INSIDER TRADING: WHERE IS THE LINE?

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Following the contours of the Securities and Exchange Commission's seminal Cady, Roberts *opinion in 1961, the federal courts developed the law of insider trading in two reasonably clear and predictable molds. Corporate insiders will incur liability for trading on material nonpublic information in breach of the duty they owe their corporations and shareholders, and corporate outsiders will be liable if they misappropriate and trade on such information in breach of a duty they owe to the source of their information.*

Recent cases have blurred the lines of liability for insider trading. Courts now may impose liability on defendants in situations where it is unclear whether they assumed any duty to the corporation or other source of their information, where the information in question is vague or speculative in nature, and where it is unclear that they acted with the requisite mental state. Compounding this uncertainty, the SEC and the Justice Department have made insider trading a high prosecutorial priority and are expending substantial resources and using new tools to bring insider trading cases that would not have been pursued in earlier times.

Faced with uncertain liability parameters and intense enforcement efforts, prudent traders may conclude that any trade based on significant nonpublic information is just too risky. A wrong guess on any duty, materiality, or scienter element—finally resolved years later on appeal—can lead to imprisonment, or at least heavy civil fines, and a ruined career. Yet such a determination not to trade on significant nonpublic information effectively pushes these prudent traders into a so-called "parity-of-information" regime, in

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which all significant information must be publicly disclosed before it can be used for trading. While Congress, the SEC, and the courts have consistently rejected parity of information as an explicit legal requirement, the European Union's enforcement model specifically embraces parity.

The SEC and DOJ commitment to insider trading enforcement is to be commended for promoting fair markets for both ordinary and sophisticated investors, and thus for encouraging capital formation and economic growth. But it is an enforcement program that can be enhanced—and a parity regime avoided—through clear definition of the elements of the offense, through good case selection, and through alternative disposition paths to fairly and efficiently resolve smaller and less clear cases.

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I. INTRODUCTION

"This is a case of first impression and one of signal importance in our administration of the Federal securities acts." With those words just over fifty years ago in *Cady, Roberts*, a Securities and Exchange Commission ("SEC") administrative proceeding, Chairman William L. Cary began the first insider trading decision ever issued under the federal securities laws.[1]

The vast majority of insider trading cases over the decades following *Cady, Roberts* have adhered to Cary's basic analysis.[2] However over the last several years, the SEC and the Department of Justice ("DOJ") have pushed their insider trading enforcement programs in new and increasingly aggressive directions.[3] Where courts have agreed with the

[1] Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907, 907 (Nov. 8, 1961). Cary was a leading corporate and securities law scholar, and was for decades the Dwight Professor of Law at Columbia Law School.

[2] In situations defined in cases following *Cady, Roberts*, trading while in possession of material nonpublic information may violate Securities Act §17(a), Securities Exchange Act ("Exchange Act") § 10(b), and Exchange Act Rule 10b-5. *See* 15 U.S.C. §§ 77q(a), 78j(b) (2011); 17 C.F.R. § 240.10b-5 (2013). Where the information pertains to a tender offer, such trading may also violate Exchange Act § 14(e) and Exchange Act Rule 14e-3. *See* 15 U.S.C. § 78n(e) (2011); 17 C.F.R. § 240.14e-3 (2013).

[3] The SEC files civil insider trading cases seeking injunctions, disgorgement of trading profits with interest, and additional civil monetary penalties under Exchange Act § 21(d)(1) and (5), as well as §

SEC and DOJ, this has resulted in new, and sometimes expansive and unpredictable takes on the familiar elements of duty, materiality, and scienter laid out by Cary. These cases on the cutting edge point to where the law of insider trading is likely headed over the decade ahead. But as discussed below, they have also created uncertainty as to where the line of liability presently exists.

Part II examines how the SEC and DOJ have pushed to significantly expand the basic elements of insider trading in recent cases. Next, Part III discusses how the risks arising from this expansion have been substantially magnified by the government's recent intense focus on investigating and prosecuting insider trading, as well as by the new electronic and other investigative tools now available to the government.

Part IV then considers how, without a bright line delineating what is right and wrong, there is real prospect that careful traders—seeking to manage this uncertainty as to the metes and bounds of insider trading liability—may find themselves adhering to a "parity-of-information" approach long ago rejected by the Supreme Court but embraced in Europe. Finally, Part V suggests a number of ways to assure fairness in the handling of insider trading matters in this new environment, including increased clarity in articulating the elements of the offense, good case selection and more flexibility in the means for resolving such cases.

II. EXPANDING CARY'S ELEMENTS

The *Cady, Roberts* case involved a corporate director who, upon learning of a dividend cut, quickly notified his colleague at a brokerage firm.[4] The colleague immediately sold shares in discretionary accounts before public

21A(a)(1). *See* 15 U.S.C. §§ 78u(d)(1), (5), 78u-1(a)(1) (2011). The DOJ prosecutes willful insider trading offenses criminally under Exchange Act § 32(a). *See id.* § 78ff(a).

[4] *Cady, Roberts*, 40 S.E.C. at 909.

announcement of the dividend cut, which predictably drove down the stock price.[5]

In holding that the trader and his firm willfully violated the antifraud provisions of the securities laws,[6] Cary defined the offense by hitting most of the core elements that the federal courts would adopt for insider trading liability over the ensuing years. Insiders with material nonpublic information must disclose the information or abstain from trading. Cary said that to avoid liability under the antifraud provisions, "insiders must disclose material facts . . . known to them by virtue of their position but . . . not known to persons with whom they deal" that "would affect their investment judgment."[7] Where "disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances . . . the alternative is to forego the transaction."[8]

Cary saw this disclose-or-abstain duty as extending, by "logical sequence," not just to traditional insiders like officers, directors, and controlling shareholders, but also to their tippees—in this case, to the director's brokerage firm colleague.[9] Cary also saw the duty as more generally extending to those in a "relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for . . . personal benefit."[10] In this respect, Cary anticipated liability for what would later be called "temporary insiders" and "misappropriators." Likewise, he foresaw the so-called "use versus possession" issue when he rejected the argument that the trading broker's awareness of the dividend cut was trumped by his need to execute his brokerage clients' preexisting share

[5] *Cady, Roberts*, 40 S.E.C. at 909–10.

[6] Specifically, Securities Act § 17(a), Exchange Act § 10(b), and Exchange Act Rule 10b-5. *Id.* at 910.

[7] *Id.* at 911.

[8] *Id.*

[9] *Id.* at 912.

[10] *Id.* at 912.

liquidation program.[11] As for scienter, Cary found that the broker "knew when he received the message that the information was not yet public and was received from a director."[12]

A. Duty Element

In the decades since Cary's original duty analysis, the Supreme Court has recognized two theories supporting the duty element for insider trading liability. Under the Court's so-called "classical" theory, corporate insiders have a duty to their shareholders not to trade on confidential information obtained "by reason of their position," unless they first disclose the information.[13] These insiders include "permanent" insiders such as officers and directors, as well as "temporary" insiders such as attorneys, accountants, and consultants.[14] Under the "misappropriation" theory, "outsiders" of a corporation have the same duty to a source who has entrusted them with access to confidential information about the corporation.[15] Typically, such misappropriation cases involve corporate outsiders who breach a duty to their own employers, rather than a duty to the issuer.[16]

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11 *Cady, Roberts*, 40 S.E.C. at 916. *Cf.* Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2013) (adopted in 2000, prohibiting trading "on the basis of" material nonpublic information, and defining such trading as a purchase or sale of the security while "aware" of such information).

12 *Id.* at 912 n.17.

13 United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980)).

14 *See id.* at 652 (citing Dirks v. SEC, 463 U.S. 646, 655, n.14 (1983)).

15 *See id.* at 652–53. Defendant was an attorney charged with misappropriating information from his law firm and its client concerning the client's planned tender offer for the shares of another company. Defendant was an outsider of the target company (whose price would soar after the takeover announcement) and thus could not be prosecuted under the classical theory. *Id.* at 653 n.5.

16 *See, e.g.*, United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19, 24 (1987). In this case, a *Wall Street Journal* columnist was charged with leaking advance information about upcoming columns to others who traded on the

These two formulations of the duty element would seem fairly straightforward. Either the trader is an insider exploiting corporate information, or an outsider who has stolen the information from his or her employer or other principal. But more recent decisions have expanded the duty element to new frontiers and thereby created increasing uncertainty as to the boundaries of liability for traders. These decisions have thus effectively created new forms of duty that can ensnare unwary traders.

1. Unwanted Duty

One such new form of duty arises from the situation in which confidential information is unwillingly thrust upon a person who then trades on the information. The trader does not seek the information, but once in possession of the information, the trader may have a duty to disclose the information or abstain from trading.

An example of such thrust-upon duty is presented in the Fifth Circuit's decision in *SEC v. Cuban*,[17] where the trader plainly did not want the information he got, but then traded on it. In that case, a CEO phoned his company's large minority shareholder and said he wished to convey "confidential" information to the shareholder. The shareholder agreed to keep whatever the information might be confidential. The CEO then told the shareholder that the company was planning a Private Investment in Public Equity ("PIPE") offering and hoped that the shareholder would purchase in the offering. The shareholder responded that he disliked PIPE offerings, as they dilute existing shareholders, and commented, "Well, now I'm screwed. I can't sell."[18] However after a call with the company's investment bankers at the CEO's suggestion, a call in which the shareholder obtained more information about the PIPE offering, the shareholder sold all of his shares in the

information. The Second Circuit ruled that the columnist's tipping activities breached a duty owed to his employer.

17 SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010).

18 *Id.* at 555.

company. On announcement of the PIPE offering, the company's stock immediately declined 8.5%, and over the following week declined 39%. The SEC contended that by selling before the announcement the shareholder avoided a $750,000 loss.[19]

The court saw a "paucity of jurisprudence" on the issue of where a duty of trust and confidence exists. The court held it more than plausible that the shareholder had not simply agreed to keep the information confidential, but had also agreed not to trade on the information, and remanded for further proceedings.[20] In so doing, the court recognized that insider trading liability may now be predicated on an unwanted duty—a situation in which information is not sought but is instead thrust upon an unwilling recipient. Thus, persons who sought no information could find themselves subject to the same duty to disclose or abstain from trading as those who actively sought the information.

2. Duty Denied by the "Victim"

Another new variant of the duty element has very recently been recognized where the entity whose information was taken and used for trading—effectively the "victim" of a misappropriation—denies that it was ever owed a duty. As a result of the Second Circuit's decision in *SEC v. Obus*,[21] a trader obtaining material nonpublic information from such an entity may later be unpleasantly surprised to learn that the government believes the entity was owed a duty, even though the "victim" entity believes it was not.

In *Obus*, the SEC charged an underwriter at GE Capital with misappropriating information concerning an acquisition his employer was financing, and with passing it to a college friend who was an analyst with a hedge fund. The SEC said that the analyst then passed the information along to his boss, who bought the target company's stock. The underwriter maintained that he knew that his friend's hedge

19 *Cuban*, 620 F.3d at 555–56.

20 *Id.* at 557–58.

21 SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).

fund already had a large position in the target's stock and that, as part of his due diligence work for GE Capital, he simply asked questions to probe the hedge fund's opinion of the target's management. GE Capital had not at the time put the acquirer's or the target's stock on its "transaction restricted" list, and only did so sometime after the trading in question. After conducting an internal investigation, GE Capital—in the SEC's view, the victim of the misappropriation—concluded that its underwriter may have disregarded GE Capital's confidentiality policy, but that the underwriter did not breach his duty to GE Capital. A GE Capital representative testified in the SEC investigation that the underwriter had simply made a "mistake" while in the process of doing his underwriting work.[22]

With the supposed victim having denied that there was a duty breach, the district court granted summary judgment, "reasoning that the alleged victim of the breach of fiduciary duty did not consider itself a victim."[23] But the Second Circuit reversed and remanded. Among other things, the court viewed GE Capital's internal investigation as "not indisputably reliable," and it pointed to other evidence that GE Capital could have considered before concluding that it had not been victimized.[24] Thus there can now be a breach of a duty to a victim who claims there has been no such breach.

3. Duty Among Friends

It has long been recognized that no duty arises when material nonpublic information is simply overheard, in an elevator, a taxi, or elsewhere. The law "does not bar trading on the basis of information inadvertently revealed by an insider."[25] But in recent cases the SEC has charged that a

22 *Obus*, 693 F.3d at 283–84.

23 *Id.* at 291.

24 *Id.*

25 SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (finding no liability where insider negligently discussed possible merger in public place).

duty may arise where the insider (who inadvertently discusses confidential information) and the listener happen to be friends.

In a recently filed case, the SEC brought charges against the friend of a CEO who overheard the CEO discussing on his cell phone information about ongoing negotiations for acquisition of the CEO's company. After overhearing the calls, according to the SEC, the friend bought the stock and profited when the deal was announced. The SEC has appropriately contended that the CEO's alleged statements during cell phone calls were purely inadvertent. But according to the SEC, the simple existence of a friendship between the two individuals was enough to give rise to a duty, and led to a misappropriation charge against the friend who allegedly overheard the statements and traded.[26]

Intentionally shared confidences between friends can also result in misappropriation liability, with the existence of the duty apparently turning on the closeness of the friendship.[27] In a recent case, the SEC premised the duty on the fact that the source and the alleged misappropriator had been "very close friends" as "two young professionals living in a foreign country far from home"—one from New Zealand and the other from Australia—and "had a history of maintaining and not betraying" shared confidences over the seven months they had known each other.[28]

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26 Press Release, SEC, SEC Charges Close Friend of Staffing Company CEO with Insider Trading Around Acquisition (July 25, 2012), *available at* http://www.sec.gov/news/press/2012/2012-143.htm.

27 The SEC has specified by rule that a duty arises where persons "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." 17 C.F.R. § 240.10b5-2(b)(2) (2013). *Cf.* United States v. Corbin, 729 F. Supp. 2d 607, 610, 616 (S.D.N.Y. 2010) (sustaining indictment charging breach of duty arising from "history, pattern, and practice of sharing and maintaining confidences").

28 Complaint at 6, SEC v. Conradt, No. 12 CIV 8676 (S.D.N.Y. Dec. 26, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-245.pdf.

In another recent matter, the SEC charged that after an Alcoholics Anonymous ("AA") meeting, a company executive casually discussed with another attendee that the executive felt under heavy pressure at work in view of his company's ongoing merger negotiations. According to the SEC, the attendee who received the information bought the company's stock and passed the information to others who traded. Again, the SEC charged that simply the personal relationship between the two AA members was sufficient to give rise to a duty.[29]

4. Liability Without a Duty

The Second Circuit has apparently found that no breach of duty at all is required in cases where a defendant engages in some form of affirmative misrepresentation. In *SEC v. Dorozhko*,[30] a Ukraine-based computer hacker invaded the server of a vendor hired to host a company's earnings call and release, and thereby obtained earnings information and profited through options trading. Pointing to the "deceptive device" language in Section 10(b), the court reversed a finding that a breach of duty was a required element in every insider trading case.[31] The court held that while a breach of duty is required when a defendant trades without disclosing nonpublic information, a breach of duty is not required when a defendant affirmatively makes a misrepresentation to obtain the nonpublic information. The court remanded for a determination of whether the defendant had affirmatively misrepresented his identity in hacking into the host company's server, or whether he had simply exploited a "weakness in an electronic code to gain unauthorized access" in a non-deceptive manner.[32] Under this holding, a trader

29 Press Release, SEC, SEC Charges Five with Insider Trading on Confidential Merger Negotiations Between Philadelphia Company and Japanese Firm (Mar. 13, 2012), *available at* http://www.sec.gov/news/press/ 20 12/ 2012-41.htm.

30 SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009).

31 *Id.* at 45, 48.

32 *Id.* at 51. The district court on remand effectively faced the unusual task of determining whether the defendant had lied to a machine.

who is a total stranger and owes no specific duty to any party involved could be liable simply if he or she made what could be interpreted as a misrepresentation.

Of course, in the parallel universe of tender offers, the absence of a duty requirement for insider trading liability has long been clear. In 1968, the Williams Act tender offer reforms added Section 14(e) to the Exchange Act to authorize the SEC to issue rules "reasonably designed to prevent . . . fraudulent, deceptive, or manipulative" acts in the tender offer context.[33] Using this authority, the SEC adopted Rule 14e-3 in 1979, prohibiting trading in a tender offer target's stock while "in possession of material information relating to such tender offer," which the trader "knows or has reason to know has been acquired directly or indirectly from" the tender offeror, the target, or the representatives of either.[34] The Supreme Court has confirmed that the rule "does not require specific proof of a breach of fiduciary duty."[35]

B. Materiality Element

Insider trading liability arises from trading on nonpublic information that is "material."[36] It has long been recognized that information is only material if there is a "*substantial likelihood* that the disclosure of the omitted fact would have been viewed by the *reasonable investor* as having *significantly altered* the '*total mix*' of information made available."[37] Recent insider trading cases, however, suggest

Ultimately the court granted the SEC's unopposed summary judgment motion. SEC v. Dorozhko, Litigation Release No. 21,465, 98 SEC Docket 448 (Mar. 29, 2010).

33 15 U.S.C. § 78n(e) (2011).

34 17 C.F.R. § 240.14e-3(a) (2013). The only other element is that a "substantial step" has been taken toward commencing the tender offer by the time of trading. *Id.*

35 United States v. O'Hagan, 521 U.S. 642, 676 (1997). *See also* SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995); United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991).

36 *See, e.g.*, *O'Hagan*, 521 U.S. at 651–52.

37 Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (emphasis added).

that the Supreme Court's "substantial" and "significantly" qualifiers cannot always be counted on in analyzing potential liability.[38]

1. Materiality of General Performance Trends

It now may very well be the case that information need not be specific to be considered material. For example, general information that an employee's company is performing well may be viewed by the SEC as material information. Recently, the SEC charged a retailer's store operations chief with trading on information that "multiple reports" over the course of two quarters showed performance trending upward.[39] The question this case poses is whether any company employee who has a general sense of how the company is doing—simply from the performance of his or her job—may now be charged with having material nonpublic information that could result in insider trading liability.

2. Materiality of Speculation

Material information may also not need to come from those with actual hard information about a transaction. It may instead be derived from mere speculation about one-off activities around an issuer's premises. Recently, the SEC filed insider trading charges against employees of a small regional freight rail line where the allegedly material information included employees' observations that "people dressed in business attire" visited the line's railyard, that one employee was asked to prepare an inventory of the line's locomotives and freight cars, and that railyard employees

[38] *E.g.*, SEC v. Steffes, 805 F. Supp. 2d 601, 612 (N.D. Ill. 2011); SEC v. Rorech, 720 F. Supp. 2d 367 (S.D.N.Y. 2010).

[39] Complaint at 3, SEC v. LoBue, No. 12 CIV 7944 (S.D.N.Y. Oct. 25, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp22519.pdf. *See also* SEC v. LoBue, Litigation Release No. 22,519, 2012 WL 5267548 (Oct. 25, 2012).

began to express concern that the company might be sold and jobs lost.[40]

In another case, the SEC charged a high-yield bond salesperson at an investment bank with passing information to a hedge fund portfolio manager, who bought credit default swaps ("CDSs") referencing the bonds.[41] This was the first case charging insider trading in credit default swaps. The information in question related principally to a possible restructuring of a planned bond offering, and a possible recommendation by the salesperson's bank concerning the restructuring. The SEC charged that this information was material to "the market price of the separately-traded CDSs that referenced" the bonds.[42] The SEC said that the CDS prices "substantially increased" after announcement of the restructuring, reflecting the cost of protection that the CDSs would be providing for the bonds.[43] The court later dismissed the case after trial for, among other reasons, failure to show materiality, as "there was widespread discussion in the market regarding investor demand for a restructuring," and any information the bond salesperson had about his bank's intention to make a recommendation about the restructuring was "completely speculative."[44]

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40 Complaint at 7–8, 37, SEC v. Steffes, 805 F .Supp. 2d 601 (N.D. Ill. 2011) (No. 10-CV-6266); Press Release, SEC, SEC Charges Family Insider Trading Ring in Million-Dollar Scheme (Sept. 30, 2010), *available at* http://www.sec.gov/news/press/2010/2010-178.htm. The court denied defendants' motion to dismiss, concluding "that although the SEC's allegations are not robust, and that development of the facts through discovery may cast doubt on whether the information available . . . truly was 'material,' . . . the allegations are sufficient to survive a motion to dismiss." *Steffes*, 805 F. Supp. 2d at 612.

41 Complaint, SEC v. Rorech, 720 F. Supp. 2d 367 (S.D.N.Y. 2010) (No. 09 CIV 4329).

42 *Id.* at 1.

43 *Id.* at 5.

44 *Rorech*, 720 F. Supp. 2d at 372.

3. Liability Without Materiality

Open-end mutual funds must, under SEC Investment Company Act Rule 22c-1, sell and redeem their mutual fund shares at "net asset value," which is simply the combined value of all of the portfolio securities the fund owns divided by the total number of shares the fund has outstanding.[45] Information about the fund itself—no matter how seemingly important—is not used to price the fund's shares. Yet, the SEC has charged in recent cases that information about the fund is still "material," and that trading while in possession of material information about the fund itself constitutes insider trading, even though the information is not used in setting the fund's share price.[46]

The extent to which this theory will be accepted is still unclear. In one such case, an SEC administrative proceeding, the defendant appeared without an attorney and the opinion contains no indication that either side alerted the judge to the novelty of the position being asserted.[47] In another such matter, the SEC and the defendant reached a no-admission settlement, but there is no indication in the SEC's release that it advised the court of the unprecedented nature of the charge.[48] What appears to be the only litigated case on this theory went in the SEC's favor on summary judgment, but it is presently on appeal to the Seventh Circuit.[49]

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45 17 C.F.R. § 270.22c-1 (2013).

46 *See, e.g.*, SEC v. Bauer, No. 03-C-1427, 2011 WL 2115924 (E.D. Wisc. May 25, 2011); David W. Baldt, Release No. 418, 100 SEC Docket 3346 (ALJ Apr. 21, 2011) (initial decision); SEC v. Marquardt, Litigation Release No. 21,383, 97 SEC Docket 2272 (Jan. 20, 2010).

47 *Baldt*, 100 SEC Docket 3346.

48 *Marquard*, 97 SEC Docket 2272.

49 *Bauer*, 2011 WL 2115924 (granting summary judgment for SEC); SEC v. Bauer, No. 03-C-1427, 2012 WL 2217045 (June 15, 2012) (denying injunction or penalty, but awarding disgorgement), *appeal docketed*, No. 12-2860 (7th Cir. argued Feb. 12, 2013). The author argued for defendant as appellate counsel.

C. Scienter Element

Scienter is the "mental state embracing intent to deceive, manipulate, or defraud."[50] The Supreme Court has not yet decided whether recklessness satisfies the scienter requirement under Exchange Act Section 10(b) and Rule 10b-5.[51] However, courts of appeals have adopted a recklessness standard.[52] In articulating the recklessness standard, the courts have typically described it as "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care."[53]

1. Dissipated Scienter

The SEC continues to pursue tipping chains, where a person with material nonpublic information tips others, who then tip others.[54] Such chain cases can yield three or four tiers of tippees who have no contact with, and little or no knowledge of, the original source of the information. At the ultimate levels of the tipping chain, the information can simply sound like a strong recommendation to buy the stock, and the actual source of the information can be a complete mystery. The question then is whether such a person at the end of the chain who trades can be said to have acted with scienter.

In *Obus*, as noted above, an underwriter was charged with misappropriating his employer's information and tipping a hedge fund analyst, who then tipped his boss. The Second Circuit said there that the final downstream tippee,

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50 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

51 Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1323 (2011); SEC v. Obus, 693 F.3d 276, 286 (2d Cir. 2012).

52 *E.g.*, *Obus*, 693 F.3d at 286.

53 *Id.* (quoting SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998)).

54 *E.g.*, Complaint, SEC v. Femenia, No. 3:12cv800 GCM (W.D.N.C. Dec. 5, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-255.pdf; Press Release, SEC, SEC Charges 10 in Insider Trading Ring Around Investment Banker's Illegal Tips on Impending Mergers (Dec. 5, 2012), *available at* http://www.sec.gov/news/press/2012/2012-255.htm.

the analyst's boss, "must both know or have reason to know that the information was obtained through a breach," and then trade "while in knowing possession of the information."[55] In this regard, the court noted that "conscious avoidance" may also establish scienter in tipping chain cases.[56]

2. Mixing Negligence and Scienter

The *Obus* court also took on the task of reconciling two Supreme Court pronouncements on the state of mind requirement for insider trading liability, and in so doing came up with a standard that mixes negligence and recklessness concepts. The court noted that *Dirks* held that tippees have a disclose-or-abstain duty only where the tippee "knows or should know" that there has been a breach of duty, but that *Hochfelder* held the "knows or should know" rule is essentially a negligence standard that would not satisfy Exchange Act Section 10(b). The court resolved this seeming contradiction by explaining that *Dirks* applied to the tippee's knowledge of the breach, while *Hochfelder* applied to the tippee's "eventual use of the tip through trading or further dissemination." The tippee is thus liable if he or she "knew or had reason to know that confidential information was initially obtained and transmitted improperly . . . and if the tippee intentionally or recklessly traded" in "knowing" possession of the information.[57]

D. "Benefit" Element

For tipper liability, the Supreme Court in *Dirks* established a "benefit" requirement. In assessing liability, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure."[58] Absent a

[55] *Obus*, 693 F.3d at 288.

[56] *Id.* at 289 (citing SEC v. Musella, 678 F.Supp. 1060, 1063 (S.D.N.Y. 1988)) (holding that scienter is found where downstream tippees "did not ask [about the source of information] because they did not want to know").

[57] *Id.* at 288.

[58] Dirks v. SEC, 463 U.S. 646, 662 (1983).

personal gain, "there has been no breach of duty to stockholders."[59] To determine the existence of a benefit, courts must focus on whether the insider receives "a pecuniary gain or a reputational benefit that will translate into future earnings," whether there is "a relationship between the insider and the recipient that suggests a quid pro quo from the latter," or "a gift of confidential information to a trading relative or friend."[60] As the Supreme Court noted more recently, the insiders in *Dirks* did not violate any duty by disclosing confidential information to an analyst because they "had acted not for personal profit, but to expose a massive fraud within the corporation."[61]

Since becoming subject to the benefit requirement in *Dirks*, the SEC has tried to minimize its burden, and this process has now reached the point where some might argue that the requirement no longer exists in practice. In *Obus*, the Second Circuit found the benefit requirement could be satisfied based on evidence that the underwriter with the information and the hedge fund analyst with whom he spoke were "friends from college."[62] The simple fact that they were college friends would be enough to support the conclusion that one was "making a gift" to the other.[63] *Obus* is thus among the cases that appear to be eliminating the benefit requirement for tipper insider trading liability. People who talk about a stock will almost always be acquaintances, and this is easily perceived as being friends. It will be rare that a case involves complete strangers discussing a stock.

The suggestion in recent cases like *Obus* that virtually any "friendship" will automatically satisfy the benefit requirement would seem to run counter to the line of cases since *Dirks*, which have typically found there to be a benefit only in situations where the people involved had a much

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

60 *Id.* at 663–64.

61 United States v. O'Hagan, 521 U.S. 642, 663 (1997).

62 *Obus*, 693 F.3d at 291.

63 *Id.*

closer relationship than simply being "friends."[64] Often these situations have involved people with a history of monetary payments or business favors.[65] If the *Obus* approach is the trend, little, if anything, will remain of the benefit requirement, which *Dirks* called "the test" for tipper liability.

III. EXPANDED PROSECUTORIAL REACH

Insider trading has taken center stage as a prosecutorial focus in recent years. This trend is only likely to continue as securities enforcers acquire more and better tools to surveil for fraudulent trading activity. The current tough enforcement environment for insider trading cases magnifies the impact of uncertainty created by the recent expansion of the elements of the offense.

64 *E.g.*, SEC v. Warde, 151 F.3d 42, 48–49 (2d Cir. 1998) (where tipper and tippee had a "close friendship"); SEC v. Sekhri, No. 98 Civ. 2320(RPP), 2002 WL 31654969, at *2 (S.D.N.Y. Nov. 22, 2002) (where tippee was father-in-law of tipper).

65 *E.g.*, SEC v. Yun, 327 F.3d 1263, 1280 (11th Cir. 2003) (where tipper and tippee "worked together . . . and split commissions on various real estate transactions over the years"); SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) (where tipper had referred over 75 dental patients to tippee, the tippee "often" helped tipper provide service to local chamber of commerce, and tipper's relatives had had financial disagreements with tippee); SEC v. Maio, 51 F.3d 623, 627–28, 633 (7th Cir. 1995) (where tipper had loaned tippee substantial sums, and they had taken trips to Las Vegas together); SEC v. Blackwell, 291 F. Supp. 2d 673, 692–93 (S.D. Ohio 2003) (where tippee was employee and "close confidant" of the tipper, who had loaned tippee money); *In re* Motel 6 Sec. Litig., 161 F. Supp. 2d 227, 230 n.1, 241 (S.D.N.Y. 2001) (where tippee with terminal illness had received financial support from tipper). *Cf.* SEC v. Maxwell, 341 F. Supp. 2d 941 (S.D. Ohio 2004) (where benefit requirement was not satisfied when executive tipped his barber that company was acquisition target, and barber bought stock and options yielding $192,000 profit; executive did not stand to gain though profit splitting or other pecuniary benefit, and there was no reason for executive to make substantial gift to barber).

A. New Era of Aggressive Prosecution

From the SEC's founding in 1934 to Chairman Cary's groundbreaking 1961 decision in *Cady, Roberts*—a span of twenty-seven years—the SEC brought no insider trading cases at all. Over the subsequent twenty years, insider trading continued to be a relatively low prosecution priority in terms of the number of cases at the agency, although several notable appellate decisions during that era confirmed the elements of the offense in Cary's mold.[66] Things changed dramatically in the 1980s as Congress responded to a perceived upsurge in insider trading, particularly in connection with corporate takeovers, by allowing the SEC to sue for monetary penalties as well as disgorgement of profits through the Insider Trading Sanctions Act of 1984.[67] This was the era in which SEC Chairman Richard Breeden famously proclaimed that insider traders should be left "naked, homeless and without wheels."[68]

Insider trading has continued to be a mainstay of the SEC's enforcement program over the intervening years, and SEC annual reports chronicle a strong and growing effort in bringing these cases since the 1980s. Particularly noteworthy over this period has been the SEC's success at nabbing foreign insider traders, both known and anonymous "unknown purchasers" trading through foreign accounts.[69]

In the last several years, however, insider trading has grown to become an intensive enforcement zone for both the SEC and DOJ. Over the SEC's last three fiscal years, it brought 168 insider trading cases, more than any one time in

66 *E.g.*, Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

67 Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u-1).

68 Richard Walker, Director, SEC Div. of Enforcement, Remarks at the National Press Club: A Bull Market in Securities Fraud? (Apr. 5, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch265.txt (quoting former Chairman Breeden).

69 *E.g.*, SEC v. Wang, 944 F.2d 80 (2d Cir. 1991).

its history, against almost 400 defendants. These cases involved profits (or losses avoided) totaling $600 million.[70] In its Galleon-related cases alone, the SEC has proceeded against 32 defendants for trading in over 15 issuers and profits of $93 million.[71] For its part, the DOJ has pursued headline-grabbing criminal cases against both sophisticated market participants and ordinary traders, and in so doing has compiled a string of notable trial victories.[72]

B. New Investigative Tools

Insider trading enforcement has been helped immeasurably over the last decade by the fact that we all now live in an electronic world—a reality that the SEC actively exploits in its investigations. The majority of business interactions occur through email and other social media that are recorded verbatim and accessible to government investigators for years. Phone and cell phone calling records are preserved in downloadable and searchable formats. We draft and edit written materials using computers, and particularly where offices use document management software, each addition and edit to

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70 *SEC Enforcement Actions: Insider Trading Cases*, SEC, http://www.sec.gov/spotlight/insidertrading/cases.shtml (last updated June 6, 2013).

71 Press Release, SEC, SEC Charges Silicon Valley Executive for Role in Galleon Insider Trading Scheme (Oct. 26, 2012), *available at* http://www.sec.gov/news/press/2012/2012-216.htm.

72 *E.g.*, Press Release, Dep't of Justice, Hedge Fund Billionaire Raj Rajaratnam Found Guilty in Manhattan Federal Court of Insider Trading Charges (May 11, 2011), *available at* http://www.justice.gov/usao/nys/pressreleases/May11/rajaratnamrajverdictpr.pdf; Press Release, Dep't of Justice, Former Chairman of Consulting Firm and Board Director, Rajat Gupta, Sentenced in Manhattan Federal Court to Two Years in Prison for Insider Trading (Oct. 24, 2012), *available at* http://www.justice.gov/usao/nys/pressreleases/October12/GuptaSentencing.php; Press Release, Dep't of Justice, Two Former Portfolio Managers Found Guilty in Manhattan Federal Court of Insider Trading Schemes that Netted More than $72 Million in Illegal Profits (Dec. 17, 2012), *available at* http://www.justice.gov/usao/nys/pressreleases/December12/NewmanChiassonVerdict.php.

each document, and the content, time, and author of the modification, are carefully recorded and preserved for years. If we delete computer records, forensic technicians can reconstruct the records and our attempts at deletion. We can be located in real time by GPS on devices we carry, and our past movements can be reconstructed using credit and debit card transaction records, building swipe-card records, transit card usage records, and street and building surveillance cameras.

With these materials easily accessible and actively used by SEC investigators—who wield statutory subpoena power before any litigation is commenced[73]—the SEC's ability to uncover direct and circumstantial evidence to support an insider trading charge is considerable. But beyond these familiar modern law enforcement tools, the SEC has, as discussed below, incorporated a number of recent enforcement program enhancements that suggest that even more rigorous insider trading enforcement lies ahead.

1. Whistleblower Program

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required the SEC to create a whistleblower program that would pay 10% to 30% bounties on information leading to cases with a recovery exceeding $1 million.[74] The SEC adopted implementing rules in May 2011 and formally launched the program in August 2011.[75] Over the SEC's first full fiscal year operating the program—the fiscal year ending September 30, 2012—the SEC received 190 whistleblower tips concerning possible insider trading. These insider trading tips represented 6.3% of the 3,001 tips

73 *See* Exchange Act § 21(a), 15 U.S.C. § 78u(a) (2011).

74 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 922(a), 124 Stat. 1376, 1841 (2010) (codified at 15 U.S.C. § 78u-6(b)).

75 Press Release, SEC, SEC's New Whistleblower Program Takes Effect Today (Aug. 12, 2011), *available at* http://www.sec.gov/news/press/2011/2011-167.htm.

the SEC received in all of its program areas.[76] As noted above, the SEC, in record times, brought between fifty and sixty insider trading cases each year, and that up to 190 new insider trading investigations result from tips in a single year can reasonably be expected to substantially increase the SEC's already significant number of insider trading cases.

2. Cooperation Credit

In early 2010, the SEC's Division of Enforcement adopted a new initiative to encourage companies and individuals to come forward with information to assist in SEC investigations. For meaningful cooperation, the division recommends lesser sanctions, and in some cases, would entirely forego remedies against the cooperator. These rewards for informers are accomplished through new tools such as: cooperation agreements, where the Division recommends to the Commission that a cooperator get an agreed lesser sanction; non-prosecution agreements, where the Commission agrees not to pursue action; deferred prosecution agreements, where the Commission agrees to forego action if the cooperator adheres to particular agreed undertakings over a defined time period; and streamlined procedures for the SEC to request that the DOJ grant criminal immunity for a cooperator.[77]

While the SEC has not yet published meaningful data on the impact of its cooperation initiative, it can be expected that this program enhancement will contribute materially to insider trading enforcement, for example, by allowing persons more peripherally involved in an insider trading situation to save themselves (or at least reduce the sanction they must take) by delivering their cohorts. Thus, in a recent settled case, an alleged tippee-of-a-tippee of inside

[76] SEC, ANNUAL REPORT ON THE DODD-FRANK WHISTLEBLOWER PROGRAM 11 (2012), *available at* http://www.sec.gov/about/offices/owb/annual-report-2012.pdf.

[77] Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010), *available at* http://www.sec.gov/news/press/2010/2010-6.htm.

information provided "significant cooperation" that "resulted in direct evidence being quickly developed" against others involved in the matter, and in return the cooperator's penalty was reduced by approximately seventy-five percent.[78]

3. Surveillance by Options Exchanges

In recent years, SEC releases announcing new insider trading cases often credit information provided by the Options Regulatory Surveillance Authority ("ORSA"). The ORSA was created in 2006 by the six U.S. options exchanges "to serve as a central organization to facilitate collaboration in insider trading surveillance and investigations."[79]

4. Audit Trail System

On July 11, 2012, the SEC adopted a rule requiring the exchanges and FINRA to establish a "market-wide consolidated audit trail" to let regulators monitor and analyze trading activity. When implemented, this will put at the SEC's disposal a single database of comprehensive and readily accessible data regarding orders and executions. The new system is intended particularly to assist in the SEC's insider trading investigations by letting the SEC "reconstruct broad-based market events in an accurate and timely manner."[80]

78 Press Release, SEC, SEC Charges Three in North Carolina with Insider Trading (Sept. 20, 2012), *available at* http://www.sec.gov/news/press/2012/2012-193.htm.

79 Press Release, Chicago Board Options Exchange, CBOE Chosen to Be Regulatory Services Provider for New Options Regulatory Surveillance Authority (Apr. 6, 2006), *available at* http://www.cboe.com/AboutCBOE/ShowDocument.aspx?DIR=ACNews&FILE=20060406.doc.

80 Press Release, SEC, SEC Approves New Rule Requiring Consolidated Audit Trail to Monitor and Analyze Trading Activity (July 11, 2012), *available at* http://www.sec.gov/news/press/2012/2012-134.htm.

5. Leveraging of Criminal Investigative Techniques

Finally, with increased DOJ resources being poured into criminal prosecution of insider trading, the SEC will be able to use some of the fruits of the criminal investigations, aside from protected grand jury information, as the basis for the SEC's often broader civil insider trading cases. It will also be able to work with the DOJ and Federal Bureau of Investigation ("FBI") in sting operations and other approaches previously not part of the SEC's playbook.[81]

IV. PARITY OF INFORMATION REVISITED

A. The Liability Risk for Retail Investors

A curiosity of insider trading is that it is the only major SEC enforcement program area that prosecutes ordinary retail investors, thus adding Main Street to the SEC's list of potential targets for just this one offense.[82] The SEC's other major enforcement efforts generally focus on entities and on individuals who are sophisticated and well counseled—mostly corporate officials, securities industry professionals, accountants, and lawyers.

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81 *E.g.*, Press Release, SEC, SEC Charges Disney Employee and Boyfriend in Brazen Insider Trading Scheme (May 26, 2010), *available at* http://www.sec.gov/news/press/2010/2010-84.htm. In this case, the SEC developed information that a corporate insider and her friend were allegedly offering to sell nonpublic earnings information concerning a major issuer, and the SEC then worked with the U.S. Attorney and the FBI on the investigation, which included an FBI sting that involved agents posing as prospective buyers of the information.

82 *E.g.*, Press Release, SEC, SEC Charges Chicago-Based Management Consultant with Insider Trading (Mar. 15, 2012), *available at* http://www.sec.gov/news/press/2012/2012-44.htm. In this settled case, the SEC alleged that on receiving confidential information about a planned takeover by a client, a consultant used a relative's account to buy the target company's stock and tipped another relative to likewise buy the stock, whereupon both earned relatively small profits. The DOJ brought a parallel criminal case against the consultant.

Few would have any sympathy for sophisticated traders who breach a duty of trust in knowingly exploiting material nonpublic information to get an unfair advantage over other market participants. But what about those who lack such sophistication? Plainly, the media has done much to educate the public that insider trading is illegal and that it can result in serious consequences, and without doubt retail investors are able to engage in fraudulent behavior. But as insider trading liability theories become more exotic, as discussed above, there may be some question as to the ability of ordinary retail investors to engage in the increasingly sophisticated duty, materiality, and scienter analyses needed to determine whether a particular contemplated trade would violate the law.

Consider the following: An assembly line worker sees production stepping up or overtime increasing. A branch store assistant manager sees signs that sales are strong. A lobby security guard notices a series of full-day meetings with well-dressed out-of-towners. An individual accidentally overhears an acquaintance—but not a close friend—mention something work related in a cell phone conversation. Can these people trade? Will they be liable if they casually mention what they have observed to another person who independently decides to trade? Suppose they first check with their boss, or other person appearing to have authority and knowledge of legal requirements, who says there is no restriction on trading?

Maybe they suspect that the information may have leaked simply from the fact that the information seems material and nonpublic. But what if they have no indication as to the source of the information or the existence of any breach of duty? Maybe their decision to trade is based on extremely vague information accompanied by a feeling that the stock has been flat, so there is little risk of a downside beyond transaction costs.

B. Self-Imposed Parity as a Possible Reaction

Given both the uncertainties as to liability as insider trading case law has evolved, and the current intense prosecution climate, a rational retail investor without access to experienced securities enforcement counsel faces a dilemma. An incorrect guess on what an appellate court may determine on a duty or materiality question years after the fact may land the investor in jail or subject to crushing civil fines and career ruin.

The only way to manage such risk would seem to be for the retail investor in possession of nonpublic information to simply refrain from trading on the information. This effectively forces the retail investor into what has been called a "parity-of-information" regime—a regime that prohibits trading on significant information unless it is broadly shared across the markets. The retail investor is then subject to a de facto restriction on trading on any particular development or piece of information, no matter how speculative or general in nature.

As insider trading law has largely evolved through judicial opinions, there have always been questions as to the ultimate contours of liability.[83] What is different now, however, is an intensified enforcement environment in which ever more creative insider trading theories are being pressed, and in which the ability to detect violations has been substantially enhanced. In such an environment, an unsophisticated investor may well feel that any trading at all based on nonpublic information is too great a risk to contemplate. In short, the retail investor may find that parity of information must now be the order of the day.

83 For example, until the Supreme Court resolved the question in 1997, uncertainty existed over the fundamental question of whether a person could be liable for trading in breach of duty to the source of the information—the misappropriation theory. United States v. O'Hagan, 521 U.S. 642, 649 (1997) (Noting that "[d]ecisions of the Courts of Appeals are in conflict on the propriety of the misappropriation theory under § 10(b) and Rule 10b-5"). In the Eighth Circuit, such trading had been held permissible. United States v. O'Hagan, 92 F.3d 612, 622 (8th Cir. 1996). However, in other circuits it could lead to heavy fines and imprisonment. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991); SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990).

Information cannot be used for trading unless it is widely available for all to trade on.

While a parity regime may be the necessary reality for many investors today, and particularly for unsophisticated retail investors, it is certainly not what the Supreme Court intended. In *Chiarella v. United States*,[84] the Court squarely rejected the notion that securities markets should be informationally level playing fields. The Court reversed the conviction of a financial printer charged with stealing information about upcoming acquisitions from his employer and trading on the information. The Court noted that "there can be no fraud absent a duty to speak,"[85] and it found the trial court's jury instructions inadequate because they "failed to specify any such duty" and effectively instructed the jury that the printer owed a duty "to the market as a whole." The Court reversed because the jury "simply was told to decide whether petitioner used material, nonpublic information at a time when 'he knew other people trading in the securities market did not have access to the same information.'"[86]

In so ruling, the Court expressly stated that "neither the Congress nor the Commission ever has adopted a parity-of-information rule." Instead, Congress and the SEC had opted for "detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets."[87] The Supreme Court and lower courts have continued to this day to stress that parity of information is not the standard for insider trading liability.[88]

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

85 *Id.* at 235.

86 *Id.* at 231.

87 *Id.* at 233. Chief Justice Burger's dissent argued for a rule that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240. But the majority found that such a "misappropriation" theory was not included in the jury instructions and thus could not support a conviction. *Id.* at 237 n.21.

88 *O'Hagan*, 521 U.S. at 661, 663. *See also* SEC v. Cuban, 634 F. Supp. 2d 713, 723 (N.D. Tex. 2009) ("*Chiarella* unequivocally rejects a 'parity-of-information' principle, under which a disclosure duty would arise

Interestingly, the government's brief in *Chiarella*, filed jointly by the DOJ and the SEC, rejected any sort of parity-of-information approach and conceded that trading while in "mere possession" of confidential information did not violate Exchange Act Section 10(b) and Rule 10b-5. Instead, the government urged the Court to adopt the misappropriation theory ultimately endorsed in *O'Hagan*, and argued that "theft or misappropriation of confidential information" for securities trading was required to prove a violation.[89]

C. Alternative Approach: Eliminate the Uncertainty

In the present environment of uncertainty as to whether trading is permitted in many circumstances, some might ask whether the Supreme Court got things wrong in *Chiarella* and its progeny. In contrast, the European Union has taken the opposite position and fully embraced a parity-of-information approach to insider trading liability. The EU approach avoids the uncertainties of the U.S. analytical scheme by simply forbidding trading by any person possessing material nonpublic information.[90] Interestingly, the EU couples this across-the-board prohibition with a requirement that issuers continuously disclose inside information as it becomes available. In short, issuers must disclose inside information on a current basis (with certain exceptions), and when traders come across inside information, they know it is illegal to use it to trade.[91] As discussed below, bright lines thus replace complicated duty and materiality analysis.

based on the mere possession of material, nonpublic information."), *vacated and remanded on other grounds*, 620 F.3d 551 (5th Cir. 2010).

89 Brief for the United States at 70 n.48, Chiarella v. United States, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 213521.

90 Directive 2003/6 of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), art. 1, 2003 O.J. (L 96) 16, 20 [hereinafter EU Directive 2003/6], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:096:0016:0016:en:PDF.

91 *Id.* art. 6.

EU Directive 2003/6 on Insider Dealing and Market Manipulation, referred to as the "Market Abuse Directive," provides for insider trading liability for "any" person "who possesses inside information while that person knows, or ought to have known, that it is inside information."[92] The directive defines inside information as "information of a precise nature which has not been made public, relating, directly or indirectly" to an issuer that if made public "would be likely to have a significant effect on the prices of" the issuer's securities or related derivatives.[93]

In the same directive, the EU put the burden on issuers to publicly disclose inside information in real time. Issuers must "inform the public as soon as possible of inside information which directly concerns" the issuers. Among other things, issuers must "post on their Internet sites all inside information that they are required to disclose publicly."[94] Issuers may delay disclosing inside information in order "not to prejudice" their "legitimate interests," provided the delay will not "mislead the public," and further provided "that the issuer is able to ensure the confidentiality of" the inside information during the delay period.[95] In such circumstances, EU members may additionally require issuers to "without delay" inform their regulators "of the

92 EU Directive 2003/6, *supra* note 90, art. 4. Before adoption of the Market Abuse Directive, insider trading enforcement abroad had lagged far behind U.S. enforcement. The directive required EU member states to enact legislation prohibiting insider trading and other fraudulent and manipulative conduct. While leaving some discretion to member states, the EU Directive specified the key elements of each of the offenses proscribed, and in general mirrored benchmarks established in 1998 by the International Organization of Securities Commissions ("IOSCO") in its *Objectives and Principles of Securities Regulation*. *See* INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf. IOSCO includes securities regulators in 108 jurisdictions that regulate over ninety percent of the world's securities markets, and its positions thus reflect sentiment well beyond Europe.

93 EU Directive 2003/6, *supra* note 90, art. 6.

94 *Id.*

95 *Id.*

decision to delay the public disclosure of inside information."[96]

The EU itself is in the process of developing its own body of insider trading law through case interpretations.[97] In the decade since the promulgation of the EU's Market Abuse Directive, foreign regulators have shown themselves increasingly willing not only to prosecute insider trading but also to bring cases that present a risk of loss.[98] But throughout the EU's development of insider trading enforcement, the European model has opted for clarity: a proscription on trading while in possession of "information of a precise nature which has not been made public" concerning the issuer.

96 EU Directive 2003/6, *supra* note 90, art. 6. The EU is presently considering proposals to toughen its insider trading prohibitions. *See Summary of Legislative Proposal for a Regulation of the European Parliament and of the Council Amending Directive 2003/6/EC on Insider Dealing and Market Manipulation (Market Abuse)*, 2011/0295 (COD) (Oct. 20, 2011), *available at* http://www.europarl.europa.eu/oeil/popups/printsummary.pdf?id=1171992&l=en&t=E.

97 *E.g.*, Case C-45/08, Spector Photo Group NV v. CBFA, 2009 E.C.R. I-12073 (ruling that trading while in "possession" of inside information creates a rebuttable presumption that the trader "used" the information, within the meaning of EU Directive 2003/6).

98 Thus, on November 15, 2012, the UK Financial Services Authority ("FSA") suffered a loss in what was perhaps the biggest criminal insider trading case ever taken to trial. The jury acquitted two defendants said to be girlfriends of an investment banker advising on a takeover. The FSA argued that the banker tipped the women and that they then kicked back half of their profits. The jury accepted one defendant's position that the banker told her the target was undervalued, which her own research confirmed. The jury accepted the other defendant's position that she followed the banker's recommendation simply to show her trust in him and build a relationship. Lindsay Fortado, *Ex-Mizuho Banker's Girlfriends Not Guilty of Inside Trade*, BLOOMBERG (Nov. 15, 2012, 10:03 AM), http://www.bloomberg.com/news/2012-11-15/ex-mizuho-banker-s-girlfriends-not-guilty-of-inside-trade.html.

V. ENHANCING INSIDER TRADING ENFORCEMENT

With the SEC's insider trading prosecution pushing to new frontiers on issues of duty, materiality, and scienter—alongside its increasingly intense focus on insider trading as an area for prosecution—questions arise over how best to assure a fair and effective enforcement effort. In particular, as discussed below, greater focus on defining the boundaries of liability, careful case selection, and consideration of new and different approaches to resolving insider trading cases can do much to enhance the effectiveness of the SEC's efforts in this important area.

A. Drawing Clearer Lines for Liability

In the half century since Cary's landmark opinion, appellate courts have developed and refined insider trading doctrine under the SEC's flexible Rule 10b-5, which simply prohibits fraud—using very broad language drafted in a single afternoon in 1942.[99] Along the way, the courts have spelled out some of the metes and bounds of insider trading liability in order to fairly deal with the cases that have come before them, but in doing so have left many questions unanswered.

It is unrealistic to suppose that Congress or the courts will soon switch to the EU's clear and direct parity-of-information approach. The United States has consciously chosen an asymmetry-of-information model that gives individuals the freedom to trade on material nonpublic

99 The iconic Milton V. Freeman, present at the creation in May 1942, has said that the rule's conceptualization, drafting, and adoption took just a few hours. *See* Milton V. Freeman, Colloquium Forward, 61 FORDHAM L. REV. S1–S2 (1993) ("I got some people in, we drafted a rule, we presented it to the Commission, and without any hesitation, the Commission tossed the paper on the table saying they were in favor of it. One Commission member said, 'Well, we're against fraud, aren't we?' So, before the sun was down, we had the rule that is now Rule 10b-5."). Freeman, the author of Rule 10b-5, was then the SEC's Assistant Solicitor and had graduated from Columbia Law School only eight years earlier.

information, as long as there is no breach of duty or deception involved. In the asymmetrical information world we trade in, to the extent we are able to draw clearer lines for insider trading liability, law enforcement can be enhanced and traders can make more aggressive bets. Plain fraudsters are easy to condemn, and all can applaud the SEC's vigorous efforts to punish them. But less sophisticated traders—and even lawyers and compliance advisers assisting sophisticated traders—can legitimately have difficulty anticipating whether certain potentially lucrative trading opportunities will cross the line.

Any effort to provide greater clarity necessitates balancing flexibility and predictability. Insider trading proscriptions, like all antifraud measures, must retain flexibility to deal with each new scam. But all will benefit from clearer guidance on the core duty, materiality, and scienter elements in situations where liability is presently not clear and not predictable, as reflected in some of the more recent cases discussed above. Such guidance can come from one or more directions: Congress,[100] SEC rulemaking,[101] and SEC staff interpretations.[102] A model for such staff guidance is the recently published SEC and DOJ guide

[100] *E.g.*, Exchange Act § 21A, 15 U.S.C. § 78u-1 (2011). Indeed in 1987 Congress considered legislation that would have set forth a precise definition of insider trading. *See Definition of Insider Trading (Part II): Hearing on S. 1380 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 100th Cong. (1987). The cover page of the hearing transcript ambitiously proclaimed that the hearing was on

> Proposed legislation to clarify the law on insider trading which will provide every professional and firm engaging in the securities business, as well as everyone else, with a single statute to determine what the law is and what their liability is in the area. Prosecution will be easier and punishment will be tougher when the law is clear.

As reflected in the transcript, the bill was the collaborative work of the SEC and several prominent private securities practitioners.

[101] *E.g.*, Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2013).

[102] In addition to informal guidance through staff speeches and publications, the Commission itself can issue reports under Exchange Act § 21(a), 15 U.S.C. § 78u(a) (2011).

interpreting the requirements of the Foreign Corrupt Practices Act, which lays out with considerable detail and explanation the liability elements of the offense, the principles the government applies in deciding whether to open an investigation and bring charges, and the range of different possible resolutions for a particular matter depending on the facts and circumstances.[103] An SEC Division of Enforcement publication of this depth and quality—covering insider trading—would surely be welcomed by traders, their counsel and compliance professionals attempting to understand and comply with the law in this area.

B. Importance of Case Selection

Insider trading cases are virtually the only cases that the SEC frequently litigates based simply on circumstantial evidence. If an individual makes a profitable trade before a market-moving announcement, the SEC will, with increasing likelihood, appear on the scene to inquire whether the trader had inside information. Any social or business contact between the trader and a corporate insider with access to material information may then be enough for the SEC to decide to open an investigation and possibly file an insider trading action.

In many cases, the SEC's instincts are correct. But there are often perfectly legitimate reasons for why a trader will invest in a company where he or she happens knows an insider. These can include general interest in the company, confidence in the people leading it, or non-material or public information about its prospects.

Such circumstantial civil cases lack the persuasive wiretap evidence and plea-bargained confessions that the DOJ relies on for many of its criminal prosecutions of insider traders. A comparison of the DOJ's direct evidence approach with the often highly circumstantial character of the SEC's

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103 *See generally* SEC & DEP'T OF JUSTICE, FCPA: A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (2012), *available at* http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf.

evidence explains for the exceptionally high success rate in the DOJ's criminal insider trading prosecutions, and the mixed record of success in the SEC's civil insider trading cases.[104] The SEC thus brings far more insider trading cases on much thinner evidence than DOJ prosecutors would find reasonable. In part, the SEC justifies the breadth of its insider trading program by pointing to the lower preponderance-of-the-evidence standard applicable in civil cases, compared with the criminal case standard of proof, which is beyond a reasonable doubt.

Given the kind of circumstantial insider trading cases the SEC brings, case selection is critical. Helping the SEC choose wisely from among the cases it could potentially bring is the agency's time-tested "Wells" process. The Wells process gives counsel for prospective defendants notice of the SEC staff's plans to recommend charges, and allows counsel to make a written submission—resembling a summary judgment brief—that marshals the evidence and legal arguments to urge against such charges.[105]

But for the Wells process to be meaningful, there needs to be access to the SEC staff's investigative file to evaluate and respond to the evidence accumulated during the investigation, particularly in situations where the proposed case is circumstantial. The SEC Enforcement Manual does currently allow this type of "Wells discovery," but it also gives SEC staff considerable discretion over whether to permit it at all, and if allowed, how much of the file to make available.[106] Needless to say, in any such discretionary

104 *See* Peter J. Henning, *The Winning Record of Prosecutors on Insider Trading*, N.Y. TIMES DEALBOOK (Aug. 21, 2012, 11:49 AM), http://dealbook.nytimes.com/2012/08/21/the-winning-record-of-prosecutors-of-insider-trading. Many SEC trial attorneys are former DOJ prosecutors or otherwise have considerable trial experience.

105 DIV. OF ENFORCEMENT, SEC, ENFORCEMENT MANUAL 22–28 (2012) [hereinafter SEC ENFORCEMENT MANUAL], *available at* http://www.sec.gov/divisions/enforce/enforcementmanual.pdf.

106 *Id.* at 24 ("On a case-by-case basis, it is within the staff's discretion to allow the recipient of the notice to review portions of the investigative file that are not privileged. In considering a request for access to portions of the staff's investigative file, the staff should keep in mind, among other

system, practice will often vary considerably among—and even within—different SEC offices. In an office where the staff is attempting to push the limits on theories of prosecuting insider trading, it is particularly important to allow potential defendants access to broad Wells discovery to enable them to prepare meaningful Wells submissions, which will in turn allow the SEC to assess the fairness and wisdom of proceeding with litigation.

The need to avoid overreaching in naming additional defendants is equally important to reforming the SEC's approach to insider trading enforcement. In a tipping situation, the SEC may, as discussed above, charge multiple tiers of traders, that is, tippees of tippees. The complaint in such a case will typically charge that an insider has tipped one or more traders directly, and that these tippees in turn have tipped others who have traded, and sometimes, that these tippees of tippees have tipped yet another tier of traders. The difficulty with such an approach is that, by the time information is far removed from its original source, it can be difficult for the recipient to make any reasonable judgment as to who was the original source and whether that person had a duty of trust or confidence that was breached by the "upstream" passing of the information. If added to the SEC's complaint, such "downstream" defendants obviously have significantly enhanced chances of victory before a jury, and these are thus often the defendants mostly likely to take up a significant portion of the SEC's litigation resources by pressing their defense through to trial.

things: whether access to portions of the file would be a productive way for both the staff and the recipient of the Wells notice to assess the strength of the evidence that forms the basis for the staff's recommendations; whether the prospective defendant or respondent failed to cooperate, invoked his Fifth Amendment rights, or otherwise refused to testify during the investigation; and the stage of the investigation with regard to other persons or witnesses, including whether certain witnesses have yet to provide testimony.").

C. Alternative Disposition Approaches

Following the *Cady, Roberts* administrative decision in 1961, the SEC has opted to file virtually all of its insider trading cases in federal district court, and not as administrative proceedings. In so doing, the SEC has structured the disposition of its insider trading cases with a rigidity not found in its other enforcement program areas. All insider trading cases are pled as intentional or reckless fraud cases. All seek full repayment of trading profits plus market-rate interest. All seek an additional payment as a civil monetary penalty. Where downstream tippees are involved, the case will seek to impose joint and several liability for those profits as well. When a case proceeds to trial, the SEC will seek a penalty equal to three times the trading profits, the maximum allowed under the applicable penalty provision. In settlement, the SEC will often insist on all of the relief sought in the complaint, but with a one-time penalty.

Insider trading cases are almost always brought against individuals, not entities. Needless to say, relief of this magnitude will often result in career annihilation for the trader, and financial ruin for his or her family—at least for all but the most well-heeled defendants. As a practical matter, few other defendants caught in the SEC's net, whether individuals or entities, suffer such harsh consequences.

Where a trader has willfully stolen material nonpublic information to make big profits at the expense of other market participants, the consequences should indeed be harsh. But where there are mitigating circumstances—for example, a relatively small sum at issue, a low level of scienter, or some doubt as to the significance of the information conveyed—a more nuanced approach to case disposition may be appropriate. This can be accomplished through a number of alternate means, other than forcing SEC staff into the difficult binary position of deciding whether or not to file a potentially life-crushing case.

In situations where an individual in good faith mistakenly thinks a trade is permissible, an appropriate resolution may be to agree to a non-prosecution or deferred-prosecution agreement that recognizes the individual's voluntary forfeiture of the trading profits. The SEC Enforcement Manual currently provides that SEC staff may negotiate non-prosecution and deferred-prosecution agreements,[107] and it would be wise to consider using such approaches in borderline insider trading situations.

Alternatively, where it is felt that there is a higher level of culpability, but still significant mitigating circumstances, it may be possible to resolve the matter through an SEC administrative order that is entered on consent without fraud findings. Such an approach, involving a resolution without admission of liability, is likely available under Section 21C(a) of the Exchange Act,[108] with accompanying disgorgement of trading profits pursuant to Section 21B(e).[109] Through legislation or rulemaking, other more tailored tools for disposition can be made available to resolve such cases.

Such creative means for alternative disposition would fairly resolve situations that do not require the heavy hammer of fraud findings that can result in financial ruin and career destruction. Likewise, such efficient and appropriate alternative resolutions in particular cases would allow the SEC to divert valuable resources away from the litigation of thin cases that may well result in a loss—resources that could much better be expended elsewhere in support of the SEC's critical mission of investor protection.

VI. CONCLUSION

Since its creation by Chairman Cary a half century ago, the SEC's insider trading enforcement program has done much to promote fair trading markets for all investors, large and small, and, in turn, to build investor confidence needed to encourage capital formation and growth for our economy.

107 SEC ENFORCEMENT MANUAL, *supra* note 105, at 129–33.

108 15 U.S.C. § 78u-3(a) (2011) (providing for administrative cease-and-desist proceedings).

109 *See id.* § 78u-2(e) (2011).

The experience of fifty years provides perspective to consider how this valuable enforcement effort can be enhanced by the generations of judges and lawyers who will follow those who have developed it in Cary's shadow.

Much will be written and suggested in this time of increased interest in insider trading enforcement, but all will agree that there can be no single prescription for improvement—only areas for consideration and focus. While not always possible, clarity in the definition of the elements of the offense—and hence the boundaries of liability—should be a continuing goal. Wise case selection by the SEC and DOJ in deciding what to pursue will be invaluable in continuing to build a fair and credible program. And new and creative approaches for alternative tracks for insider trading case resolution that recognize the range of culpability and other factors that particular matters present can only serve to strengthen this important program.