Poetic Expansions of Insider Trading Liability

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I. INTRODUCTION

The Second Circuit's 2014 decision in *United States v. Newman* represented a significant setback to the Securities and Exchange Commission's (SEC) slow push through rulemaking and enforcement actions toward an equal access insider trading enforcement regime in the United States.[1]

The *Newman* court held that a factfinder is not permitted to infer a tipper personally benefitted by gifting confidential information to a trading relative or friend absent "proof of a meaningfully close personal relationship" between the tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[2] This test is far more difficult to satisfy than the government's preferred test, which would permit the inference of a personal benefit from *any* gift of confidential information from an insider for a non-corporate purpose.[3] When combined with the *Newman* Court's added insistence that the government also prove a

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1. United States v. Newman, 773 F.3d 438, 452 (2014). An equal-access enforcement regime is one that precludes securities trading by those who have acquired information advantages from sources that are closed to other market participants, regardless of whether such trading violates a fiduciary or similar duty of trust and confidence. Starting in the early 1960s, the SEC began regulating insider trading under the equal access model pursuant to Section 10(b) of the Securities Exchange Act of 1934. *See In re*, Roberts & Co., 40 SEC 907 (1961). Two decades later, the United States Supreme Court expressly rejected the equal access model as inconsistent with the SEC's statutory authority under Section 10(b). The Court held that Section 10(b) is a fraud provision, and, in the context of insider trading, the insider's failure to disclose prior to trading is only fraudulent when it violates a "fiduciary or other similar relation of trust and confidence." Chiarella v. United States, 445 U.S. 222, 228 (1980). Despite the fact that the Supreme Court has never backed away from its insistence that ours is a fiduciary-cum-fraud insider trading enforcement regime, the SEC has continued to press for broader insider trading liability through its rulemaking (e.g., with the adoption of Rules 14e-3, 10b5-1, and 10b5-2) and enforcement. *See, e.g.*, John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 368–69 (2015) (addressing tension between SEC and the courts over the scope of insider trading liability).

2. *Newman*, 773 F.3d at 452.

3. *See* Salman v. United States, 137 S. Ct. 420, 426 (2016) ("Under the Government's view, a tipper personally benefits whenever the tipper discloses confidential information for a noncorporate purpose.").

tippee's knowledge that this personal benefit test was satisfied, the Second Circuit's decision made it exponentially more difficult for the SEC and prosecutors to establish remote tippee liability. And in light of the Supreme Court's recent holding in *Salman v. United States*, much—though certainly not all—of *Newman's* rigor appears to remain intact.[4]

The *Salman* Court unanimously reaffirmed the personal benefit test for tipper-tippee insider trading liability and did not overturn the *Newman* court's requirement that the government prove the tippee's knowledge of the tipper's personal benefit.[5] Moreover, the Court was very careful to limit its decision to the facts of *Salman*, where the tipper was the brother of, and had a "very close relationship" with, the tippee.[6] The Court noted that these facts were within the "heartland" of the *Dirks v. SEC*[7] rule concerning gifts of material nonpublic information to relatives and friends,[8] and it left open the question of whether proof of a tangible benefit may be required where a gratuitous tip is made to a remote relative or to a mere acquaintance (as was the case in *Newman*).[9] The *Salman* Court did, however, limit *Newman* by making it clear that receipt of money, property, or something of a "pecuniary or similarly valuable nature" is *not* necessary for satisfying the *Dirks* personal benefit test for tipper-tippee liability in all cases.[10]

The post-*Salman* status of *Newman* was very recently called into question by a split panel of the Second Circuit in *United States v. Martoma*.[11] Nevertheless, while circuits may continue to differ in their interpretations of the scope and extent of the personal benefit test, *Salman's* unanimous reaffirmation of *Dirks* suggests that the test itself will remain undisturbed for some time to come. With this in mind, many scholars have joined the SEC and prosecutors in expressing concern that *any* meaningful personal benefit test opens "a disturbing loophole" for insider trading resulting from gratuitous tipping,[12] and some have looked to identify novel theories of liability to capture such conduct from within the existing regulatory framework.

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4. *See id.*

5. *Id*. at 427 (adhering to *Dirks*, the Court affirmed that "the disclosure of confidential information without personal benefit is not enough to establish tipper-tippee liability"). *Newman's* holding that tippee liability requires proof of knowledge of the tipper's personal benefit was not before the Court and was therefore left untouched by *Salman*.

6. *Id.* at 424.

7. Dirks v. SEC, 463 U.S. 646, 664 (1983) ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.").

8. *Salman*, 137 S. Ct. at 429.

9. *Id*. It remains the case that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." But there is no need for us to address those difficult cases today, because this case involves "precisely the 'gist of confidential information to a trading relative' that Dirks envisioned." *Id.*

10. *Id.* at 428 ("To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, we agree with the Ninth Circuit that this is inconsistent with *Dirks*.")

11. United States v. Martoma, 869 F.3d 58 (2d Cir. 2017). The *Martoma* majority held that the Supreme Court's decision in *Salman* not only overruled *Newman's* requirement of a tangible benefit, but also its holding that gifts of material nonpublic information will only result in a personal benefit to the tipper where there is a "meaningfully close personal relationship" between the tipper and tippee. *Id*. at 61. Judge Rosemary Pooler filed a vigorous dissent in *Martoma*, and the decision was pending possible *en banc* review before the Second Circuit (and perhaps even Supreme Court review) as this Article went to press.

12. Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1, 22 (2016).

For example, Professors Michael Guttentag and Donna Nagy have each offered arguments suggesting that the entire tipper-tippee framework first laid out by the Supreme Court in *Dirks*, including the personal benefit test, has been rendered obsolete by subsequent common law and regulatory developments that have fundamentally transformed the U.S. insider trading enforcement regime.[13] These developments include: (1) the Supreme Court's endorsement of the misappropriation theory in *United States v. O'Hagan*,[14] (2) recent state court decisions offering more expansive accounts of what conduct constitutes a breach of fiduciary duty of loyalty in the corporate context, and (3) the SEC's adoption of Regulation Fair Disclosure (Regulation FD) in 2000.[15]

Both Guttentag's and Nagy's arguments are erudite and quite creative. Such creativity is a virtue in law professors, but not in prosecutors. Exercising poetic license to expand criminal liability risks violating the time-honored principle of legality and leaving citizens without adequate notice of the crimes for which they may be charged.[16] Insider trading law in the United States is already plagued by vagueness,[17] and concern over prosecutors' continued exploitation of this ambiguity to push the line of liability further and further out is part of what motivated the Second Circuit to push back in *Newman*.[18] I share the *Newman* court's concern.[19]

In what follows, I summarize what I take to be the most crucial aspects of Guttentag's and Nagy's arguments. I then offer some criticism. Specifically, I explain why I regard these interpretations as poetic expansions (rather than straightforward readings) of the law, a conclusion that was only strengthened by the Supreme Court's recent decision in *Salman*.

II. POETIC EXPANSIONS

First, both Guttentag and Nagy point out that when the Supreme Court endorsed the misappropriation theory in *O'Hagan*, it expanded the set of persons the deception of whom could trigger insider trading liability from including just counterparties to also including sources of material nonpublic information.[20] In doing so, the Court also opened the door

13. *See* Nagy, *supra* note 12; Michael D. Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519 (2017).

14. *See* United States v. O'Hagan, 521 U.S. 642, 653 (1997) (recognizing that the misappropriation theory of insider trading liability "satisfies § 10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities").

15. *See generally,* Nagy, *supra* note 12; Guttentag, *supra* note 13.

16. Also sometimes expressed in the Latin phrase, *nullum crimen sine lege*. *See, e.g.*, DAVID A.J. RICHARDS, THE MORAL CRITICISM OF LAW 195 (1977). This principle gives expression to our shared intuition that justice requires that persons be given reasonable notice of when criminal sanctions will be imposed. The same moral intuition informs our repugnance towards *ex post facto* laws. *See* U.S. CONST. art. I, §§ 9, 10. *See also*, Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J. F. 129 (2017).

17. *See, e.g.*, John P. Anderson, *Solving the Paradox of Insider Trading Compliance*, 88 TEMPLE L. REV 273, 278–87 (2016) [hereinafter Anderson, *Solving the Paradox*].

18. United States v. Newman, 773 F.3d 438, 448 (2014). The *Newman* Court noted the concern that the "Government has not cited, nor have we found, a single case in which tippees as remote as [the defendants in that case] have been held criminally liable for insider trading."

19. I have argued extensively that vagueness in the law of insider trading in the United States is responsible for great moral injustices and significant economic harms. *See, e.g.*, Anderson, *Solving the Paradox, supra* note 17; John P. Anderson, *The Final Step to Insider Trading Reform: Answering the "It's Just Not Right!" Objection*, 12 J.L. ECON. & POL'Y 279, 279 (2016).

20. *See* Guttentag, *supra* note 13, at 545–50; *see also*, Nagy, *supra* note 12, at 17–26 (similarly emphasizing the significance of *O'Hagan* for interpreting the application of the *Dirks* test).

to new types of deception that might trigger Section 10(b) insider trading liability. As Guttentag explains, the "types of deceptive conduct that a misappropriator might engage in when taking information from the source are far more numerous than the silence that constitutes the only type of deception that can take place on an impersonal securities market."[21] For example, a misappropriator may gain access to material nonpublic information by affirmative conduct, such as making a false statement or by overt trickery. If the fraud is affirmative, there would be no need to prove fraud by silence, and therefore no need to show the breach of a fiduciary relation of trust and confidence—and therefore no need to prove a personal benefit.[22]

Second, even if courts were to continue to insist that the breach of a fiduciary-like duty is required for insider trading liability under the misappropriation theory, one's fiduciary duties to the source of material nonpublic information (e.g., to one's employer) are different from one's duties as an insider to shareholders. So, while the duty to refrain from self-dealing may be the only relevant fiduciary duty under the classical theory (where the beneficiary is a current or prospective shareholder), there is no reason to think it is the only relevant fiduciary duty under the misappropriation theory (where the beneficiary is the source of the information). Nagy points out that some recent Delaware cases have shattered traditional common-law limits on fiduciary duties as they pertain to corporate officers and employees, expanding them beyond the classical understanding of a duty of loyalty (involving self-dealing) to a far more general duty of good faith.[23] This fiduciary duty of good faith requires more than refraining from self-dealing and avoiding conflicts of interest. It requires that fiduciaries always act in the "best interest of the corporation."[24] Consequently, "where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act," she breaches her fiduciary duty to the firm.[25] If courts and regulators were to adopt this expanded understanding of fiduciary duty in applying the misappropriation theory, *any* tipping of material nonpublic information that violates a firm's internal policies or external laws (regardless of personal benefit) would be sufficient to establish a fiduciary breach and therefore to predicate insider trading liability.[26]

Third, the SEC's adoption of Regulation FD in 2000 introduced yet another significant change to the post-*Dirks* regulatory landscape.[27] Regulation FD requires that whenever an issuer, or certain defined persons acting on its behalf, discloses material nonpublic information concerning the issuer or its shares to market professionals or those who are likely to trade the firm's shares, they must simultaneously disclose that information to the general investing public.[28] Both Guttentag and Nagy suggest that the adoption of Regulation FD significantly changed the moral and legal landscape concerning selective disclosures of material nonpublic information from what it was when *Dirks* was decided

21. Guttentag, *supra* note 13, at 545.

22. Guttentag cites SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009) as an example of a case in which the court recognized insider trading could be incurred by deception without a breach of fiduciary duty. *Id.* at 548–49.

23. *See, e.g.*, Stone v. Ritter, 911 A.2d 362 (Del. 2006); Brehm v. Eisner (*In re* Walt Disney Co. Derivative Litig.), 906 A.2d 27 (Del. 2006).

24. *Disney*, 906 A.2d at 67.

25. *Id.*

26. *See* Nagy, *supra* note 12, at 43–45.

27. 17 C.F.R. § 243.100 (2011).

28. *Id.*

seventeen years before.[29] One of the principal justifications advanced by Justice Powell in defense of the personal benefit test in *Dirks* was that it would preserve a space for legitimate selective disclosures to further the issuer's interests and speed information to the market.[30] Guttentag and Nagy both argue that this space for selective disclosure once protected by *Dirks* was closed by Regulation FD.[31] Most of these disclosures are now illegal. Moreover, since the adoption of Regulation FD, virtually every firm has adopted internal rules that selective disclosures would violate.[32] Consequently, any such selective disclosure would deceive the source of the information (the issuing firm) by feigning fidelity while violating its disclosure rules, and by violating the law.

By combining the expanded reach of *O'Hagan* with expanded articulations of fiduciary duty under the common law, and then considering them against the backdrop of the adoption of Regulation FD, Guttentag and Nagy each argue that one can sidestep the personal benefit test altogether when applying the misappropriation theory.[33] And since most scholars agree that any insider trading cases brought under the classical theory could also be brought under the misappropriation theory, the result is that the *Dirks* personal benefit test is rendered obsolete.[34] But more than that, if we recognize Section 10(b) insider trading liability to have expanded as far as Guttentag and Nagy suggest, it is hard to conceive of a selective disclosure of material nonpublic information that (if traded upon) would not expose the tipper and tippee to liability. So understood, this expanded interpretation would paradoxically render the U.S. insider trading regime functionally equivalent to the equal access model that has been consistently rejected by the Supreme Court since *Chiarella v. United States*.[35]

III. SOME CRITICISM

Each of the above-referenced premises offered by Guttentag and Nagy for the conclusion that the *Dirks* personal benefit test has been rendered obsolete by subsequent legal developments is controversial.

First, it is true that by recognizing the fraud-on-the-source theory in *O'Hagan*, the Supreme Court created logical space for new forms of deception that might predicate insider trading liability. And the Court certainly could have exploited this opening to embrace a broader theory of insider trading liability that would recognize any form of deceptive or wrongful conduct towards the source as a form of affirmative misrepresentation, thereby dispensing with the need to establish a fiduciary duty to disclose or abstain. The *O'Hagan* court did not, however, do this. Justice Ginsburg's opinion explained that "[d]eception through nondisclosure is central to liability under the misappropriation theory."[36] And the Court explicitly cabined the type of deceptive

29. *See* Nagy, *supra* note 12, at 36–41; Guttentag, *supra* note 13.

30. *See* Dirks v. SEC, 463 U.S. 646, 658 (1983) (expressing concern that too broad a restriction on selective disclosure could inhibit analysts in their useful role of "ferret[ing] out and analyz[ing] information").

31. *See* Guttentag, *supra* note 13; *see also* Nagy, *supra* note 12, at 40–41.

32. *See* Nagy, *supra* note 12, at 40; Guttentag, *supra* note 13.

33. Instead of the personal benefit test, Guttentag would turn to a basic deception test. *See* Guttentag, *supra* note 13; Nagy suggests a broad "deceptive breach of loyalty test." *See* Nagy, *supra* note 12, at 48–51.

34. *See, e.g.*, 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 6-1 (West 2015).

35. Chiarella v. United States, 445 U.S. 222, 231–32 (1980).

36. United States v. O'Hagan, 521 U.S. 642, 643 (1997).

nondisclosure that triggers such liability as the "breach of a fiduciary duty owed to the source of the information."[37] One could hardly ask for a clearer statement that Section 10(b) insider trading liability under the misappropriation theory, in symmetry with the classical theory, is a form of fraud by silence that requires the breach of a fiduciary or similar duty of trust and confidence.[38] And since the Court clearly intended to establish this symmetry between the "complementary" classical and misappropriation theories, it would be a poetic stretch in interpretation to suggest that it nevertheless contemplated that the personal benefit test would apply under the former but not the latter.[39] Indeed, this narrow reading of the scope of misappropriation liability was undisputed in *Salman*,[40] where the Court expressly reaffirmed *Dirks* and the fiduciary model while unequivocally holding that "disclosure of confidential information without personal benefit is not enough" to incur tipper liability.[41]

Second, though Nagy correctly points out that the Delaware Supreme Court has expanded its understanding of fiduciary disloyalty in corporate contexts to include any conduct reflecting bad faith, application of this precedent to expand the scope of Section 10(b) insider trading liability is dubious on a number of levels. To begin, Nagy cites no Delaware precedent suggesting that violating a fiduciary duty of good faith without self-dealing would suffice as proof of criminal fraud in that state. The Delaware cases cited by Nagy recognize a spectrum of corporate culpability in the context of shareholder derivative suits, ranging from mere negligence—least culpable, to bad faith that does not involve self-dealing—more culpable, to bad faith involving self-dealing—most culpable.[42] Absent some precedent to the contrary, it should be assumed that Delaware still requires bad faith at the highest culpability level (i.e., involving self-dealing) as a predicate for criminal fraud. But even assuming *arguendo* that criminal fraud no longer requires self-dealing in Delaware, does this somehow overturn more than three decades of federal court precedent interpreting Section 10(b) insider trading liability as requiring self-dealing? Any regulator or court following Nagy's lead on this would have been making a poetic leap even before *Salman*. But after the *Salman* Court's reaffirmation of *Dirks* and its personal benefit test, Nagy's poetic leap seems more like an Olympic long jump.

Third, there are a number of reasons why it would be problematic for the SEC or the courts to regard Regulation FD as creating duties the violation of which would serve to predicate Section 10(b) insider trading liability. To begin, Rule 101(c) of Regulation FD expressly excludes tipping "in breach of a duty of trust or confidence to the issuer" from the regulation's coverage.[43] Since both *O'Hagan* and SEC Rule 10b5-2 require the

37. *Id.* at 652.

38. The *O'Hagan* Court emphasized that the two theories are "complementary" and that, under the misappropriation theory, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." *Id.*

39. *Id.*

40. In a footnote, the Court notes that the "parties do not dispute that *Dirks's* personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does." Salman v. United States, 137 S. Ct. 420, 425 n.2. (2016)

41. *Id.* at 427.

42. *See* Nagy, *supra* note 12, at 43–45.

43. 17 C.F.R. § 243.101(c). Guttentag and Nagy both recognize Rule 101(c), but suggest it was included "presumably so that issuers do not face liability for violations carried out by rogue employees." Guttentag, *supra* note 13, at 542; Nagy, *supra* note 12, at 38 ("But for this latter qualification, an insider's illegal tipping in violation

violation of some duty of trust and confidence as an element of misappropriation liability,[44] Section 101(c) seems designed to make it logically impossible for a violation of Regulation FD to provide the basis of insider trading liability under the misappropriation theory. If an insider's tipping violates a duty of trust and confidence to the issuer, then by definition it cannot violate Regulation FD. If, alternatively, tipping does not violate a duty of trust and confidence, it may violate Regulation FD, but by definition it cannot support misappropriation liability. Section 102 of Regulation FD offers proof that the SEC intended this logical separation, providing that no "failure to make a public disclosure required solely by [Regulation FD] shall be deemed to be a violation of Rule 10b-5."[45] One could hardly ask for a clearer statement that Regulation FD was not intended to affect Section 10(b) insider trading liability. And it makes perfect sense that the SEC would exercise such care. It was no doubt concerned that, without this clear separation, the Supreme Court would strike down offending aspects of Regulation FD as making a not-so-subtle end run around *Dirks*. Finally, even if it is assumed *arguendo* that violations of Regulation FD could form the basis of insider trading liability, its impact would be limited to a relatively limited number of insiders defined by Section 101(c). It would not apply to outsiders, most constructive insiders, or even mid-to-low-level employees of the issuer.[46]

IV. CONCLUSION

To say that Guttentag's and Nagy's interpretations of recent trends in insider trading law are controversial and require poetic leaps is not to say that the SEC and prosecutors will not embrace them in the wake of *Salman's* reaffirmation of the personal benefit test. Keep in mind that the misappropriation theory was itself a poetic, metaphorical response to a setback before the Supreme Court in *Chiarella*. But while building metaphor on top of metaphor may be a sound method for expanding our aesthetic understandings of the arts, I am convinced it is an unjust method for expanding the scope of common-law criminal liability. Citizens expect and deserve advance notice of precisely what conduct will violate the criminal law so they can guide their actions to reliably avoid the associated reputational and penal sanctions. Justice therefore demands that the criminal law be expanded by legislative action, not poetic license.

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of Rule 10b-5 would likewise trigger a Regulation FD violation on the part of the issuer."). This interpretation is, however, inconsistent with the express language of the provision, which excludes both the issuer and the tipper from Regulation FD liability where an insider discloser breaches a duty of trust and confidence. The provision therefore appears to be designed to avoid potential conflicts with Section 10(b).

44. 17 C.F.R. § 240.10b5-2 (2017).

45. 17 C.F.R. § 243.102 (2017). Guttentag argues that Rule 102 was not intended to shield individuals from insider trading liability pursuant to Rule 10b-5, only to protect issuers from private rights of pursuant to Rule 10b-5 for violations of Regulation FD. The problem with this argument is that Rule 102 is not limited by its language to private rights of action. It is a blanket exclusion. Guttentag, *supra* note 13, at 543.

46. 17 C.F.R. § 243.101(c) (2017).