

103. Manne, *supra* note 66, at 935–36.

104. Chiarella's attorney acknowledged the following in closing argument:

Let me say right up front, too, Mr. Chiarella got on the stand and he conceded, he said candidly, “I used clues I got while I was at work. I looked at these various documents and I deciphered them and I decoded them and I used that information as a basis for purchasing stock.” There is no question about that. We don't have to go through a hullabaloo about that. It is something he concedes. There is no mystery about that.

Chiarella, 445 U.S. at 244–45 (Burger, C.J., dissenting).

105. I am not necessarily a fan of Chief Justice Burger. He fell asleep on me during my oral argument in *Marrese v. Am. Acad. of Orthopedic Surgeons*, 470 U.S. 373 (1985).

106. *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

This is where the Court ran amuck. As stated earlier,¹⁰⁷ the securities laws were enacted because the common law was inadequate.¹⁰⁸ However, the Court now turned to the common law to determine whether there is a violation of the federal securities laws. Long ago, a justice who advocated judicial restraint nevertheless observed, in discussing disclosure obligations under the securities laws, that where federal rights are involved, federal courts can fashion a federal common law.¹⁰⁹ Unfortunately, the Rehnquist and Roberts courts have rejected looking to a federal common law to enforce federal rights on the basis that this is judicial activism.¹¹⁰ Paradoxically, these courts themselves have engaged in unparalleled judicial activism.¹¹¹

The lack of judicial craftsmanship in *Chiarella* is illustrated by the fact that the Court cited *Cady, Roberts* to support its position that a common law duty must be violated before an insider violates Rule 10b-5.¹¹² In fact, *Cady, Roberts* held just the opposite. As stated above, *Cady, Roberts* was a “bad news” situation where the price was likely to go down, so the insider sold. Gintel, the colleague of the Curtiss-Wright director who passed the information to him, argued that he had no fiduciary duty to those to whom he sold because they were non-shareholders.¹¹³ The *Cady, Roberts* opinion made short shrift of this argument by stating:

“Whatever distinctions may have existed at common law . . . that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.”¹¹⁴

Thus, in no way does *Cady, Roberts* stand for the proposition that the evil in insider trading devolves from common law principles.

Assuming, arguendo, the need to find a duty, Chief Justice Burger would find such a duty from the fact that the information was illicitly obtained. Justice Burger acknowledged that, in an arm’s-length transaction between two parties, the rule is that there is not normally an obligation to disclose. The rationale for

107. See *supra* text following note 30.

108. See *supra* text at notes 24–27; see also *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting) (discussing that the purpose of the securities laws is “to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate”).

109. *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964) (“[I]t ‘is not uncommon for federal courts to fashion federal law where federal rights are concerned.’” (quoting *Textile Workers v. Lincoln Mills*, 353 U.S. 448, 457 (1957))). Justice Clark also stated, “Private enforcement of the proxy rules provides a necessary supplement to Commission action.” *Id.* at 432.

110. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 576–79 (1979).

111. Consider, for example, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), where the court, on its own motion, requested the parties to brief a different issue than the parties had brought before the court. It then overturned the uniform decisions of the Circuit Courts that defendants could aid and abet a violation of Rule 10b-5. *Id.* at 177–78.

112. *Chiarella*, 445 U.S. at 227–29.

113. *Cady, Roberts & Co.*, 40 S.E.C. 907, 908–09 (1961).

114. *Id.* at 913–14.

this is that a person in a securities transaction should get the benefit of his or her “hard work, careful analysis, and astute forecasting.”¹¹⁵ However, the rationale for this rule fails “when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.”¹¹⁶ Since *Chiarella* did not disclose—indeed, he had a duty not to disclose—he had an absolute obligation to abstain and his failure to do so was illegal.

Recall that *Chiarella* was a criminal case. The duty in criminal law is not to anyone in particular—it is a duty to obey the law which the legislature has adopted for the benefit of all. While there may be some who are especially benefited by the law, establishment of such a benefit is not a prerequisite to a determination that the law has been violated. The prohibition against driving through a red light is for the especial benefit of pedestrians and drivers in cross-traffic. One who was hit by someone who runs a red light can establish negligence by showing that the defendant violated the law.¹¹⁷ However, the driver who ignores a red light is not exculpated by the fact that he did not hit anyone. The statute was violated, and the act is illegal irrespective of whether anyone is injured. This is the approach that the majority in *Chiarella* should have taken. Focusing upon whether there is a duty to some particular person or group of persons misses the point.

Unfortunately, the Supreme Court began its analysis by improperly framing the issue. According to the Court, the issue was “whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10(b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company’s securities.”¹¹⁸

Based upon the *Cady, Roberts* decision, which Justice Powell later characterized as a “seminal” case in *Dirks*,¹¹⁹ Justice Powell should have stated the issue to be whether a person with material non-public information, which the person knows is “intended to be available only for a corporate purpose and not for the personal benefit of anyone,” violates Rule 10b-5 by trading on the basis of that information before it is disclosed to the public.¹²⁰

The Court continued its analysis by stating that the “case concerns the legal effect of the petitioner’s silence.”¹²¹ Again, this misstates the issue. This is not a silence case similar to that in the *Affiliated Ute* case.¹²² This case does not

115. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

116. *Id.* (Burger, C.J., dissenting).

117. See RESTATEMENT (THIRD) OF TORTS: STATUTORY VIOLATIONS AS NEGLIGENCE PER SE § 14 (AM. LAW INST. 2010).

118. *Chiarella*, 445 U.S. at 224.

119. *Dirks v. SEC*, 463 U.S. 646, 653 (1983).

120. *Cady, Roberts & Co.*, 40 SEC 907, 912 (1961).

121. *Chiarella*, 445 U.S. at 226.

122. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The securities claim arose from the mixed-blood members being compelled to deal with the First Security Bank of Utah regarding the sale of their shares per agreement with the Ute Development Corporation (UDC). *Id.* at 145. The mixed-bloods began selling their shares through the bank to nonmembers, including two of the bank managers, at prices lower than the price

involve Chiarella's failure to speak, but rather Chiarella's actions, namely, trading on the basis of material, non-public information. Once again, if *Cady, Roberts* is seminal, *Cady, Roberts* focused not upon silence by Gintel, the tippee, but rather, his trading in a situation that involved an unfair advantage because of the premature disclosure of material information to him.¹²³

When you start down the wrong path, it is not surprising that you end up in the wrong place. As Yogi Berra once said, "You've got to be very careful if you don't know where you are going because you might not get there."¹²⁴

Since Chiarella did not disclose the confidential information before trading, the majority allowed itself to be euchred by the faulty language in *Texas Gulf Sulfur* that insiders have an obligation to disclose or abstain. Since he did not abstain, under this flawed phraseology, he had a duty to disclose and, since he did not disclose, the Court treated the case as a silence case.¹²⁵

In so doing, the Court recognized, properly so, that silence is actionable only when there is a duty to disclose. But, clearly, Chiarella did not have a duty to disclose stemming from his employment relationship. To the contrary, he had a duty to maintain confidentiality. The only other relationship that Chiarella had was a buyer/seller relationship with the shareholders of the target corporation from whom he bought.

According to the majority, "[p]etitioner's use of . . . [the forthcoming tender offer] was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading."¹²⁶ The Court could see no basis upon which posit such a duty:

Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.¹²⁷

Consequently, the Court concluded:

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on

that the shares were eventually sold for between nonmembers. *Id.* at 146–47. The mixed-blood members then brought suit against the United States, the bank managers, and the bank. *Id.* at 140. As to the United States, the Court found that as federal termination of the shares was complete, the United States had no liability for failure to restrain sale. *Id.* at 150. The Court also found the bank managers committed fraud in that they planned to entice the mixed-bloods to sell their shares without disclosing facts that would influence their decision to sell. *Id.* at 153. The Court found that the bank managers were market makers, and had a duty to disclose to the sellers that they would benefit from any such sales of shares. *Id.* The Court lastly found that the Bank was coextensive with that of its managers. *Id.* at 154.

123. See *Cady, Roberts & Co.*, 40 S.E.C. at 915.

124. James Jahnke, *Yogi Berra's 50 Greatest Quotes*, DET. FREE PRESS, (Sept. 23, 2015), <https://www.freep.com/story/sports/mlb/2015/09/23/yogi-berra-quotes-isms/72669094/>.

125. See *Chiarella*, 445 U.S. at 226.

126. *Id.* at 231.

127. *Id.* at 232–33.

material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . should not be undertaken absent some explicit evidence of congressional intent.¹²⁸

More succinctly: “We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.”¹²⁹ The Court opined that a contrary result “would be inconsistent with the careful plan that Congress has enacted for the regulation of the securities markets.”¹³⁰

This was a remarkable piece of legerdemain by Justice Powell, an experienced corporate lawyer, who was undoubtedly very familiar with the securities laws and their history.

To support the statement that a contrary result would be inconsistent with the careful plan that Congress had enacted for the regulation of the securities markets, Justice Powell relied upon the Williams Act,¹³¹ and the SEC’s regulation of “parking.”¹³² According to the Court, the Williams Act merely limits “but does not completely prohibit a tender offeror’s purchases of target corporation stock before public announcement of the offer.”¹³³ The Court intellectualized from this legislation that Congress does not mind some insider trading. What the Court failed to recognize was that the bidder utilized its own information, not someone else’s, by purchasing the stock of the target corporation. As suggested by the Court, instead of empowering the bidder to do something that it otherwise could not do, the Williams Act actually constrains the bidder by limiting the time period during which it can use its own information to purchase stock.

Similarly, the argument that using section 14(e) of the 1934 Securities Exchange Act,¹³⁴ instead of section 10(b),¹³⁵ indicates that Rule 10b-5, promulgated pursuant to section 10(b), somehow indicates that Congress does not believe in parity-of-information is fallacious. This is a non sequitur. The SEC promulgated a rule against warehousing and tender offers under section 14(e), rather than section 10(b) because, in the first place, section 14 is totally focused upon tender offers. In addition, in section 14, Congress explicitly gave the SEC the authority not just to define wrongful conduct, as in section 10(b), but also to “prescribe means reasonably designed to prevent” fraudulent acts.¹³⁶ In other words, the scope of SEC authority under section 14 is greater than under section

128. *Id.* at 233.

129. *Id.* at 235.

130. *Id.*

131. 15 U.S.C. § 78m(d)(1) (2012).

132. *United States v. Bilzerian*, 926 F.2d 1285, 1290 (2d. Cir. 1991) (“‘Parking’ refers to a transaction in which a broker-dealer buys stock from a customer with the understanding that the customer will buy stock back at a later date for the purchase price plus interest and commissions.”).

133. *Chiarella*, 445 U.S. at 233.

134. 15 U.S.C. § 78n(a)–(c) (2012).

135. 15 U.S.C.A. § 78j (West 2015).

136. *Id.* § 78n(e) (West 2015).

10. In promulgating a rule, it is wise for an administrative body to use its broadest legislative authorization.

Consequently, the fact that the SEC promulgated a rule against warehousing and tender offers under section 14, which is focused upon tender offers and provides a broad grant of SEC authority, says nothing at all about the scope of Rule 10b-5. Unfortunately, Justice Powell, a former corporate lawyer, used his broad knowledge of corporate law to muddy the waters by coming up with analogies that superficially support his position, but are actually irrelevant.¹³⁷

The outcome-determinative nature of Justice Powell's analysis is most clearly indicated by its lack of reference to clearly stated congressional policy. In recounting the necessity for regulation, Congress explicitly stated in section 2 of the Securities Exchange Act of 1934 that one of the purposes was "to insure the maintenance of fair and honest markets" in securities transactions.¹³⁸ Later, in connection with the massive 1975 amendments creating a national market system, the joint conference report stated that the "basic goals of the Exchange Act remain salutatory and unchallenged," including the need "to assure that dealing in securities is fair and without undue preferences or advantages among investors."¹³⁹

While I quarrel with the sophistry utilized by Justice Powell, the U.S. Attorney and the Second Circuit were complicit in the focus of the majority on whether there was a duty to disclose. The indictment charged that Chiarella traded "without disclosing the material nonpublic information he had obtained in connection with his employment,"¹⁴⁰ and the Second Circuit affirmed the conviction by holding that "[a]nyone corporate insider or not who regularly receives material nonpublic information may not use that information to trade in

137. Justice Powell is sometimes thought of as a moderate, but was actually a rabid pro-business conservative whose "Manifesto" resulted in the formation of conservative think tanks. In his Memorandum or Manifesto, he asserted:

No thoughtful person can question that the American economic system is under broad attack. . . .

The sources are varied and diffused. They include, not unexpectedly, the Communists, New Leftists and other revolutionaries who would destroy the entire system, both political and economic. These extremists on the left are far more numerous, better financed, and increasingly are more welcomed and encouraged by other elements of society, than ever before in our history. But they remain a small minority, and are not yet the principal cause for concern.

The most disquieting voices joining the chorus of criticism, come from perfectly respectable elements of society: from the college campus, the pulpit, the media, the intellectual and literary journals, the arts and sciences, and from politicians.

Memorandum from Lewis F. Powell, Jr. to Mr. Eugene B. Synder, Jr., Chairman, Educ. Comm., U.S. Chamber of Commerce 1-3 (Aug. 23, 1971) [hereinafter Powell Memorandum] (on file with Washington & Lee University School of Law Scholarly Commons).

138. 15 U.S.C.A. § 78b (West 2015).

139. H.R. REP. NO. 94-229, at 91 (1975) (Conf. Rep.).

140. *Chiarella v. United States*, 445 U.S. 222, 244 (1980) (Burger, C.J., dissenting).

securities without incurring an affirmative duty to disclose.”¹⁴¹ Thus, both bought into the inept phraseology of *Texas Gulf Sulfur* that the obligation was to “disclose or abstain” rather than “abstain until disclosable.” In point of fact, the language of the Second Circuit would be compatible with the *Cady, Roberts* rule if the Second Circuit had simply deleted the phrase “without incurring an affirmative duty to disclose” in the above sentence.

The foregoing illustrates the soundness of my assertion that the *Texas Gulf Sulfur* court created unnecessary mischief when it articulated the mantra “disclose or abstain” instead of more accurately articulating a standard of “abstain until disclosable.”

Had the mantra been “abstain until disclosable,” the Supreme Court would not have had the opportunity to wax eloquently on its inability to find a basis for any duty of Chiarella to disclose the confidential information to target shareholders—an absurd issue in the first place since Chiarella clearly had a duty not to disclose to anyone pursuant to his employment.

The ineptness of the “disclose or abstain” standard does not, however, let the Supreme Court off the hook for the distraction it created by focusing upon the absurd proposition that it needed to find a *common law duty* that Chiarella owed to target shareholders in order to convict him under *federal law*. In effect, Justice Powell engaged in a masterful distraction to introduce uncertainty and ambiguity into the law of insider trading.

According to Chief Justice Burger, in his dissent, the jury was told:

[In] simple terms, the charge is that Chiarella wrongfully took advantage of information he acquired *in the course of his confidential position at Pandick Press* and secretly used that information when he knew other people trading in the securities market did not have access to the same information that he had at a time when he knew that that information was material to the value of the stock.¹⁴²

This charge clearly fits within the “seminal” *Cady, Roberts* standard that Chiarella knowingly took information that was intended only for corporate purposes and not for the personal benefit of anyone, and used it unfairly, realizing that his knowledge was not available to others who traded in the market. This formulation of the fraud was also consistent with the congressional policy that the purpose of the securities laws was to “assure that dealing in securities is fair and without undue preferences or advantages among investors.”¹⁴³

Instead of dealing with existing law and revising the *Texas Gulf Sulfur* standard to “abstain until disclosable,” Justice Powell, who authored the famous “Powell Memorandum”¹⁴⁴ challenging “liberal” positions such as auto safety, subtly and cleverly took the law of insider trading in a new and restrictive

141. *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978) (emphasis added).

142. *Chiarella*, 445 U.S. at 243–44 (Burger, C.J., dissenting) (alteration in original).

143. H.R. REP. NO. 94-229, at 91.

144. Powell Memorandum, *supra* note 137.

direction. Justice Powell also began to undercut the notion of fairness that was inherent in the securities laws, stating that “not every instance of financial unfairness constitutes fraudulent activity under § 10 (b).”¹⁴⁵ He continued his campaign against “fairness” in the subsequent insider trading opinion in *Dirks*.¹⁴⁶

The majority opinion declined to address the misappropriation theory articulated by Chief Justice Burger,¹⁴⁷ and again avoided it in the *Carpenter* case. Nevertheless, while Justice Burger lost the battle, he ultimately won the war when the Supreme Court adopted the misappropriation theory in *O’Hagan*.¹⁴⁸

B. THE *DIRKS* DECISION—TIPPEE DOESN’T SIN UNLESS TIPPER SINS

If *Chiarella* was bad, *Dirks* was worse, both on the facts and the Supreme Court’s jurisprudence. Reading the majority and dissenting opinions is like watching two dramatically different movies: one involves a hero and the other a desperado.¹⁴⁹

Dirks involved an unbelievable set of facts. Equity Funding was an insurance company that wanted to enhance its earnings.¹⁵⁰ Since an insufficient number of real persons purchased its policies, it began creating people and, since the insurance business involves both inflows (customers paying premiums) and outflows (customers dying and beneficiaries collecting on the policies), Equity Funding also needed to kill some people.¹⁵¹ Fortunately, the company only killed some of the fictitious people that it had created.¹⁵²

Secrist, an unhappy former executive of Equity Funding, informed Dirks, an analyst, of the scam and asked Dirks to publicize the fraud.¹⁵³ While Dirks

145. *Chiarella*, 445 U.S. at 232.

146. *Dirks v. SEC*, 463 U.S. 646, 653–54 (1983).

147. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting). Arguably, a majority of the Justices in *Chiarella* accepted the misappropriation theory: the three dissenters, Justice Brennan concurring with the judgment, and Justice Stevens, in his concurring opinion.

148. *United States v. O’Hagan*, 521 U.S. 642, 650 (1997).

149. The opinion describes Dirks’ investigation in the Los Angeles Equity Funding office as innocent, stating that “[n]either Dirks nor his firm owned or traded . . . stock,” but instead, he “openly discussed the information” resulting in some clients and investors selling their holdings. *Dirks*, 463 U.S. at 649. The Court also favorably frames Dirks’ involvement in describing the SEC decision: “[r]ecognizing, however, that Dirks ‘played an important role in bringing [Equity Funding’s] massive fraud to light’ . . . the SEC only censured him.” *Id.* at 651–52 (second alteration in original) (citing Raymond L. Dirks, Exchange Act Release No. 17480, 1981 WL 36329 (Jan. 22, 1981)). The dissent, however, describes Dirks’ investigation differently, stating: “Instead of reporting that information to the Securities and Exchange Commission . . . Dirks began to disseminate the information to his clients,” and “[a]s he gathered more information, he selectively disclosed it to his clients.” *Id.* at 669–70 (Blackmun, J., dissenting). The dissent also states that “Dirks’ attempts to disseminate the information to nonclients were feeble, at best.” *Id.* at 670 (Blackmun, J., dissenting). The effect of this, the dissent states, was that “Dirks’ clients were able to shift the losses that were inevitable.” *Id.* (Blackmun, J., dissenting).

150. *Dirks*, 463 U.S. at 649.

151. Raymond L. Dirks, Exchange Act Release No. 17480, 1981 WL 36329, at *2 (Jan. 22, 1981).

152. *Id.*

153. *Dirks*, 463 U.S. at 649–50.

took some steps to publicize the fraud,¹⁵⁴ he also told a number of clients and institutional investors, of which five of the latter liquidated holdings in Equity Funding worth \$16 million.¹⁵⁵ As a result of the increased trading and drop in price, the New York Stock Exchange suspended trading, the SEC filed a complaint, and Equity Funding officers and directors were indicted.¹⁵⁶

The majority began its analysis by interpreting *Chiarella* as requiring a breach of common law fiduciary duty, or duty of confidentiality, as a prerequisite to finding fraudulent activity in insider trading.¹⁵⁷ The Court asserted that it would not “recogniz[e] a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.”¹⁵⁸ As will be developed later, the Supreme Court’s horror in recognizing such a duty is undercut when one recognizes that a defendant’s conduct is illegal only when it can be established that the defendant has the requisite state of mind, or scienter.

The Court then stated that there are “analytical difficulties” in “policing tippees who trade on inside information,”¹⁵⁹ and that it is “unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information.”¹⁶⁰ Perhaps the Court would have found it helpful to have read the *Cady, Roberts* decision since a tippee, trading on inside information, was exactly the subject matter of the opinion. That the Supreme Court can acknowledge that *Cady, Roberts* is a seminal opinion, but not understand the case, is mind-boggling. Instead of clarifying existing law, the *Dirks* opinion muddled it.

Cady, Roberts was clear: “those persons who are in a special relationship with a company and privy to its internal affairs . . . thereby suffer correlative duties in trading in its securities.”¹⁶¹ With regard to tippees, their liability arises from “a relationship giving access, directly or indirectly, to information intended

154. Dirks attempted to contact *The Wall Street Journal* to publicize the fraud on March 12, and succeeded on March 19 when he was told by Herbert Lawson, the bureau chief, that Lawson would refer the matter to a *Journal* reporter based in Los Angeles where Equity Funding was located. *Id.* at 670. Dirks later met with William Blundell, the *Journal*’s Los Angeles bureau chief on March 21. *Id.* Blundell indicated he would pursue his own inquiry but did appear skeptical. *Id.*

155. *Id.* at 649. See SEC v. MacDonald, 699 F.2d 47, 58 (1st Cir. 1983) (“In an SEC enforcement action, a court can legitimately seek to ‘disgorge ill-gotten gains or to restore the status quo, or to accomplish both objectives.’” (quoting SEC v. Commonwealth Chem. Sec. Inc., 574 F.2d 90, 95, 102 (2d Cir. 1978)); see also SEC v. Yun, 148 F. Supp. 2d 1287, 1293 (M.D. Fla. 2001) (ordering defendants to disgorge the profits of their insider trading scheme); SEC v. Druffner, 517 F. Supp. 2d 502, 512 (D. Mass. 2007) (requiring defendant to disgorge profits in the amount of \$732,281); SEC v. Happ, 295 F. Supp. 2d 189, 198 (D. Mass. 2003) (ruling that disgorgement of the loss avoided is appropriate); SEC v. Ingoldsby, SEC Memorandum and Order, Fed. Sec. L. Rep. (CCH) ¶ 95,351 (May 15, 1990) (ordering that defendant disgorge profits of \$24,663); SEC v. Smith, Fed. Sec. L. Rep. (CCH) ¶ 98,564 (2015) (ordering defendant to disgorge profits of \$43,342.88).

156. *Dirks*, 463 U.S. at 650.

157. *Id.* at 654–655.

158. *Id.* at 655 (quoting *Chiarella v. United States*, 455 U.S. 222, 232–23 (1980) (internal quotation marks omitted)).

159. *Id.*

160. *Id.*

161. *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁶² Violations require scienter, which means that the defendant knew, or was reckless in not knowing, that the “information [was] intended to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁶³ Once this test is met, *Cady, Roberts* would find the defendant to be culpable, irrespective of whether the tipper received a benefit or breached any fiduciary duty—recall that the tipper in *Cady, Roberts* did not sin, because the tipper neither breached a fiduciary duty nor received any benefit.¹⁶⁴

Having created a problem where one theretofore did not exist, the majority set forth to solve it. The SEC’s position in *Dirks* was simple—the tippee inherited the insider’s duty:

In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public, material information from insiders become ‘subject to the same duty as [the] insiders.’ Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof.... Presumably, Dirks’ informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice. However, Dirks—standing in their shoes—committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed the information on to traders.¹⁶⁵

But, according to the majority, *Chiarella* determined that “there can be no duty to disclose where the person who has traded on inside information ‘was not [the corporation’s] agent . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.’”¹⁶⁶

Justice Powell referenced the *Cady, Roberts* duty numerous times, but was oblivious to what *Cady, Roberts* actually held. For example:

Thus, some tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. And for Rule 10b–5 purposes, the insider’s disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.¹⁶⁷

In fact, *Cady, Roberts* held just the opposite. As stated above, *Cady, Roberts* was a “bad news” situation where the price is likely to decrease, so the insider sells to persons to whom he arguably does not have a common law

162. *Id.*

163. *Id.*

164. See *supra* text accompanying notes 36–38.

165. *Dirks*, 463 U.S. at 655–56 (citing 21 S.E.C. Docket, at 1410 n.42) (citations omitted).

166. *Id.* at 654 (citing *Chiarella v. United States*, 445 U.S. 222, 232 (1980)).

167. *Id.* at 660.

fiduciary duty.¹⁶⁸ The defendant was not a traditional corporate insider and was not a person in whom the sellers had placed their trust and confidence. In addition, the tipper breached no fiduciary duty and received no benefit.

Having rejected the SEC view that “the antifraud provisions require equal information among all traders,”¹⁶⁹ the Court interpreted *Chiarella* as setting forth that “only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.”¹⁷⁰ The Court considered the duty to “disclose-or-refrain” to be “extraordinary,”¹⁷¹ and reaffirmed its view of *Chiarella* as holding “[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one’s ability to acquire information because of his position in the market.”¹⁷²

Since only some persons under *some circumstances* are prohibited from using inside information and since the duty to disclose or refrain is *extraordinary*, one would draw the conclusion that insider trading is the exception and not the rule. In such a case, it would not be unlikely that there would be an explosion in insider trading following these decisions, but that is exactly what happened.¹⁷³

At this point in the decision, we know that a tippee’s duty is derivative, and that a tippee is liable only when the tipper has “sinned,” or breached a fiduciary duty. Once again, the majority opinion manifested its concern for analysts. According to the Court, a legitimate use of inside information occurs when management conveys information to analysts:

In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.¹⁷⁴

Justice Powell resolved this dilemma by asserting: “[w]hether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.”¹⁷⁵ In so doing, he once again inadvertently misinterpreted *Cady, Roberts*. According to Justice Powell, “[t]his standard was identified by the SEC itself in *Cady, Roberts*: a purpose of the securities laws was to eliminate the ‘use of inside information for personal advantage.’”¹⁷⁶ But the culprit who received a benefit in *Cady, Roberts* was not the tipper, but rather the tippee.

168. *Cady, Roberts & Co.*, 40 S.E.C. 907, 908 (1961).

169. *Dirks*, 463 U.S. at 657.

170. *Id.*

171. *Id.*

172. *Id.* at 657–58 (citing *Chiarella v. United States*, 445 U.S. 222, 231–32, n.14 (1980)) (alterations in original).

173. See H.R. REP. NO. 98-355, at 2287 (1983); H.R. REP. NO. 100-910, at 6044 (1988).

174. *Dirks*, 463 U.S. at 662.

175. *Id.*

176. *Id.* (quoting *Cady, Roberts, & Co.* 40 S.E.C. 907, 912, n. 15 (1961)).

The Court put the pieces of the picture together as follows: “Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”¹⁷⁷

According to the Court, this will introduce objectivity, as opposed to subjectivity, into the analysis: “This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.”¹⁷⁸

The Court loosened this objective criteria by acknowledging the possibility that the insider might recognize a benefit by making a gift of the information. This addition was germane to and in fact, dispositive of, the *Salman* decision: “The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”¹⁷⁹

Having thus formulated the law of the case, resolution was simple:

The tippers received no monetary or personal benefit for revealing Equity Funding’s secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks.¹⁸⁰

Even here, the Supreme Court’s approach was simplistic and outcome-determinative. In the view of the majority, the tipper and tippee were heroes—they sought to expose a fraud. The dissent took a much more jaundiced view of the situation: “In disclosing that information to Dirks, Secrist intended that Dirks would disseminate the information to his clients, those clients would unload their Equity Funding securities on the market, and the price would fall precipitously, thereby triggering a reaction from the authorities.”¹⁸¹

There were no heroes in the dissenters’ view, only winners and losers: Dirks’ clients gained and the public lost. As the dissent pointed out:

By that time [when the SEC finally suspended trading], Dirks’ clients had unloaded close to \$15 million of Equity Funding stock and the price had plummeted from \$26 to \$15. The effect of Dirks’ selective dissemination of Secrist’s information was that Dirks’ clients were able to shift the losses that

177. *Id.*

178. *Id.* at 663. The court did recognize that “[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. But it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC’s inside-trading rules.” *Id.* at 664.

179. *Id.*

180. *Id.* at 667 (citation omitted).

181. *Id.* at 669 (Blackmun, J., dissenting).

were inevitable due to the Equity Funding fraud from themselves to uninformed market participants.¹⁸²

The dissent also rejected the notion that Dirks acted altruistically:

The Court's implicit suggestion that Dirks did not gain by this selective dissemination of advice is inaccurate. The ALJ found that because of Dirks' information, Boston Company Institutional Investors, Inc., directed business to Delafield Childs that generated approximately \$25,000 in commissions. App. 199, 204–205. While it is true that the exact economic benefit gained by Delafield Childs due to Dirks' activities is unknowable because of the structure of compensation in the securities market, there can be no doubt that Delafield and Dirks gained both monetary rewards and enhanced reputations for "looking after" their clients.¹⁸³

The dissent would not accept the premise that "the end justified the means."¹⁸⁴

The SEC also took a dim view of the majority's approach, asserting that "if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information."¹⁸⁵ The majority disagreed, stating "[w]e think the SEC is unduly concerned."¹⁸⁶ History has proved the SEC correct. As this Article will demonstrate, it is very difficult to obtain a conviction if the tipper and tippee concoct a story and stick to it.¹⁸⁷

For the dissent, the fallacy in the majority's approach was that it "engraft[ed] a special motivational requirement on the fiduciary duty doctrine," which "excuses a knowing and intentional violation of an insider's duty to shareholders if the insider does not act from a motive of personal gain."¹⁸⁸ According to the dissent:

The fact that the insider himself does not benefit from the breach does not eradicate the shareholder's injury. It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of nonpublic information. The duty is addressed not to the insider's motives, but to his actions and their consequences on the shareholder. *Personal gain is not an element of the breach of this duty.*¹⁸⁹

A major problem in the majority's analysis was that, while asserting that only *some* insider trading was wrongful, it provided us with very little insight as to what is a legitimate use of inside information. The Court appeared to have no problem with insiders making selective disclosure to analysts:

182. *Id.* at 670 (Blackmun, J., dissenting).

183. *Id.* at 669 n.4 (citations omitted) (Blackmun, J., dissenting).

184. *Id.* at 677 (Blackmun, J., dissenting).

185. *Id.* at 663.

186. *Id.*

187. *See* SEC v. Switzer, 590 F. Supp. 756, 762 (W.D. Okla. 1984) (describing a situation where the tipper and tippee concocted a story that the tippee, while laying on a bench at a track meet, overheard the tipper and his wife, several feet away, discussing a forthcoming trip due to a recapitalization).

188. *Dirks*, 463 U.S. at 668 (Blackmun, J., dissenting).

189. *Id.* at 673–74 (Blackman, J., dissenting) (citation omitted) (emphasis added).

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to “ferret out and analyze information,” and this often is done by meeting with and questioning corporate officers and others who are insiders.¹⁹⁰

Once again, Justice Powell’s analysis was sloppy. From reading the foregoing, one would gather the impression that the SEC was fearful that holding Dirks liable would inhibit the legitimate work of analysts. In fact, the decision of the SEC was to the contrary. Here is how the SEC viewed the role of analysts:

In this connection, it is important to recognize that this [Dirks] is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a “mosaic” which is only material after the bits and pieces are assembled into one picture. We have long recognized that an analyst may utilize non-public, inside information which in itself is immaterial in order to fill in “interstices in analysis.” That process is legitimate even though such “tidbits” of inside information “may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere,” thereby creating material information. But this is not such a case. Secrist’s information certainly was not “seemingly inconsequential data.” Instead, its significance was immediately clear. Upon receipt of the information from Secrist, there was no need for Dirks to obtain, and he did not obtain, significant new facts to be woven together with Secrist’s original allegations. All that occurred was corroboration and confirmation from inside sources of the original allegations. Under these circumstances, our decision here will not discourage analysts from engaging in the legitimate and desirable function of seeking out corporate information.¹⁹¹

Justice Powell’s bias in favor of the business community, as opposed to the interests of individual shareholders, would be apparent to anyone who has read the Powell Memorandum, in which he saw a “massive assault upon [the business community’s] fundamental economics, upon its philosophy, upon its right to continue to manage its own affairs, and indeed upon its integrity”¹⁹² He saw this attack as essentially led by the left and those who advocated for the regulatory state. No wonder Justice Powell was more sympathetic to the world of analysts than to the viewpoint of the SEC. Justice Powell’s approach benefits corrupt traders, who make millions of dollars from illicitly obtained information, as illustrated by the facts in *Newman*.¹⁹³

To the extent that Justice Powell’s viewpoint had any validity, it has been undercut by two subsequent developments. In 2000, the SEC adopted Regulation FD, which required that, when a corporation discloses material nonpublic information, particularly to market professionals such as analysts, it makes a

190. *Id.* at 658 (citation omitted).

191. Raymond L. Dirks, Exchange Act Release No. 17480, 21 S.E.C. Docket 1401, 1409 (Jan. 22, 1981) (opinion of the commission) (citations omitted).

192. Powell Memorandum, *supra* note 137, at 7.

193. *United States v. Newman*, 773 F.3d 438, 443, 447–48 (2d Cir. 2014).

public disclosure either immediately, in the case of an intentional disclosure, and promptly, in the case of an inadvertent disclosure.¹⁹⁴

In addition, about this time, during the dot-com bubble, the analyst community grossly embarrassed itself by publicly touting stocks which it privately disparaged as “junk,” “crap,” and a “powder keg.”¹⁹⁵ Ten investment banking firms and two analysts paid 1.4 billion dollars in fines, restitution, and other payments.¹⁹⁶

Similarly, the following assertion by Justice Powell was never accurate: “It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.”¹⁹⁷

Recall that in *Cady, Roberts*, the company instructed a secretary to notify the exchanges and Dow Jones about the dividend cut.¹⁹⁸ In today’s world, such an assertion is all the more fallacious. Regulation FD requires disclosure of material nonpublic information and there are many ways in which disclosure can be made. Companies are mandated to file quarterly reports setting forth financial information;¹⁹⁹ in the interim, current reports can be filed;²⁰⁰ and companies have websites and frequently set up investor conference calls.²⁰¹ On top of this, it is still possible to notify the stock exchanges, NASDAQ, and Dow Jones.

The lack of respect by the majority for the notion of parity of information is at odds with the frequently repeated Congressional policy that the playing field should be level and that no investor should have any undue advantage.²⁰² Congress itself has stated that, if *Dirks* is “properly and narrowly construed by the courts, the Commission’s insider trading program will not be adversely affected.”²⁰³

C. THE *CARPENTER* CASE—CONFUSION OVER “IN CONNECTION WITH.”

Carpenter v. United States, the third of the 1980s trilogy of insider trading cases, involved a unique scam to make profits by trading stocks.²⁰⁴ David Carpenter and R. Foster Winans, one of the writers of the “Heard on the Street,” a widely-read financial column at that time in *The Wall Street Journal*, were

194. 17 C.F.R. § 243.100 (2012).

195. *Top 10 Regrettable Emails, Pumping and Dumping*, TIME http://content.time.com/time/specials/packages/article/0,28804,1907771_1907778_1907820,00.html (last visited July 27, 2019).

196. Stephen Labaton, *Wall Street Settlement: The Overview; 10 Wall St. Firms Reach Settlement in Analyst Inquiry*, N.Y. TIMES (Apr. 29, 2003), <http://www.nytimes.com/2003/04/29/business/wall-street-settlement-overview-10-wall-st-firms-reach-settlement-analyst.html>.

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

198. See *supra* text accompanying notes 36–39.

199. 17 CFR §§ 240.13a-1; 240.13a-13 (2018).

200. 17 CFR § 240.13a-11.

201. Brian Beers, *What is an Earnings Conference Call?*, INVESTOPEDIA, (May 31, 2018), <http://www.investopedia.com/ask/answers/04/052104.asp>.

202. See *supra* notes 12–13 and accompanying text.

203. H.R. REP. NO. 98-355, at 15 (1983).

204. *Carpenter v. United States*, 484 U.S. 19 (1987).

roommates.²⁰⁵ Peter Brant, one of the leading brokers at the Kidder, Peabody brokerage house, had noticed that the stock of companies discussed by Winans would “move” after his column was published—up when the column was positive, and down when it was negative.²⁰⁶ Brant approached Winans about leaking the content of the columns before publication.²⁰⁷ Brant would buy a company’s stock when Winans was about to write a positive column about the company and would sell short when Winans was about to write a negative column on a company.²⁰⁸ After the column was published and the stock moved, Brant would close out the transaction.²⁰⁹ Over a four-month period, the scheme netted almost \$700,000.²¹⁰

After the scheme was uncovered, Brant cooperated, while Winans and Carpenter were convicted both of wire fraud and a violation of Rule 10b-5 predicated upon the misappropriation theory.²¹¹ The Supreme Court affirmed the wire fraud conviction but split 4-4 on the Rule 10b-5 count.²¹²

What undoubtedly troubled some members of the Court was the fact that the Rule 10b-5 conviction was predicated upon the schemers misappropriating the publication schedule of *The Wall Street Journal*. For some this raised a problem as to whether the fraud was “in connection with” a purchase or sale of a security.²¹³

This case, like *Chiarella*, involved, not a corporate insider misusing company-specific information for his own benefit, but rather “market” information used by market professionals for their own advantage. It also illustrates the tenuous premise of the misappropriation theory in which a fraud in one area, misappropriating one person’s information, is used to engage in a stock transaction with entirely different persons.

Winans engaged in this scheme because he did not believe that *The Wall Street Journal* adequately compensated him for the exposure his column gave the *Journal*. But what if his superiors at the *Journal* suggested that, in lieu of giving him a salary raise, he should simply trade stocks based upon his column’s impact? Now there is no misappropriation of the *Journal*’s printing schedule; rather, he has been given permission to access it for his benefit.

Thus, this Article argues that it would be more straightforward to recognize the so-called “possession” theory and require market professionals not to use material, nonpublic information for their own benefit prior to dissemination to the public.

205. *Id.* at 22.

206. *Id.* at 23.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *See id.* at 24. In addition, arguably, and to retaliate, Winans published a book, *Trading Secrets*, which detailed Brant’s role in the scheme, and painted Brant in a very unfavorable light.

212. *Id.*

213. *See United States v. O’Hagan*, 521 U.S. 642, 667 (1997).

It was ten more years before the Supreme Court recognized the misappropriation theory and determined that the “in connection with” requirement was satisfied because the purpose of misappropriating information was to engage in a securities transaction.²¹⁴ Thus, the *Carpenter* case is noteworthy for what it did not do, rather than for the insights it provided.²¹⁵

III. THE AFTERMATH OF *CHIARELLA* AND *DIRKS*

The 1980s witnessed an explosion of insider trading. This is recounted in the well-documented book, *Den of Thieves*,²¹⁶ as well as in the committee reports to the Insider Trading Sanctions Act of 1984,²¹⁷ and the Insider Trading Securities Fraud Enforcement Act of 1988.²¹⁸ While correlation does not necessarily mean causation, the message from the Supreme Court was clear: only *some* insider trading in *some* circumstances is unlawful, and the duty to “disclose or abstain” is *extraordinary*. It would be naïve to assume that such a judicial philosophy would not embolden investors who are greedy and also risk-averse. The SEC’s warning that “it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information”²¹⁹ more than played out in subsequent cases. In fact, what developed was not the fabrication of business justification, but rather pure fabrication.²²⁰ The reality is that conviction for insider trading is difficult if the tipper and tippee concoct a false story and stick to it.²²¹

214. *See generally id.*

215. The House of Representatives recognized in a report:

“The Court divided on a 4–4 vote on the question of whether Winans’ ‘misappropriation’ of information rightfully belonging to his employer constituted insider trading, even absent any direct fiduciary duty owed from Winans to the issuers or purchasers and sellers of the securities. The Court’s opinion contained no discussion of the issue. Thus the misappropriation theory clearly remains valid in the Second Circuit, the lower Court in the Winans case, but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5.”

H.R. REP. NO. 100-910, at 10 (1988).

216. STEWART, *supra* note 10.

217. Insider Trading Sanction Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered sections of 15 U.S.C. § 78 (1998)).

218. Insider Trading and Securities Fraud Enforcement Act Of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.).

219. *Dirks v. SEC*, 463 U.S. 646, 663 (1983).

220. *See, e.g.*, *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

221. On the other hand, if the tipper and tippee tell the truth instead of fabricating a story, they will be convicted of insider trading. For example, in *SEC v. Yun*, 327 F. 3d 1263 (2003), a real estate agent walked into the office as another agent was talking to her husband about the reason for the low valuation of stock in their post-nuptial agreement. *Id.* at 1268. That evening, at a dinner, they further discussed the matter and the wife apparently confirmed the information, and the other realtor traded on it. *Id.* If they had lied about discussing the matter together and agreed that the first realtor had just overheard a telephone conversation, the charge of insider trading most likely would not have been successful because there was no conscious transmission of information to the trading realtor. *See supra* notes 191-196 and accompanying text. The law is in a sad state when it encourages lying.

A. CASES ILLUSTRATING THE BENEFITS OF LYING AND THE CONSEQUENCES OF TELLING THE TRUTH

Shortly after the *Chiarella* and *Dirks* decisions, two cases illustrated the SEC's concern about fabrication. In *SEC v. Switzer*,²²² a famous football coach attended his son's track meet and had several conversations with a corporate executive who was a sponsor of Switzer's football television program. According to the testimony:

Sometime in the afternoon, after his last conversation with G. Platt, Switzer laid down on a row of bleachers behind the Platts to sunbathe while waiting for his son's next event. While Switzer was sunbathing, he overheard G. Platt talking to his wife about his trip to New York the prior day. In that conversation, G. Platt mentioned Morgan Stanley and his desire to dispose of or liquidate Phoenix. G. Platt further talked about several companies bidding on Phoenix. Switzer also overheard that an announcement of a "possible" liquidation of Phoenix might occur the following Thursday. Switzer remained on the bleachers behind the Platts for approximately twenty minutes then got up and continued to move about.²²³

How plausible is this story? In an outdoor stadium, have you ever tried to listen to a conversation between two people a few feet away?

So what did Switzer do? That weekend, he initiated conversations with three groups of investors.²²⁴ The first group purchased 6000 shares for about \$260,000 and sold a few days later for a profit of \$118,587.²²⁵ A second group put up the capital to purchase 16,500 shares for a total investment of about \$700,000; the stock was sold a few days later for a profit of \$267,728, of which \$110,491 was paid to Switzer and his buddy who introduced him to the group.²²⁶ A third group purchased 13,000 shares for a total investment of about \$575,000, making a profit of \$205,055, of which \$85,310 was paid to Switzer and his buddy.²²⁷

How likely would it be that a group of investors would invest these sums of money and split the profits with the tipper, who supposedly overheard an unnamed executive talking to his wife at a track meet while the tipper lay on the bleachers a few feet away?²²⁸

222. 590 F. Supp. 756 (W.D. Okla. 1984).

223. *Id.* at 762.

224. *Id.* at 762–63.

225. *Id.* at 759.

226. *Id.*

227. *Id.*

228. In 1987, I put on a program for the Continuing Legal Education Satellite Network on "Insider Trading: Definitions, Enforcement, Defense and Avoidance," with a balanced panel from the SEC and private industry. In connection with the program, I used actors to create a vignette depicting the supposed facts in the Switzer case. After watching the vignette, the general consensus was that Switzer's story was inherently implausible.

These dollar amounts may not seem impressive in today's world where insiders are raking in millions of dollars, but, in the 1980s, they were quite significant. You could calculate a factor of about four to get the equivalent value in today's dollars.

In a highly publicized case at the time,²²⁹ *United States v. Reed*,²³⁰ Thomas Reed, a former secretary of the Air Force, purchased 500 out of the money call options on Amax for \$3000, enabling him to buy Amax stock at \$50 per share.²³¹ The stock was then trading at \$38; consequently, the options were "out of the money" and thus very inexpensive.²³² Prior to his purchase, he had several telephone conversations with his father, a director of Amax, who was out of town.²³³ The next day, Amax announced that it had rejected a buyout offer from Chevron, and the price of its stock soared.²³⁴ Reed then sold his options for \$430,000.²³⁵ While his father knew of the offer from Chevron, Reed and his father testified that they did not discuss it in their telephone conversations.²³⁶ But why else would someone buy out of the money call options that were soon to expire?

Fast-forward to more current times and the case of *SEC v. Yun*,²³⁷ in which the defendants did not fabricate a story, but apparently told the truth. Donna Yun was entering into a postnuptial division of assets with her husband, the president of a subsidiary of Scholastic Corporation.²³⁸ Her husband had informed her that the earnings of scholastic would be substantially down and that is why he had entered a low valuation.²³⁹ While she was discussing this matter on the telephone with her attorney, a fellow realtor, Jerry Burch, entered the office and overheard the conversation.²⁴⁰ He later testified that he did not learn enough from overhearing the conversation to make a decision to trade the Scholastic stock.²⁴¹

However, he and Donna went to a cocktail party that evening and discussed the conversation.²⁴² The following day, he purchased \$19,750 in Scholastic put options and, a day later, Scholastic announced that its earnings would be well

Charles W. Murdock, *Insider Trading: Definitions, Enforcement, Defense and Avoidance*, Program at the JCPenney Conference Ctr., New York City (June 3, 1987).

229. *Jury Clears Reed in Amax Case*, N.Y. TIMES (Dec. 17, 1985), <https://nyti.ms/29DtYYL>.

230. 601 F. Supp 685 (S.D.N.Y. 1985). While Reed was indicted, the jury apparently believed the testimony of the father and son. Reed, however, resigned as an advisor to President Reagan when this transaction became public.

231. *Id.* at 690–91.

232. *Id.* at 691.

233. *Id.* at 690.

234. *Id.* at 691.

235. *Id.*

236. *Id.* at 688–93.

237. 327 F.3d 1263 (11th Cir. 2003).

238. *Id.* at 1267.

239. *Id.*

240. *Id.* at 1268.

241. *Id.*

242. *Id.*

below the analysts' expectations.²⁴³ The next day, the price of Scholastic shares had dropped approximately forty percent, and he sold his Scholastic puts, realizing a profit of \$269,000, a 1300 percent return on his investment.²⁴⁴ Within hours, the SEC commenced an investigation.²⁴⁵

The jury returned a verdict in favor of the SEC, but the Eleventh Circuit reversed on the basis that the jury instructions did not require that Donna receive a benefit from sharing information with Burch.²⁴⁶ The Eleventh Circuit did recognize that a jury could reasonably conclude that "Donna expected to benefit from her tip to Burch by maintaining a good relationship between a friend and frequent partner in real estate deals."²⁴⁷ The Eleventh Circuit also recognized that a confidential relationship existed between husband and wife:

We conclude that the SEC provided sufficient evidence both that an agreement of confidentiality and a history or pattern of sharing and keeping of business confidences existed between David and Donna Yun such that David could have reasonably expected Donna to keep confidential what he told her about Scholastic's pending announcement.²⁴⁸

This latter position is in sharp contradistinction to the Second Circuit's position in *United States v. Chestman*, where the Second Circuit held that a confidential relationship did not exist between husband and wife:

Keith's status as Susan's husband could not itself establish fiduciary status. Nor, absent a pre-existing fiduciary relation or an express agreement of confidentiality, could the coda—"Don't tell." That leaves the unremarkable testimony that Keith and Susan had shared and maintained generic confidences before. The jury was not told the nature of these past disclosures and therefore it could not reasonably find a relationship that inspired fiduciary, rather than normal marital, obligations.²⁴⁹

The Second Circuit's view of the marriage relationship is certainly not one that I hold, nor is it, I suspect, one with which most people would agree. How does the Second Circuit explain the marital privilege that one spouse need not testify against another? Subsequent to *Chestman*, the SEC promulgated a rule which set forth a presumption that there is a relationship of confidentiality between spouses and certain other family members.²⁵⁰

For the sake of argument, assume that Donna and Burch agreed that Burch made his decision based upon overhearing Donna's phone call with her attorney and that the subject was never discussed at the subsequent cocktail party. Would an SEC judgment then have been possible? The husband did not breach any duty of confidentiality or fiduciary duty by telling his wife about relevant information

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.* at 1281.

247. *Id.* at 1280.

248. *Id.* at 1273–74.

249. *United States v. Chestman*, 947 F.2d 551, 571 (2d Cir. 1991).

250. 17 C.F.R. § 240.10b5-2 (2003).

concerning their postnuptial division of assets. Nor did Donna breach any duty of confidentiality or fiduciary duty by discussing the matter with her attorney. Had Burch merely overheard the privileged conversation, Donna would not have sinned, and thus Burch could not have sinned. Moreover, Donna did not communicate the information to Burch with the expectation of a benefit—she did not intentionally communicate the information at all.

In securities transactions, there are winners and losers. Why should greedy, risk-averse investors be entitled to keep their ill-gotten gains? Is this something that the law should facilitate? But that is exactly what the tortured opinions in *Chiarella* and *Dirks* accomplish. Why should the existence of a benefit, or lack thereof, determine whether or not the tippee retains the benefit from trading in an essentially riskless transaction?

B. THE ANALYSTS' DOT-COM FRAUDULENT SCHEME

Fast-forward ten years to the late 1990s and the emergence of a slew of Internet-based startup companies that ultimately led to the bursting of the so-called dot-com bubble.²⁵¹ Reading between the lines in the *Dirks* opinion, one could conclude that Justice Powell's goal was not to endanger the analyst industry by exposing it to insider trading liability.²⁵² Contrariwise, Congress did not believe that enforcement of insider trading law would discourage legitimate analyst activity.²⁵³

However, at this time, the analyst industry brought itself into disrepute. Analysts were touting high-tech companies with little or no earnings, while at the same time, privately disparaging the stock of such companies as “junk,” “crap,” and “a disaster.”²⁵⁴ Nevertheless, the analysts promulgated “buy” ratings on such companies to help their employers gain business.

The conflict of interest that infected the recommendations of analysts is illustrated by the history of Interliant, Inc. Interliant was touted by Henry Blodgett, the star analyst for Merrill Lynch. When Merrill Lynch initiated coverage on August 4, 1999, the company stock was trading at \$16.375, rose to a high of \$55.50, and plummeted to \$4.00 as of February 21, 2001.²⁵⁵ “Throughout this period, Merrill's investment-banking arm assisted Interliant in

251. Mathew Honan & Steven Leckart, *10 Years After: A Look Back at the DotCom Boom and Bust*, (Feb. 17, 2010) WIRED, <https://www.wired.com/2010/02/10yearsafter/>.

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

253. H.R. REP. NO. 100-910, at 19 (1988).

254. See *Merrill Lynch*, IMPACT LAW, <http://www.lawyershop.com/practice-areas/criminal-law/white-collar-crimes/securities-fraud/lawsuits/merrill-lynch/> (last visited July 27, 2019) (explaining that, at this time, analysts were labeling stock a “good buy” to the public, but a “bad buy” to other analysts). Examples include: “Internet Capital Group (ICGE): E-mail: “October 6, 2000 – ‘No helpful news to relate, I’m afraid. This has been a disaster- there really is no floor to the stock,’” followed by “Investor advice: October 5, 2000 – 2-1 rating (buy to strong buy); “excite@home (ATHM): E-mail: June 3, 2000 – ‘ATHM is such a piece of crap!’” followed by “Investor advice: June 3, 2000 – 2-1 rating (buy to strong buy);” “Lifeminders (LFMN) E-mail: December 4, 2000 – ‘I can’t believe what a POS that thing is,’” followed by “Investor advice: December 4, 2000 – 2-1 rating (buy to strong buy).” *Id.*

255. *Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161, 167 (2d Cir. 2005).

its acquisition of 27 companies, and underwrote a \$150 million convertible-bond offering.”²⁵⁶ The analysts hyped their ratings, not just to obtain investment banking work for their firms, but sometimes for personal profit, such as getting their daughters into nursery school.²⁵⁷

The scandal came to light when New York State Attorney General Eliot Spitzer announced litigation against Merrill Lynch.²⁵⁸ Merrill Lynch, at first, denied the allegations, but then settled for \$100 million and agreed to revise its practices with respect to analysts.²⁵⁹ Within a year of Merrill Lynch being sued, ten top United States investment banking firms agreed to pay a total of \$875 million in penalties and disgorgement for similar practices.²⁶⁰

As a result of this litigation, supposedly there would be a Chinese wall between analysts and the investment banking side of the firm. As the *Newman* case illustrates,²⁶¹ there does not appear to be any Chinese wall between analysts and portfolio managers at hedge funds.

In 1988, Congress was concerned about the dissemination of inside information within investment banking firms that led to what it considered illegal insider trading. To remedy this, Congress required investment banking firms to implement procedures to prevent insider trading or else face liability themselves:

The mergers and acquisition departments of investment houses contain highly sensitive materials detailing the intricacies of corporate takeovers, invaluable information in the hands of skilled market professionals. In the view of the Committee, there is a need for an affirmative statutory obligation for every broker, dealer and investment advisor to design effective procedures to restrict and monitor access to such information and prevent insider trading. The Committee links this affirmative obligation to the ITSA penalties. The Committee believed it is necessary to expand the potential exposure to civil penalties under ITSA beyond the primary insider trading violators to securities firms and other “controlling persons” who knowingly

256. *Id.*

257. Jack Grubman, one of the leading analysts on Wall Street, sent an e-mail stating that his boss, Sanford Weill, the chairman of Citigroup and a member of the Board of Directors of AT&T, helped Grubman to get his twin daughters enrolled in an exclusive nursery school after Grubman began recommending AT&T stock. See Gretchen Morgenson & Patrick McGeehan, *Wall St. and the Nursery School: A New York Story*, N.Y. TIMES (Nov. 14, 2002), <https://www.nytimes.com/2002/11/14/business/wall-st-and-the-nursery-school-a-new-york-story.html>. Mr. Weill has acknowledged that he asked Grubman to “take a fresh look at AT&T,” which was code on Wall Street for changing your opinion. *Id.*

258. *Merrill Ordered to Reform Ratings: New York AG Wins Court Order Finding Brokerage Firm Issued ‘Misleading Stock Ratings,’* CNN MONEY, (Apr. 8, 2002), <http://money.cnn.com/2002/04/08/news/companies/merrill/index.htm>.

259. *The Merrill Lynch Settlement: Good for Merrill, Not for Investors*, WHARTON (June 5, 2002), <http://knowledge.wharton.upenn.edu/article/the-merrill-lynch-settlement-good-for-merrill-not-for-investors/>.

260. Press Release, U.S. Sec. and Exch. Comm’n, Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest between Research and Investment Banking (Apr. 28, 2003), <http://www.sec.gov/news/press/2003-54.htm>.

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

or recklessly fail to take the appropriate measures to prevent insider trading violations by their employees.²⁶²

The securities industry has changed markedly since 1988, and hedge funds have joined investment banking firms as significant players in the securities markets. If it was necessary in 1988 to constrain the use of inside information by investment banks, it is all the more necessary today to constrain the use of such information by hedge funds. Unfortunately, the *Newman* case, discussed in the following section, is a step in the wrong direction.

IV. THE CURRENT SITUATION ON INSIDER TRADING

Federal courts recently handed down three noteworthy decisions: *Newman*,²⁶³ by the Second Circuit in 2014; *Salman*,²⁶⁴ by the Supreme Court in 2016; and *Martoma*,²⁶⁵ by the Second Circuit in 2017 as a counterpoint to *Newman*. The facts in these cases have become all too typical since, as Congress has stated, “insider trading continues because it presents the opportunity to reap huge profits with little risk”²⁶⁶ and there is a “public perception that the risk of detection is slight.”²⁶⁷ Unfortunately, after *Newman*, there could be public perception that, if you make the tipping extensive and convoluted enough, there is no liability for insider trading.²⁶⁸

A. *NEWMAN*—THE BENEFIT REQUIREMENT CARRIED TO THE EXTREME

Let us consider the facts in *Newman*, as recounted by the Court:

The Government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies. The Government charged Newman, a portfolio manager at Diamondback Capital Management, LLC (“Diamondback”), and Chiasson, a portfolio manager at Level Global Investors, L.P. (“Level Global”), with willfully participating in this insider trading scheme by trading in securities based on the inside information illicitly obtained by this group of analysts.²⁶⁹

262. H.R. REP. NO. 100-910, at 15 (1988).

263. *Newman*, 773 F.3d at 438.

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

265. *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017).

266. H.R. REP. NO. 98-355, at 21 (1983).

267. *Id.* at 6.

268. Shortly after the Enron decision by the Federal District Court in Texas, in response to a friend who was the editor, I wrote a quick, “pop” piece for the Chicago Bar Record in which I coined the phrase “MICI” as a counterpoint to the phrase “KISS.” Charles W. Murdock, *Attorney Liability Under Enron*, CHI. BAR REC., Apr., 2003, at 34, 36. KISS, which stands for “keep it simple stupid,” is the tack taken by honest people. On the other hand, MICI, which stands for “make it complex idiot,” is now the order of the day, after *Newman*, for those who want to make a quick killing through insider trading. *Id.*

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

What is your reaction to the foregoing set of facts? What would be the reaction of most Americans? What would be the reaction of the Congress that enacted ITSA and ITSFEA?

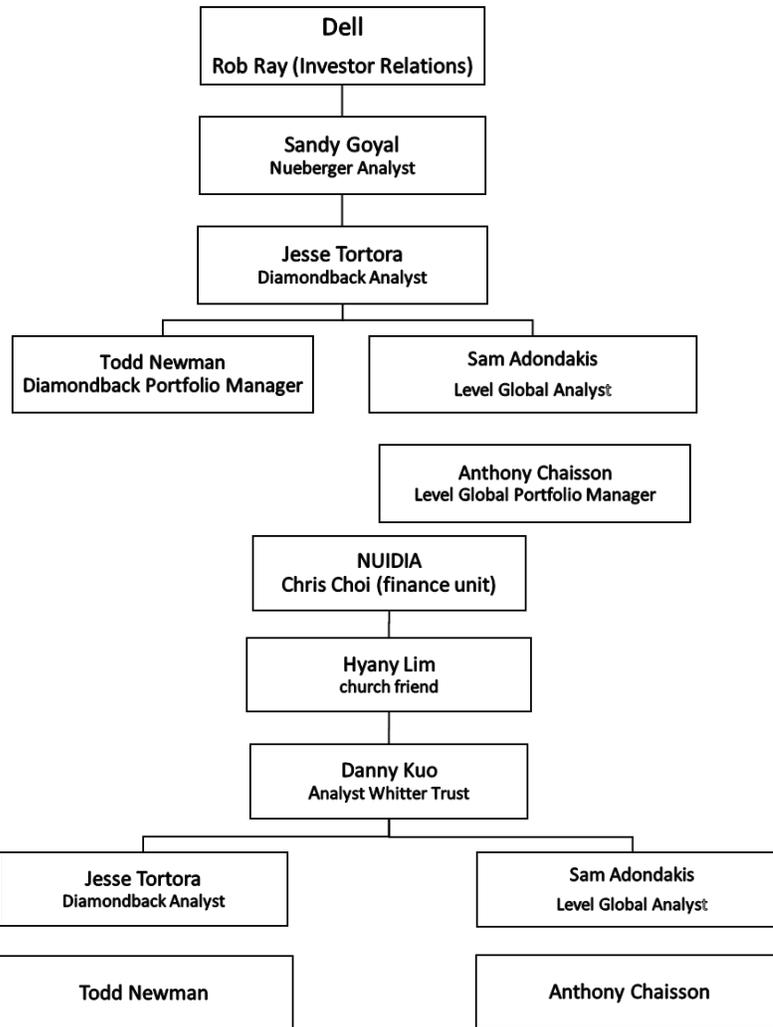
Corporate employees, who received information because of their positions, and who knew that the information was available to them only for use in connection with their employment, and not for their personal benefit or for the personal benefit of others, improperly transmitted this information to analysts at hedge funds who, in a chain of tipping, transmitted the information to portfolio managers, who then traded upon the information and made substantial profits.

Do courts ever step back and look at the foregoing situation from the perspective of whether this activity is right or wrong? Whether this type of activity is to be encouraged or curtailed? Whether this type of activity is consistent with the mandate of the securities laws that there is to be a level playing field and that no investor should have an undue advantage over any other investor? Are these people making millions of dollars because of their analytical abilities or by cheating? According to the government, the “club” in *Newman* made \$72 million in trading profits.²⁷⁰ Are the federal courts not complicit by condoning this cheating activity? Is it any wonder that a substantial amount of our electorate is disenchanted with government and thinks that the system is rigged for those with money and power?

I now turn to how the Second Circuit dealt with the factual situation it recounted. Let us take the facts, as recounted by the Court,²⁷¹ and put them in graphical form:

270. Peter Lattman, *Ex-Hedge Fund Manager Sentenced in Insider Trading Case*, N.Y. TIMES, May 14, 2013, at B3.

271. *Newman*, 773 F.3d at 443.



According to the Court, there were two critical questions that one cannot glean by looking at the foregoing chain of transactions. The first is whether the tippers, Robert Ray of Dell and Chris Choi of NVIDIA, received a personal benefit for the tipping. The second question is whether the persons who ultimately traded in the stocks of the respective companies knew of the benefit the tippers received.

The appropriate response to both these “significant” questions addressed by the Second Circuit is ultimately, “who cares?” Is it wrong for tippers to disclose information only if they receive a personal benefit, as the Supreme Court, in *Dirks*, foolishly held? What difference does it make from the perspective of a level playing field or ensuring that no investor has an undue

advantage over another investor, whether or not the tippers received a benefit? They had information that should have been used solely for the benefit of their employer and not for their own benefit or the benefit of anyone outside the company. The plain fact of the matter is that it makes no difference whatsoever whether the tippers received a benefit. The harm is the same irrespective of whether the tippers received a personal benefit or not.

Next, let's examine the concept of personal benefit. Clearly, receipt of ten dollars would be a personal benefit. It is certainly a pecuniary benefit as articulated in *Dirks*. But is the legality or illegality of insider trading to be premised on such a tenuous benefit? What about a hundred dollars? Or a thousand dollars?

What if the tippee invited the tipper for a drink? Would that be a benefit to the tipper? Would it make a difference which one paid for the drinks? Or what if the tippee had simply been nice to the tipper and empathized with the tipper regarding a personal tragedy or difficulties on the job with an overbearing boss?

In law school, we are trained to be logical and conclude that no one would do something illegal on such a flimsy "emotional" or "psychological" basis. But the reality is that a kind word may be worth far more than a \$100 bill. Why should courts anguish over whether or not something constitutes a benefit when the existence of a benefit is irrelevant to the public policy involved?

The *Dirks* notion that the tipper must receive a benefit in order to sin was a convenient conclusion for an outcome-determinative Justice, aggressively advocating for the corporate world. Justice Powell let a member of a class that he admired—analysts—off the hook. This flawed logic should not be enshrined in subsequent judicial decisions.

Unfortunately, the law has not yet caught up with the economic profession, where behavioral economics now recognizes that people do not always act in an abstract rational fashion.²⁷² The law, instead of philosophizing about whether or not the tipper received what could be considered a rational benefit, should look to the act and not the motivation. We cannot get inside someone's head to determine what is important to them, a \$100 bill or an empathetic response.

Even more absurd is the notion adopted in *Newman* that the person ultimately held liable must know of a "personal benefit" obtained by a remote tipper. What is necessary to hold a defendant, such as Newman, liable is an important question. He obviously must have scienter. But for what knowledge should he be held accountable? Should he be liable if the analyst gave the corporate employee a \$100 bill and he knew that the money was passed, but not liable if he did not know? This question goes again to the basic issue of the wrong sought to be remedied. Is it the evil corporate employees wrongfully passing information, or corporate employees wrongfully passing information for profit?

272. For an overview of behavioral economic and its findings, see DANIEL KAHNEMAN, THINKING FAST AND SLOW (2011).

Since information is a corporate asset, possessed by the employees only for a corporate purpose and available to employees only to be used for the corporation's benefit and not that of the employee, any transfer of material non-public information outside the corporation without specific authorization to do so should be presumptively wrongful.

Assuming *arguendo* that the tipper must receive a benefit, why is it necessary that the tippee know of the benefit? The tippee knows that the corporate employee has a duty not to disseminate corporate information outside the corporation. The tippee knows that the information is material and nonpublic. Is this not a sufficient basis to find culpability?

Since a portfolio manager is responsible for investing millions of dollars for the benefit of others, should such a manager not know the basis for the recommendation to purchase a particular stock? Should he or she not know the basis for the recommendation provided by the analysts and the source of the information upon which the analysts were basing their recommendation? And would he or she not be reckless in failing to investigate? Would we expect a portfolio manager investing millions of dollars to blindly rely upon someone's recommendation to purchase a particular stock?

Any other approach invites the trader or portfolio manager to send his minions to ferret out information with the coda—I don't care how you get it, just don't tell me.

The *Newman* fact pattern reflects the MICI concept:²⁷³ the more complicated the fraud, the less the likelihood of any accountability. Federal courts want a nice, clean set of facts: A tips B in exchange for A receiving cash or an equivalent tip from B. Courts would do well to read *The Den of Thieves* to learn how intermingled and intermeshed the web of insider trading can be.²⁷⁴ *Newman* reflects such a situation. As the Court recognized, "a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies."²⁷⁵

I have argued above that the use of such inside information by portfolio managers of hedge funds is wrongful. But that is not the way the Second Circuit saw the situation in *Newman*.

In *Newman*, the government conceded that it must establish that the tipper received a personal benefit. However, the government argued that *Dirks* only required that the "tippee know that the tipper disclosed information in *breach of a duty*."²⁷⁶ Nevertheless, the Second Circuit held that "the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in

273. See *supra* note 268.

274. See SHEELAH KOLHATKAR, *BLACK EDGE: INSIDE INFORMATION, DIRTY MONEY, AND THE QUEST TO BRING DOWN THE MOST WANTED MAN ON WALL STREET* (2017) [hereinafter *BLACK EDGE*].

275. *Newman*, 773 F.3d at 442.

276. *Id.* at 447.

exchange for the disclosure,”²⁷⁷ parroting *Dirks*,²⁷⁸ and thus, the tippee cannot know of the breach unless the tippee also knows of the benefit.

But, as argued earlier, this is sheer nonsense. A corporate employee holds the information he or she has for the benefit of the corporation, not for the benefit of himself or herself or anyone else.²⁷⁹ Any unauthorized disclosure of such information is wrongful and a breach of fiduciary duty.

Moreover, the whole idea of requiring a benefit to the tipper as a condition of liability for the tipper is also utter nonsense. What if, in the *Newman* situation, Goyal and Tortora got their tippers drunk, pried out the information, and told Newman and Chiasson the nonpublic information. Is this now a legitimate situation with no insider trading liability? What if Newman and Chiasson suggested the ploy of getting the tippers drunk? Would we find a benefit to the tippers because of the free alcohol they consumed? What if they paid for their own drinks?

Slavish adherence to the flawed decision in *Dirks* leads to absurd results. As Congress has suggested, *Dirks* will do no mischief if limited to its narrow factual situation involving an attempt to publicize a fraud.²⁸⁰

The Second Circuit completed its circle of logic by holding that defendants must know of the benefit in order to be liable because, without the benefit, there is no breach of duty. The Court was shocked that the government would try to hold liable tippees who are separated by many levels from their tippers, “[t]he Government’s overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders.”²⁸¹

This ignores the reality of how the game is played. Consider the diagram above. There was obviously a web of analysts exchanging information. But there was no market impact until the portfolio managers traded. The Second Circuit seemed disturbed that the government went after the portfolio managers in a criminal proceeding but not the analysts:

Although Ray has yet to be charged administratively, civilly, or criminally, and Choi has yet to be charged criminally, for insider trading or any other

277. *Id.* at 447.

278. *Dirks v. SEC*, 463 U.S. 646, 662 (1983).

279. Since the Supreme Court is enamored with common law notions of fiduciary duty, they might well read the early case of *Oliver v. Oliver*, 45 S.E. 232, 234 (Ga. 1903):

It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known. . . . In a certain sense the information is a quasi asset of the company, and the shareholder is as much entitled to the advantage of that sort of an asset as to any other regularly entered on the list of the company’s holding.

280. H.R. REP. NO. 98-355, at 15 (1983).

281. *Newman*, 773 F.3d at 448.

wrongdoing, the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose.²⁸²

Absolutely! The portfolio managers knew that this was material, non-public information. How else could it have been obtained, except illegally?

With regard to the reasons why the government went easy on Ray and Choi, the analysts, but zeroed in on Newman and Chiasson, the portfolio managers—that is what typically happens in a corporate criminal matter. The government goes easier on the little fish in order to catch the big fish. Who has the power in a hedge fund: the portfolio manager or the analysts? If you want to shape up the power structure, you go after the portfolio managers. The portfolio managers often make tens or hundreds of millions of dollars,²⁸³ and, if you are going to affect a change in corporate culture, it is the portfolio managers that need to be held accountable.

The analysts understand that their job is to ferret out information and give it to the portfolio managers who will trade on it. Everybody's compensation is a function of trading profits. As suggested earlier, if the portfolio manager just winks and says, "do what you must to get me information, but don't tell me about it," the Second Circuit's tack in *Newman* enables the portfolio manager to commit the perfect crime.

Adhering to the Supreme Court decision in *Dirks*, the Second Circuit summarized the conditions for liability:

First, the tippee's liability derives *only* from the tipper's breach of a fiduciary duty, *not* from trading on material, non-public information. *Second*, the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. *Third*, even in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach.²⁸⁴

The Second Circuit acknowledged that, "[w]hile we have not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit, the answer follows naturally from *Dirks*."²⁸⁵ The Second Circuit explained: "*Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it [the personal benefit] *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b-5."²⁸⁶

So, once again, the *Dirks* foolishness confounds accountability. As stated earlier, if the federal courts are really looking back to the common law to assess insider trading liability, an employee who discloses material corporate

282. *Id.* at 443–44.

283. *Id.* at 443. In *Martoma*, the hedge fund made \$80.3 million in gains and avoided \$194.6 million in losses. *United States v. Martoma*, 869 F.3d 58, 62 (2d. Cir. 2017).

284. *Newman*, 773 F.3d at 447 (citation omitted).

285. *Id.*

286. *Id.* at 447–48.

information to an outsider without authority to do so breaches his or her fiduciary duty to the employer. The Second Circuit may have realized this since it added “[f]or purposes of insider trading liability, the insider’s disclosure of confidential information, standing alone, is not a breach.”²⁸⁷ The Court also stated that “a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit.”²⁸⁸

But why should there be this exception from the common law perspective on fiduciary duty when dealing with insider trading? Why is a breach of the duty of confidentiality not actionable? Is insider trading something that we should curtail because it deviates from the congressional notion of a level playing field, or should we encourage insider trading by erecting roadblocks to effective prosecution of insider trading?

Based upon *Dirks*, the Second Circuit concluded that “without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.”²⁸⁹ This phraseology suggests that, when an insider tips, there is a bargained for consideration: “I won’t give you a tip for \$10 but I will for \$100.”

But whether the tippee must know of the nature of the benefit received by the tipper was an issue not reached by *Dirks*, as the *Newman* court acknowledged.²⁹⁰ As stated earlier, Congress thought that insider trading enforcement would not be impeded by *Dirks* if *Dirks* were limited to its facts.²⁹¹ But, instead of reading *Dirks* narrowly, *Newman* sought to extend its reach.

Having determined that the tippee must know of the inside tipper’s benefit, the Second Circuit then analyzed whether the tippers received a benefit. The Court acknowledged that “a defendant challenging the sufficiency of the evidence [in a jury case] bears a heavy burden, as the standard of review is exceedingly deferential.”²⁹² Nevertheless, “if the evidence ‘is nonexistent or . . . meager,’” the verdict can be set aside.²⁹³ In this case, the Second Circuit determined that “[t]he circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips.”²⁹⁴

With respect to the Dell tip, the Second Circuit determined:

Here the “career advice” that Goyal gave Ray, the Dell tipper, was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance. Crucially, Goyal testified that he would have given Ray advice without receiving information because he routinely did so for industry

287. *Id.* at 448 (emphasis added).

288. *Id.* at 450.

289. *Id.* at 448.

290. *Id.* at 447–48.

291. See *supra* note 280 and accompanying text.

292. *Newman*, 773 F.3d. at 451.

293. *Id.* (quoting *United States v. Coplan*, 703 F.3d 46, 62 (2d Cir. 2012)).

294. *Id.* at 451–52.

colleagues. Although the Government argues that the jury could have reasonably inferred from the evidence that Ray and Goyal swapped career advice for inside information, Ray himself disavowed that any such *quid pro quo* existed. Further, the evidence showed Goyal began giving Ray “career advice” over a year before Ray began providing any insider information. Thus, it would not be possible under the circumstances for a jury in a criminal trial to find beyond a reasonable doubt that Ray received a personal benefit in exchange for the disclosure of confidential information.²⁹⁵

Once again, this opinion ignores human nature and the way the world actually works. If Goyal had been giving Ray career advice for over a year, would Ray have felt indebted to Goyal? The Second Circuit was also impressed by the fact that Goyal testified that he would have given career advice to Ray even if Ray did not give him any tips. What federal courts do not get is that Ray and Goyal could be “nice guys” and generally pretty decent people. That does not mean that they could therefore do no wrong.

In this regard, behavioral economics is instructive. As Professor Kahneman points out, human nature wants a consistent story. For example, people have a hard time accepting the fact that Hitler might have loved babies.²⁹⁶ Here, the Second Circuit could not fathom that Goyal could be a nice guy in providing career advice and still be a crook.

In the NVIDIA case, the Second Circuit observed that Choi (the tipper) and Lim (the tippee) were “merely casual acquaintances.”²⁹⁷ Lim testified that “Choi did not know that Lim was trading NVIDIA stock (and in fact for the relevant period Lim did not trade stock), thus undermining any inference that Choi intended to make a ‘gift’ of the profits earned on any transaction based on confidential information.”²⁹⁸ What the Court failed to further observe is that Lim did pass the information on to others who did in fact trade.²⁹⁹ Since the two defendants were not close family members, as in *Salman*, according to the *Newman* court, there was no benefit to the tipper from the transfer of information.

Again, what federal courts fail to realize is that there are many reasons why an insider may pass on confidential information. It may be because of friendship or an attempt to curry friendship. It might be an attempt to impress another with the insider’s position or access to information. Some people are just blowhards. It may be to get a “leg up” by being able to call in a favor at a later date. In the *Salman* case, discussed below, the younger brother gave the older brother information because the older brother “pestered” him.³⁰⁰ Although it may be

295. *Id.* at 453 (citations omitted).

296. See DANIEL KAHNEMAN, *supra* note 272, at 200 (suggesting that if someone were to say that Hitler loved little children that such a statement would have a “shocking” effect).

297. *Newman*, 773 F.3d at 453.

298. *Id.*

299. *Id.* at 443.

300. *Salman v. United States*, 137 S. Ct. 420, 424 (2016).

unlikely, there may be bargained for consideration. While federal courts seem to think that this is the norm, it is likely the exception.

But motive should be immaterial. Whatever the motive, the harmful effect is the same—an investor enters the market armed with information that the rest of the investing public does not have and cannot access. As the tippee/older brother in *Salman* said, his brother's tips gave him “timely information that the average person does not have access to.”³⁰¹ This is the unfair advantage that Congress proscribed.³⁰² This also is the kind of activity that the SEC proscribed through Regulation FD.³⁰³

The Second Circuit bulwarked its conclusion by citing the oft repeated statement in *Dirks* that “[a]ll disclosures of confidential corporate information are not inconsistent with the duty . . . to shareholders.”³⁰⁴ Why are they not inconsistent with the insider's duty?

The Second Circuit noted:

Moreover, the evidence established that NVIDIA and Dell's investor relations personnel routinely “leaked” earnings data in advance of quarterly earnings. Appellants introduced examples in which Dell insiders, including the head of Investor Relations, Lynn Tyson, selectively disclosed confidential quarterly financial information arguably similar to the inside information disclosed by Ray and Choi to establish relationships with financial firms who might be in a position to buy Dell's stock. For example, appellants introduced an email Tortora sent Newman summarizing a conversation he had with Tyson in which she suggested “low 12% opex [was] reasonable” for Dell's upcoming quarter and that she was “fairly confident on [operating margin] and [gross margin].”³⁰⁵

This is shocking! Two wrongs do not make a right. While the *Dirks* opinion preceded Regulation FD, the release of earnings data today clearly violates Regulation FD and is therefore unlawful. The Second Circuit should have excoriated the investor relations personnel, not used their wrongful conduct to protect portfolio managers who made millions on trades which, in turn, enabled them to make millions in compensation.³⁰⁶

301. *Id.* at 425 (internal quotation marks omitted).

302. *See supra* notes 11–13.

303. 17 C.F.R. § 243.100 (2012).

304. *Newman*, 773 F.3d at 454 (internal quotation marks omitted).

305. *Id.*

306. Average salaries for portfolio managers in the past years have been listed as \$2.2 million in 2013. Katie Holliday, *This Industry Has an Entry Level Salary of \$335,000*, CNBC (Nov. 3, 2013), <https://www.cnbc.com/2013/11/01/this-industry-has-an-entry-level-salary-of-335000.html>. In 2014, the average salaries rose to \$2.4 million. Anshya Harjani, *Hedge Fund Manager Pay Rises to \$2.4 Million*, CNBC (Nov. 7, 2014), <https://www.cnbc.com/2014/11/06/hedge-fund-manager-pay-rises-to-24-million.html>. Then again, in 2015, they stayed relatively consistent at \$2.21 million, and they posted at \$2.23 million in 2016. Lawrence Delevingne, *Hedge Fund Managers Have Lost Touch with Reality*, BUSINESS INSIDER (Nov. 21, 2016), <http://www.businessinsider.com/r-rpt-hedge-funds-slow-to-adjust-champagne-tastes-to-beer-budgets-2016-11>. For the securities industry in general, average salaries in the New York securities industry were \$388,000 in 2015. *Wall Street Profits Up in 2016*, N.Y. STATE COMPTROLLER (Mar. 15, 2017), <http://www.osc.state.ny.us/press/releases/mar17/031517.htm>. (reporting last numbers from 2015). In 2014, these salaries rose to \$404,800.

The position of federal courts with regard to insider trading turns the stock market into a roulette game, with certain investors given the right to have their finger on the wheel.

Obviously, Circuit Courts do not have the authority to overrule the *Chiarella* and *Dirks* decisions. However, they could follow the Congressional dictate to interpret these cases restrictively, rather than expanding their foolish policy to its logical, or illogical, extreme.

B. *SALMAN* CASE—REPUDIATION OF *NEWMAN*'S PECUNIARY BENEFIT REQUIREMENT

The *Salman* case is almost anticlimactic. Had the Supreme Court taken the *Newman* case, the opinion could have had a significant impact on the law of insider trading. However, due to the present composition of the Supreme Court, this impact probably would have been negative. So, those of us who believe insider trading is wrongful and should be curtailed, should be thankful the Supreme Court chose to review *Salman*.

Salman was a pedestrian “gift” exception to the requirement that the tipper received a personal benefit. The tipper, Maher Kara, was the brother of the intermediate tippee/tipper, Michael, who passed the information on to the tipper’s brother-in-law, Salman.³⁰⁷ Salman argued, relying upon *Newman*, that “there was no evidence that Maher received anything of ‘a pecuniary or similarly valuable nature’ in exchange—or that Salman knew of any such benefit.”³⁰⁸ On the other hand, the government argued, properly so in my opinion, that “a gift of confidential information to anyone, not just a ‘trading relative or friend,’ is enough to prove securities fraud.”³⁰⁹

To the extent that *Newman* “held that the tipper must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends,”³¹⁰ the Supreme Court rejected *Newman*, and held that “[w]e adhere to *Dirks*, which easily resolve[d] the narrow issue presented here.”³¹¹

However, the Court did not seem to realize that some of its analysis is inconsistent with *Dirks* and its requirement of a personal benefit. The Court pointed out that Salman’s counsel acknowledged that “Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother,”³¹² and concluded that, “[i]t is obvious that Maher would personally benefit in that situation.”³¹³ In other words, trading

Wall Street Bonuses and Profits Decline in 2015, N.Y. STATE COMPTROLLER (Mar. 7, 2016), <http://osc.state.ny.us/press/releases/mar16/030716.htm> (reporting the 2014 numbers).

307. *Salman v. United States*, 137 S. Ct. 420, 423–24 (2016).

308. *Id.* at 425.

309. *Id.* at 426.

310. *Id.* at 428.

311. *Id.* at 427.

312. *Id.* at 427–28.

313. *Id.* at 428.

on inside information by an insider is wrong and is a breach of fiduciary duty to the employer:

Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty *Salman* acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.³¹⁴

When the Court recognized that Maher would have breached his fiduciary duty had he himself traded, the Court noted that he would then obtain a personal benefit.³¹⁵ But the person who obtains the personal benefit is always the person who trades on the inside information. *Dirks*'s fundamental flaw was requiring that the disclosing/tipper receive a benefit rather than the tippee/recipient of the information who thereupon trades.

The Supreme Court recognized the fundamental unfairness in permitting insiders or their tippees to trade on confidential inside information. The Court recounted Michael's testimony: "For his part, Michael told the jury that his brother's tips gave him 'timely information that the average person does not have access to' and 'access to stocks, options, and what have you, that I can capitalize on, that the average person would never have or dream of.'"³¹⁶

Since the two brothers and their brother-in-law were close relatives, the Court had no difficulty in affirming the wrongdoing. But what if they were distant relatives or as the government argued, not relatives at all? What difference would it make? The evil is the same. Maher is providing "timely information that the average person does not have access to."³¹⁷ This is the evil, not the personal benefit or lack thereof that the tipper experiences.

But the Supreme Court, in dicta before addressing the gift situation, reverted to the notion that insider trading involving non-family tippees is only wrongful when there is a "quid pro quo"³¹⁸ between the insider and the tippee, essentially applying contractual notions of a bargained for consideration, without realizing that there can be many reasons why an insider would pass along information.

C. *MARTOMA*—CONSTRAINING *NEWMAN*'S "MEANINGFULLY CLOSE PERSONAL RELATIONSHIP" REQUIREMENT

While *Salman* was a pedestrian application of the gift language in *Dirks* to a fairly rare situation—the transmission of inside information within a close family relationship—and involved a pittance—³¹⁹ compared to the hundreds of

314. *Id.*

315. *See id.* at 427.

316. *Id.* at 425.

317. *Id.*

318. *Id.* at 427.

319. The trader in *Salman* made only \$1.5 million in profits, while the "club" in *Newman* made \$72 million in insider trading profits, and the insider trading in *Martoma* generated \$80.3 million in gains and avoided \$190.6

millions of dollars involved in *Newman—Martoma* was a very significant application of the *Dirks* gift language to a much more typical case of insider trading.³²⁰

Martoma was a portfolio manager for S.A.C. Capital Advisers (SAC), a hedge fund that was the subject of a massive insider trading investigation.³²¹ His portfolio had between \$400 and \$500 million in buying power and was focused upon the pharmaceutical and healthcare industry.³²² He also recommended securities to Stephen Cohen, the head of SAC, who managed to avoid indictment.³²³

Martoma invested funds in Elan and Wyeth pharmaceutical companies, which were trying to develop an experimental drug to treat Alzheimer's disease.³²⁴ He also recommended these investments to Cohen.³²⁵ To get information about the drug, Martoma established a relationship with two doctors, Dr. Gilman and Dr. Ross, who were working on its clinical trials.³²⁶ They were paid \$1000 and \$1500 an hour, respectively; however, the doctors were not paid directly by Martoma.³²⁷ His payments were routed through an expert networking firm to the doctors.³²⁸ Dr. Gilman met with Martoma forty-three times and provided Martoma with updates on the safety of the drug, information Dr. Gilman was expected to keep confidential.³²⁹

A June 17, 2008 press release described preliminary results as “encouraging” and the price of Elan stock rose following the press release.³³⁰ The press release also announced that results would be presented in greater detail at an international conference on Alzheimer's on July 29, 2008.³³¹ Dr. Gilman was selected to present the results on July 29 and was then given the final results of the clinical study.³³²

Dr. Gilman identified “two major weaknesses in the data,” and the following day, July 17, he called Martoma and spoke with him for 90 minutes.³³³ Two days later, Martoma flew to Ann Arbor and met with Dr. Gilman in his office, where Dr. Gilman showed him a PowerPoint presentation on the efficacy

million in losses. *See id.* at 424; *United States v. Newman*, 773 F.3d 438, 443 (2d Cir. 2014); *United States v. Martoma*, 869 F.3d 58, 62 (2d Cir. 2017) (*Martoma I*).

320. *Martoma*, 869 F.3d at 58 (*Martoma I*). After this Article was in production, the Second Circuit amended the opinion, 894 F.3d 64 (2d Cir. 2018) (*Martoma II*). *See infra* Subpart IV.C.3.

321. James B. Stewart, *On Insider Trading, an Appeals Court Comes to Its Senses*, N.Y. TIMES (Sept. 14, 2017), <https://www.nytimes.com/2017/09/14/business/insider-trading-court.html>.

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

323. *Id.*

324. *Id.*

325. *Id.*

326. *Id.*

327. *Id.* at 61, n.1.

328. *Id.*

329. *Id.* at 61–62, 67.

330. *Id.* at 62.

331. *Id.* at 62.

332. *Id.*

333. *Id.*

of the study and discussed the data with him in detail.³³⁴ Dr. Gilman did not bill for the phone conversation or this meeting.³³⁵

The next morning, Martoma sent Cohen an email labeled “It’s important,” and followed with a telephone call, after which Martoma emailed Cohen a summary of Elan and Wyeth holdings.³³⁶ On Monday, SAC began to hedge its position in these two companies through short sales and option trades.³³⁷ After the results were made public on July 29, the next day, the price of Elan and Wyeth declined by 42% and 12%, respectively, and the trades that Martoma and Cohen made generated \$80.3 million in gains and avoided \$194.6 million in losses.³³⁸ Thereafter, Martoma received a \$9 million bonus.³³⁹

Martoma argued that he and Dr. Gilman did not have a “meaningfully close personal relationship” and that Dr. Gilman did not receive any “objective, consequential . . . gain of a pecuniary or similarly valuable nature” in connection with providing information to Martoma, relying upon the standards set in *Newman*.³⁴⁰ Martoma also argued that the jury instructions were erroneous because they did not include the limitations on personal benefit set forth in *Newman*.³⁴¹

1. Martoma I: *Reversing Newman*

The *Martoma I* court declined to rely upon *Newman* because the intervening Supreme Court decision in *Salman* held that “[t]o the extent the Second Circuit [in *Newman*] held that a tipper must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends . . . this requirement is inconsistent with *Dirks*.”³⁴²

The *Martoma* court first determined that Martoma had received a pecuniary benefit:

Martoma was a frequent and lucrative client for Dr. Gilman, who was paid \$1,000 per hour for approximately 43 consultation sessions. At the same time, Dr. Gilman was regularly feeding Martoma confidential information about the safety results of clinical trials involving bapineuzumab. And when Dr. Gilman gained access to the final clinical study efficacy data in July 2008, he immediately passed it along to Martoma.³⁴³

The Court acknowledged that “Dr. Gilman did not bill Martoma specifically for the July 17 and 19, 2008 meetings at which Dr. Gilman provided

334. *Id.* at 62.

335. *Id.* at 67.

336. *Id.* at 62.

337. *Id.*

338. *Id.*

339. *Id.* at 62–63.

340. *Id.* at 65 (alteration in original).

341. *Id.*

342. *Id.* at 80 (Pooler, J., dissenting) (quoting *Salman v. United States*, 137 S. Ct. 420, 428 (2016)) (citation omitted).

343. *Id.* at 67.

Martoma with the efficacy data,”³⁴⁴ a factor which the dissent thought significant.³⁴⁵ However, Martoma acknowledged at trial that, had he billed for the July meetings, this would have been “tantamount to confessing that [he] was . . . giving [Martoma] inside information.”³⁴⁶ The majority therefore concluded that the evidence presented at trial was sufficient to sustain Martoma’s conviction: Dr. Gilman regularly disclosed confidential information in exchange for fees; therefore “‘a rational trier of fact could have found the essential elements of the crime [of insider trading] beyond a reasonable doubt’ under a pecuniary *quid pro quo* theory.”³⁴⁷

The *Martoma I* court then turned to the adequacy of the jury instructions. It reversed the *Newman* precedent on the basis of the intervening Supreme Court opinion in *Salman* regarding jury instructions.³⁴⁸ The *Salman* opinion explicitly rejected the *Newman* requirement that a tipper, in a gift situation, must receive something of a “pecuniary or similarly valuable nature” in exchange for a gift to family or friends.³⁴⁹ The *Martoma* court, in determining that *Newman*’s requirement of a “meaningfully close personal relationship” was also no longer valid, first acknowledged that:

While the Supreme Court did not have occasion to expressly overrule *Newman*’s requirement that the tipper have a “meaningfully close personal relationship” with a tippee to justify the inference that a tipper received a personal benefit from his gift of inside information—because that aspect of *Newman* was not at issue in *Salman*—“[e]ven if the effect of a Supreme Court decision is ‘subtle,’ it may nonetheless alter the relevant analysis fundamentally enough to require overruling prior, ‘inconsistent’ precedent.”³⁵⁰

The *Martoma I* court then concluded:

We respectfully conclude that *Salman* fundamentally altered the analysis underlying *Newman*’s “meaningfully close personal relationship” requirement such that the “meaningfully close personal relationship” requirement is no longer good law. In a case involving a tipper and tippee who were brothers, *Salman* found it “obvious” that an insider would personally benefit from “trad[ing] on [inside] information . . . himself and then giv[ing] the proceeds as a gift to his brother.” And *Salman* observed that

344. *Id.*

345. The dissent pointed out that Dr. Gilman “did not bill for the sessions in July of 2008 during which he gave Martoma the information leading to Martoma’s trades.” *Id.* at 90 (Pooler, J., dissenting). The dissent opined that “a jury could have believed SAC’s payments were for information Gilman told Martoma during other sessions—information that was either public, non-material, or did not prompt a trade, and thus was not a violation of insider-trading laws. *Id.* at 91 (Pooler, J., dissenting). As developed in the next section, the dissent represents a mode of thinking by federal courts that is rigid and logical, but irrational, since it is predicated upon a view of human nature that is at odds with reality.

346. *Id.* at 67 (alterations in original).

347. *Id.* (quoting *United States v. Coplan*, 703 F.3d 46, 62 (2d Cir. 2012) (alterations in original)).

348. *Id.* at 61.

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

350. *Martoma*, 869 F.3d at 69 (quoting *Wojchowski v. Daines*, 498 F.3d 99, 108 (2d Cir. 2007) (citation omitted) (alterations in original)).

an insider “effectively achieve[s] the same result by disclosing the information to [the tippee], and allowing him to trade on it,” because “giving a gift of [inside] information is the same thing as trading by the tipper followed by a gift of the proceeds.”³⁵¹

The Court also supported its conclusion from the fact that *Salman* referenced the following statement from *Dirks*:³⁵² “Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.”³⁵³

The *Martoma I* court indicated its dissatisfaction with the result reached in *Newman*, where although portfolio managers realized tens of millions of dollars in insider trading profits, their convictions were not upheld because the relationship between the tippers and the tippees was not a “meaningfully close personal relationship”:

Nothing in *Salman*’s reaffirmation of this [gift] logic supports a distinction between gifts to people with whom a tipper shares a “meaningfully close personal relationship”—a term left undefined in *Newman*, but which apparently did not reach two people who “had known each other for years, having both attended business school and worked . . . together,”—and gifts to those with whom a tipper does not share such a relationship.³⁵⁴

The following example was used by the court to illustrate a situation where there is not a meaningfully close personal relationship, but yet a benefit to the tipper:

Imagine that a corporate insider, instead of giving a cash end-of-year gift to his doorman, gives a tip of inside information with instructions to trade on the information and consider the proceeds of the trade to be his end-of-year gift. In this example, there may not be a “meaningfully close personal relationship” between the tipper and tippee, yet this clearly is an illustration of prohibited insider trading, as the insider has given a tip of valuable inside information in lieu of a cash gift and has thus personally benefitted from the disclosure.³⁵⁵

Accordingly, the court held as follows:

Thus, we hold that an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed “with the expectation that [the recipient] would trade on it,” and the disclosure “resemble[s] trading by the insider followed by a gift of the profits to the recipient,” whether or not there was a “meaningfully close personal relationship” between the tipper and tippee.³⁵⁶

351. *Id.* (citations omitted) (alterations in original).

352. *Salman*, 137 S. Ct. at 428.

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

354. *Martoma*, 869 F.3d at 69 (citation omitted) (second alteration in original).

355. *Id.* at 70.

356. *Id.* (citations omitted) (alterations in original).

This is a common-sense approach to the problem of insider trading. In my opinion, the tipper has “sinned” any time the tipper discloses material nonpublic information that the tipper is obligated to keep confidential. Yet, for the tipper to “sin,” the tipper must have scienter and, pursuant to the approach taken by the *Martoma* court, the tipper’s wrongful state of mind is determined by the fact that the information is conveyed with the expectation that the tippee will trade on it.

Hopefully, the *Martoma I* approach will be followed in other jurisdictions. But as reflected in the dissenting opinion discussed below, an outcome-determinative court that is more focused on an abstract analysis of *Dirks*, and that does not appreciate either the caution of Congress to read *Dirks* narrowly or the negative effects of insider trading, could take a contrary approach.

2. *The Dissent in Martoma I—Majority’s Over-Extension of Salman*

The dissenting opinion in *Martoma* was extensive, logical to the extent that it relied upon *Dirks*, but an ultimately fallacious attempt to defend and rationalize the personal benefit requirement of *Dirks*. The dissent asserted that, while the Supreme Court in *Salman* overruled *Newman* “[t]o the extent that it required an insider to ‘receive something of a pecuniary or similarly valuable nature,’” the Supreme Court “showed no disapproval of the ‘meaningfully close personal relationship’ language in *Newman*.”³⁵⁷ Thus, the dissent acknowledged that, in an insider trading case predicated upon the gift theory, there is no need to show that the insider/tipper received a pecuniary or similar benefit, but argued that there still must be a meaningfully close personal relationship between the tipper and the tippee in order to apply the gift theory in *Dirks*.³⁵⁸

So, let us examine the rationale, as explicated by the dissent, as to why a meaningfully close personal relationship is necessary in order to apply the gift theory.

First, the rationale of *Dirks*, as analyzed by the dissent, for requiring a benefit to the tipper was to introduce “objectivity” into the analysis.³⁵⁹ But how objective is a determination of whether or not there is a “meaningfully close personal relationship” among the parties? What if the brothers, in *Salman*, had been alienated from each other for a number of years? Then, inexplicitly from a purely logical perspective, one brother tips the other. Was this done in an attempt to mend the relationship? Is there now a “meaningfully close personal relationship?” Or did the tipping brother simply get tired of being badgered? As the Supreme Court recounted in *Salman*, “Maher explained that he disclosed the

357. *Id.* at 80 (Pooler, J., dissenting) (quoting *Salman*, 137 S. Ct. at 428).

358. *Id.* at 87 (Pooler, J., dissenting).

359. *Id.* at 76 (Pooler, J., dissenting). The dissent, quoting *Dirks*, stated: “The Supreme Court also noted that the question of whether an insider personally benefitted from disclosure would ‘require[] courts to focus on objective criteria.’” *Id.* (Pooler, J., dissenting) (quoting *Dirks v. SEC*, 463 U.S. 646, 663 (1983)) (alteration in original). The dissent continued, “[r]ather than courts attempting to ‘read the parties’ minds,’ they would look to ‘objective facts and circumstances that [would] justify . . . an inference’ that an insider received a personal benefit.” *Id.* (quoting *Dirks*, 463 U.S. at 663–64) (Pooler, J., dissenting) (citation omitted) (second and third alterations in original).

information in large part to appease Michael (who pestered him incessantly for it).”³⁶⁰

But why do we care? The tipping brother breached his duty to the corporation by disclosing confidential, nonpublic, material corporate information. This is where objectivity comes into play. The tipping brother was employed by the corporation; he received material nonpublic information, not for his own benefit, but to use for the benefit of the corporation. He disclosed such information in breach of his duty to the corporation to keep material nonpublic information within the corporate entity.³⁶¹

The negative impact to existing shareholders from this breach of duty can easily be identified in a “bad news” situation. The tippee brother uses the information to sell stock to avoid a personal loss, thereby depressing the price of the stock and the price that other shareholders would receive when they seek to sell.³⁶² Arguably, in a “good news” situation, the action of the tippee brother raises the price of the stock and, possibly, only non-shareholders who seek to buy are adversely affected. But this argument misses two fundamental points: first, there might be existing shareholders who seek to increase their position in the company and are thereby disadvantaged. Second, the purpose of the 1934 Securities Exchange Act was to ensure that *all* participants in securities transactions play on a level playing field.³⁶³

In arguing for the personal benefit requirement in situations not involving a meaningfully close relationship, the dissent in *Martoma I* offered several examples which, supposedly, demonstrated the necessity of such requirement.³⁶⁴ However, none of these rationales hold water.

The first example was of an insider who revealed information inadvertently. However, today, after the adoption of Regulation FD, the insider in such a situation has an obligation to make a prompt public disclosure.³⁶⁵ Moreover, as in *Cady, Roberts*, a person who makes an inadvertent disclosure would have no liability, but the person who takes advantage of such inadvertent disclosure should be liable.³⁶⁶ Analyzing the situation from another perspective, the insider making an inadvertent disclosure would not have scienter, while the trading tippee would have scienter.

A second example suggested by the dissent is that “insiders speaking for public-spirited reasons, such as ‘a desire to expose . . . fraud,’ do not commit

360. *Salman v. United States*, 137 S. Ct. 420, 424 (2016).

361. *Id.*

362. *See supra* note 72 and accompanying text.

363. *See supra* note 12 and accompanying text.

364. *See Martoma*, 869 F.3d at 85-86 (Pooler, J., dissenting).

365. *See* 17 CFR § 243.100(a)(2) (2012) (stating that whenever any person acting on behalf of an issuer discloses any material nonpublic information regarding the issuer or its securities, the issuer shall make public disclosure of such information “[p]romptly, in the case of a non-intentional disclosure.”).

366. *In re Cady, Roberts, & Co.*, 40 S.E.C. 907, 910-13 (1961).

insider trading.”³⁶⁷ The dissent took this example from the *Dirks* case. As previously discussed, in *Dirks*, the majority and the dissent were watching two different movies. The majority saw *Dirks* as a hero, exposing a fraud, while the dissent saw *Dirks* as an opportunist who, pursuant to the “backscratching” that was prevalent in the securities industry at that time, obtained a fee of \$25,000 for his employer as a result of “looking after” their clients.³⁶⁸

If you want to stop a crime, the proper approach is to contact the SEC or the U.S. Attorney, not tip your clients so they can engage in so much trading that trading in the stock is eventually suspended. *Dirks* was hardly a public-spirited citizen!

The *Martoma I* dissent utilizes the following example to show why the existence of a benefit to the tipper is necessary: “[A] situation where an insider conveys material, nonpublic information to a reporter, and the reporter tells it to a third person who trades on it. Such a situation is entirely plausible for a financial news reporter who speaks to many sources.”³⁶⁹

What the dissent does not seem to realize is that the role of a reporter is to report, not tip others. If the reporter obtained the information under the guise that he or she was obtaining it in order to write a story, and instead used the information to benefit some friend or acquaintance, the reporter would be breaching the duty to his or her employer by using what is now the publication’s information for an improper purpose and, in addition, obtaining information under false pretenses. If the reporter publishes the information, the reporter may be enabling the issuer to fulfill its responsibility to disclose material information.

But if the reporter first transmits the news to another person to enable them to trade ahead of the public dissemination of the information, this conduct by the reporter is wrongful and should subject the reporter to insider trading liability. This situation is similar to *Carpenter*, where Foster Winans, who wrote the “*Heard on the Street*” column for the *Wall Street Journal*, tipped a broker with Kidder Peabody to enable the broker to trade ahead of the news in Winans’s column.³⁷⁰ In this case, Winans did receive a benefit because he split the trading profits with the broker.³⁷¹ But, irrespective of the fee splitting arrangement, Winans’ conduct was wrongful because he misappropriated the information of his employer for an improper purpose.³⁷²

In *Salman*, the Supreme Court noted that “the tipper benefits personally because giving a gift of trading information is the same as trading by the tipper followed by a gift of the proceeds.”³⁷³ The dissent in *Martoma* then took the majority to task for believing that “a benefit may be imputed to a gift-giver even

367. *Martoma*, 869 F.3d at 75 (Pooler, J., dissenting) (quoting *Dirks v. SEC*, 463 U.S. 646, 667 (1983)) (alteration in original).

368. *Dirks v. SEC*, 463 U.S. 646, 669 n.4 (1983) (Blackmun, J., dissenting).

369. *Martoma*, 869 F.3d at 76 (Pooler, J., dissenting).

370. *Carpenter v. United States*, 484 U.S. 19, 22–23 (1984).

371. *Id.* at 27–28.

372. *Id.* at 24.

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

when the recipient is not a friend or relative.”³⁷⁴ The majority in *Martoma* took the position that the *only* question should be whether “the tip and trade resemble trading by the insider followed by a gift of the profits to the recipient.”³⁷⁵

According to the dissent, the gift analogy may only be employed when the gift-giver obtains a benefit from the gift. From this proposition, the dissent would limit the gift analogy only to those situations where family or close friends are involved because only there does the gift-giver receive a benefit:

Gifts to family or friends are more likely to confer a benefit upon the gift-giver because, as noted above, “to help a close family member [or friend] is like helping yourself.” This is true for several reasons. First, a person often benefits directly when making significant gifts to friends and relatives. A family member who receives a new car or apartment (or even a book) might share it with the gift-giver; similarly, providing a stock tip to a relative may obviate the need to give the type of loan sometimes expected of close kin. A gift-giver may also benefit because of his or her genuine enjoyment of the recipient’s happiness. And last, the gift-giver may benefit from improved relations with friends or relatives. When gifts pass to relatives or friends, there is thus far greater reason than usual to believe that the gift-giver has benefitted personally, as the same benefits rarely accompany a gift to a casual acquaintance or a stranger.³⁷⁶

Now ask yourself: does this sort of analysis belong in a criminal proceeding where a doctor, in violation of his duty of confidentiality, has disclosed material nonpublic information to a hedge fund manager who saved hundreds of millions of dollars by trading on the information? What business do federal courts have in trying to ferret out the various motivations pursuant to which someone might make a gift?

Moreover, the notion that someone cannot obtain a personal benefit from a gift to a stranger reflects a very limited view of human nature. I get more pleasure in buying breakfast for a homeless person on a cold winter day than I do in giving a gift to my adult children, all of whom are well-off and more than capable of purchasing the subject matter of the gift themselves.

The dissent also quibbled with the jury instructions because they would permit a conviction if the doctor gave information to *Martoma* “as a gift with the goal of developing . . . a personal friendship.”³⁷⁷ The dissent was shocked that the government could convict someone based upon “a gift between persons who are not friends, but might become friends.”³⁷⁸ Consequently, the dissent found the instruction clearly erroneous because “whatever counts as a ‘meaningfully close’ relationship, a non-existent friendship clearly is not one.”³⁷⁹ The dissent

374. *Martoma*, 869 F.3d at 85 (Pooler, J., dissenting).

375. *Id.* (Pooler, J., dissenting) (citing majority opinion at 69).

376. *Id.* at 85–86 (Pooler, J., dissenting) (citation omitted) (alteration in original).

377. *Id.* at 89 (Pooler, J., dissenting).

378. *Id.* (Pooler, J., dissenting).

379. *Id.* (Pooler, J., dissenting).

did not realize that developing a friendship can be as important as maintaining one. This is rigidity carried to the extreme.

But all of this should be irrelevant. There are many reasons why a person might give a “gift.” It is not the role of federal courts to play amateur psychologist. It is the role of the federal courts to enforce the securities laws and to carry out the congressional dictate that the playing field should be level.

3. Martoma II: *Finessing Newman*

Ten months after the Second Circuit’s opinion in *Martoma I*, the Second Circuit amended that opinion in *Martoma II*.³⁸⁰ Rather than announcing that *Newman*’s requirement of a “meaningfully close relationship” was “no longer good law,”³⁸¹ *Martoma II* looked at the basis for such articulation in *Newman*, namely, that there must be evidence of “a relationship between the insider and the recipients that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter],”³⁸² and determined both that there was a *quid pro quo* and an intent to benefit the relationship between Dr. Gilman and Martoma.

This approach was probably taken in response to the dissent’s objection in *Martoma I* that the panel could not overrule *Newman* without convening the court en banc.³⁸³

The Second Circuit, in *Martoma II*, first observed that the Supreme Court had “defined personal benefit broadly.”³⁸⁴ The court then listed the personal benefits recognized by the Second Circuit:

We held that a jury could infer a personal benefit from the fact that a tipper “hoped to curry favor with his boss,” and from the fact that another tipper and the tippee “were friends from college.” We found evidence of a personal benefit sufficient where the tippee gave one tipper “an iPhone, live lobsters, a gift card, and a jar of honey,” and where the tippee had another tipper admitted into an investment club where the tipper “had the opportunity to access information that could yield future pecuniary gain” (even though he never realized that opportunity). In another case, we held that the government “need not show that the tipper expected or received a specific or tangible benefit in exchange for the tip,” and that the personal benefit element is satisfied where there is evidence that the tipper “intend[ed] to benefit the . . . recipient.”³⁸⁵

The court, in *Martoma II*, found both that there was a *quid pro quo* arising from the thousands of dollars in consulting payments paid by

380. *Martoma v. United States*, 894 F.3d 64 (2d Cir. 2018) (*Martoma II*).

381. See *Martoma*, 869 F.3d at 69.

382. *Martoma II*, 894 F.3d at 69 (“The [*Newman*] Court explained that this standard ‘requires evidence of a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].’ (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013) (internal quotation marks omitted)).

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

384. *Martoma II*, 894 F.3d at 73.

385. *Id.* at 74. (citations omitted) (alterations in original).

Martoma to Dr. Gilman, and that Dr. Gilman intended to benefit Martoma with inside information.³⁸⁶ Relying upon *Dirks*, the court stated, with respect to Dr. Gilman's intent to benefit Martoma: "We think a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it."³⁸⁷

To support its conclusion that Dr. Gilman intended to benefit Martoma, the court stated:

Here, as previously noted, Dr. Gilman knew that Martoma was an investment manager who was seeking information on which to base securities trading decisions. And Dr. Gilman plainly understood the valuable nature of the information about the bapineuzumab clinical trial, as Martoma had previously paid him \$1,000 per hour over the course of 43 consultations to convey his knowledge on the subject, and had visited Dr. Gilman in his Ann Arbor office to receive the key drug efficacy results firsthand. From these facts, a reasonable jury could infer that Dr. Gilman personally benefited by conveying inside information about the trial with the purpose of benefiting Martoma, even if it was not persuaded that the two had a relationship suggesting a *quid pro quo* (or a personal relationship, for that matter).³⁸⁸

Consequently, the court concluded that Martoma's substantial rights were not affected by a jury instruction that would have permitted him to be convicted on the basis that Dr. Gilman tipped him in order to maintain or develop a friendship since the evidence more than supported a conclusion that a properly instructed jury would also have convicted him on the basis of either a *quid pro quo* or intention to benefit.

V. LEGISLATION DEFINING INSIDER TRADING

In connection with both the previously discussed 1984 and 1988 legislation, Congress considered setting forth the definition of insider trading. Senators Riegle and D'Amato received a draft of proposed legislation from a distinguished group of securities lawyers led by Harvey Pitt, the former general counsel of the SEC, and John Olson, the chairman of the American Bar Association's Task Force on Regulation of Insider Trading.³⁸⁹

386. *Martoma II*, 894 F.3d at 78.

387. *Id.* at 79. (citations omitted).

388. *Id.*

389. Letter from Donald W. Riegel, Jr., Chairman of the Senate Subcommittee on Securities, to Harvey L. Pitt, Lawyer (Mar. 11, 1987), http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1980/1987_0311_PittRiegleT.pdf. Harvey Pitt was the SEC's twenty-sixth Chairman from 2001–2003 and its youngest General Counsel. He was selected as the nineteenth recipient of the William O. Douglas Award which honors SEC alumnus who contributed to development of federal securities laws or served the SEC community with distinction. *SEC Biography: Chairman Harvey L Pitt*, U.S. SEC. & EXCH. COMM., <https://www.sec.gov/about/commissioner/pitt.htm> (last visited July 27, 2019). John Olson was named Washington, DC Corporate Law Lawyer of the year in 2013 and Washington, DC Corporate Governance Law

The proposed legislation had two critical components: trading on material, nonpublic information would be unlawful when the trader “knows or is reckless in not knowing” that the information has been obtained “wrongfully,” coupled with a definition of “wrongful.”³⁹⁰

The unlawful aspect provides as follows:

It shall be unlawful for any person, directly or indirectly, to use material, non-public information to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotation system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information.³⁹¹

What constitutes wrongful use or acquisition of information is defined as follows: “For purposes of this section, information shall 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.”³⁹²

In addition, the legislation would prohibit wrongful communication of material, non-public information:

It shall be unlawful for any person, directly or indirectly, wrongfully to communicate material, nonpublic information to another person who, directly, or indirectly, purchases or sells any security that is directly or indirectly the subject of the communication, while in possession of such information, if the person making the communication knows (or is reckless in not knowing) that such information would be used for a purchase or sale of a security that would violate [the above provisions].³⁹³

The key to the above provisions is that they implicitly remove the requirement that the tippee must receive a benefit. As former SEC chairman David Ruder pointed out, this legislation “should remove the *Dirks* requirement that in tipping cases a personal benefit to the tipper must be found in order to charge the tipper or the tippee.”³⁹⁴ Thus, this legislation would have reversed the result in the *Dirks* case and its progeny, but was never acted on.

Congress believed that “if the *Dirks* is properly and narrowly construed by the courts, the Commission’s insider trading program will not be adversely affected.”³⁹⁵ As the *Newman* case illustrates, *Dirks* has been neither properly

Lawyer of the year in 2012 by *The Best Lawyers in America. Biography of John F. Olson*, GIBSON DUNN, <https://www.gibsondunn.com/lawyer/olson-john-f/> (last visited July 27, 2019).

390. Insider Trading Proscriptions Act, S. 1380, 100th Cong. § 16A(b)(1) (1987).

391. *Id.*

392. *Id.* § 16A(b)(2).

393. *Id.* § 16A(c)(2).

394. David Ruder, Chairman, SEC. & EXCH. COMM., Remarks Before the National Investor Relations Institute: Recent Developments in Insider Trading Law and Enforcement (Nov. 11, 1987).

395. H.R. REP. NO. 98-355, at 15 (1983).

construed, nor narrowly construed; rather, the Second Circuit gave a free ride to remote tippees who made millions from the tip.

During the 2000s, insider trading again exploded,³⁹⁶ arguably as a result of the rise of hedge funds and their desire to gain an edge on their competitors, a black edge if necessary.³⁹⁷ In 2009, Preet Bharara was appointed U.S. Attorney for the Southern District of New York and promptly set out to curb insider trading. At one point, he had 79 consecutive convictions.³⁹⁸

As a result of the *Newman* decision, Congressman Himes introduced a bipartisan bill to define insider trading, similar to the bill introduced earlier by Senators Riegle and D'Amato, but Himes' bill specifically provided that knowledge of the means by which the information was obtained or any benefit to the tipper was not required an element of the crime:

It shall not be necessary that the person trading while in possession of such information . . . or making the communication . . . know the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while in possession of such information or making the communication, as the case may be, was aware or recklessly disregarded that such information was wrongfully obtained or communicated.³⁹⁹

Congressman Himes set forth the necessity for the legislation as follows:

The absence of a clear statutory prohibition on insider trading has left us with an amorphous body of case law instead of bright lines around what's legal and what isn't . . . [t]his haziness opens the door to letting wrongdoers walk free, and provides uncertainty to those who are genuinely trying to operate within the bounds of the law. This isn't a partisan issue—no one should profit from illegally obtained information. The need for a clear definition of insider trading is particularly important in an era in which complex trades and information literally move at the speed of light. This legislation explicitly defines insider trading and will help ensure that bad actors are held accountable, protect legitimate investors and strengthen confidence and safety in our markets.⁴⁰⁰

According to Professor Coffee, a leading expert on securities regulation:

396. See, e.g., Peter Lattman & Azam Ahmed, *Hedge Fund Billionaire Is Guilty of Insider Trading: A Circle of Tipsters Who Shared Illicit Secrets*, N.Y. TIMES (May 12, 2011), <https://dealbook.nytimes.com/2011/05/11/galleon-chiefs-network-of-friendswho-tell-secrets/>; *Wall Street, Held Accountable: The Conviction of a Major Hedge Fund Manager Comes at a Moment of Distrust in the Markets*, N.Y. TIMES (May 12, 2011), <https://www.nytimes.com/2011/05/12/opinion/12thu1.html>.

397. See, e.g., BLACK EDGE, *supra* note 274.

398. Jonathan Marino, *Preet Bharara Was the Undefeated Top Cop of Wall Street—But Now His Legacy Is in Question*, BUSINESS INSIDER (Oct. 27, 2015), <https://www.businessinsider.com/preet-bharara-was-once-the-undefeated-top-cop-of-wall-street-but-that-has-all-changed-2015-10>.

399. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. § 16A2(c) (2015–2016).

400. Press Release, Himes Introduces Bipartisan Bill to Define and Prohibit Illegal Insider Trading (Mar. 25, 2015), <https://himes.house.gov/media-center/press-releases/himes-introduces-bipartisan-bill-define-and-prohibit-illegal-insider>.

In my judgment, Congressman Himes has performed a real service in producing a draft bill to codify the prohibition on insider trading in a manner that is tough, effective and fair . . . [i]t closes the loophole created by the [*Newman*] decision, updates the law to cover computer hacking and other newer forms of misappropriation, but does not overcriminalize.⁴⁰¹

Clearly, this legislation would clarify the concept of when trading is illegal, by eliminating the knowledge of how the information was obtained requirement and the personal benefit requirement. While this should not be necessary, new legislation should also clarify that an employee of a corporation holds material nonpublic information received in the course of employment solely for the corporation's benefit and would breach his or her fiduciary duty to the corporation by any unauthorized disclosure.

Unfortunately, Congress was focused on the upcoming election and the Supreme Court vacancy, and this legislation also did not advance.

CONCLUSION

The committee report accompanying the Insider Trading Sanctions Act of 1984 referred to *Cady, Roberts* and *Texas Gulf Sulfur* as "seminal cases."⁴⁰² While Justice Powell, in *Chiarella* and *Dirks* also referred to these cases as seminal, he not only misinterpreted these cases, but unfathomably asserted that they held the opposite. The committee report noted that there was concern about the *Dirks* decision but noted that "the Court acknowledged . . . the *Dirks* case had unique facts."⁴⁰³ The committee then stated that "if the *Dirks* decision is properly and narrowly construed by the courts, the Commission's insider trading program will not be adversely affected."⁴⁰⁴ Rather than narrowly construing *Dirks*, the Second Circuit carried it to its illogical extreme in *Newman*.

After 1983, the lower federal courts had little choice but to follow Justice Powell's severely flawed analysis in *Dirks*. However, lower courts could have followed Congress's recommendation that the *Dirks* holding be limited to its very unusual facts, rather than expanding the limitations upon effective policing of insider trading. The *Newman* court did not limit *Dirks*, choosing instead to require that the penultimate head of a "club" passing along material, nonpublic inside information—namely, the portfolio manager who could amass tens of millions of dollars through insider trading—must know of the benefit received by the initial tipper—a person who breached his fiduciary duty to his employer by disclosing the information.

The Supreme Court, in *Salman*, though not dealing with the massive insider trading schemes developed by hedge funds and other large trading entities, rejected *Newman*'s notion that a tipper must also receive something of a

401. *Id.*

402. H.R. REP. NO. 98-355, at 14 (1983).

403. *Id.*

404. *Id.* at 15.

“pecuniary or similarly valuable nature”⁴⁰⁵ in exchange for a gift of inside information. Building upon *Salman*, the Second Circuit, in *Martoma II*, then determined that it was not necessary to establish *Newman*’s requirement of a “meaningfully close personal relationship” between the tipper and tippee, in order to use the gift analogy of *Dirks*. Rather, to meet the personal benefit requirement, it was necessary only to establish either a *quid pro quo* or an intent by the tipper to benefit the tippee.

There are several practical problems with *Newman*. As Sheelah Kolhatkar, a former hedge fund analyst and later a staff writer for *The New Yorker*, noted, the basic problem with *Newman* “is that it completely misunderstood the way the world actually works.”⁴⁰⁶ For the *Newman* court, defendants’ lack of culpability stemmed from the fact that “Newman and Chiasson were several steps removed from the corporate insiders,” since Newman and Chiasson were three and four levels removed from the inside tipper, respectively, “and there was no evidence that either was aware of the source of the inside information.”⁴⁰⁷

The *Newman* court failed to realize that this is the way the game is played. The portfolio manager orders trades, which make millions for the organization, and indirectly for the analysts and others who feed information to the portfolio manager. All of these people are aware of the risks of insider trading and, when a dark edge is employed, want to obfuscate insider trading as much as possible.

For example, in the SAC Capital situation, Steve Cohen received reports in a specified formant, the most important element of which was the requirement that recommendations have a “conviction” rating from 1 to 10 as to the strength of the recommendation:

A conviction rating of 10 was reserved for “absolute certainty,” a level that would seem to be impossible to achieve through conventional research methods. How could a person be 100 percent certain about any event in the future, let alone the performance of a stock? The rating was how traders communicated the value of their information to Cohen without exposing him to the details of how they knew something. Cohen relied on it to decide whether to buy for his own account. The rating system had been the idea of the compliance department, which was always trying to ways to protect Cohen and keep him from explicitly receiving material nonpublic information—it was like a moat around the company’s most valuable asset.⁴⁰⁸

It is critical for courts to understand the pressures to receive illegal information, the chain through which it travels, where it must end in order to be operational, and the devices to disguise the illegal sources.

Courts also need to understand that much of the world operates on networking and relationships, and that people are motivated by factors other than

405. *Salman v. United States*, 137 S. Ct. 420, 425 (2016).

406. Stewart, *supra* note 321. Sheelah Kolhatkar is the author of *BLACK EDGE*, *supra* note 274, a three-year study of the skullduggery that inheres in much of the hedge fund industry.

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

408. *BLACK EDGE*, *supra* note 274, at 95.

immediate pecuniary gain. For example, Martoma preyed on Dr. Gilman's loneliness and the loss of his two sons.⁴⁰⁹ Martoma, by creating a relationship with Dr. Gilman, might have induced Dr. Gilman to provide the inside information without any pecuniary benefit. However, in a world that is often selfish and greedy, Justice Powell and some other federal jurists unfortunately failed to understand that people can be motivated by something other than money.

But there are indeed huge sums of money to be gained through the improper use of inside information. The insider trading in *Texas Gulf Sulfur*, *Chiarella*, and *Dirks* was fairly modest. The employees in *Texas Gulf Sulfur* traded a few hundred to a few thousand shares.⁴¹⁰ Chiarella realized a gain of slightly more than \$30,000 in the course of 14 months.⁴¹¹ And Dirks' tippees avoided a loss of about \$6 million.⁴¹²

By way of contrast, the defendants in *Newman* earned \$72 million in profits for their respective funds; in *Martoma*, the tippees realized \$80.3 million in gains and \$194.6 million in averted losses.⁴¹³ "Martoma personally received a \$9 million bonus based in large part on his trading activity in Elan and Wyeth."⁴¹⁴ Today, the hedge fund industry is a \$3 trillion industry in which the participants seek any edge to enable their results to outperform their competitors.⁴¹⁵

In 1970, daily trading volume as high as 20 million shares was unusual, and average trading volume was about 12 million shares.⁴¹⁶ Today, trading volume of 3 billion shares is not unusual,⁴¹⁷ and trading volume can range from 2 billion to 6 billion shares. If the "potential for immense profits [was] a powerful lure" for insider trading in the 1970s and 1980s, that risk is almost exponentially greater in today's supercharged world.

Congress has stated that the purpose of securities regulation is to ensure a level playing field where one participant does not have an undue advantage over another participant. Congress also was of the opinion that a legislative definition

409. *Id.* at 97.

410. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 841 n.4 (2d Cir. 1968). Since the price of Texas Gulf sulfur shares on November 8, 1963, when the drilling began was 17 3/8 and rose to a high of 37 1/8 on April 16, 1964, the day the discovery was announced, someone who purchased 2000 shares, such as Fogarty, a director, could obtain at best \$40,000 from his insider trading. *Id.* at 847.

411. *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

412. *Dirks v. SEC*, 463 U.S. 646, 670 (1982) ("Dirks' clients had unloaded close to \$15 million of Equity Funding stock and the price had plummeted from \$26 to \$15.").

413. *United States v. Martoma*, 869 F.3d 58, 62 (2d Cir. 2017).

414. *Id.* at 62-63.

415. Christine Williamson, *Hedge Fund Assets End 2017 at Record \$3.2 Trillion*, PENSIONS & INVESTMENTS (Jan. 19, 2018), <http://www.pionline.com/article/20180119/ONLINE/180119827/hedge-fundassets-end-2017-at-record-32-trillion-8211-hfr>.

416. For example, in 1970, 3.124 billion shares were traded. See Table 1210, Volume of Trading on New York Stock Exchange: 1970 to 2010, U.S. CENSUS BUREAU <https://www2.census.gov/library/publications/2011/compendia/statab/131ed/tables/12s1210.xls>. Since there are about 252 trading days in a year, the average daily trading volume would be about 12.4 million shares. See *id.*

417. See *Markets Diary*, WALL STREET JOURNAL (July 11, 2019), http://www.wsj.com/mdc/public/page/2_3021-tradingdiary2.html.

of insider trading was not necessary. That may well be the case if other federal courts follow the lead of the *Martoma* court and recognize that, when a corporate employee breaches his fiduciary duty by disclosing material, nonpublic information outside his or her employer to someone who may trade on the basis of such information, the person who trades on the basis of this wrongfully obtained information is guilty of insider trading. Moreover, a market professional who obtains material nonpublic information himself or herself has a responsibility to know the source of such information and should not be able to use ignorance as an excuse.

If federal courts do not have the wisdom to follow the lead of the Second Circuit in *Martoma*, then Congress should act. But, in today's politically polarized world, acting rationally may be too much to hope for.
