FRIENDS WITH BENEFITS? CLARIFYING THE ROLE RELATIONSHIPS PLAY IN SATISFYING THE PERSONAL BENEFIT REQUIREMENT UNDER TIPPER-TIPPEE LIABILITY

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INTRODUCTION

Between 2009 and 2013, insider trading networks generated an estimated $928 million in illegal trading profits.[1] Although insider trading entails high risk, the ease of acquiring confidential information and the opportunity for extraordinary profits entice many individuals to participate in the illicit scheme.[2] When the Securities and Exchange Commission ("SEC") successfully brings an insider trading case, agency officials usually trace the trade to a top executive or board member with access to confidential information.[3] However, the investigation may further reveal other actors participating in the same scheme.[4] Typically, these actors are the insider's close family and friends, whom traded on the material nonpublic information that the insider "tipped" or divulged to them.[5] In such cases, all actors within the insider's network ("tippees") may be found civilly or criminally liable for their involvement under the tipper-tippee theory of insider trading.[6]

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[1] Kenneth R. Ahern, *Information Networks: Evidence from Illegal Insider Trading Tips*, J. OF FIN. ECON. (forthcoming 2016) (manuscript at 2), http://ssrn.com/abstract=2511068.

[2] *See* Chris Matthews, *How Profitable Is Insider Trading, Anyway?*, FORTUNE (Oct. 20, 2014), http://fortune.com/2014/10/20/insider-trading-profits/.

[3] *See* Ahern, *supra* note 1, (manuscript at 2) ("The most common occupation among inside traders is top executive, including CEOs and directors, accounting for 17% of known occupations.").

[4] *Id.* (manuscript at 2–3).

[5] *Id.* (manuscript at 3) (finding that a majority of inside traders' social connections comprise of family members, friends, and business associates).

[6] *See* Edward Greene & Olivia Schmid, *Duty Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 390–91 (2013); *see generally* Dirks v. SEC, 463 U.S. 646, 650–51 (1983) (addressing the civil sanctions against tipper-tippee defendants); United States v. Libera, 989 F.2d 596, 598–99 (2d Cir. 1993) (addressing the criminal liability of tipper-tippee defendants). While Congress has not granted criminal authority to the SEC, the SEC possesses broad powers to conduct investigations that aid the attorney general to prosecute insiders. *See* Mary Jo White, Chair, Sec. & Exch. Comm'n, All-Encompassing Enforcement: The Robust Use of Civil and Criminal Actions to Police the Markets, Keynote Address at the

An essential element of tipper-tippee liability requires the government to establish that the insider-tipper received a personal benefit by sharing the information.[7] The benefit is not limited to monetary gain or reputational benefits; evidence that the tipper maintained a "close[] relationship" to the tippee might also satisfy the requirement.[8] However, a clear standard to determine what constitutes a "close relationship" does not yet exist.[9] Most recently, in *United States v. Newman*,[10] the United States Court of Appeals for the Second Circuit held that a personal relationship between the tipper and tippee alone was not enough to constitute a personal benefit, whereas the United States Court of Appeals for the Ninth Circuit in *United States v. Salman*[11] found such a relationship was enough to constitute a personal benefit.[12] Initial reactions characterized the Second Circuit's opinion as "strict[]"[13] and "overly narrow,"[14] yet the Ninth Circuit's opinion was considered to be in "adherence with insider trading precedent."[15] While a facial reading of both cases suggests a clear circuit split, a deeper analysis into each case's language and precedent reveals greater compatibility.[16] However, reconciliation between the two cases still leaves an incomplete approach to analyzing relationships for the personal benefit requirement. Without a clear standard, tipper-tippee liability will remain inconsistent and inadequate in situations that analyze relationships to determine liability.

Part I of this comment provides background information on insider trading laws, the prominent theories of insider trading liability, the development

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SIFMA Compliance & Legal Society Annual Seminar (Mar. 31, 2014); C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 6 (1991).

7 *See Dirks,* 463 U.S. at 663.

8 *See* Stephen J. Crimmins, *Insider Trading: Where Is The Line?*, 2013 COLUM. BUS. L. REV. 330, 347–48 (2013).

9 *See* Petition for Writ of Certiorari at 13–14, Salman v. United States, No. 15-628 (U.S. Nov. 10, 2015) (arguing that the Supreme Court should grant certiorari because of the Second, Seventh, and Ninth Circuit's conflicted interpretations of *Dirks*); Petition for a Writ of Certiorari at 14, United States v. Newman, No. 15-137 (U.S. July 30, 2015) (arguing that the Second Circuit's opinion redefined the personal benefit requirement and that it "cannot be reconciled with *Dirks*").

10 773 F.3d 438 (2d Cir. 2014).

11 792 F.3d 1087 (9th Cir. 2015).

12 *See Newman*, 773 F.3d at 452; *Salman*, 792 F.3d at 1093–94.

13 Chris Yates, *Attorneys React To 2nd Circ.'s Insider Trading Ruling*, LAW360 (Dec. 10, 2014), http://www.law360.com/articles/603374/attorneys-react-to-2nd-circ-s-insider-trading-ruling.

14 *See* Ed Beeson, *SEC's White Calls 2nd Circ. Insider Ruling 'Overly Narrow'*, LAW360 (Dec. 11, 2014), http://www.law360.com/articles/603894/sec-s-white-calls-2nd-circ-insider-ruling-overly-narrow-.

15 *Id.*; Stephanie Russell-Kraft, *3 Takeaways From The 9th Circ.'s Insider Trading Ruling*, LAW360 (July 7, 2015), http://www.law360.com/articles/676435/3-takeaways-from-the-9th-circ-s-insider-trading-ruling.

16 *See* Jonathan E. Richman et al., *9th Circ. Rebuffs* Newman, LAW360 (July 8, 2015), http://www.law360.com/articles/676604/9th-circ-rebuffs-newman.

of tipper-tippee liability, and an introduction to the personal benefit requirement. Part II analyzes the Second Circuit and the Ninth Circuit opinions, the ideological consistencies between them, and a survey of several district court and circuit court opinions that examine relationships in determining whether a personal benefit exists. Finally, Part III proposes a completely new approach to addressing relationships that mitigate the identified inadequacies of current interpretations and recommends that the SEC adopt the new standard. This Part also delves into a constitutional issue resulting from the current vagueness of the personal benefit requirement.

I. OVERVIEW OF THE DEVELOPMENT OF INSIDER TRADING LAW

The early twentieth century was plagued with a flourishing culture of dishonesty in the trading markets, prompting Congress to enact one of the most significant pieces of securities legislation in history.[17] In part, Congress intended to eliminate the negative economic and moral consequences of insider trading.[18] Illegal insider trading is the purchase or sale of securities on the basis of material nonpublic information that is obtained through a breach of fiduciary duty.[19] As insider trading laws became more complex and pervasive, several categories and theories of liability evolved, including tipper-tippee liability.[20] Section A begins by tracing the evolution of insider trading laws under statute, agency interpretation, and judicial resolution. Sections B and C describe the major theories of liability, and most notably, tipper-tippee liability. Finally, Section D provides an introduction to the personal benefit requirement as currently interpreted.

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17 *See* David A. Lipton, *Governance of Our Securities Markets and the Failure to Allocate Regulatory Responsibility*, 34 CATH. U. L. REV. 397, 397 n.2 (1985) ("The Supreme Court described Congress' motivation in adopting the Securities Exchange Act of 1934 as a response to 'the combination of the enormous growth in the power and impact of exchanges in our economy, and their inability and unwillingness to curb abuses.'" (quoting Silver v. NYSE 373 U.S. 342, 351–52 (1963))).

18 *See id.* at 397; Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L. J. 329, 348 (1988) ("The Exchange Act intended to reach various exchange abuses: notably speculation and market manipulation.").

19 *See* ELIZABETH SZOCKYJ, THE LAW AND INSIDER TRADING: IN SEARCH OF A LEVEL PLAYING FIELD 2, 4 (1993). Information is considered material when "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The Court subsequently applied this definition to insider trading laws. *See* Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

20 *See* Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & BUS. 151, 156–57 (2011).

A. *Section 10(b) of the Securities Exchange Act and Rule 10b-5 Thereunder*

The Roaring 1920s came to an abrupt halt in 1929 with one of the worst economic crises in history.[21] As the Great Depression eroded market confidence and created a general distrust of financial actors, President Roosevelt intended to regulate the markets as part of his New Deal initiatives.[22] In an effort to regain public control over the markets, Congress swiftly enacted the two most prominent pieces of securities legislation to date: The Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[23] The Securities Act prohibits fraud involved in the sale of securities and regulates what information must be provided to investors prior to an initial public offering.[24] Building upon the initial protections of the Securities Act, the Exchange Act protects market participants from unfair distortions in the market by regulating various types of secondary security transactions.[25] The Exchange Act also created the SEC and empowered it with rulemaking authority in securities regulation.[26]

In 1934, the Senate Committee on Banking and Currency released an investigative report detailing, among other findings, corporate stockholders' regular abuse of the market when trading on material nonpublic information.[27] In addition to further validating efforts to regulate the securities market, the report identified insider trading as a problem straining market regularity and efficiency.[28] Thus, Congress responded by enacting Section 16(b) of the Exchange Act ("Section 16(b)") to combat insider trading.[29] However, Section 16(b) only applies to a limited range of transactions involving specific corporate actors and shareholders.[30] As fewer transactions

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21 Keller & Gehlmann, *supra* note 18, at 329.

22 *Id.* at 338.

23 *Id.* at 329.

24 *Id.* at 330.

25 *Id.*

26 *Id.*

27 S. REP. NO. 73-1455, at 55 (1934).

28 *See id.* at 55, 68.

29 *Stock Exchange Practices: Hearing on S. Res. 84, S. Res. 56, and S. Res. 97 Before the S. Comm. on Banking and Currency*, 73rd Cong. 6555 (1934) [hereinafter *Hearings*] (Statement of Thomas Gardiner Corcoran, in the Office of Counsel for the Reconstruction Fin. Corp.) ("[Section 16 referenced as Section 15] is one of the most important provisions in the act in that it provides for the protection of the stockholder from the so-called 'corporate insider.'").

30 15 U.S.C. § 78p(b) (1988). The section provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or

fell within the reach of Section 16(b), it became virtually obsolete and criticism over its narrow scope grew.[31]

Eventually, Section 10(b) of the Exchange Act ("Section 10(b)") became the avenue for effectively regulating insider trading.[32] Section 10(b) contains the statute's general antifraud provision, prohibiting the use of "manipulative or deceptive device[s]" in connection with the purchase or sale of securities.[33] However, Congress did not intend Section 10(b) to govern insider trading specifically; the term never appears in the section and a definition of insider trading is not given.[34] Instead, Section 10(b) meant to grant the SEC broad enforcement authority over three distinct categories: short selling, stop-loss orders, and employment or use of manipulative devices in the stock market.[35]

In 1942, the SEC seized upon its statutory rulemaking authority and promulgated Rule 10b-5.[36] Rule 10b-5 makes it unlawful to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any

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> officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

31 *See Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934: Hearing on H.R. 4344, H.R. 5065, H.R. 5832 Before the H. Comm. on Interstate and Foreign Commerce*, 77th Cong. 1247–48 (1941) (calling for the Section 16(b)'s repeal because it failed to cover security transactions made using inside information obtained through taking advantage of corporate position).

32 *See* Bondi & Lofchie, *supra* note 20, at 156.

33 15 U.S.C. § 78j(b) (2006). The provision prohibits any person:

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

"Manipulative or deceptive device" is undefined in the legislative history. *See* CHARLES H. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 ANALYZED AND EXPLAINED 86 (2003) (explaining that the purpose of adding "manipulative or deceptive device" to the Act was not to refer to any specific device or practice but "to forestall the general adoption or use of any such practice").

34 *See* SZOCKYJ, *supra* note 19, at 6 ("Nowhere in the legislation or in related discussions at the time is there an implication that Section 10(b) should be interpreted to include or could be applied against insider trading."); *see also Hearings, supra* note 29, at 6987–88 (Statement of Eugene E. Thompson, President of Associated Stock Exch.) ("This subsection [10(b) referenced as 9(c)] is so vague and inadequate for the purpose evidently intended to be accomplished that it should be stricken out in its entirety.").

35 *See Hearings, supra* note 29, at 6657 (Statement of Richard Whitney, President of the N.Y. Stock Exch.) (describing section 10's function [referenced as section 9] as a means for the SEC to eliminate short selling, stop-loss orders, and devices detrimental to the public interest [in regards to security transactions]).

36 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.16 (7th ed. 2016).

security."[37] Under this rule, the SEC and the U.S. government can pursue individuals in relation to false statements or omissions involving security trades.[38] Section 10(b) and Rule 10b-5 thereunder serve as both a civil and criminal statutory basis for insider trading liability.[39] The Department of Justice may charge individuals for insider trading in federal district courts, while the SEC has the authority to bring civil suits in its own administrative proceedings or in the federal courts.[40] The SEC relies on Rule 10b-5 for investigating most fraud-related activities.[41] Because insider trading laws are vague, the judicial courts have had great liberty in shaping the laws.[42] Initially, SEC and judicial interpretations continuously expanded Rule 10b-5's scope to include a variety of activities and actors.[43] However, the Supreme Court began to reign in this extensive reach in the 1970s.[44]

Although neither Section 10(b) nor Rule 10b-5 explicitly prohibit insider trading, the prohibition is crafted under the "fraud or deceit" language of the rule.[45] Judges began using the common law concept of fraud to interpret the "deceptive" and "manipulative" language found in Section 10(b).[46] Thus, establishing that an insider's activities were fraudulent is a critical first step in finding a violation of the law.[47] To establish liability for fraud, an individual must (1) intentionally misrepresent a "fact, opinion, intention or law" (2) for the purpose of causing someone else pecuniary loss due to that person's "justifiable reliance upon the misrepresentation."[48]

In re Cady, Roberts & Co.[49] was the earliest case to pursue insider trading liability under the realm of fraud.[50] The SEC reasoned that fraud associated with the trading of material nonpublic information arises out of a

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37 17 C.F.R. § 240.10b-5(c) (2016).

38 *See* 2 WILLIAM K.S. WANG & MARC. I. STEINBERG, INSIDER TRADING § 7.1 (2d ed. 2008).

39 *See supra* note 6 and accompanying text. Section 32(a) serves as the penalty provision under the Act. 15 U.S.C. § 78ff(a) (2006).

40 U.S. Securities and Exchange Commission, *How Investigations Work*, SEC.GOV (July 15, 2013), https://www.sec.gov/News/Article/Detail/Article/1356125787012.

41 *See* FLETCHER, *supra* note 6, at 99.

42 *See* 17 C.F.R. § 240.10b5-2 (2016) (Preliminary Note) ("The law of insider trading is otherwise *defined by judicial opinions construing Rule 10b-5*, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.") (emphasis added).

43 FLETCHER, *supra* note 6, at 99.

44 *Id.*

45 *See* SZOCKYJ, *supra* note 19, at 3.

46 *See* FLETCHER, *supra* note 6, at 13–14.

47 *See* SZOCKYJ, *supra* note 19, at 3–4 ("The behavior must involve fraud to make it illegal; simple "unfairness" to the investor is not prohibited.").

48 RESTATEMENT (SECOND) OF TORTS § 525 (1977).

49 40 S.E.C. 907 (1961).

50 *See* Joanna B. Apolinsky, *Insider Trading as Misfeasance: The Yielding of the Fiduciary Requirement*, 59 U. KAN. L. REV. 493, 495–96 (2011); SZOCKYJ, *supra* note 19, at 15 (stating that although *SEC v. Texas Gulf Sulpher* was the first case to "flesh[] out the foundation for a definition of insider trading as a fraudulent act" *In re Cady, Roberts & Co.* was the first case to invoke Section 10(b)).

breached duty to either disclose the information to shareholders, or abstain from trading.[51] The Commission rooted this duty in two principles: (1) the existence of a relationship between the insider and the shareholders that creates a fiduciary obligation to the shareholders and (2) the inherent unfairness involved when a party takes advantage of another party with whom he is dealing.[52] Thus, the SEC's judicial proceeding found that the defendant, a securities broker, violated Rule 10b-5 when he sold his company shares after receiving confidential information that shareholder dividends were going to drop.[53] Courts settled on the theory that insider trading is deceptive when an insider fails to disclose the material nonpublic information to shareholders because it provides a practical basis for demonstrating a fiduciary breach.[54]

B. *Theories of Insider Trading Liability*

The Supreme Court endorsed two main theories of insider trading liability, the classical and misappropriation theories, under Section 10(b) and Rule 10b-5 thereunder, both of which became prominent after decades of insider trading litigation.[55] Evolving from the interpretation of Section 10(b)'s antifraud provision, both the classical theory and the misappropriation theory are based on a violation of fiduciary obligations.[56]

The classical theory acts as a basis for liability when an insider owes a fiduciary duty to the company and its shareholders.[57] Liability arises when

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51 *In re Cady*, 40 S.E.C. at 911.

52 *Id.* at 912.

53 *Id.* at 908–11.

54 *See* Micah A. Acoba, Note, *Insider Trading Jurisprudence After* United States v. O'Hagan*: A Restatement (Second) of Torts § 551(2) Perspective*, 84 CORNELL L. REV. 1356, 1369 (1999).

55 *See* Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 269 (2003).

56 *See id.* at 269–70. However, not all insider trading claims result from a breach of fiduciary duty. *See* Bondi & Lofchie, *supra* note 20, at 158–59; *cf.* Michael D. Wheatley, *Apologia for the Second Circuit's Opinion in* SEC v. Dorozhko, 7 J.L. ECON. & POL'Y 25, 50 (2010) (stating that "the Supreme Court has not explicitly stated that a fiduciary duty is a prerequisite to Rule 10b-5 liability"). In 1980, the SEC promulgated Rule 14e-3(a), which "imposes a duty of disclosure under Section 14(e) [of the Exchange Act] on any person who trades in securities which will be sought . . . in a tender offer while that person is in possession of material [nonpublic] information . . . ." FLETCHER, *supra* note 6, at 261. Since this theory of liability does not emerge from Section 10(b), it is not based on a breach of fiduciary duty. *See* United States v. O'Hagan, 521 U.S. 642, 676 (1997) (stating that "[t]he SEC . . . placed in Rule 14e-3(a) a 'disclose or abstain from trading' command that does not require specific proof of a breach of fiduciary duty").

57 Bondi & Lofchie, *supra* note 20, at 157.

the insider breaches this fiduciary duty by trading on material nonpublic information obtained through the insider's position in the company.[58] This theory extends accountability to directors, executives, board members, and agents of the company.[59]

SEC v. Texas Gulf Sulphur Company[60] laid the foundation for classical theory analysis.[61] The Texas Gulf Sulphur Company ("Texas Gulf") began a mining exploration in a promising area.[62] When mineral deposits were found, some of Texas Gulf's officers and employees bought company shares before the mineral discovery was revealed to the public.[63] The Second Circuit affirmed the lower court's finding that the individuals were liable for insider trading because the information was material to the company share price.[64] Thus, the defendants had an obligation to disclose this information to the rest of the shareholders or abstain from trading completely.[65] As the Supreme Court later clarified, however, the duty to abstain or disclose applied only to those who owe a fiduciary duty to the company.[66]

As the Supreme Court narrowed the classical theory's application, the misappropriation theory evolved to curb insider trading by individuals who possessed material nonpublic information, but did not owe a fiduciary duty to company shareholders.[67] Under this theory, liability is based on the breach of a duty of "trust or confidence" owed to the source of the information.[68] An individual trading on insider information acquired via such a relationship commits fraud because the exchange of information is made under the assumption, inherent in the relationship, that neither person would trade on or disclose the information.[69] Due to its expansive application, the misappropriation theory is the most common basis for insider trading liability.[70]

The Supreme Court officially endorsed the misappropriation theory in *United States v. O'Hagan*.[71] James O'Hagan, a law firm partner, traded on

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58 *Id.*

59 *Id.*

60 401 F.2d 833 (2d Cir. 1968) (en banc).

61 *See* Ebaugh, *supra* note 55, at 272.

62 *Texas Gulf Sulpher Co.*, 401 F.2d at 843.

63 *Id.* at 839–40.

64 *Id.* at 864.

65 *Id.* at 848.

66 *See* Chiarella v. United States, 445 U.S. 222, 230–33 (1980).

67 *See* Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L. 865, 871 (2003); *see also* David T. Cohen, *Old Rule, New Theory: Revising The Personal Benefit Requirement For Tipper/Tippee Liability Under The Misappropriation Theory of Insider Trading*, 47 B.C. L. REV. 547, 555 (2006); 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION, § 6:2 (2015).

68 LANGEVOORT, *supra* note 67, § 6:4.

69 *Id.*

70 *Id.* at § 6:1.

71 521 U.S. 642 (1997).

material nonpublic information from a takeover deal involving one of his firm's clients.[72] The Court held that O'Hagan violated a duty of trust and confidence to his client by purchasing stock from the target company.[73] O'Hagan's actions were deceptive under Rule 10b-5 because he was "feigning fidelity to the source of the information."[74] Further expanding upon the Court's finding of an implied duty of trust, the SEC introduced Rule 10b-5-2, which identifies three specific circumstances that inherently create a fiduciary relationship: (1) when an individual agrees to maintain information in confidence; (2) when the two individuals have a history of sharing confidences; and (3) when the two individuals are family members.[75]

C. *Tipper-Tippee Liability*

Trading based on material nonpublic information is not the only way insiders and misappropriators may incur liability under Rule 10b-5. A fiduciary duty may be breached when those with the insider information "tip," or share, that information with others who then trade on it.[76] The Supreme Court determined that such liability is imposed when: (1) the tipper (insider) breaches a fiduciary duty by tipping the material nonpublic information to a tippee; (2) the tipper receives a personal benefit from tipping the tippee; (3) the tippee knows or should have known the tipper breached his fiduciary duty; and (4) the tippee uses the information in connection with a securities transaction.[77]

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72 *Id.* at 647–48.

73 *Id.* at 647–49.

74 *Id.* at 655.

75 17 C.F.R. § 240.10b5-2 (2016). The statute provides that:

[A] "duty of trust or confidence" exists in the following circumstances, among others:

(1) Whenever a person agrees to maintain information in confidence;

(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or

(3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

See, e.g., United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (recognizing attorneys, executors, guardians, trustees, and agency principals as creating a duty of trust or confidence).

76 LANGEVOORT, *supra* note 67, § 4:1.

77 Dirks v. SEC, 463 U.S. 646, 663–64 (1983).

Tippee liability is derived from the insider-tipper's breach of fiduciary duty; a tippee cannot be found liable for insider trading until the government first proves the original tipper violated insider trading laws by fraudulently disclosing the information.[78] Although the tipper and tippee chain may involve several actors, each called a "remote tippee," the courts only analyze the tip made from the original tipper (the insider) to the original tippee.[79] If a breach of fiduciary duty is found from that first transaction, then the rest of the tippees in the chain may also be held liable if they knew the transaction was fraudulent.[80] Neither Congress nor the SEC has spoken on the elements crafted in the *Dirks v. SEC*[81] decision over thirty years ago, signaling approval of its legal implications.[82] Consequently, the lack of formal clarity has left the nuances of the *Dirks* elements to judicial resolution.[83]

D. *The Personal Benefit Requirement*

The Supreme Court's decision in *Dirks* required evidence that a tipper received a "personal benefit" to establish tipper-tippee liability.[84] Raymond Dirks was an investment analyst who learned of an equity company's fraudulent management.[85] A former employee of the equity company, Ronald Secrist, revealed the information to Dirks in order to enlist his help in exposing the fraud.[86] After extensive investigation, Dirks reached out to a columnist to publicize the story.[87] In the meantime, he informed many people of the fraud, including some of his clients who sold their company shares.[88] After the D.C. Circuit dismissed Dirks' petition to review the SEC's administrative proceeding, which found him liable under Rule 10b-5, Dirks sought review in the Supreme Court.[89] The Supreme Court overturned the lower court's decision, concluding that Secrist did not receive a personal benefit from tipping Dirks the information because his sole motivation was to expose fraud in the

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78 *Id.* at 659, 662 ("[T]he tippee's duty to disclose or abstain is derivative from that of the insider's duty. . . [A]bsent a breach by the insider, there is no derivative breach.").

79 *See* United States v. Newman, 773 F.3d 438, 451–52 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) (analyzing the exchange between the insiders and the people they tipped the information to).

80 *Id.* at 447–48.

81 463 U.S. 646 (1983).

82 *See* Andrew Vollmer, *A Rule of Construction for* Salman, THE CLS BLUE SKY BLOG (May 6, 2016), http://clsbluesky.law.columbia.edu/2016/05/06/a-rule-of-construction-for-salman/; *infra* note 273 and accompanying text.

83 *See* LANGEVOORT, *supra* note 67, § 4:6.

84 *See Dirks*, 463 U.S. at 663–64.

85 *Id.* at 648–49.

86 *Id.* at 649.

87 *Id.*

88 *Id.*

89 Dirks v. SEC, 681 F.2d 824, 832–33 (D.C. Cir. 1982).

market.[90] The Court further defined personal benefit as "a pecuniary gain or a reputational benefit that will translate into future earnings" as well as "a gift of confidential information to a trading relative or friend."[91]

The personal benefit requirement became a mechanism to decipher whether the initial tipper violated a fiduciary duty by disclosing the information.[92] The Supreme Court reasoned that an insider breaches his fiduciary duty when the tip results in a private benefit to the tipper or deprives company shareholders from reaping any gains.[93] As not all trading on insider information is illegal, this principle serves to protect those who do not fraudulently breach a fiduciary obligation, or when the benefits of the breach do not outweigh the harm.[94] In *Dirks*, for example, the Court did not want to punish or discourage a person from exposing fraudulent activities.[95] Without much further direction from the Court or SEC, lower courts are only left with the language in *Dirks* to determine which situations involve a personal benefit.[96]

Like several tipper-tippee cases to follow, the SEC brought suit against Dirks under the classical theory.[97] Although tipper-tippee liability can be brought under both theories, courts have more consistently applied the personal benefit requirement to cases arising under the classical than misappropriation theory.[98] Because the misappropriation theory developed more recently than the classical theory, courts are divided as to whether the personal benefit requirement should be applied in misappropriation cases.[99] While

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90 *Dirks*, 463 U.S. at 665–67.

91 *Id.* at 663–64.

92 *See* LANGEVOORT, *supra* note 67, § 4:6.

93 *Dirks*, 463 U.S. at 663–64.

94 *See id.* at 654 (recognizing that only a breach of fiduciary duty in connection with fraud "come within the ambit of Rule 10b-5"); Cohen, *supra* note 67, at 567 ("[The personal benefit requirement] protects tippers and tippees in several instances where the benefits of the disclosure do not outweigh the harm."); *see generally* Chiarella v. United States, 445 U.S. 222, 227–28 (1980) (rejecting the notion of a "general" fiduciary duty between all participants in the market).

95 *See Dirks*, 463 U.S. at 667. Other policy reasons exist for courts declining to create a bright line rule outlawing all uses of material nonpublic information, like protecting individuals who accidently or inadvertently informs others of material nonpublic information. *See, e.g.,* SEC v. Switzer, 590 F. Supp. 756, 764, 766 (W.D. Okla. 1984) (finding that a "tippee" who inadvertently overheard an insider relay material nonpublic information to his wife did not acquire or assume fiduciary duty to the insider's corporate shareholders).

96 *See Dirks*, 463 U.S. at 664 ("Determining 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 insider-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain."); LANGEVOORT, *supra* note 67, § 4:6.

97 Dirks v. SEC, 681 F.2d 824, 832–33 (D.C. Cir. 1982).

98 *See* Ebaugh, *supra* note 55, at 270.

99 *See, e.g.,* SEC v. Willis, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) ("[T]he misappropriation theory does not require a showing of a benefit to the tipper. *Dirks* is not to the contrary, as it did not involve the misappropriation theory."); SEC v. Musella, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989) ("The misappropriation theory of liability does not require a showing of a benefit to the tipper . . . ."). *But*

courts that find the personal benefit requirement inapplicable do not explain the rationale behind such a decision,[100] the Second Circuit suggested in *SEC v. Libera*[101] that the nature of the relationship alone creates a presumption that the tipper benefits from his tip.[102] However, the Second Circuit recently deviated from this position, declaring that the personal benefit test appropriately applied in misappropriation cases.[103] Without clear guidance from the Supreme Court or the SEC, the personal benefit requirement's role in misappropriation cases, if any, is left to circumstantial interpretation.

II. ANALYSIS OF RELATIONSHIPS SATISFYING THE PERSONAL BENEFIT REQUIREMENT

Absent a clearer articulation of the role relationships play in personal benefit analysis, courts are left to fill the void through autonomous interpretations of *Dirks*. Section A describes the Second Circuit and Ninth Circuit opinions, analyzes the opinions' languages and precedent, and concludes that the two opinions are largely compatible. Section B then analyzes how several district and circuit court opinions consider relationships as evidence sufficient to fulfill the personal benefit requirement, demonstrating the decisions' compatibility with the analysis presented in Section A.

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see, *e.g.*, United States v. Newman, 773 F.3d 438, 446 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) ("The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory."); SEC v. Yun, 327 F.3d 1263, 1279 (11th Cir. 2003) ("[A] misappropriator must gain personally from his trading on the confidential information.").

100 *Willis*, 777 F. Supp. at 1172 n.7; *Muscella*, 748 F. Supp. at 1038 n.4; *see also* Ebaugh, *supra* note 55, at 281–82 ("The district courts in [SEC v. Willis and SEC v. Musella] . . . did not explain the basis for their conclusion that personal benefit was not a required element.").

101 989 F.2d 596 (2d Cir. 1993).

102 United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) ("[T]he misappropriation theory requires the establishment of two elements: (i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty. We believe these two elements, without more, are sufficient for tippee liability. The tipper's knowledge that he or she was breaching a duty to the owner of confidential information suffices to establish the tipper's expectation that the breach will lead to some kind of a misuse of the information. This is so because it may be presumed that the tippee's interest in the information is, in contemporary jargon, not for nothing." (internal citations omitted)). *See also* SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) ("It appears from these statements [language quoted above] that the Second Circuit would probably not require a showing of benefit to the tipper for tipper (or tippee) liability, but would create a presumption of section 10(b) and Rule 10b-5 liability if there was misappropriation followed by a tip.").

103 *Newman*, 773 F.3d at 446 ("The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory.").

A. *The "Circuit Split"*

In late 2014, the Second Circuit provided a seemingly unprecedented and controversial opinion regarding tipper-tippee liability.[104] In United States v. Newman, the government charged two hedge fund managers with insider trading violations under the classical theory.[105] A "cohort" of analysts at various investment firms received material nonpublic information regarding publicly traded technology companies.[106] Those analysts shared the information with two fund managers, Todd Newman and Anthony Chiasson, who then traded on the information.[107] After Newman and Chiasson were convicted at the district court level, they appealed the decision to the Second Circuit.[108] The defendants argued that the government failed to prove both that the original tippers (the technology company employees) received a personal benefit by disclosing the information to the original tippees (the investment analysts), and that the defendants knew the information was illegally obtained.[109] The Second Circuit overturned the conviction, finding the evidence insufficient to prove proper knowledge of the crime or to link Newman and Chiasson to the insiders.[110]

More importantly, the Second Circuit concluded that the original tippers did not receive any benefit by sharing the information with the original tippees.[111] Rob Ray, the tipper who worked at Dell, received career advice and assistance from Sandy Goyal, a tippee, over a year before the tip was made.[112] Although the government acknowledged that Ray and Goyal were not "'close friends,'" it presented evidence that they "both attended business school and worked at Dell together."[113] The court did not believe the career advice amounted to a benefit from the tip, but merely an "encouragement one would generally expect of a fellow alumnus or casual acquaintance."[114] Chris Choi, the tipper who worked at NVIDIA, shared the insider information with Hyung Lim, a former technology company executive.[115] The two met at church and "occasionally socialized together," but had no "history of loans

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104 *See* Jonathan D. Schmidt et al., *What* Newman *Means for the Market*, 21 WESTLAW J. DERIVATIVES 3, 3 (2015); Kevin Dugan, *Manhattan Judge Opens Door for More Insider Trading Convictions*, N.Y. POST (July 7, 2015), http://nypost.com/2015/07/07/manhattan-judge-opens-door-for-more-insider-trading-convictions/.

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

106 *Id.*

107 *Id.* at 443.

108 *Id.* at 442.

109 *Id.* at 444.

110 *Id.* at 455.

111 *Newman*, 773 F.3d at 443, 453.

112 *Id.* at 452–53.

113 *Id.* at 452.

114 *Id.* at 453.

115 *Id.* at 443.

or personal favors."[116] This "scant evidence" was insufficient because only "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential [pecuniary or similar] gain . . . a *quid pro quo* [exchange], or an intention to benefit the [tippee]" would fulfill the personal benefit requirement.[117]

The Ninth Circuit came to a different conclusion in *United States v. Salman*.[118] The case stemmed from the actions of Maher Kara, an investment banking analyst in the healthcare industry, and his brother, Michael Kara.[119] Maher frequently sought work advice from his older brother because Michael studied chemistry in college.[120] Maher's work was a frequent topic of discussion between the brothers, and Michael began asking Maher about any upcoming mergers within the healthcare market.[121] Before long, Maher was constantly updating Michael on impending mergers and acquisitions involving his firm's clients.[122] Maher continued to provide this information even though he predicted his brother was illegally trading.[123] Michael became very close to Bassam Yacoub Salman after Maher married Salman's sister.[124] Michael subsequently shared the insider information with Salman.[125] Salman was convicted for trading on the information, but appealed his conviction on the grounds that Maher never received any personal benefit by disclosing information to his brother.[126]

The Ninth Circuit found sufficient evidence that the brothers maintained a close enough relationship that Maher personally benefitted from his actions.[127] According to the court,

> Michael gave a toast at Maher's wedding, which Salman attended, in which Michael described how he spoke to his younger brother nearly every day and described Maher as his "mentor," his "private counsel," and "one of the most generous human beings he knows." Maher, overcome with emotion, began to weep.[128]

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116 *Id.* at 452–53.

117 *Newman*, 773 F.3d at 452–53 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).

118 United States v. Salman, 792 F.3d 1087, 1093–94 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

119 *Id.* at 1088–89.

120 *Id.* at 1089.

121 *Id.*

122 *Id.*

123 *Id.*

124 *Salman*, 792 F.3d at 1089.

125 *Id.*

126 *Id.* at 1090.

127 *Id.* at 1094.

128 *Id.* at 1090.

In addition, Michael helped with Maher's college tuition and other financial needs, and Maher generally confided in Michael and sought his guidance.[129] It was not inconceivable that Maher provided this information as gratitude for the benefits he had already received and those he would likely continue to receive by maintaining and furthering their strong familial ties.[130] The Ninth Circuit refused to interpret *Newman* as eliminating the consideration of friendship and familial relationships from the personal benefit analysis.[131] Such an interpretation would "depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend.'"[132]

Prosecutors criticized the *Newman* decision for making it more difficult to act against securities fraud.[133] The *Salman* decision became significant because it indicated a potential circuit split on the interpretation of the personal benefit requirement.[134] The *Newman* court uses particular language to describe the type of relationships that qualify under the requirement, giving the impression that such relationships are unique or uncommon.[135] However, the Ninth Circuit did not fundamentally disagree with the Second Circuit; it merely declined to acquit Salman's conviction based on an interpretation of *Newman* that disregarded personal relationships entirely from the personal benefit analysis.[136] In fact, the Ninth Circuit rejected a narrow interpretation because the Second Circuit acknowledged that the personal benefit included more than pecuniary gain; it included "the benefit one would obtain from simply making a gift of confidential information to a trading relative or

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129 *Id.* at 1089.

130 *Salman*, 792 F.3d at 1089 ("Maher, for his part, testified that he 'love[d] [his] brother very much' and that he gave Michael the inside information in order to 'benefit him' and to 'fulfill[ ] whatever needs he had.'").

131 *Id.* at 1093 (Salman urged the Court to extend the *Newman* reasoning in this appeal, which he interpreted "to hold that evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit").

132 *Id.* (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

133 *See* Matt Levine, *Justices Will Know Insider Trading When They See It*, BLOOMBERG VIEW (Jan. 19, 2016), http://www.bloombergview.com/articles/2016-01-19/justices-will-know-insider-trading-when-they-see-it; Ben Protess & Matthew Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, N.Y. TIMES (Dec. 10, 2014), http://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions/?_r=0.

134 *See* Dugan, *supra* note 104.

135 *See* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) ("[W]e hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is *objective*, *consequential*, and *represents* at least a potential gain of a pecuniary or similarly valuable nature.") (emphasis added). *But cf.* Petition for a Writ of Certiorari, *supra* note 9, at 25–26 (arguing that the Second Circuit's opinion produced an incomprehensible doctrine).

136 *See Salman*, 792 F.3d at 1093–94.

friend."[137] Thus, when examining the case law closely, the rationales underlying both cases are not necessarily incompatible or inconsistent; loose, fact-dependent, subjective standards can usually explain perceived inconsistency.

The seemingly disparate outcomes are likely the result of important variations in the underlying fact patterns of the two cases. The Second Circuit did not discount the value of personal relationships; a "meaningfully close relationship" can provide a personal benefit to the tipper when it has the potential of producing pecuniary gains.[138] The court emphasized that the relationship between the tippers and tippees were too "casual" to meet the "meaningfully close personal relationship" threshold set forth in the opinion.[139] There is little basis to infer that the Second Circuit would come to the same conclusion on this specific issue if it were presented with strong evidence that the original tippers and tippees possessed a close relationship.[140] If the facts of *Salman* were before the Second Circuit, the court would likely yield a different conclusion than *Newman* because abundant evidence existed to demonstrate a personal benefit resulting from a "meaningfully close relationship."[141] Thus, the evidentiary weakness, not an outright rejection of personal relationship evidence, sets the foundation for the *Newman* decision.[142]

This is a fair construction of *Newman* in light of existing precedent in the Second Circuit. In *SEC v. Warde*,[143] Edward Downe, a company director, learned that another company intended to purchase a large portion of his company's shares.[144] Downe informed his friend, Thomas Warde, of the buy-out, and each bought substantial portions of the company stock.[145] Prior to the purchase, evidence was presented that the two socialized several times a year, visited each other's private homes, and frequently "discussed subjects ranging from art to the stock market."[146] The Second Circuit determined that these attributes reflected a "close friendship" and were enough to infer that the tipper received a personal benefit from sharing the insider information,

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137 *Id.* (quoting *Newman*, 773 F.3d at 452).

138 *Newman,* 773 F.3d at 452 (willing to recognize "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter" as a personal benefit (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013))). The interpretation is compatible with the gift provision in *Dirks*, where the Court acknowledges that a gift of confidential information serves as a personal benefit to the insider when the gift recipient trades the confidential information for profit. *See* Dirks v. SEC, 463 U.S. 646, 664 (1983).

139 *Newman*, 773 F.3d at 452–53.

140 *Id.* at 453 (indicating that the "scant evidence" prevented the Court from "permit[ting] the inference of a personal benefit . . . ").

141 *See supra* notes 128–130 and accompanying text.

142 *See Newman*, 773 F.3d at 455 (stating that the government did not meet its burden because "the bare facts in support of the Government's theory of the case are as consistent with an inference of innocence as one of guilt").

143 151 F.3d 42 (2d Cir. 1998).

144 *Id.* at 45.

145 *Id.* at 45–46.

146 SEC v. Downe, 969 F. Supp. 149, 152 (S.D.N.Y. 1997).

and subsequent profits, with his friend.[147] More than a decade later, the Second Circuit came to a similar conclusion.[148] In *SEC v. Obus*,[149] Thomas Strickland became privy to insider information through his position in General Electric Capital Corporation.[150] He informed Peter Black, a good friend from college, of this information.[151] Black subsequently warned Nelson Obus of the eminent takeover because Obus owned shares in the target company.[152] Obus traded on the information and all three were charged with insider trading.[153] The Second Circuit determined that Strickland and Black's mere college friendship was sufficient to infer that Strickland received a personal benefit from tipping his friend.[154]

These two decisions clearly interpreted the personal benefit requirement more broadly than the *Newman* case facially suggests. In particular, the *Obus* opinion generated concern over the future application of personal relationships because the expansive interpretation suggested that anything indicating a relationship between the tipper and tippee would satisfy the requirement.[155] If the Second Circuit intended its *Newman* decision to read narrowly, it would effectively become incompatible with the two previous decisions. Because the court did not indicate that *Newman* affected the reasoning set forth in these relatively recent cases, it is unlikely that it meant to adopt a contradictory interpretation in *Newman*. That said, with *Newman* occurring only two years after *Obus*, the Second Circuit may have used this case as an opportunity to limit what is found to be an overly expansive earlier opinion.[156] Notwithstanding such speculation, the rule derived from the *Newman* opinion must be construed within the context of precedent, which is not compatible with an interpretation that nearly eliminates relationships from the personal benefit requirement.

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147 *Warde*, 151 F.3d at 48–49.

148 *See* SEC v. Obus, 693 F.3d 276, 279 (2d Cir. 2012).

149 693 F.3d 276 (2d Cir. 2012).

150 *Id.* at 279–80.

151 *Id.* at 280.

152 *Id.* at 280–81.

153 *Id.* at 279.

154 *Id.* at 291.

155 *See* John C. Coffee, Jr., *Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 292–93 n.24 (2013) ("Nonetheless, any passage of such information to a friend, after *Obus*, may be viewed by regulators as a 'gift' that satisfies the *Dirks* standard."); Crimmins, *supra* note 8, at 347 ("*Obus* is thus among the cases that appear to be eliminating the benefit requirement for tipper insider trading liability.").

156 *See id.*

B. *Survey of Case Law Analyzing Relationships That Satisfy the Personal Benefit Requirement*

Although district court and other circuit court decisions are not binding on the Second or Ninth Circuit, it is worthwhile to evaluate how those courts read *Dirks* to understand how the personal benefit requirement is generally interpreted. A survey of the major case law that evaluates the personal benefit requirement reveals that a close relationship may suffice as the tipper's personal benefit even when the tipper did not receive a pecuniary or reputational gain.[157]

The United States District Court for the Southern District of New York hears many insider trading cases because Wall Street and New York City's financial centers fall within its jurisdiction.[158] In *In re Motel 6 Securities Litigation*,[159] Hugh Thrasher, a Motel 6 executive, informed his friend, Carl Harris, about his company's tender offer negotiations.[160] Harris passed this along to several people who eventually traded on the information.[161] Thrasher did not receive any pecuniary benefit from tipping Harris.[162] However, Harris was dying of a terminal illness and Thrasher helped finance his medical bills.[163] The court determined that a reasonable jury could find that Thrasher benefitted by tipping his friend; Thrasher likely knew that Harris would profit from trading, which would allow Harris to gain financial independence from Thrasher.[164]

After *In re Motel 6*, the Southern District of New York again found a personal relationship to constitute a personal benefit.[165] Raj Rajaratnam, head of the Galleon Management Co. hedge fund, participated in multiple insider trading schemes resulting in several charges of securities fraud.[166] One of Rajaratnam's charges involved trading on insider information regarding another company's financial transactions, which he received from his friend, Rajiv

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157 *See* Crimmins, *supra* note 8, at 3487 n.64–65 (collecting cases).

158 *See* Jeffrey Toobin, *The Showman: How U.S. Attorney Preet Bharara Struck Fear into Wall Street and Albany*, THE NEW YORKER (May 9, 2016), http://www.newyorker.com/magazine/2016/05/09/the-man-who-terrifies-wall-street; Maureen Farrell, *Preet Bharara: Now 79 for 79 on Insider-Trading Cases*, WALL ST. J. L. BLOG (Feb. 6, 2014, 5:43 PM ET), http://blogs.wsj.com/moneybeat/2014/02/06/preet-bhara-now-79-for-79-on-insider-trading-cases/.

159 161 F. Supp. 2d 227 (S.D.N.Y. 2001).

160 *Id.* at 230.

161 *Id.*

162 *See id.*

163 *Id.* at 230 n.1.

164 *See id.* at 241.

165 United States v. Rajaratnam, 802 F. Supp. 2d 491, 507 (S.D.N.Y. 2011) [*hereinafter Rajaratnam Criminal Prosecution*].

166 SEC v. Rajaratnam, 822 F. Supp. 2d 432, 433 (S.D.N.Y. 2011) [*hereinafter Rajaratnam Civil Prosecution*].

Goel.[167] Although the court found that Goel's monetary gains from tipping Rajaratnam were sufficient to exhibit a personal benefit, the court heavily emphasized the close relationship between the two defendants as additional proof that Goel received a personal benefit.[168] Goel testified that the two had been good friends since business school and were very close family friends.[169]

In more recent cases, the Southern District of New York had an opportunity to weigh in on the *Newman* decision.[170] In *United States v. Riley*,[171] David Riley was the CIO and Vice President for Information Systems and Technology at Foundry Networks, Inc.[172] Riley kept in contact with a former colleague, Matthew Teeple.[173] Teeple worked as an analyst for the Artis Capital Management hedge fund.[174] Riley and Teeple would frequently travel to San Jose together, after which, "Artis would alter its position in Foundry."[175] Eventually, Riley informed Teeple that Foundry was going to be acquired.[176] Using *Newman* as precedent, the court determined that a tip given to "maintain[] or further[] a friendship" satisfies the personal benefit requirement.[177] The court cited three instances that exhibited the depth of the tipper and tippee's relationship: Teeple previously helped Riley maintain his side business, assisted him in securing a new job, and offered him investment advice.[178] From these facts, the court determined that their relationship was strong enough to predicate that Riley would eventually profit from the tip.[179]

Several other district courts have considered the strength of personal relationships in satisfying the personal benefit requirement. In *SEC v. Clay Capital Management, LLC*,[180] Scott Vollmar was the director of Autodesk, a business development company.[181] Vollmar shared material nonpublic information about Autodesk with James Turner, the CIO of Clay Capital hedge fund.[182] The court described Vollmar and Turner as close friends; they were

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167 *Rajaratnam Criminal Prosecution*, 802 F. Supp. 2d at 506.

168 *Id.* at 507.

169 *Id.* at 506.

170 United States v. Riley, 90 F. Supp. 3d 176, 185–86 (S.D.N.Y. 2015).

171 90 F. Supp. 3d 176 (S.D.N.Y. 2015).

172 *Id.* at 181.

173 *Id.* at 182.

174 *Id.*

175 *Id.*

176 *Id.* at 196.

177 *Riley*, 90 F. Supp. 3d at 186.

178 *Id.* at 186–89.

179 *Id.* at 189 ("Even if none of the specific benefits that Teeple provided to Riley were sufficient standing alone to satisfy *Newman's* 'personal benefit' standard, the totality of the circumstances clearly demonstrates that Riley provided Teeple MNPI in anticipation of a personal benefit of a pecuniary nature.").

180 No. 2:11–cv–05020–DMC–JBC, 2013 WL 5946989 (D.N.J. Nov. 6, 2013).

181 *Id.* at *1.

182 *Id.*

brothers-in-law and attended business school together.[183] The court concluded that Vollmar personally benefitted from tipping Turner because doing so strengthened their close familial relationship.[184]

The United States District Court for the Southern District of Ohio arrived at two different conclusions in separate cases arising from the same event.[185] In *SEC v. Blackwell*,[186] Roger Blackwell was a member of Worthington's board of directors.[187] Worthington, a company that produced meat alternative food products, began negotiating a merger with Kellogg.[188] Blackwell was present at all the board meetings and informed one of his employees, Kelly Hughes, of the merger during her end-of-the-year review.[189] Hughes traded on the information, and because she was a member of Blackwell's trust, the court found that Blackwell was in a position to financially benefit from the relationship.[190]

In the related case, *SEC v. Maxwell*,[191] David Maxwell learned of the Kellogg and Worthington merger through his position as director of material management for Worthington.[192] However, instead of disclosing to relatives or friends, Maxwell tipped Elton Jehn, his barber.[193] The court found that Maxwell and Jehn did not have "a close friendship, family relationship, or business association" to infer that Maxwell received any gain from furthering their relationship.[194] The court found no history of personal favors and no possibility of Maxwell receiving pecuniary gain from the tip.[195] Consequently, the court found that the government did not meet its burden in providing evidence that Maxwell personally benefitted.[196]

The Second and Ninth Circuits were not the only circuit courts to interpret *Dirks*. In *SEC v. Sargent*,[197] Dennis Shepard learned about a merger be-

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183 *Id.*

184 *Id.* at *3.

185 *Compare* SEC v. Blackwell, 477 F. Supp. 2d 891, 896, 898, 917 (S.D. Ohio 2007) (recognizing a personal benefit in a disclosure to a long-time employee and confidant), *and* SEC v. Maxwell, 341 F. Supp. 2d 941, 944, 948 (S.D. Ohio 2004) (concluding that no personal benefit was present in a disclosure to the defendant's long-time barber due to a lack of familial ties, friendship, or future advantage to the defendant).

186 477 F. Supp. 2d 891 (S.D. Ohio 2007).

187 *Id.* at 895.

188 *Id.*

189 *Id.* at 895–96.

190 *Id.* at 896, 902, 914.

191 341 F. Supp. 2d 941 (S.D. Ohio 2004).

192 *Id.* at 943.

193 *Id.* at 943–44.

194 *Id.* at 947–49.

195 *Id.* at 947.

196 *Id.* at 949–50.

197 229 F.3d 68 (1st Cir. 2000).

tween two automotive manufacturers from his business partner, Anthony Aldrich, who sat on the board for one of the merging companies.[198] Shepard shared the information with Michael Sargent, his dentist.[199] Outside of their doctor-patient relationship, Shepard and Sargent's families were good friends.[200] Shepard referred over 75 patients to Sargent, and Sargent helped Shepard operate one of his local businesses.[201] Although Shepard did not receive or expect to receive anything in return for the tip, the United States Court of Appeals for the First Circuit found that Shepard benefitted because his tip helped to further their relationship.[202]

In *SEC v. Maio*,[203] the United States Court of Appeals for the Seventh Circuit affirmed a finding of insider trading liability based on the tipper and tippee's social relationship.[204] Louis Ferrero, Chairman, President, and CEO of Anacomp, Inc., told his friend, Michael Maio, that Anacomp was negotiating a tender offer for stock in Xidex Corp.[205] Ferrero and Maio met through a mutual friend, Ronald Palamara.[206] The three frequently traveled together and attended each other's family events.[207] As evidence of Ferrero and Maio's close relationship, the court emphasized that Ferrero honored Palamara's dying request to provide financial care for Maio.[208] Even though Ferrero did not profit from Maio's trade or have a history of financial gains from Maio, Ferrero was significantly impacted by their friendship, which he found important to maintain.[209]

The Seventh Circuit reaffirmed its position more than a decade later.[210] In *United States v. Evans*,[211] Paul Gianamore was a financial analyst at Credit Suisse First Boston, an investment banking firm.[212] Gianamore informed his friend, Ryan Evans, about three tender offers and a merger involving his firm.[213] Gianamore and Evans met in college and reconnected after moving to the same city, at which point they kept in touch via daily phone calls and

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198 *Id.* at 71.

199 *Id.* at 72.

200 *Id.*

201 *Id.* at 72, 77.

202 *Id.* ("From this evidence, a jury could infer that Shepard tipped Sargent about Purolator [the auto manufacturer] in an effort to effect a reconciliation with his friend and to maintain a useful networking contact.").

203 51 F.3d 623 (7th Cir. 1995).

204 *Id.* at 627, 632–34, 638.

205 *Id.* at 626.

206 *Id.* at 627.

207 *Id.*

208 *Id.*

209 *Maio*, 51 F.3d at 632 (7th Cir. 1995).

210 United States v. Evans, 486 F.3d 315, 324–25 (7th Cir. 2007).

211 486 F.3d 315 (7th Cir. 2007).

212 *Id.* at 319.

213 *Id.* at 318–20.

emails.[214] The court concluded that a reasonable jury could find that Gianamore benefitted from his financial tip because it was made as a gift to a friend.[215]

Finally, the United Stated Court of Appeals for the Eleventh Circuit weighed in on this issue in *SEC v. Yun*.[216] David Yun was President of Scholastic Book Fairs, Inc. when he learned that the company was taking a loss for the quarter.[217] David informed his wife, Donna Yun, of the loss because he invested in the company's stock under her name.[218] Donna informed her work colleague, Jerry Burch, of the loss as he had stock in the company as well.[219] Burch traded on the information he received from Donna and the SEC filed suit against them for insider trading.[220] The Eleventh Circuit concluded that Donna divulged the confidential information to Burch in order to strengthen their mutually beneficial business and professional relationship, and thus personally benefitted.[221]

This case survey provides an overall picture that is consistent with the Ninth Circuit's articulation of the role relationships play in determining whether a personal benefit is pursued: where evidence is presented to show that a tip was made to further a mutually beneficial relationship between the tipper and tippee, the personal benefit requirement is satisfied. However, each case relies on specific facts instead of crystallizing a consistent legal standard of personal benefit analysis that can be applied in various situations. This creates precedent in each jurisdiction based upon isolated cases and fact patterns, which requires additional litigation each time a unique fact scenario appears. Moreover, unlike *Newman*, these fact patterns fail to indicate how the law applies to "remote tippees," who are many steps removed from the original tipper and tippee communication.[222] Thus, it is difficult to extract from the case law the exact role relationships play in any one scenario.

III. THE NECESSITY OF A CONSISTENT PERSONAL BENEFIT STANDARD

Current case law does not provide the exact criteria necessary to determine the role of relationships in satisfying the personal benefit requirement. Section A identifies the inadequacies of the personal benefit requirement as currently interpreted. Section B proposes a new approach that articulates how the courts should analyze relationships, and provides several hypothetical

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214 *Id.* at 319.
215 *Id.* at 321, 323–24.
216 327 F.3d 1263 (11th Cir. 2003).
217 *Id.* at 1267.
218 *Id.*
219 *Id.* at 1268.
220 *Id.*
221 *Id.* at 1280.
222 *See* United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

scenarios to demonstrate the potential of the approach. Section C considers the constitutionality of the current state of the law. Finally, Section D emphasizes that agency action is urgently needed to conclusively resolve this matter.

A. *The Inadequacy of the Current Interpretation*

As demonstrated in Part II, the personal benefit requirement can be fulfilled without pecuniary or reputational gain where the government can prove that the original tipper and tippee maintained a close enough relationship for the tip to have symbolic personal meaning to the tipper.[223] While the *Salman* opinion articulates this conclusion more clearly than the *Newman* opinion, the Ninth Circuit still fails to clearly define the kinds of relationships that satisfy the requirement.[224] Without setting clear guidelines, the personal benefit requirement remains susceptible to inconsistent interpretation or circumvention.[225] Furthermore, because the benefit elicited from a relationship is not as apparent as a pecuniary or reputational gain, it must receive deeper analysis to ensure the tip actually benefits someone with a "close relationship" to the tipper. In theory, the "close relationship" signifies a personal benefit because the tipper gains something of personal value by providing the material nonpublic information to the tippee.[226] It follows, then, that where a tip does not culminate into an actual trade, that the tipper cannot be said to have attained a true benefit. After all, possession of material nonpublic information alone does not carry any objective value in itself; the information only creates value once traded on.[227] Finding otherwise would mean that any disclosure between two parties with a "close relationship" might result in tipper-tippee liability, even if it does not result in a trade. This is an absurd result because the statute prohibits a *purchase* or *sale*, not the disclosure of information that does not result in a securities transaction.[228]

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223 *See supra* Part II.B.

224 *See* United States v. Newman*,* 773 F.3d 438, 452 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

225 *See, e.g.*, Levine, *supra* note 133 (discussing differing judicial interpretations in applying the personal benefit test).

226 Dirks v. SEC, 463 U.S. 646, 664 (1983) ("For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient.").

227 *See* Chiarella v. United States, 445 U.S. 222, 235 (1980) (finding that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information"); *Newman*, 773 F.3d at 448 ("For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach.").

228 15 U.S.C. § 78j(b) (2006); *Newman*, 773 F.3d at 448; *Chiarella*, 445 U.S. at 235..

B. *A New Approach to Analyzing Relationships for the Personal Benefit Requirement*

Under the current state of insider trading laws, a tipper may be found liable for receiving a personal benefit when disclosing material nonpublic information to "a trading relative or friend".[229] However, the law fails to articulate a standard for exactly which relationships qualify under the requirement. In setting forth such a standard, the law must avoid both an overly broad construction that renders it virtually ineffective, and an unduly narrow construction that allows insiders or misappropriators to evade liability. The standard should accurately and effectively account for the objective nature and strength of the relationship between the tipper and tippee. Thus, the law should instruct that the personal benefit requirement is satisfied when a tipper either receives an objective gain from the tippee for the information, or strengthens a personal relationship with any tippee who serves to gain from trading on the information.[230] This comment proposes that a personal relationship is sufficient to satisfy the personal benefit requirement when the tipper and tippee (a) are immediate family members, (b) have shared a household together for at least four weeks or (c) have maintained reasonably consistent communication via personal contact through social engagements, work projects, or personal favors.

This new standard directs courts to examine the relationship between the original tipper and any tippee in the chain who gains from the trade. This approach to the new standard is vital because liability cannot solely depend on sharing information with a personal contact, but must also link that interaction to the act of illegal trading. The focus moves away from the relationship between the original tipper and the original tippee, and instead identifies whether a personal benefit exists between the original tipper and *any tippee* who benefits from the original trade.[231] A "benefitting" tippee is not limited to a "trading" tippee; any tippee who also benefits from pecuniary, reputational, or relationship gains suffices. This definition is specific enough to provide courts with the additional guidance needed to tackle this issue, yet it does not completely divert from the interpretation proffered by courts today.

Further, the new standard is based on two general characteristics of relationships that courts have relied on for finding a personal benefit.[232] First, a personal relationship may be measured by the length of time two individuals know each other. Typically, this is the characteristic of a family member, childhood friend, roommate, or anyone else one would normally confide in

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

230 For example, an elevation in wealth, reputation, or professional status. *See* LANGEVOORT, *supra* note 67, § 4:6.

231 *Cf.* United States v. Newman, 773 F.3d 438, 455 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) (examining the relationship between the original tippers [insider] and original tippees [investment analysts], instead of examining the relationship between the original tipper and Newman or Chiasson).

232 *See supra* Part II.B.

or consult. Second, a personal relationship may be measured by the amount of time two individuals spend together. This may describe a colleague, friend, group member, or anyone else that one would normally socialize or frequent with. While it is impossible to construct exact barriers that confine subjective terms to a specific definition, such a standard provides merely a point of reference to conduct relationship analysis.

A few hypothetical examples will better illustrate the practical application of this new approach. Nina is CEO of a giant risk management and consulting firm in New York City. She shares an apartment with her sister, Mary. Nina's company is getting ready to acquire a smaller consulting firm operating in northern New Jersey, which will give the company a greater regional stronghold. Negotiating the acquisition requires Nina to work much longer hours at the office. Concerned for Nina's well-being, Mary asks Nina about the work that is keeping her so busy. Against her better judgment, Nina divulges everything to Mary about the acquisition, including the grueling meetings and incredible financial stakes. Mary consoles Nina, but trades on the information and profits heavily.

Assuming the government charged Mary with insider trading under the classical theory, there is sufficient evidence to prove that Nina received a benefit from tipping Mary the information; she received comfort from her sister and possibly direct or indirect monetary benefits from the trade. Nina and Mary's relationship easily falls into the first category of the new standard. Thus, Nina breaches a fiduciary duty owed to her company by tipping Mary. This is a situation where the proposed guidance is consistent with current case law analyzing the personal benefit requirement.

Now imagine Mary does not trade on the information, but tips it to her best friend, Anna. Mary and Anna grew up together, went to the same school, and Anna asked Mary to be her daughter's Godmother. Anna trades on the information. Based on current law, the focal point would remain on the relationship between Nina and Mary. Because the relationship is shown to be sufficient, Nina receives a benefit, and that requirement is satisfied with respect to Anna's conviction, assuming she knew the information came from an insider.[233]

Under the new interpretation, however, the focal point changes to the relationship between the original tipper and the tippee who actually trades. In this case, because Anna traded instead of Mary, the analysis turns on whether Nina and Anna's relationship was sufficient enough to establish that Nina would benefit from Anna's gain. Even if the evidence does not show a sufficient relationship based on the first or second category of the new standard, one could argue that Mary benefits from Anna based on the nature of their relationship; they are in regular contact and maintain an integral part of each other's lives, qualifying their relationship for the third category. Because Mary benefits from strengthening their relationship, she also becomes

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233 *See Newman*, 773 F.3d at 455 (finding that neither Newman nor Chiasson could have known that the "information originated with corporate insiders").

a "benefitting" tippee, like Anna. Therefore, either the relationship between Nina and Mary or Nina and Anna may be analyzed to determine whether Nina received a personal benefit by tipping the information to Mary. To reiterate, this shift in analysis does not necessarily aim to expand or narrow the personal benefit application, but strives to provide an avenue for demonstrating that the tipper benefits from, and is connected to, the illegal trade.

Some might criticize this approach for not solving a perceived defect with the personal benefit requirement, which is embodied in *SEC v. Maxwell*.[234] As noted, the Southern District of Ohio held that the tipper, Maxwell, did not gain a personal benefit from tipping material nonpublic information to his barber, Jehn, because there was insufficient evidence of a close relationship between them to infer that Maxwell benefitted from his disclosure.[235] This relationship also does not clearly fall into any category of the proposed standard, as the two only interacted when Maxwell needed a haircut.[236] Intuitively, the personal benefit requirement seems flawed for shielding Maxwell and his barber from liability.

While the proposed standard does not provide a satisfactory result in that instance, it does provide other avenues to convict Maxwell should additional facts warrant a conviction. For example, imagine Maxwell's barber serviced many of Maxwell's colleagues and ends up sharing this tip with one of Maxwell's friends. Better yet, suppose Maxwell was attempting to evade the law by tipping Jehn, knowing that he would share the tip with one of Maxwell's colleagues. In these cases, Maxwell gains a personal benefit because he strengthens his relationship with his colleagues by allowing them to acquire considerable profits, qualifying under the suggested standard's third category.

Others might object to this application because it makes it more difficult to convict remote tippees, who are so far removed from the original tipper that a relationship between them is unlikely.[237] The *Newman* case is a prime example of remote tippees; Newman and Chiasson were three to four degrees removed from the original tippers.[238] While it may be harder to convict remote tippees, an effective approach to the personal benefit requirement should not cater to prosecutorial goals.[239]

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234 *See* Cohen, *supra* note 67, at 568 (referring to *SEC v. Maxwell*, the author argues that "[t]he personal benefit requirement, however, also protects disclosures to self-serving tippees who will use the information solely for their own benefit by trading").

235 SEC v. Maxwell, 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004).

236 *Id.* at 943–44.

237 *See supra* note 133 and accompanying text. *But see* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 198 (2006) (arguing for a revised definition of the personal benefit because of its unfair application to remote tippees).

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

239 *See id.* at 448 (dismissing the government's strong reliance on the court's previous dicta because it "merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders").

The Supreme Court developed the personal benefit requirement to preserve the notion that insider trading liability does not result from mere possession of insider information.[240] The new standard ensures that the tipper actually benefits from the trade, whether that results from receiving a pecuniary gain or benefitting a close relative or friend. If the tippee is so removed from the tipper that reasonable minds cannot connect the tipper to anyone who benefitted from the trade, then a personal benefit is nonexistent.[241] Because this interpretation examines the direct relationship between the original tipper and remote tippee, it potentially eliminates the need for prosecutors to prove that tippees knew the information came from corporate insiders.[242]

A final criticism the proposed analysis may face is that it does not incorporate scienter. The "scienter theory" entertains the idea that a tipper must intend to receive a benefit from tipping, and without the intent, the personal benefit requirement is not satisfied.[243] Some argue that the Supreme Court, in *Dirks*, did not find a personal benefit because Dirks did not intend to receive a benefit, he only intended to expose the fraud.[244] However, the Court did not specify the need for "intent" when it formed the personal benefit requirement.[245] Instead, the Court stated that the personal benefit requirement is an objective standard based on the facts presented.[246] A plain reading indicates that an intention is not required, and thus the new approach is consistent with that logic.[247]

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240 *See Dirks*, 463 U.S. at 654 ("In an inside-trading case this fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'" (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 SEC 933, 936 (1968))); *see also supra* notes 92-95 and accompanying text.

241 *See supra* Part I.D; *see also, e.g., Newman*, 773 F.3d at 455 ("No reasonable jury could have found beyond a reasonable doubt that Newman and Chiasson knew, or deliberately avoided knowing, that the information originated with corporate insiders.").

242 *See Newman*, 773 F.3d at 442 ("[T]he Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit.").

243 *See* A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 874 (2015) ("[T]he personal benefit element requires the government to prove that the tipping insider disclosed the information for the *purpose* of receiving a personal benefit, direct or indirect.").

244 *See id.* at 870 ("The *Obus* court goes astray because it ignores that the *Dirks* personal benefit test requires not just that tippers *receive* a personal benefit, but that they disclose confidential information for the *purpose* of receiving a personal benefit. The absence of a personal benefit will end that inquiry, but the presence of one is not dispositive: purpose must still be shown." (footnote omitted)).

245 *See Dirks*, 463 U.S. at 663.

246 *Id.* ("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.") (emphasis added).

247 *See id.*

The proposed standard is an improvement to the existing one and remains consistent with the purpose of the requirement. It provides clear guidance that courts can follow and apply consistently in different jurisdictions.[248] It is important to keep in perspective that insider trading law is not the only deterrent to insider trading; insiders who are caught tipping information are in jeopardy of losing their job and damaging their reputation.[249] Thus, there should be no hesitation to adopt this standard for concern that insiders may find a loophole to its interpretation.

C. *Due Process Concerns Stemming from a Vague Rule 10b-5*

A graver issue concerning the current application of the personal benefit requirement is that it potentially violates the void for vagueness doctrine. The Supreme Court established the void for vagueness doctrine as a measure of due process for individuals' rights.[250] Under the doctrine, due process is violated when a statute "forbids or requires the doing of an act in terms so vague that persons of common intelligence must necessarily guess at its meaning and differ as to its application," and when it does not prescribe specific standards for the statute's application.[251] The goal of the doctrine is to provide fair warning to the conduct prohibited by the statute, and to avoid arbitrary and discriminatory application by preventing an impermissible delegation of "judges and juries for resolution [of the statute's language] on an *ad hoc* and subjective basis[.]"[252]

While the doctrine tends to apply more strictly to cases concerning a "constitutionally protected right," it is applied less strictly in cases involving economic regulation because it is assumed that individuals in specialized fields have greater means of receiving clarification for any perceived ambiguity.[253] The doctrine also tends to apply more strictly for actions resulting in

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248 *See* Walter Pavlo, *DOJ Takes* Newman *Decision to SCOTUS: What's In Request And What's Not*, FORBES (Aug. 5, 2015) ("'A clear definition of 'personal benefit' would be helpful to both prosecutors and the investment community.' It most certainly helps everyone who is playing the game when they know the rules."), http://www.forbes.com/sites/walterpavlo/2015/08/05/doj-takes-newman-decision-to-scotus-whats-in-request-and-whats-not/print/.

249 *See* HONGMING CHENG, COMMERCIAL CRIME AND COMMERCIAL REGULATION: A COMPARATIVE PERSPECTIVE 187 (2011).

250 The Supreme Court's clearest articulation of the rule is in Connally v. Gen. Constr. Co., 269 U.S. 385, 391 (1926), although the core concepts developed earlier. *See* Daniel J. Bacastow, Comment, *Due Process and Criminal Penalties under Rule 10b-5: The Unconstitutionality and Inefficiency of Criminal Prosecutions for Insider Trading*, 73 J. CRIM. L. & CRIMINOLOGY 96, 112 n. 86 (1982).

251 *Connally*, 269 U.S. at 391. *See also* Grayned v. City of Rockford, 408 U.S. 104, 108 (1972).

252 *See Grayned*, 408 U.S. at 108–09.

253 *See* Hoffman Estates v. Flipside, 455 U.S. 489, 498–99 (1982).

criminal convictions than civil liability because in a criminal case, an individual's liberty is at stake.[254] If the language is too vague, the court must strike the legislation as failing to provide the defendant with proper notice of his crime.[255]

In its current form, a Section 10(b) and Rule 10b-5 violation may result in criminal penalties for insider trading.[256] Although criminal statutes are typically read narrowly to avoid convictions based on vague language in the statute, Section 10(b) and Rule 10b-5 are interpreted liberally for insider trading prosecution.[257] This liberal interpretation originated in *United States v. Charnay*,[258] where the Ninth Circuit extended Section 10(b) and Rule 10b-5's broad application of insider trading liability to criminal suits to further a policy of fair and efficient markets.[259] The concurrence noted that the court's decision did not violate an individual's due process.[260] The Second Circuit echoed *Charnay* by rejecting due process concerns regarding criminal convictions under Rule 10b-5.[261] While the Supreme Court narrowed the Second Circuit's scope of insider trading laws and adopted the infamous "breach of a fiduciary duty" requirement, the Court did not discuss the due process issue, leaving intact the potential for overly broad interpretation in criminal proceedings.[262]

While Section 10(b) and Rule 10b-5 thereunder survived the void for vagueness doctrine with respect to convictions of insiders, the law is not sufficiently clear for tipper-tippee convictions. Without providing a clear basis for liability, the potential consequences for violating insider trading law are more severe because Rule 10b-5 may result in severe criminal penalties for multiple individuals involved in a tipper-tippee chain.[263] In addition, Rule 10b-5 potentially implicates an individual's First Amendment rights to free speech when it is used in the tipper-tippee context. For example, a corporate

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254 *See id.* at 499.

255 Bacastow, *supra* note 250, at 112.

256 *See* United States v. Charnay, 537 F.2d 341, 357 (9th Cir. 1976) (Sneed, J., concurring); *see also supra* note 6 and all accompanying text.

257 Bacastow, *supra* note 250, at 117.

258 537 F.2d 341 (9th Cir. 1976).

259 Bacastow, *supra* note 250, at 118.

260 *Charnay*, 537 F.2d at 356–57 (Sneed, J., concurring) ("[I]n fixing criminal liability under section 10(b) and Rule 10b-5, we attach reduced importance to assertions of vagueness. The fact that men of common intelligence—or lawyers and judges for that matter—'must necessarily guess at its meaning and differ as to its application,' does not require that we declare this section 10(b) void for vagueness." (citations omitted)).

261 *See* United States v. Chiarella, 588 F.2d 1358, 1365, 1369 (2d Cir. 1978), *rev'd on other grounds*, 445 U.S. 222 (1980) (finding that Rule 10b-5 applied to "*[a]nyone*—corporate insider or not—who regularly receives [and trades on] material nonpublic information" because precedent provided adequate notice that such conduct is criminal).

262 *See* Chiarella v. United States, 445 U.S. 222, 234–35 (1980); Bacastow, *supra* note 250, at 123–24.

263 *See supra* notes 5-6 and accompanying text.

insider may argue that tipper-tippee liability unduly restricts his speech, regarding material nonpublic information, because he constantly fears that anyone he may speak to will trade on the information. Thus, Rule 10b-5 in the tipper-tippee context may indirectly restrict the tipper's speech more broadly than appropriate.[264] Although the prohibition on insider trading primarily serves as an economic regulation, the multitude of criminal penalties and potential implication of free speech call for a stricter application of the void for vagueness doctrine.

In order for insider trading law to comply with the fair notice requirement, it must provide fair warning to tippers and tippees of the conduct it prohibits and apply explicit standards for its enforcement.[265] Section 10(b) prohibits fraud *generally* from security transactions, without any reference to insider trading.[266] Rule 10b-5 is the statute's enforcement mechanism, but it does not expound on what constitutes "fraud or deceit" in security transactions.[267] Neither defines substantive elements for statutory violations, especially in regards to tipper-tippee liability or how relationships factor into personal benefit analysis.[268] On the face of the statute and rules thereunder, an individual who passes along information to a friend or relative without pecuniary gain cannot reasonably know that the statute prohibits his actions. Thus, this law and the rules thereunder have serious constitutional implications when applied to tipper-tippee contexts.

D. *The SEC Must Provide Official Guidance Setting a Standard for the Personal Benefit Requirement*

The intricacies of tipper-tippee law have evolved for decades without congressional or agency input.[269] Although imperfect, the judiciary has continued to apply the *Dirks* test for determining liability in tipper-tippee cases.[270] Within the past year, both the *Newman* and *Salman* decisions have been appealed to the Supreme Court to clarify the personal benefit requirement set out thirty-three years ago.[271] While the Court finally agreed to rule on the issue, it will more likely adopt one of the circuit court's interpretations

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264 *See* Nicholas Kappas, Note, *A Question of Materiality: Why The Securities and Exchange Commission's Regulation Fair Disclosure Is Unconstitutionally Vague*, 45 N.Y.L. SCH. L. REV. 651, 668–69 (2002) (arguing that the SEC's fair disclosure regulations implicate the right to free speech because the prohibition of speech is so broad that "corporate officers are no longer able to communicate freely with certain persons" without facing repercussions).

265 *See* Grayned v. City of Rockford, 408 U.S. 104, 108 (1972).

266 *See supra* notes 33–35 and accompanying text.

267 *See supra* note 37 and accompanying text.

268 *See supra* notes 33–35 and accompanying text.

269 *See supra* notes 82–83 and accompanying text.

270 *Id*.

271 *See supra* note 9 and accompanying text.

rather than articulate the standard proposed in this comment.[272] Given that the Second and Ninth Circuit opinions are insufficient for resolving this issue, and the potential violation of defendants' due process rights, agency action is necessary to create a uniform standard for tipper-tippee liability. Specifically, the SEC should provide official guidance adopting a more specific standard based on the foundation set out in *Dirks*. Courts have used the case as a starting point, and Congress has taken some measures to indicate its support.[273] In doing so, the SEC should then adopt the personal benefit definition that this comment provides. The proposed standard requires SEC guidelines to ensure effective and uniform application. Official guidelines also allow for an objective starting point and a proper rule-of-thumb in conducting tipper-tippee analysis.[274] As Congressional leaders failed to pass clearer legislative direction in the wake of *Newman*, adopting this approach to tipper-tippee liability serves as a more pragmatic step in the right direction.[275]

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272 *See* Peter J. Henning, *An Insider Trading Case Heads to the Supreme Court*, N.Y. TIMES (Jan. 20, 2016), http://www.nytimes.com/2016/01/21/business/dealbook/an-insider-trading-case-heads-to-the-supreme-court.html?_r=2.

273 Congress passed the Insider Trading Sanctions Act of 1984, which created a statutory private right of action against securities fraud, allowing a money penalty up to three times of the trading profits. *See* Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. L. 145, 153 (1989). Congress subsequently passed the Insider Trading and Securities Fraud Enforcement Act of 1988 to extend these penalties to derivative liability from insider trading. *Id.* at 158–59. While Congress declined to define insider trading, the congressional findings indicated that Congress believed the Court provided "clear" rules in determining insider trading convictions, and to expressly acknowledge that the misappropriation theory was included under Section 10b-5. *See id.* at 157–58. The congressional findings did not specify Congress's approval of the *Dirks* elements, but it can be inferred given the ITSFEA was enacted after the Supreme Court decision and Congress has not disapproved of its elements.

274 Joan MacLeod Hemingway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 LA. L. REV. 999, 1005 (2012) ("[An agency's guidelines] can be helpful guidance to the court in exercising its decision-making authority.").

275 *See* Peter J. Henning, *Court Strikes on Insider Trading, and Congress Lobs Back*, N.Y. TIMES (Mar. 16, 2015), http://www.nytimes.com/2015/03/17/business/dealbook/court-strikes-on-insider-trading-and-congress-lobs-back.html ("In response to that decision, Representative Stephen F. Lynch, Democrat of Massachusetts, introduced the 'Ban Insider Trading Act' on Feb. 27, and the Democratic Senators Jack Reed of Rhode Island and Robert Menendez of New Jersey submitted the 'Stop Illegal Insider Trading Act' on March 11. Both would make it illegal to buy and sell securities based on information the person knew or should have known was confidential, differing somewhat in the details of how the prohibition would be enforced."); *see also* Brief for Amicus Curiae Mark Cuban in Opposition to Petition for Rehearing and Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837), 2015 WL 1064412, at *2 ("Although Congress has been repeatedly challenged and even beseeched to provide a definition of insider trading as it relates to section 10(b), it has declined to do so. Instead of a statutory definition with boundaries, there is a patchwork of judicial decisions cobbling together, on a case-by-case basis, what conduct gives rise to liability. This has resulted in an 'intolerable degree of uncertainty.'" (footnote omitted) (citations omitted)).

CONCLUSION

For far too long, tipper-tippee liability has exhibited a serious void in attempts to articulate a well-defined role for relationships in personal benefit analysis. As insider trading schemes increasingly involve interconnected webs of close social relationships, the need to carve out a clear standard for personal relationships becomes more urgent.[276] Promulgating guidelines adopting the standard and approach provided in this comment will supply courts with clear guidance and uniformity. This in turn will place potential defendants on notice of the statute's criminal prohibitions, while preserving the common law foundation of tipper-tippee liability. The confusion surrounding the Second Circuit and Ninth Circuit's opinions can serve as the impetus for the SEC to finally clarify one of the most judicially constructed areas of insider trading laws.

276 *See supra* notes 1–5 and accompanying text.