4. INSIDER TRADING

Surprisingly, there is no general law against insider trading in the United States. The prohibition on insider trading developed through the common law process as a type of securities fraud—that is, an interpretation of the securities statutes you have already studied. So what is important to understand—because it guides and limits the development of the doctrine—is just what the theory of *fraud* is for insider trading, and what the extensions and limitations of that theory of fraud might be.

The materials in this chapter consist mostly of case law. Because insider trading prosecutions have been front and center on Wall Street in recent years, the chapter also includes some material for talking about recent prosecutions in the area and potential law reform in the U.S. Section A provides the applicable statutes. Section B covers the "classical theory" of insider trading. Section C adds the issue of insider trading liability for "tippers" and "tippees." Section D covers the "misappropriation theory" of insider trading. Section E includes materials illustrating a recent wave of high-profile prosecutions initiated by the U.S. Attorney in the Southern District of New York. Section F explores problems of liability involving "tipping chains" among groups and communities of individuals in the investment industry. Section G briefly considers the possibility of statutory reform of insider trading law.

A. Statutes

The securities fraud statutes and rules are repeated below. Reread them. Where in the *text* do they prohibit insider trading? How have the courts situated insider trading doctrine in the text of these statutes and rules?

15 U.S.C. §78j. Manipulative and deceptive devices ("Section 10 of the '34 Act")

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

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

17 C.F.R. § 240.10b-5. Employment of manipulative and deceptive devices ("Rule 10b-5")

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

18 U.S.C. § 1348. Securities and commodities fraud

Whoever knowingly executes, or attempts to execute, a scheme or artifice—

(1) to defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)); or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d));

shall be fined under this title, or imprisoned not more than 25 years, or both.

B. The "Classical" Theory of Insider Trading

This is the origin case, in which the SEC first articulated the theory of insider trading as securities fraud, albeit in a civil administrative proceeding not a federal district court case, much less a criminal prosecution. What is the theory? The question after this case was whether the federal courts would follow the SEC's interpretive lead. As you will see, they did.

IN RE CADY, ROBERTS & CO., 40 S.E.C. 907 (1961)

CARY, Chairman:

This is a case of first impression and one of signal importance in our administration of the Federal securities acts. It involves a selling broker who executes a solicited order and sells for discretionary accounts (including that of his wife) upon an exchange. The crucial question is what are the duties of such a broker after receiving nonpublic information as to a company's dividend action from a director who is employed by the same brokerage firm.

These proceedings were instituted to determine whether Cady, Roberts & Co. ('registrant') and Robert M. Gintel, the selling broker and a partner of the registrant, willfully violated the 'anti-fraud' provisions of Section 10(b) of the Securities Exchange Act of 1934 ('Exchange Act'), Rule 10b–5 issued under that Act . . . and, if so, whether any disciplinary action is necessary or appropriate in the public interest. . . .

Rule 10b–5 appl[ies] to securities transactions by 'any person.' Misrepresentations will lie within their ambit, no matter who the speaker may be. An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

The ingredients are here and we accordingly find that Gintel willfully violated Section 10(b) and Rule 10b–5. We also find a similar violation by the registrant, since the actions of Gintel, a member of registrant, in the course of his employment are to be regarded as actions of registrant itself. It was obvious that a reduction in the quarterly dividend by the Board of Directors was a material fact which could be expected to have an adverse impact on the market price of the company's stock. The rapidity with which Gintel acted upon receipt of the information confirms his own recognition of that conclusion.

We have already noted that the anti-fraud provisions are phrased in terms of 'any person' and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.

The facts here impose on Gintel the responsibilities of those commonly referred to as 'insiders.' He received the information prior to its public release from a director of Curtiss-Wright, Cowdin, who was associated with the registrant. Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence, it should prohibit Gintel, a partner of registrant. This prohibition extends not only over his own account, but to selling for discretionary accounts and soliciting and executing other orders. In somewhat analogous circumstances, we have charged a broker-dealer who effects securities transactions for an insider and who knows that the insider possesses non-public material information with the affirmative duty to make appropriate disclosure or dissociate himself. . . .

The next case was the first time a federal appellate court fully accepted the theory of insider trading as securities fraud. In insider trading cases, you must be clear on who is doing the trading, where the information is coming from, and what the relationships are among the relevant people, including their employer-employee or, more generally, principal-agent relationships. If you get confused, draw a diagram.

S.E.C. v. TEXAS GULF SULPHUR CO., 401 F.2d 833 (2d Cir. 1968)

WATERMAN, Circuit Judge:

[The facts of this case are very dense, so the discussion has been omitted. The case involved engineering personnel for a fossil fuel company who traded in securities related to the company when they knew, before others, about promising early results of drilling cores tested from a new exploration area on the Canadian Shield in eastern Canada.]

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)). By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges. The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. Whether predicated on traditional fiduciary concepts or on the 'special facts' doctrine, the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information. The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an 'insider' within the meaning of Sec. 16(b) of the Act. *Cady, Roberts*, *supra*. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished. *Cady, Roberts*, *supra* at 911. . . .

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in 'those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if (the extraordinary situation is) disclosed.' Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 Va. L. Rev. 1271, 1289.

Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

This is not to suggest, however, as did the trial court, that 'the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight,' in the sense that the materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors. As we stated in *List v. Fashion Park, Inc.*, 340 F.2d 457, 462, 'The basic test of materiality . . . is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question. Restatement, Torts § 538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66.' This, of course, encompasses any fact '. . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities. . . .' *List v. Fashion Park, Inc.*, *supra* at 462, quoting from *Kohler v. Kohler Co.*, 319 F.2d 634, 642, 7 A.L.R.3d 486 (7th Cir. 1963). Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders. Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities. . . .

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results of K-55-1 were made in violation of Rule 10b-5. Inasmuch as the visual evaluation of that drill core (a generally reliable estimate though less accurate than a chemical assay) constituted material information, those advised of the results of the visual evaluation as well as those informed of the chemical assay traded in violation of law. The geologist Darke possessed undisclosed material information and traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. The trial court also found that Darke, after the drilling of K-55-1 had been completed and with detailed knowledge of the results thereof, told certain outside individuals that TGS 'was a good buy.' These individuals thereafter acquired TGS stock and calls. The trial court also found that later, as of March 30, 1964, Darke not only used his material knowledge for his own purchases but that the substantial amounts of TGS stock and calls purchased by these outside individuals on that day was 'strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed.' Obviously if such a resumption were to have any meaning to such 'tippees,' they must have previously been told of K-55-1. . . .

In the next case the Supreme Court gets in the game and sort of blesses the theory. But the Court overturns the defendant's conviction, thereby also establishing limits to the classical theory. Why doesn't the theory fit this defendant? (The Court does not yet use the word, but under present doctrine, explored later in this chapter, the defendant would be a "misappropriator.")

CHIARELLA v. UNITED STATES, 445 U.S. 222 (1980)

Mr. Justice POWELL delivered the opinion of the Court.

The question in this case is whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10(b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities.

Petitioner is a printer by trade. In 1975 and 1976, he worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. Among documents that petitioner handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces or false names. The true names were sent to the printer on the night of the final printing.

The petitioner, however, was able to deduce the names of the target companies before the final printing from other information contained in the documents. Without disclosing his knowledge, petitioner purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. By this method, petitioner realized a gain of slightly more than $30,000 in the course of 14 months. Subsequently, the Securities and Exchange Commission (Commission or SEC) began an investigation of his trading activities. In May 1977, petitioner entered into a consent decree with the Commission in which he agreed to return his profits to the sellers of the shares. On the same day, he was discharged by Pandick Press. . . .

This case concerns the legal effect of the petitioner's silence. The District Court's charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. In order to decide whether silence in such circumstances violates § 10(b), it is necessary to review the language and legislative history of that statute as well as its interpretation by the Commission and the federal courts.

Although the starting point of our inquiry is the language of the statute, § 10(b) does not state whether silence may constitute a manipulative or deceptive device. Section 10(b) was designed as a catch-all clause to prevent fraudulent practices. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b–5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of § 10(b).

The SEC took an important step in the development of § 10(b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm. In *Cady, Roberts & Co*., 40 S.E.C. 907 1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from

> "[a]n affirmative duty to disclose material information[, which] has been traditionally imposed on corporate 'insiders,' particular officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment." *Id*., at 911.

The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.

That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law. At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." In its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders." *Speed v. Transamerica Corp*., 99 F. Supp. 808, 829 (D. Del. 1951).

The federal courts have found violations of § 10(b) where corporate insiders used undisclosed information for their own benefit. *E.g., SEC v. Texas Gulf Sulphur Co*., 401 F.2d 833 (CA2 1968). The cases also have emphasized, in accordance with the common-law rule, that "[t]he party charged with failing to disclose market information must be under a duty to disclose it." *Frigitemp Corp. v. Financial Dynamics Fund, Inc*., 524 F.2d 275, 282 (CA2 1975). Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts. . . .

In this case, the petitioner was convicted of violating § 10(b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. Petitioner's use of that information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading. In this case, the jury instructions failed to specify any such duty. In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole. 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."

The Court of Appeals affirmed the conviction by holding that "*[a]nyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." Although the court said that its test would include only persons who regularly receive material, nonpublic information, its rationale for that limitation is unrelated to the existence of a duty to disclose. The Court of Appeals, like the trial court, failed to identify a relationship between petitioner and the sellers that could give rise to a duty. Its decision thus rested solely upon its belief that the federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.

This reasoning suffers from two defects. First not every instance of financial unfairness constitutes fraudulent activity under § 10(b). Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties should not be undertaken absent some explicit evidence of congressional intent.

As we have seen, no such evidence emerges from the language or legislative history of § 10(b). Moreover, neither the Congress nor the Commission ever has adopted a parity-of-information rule. Instead the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets. . . .

We see no basis for applying such a new and different theory of liability in this case. As we have emphasized before, the 1934 Act cannot be read "'more broadly than its language and the statutory scheme reasonably permit.'" *Touche Ross & Co. v. Redington,* 442 U.S. 560, 578 (1979), quoting *SEC v. Sloan,* 436 U.S. 103, 116 (1978). Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets. . . .

Insider trading, say the courts in interpreting 10b-5, is a form of fraud. Here is a civil enforcement case that, whether or not decided correctly, is helpful in driving home the point that insider trading actions must rest on a viable theory of fraud.

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

JOSÉ A. CABRANES, Circuit Judge:

We are asked to consider whether, in a civil enforcement lawsuit brought by the United States Securities and Exchange Commission ("SEC") under Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)"), computer hacking may be "deceptive" where the hacker did not breach a fiduciary duty in fraudulently obtaining material, nonpublic information used in connection with the purchase or sale of securities. For the reasons stated herein, we answer the question in the affirmative.

In early October 2007, defendant Oleksandr Dorozhko, a Ukrainian national and resident, opened an online trading account with Interactive Brokers LLC ("Interactive Brokers") and deposited $42,500 into that account. At about the same time, IMS Health, Inc. ("IMS") announced that it would release its third-quarter earnings during an analyst conference call scheduled for October 17, 2007 at 5 p.m.—that is, after the close of the securities markets in New York City. IMS had hired Thomson Financial, Inc. ("Thomson") to provide investor relations and web-hosting services, which included managing the online release of IMS's earnings reports.

Beginning at 8:06 a.m. on October 17, and continuing several times during the morning and early afternoon, an anonymous computer hacker attempted to gain access to the IMS earnings report by hacking into a secure server at Thomson prior to the report's official release. At 2:15 p.m.—minutes after Thomson actually received the IMS data—that hacker successfully located and downloaded the IMS data from Thomson's secure server.

Beginning at 2:52 p.m., defendant—who had not previously used his Interactive Brokers account to trade—purchased $41,670.90 worth of IMS "put" options that would expire on October 25 and 30, 2007. These purchases represented approximately 90% of all purchases of "put" options for IMS stock for the six weeks prior to October 17. In purchasing these options, which the SEC describes as "extremely risky," defendant was betting that IMS's stock price would decline precipitously (within a two-day expiration period) and significantly (by greater than 20%).

At 4:33 p.m.—slightly ahead of the analyst call—IMS announced that its earnings per share were 28% below "Street" expectations, *i.e.,* the expectations of many Wall Street analysts. When the market opened the next morning, October 18, at 9:30 a.m., IMS's stock price sank approximately 28% almost immediately—from $29.56 to $21.20 per share. Within six minutes of the market opening, defendant had sold all of his IMS options, realizing a net profit of $286,456.59 overnight. . . .

In *Chiarella,* the defendant was employed by a financial printer and used information passing through his office to trade securities offered by acquiring and target companies. In a criminal prosecution, the government alleged that the defendant committed fraud by not disclosing to the market that he was trading on the basis of material, nonpublic information. The Supreme Court held that defendant's "silence," or nondisclosure, was not fraud because he was under no obligation to disclose his knowledge of inside information. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." 445 U.S. at 235; *see also United States v. Chestman,* 947 F.2d 551, 575 (2d Cir. 1991) (Winter, *J.,* concurring in part and dissenting in part) (stating that, after *Chiarella,* "silence cannot constitute a fraud absent a duty to speak owed to those who are injured"). Justice Blackmun, joined by Justice Marshall, dissented. In their view, stealing information from an employer was fraudulent within the meaning of Section 10(b) because the statute was designed as a "catchall" provision to protect investors from unknown risks. According to Justice Blackmun, the majority had "confine[d]" the meaning of fraud "by imposition of a requirement of a 'special relationship' akin to fiduciary duty before the statute gives rise to a duty to disclose or to abstain from trading upon material, nonpublic information." . . .

[Several Supreme Court decisions] stand for the proposition that nondisclosure in breach of a fiduciary duty "satisfies § 10(b)'s requirement . . . [of] a 'deceptive device or contrivance,'" *O'Hagan*, 521 U.S. at 653. However, what is sufficient is not always what is necessary, and none of the Supreme Court opinions considered by the District Court *require* a fiduciary relationship as an element of an actionable securities claim under Section 10(b). . . . Even if a person does not have a fiduciary duty to "disclose or abstain from trading," there is nonetheless an affirmative obligation in commercial dealings not to mislead. *See, e.g., Basic*

Inc. v. Levinson, 485 U.S. 224, 240 n.18, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988) (distinguishing "situations where insiders have traded in abrogation of their duty to disclose or abstain," from "affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead)").

In this case, the SEC has not alleged that defendant fraudulently remained silent in the face of a "duty to disclose or abstain" from trading. Rather, the SEC argues that defendant affirmatively misrepresented himself in order to gain access to material, nonpublic information, which he then used to trade. We are aware of no precedent of the Supreme Court or our Court that forecloses or prohibits the SEC's straightforward theory of fraud. . . . Accordingly, we adopt the SEC's proposed interpretation of *Chiarella* and its progeny: "misrepresentations are fraudulent, but . . . silence is fraudulent only if there is a duty to disclose." Appellant's Br. 44. . . .

In its ordinary meaning, "deceptive" covers a wide spectrum of conduct involving cheating or trading in falsehoods. *See* Webster's International Dictionary 679 (2d ed.1934) (defining "deceptive" as "tending to deceive," and defining "deceive" as "[t]o cause to believe the false, or to disbelieve the true" or "[t]o impose upon; to deal treacherously with; cheat"). In light of this ordinary meaning, it is not at all surprising that Rule 10b–5 equates "deceit" with "fraud." *See* 17 C.F.R. § 240.10b–5 (prohibiting "any untrue statement of a material fact . . . or . . . *any act, practice, or course of business* which operates or would operate as a *fraud or deceit* upon any person, in connection with the purchase or sale of any security" (emphases added)). Indeed, we have previously observed that the conduct prohibited by Section 10(b) and Rule 10b–5 "irreducibly entails some act that gives the victim a false impression." *United States v. Finnerty,* 533 F.3d 143, 148 (2d Cir. 2008).

The District Court—summarizing the SEC's allegations—described the computer hacking in this case as "employ[ing] electronic means to trick, circumvent, or bypass computer security in order to gain unauthorized access to computer systems, networks, and information . . . and to steal such data." On appeal, the SEC adds a further gloss, arguing that, in general, "[computer h]ackers either (1) 'engage in false identification and masquerade as another user['] . . . or (2) 'exploit a weakness in [an electronic] code within a program to cause the program to malfunction in a way that grants the user greater privileges.'" Appellant's Br. 22–23 (quoting Orin S. Kerr, *Cybercrime Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes,* 78 N.Y.U. L. Rev. 1596, 1645 (2003)). In our view, misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly "deceptive" within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is "deceptive," rather than being mere theft. Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a "deceptive device or contrivance" that is prohibited by Section 10(b) and Rule 10b–5.

However, we are hesitant to move from this general principle to a particular application without the benefit of the District Court's views as to whether the computer hacking in this case—as opposed to computer hacking in general—was "deceptive." Our caution is counseled by the considerable and careful efforts the District Court has already devoted to this case, including hearing live testimony from witnesses at a preliminary injunction hearing that covered, among other topics, how Thomson's secure servers were infiltrated. Having established that the SEC need not demonstrate a breach of fiduciary duty, we now remand to the District Court to consider, in the first instance, whether the computer hacking in this case involved a fraudulent misrepresentation that was "deceptive." . . .

Problem 4-1
Chiarella makes clear that only insiders and quasi-insiders of the firm whose securities are being traded can be liable under the classical theory. The classical theory rests on a theory of fraud through omission when the trader has a duty to disclose, but to whom does this duty run? Are there any problems with this theory?

C. Tippers and Tippees

A common insider trading fact pattern involves a tipper and one or more tippees. Tippers are insiders or quasi-insiders who give inside information to outsiders, referred to as tippees. It is not uncommon for tipper-tippee chains to exist, in which the original tippee then acts as a tipper to additional tippees farther down the chain. However, only the original tipper must be an insider or quasi-insider in order for the later tippees to be liable (with some caveats). Tippers can be liable under either the classical theory or the misappropriation theory (discussed in Part D).

The next case involves a tipper-tippee scenario, in which the Supreme Court again sort of accepts the classical theory, but does so in the process of reversing civil SEC sanctions. Why doesn't the classical theory fit this particular version of a tipper-tippee scenario?

DIRKS v. S.E.C., 463 U.S. 646 (1983)

Justice POWELL delivered the opinion of the Court.

Petitioner Raymond Dirks received material nonpublic information from "insiders" of a corporation with which he had no connection. He disclosed this information to investors who relied on it in trading in the shares of the corporation. The question is whether Dirks violated the antifraud provisions of the federal securities laws by this disclosure.

In 1973, Dirks was an officer of a New York broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors. On March 6, Dirks received information from Ronald Secrist, a former officer of Equity Funding of America. Secrist alleged that the assets of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds, were vastly overstated as the result of fraudulent corporate practices. Secrist also stated that various regulatory agencies had failed to act on similar charges made by Equity Funding employees. He urged Dirks to verify the fraud and disclose it publicly.

Dirks decided to investigate the allegations. He visited Equity Funding's headquarters in Los Angeles and interviewed several officers and employees of the corporation. The senior management denied any wrongdoing, but certain corporation employees corroborated the charges of fraud. Neither Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors. Some of these persons sold their holdings of Equity Funding securities, including five investment advisers who liquidated holdings of more than $16 million.

While Dirks was in Los Angeles, he was in touch regularly with William Blundell, the *Wall Street Journal*'s Los Angeles bureau chief. Dirks urged Blundell to write a story on the fraud allegations. Blundell did not believe, however, that such a massive fraud could go undetected and declined to write the story. He feared that publishing such damaging hearsay might be libelous.

During the two-week period in which Dirks pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell from $26 per share to less than $15 per share. This led the New York Stock Exchange to halt trading on March 27. Shortly thereafter California insurance authorities impounded Equity Funding's records and uncovered evidence of the fraud. Only then did the Securities and Exchange Commission (SEC) file a complaint against Equity Funding and only then, on April 2, did the *Wall Street Journal* publish a front-page story based largely on information assembled by Dirks. Equity Funding immediately went into receivership.

The SEC began an investigation into Dirks' role in the exposure of the fraud. After a hearing by an administrative law judge, the SEC found that Dirks had aided and abetted violations of § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b–5, 17 CFR § 240.10b–5 (1982), by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock. The SEC concluded: "Where 'tippees'—regardless of their motivation or occupation—come into possession of material 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." Recognizing, however, that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light," the SEC only censured him. . . .

In the seminal case of *In re Cady, Roberts & Co.,* 40 S.E.C. 907 (1961), the SEC recognized that the common law in some jurisdictions imposes on "corporate 'insiders,' particularly officers, directors, or controlling stockholders" an "affirmative duty of disclosure ... when dealing in securities." The SEC found that not only did breach of this common-law duty also establish the elements of a Rule 10b–5 violation, but that individuals other than corporate insiders could be obligated either to disclose material nonpublic information before trading or to abstain from trading altogether. In *Chiarella,* we accepted the two elements set out in *Cady, Roberts* for establishing a Rule 10b–5 violation: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." In examining whether Chiarella had an obligation to disclose or abstain, the Court found that there is no general duty to disclose before trading on material nonpublic information, and held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." Such a duty arises rather from the existence of a fiduciary relationship.

Not "all breaches of fiduciary duty in connection with a securities transaction," however, come within the ambit of Rule 10b–5. There must also be "manipulation or deception." In an inside-trading case this fraud derives from the "inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 43 S.E.C. 933, 936 (1968). Thus, an insider will be liable under Rule 10b–5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes "secret profits." *Cady, Roberts,* 40 S.E.C., at 916, n.31.

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." This requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts in policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. In view of this absence, it has been unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information.

The SEC's position, as stated in its opinion in this case, is that a tippee "inherits" the *Cady, Roberts* obligation to shareholders whenever he receives inside information from an insider:

> "In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public material information from insiders become 'subject to the same duty as [the] insiders.' *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* [495 F.2d 228, 237 (CA2 1974) (quoting *Ross v. Licht,* 263 F.Supp. 395, 410 (SDNY 1967))]. Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof.... Presumably, Dirks' informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice. However, Dirks—standing in their shoes—committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed the information on to traders."

This view differs little from the view that we rejected as inconsistent with congressional intent in *Chiarella.* In that case, the Court of Appeals agreed with the SEC and affirmed Chiarella's conviction, holding that "'[*a*]*nyone* —corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.'" Here, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.

In effect, the SEC's theory of tippee liability in both cases appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information. Judge Wright correctly read our opinion in *Chiarella* as repudiating any notion that all traders must enjoy equal information before trading: "[T]he 'information' theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws." 220 U.S. App. D.C., at 322, 681 F.2d, at 837. We reaffirm today that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. See 15 U.S.C. § 78t(b) (making it unlawful to do indirectly "by means of any other person" any act made unlawful by the federal securities laws). Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are "as forbidden" as transactions "on behalf of the trustee himself." *Mosser v. Darrow,* 341 U.S. 267, 272 (1951). As the Court explained in *Mosser,* a contrary rule "would open up opportunities for devious dealings in the name of the others that the trustee could not conduct in his own." 341 U.S., at 271. Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty. As we noted in *Chiarella,* "[t]he tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly.* And for Rule 10b–5 purposes, the insider's disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach. As Commissioner Smith perceptively observed in *Investors Management Co.:* "[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information. . . ." Tipping thus properly is viewed only as a means of indirectly violating the *Cady, Roberts* disclose-or-abstain rule.

In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider's *Cady, Roberts* duty is when insiders disclose information to analysts. In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear—either to the corporate insider or to the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. This standard was identified by the SEC itself in *Cady, Roberts:* a purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach. As Commissioner Smith stated in *Investors Management Co.:* "It is important in this type of case to focus on policing insiders and what they do . . . rather than on policing information *per se* and its possession. . . ."

The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned. In determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds. Scienter in some cases is relevant in determining whether the tipper has violated his *Cady, Roberts* duty. But to determine whether the disclosure itself "deceive[s], manipulate[s], or defraud[s]" shareholders, *Aaron v. SEC,* 446 U.S. 680, 686, the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i.e.,* whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings. *Cf.* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 Harv. L. Rev. 324, 348 (1979) ("The theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself. . . ."). There are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. But it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain. In contrast, the rule adopted by the SEC in this case would have no limiting principle.

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirk's sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their *Cady, Roberts* duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the *Wall Street Journal.*

It is clear that neither Secrist nor the other Equity Funding employees violated their *Cady, Roberts* duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Dirks therefore could not have been "a participant after the fact in [an] insider's breach of a fiduciary duty." *Chiarella,* 445 U.S., at 230, n.12. . . .

Problem 4-2
According to the Supreme Court, what is the mens rea required for tippee liability, at least in a civil action? Is this problematic?

D. Misappropriation Theory

At this point in the case law, the Supreme Court has pretty much accepted the classical theory of insider trading as securities fraud. However, the classical theory left a fairly large gap in the types of traders who could be liable. For example, in *Chiarella*, Chiarella was a quasi-insider of Firm A who, through this relationship, gained inside information into Firms B and C, in whose stocks he eventually traded. Under the classical theory, Chiarella was not liable because he was not an insider or quasi-insider of Firms B and C.

In the next case, the Supreme Court not only blesses the theory of insider trading as securities fraud but also approves an expansion to include the "misappropriation" theory, which then covered future individuals like Chiarella. There is a disagreement here about how this theory can fit within the concept of fraud and the language of 10b-5. Think about the policy problem (how to get the law to cover people like Chiarella and the defendant in this next case) and how to accommodate policy goals within the language of 10b-5 and a theory of fraud.

UNITED STATES v. O'HAGAN, 521 U.S. 642 (1997)

Justice GINSBURG delivered the opinion of the Court.

This case concerns the interpretation and enforcement of § 10(b) and § 14(e) of the Securities Exchange Act of 1934, and rules made by the Securities and Exchange Commission pursuant to these provisions, Rule 10b–5 and Rule 14e–3(a). . . . The first [question] relates to the misappropriation of material, nonpublic information for securities trading; the second concerns fraudulent practices in the tender offer setting. In particular, we address and resolve these issues: (1) Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b–5? . . .

Respondent James Herman O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988. Less than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options. By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor. O'Hagan also purchased, in September 1988, some 5,000 shares of Pillsbury common stock, at a price just under $39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million.

The Securities and Exchange Commission (SEC or Commission) initiated an investigation into O'Hagan's transactions, culminating in a 57–count indictment. The indictment alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, nonpublic information regarding Grand Met's planned tender offer. . . .

Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b–5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." *Chiarella v. United States,* 445 U.S. 222, 228 (1980). That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from . . .

tak[ing] unfair advantage of . . . uninformed . . . stockholders.'" The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b–5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this 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. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."

In this case, the indictment alleged that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock. This conduct, the Government charged, constituted a fraudulent device in connection with the purchase and sale of securities.

We agree with the Government that misappropriation, as just defined, satisfies § 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," Brief for United States 17, "dupes" or defrauds the principal.

We addressed fraud of the same species in *Carpenter v. United States,* 484 U.S. 19 (1987), which involved the mail fraud statute's proscription of "any scheme or artifice to defraud," 18 U.S.C. § 1341. Affirming convictions under that statute, we said in *Carpenter* that an employee's undertaking not to reveal his employer's confidential information "became a sham" when the employee provided the information to his co-conspirators in a scheme to obtain trading profits. A company's confidential information, we recognized in *Carpenter,* qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter,* constitutes fraud akin to embezzlement—"'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'" *Carpenter*'s discussion of the fraudulent misuse of confidential information, the

Government notes, "is a particularly apt source of guidance here, because [the mail fraud statute] (like Section 10(b)) has long been held to require deception, not merely the breach of a fiduciary duty."

Deception through nondisclosure is central to the theory of liability for which the Government seeks recognition. As counsel for the Government stated in explanation of the theory at oral argument: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure." . . .

We turn next to the § 10(b) requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security." This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. *See* Aldave, 13 Hofstra L. Rev., at 120 ("a fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons"). A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.

The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.

The Government notes another limitation on the forms of fraud § 10(b) reaches: "The misappropriation theory would not . . . apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." In such a case, the Government states, "the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)'s "in connection with" requirement would not be met.

Justice THOMAS' charge that the misappropriation theory is incoherent because information, like funds, can be put to multiple uses, *see post,* at 2221–2223 (opinion concurring in judgment in part and dissenting in part), misses the point. The Exchange Act was enacted in part "to insure the maintenance of fair and honest markets," 15 U.S.C. § 78b, and there is no question that fraudulent uses of confidential information fall within § 10(b)'s prohibition if the fraud is "in connection with" a securities transaction. It is hardly remarkable that a rule suitably applied to the fraudulent uses of certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money.

Justice THOMAS does catch the Government in overstatement. Observing that money can be used for all manner of purposes and purchases, the Government urges that confidential information of the kind at issue derives its value *only* from its utility in securities trading. Substitute "ordinarily" for "only," and the Government is on the mark.

Our recognition that the Government's "only" is an overstatement has provoked the dissent to cry "new theory." But the very case on which Justice THOMAS relies, *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.,* 463 U.S. 29 (1983), shows the extremity of that charge. In *State Farm,* we reviewed an agency's rescission of a rule under the same "arbitrary and capricious" standard by which the promulgation of a rule under the relevant statute was to be judged; in our decision concluding that the agency had not adequately explained its regulatory action, we cautioned that a "reviewing court should not attempt itself to make up for such deficiencies." Here, by contrast, Rule 10b–5's promulgation has not been challenged; we consider only the Government's charge that O'Hagan's alleged fraudulent conduct falls within the prohibitions of the Rule and § 10(b). In this context, we acknowledge simply that, in defending the Government's interpretation of the Rule and statute in this Court, the Government's lawyers have pressed a solid point too far, something lawyers, occasionally even judges, are wont to do.

The misappropriation theory comports with § 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. *See* 45 Fed. Reg. 60412 (1980) (trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets"). Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-á-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill. *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 356 (1979) ("If the market is thought to be systematically populated with . . . transactors [trading on the basis of misappropriated information] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages.").

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result. The misappropriation at issue here was properly made the subject of a § 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" securities transactions. . . .

Under the classical theory, the trader's duty is to the firm in whose securities he trades. Under the misappropriation theory, the trader's duty is to the source of his inside information. Note that most every individual who could be liable under the classical theory could also be liable under the misappropriation theory.

Problem 4-3

Construct simple but original fact patterns that represent each of the following types of violators:

(a) a classical insider who trades

(b) a classical tipper who tips another who trades

(c) a tippee of a classical tipper; the tippee trades

(d) a misappropriator who trades

(e) a misappropriating tipper who tips another who trades

(f) a tippee of a misappropriating tipper; the tippee trades

(g) a tippee who was tipped by another tippee who was tipped by a misappropriating tipper; the second tippee trades

(h) a person who trades on material nonpublic information but commits no violation

E. Recent Prosecutions and Wall Street

The following case summarizes the facts of former McKinsey CEO Rajat Gupta's prosecution and conviction, one in a recent wave of prosecutions by the U.S. Attorney in Manhattan that targeted hedge fund traders at varying levels of seniority.

Prosecutions included the convictions (and lengthy sentence) of fund owner Raj Rajaratnam, who is discussed in the next opinion, and several traders who worked at SAC Capital for renowned hedge fund boss Steven Cohen, as well as the SAC firm itself (which settled with the government). Cohen, who was extensively investigated but never personally prosecuted and is reporter to have been the inspiration for the main character in the Showtime series *Billions*, is back in the hedge fund business (with a new firm called Point72) and recently acquired the New York Mets. For entertaining book-length treatments of these investigations and prosecutions, see ANITA RAGHAVAN, THE BILLIONAIRE'S APPRENTICE (2013) (Rajaratnam and the Galleon fund), and SHEELA KOLHATKAR, BLACK EDGE (2017) (Cohen and SAC Capital).

As you read the materials in this part, consider the question of enforcement policy and discretion. What is DOJ trying to accomplish with these cases? Why is it doing them? Are they beneficial? In what way(s)? Leaving the doctrine aside, consider the social value, or lack thereof, of criminalizing and prosecuting insider trading.

UNITED STATES v. GUPTA, 747 F.3d 111 (2d Cir. 2014)

KEARSE, Circuit Judge:

Defendant Rajat Gupta ("Gupta") appeals from a judgment entered in the United States District Court for the Southern District of New York on November 9, 2012, following a jury trial before Jed S. Rakoff, Judge, convicting him on three counts of securities fraud, in violation of 15 U.S.C. §§ 78j(b) and 78ff, and one count of conspiracy to commit securities fraud, in violation of 18 U.S.C. § 371. . . .

At the times pertinent to this prosecution, Gupta was a member of the board of directors of The Goldman Sachs Group, Inc. ("Goldman Sachs" or "Goldman"), the global financial services firm headquartered in New York. Gupta was also involved in several financial ventures with Raj Rajaratnam (or "Raj"), founder of The Galleon Group ("Galleon"), a family of hedge funds that invested billions of dollars for its principals and clients. The present prosecution arose out of a multiyear government investigation of insider trading at Galleon which included court-authorized wiretaps of Rajaratnam's cell phone, *see United States v. Rajaratnam*, 719 F.3d 139, 144–45 (2d Cir. 2013), petition for cert. filed, No. 13-1001 (U.S. Feb. 18, 2014). . . .

All of the government's evidence that Gupta passed confidential information about Goldman Sachs to Rajaratnam, on the basis of which Rajaratnam made purchases or sales of Goldman stock, was circumstantial. Most of the evidence described below was presented through testimony from employees of Galleon or Goldman, wiretapped telephone calls between Rajaratnam and other Galleon employees, records of calls made to or from telephones used by Gupta or Rajaratnam, and records as to the timing of trades by Galleon in Goldman Sachs stock.

At 3:15 p.m. on September 23, 2008, Goldman Sachs held a special meeting of its board of directors. The purpose of the meeting was to approve an investment of $5 billion in Goldman by Warren Buffett. The imminent investment was highly confidential, as it was likely to have "a meaningful impact" on Goldman's stock price. It was to be announced to the public after the 4 p.m. close of trading on the New York Stock Exchange.

Gupta, a former managing director of the consulting firm McKinsey & Company ("McKinsey"), participated in the Goldman Sachs board meeting via telephone from a conference room at McKinsey's New York office. Telephone records indicated that Gupta was on the Goldman Sachs conference call from 3:13 p.m. until 3:53 p.m.

At approximately 3:54 p.m., Gupta's assistant, Renee Gomes, dialed Rajaratnam's direct line; the McKinsey conference room telephone from which Gupta had participated in the Goldman Sachs board meeting was then connected to the call to Rajaratnam's line. The connection between Rajaratnam's line and the telephone Gupta used lasted approximately 30 to 35 seconds.

Caryn Eisenberg, Rajaratnam's assistant in 2008–2009, testified that on September 23, 2008, she answered a call on his direct line at about 10 minutes before the 4:00 p.m. market close. As a general rule Eisenberg was not to put calls through to Rajaratnam near the end of the trading day, but she put the caller on hold, located Rajaratnam, and put the call through. Although at the time of trial Eisenberg no longer remembered the name of the man who was on the line, she testified that she put this call through because his name was on the short list of persons whose calls Rajaratnam would accept near the end of the trading day; she recognized his voice as that of a frequent caller; and the man said it was "urgent" that he "speak to Raj."

Rajaratnam took the call in his office and was on the telephone only briefly. Eisenberg testified that Rajaratnam thereafter summoned Galleon cofounder Gary Rosenbach into his office and the two had a closed-door conversation. Rosenbach then "went back to his desk," picked up his telephone, "and started saying buy Goldman Sachs."

Galleon trader Ananth Muniyappa testified that at approximately 3:56 p.m. on September 23, Rajaratnam, as he was hanging up his telephone, instructed Muniyappa, who was at his own desk nearby, to purchase 100,000 shares of Goldman Sachs stock. When Muniyappa determined that he would probably be unable to buy as many as 100,000 shares before the market's close (he managed to buy only a total of 67,200 shares), he quickly informed Rajaratnam, who promptly instructed Rosenbach to buy Goldman stock.

Rosenbach proceeded to buy 200,000 shares of the stock, 150,000 for Rajaratnam's portfolio—which specialized in technology stocks—and 50,000 for Rosenbach's own portfolio. Rosenbach also bought 1.5 million shares (1,000,000 for Rajaratnam's portfolio and 500,000 for his own) of a financial-sector index fund made up of stocks of several institutions, including Goldman. Each of these trades was made in the final "three to four minutes" of the trading day (Tr. 401), i.e., between approximately 3:56 p.m. and 4:00 p.m. In all, the Goldman Sachs stock purchased by Muniyappa and Rosenbach at the behest of Rajaratnam in the final minutes of the trading day on September 23—excluding the shares of the index fund—cost more than $33 million.

Warren Buffett's $5 billion investment in Goldman Sachs was announced at approximately 6:00 p.m. on September 23. The next morning, Goldman's stock price rose to a high nearly 7% above its September 23 closing price. A government witness testified that the profits on the above Galleon purchases of Goldman stock at the end of the trading day on September 23 exceeded $1 million.

Eisenberg testified that after Rajaratnam took the urgent call near the close of trading on September 23 he was smiling more than usual. But not everyone at Galleon was happy. Leon Shaulov was a Galleon trader and portfolio manager. Muniyappa did not buy any Goldman Sachs stock for Shaulov on September 23. Muniyappa testified that that evening, shortly after Goldman announced the Warren Buffett investment, Shaulov sent Rosenbach an email saying, "Thanks for the heads up, by the way. I'm short 170 million in financials. Not one word from anyone. Thank you very much. All I get is sick dilution. Zero help. Zero." . . .

On the morning of September 24, 2008, before the stock markets opened, Rajaratnam placed two calls from his cell phone (which was wiretapped) to Ian Horowitz, his principal trader. In the first call, at 7:09 a.m., Rajaratnam began to tell Horowitz about the events of the previous afternoon:

> RAJ RAJARATNAM: .... So, big drama yesterday, but I have to....
>
> IAN HOROWITZ: Yeah, I, I, I heard.
>
> RAJ RAJARATNAM: Hum.
>
> IAN HOROWITZ: I heard a little, um, you mean the last three minutes of the day?
>
> RAJ RAJARATNAM: No, I got a call at 3:58, right?
>
> IAN HOROWITZ: Yeah.
>
> RAJ RAJARATNAM: Saying something good might happen to Goldman. Right?
>
> IAN HOROWITZ: So it is what it is. Everything's, everyone's fine, I saw it cross the board....
>
> RAJ RAJARATNAM: No I saw, I, so, I told Ananth [Muniyappa] to buy some, he was fucking around, he can't, you know. So I went to Gary [Rosenbach] and said just buy me, right?
>
> IAN HOROWITZ: Mm hmm.
>
> RAJ RAJARATNAM: Because you were not there. It happens all the fucking time, you know you're there every day of the year, right? ....

Rajaratnam called Horowitz again at 7:56 a.m. After asking how much Goldman Sachs stock Galleon currently owned, Rajaratnam continued his report on the previous afternoon's events:

> RAJ RAJARATNAM: Okay, yeah, let me tell you what happened, honestly, right?
>
> IAN HOROWITZ: Yeah, no, I looked at our price, I looked at our price, and I looked at what happened.
>
> RAJ RAJARATNAM: Yeah.
>
> IAN HOROWITZ: Someone had this before us, someone, whatever went on, something happened, someone, they ...
>
> RAJ RAJARATNAM: I got a call, right, saying something good's gonna happen.
>
> IAN HOROWITZ: We'll talk about, how 'bout this, we'll talk when you come in.
>
> RAJ RAJARATNAM: Okay.
>
> IAN HOROWITZ: We'll talk when you come in, okay?

> RAJ RAJARATNAM: But I didn't do anything, you were not there, I asked Ananth to buy some.
>
> IAN HOROWITZ: You did nothing.
>
> RAJ RAJARATNAM: Then I went to Gary ... and ...
>
> IAN HOROWITZ: You did nothing wrong.
>
> RAJ RAJARATNAM: Yeah at 3:58, I can't, I can't yell out in the fucking halls.
>
> IAN HOROWITZ: No. You did nothing wrong, we'll talk about it when you come in, nothing's wrong.
>
> RAJ RAJARATNAM: It is, I guess, Leon [Shaulov] was very upset. You know, fuck him, look, I've kept my mouth shut when he gave me WaMu, right?
>
> IAN HOROWITZ: Get, get upset about what? You got nothing, this is at 3:58.
>
> RAJ RAJARATNAM: Yeah, if it was, one o'clock, I always am good with him, I always call him in, I tell him everything, you know? AMD, IBM, everything, right?
>
> IAN HOROWITZ: He's not in, so I'm, he hasn't said anything. Listen, if something comes in, I'll let you know.

On October 23, 2008, more than halfway through the fourth quarter of Goldman Sachs's fiscal year, Goldman's chairman convened an unofficial board meeting by conference call to bring the directors up-to-date on company events. At that time, Wall Street analysts were projecting that Goldman—which, since becoming a public company, had never reported a quarterly loss—would continue to report profits. In the conference call, which began at 4:15 p.m., Goldman's management informed the board that the company's fourth-quarter result would be a loss.

Records were introduced to show that Gupta, on a telephone in his home office, participated in the Goldman Sachs conference call for approximately 33 minutes and disconnected at 4:49 p.m. At 4:50 p.m., a call was placed from the telephone of Gupta's assistant Renee Gomes to the direct office line of Rajaratnam; Gupta's home office line was conferenced in to that call, and Gomes's line was disconnected. Gupta's home office telephone was connected to Rajaratnam's direct line for some 12 ½ minutes, until 5:03 p.m.

The next morning, October 24, 2008, in three transactions, Rajaratnam sold a total of 150,000 shares of Goldman Sachs stock. The first 50,000 shares were sold at 9:31 a.m., one minute after the stock market opened—the first opportunity to trade in Goldman shares since the board meeting the previous day. Another 50,000 shares were sold at 10:09 a.m.; and the final 50,000 shares were sold at 10:37 a.m. Goldman Sachs's fourth-quarter losses were not announced to the public until December 16. Based on the decline in Goldman's stock price after that announcement, the government introduced calculations showing that Rajaratnam, by selling his shares on October 24, avoided a loss of more than $3.8 million.

At 12:12 p.m. on October 24, Rajaratnam returned a call to David Lau, a Singapore-based portfolio manager for Galleon International, one of Galleon's hedge funds. Lau had sought to reach Rajaratnam for general investment advice. Galleon International invested in non-U.S. securities primarily (see Tr. 1467), but not exclusively (see id. at 2415); and it had in the past owned stock in Goldman (see GX 90). The conversation began with Rajaratnam advising that, as a general matter, it would be safer to invest in United States companies than in emerging market countries:

> RAJ RAJARATNAM: Hey David, you called?
>
> DAVID LAU: Yeah, just to give me, give me a, find the pulse because we are quite shocked overseas and uh long bonds, I mean quite shocked in relative for the VAR ... because VAR broke out, blew out and our positions are the same so I just want to find out what you guys are thinking.
>
> RAJ RAJARATNAM: Yeah, I mean, I think, ah we think that the US is um relatively the safe haven, right.
>
> DAVID LAU: Um.
>
> RAJ RAJARATNAM: Because all of these um emerging market ah countries, many of them have to reduce interest rates, which is bad for their currencies, right.
>
> DAVID LAU: Um um um.
>
> RAJ RAJARATNAM: And, I mean today for example there is a reasonable calmness in the market you know the market is only down 2 or 3%, right.
>
> DAVID LAU: Yeah, that's why I'm surprised. I thought it would go nuts.
>
> RAJ RAJARATNAM: Yeah I mean our risk here is ah hedge fund redemption risk, right Citadel I hear is in trouble, you know, and things like that but I think generally, not that I want to be long equities, but generally I think one trade in equities would be, you know, buy the Spiders and short the EEMs or something, you know.
>
> DAVID LAU: Hmm Hmm.
>
> RAJ RAJARATNAM: But it looks like here the most cyclical companies the semi equipment companies, and the home builders are the ones that are leading the way out right.
>
> DAVID LAU: Right.

Rajaratnam then proceeded to describe to Lau the confidential negative information he had received the previous day "from somebody who's on the Board of Goldman Sachs," which "they don't report until December." Rajaratnam noted the current optimistic view of Wall Street analysts of Goldman Sachs's likely profits, and he described the potential for selling the stock short:

> RAJ RAJARATNAM: Um, now I, I heard yesterday from somebody who's on the Board of Goldman Sachs, that they are gonna lose $2 per share. The Street has them making $2.50.
>
> DAVID LAU: Really?
>
> RAJ RAJARATNAM: You know. Yeah. Now I can get that number, you know, one, they don't report until December, they, I think their quarter ends in November, but (UI [i.e., unintelligible]) one more, but you know they have these huge marks in ICBC and all of that stuff right. That uh is getting absolutely clobbered. You know.
>
> DAVID LAU: Right.
>
> RAJ RAJARATNAM: So what he was telling me was that uh, Goldman, the quarter's pretty bad. They have zero revenues because their trading revenues are offset by asset losses, and to date they have lost $2 per share, they just announced a 10% cut and uh you know, the basic business is ok but uh you know this is uh tough for them. I don't think that's built into Goldman Sachs stock price. So if it gets to $105, I'm gonna, it's $99 now, it was at $102. I was looking for $105, I'm gonna whack it you know.
>
> DAVID LAU: (Laughs) Okay. Okay. Okay (UI) ...
>
> RAJ RAJARATNAM: Okay, I don't think it makes sense to take longer term views right now....

The government also presented evidence that Gupta and Rajaratnam had a close relationship. Gupta described Rajaratnam as a "close friend[ ]"—indeed, "a very close friend"—and was in frequent communication with him. Rajaratnam's address book noted Gupta as a "Good friend." Rajaratnam had instructed Eisenberg that there were only five people she was authorized to connect with him near the end of the trading day; Gupta was one of them. (during the two years when Eisenberg was Rajaratnam's assistant, the list was expanded to about 10 names)

Gupta and Rajaratnam were also involved in several business ventures together. In 2005, they, along with a third partner, formed Voyager Capital Partners Ltd. ("Voyager"), an investment fund capitalized with $50 million, $5 million of which was contributed by Gupta and $40 million by Rajaratnam; Gupta later borrowed $5 million from Rajaratnam in order to buy out the third partner's share (see Tr. 1858–59), giving Gupta a $10 million stake in Voyager. Other collaborations were discussed in a July 29, 2008 call from Gupta to Rajaratnam—the only call between these two that was captured in the wiretaps. In 2007, Gupta, Rajaratnam, and two others launched another investment fund, New Silk Route, in which Rajaratnam invested $50 million (see id. at 8); Gupta was the chairman. Gupta was also heavily involved in Galleon itself. He had invested several million dollars in Galleon funds; he was involved in the planning of a new Galleon fund called Galleon Global (which ultimately was not created); he had a keycard allowing him access to Galleon's New York offices; and he regularly worked on Galleon's behalf in seeking potential investors. In early 2008, Gupta was made chairman of Galleon International, which, as of April 2008, managed assets totaling some $1.1 billion and could earn “performance fees”. Gupta was given a 15 percent ownership stake.

In the July 2008 Gupta–Rajaratnam Call, Rajaratnam asked Gupta about a rumor that Goldman Sachs might seek to buy a commercial bank. Gupta responded that there had been “a big discussion” of that possibility, in particular with respect to “Wachovia,” as well as of the possibility of buying an insurance company, in particular “AIG.” Gupta said the Goldman board was divided and that such purchases were unlikely to be “imminent,” but that if certain banks were “a good deal ... it’s quite conceivable they’d come and say let’s go buy” one. The board’s discussions were confidential. Even the matter of whether or not a subject had been discussed at a Goldman board meeting was confidential.

Gupta called several witnesses in his defense. Most were character witnesses who testified that they believed Gupta to be an honest person; Gupta also sought to have them testify that he had “integrity” and thus would not have been inclined to share inside information with Rajaratnam. Gupta’s daughter Geetanjali Gupta (“Geetanjali”) testified about certain conversations Gupta had with her about Rajaratnam, and sought to indicate that Gupta would not have been inclined to share inside information with Rajaratnam because Gupta believed Rajaratnam had cheated him out of money with respect to the Voyager investment. Gupta also sought to introduce documentary evidence suggesting that a different Goldman Sachs insider was giving Rajaratnam confidential information about Goldman Sachs, and that Gupta contemplated leaving a substantial portion of his wealth to charity. . . .

The jury found Gupta guilty on four of the six counts against him: Count One, conspiracy to commit securities fraud in violation of 18 U.S.C. § 371, and three substantive counts of securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff The substantive securities fraud convictions were on Count Three, based on Rosenbach’s purchase of 150,000 shares of Goldman Sachs stock for Rajaratnam on September 23, 2008; Count Four, based on Muniyappa’s purchase of 67,200 shares of Goldman Sachs stock for Rajaratnam on September 23, 2008; and Count Five, based on Rajaratnam’s sale of 150,000 shares of Goldman Sachs stock on October 24, 2008. . . .

[The court rejected all of Gupta’s claims on appeal, all of which had to do with the trial court’s admission and non-admission of a variety of forms of evidence, and affirmed his conviction.]

Problem 4-4

Rajat Gupta was born in modest circumstances in Calcutta, India. His father, a journalist, was imprisoned and beaten for supporting Gandhi's movement. Gupta worked to gain admission to the most elite schools in India and the United States, including Harvard Business School. He rose through the ranks to become the first foreign-born CEO at the vaunted McKinsey consulting firm. He donated large portions of his wealth to causes including global health and education in India, and founded several important institutions in India.

The foreperson of the jury at Gupta's trial called him an example of the American dream, who had lived a "storybook life," and said that the jurors "were hoping he would walk out" of the courthouse but found the evidence too overwhelming not to return a guilty verdict. *See* William Alden & Azam Ahmed, *A Conflicted Jury Finds Rajat Gupta Guilty*, N.Y. TIMES DEALBOOK (June 15, 2012), https://dealbook.nytimes.com/2012/06/15/a-conflicted-jury-finds-rajat-gupta-guilty/?mtrref=www.google.com&gwh=671D1837015A84598509BD09A193D5D1&gwt=regi&assetType=REGIWALL.

Why did Gupta do what he did, especially in light of the fact that he did not share in the profits of the trades charged in his case? Does his case afford any insight on the general problem of insider trading?

And then we have, in the civil enforcement context, the battle between Mark Cuban and the SEC, which involved Rule 10b5-2 (not to be confused with Rule 10b-5), by which the SEC has sought to further specify the scope of duties for purposes of misappropriation cases. Cuban won, as you will see.

Rule 10b5-2. Duties of trust or confidence in misappropriation insider trading cases.

This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.

(a) Scope of Rule. This section shall apply to any violation of Section 10(b) of the Act (15 U.S.C. 78j(b)) and §240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) Enumerated "duties of trust or confidence." For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:

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

(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the

information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or

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

Problem 4-5
What is the SEC's statutory authority for Rule 10b5-2? Is this problematic?

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

PATRICK E. HIGGINBOTHAM, Circuit Judge:

This case raises questions of the scope of liability under the misappropriation theory of insider trading. Taking a different view from our able district court brother of the allegations of the complaint, we are persuaded that the case should not have been dismissed under Fed. R. Civ. P. 9(b) and 12 and must proceed to discovery.

Mark Cuban is a well known entrepreneur and current owner of the Dallas Mavericks and Landmark theaters, among other businesses. The SEC brought this suit against Cuban alleging he violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b–5 by trading in Mamma.com stock in breach of his duty to the CEO and Mamma.com—amounting to insider trading under the misappropriation theory of liability. The core allegation is that Cuban received confidential information from the CEO of Mamma.com, a Canadian search engine company in which Cuban was a large minority stakeholder, agreed to keep the information confidential, and acknowledged he could not trade on the information. The SEC alleges that, armed with the inside information regarding a private investment of public equity (PIPE) offering, Cuban sold his stake in the company in an effort to avoid losses from the inevitable fall in Mamma.com's share price when the offering was announced.

Cuban moved to dismiss the action under Rule 9(b) and 12(b)(6). The district court found that, at most, the complaint alleged an agreement to keep the information confidential, but did not include an agreement not to trade. Finding a simple confidentiality agreement to be insufficient to create a duty to disclose or abstain from trading under the securities laws, the court granted Cuban's motion to dismiss. The SEC appeals, arguing that a confidentiality agreement creates a duty to disclose or abstain and that, regardless, the confidentiality agreement alleged in the complaint also contained an agreement not to trade on the information and that agreement would create such a duty. . . .

While O'Hagan did not set the contours of a relationship of "trust and confidence" giving rise to the duty to disclose or abstain and misappropriation liability, we are tasked to determine whether Cuban had such a relationship with Mamma.com. The SEC seeks to rely on Rule 10b5–2(b)(1), which states that a person has "a duty of trust and confidence" for purposes of misappropriation liability when that person "agrees to maintain information in confidence." In dismissing the case, the district court read the complaint to allege that Cuban agreed not to disclose any confidential information but did not agree not to trade, that such a confidentiality agreement was insufficient to create a duty to disclose or abstain from trading under the misappropriation theory, and that the SEC overstepped its authority under section 10(b) in issuing Rule 10b5–2(b)(1). We differ from the district court in reading the complaint and need not reach the latter issues.

The complaint alleges that, in March 2004, Cuban acquired 600,000 shares, a 6.3% stake, of Mamma.com. Later that spring, Mamma.com decided to raise capital through a PIPE offering on the advice of the investment bank Merriman Curhan Ford & Co. At the end of June, at Merriman's suggestion, Mamma.com decided to invite Cuban to participate in the PIPE offering. "The CEO was instructed to contact Cuban and to preface the conversation by informing Cuban that he had confidential information to convey to him in order to make sure that Cuban understood—before the information was conveyed to him—that he would have to keep the information confidential."

After getting in touch with Cuban on June 28, Mamma.com's CEO told Cuban he had confidential information for him and Cuban agreed to keep whatever information the CEO shared confidential. The CEO then told Cuban about the PIPE offering. Cuban became very upset "and said, among other things, that he did not like PIPEs because they dilute the existing shareholders." "At the end of the call, Cuban told the CEO 'Well, now I'm screwed. I can't sell."

The CEO told the company's executive chairman about the conversation with Cuban. The executive chairman sent an email to the other Mamma.com board members updating them on the PIPE offering. The executive chairman included:

> Today, after much discussion, [the CEO] spoke to Mark Cuban about this equity raise and whether or not he would be interested in participating. As anticipated he initially "flew off the handle" and said he would sell his shares (recognizing that he was not able to do anything until we announce the equity) but then asked to see the terms and conditions which we have arranged for him to receive from one of the participating investor groups with which he has dealt in the past.

The CEO then sent Cuban a follow up email, writing "'[i]f you want more details about the private placement please contact ... [Merriman].'"

Cuban called the Merriman representative and they spoke for eight minutes. "During that call, the salesman supplied Cuban with additional confidential details about the PIPE. In response to Cuban's questions, the salesman told him that the PIPE was being sold at a discount to the market price and that the offering included other incentives for the PIPE investors." It is a plausible inference that Cuban learned the off-market prices available to him and other PIPE participants.

With that information and one minute after speaking with the Merriman representative, Cuban called his broker and instructed him to sell his entire stake in the company. Cuban sold 10,000 shares during the evening of June 28, 2004, and the remainder during regular trading the next day.

That day, the executive chairman sent another email to the board, updating them on the previous day's discussions with Cuban, stating "'we did speak to Mark Cuban ([the CEO] and, subsequently, our investment banker) to find out if he had any interest in participating to the extent of maintaining his interest. His answers were: he would not invest, he does not want the company to make acquisitions, he will sell his shares which he cannot do until after we announce.'"

After the markets closed on June 29, Mamma.com announced the PIPE offering. The next day, Mamma.com's stock price fell 8.5% and continued to decline over the next week, eventually closing down 39% from the June 29 closing price. By selling his shares when he did, Cuban avoided over $750,000 in losses. Cuban notified the SEC that he had sold his stake in the company and publicly stated that he sold his shares because Mamma.com "was conducting a PIPE, which issued shares at a discount to the prevailing market price and also would have caused his ownership position to be diluted." . . .

In isolation, the statement "Well, now I'm screwed. I can't sell" can plausibly be read to express Cuban's view that learning the confidences regarding the PIPE forbade his selling his stock before the offering but to express no agreement not to do so. However, after Cuban expressed the view that he could not sell to the CEO, he gained access to the confidences of the PIPE offering. According to the complaint's recounting of the executive chairman's email to the board, during his short conversation with the CEO regarding the planned PIPE offering, Cuban requested the terms and conditions of the offering. Based on this request, the CEO sent Cuban a follow up email providing the contact information for Merriman. Cuban called the salesman, who told Cuban "that the PIPE was being sold at a discount to the market price and that the offering included other incentives for the PIPE investors." Only after Cuban reached out to obtain this additional information, following the statement of his understanding that he could not sell, did Cuban contact his broker and sell his stake in the company.

The allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement. By contacting the sales representative to obtain the pricing information, Cuban was able to evaluate his potential losses or gains from his decision to either participate or refrain from participating in the PIPE offering. It is at least plausible that each of the parties understood, if only implicitly, that Mamma.com would only provide the terms and conditions of the offering to Cuban for the purpose of evaluating whether he would participate in the offering, and that Cuban could not use the information for his own personal benefit. It would require additional facts that have not been put before us for us to conclude that the parties could not plausibly have reached this shared understanding. Under Cuban's reading, he was allowed to trade on the information but prohibited from telling others—in effect providing him an exclusive license to trade on the material nonpublic information. Perhaps this was the understanding, or perhaps Cuban mislead the CEO regarding the timing of his sale in order to obtain a confidential look at the details of the PIPE. We say only that on this factually sparse record, it is at least equally plausible that all sides understood there was to be no trading before the PIPE. That both Cuban and the CEO expressed the belief that Cuban could not trade appears to reinforce the plausibility of this reading.

The *Cuban* case proceeded to a trial, after which a jury found Cuban not liable. The *Cuban* matter demonstrates just how difficult it can be for the government to win even a civil enforcement case that amounts to a "he said, she said" situation. To prevail, the SEC needed to prove to the jury that Cuban breached his duty to Mamma.com by breaking his alleged agreement to keep the company's impending offering secret. Without a confidentiality agreement, the jury was left to compare the prerecorded testimony of Guy Faure, the former Mamma.com CEO, with the live testimony of Cuban himself. At the end of the day, the result may have turned on Cuban's charisma as much as the law.[24]

Here is another case arising out of the government's recent wave of insider trading prosecutions. It is a case with facts that any beginning or aspiring lawyer must never forget.

UNITED STATES v. GOFFER, 721 F.3d 113 (2d Cir. 2013)

WESLEY, Circuit Judge:

[Defendants Zvi] Goffer, [Michael] Kimelman, and [Craig] Drimal, along with non-party defendants, conducted a double-blind, high-volume insider trading network that led the participants to acquire over $10 million in profits. Goffer, who worked as a proprietary trader at the Schottenfeld Group, LLC ("Schottenfeld"), spearheaded the conspiracy.

In 2007, Drimal traded from the offices of the Galleon Group ("Galleon"), a firm led by Raj Rajaratnam. Kimelman, previously an attorney at a New York law firm, traded for Quad Capital ("Quad"), a proprietary trading firm. In late 2007, Kimelman, Goffer, and Goffer's brother Emanuel established a new trading firm, Incremental Capital ("Incremental"), though they retained their other positions. In early 2008, Kimelman left Quad to trade with Emanuel, and Goffer began trading at Galleon. Kimelman and Goffer spoke often and shared information that led them to trade in the same stocks. In 2007 and 2008, Kimelman and Goffer traded 151 stocks within five days of each other, including 88 stocks that they both traded on the same day.

In the summer of 2007, Arthur Cutillo and Brian Santarlas, attorneys at Ropes & Gray LLP, met with Jason Goldfarb, a workers' compensation attorney who had attended law school with Cutillo. Goldfarb indicated to the Ropes & Gray attorneys that he had a friend who traded stocks and would pay for information about corporate acquisitions. The Government showed at trial that Goffer was this friend. What followed was a

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[24] For more on the Cuban trial, see Andrew Harris and Tom Korosec, *SEC Loses as Mark Cuban Triumphs in Insider-Trading Trial*, BLOOMBERG (Oct. 17, 2013), https://www.bloomberg.com/news/articles/2013-10-16/billionaire-mark-cuban-found-not-liable-in-sec-lawsuit.

series of "tips" in which Cutillo and/or Santarlas would obtain material non-public information and pass it to Goldfarb, who, in turn, would pass it to Goffer. Goffer distributed these "tips," which frequently related to impending takeovers, to friends and partners. Based on these tips, Goffer and his co-conspirators would acquire positions in the targeted companies and profit from the takeover's effect on the share price.

Goffer's network used prepaid cellular telephones to avoid detection; these phones—used by the attorneys and the traders—were destroyed after each successful tip. Throughout the relevant time period, Goffer spoke with coconspirators, especially Kimelman, guardedly when on the phone. For instance, he described the P.F. Chang's tip as "a good thing" but "nothing I'm going to talk about on the telephone." Goffer often asked Kimelman to meet in person or "in the street" when conveying sensitive information. They also discussed countermeasures and ways to avoid detection, suspecting that high-volume trades in little-traded companies immediately prior to their acquisition could raise regulatory eyebrows. Goffer relied on Kimelman to provide him with insights into the meaning of legal documents associated with the acquisitions, including revised merger agreements, settlement agreements, signature pages, and limited guarantees, *inter alia.*

The first tip presented at trial related to Bain Capital's bid to acquire 3Com. When Cutillo and Santarlas learned about the progress of the deal—for example, by finding documents entitled "closing agenda" or "signature papers" on Ropes & Gray's document management system or on a communal printer—they reported this progress to Goldfarb, who passed it on to Goffer. Goffer shared information relating to the takeover bid with some of his coconspirators. Goffer frequently convened a group of co-conspirator traders (typically including Emanuel, Kimelman, and David Plate, another Schottenfeld trader) at a bar where the group would discuss the progress of the takeover bid and any new information that Goffer had received regarding the plans.

On August 7, 2007, Goffer, Drimal, Emanuel, and Plate began acquiring 3Com stock based on the material nonpublic information that Goffer received from Goldfarb. That evening, Goffer had a 25–minute phone conversation with Kimelman. The next day, Kimelman purchased 94,200 shares of 3Com stock. That week, forbidden from purchasing more 3Com stock by Quad's risk management team, Kimelman sent an otherwise wordless email to Goffer into which he had pasted an instant message conversation with Quad's risk management expert.

Goffer also provided details about the acquisition and the sources of his information to Drimal; Drimal passed both on to David Slaine, a cooperating witness. Drimal explained that the information came from an attorney from "Ropeson" who risked "his whole . . . career and maybe going to jail" by sharing these tips.

On September 27, 2007, Goffer told Plate and other coconspirators that the acquisition of 3Com would happen the next day. Goffer had learned that the signature papers were prepared and he confirmed with Kimelman, who verified, based on his background as an attorney, that signature papers "were what they sounded like; they were something that took place at the end of a deal." Kimelman was either present or was consulted over the phone. Bain announced its acquisition of 3Com the next day; the co-conspirators all profited. Goffer told Plate that he needed to pay his source, and identified those who were contributing (including Drimal); the co-conspirators paid Santarlas, Cutillo, and Goldfarb $25,000 each.

In November 2007, Santarlas overheard other Ropes & Gray associates discussing a client's upcoming acquisition of Axcan. Santarlas, who did not work on mergers and acquisitions, accessed at least four documents on the Ropes & Gray document management system relating to the acquisition; he and Cutillo shared the tip with Goldfarb. Goldfarb passed the attorneys' information to Goffer, who disseminated it (at a minimum) to Drimal and Slaine. Drimal shared the information with Michael Cardillo, a Galleon trader, though he again attributed the tip to "Ropeson" attorneys. Drimal and Plate purchased Axcan stock and benefitted from the Axcan acquisition announced on November 29, 2007; Drimal gained $1,984,867. Goffer did not trade Axcan because it was a small, rarely-traded stock and he did not want to attract regulatory attention.

In February 2008, Santarlas learned about a possible takeover of P.F. Chang's China Bistro, Inc. ("P.F.Chang's") from a colleague; he conveyed this information to Goldfarb, who shared it with Goffer. A few days later Goffer called Kimelman to seek his advice, but noted that it was "nothing I'm going to talk about on the telephone." Kimelman agreed to come into Manhattan to "figure out our plan of attack." Goffer, Emanuel, and Kimelman decided to purchase P.F. Chang's stock as part of an acquisition of a broad restaurant portfolio to disguise their use of the inside information. Goffer instructed the group that "everything's got to be printed out" to help them "go about . . . justifying a trade." No P.F. Chang's acquisition was announced in 2008.

In March 2008, Cutillo and Santarlas observed that deal documents for Bain Capital's acquisition of Clear Channel Communications, Inc. ("Clear Channel") were laid out in a "closing room" at the law firm, apparently ready for execution, and reported that closing was imminent. Unbeknownst to these tippers, neither of whom worked on the deal, the Clear Channel acquisition was staged so that the lenders could be sued for specific performance. When the deal did not close as anticipated, Goffer, Kimelman, and Drimal all suffered losses on their Clear Channel investments.

In May, there was more Clear Channel activity at the Ropes & Gray offices. Cutillo passed the information to Goldfarb, who told Goffer. Goffer summoned Kimelman for an "urgent meeting;" immediately afterwards, he called another trader and told him to purchase Clear Channel call options for "everybody." Over the next two business days, Clear Channel publicly announced that it was in settlement talks with the lenders and that an amended merger agreement had been reached. The market reacted favorably to this news and Goffer earned over $1 million in profits in his Galleon account trading on this tip.

Schottenfeld trader Gautham Shankar provided several tips to Goffer, including acquisitions of Kronos, Inc. and Hilton Hotels Corp. ("Hilton"). Goffer, Kimelman, Drimal, and Emanuel benefitted from trading on this inside information. Profits from these illegal trades were included in calculating the loss amount for sentencing purposes, but the trades were not charged at trial.

In the fall of 2007, Goffer and Kimelman recruited David Slaine to join Incremental Capital. The co-conspirators hoped that Slaine, who unbeknownst to them was working as a cooperating witness after his own arrest for insider trading, would provide them with the financial backing to get their insider trading-fueled business off the ground. Kimelman urged Goffer to tell Slaine that he would "get great information" by investing with Incremental. Goffer mentioned that he had received tips about certain acquisitions before they happened, including 3Com, Axcan, and Hilton. Goffer jokingly told Slaine that the information came from a construction worker, but when pushed he elaborated “you [are] probably better off not knowing where they were coming from . . . [Y]ou don't want to know where it's coming from obviously.” Kimelman chimed in, asserting that the source was that “[g]uy fixing that pothole down there.” . . .

Kimelman challenges the sufficiency of the evidence supporting his substantive securities fraud conviction for his purchase of 15,000 shares of 3Com stock on August 10, 2007 and 5,000 shares of 3Com stock on September 25, 2007. Specifically, he contends that the Government did not prove that Goffer had tipped him about 3Com or that he knew or consciously avoided knowing that Goffer had material nonpublic information about 3Com that was disclosed in violation of a fiduciary duty. More specifically, he argues that the Government's main evidence, an unrecorded phone call he had with Goffer on August 7 and an email he wrote to Goffer on August 15, does not indicate that he received a tip from Goffer or knew that any such tip was based on illegally-disclosed information. He also insists that a discussion he had with the other co-conspirators on September 27, on the eve of the deal's announcement, cannot count as proof of his awareness of the earlier fraud. . . .

The Government did not need to prove that Kimelman knew the identity or nature of the source if he knew that the information was illegally obtained. In denying Kimelman's Rule 29 motion, the district court described this as “a verdict that could go either way” and “certainly a close case,” but decided that the “jury's verdict [was not] unreasonable such that it should be overturned.” Reviewing *de novo* and “crediting ‘every inference that the jury may have drawn’ in the government's favor,” we agree. . . .

Kimelman argues that we should exclude from our analysis evidence related to activity *after* the trades at issue. We reject this argument. Kimelman's knowledge of the illicit nature of Goffer's source after the trades is still probative (though not in itself sufficient to establish his knowledge before the trades).

Evidence indicating a defendant's knowing participation in a later stock manipulation scheme is relevant to the earlier scheme where, for example, it shows that a defendant was “conversant in the language of stock manipulation.” *United States v. Rutkoske,* 506 F.3d 170, 177 (2d Cir. 2007). This analysis applies equally in the context of insider trading. “Relevancy cannot be reduced to [a] mere chronology; whether the similar act evidence occurred prior or subsequent to the crime in question is not necessarily determinative to its admissibility [and therefore its probative value].” *United States v. Ramirez,* 894 F.2d 565, 569 (2d Cir. 1990). Subsequent acts are frequently probative as to intent. *See, e.g.,* United States *v. Germosen,* 139 F.3d 120, 127–28 (2d Cir. 1998). Here, Kimelman's participation in Goffer's ongoing scheme led to later transactions that “so closely paralleled the charged conduct that it was probative regardless of the temporal difference.” *United States v. Curley,* 639 F.3d 50, 61 (2d Cir. 2011).

If we focus on the evidence in the record from prior to the public announcement of Bain's bid for 3Com on September 28, 2007, and credit every inference that the jury could have drawn in the Government's favor, we find ample support for the jury to conclude that Kimelman was tipped by Goffer and knew or consciously avoided knowing that Goffer's tip about 3Com was based on nonpublic information illegally disclosed in breach of a fiduciary duty.

The Kimelman–Goffer telephone call of August 7, though unrecorded, marked a change in Kimelman's 3Com stock trading behavior. Prior to August 7, Kimelman day-traded 3Com stock in smaller quantities of 1,000, 2,000 and 5,000 shares, including on August 5, just two days before the call. Kimelman did not maintain those positions but sold them before the end of each trading day. On August 8, the day after the evening phone call, however, Kimelman bought 94,200 shares of 3Com, easily his largest single-day purchase, which he did not sell. In the subsequent days and weeks, he continued to add to that position—buying another 24,000 shares on August 9 and 15,000 more shares on August 10. He maintained the accumulated position until after the 3Com merger bid was announced; when the share price shot up, he sold the position and profited.

Kimelman was so aggressive in acquiring 3Com that his employer at Quad restrained him from making further purchases of 3Com stock. Despite the warning from Quad, Kimelman managed to buy 5,000 more shares of 3Com on September 25. From August 7 to 8, Kimelman's behavior changed from being very cautious about 3Com to suddenly becoming very confident. Such a sudden change in a defendant's stock trading pattern, which cannot be readily explained by other reasons, could be probative of trading on insider information. *See United States v. Smith,* 155 F.3d 1051, 1069 (9th Cir. 1998)_(recognizing "situations in which unique trading patterns or unusually large trading quantities suggest that an investor had used inside information").

His e-mail to Goffer on August 15, with news of Quad's restraint, indicates at the very least that the two were actively discussing the trading in 3Com shares. Kimelman's new 3Com trading behavior matched that of Goffer and of the other co-conspirators who were tipped by Goffer on August 7. And like the others, Kimelman cashed out of his 3Com positions shortly after Bain's bid was announced. Parallel trading patterns among co-conspirators can be another indicator of insider trading. In this case, the manner in which Kimelman sold the stock is at least suggestive of the motive he had for buying it, which was not for long term investment value, but in anticipation of a particular event.

Also revealing is the discussion Kimelman had with Goffer on the eve of the 3Com deal's announcement on September 27. Goffer asked about the significance of signature pages in a pending transaction, and Kimelman explained that the preparation of the signature pages meant that a deal signing was imminent. As a former associate at a leading corporate law firm, Kimelman had to know that Goffer, in asking such a question, was privy to the inner workings of a pending transaction to be aware of the status of signature pages. Since Goffer had no legal basis to have access to such information, Kimelman must therefore have known or been aware of a high probability that this insider information was made available to Goffer in breach of a fiduciary duty. Indeed, it was from this exchange that Plate, who testified about the conversation, became convinced that Goffer's tip was illegally obtained.

Kimelman also argues that much of the Government's evidence applied equally convincingly to Plate, who claimed at trial that he did not know of Goffer's inside source until the "signature pages" conversation. However, a rational juror could readily infer from the trust that Goffer showed in Kimelman by asking him about the signature pages and the matter-of-fact manner in which Kimelman answered—without astonishment as to Goffer's knowledge or expression of concern about the sensitivity of such information—that Kimelman shared a relationship of trust with Goffer that Plate did not. This, in turn, would support an inference that Kimelman had some degree of prior awareness of Goffer's illegal source of information, even if the jury also concluded that Plate had no such awareness. Moreover, the jury was free not to credit Plate's self-serving testimony that he did not know about the source of the inside information. . . .

After September 2007, evidence of his knowledge of the fraud becomes overwhelming and Kimelman does not deny the sufficiency of the showing in support of his conspiracy conviction. Goffer later described Kimelman and Emanuel as members of his "inner circle" or "tight circle." A rational juror could find that this circle came together well before those statements were made and prior to the beginning of the 3Com trades. The government produced evidence from July 2007 showing that the trio bought and profited from shares of Hilton Hotels shortly after Goffer received an insider tip. Goffer and Emanuel, along with co-conspirators outside the "inner circle," bought shares of 3Com on August 7. Kimelman's habit of feigning indifference to the source of Goffer's information in the presence of co-conspirators not within the "inner circle" also continued in the subsequent months.

Viewed in its totality, the Government's proof provides enough evidence for a reasonable jury to conclude that Kimelman was guilty beyond a reasonable doubt of insider trading in 3Com. The jury's verdict is supported by sufficient evidence and is not unreasonable; we affirm Kimelman's conviction. . . .

Over Kimelman's objections, the district court instructed the jury on the theory of "conscious avoidance," which permits a jury to convict a defendant for "deliberately clos[ing] his eyes to what would otherwise have been obvious to him." *United States v. Gansman,* 657 F.3d 85, 94 (2d Cir. 2011). Kimelman appeals the issuance and the substance of jury instructions on conscious avoidance as to the illicit origins of Goffer's tips. Finding no flaw in either, we affirm.

"A conscious avoidance instruction 'may only be given if (1) the defendant asserts the lack of some specific aspect of knowledge required for conviction [ ] and (2) the appropriate factual predicate for the charge exists, i.e. the evidence is such that a rational juror may reach the conclusion beyond a reasonable doubt that the defendant was aware of a high probability of the fact in dispute and consciously avoided confirming that fact.'" *United States v. Svoboda,* 347 F.3d 471, 480 (2d Cir. 2003) (quoting *United States v. Ferrarini,* 219 F.3d 145, 154 (2d Cir. 2000)). In this case, the first prong is met; Kimelman claimed ignorance at trial as to the source of the 3Com tip. However, Kimelman contends that there was insufficient evidence (1) for a juror to conclude that he was aware of a high probability that the 3Com tip came from an insider and chose to avoid confirming that fact, and (2) for a juror to conclude that he *ever* knew about the illicit nature of Goffer's information. We disagree.

For substantially the same reasons discussed above, there was ample evidence supporting the inference that if Kimelman did not know about those facts, that he had to have consciously avoided becoming aware of them. First, given the 25–minute telephone conversation he had with Goffer on the evening of August 7, the abrupt and pronounced change in his trading pattern of 3Com stock immediately thereafter, his subsequent outreach to Goffer about 3Com trading on August 15, and the fact that Goffer had shared the tip with other co-conspirators whom Kimelman knew, a rational juror was entitled to conclude that Kimelman was aware of a high probability that Goffer had insider information about 3Com. Second, the fact that Goffer asked about signature pages on the eve of the 3Com deal announcement and the routine manner in which Kimelman answered the question, again provides the basis for a juror to conclude that he was aware of a high probability that the source of Goffer's information was illegal.

With respect to Kimelman's conscious avoidance of knowledge of Goffer's sources throughout the conspiracy, Kimelman's challenge lacks any merit. While he and Kimelman were recruiting Slaine for Incremental, Goffer told Slaine that he was "better off not knowing where [his tips] were coming from." That way, Goffer continued, if "someone from the government ever ask[ed] you where did [that tip] come from. You [would] be like, I don't freakin' know where it came from." Building on Goffer's (facetious) assertion that his source was a construction worker, Kimelman added that it was a "[g]uy fixing that pothole down there." His additions to this conversation about the need for plausible deniability underscore Kimelman's conscious avoidance of knowledge as to Goffer's source. The jury was entitled to hear the conscious avoidance instruction. . . .

Kimelman alleges that the district court erred in declining to amend its jury instructions to accord with the Supreme Court's ruling in *Global–Tech Appliances, Inc. v. SEB S.A.,* 131 S. Ct. 2060 (2011). Specifically, Kimelman contends that the *Global–Tech* decision required that jury charges indicate that "the mental state of recklessness is insufficient for a finding of conscious avoidance." Because *Global–Tech* did not alter the conscious avoidance standard, we hold that the district court's refusal to amend the jury instructions to accord with *Global–Tech* was not error.

In *Global–Tech,* the Supreme Court synthesized conscious avoidance holdings from eleven circuit courts in order to import the doctrine from criminal law to patent law. The Court did not alter or clarify the doctrine, but instead identified the common ground among the Courts of Appeals:

> [A]ll [Courts of Appeals] appear to agree on two basic requirements: (1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact. We think *these requirements* give willful blindness an appropriately limited scope that surpasses recklessness and negligence. . . .

The district court's instructions in this case properly imposed the two requirements discussed by the *Global–Tech* decision. Kimelman requested that the district court insert the word "reckless" into a list of mental states that were insufficient. However, *Global–Tech* makes clear that instructions (such as those in this case) that require a defendant to take "deliberate actions to avoid confirming a high probability of wrongdoing" are inherently inconsistent with "a reckless defendant . . . who merely knows of a substantial and unjustified risk of such wrongdoing." The district court's instructions were consistent with *Global–Tech;* we therefore affirm Kimelman's conviction.

Problem 4-6	
(a)	Between 2009 and 2015, the office of Preet Bharara, U.S. Attorney for the Southern District of New York, secured 79 convictions, through trials and guilty pleas, for insider trading among players at various levels in the Wall Street fund industry (several of these convictions were later overturned on appeal). What might this wave of prosecutions have accomplished, if anything?
(b)	Is it morally blameworthy to engage in insider trading? Why or why not?
(c)	What are some policy arguments for and against sanctioning insider training? Some academics have argued, over the course of the last half century, that insider trading should not be illegal. Can you imagine what some of their arguments have been, as well as the responses of their critics?

F. Personal Benefit, Mens Rea, and Tipping Chains

Remember that in order for a tippee to be liable, the tipper must have breached his fiduciary duty, which requires the tipper to have received some personal benefit in exchange for providing material non-public information. Recall the following language from *Dirks*:

> This standard was identified by the SEC itself in *Cady, Roberts:* a purpose of the securities laws was to eliminate "use of inside information for personal advantage." Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

The following three cases lay out the recent sequence of important court rulings on the subject of tipper-tippee liability in insider trading law. The first case, *Newman*, out of the Second Circuit, made a splash for cutting back on the scope of liability by more narrowly defining what constitutes a personal benefit. In the second case, *Salman*, the Supreme Court partially rejected the Second Circuit's analysis in *Newman*, pulling back from *Newman*'s narrow definition. In the third case, *Martoma*, which is the current last word, another Second Circuit panel further rejected aspects of the court's earlier decision in *Newman*.

The story is easiest to understand by working through these three decisions sequentially. As you will see, decades after starting down the path of theorizing insider trading as a form of fraud, the decisions have now arrived at what one could see as a kind of end point. The courts are drawing, and arguing over, some exceptionally fine lines between what sort of trading on tips counts as the crime of securities fraud and what does not.

As you read, consider whether it might be time to handle insider trading with a new statute. If so, what lines might such a statute draw?

UNITED STATES v. NEWMAN, 773 F.3d 438 (2d Cir. 2014)

BARRINGTON D. PARKER, Circuit Judge:

The Government alleged that a cohort of analysts at various hedge funds and investment firms obtained material, nonpublic information from employees of publicly traded technology companies, shared it amongst each other, and subsequently passed this information to the portfolio managers at their respective companies. The Government charged [Todd] Newman, a portfolio manager at Diamondback Capital Management, LLC ("Diamondback"), and [Anthony] Chiasson, a portfolio manager at Level Global Investors, L.P. ("Level Global"), with willfully participating in this insider trading scheme by trading in securities based on the inside information illicitly obtained by this group of analysts. On appeal, Newman and Chiasson challenge the sufficiency of the evidence as to several elements of the offense, and further argue that the district court erred in failing to instruct the jury that it must find that a tippee knew that the insider disclosed confidential information in exchange for a personal benefit.

We agree that the jury instruction was erroneous because we conclude that, in order to sustain a conviction for insider trading, the Government must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit. Moreover, we hold that the evidence was insufficient to sustain a guilty verdict against Newman and Chiasson for two reasons. First, the Government's evidence of any personal benefit received by the alleged insiders was insufficient to establish the tipper liability from which defendants' purported tippee liability would derive. Second, even assuming that the scant evidence offered on the issue of personal benefit was sufficient, which we conclude it was not, the Government presented no evidence that Newman and Chiasson knew that they were trading on information obtained from insiders in violation of those insiders' fiduciary duties.

Accordingly, we reverse the convictions of Newman and Chiasson on all counts and remand with instructions to dismiss the indictment as it pertains to them with prejudice. . . .

At trial, the Government presented evidence that a group of financial analysts exchanged information they obtained from company insiders, both directly and more often indirectly. Specifically, the Government alleged that these analysts received information from insiders at Dell and NVIDIA disclosing those companies' earnings numbers before they were publicly released in Dell's May 2008 and August 2008 earnings announcements and NVIDIA's May 2008 earnings announcement. These analysts then passed the inside information to their portfolio managers, including Newman and Chiasson, who, in turn, executed trades in Dell and NVIDIA stock, earning approximately $4 million and $68 million, respectively, in profits for their respective funds.

Newman and Chiasson were several steps removed from the corporate insiders and there was no evidence that either was aware of the source of the inside information. With respect to the Dell tipping chain, the evidence established that Rob Ray of Dell's investor relations department tipped information regarding Dell's consolidated earnings numbers to Sandy Goyal, an analyst at Neuberger Berman. Goyal in turn gave the information to Diamondback analyst Jesse Tortora. Tortora in turn relayed the information to his manager

Newman as well as to other analysts including Level Global analyst Spyridon "Sam" Adondakis. Adondakis then passed along the Dell information to Chiasson, making Newman and Chiasson three and four levels removed from the inside tipper, respectively.

With respect to the NVIDIA tipping chain, the evidence established that Chris Choi of NVIDIA's finance unit tipped inside information to Hyung Lim, a former executive at technology companies Broadcom Corp. and Altera Corp., whom Choi knew from church. Lim passed the information to co-defendant Danny Kuo, an analyst at Whittier Trust. Kuo circulated the information to the group of analyst friends, including Tortora and Adondakis, who in turn gave the information to Newman and Chiasson, making Newman and Chiasson four levels removed from the inside tippers.

Although Ray has yet to be charged administratively, civilly, or criminally, and Choi has yet to be charged criminally, for insider trading or any other wrongdoing, the Government charged that Newman and Chiasson were criminally liable for insider trading because, as sophisticated traders, they must have known that information was disclosed by insiders in breach of a fiduciary duty, and not for any legitimate corporate purpose. . . .

[T]he district court did not give Newman and Chiasson's proposed jury instruction. Instead, the district court gave the following instructions on the tippers' intent and the personal benefit requirement:

> Now, if you find that Mr. Ray and/or Mr. Choi had a fiduciary or other relationship of trust and confidence with their employers, then you must next consider whether the [G]overnment has proven beyond a reasonable doubt that they intentionally breached that duty of trust and confidence by disclosing material[,] nonpublic information for their own benefit.

On the issue of the appellants' knowledge, the district court instructed the jury:

> To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material, nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material, nonpublic information by a defendant, and even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality. . . .

The insider trading case law . . . is not confined to insiders or misappropriators who trade for their own accounts. Courts have expanded insider trading liability to reach situations where the insider or misappropriator in possession of material nonpublic information (the "tipper") does not himself trade but discloses the information to an outsider (a "tippee") who then trades on the basis of the information before it is publicly disclosed. *See Dirks*, 463 U.S. at 659, 103 S. Ct. 3255. The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the "classical" or the "misappropriation" theory. *Obus*, 693 F.3d at 285–86. . . .

Liability for securities fraud . . . requires proof that the defendant acted with scienter, which is defined as "a mental state embracing intent to deceive, manipulate or defraud." *Hochfelder*, 425 U.S. at 193 n.12. In order to establish a criminal violation of the securities laws, the Government must show that the defendant acted "willfully." 15 U.S.C. § 78ff(a). We have defined willfulness in this context "as a realization on the defendant's part that he was doing a wrongful act under the securities laws." *United States v. Cassese*, 428 F.3d 92, 98 (2d Cir. 2005) (internal quotation marks and citations omitted); *see also United States v. Dixon*, 536 F.2d 1388, 1395 (2d Cir. 1976) (holding that to establish willfulness, the Government must "establish a realization on the defendant's part that he was doing a wrongful act . . . under the securities laws" and that such an act "involve[d] a significant risk of effecting the violation that occurred.") (quotation omitted).

The Government concedes that tippee liability requires proof of a personal benefit to the insider. However, the Government argues that it was not required to prove that Newman and Chiasson knew that the insiders at Dell and NVIDIA received a personal benefit in order to be found guilty of insider trading. Instead, the Government contends, consistent with the district court's instruction, that it merely needed to prove that the "defendants traded on material, nonpublic information they knew insiders had disclosed in breach of a duty of confidentiality. . . ."

In support of this position, the Government cites *Dirks* for the proposition that the Supreme Court only required that the "tippee know that the tipper disclosed information in breach of a duty." *Id.* at 40. In addition, the Government relies on dicta in a number of our decisions post-Dirks, in which we have described the elements of tippee liability without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit. By selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected in *Dirks*.

Although this Court has been accused of being "somewhat Delphic" in our discussion of what is required to demonstrate tippee liability, the Supreme Court was quite clear in *Dirks*. First, the tippee's liability derives only from the tipper's breach of a fiduciary duty, not from trading on material, non-public information. *See Chiarella*, 445 U.S. at 233, 100 S. Ct. 1108 (noting that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information"). Second, the corporate insider has committed no breach of fiduciary duty unless he receives a personal benefit in exchange for the disclosure. Third, even in the presence of a tipper's breach, a tippee is liable only if he knows or should have known of the breach.

While we have not yet been presented with the question of whether the tippee's knowledge of a tipper's breach requires knowledge of the tipper's personal benefit, the answer follows naturally from *Dirks*. *Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it is the fiduciary breach that triggers liability for securities fraud under Rule 10b–5. For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.

The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders. By contrast, our prior cases generally involved tippees who directly participated in the tipper's breach (and therefore had knowledge of the tipper's disclosure for personal benefit) or tippees who were explicitly apprised of the tipper's gain by an intermediary tippee. *See, e.g.*, *Jiau*, 734 F.3d at 150 ("To provide an incentive, Jiau promised the tippers insider information for their own private trading."); *United States v. Falcone*, 257 F.3d 226, 235 (2d Cir. 2001) (affirming conviction of remote tipper where intermediary tippee paid the inside tipper and had told remote tippee "the details of the scheme"); *Warde*, 151 F.3d at 49 (tipper and tippee engaged in parallel trading of the inside information and "discussed not only the inside information, but also the best way to profit from it"); *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996) (tippee acquired inside information directly from his insider friend). We note that the Government has not cited, nor have we found, a single case in which tippees as remote as Newman and Chiasson have been held criminally liable for insider trading. . . .

In light of *Dirks*, we find no support for the Government's contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability. Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets. The Supreme Court explicitly repudiated this premise not only in *Dirks*, but in a predecessor case, *Chiarella v. United States*. In *Chiarella*, the Supreme Court rejected this Circuit's conclusion that "the federal securities laws have created a system providing equal access to information necessary for reasoned and intelligent investment decisions. . . . because [material non-public] information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers." The Supreme Court emphasized that "[t]his reasoning suffers from [a] defect. . . . [because] not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." *See also United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring) ("[The policy rationale [for prohibiting insider trading] stops well short of prohibiting all trading on material nonpublic information. Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate....")]. Thus, in both *Chiarella* and *Dirks*, the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nation's securities markets.

As noted above, *Dirks* clearly defines a breach of fiduciary duty as a breach of the duty of confidentiality in exchange for a personal benefit. Accordingly, we conclude that a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit. . . .

Our conclusion also comports with well-settled principles of substantive criminal law. As the Supreme Court explained in *Staples v. United States*, 511 U.S. 600, 605 (1994), under the common law, mens rea, which requires that the defendant know the facts that make his conduct illegal, is a necessary element in every crime. Such a requirement is particularly appropriate in insider trading cases where we have acknowledged "it is easy to imagine a . . . trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful." *United States v. Kaiser*, 609 F.3d 556, 569 (2d Cir. 2010). This is also a statutory requirement, because only "willful" violations are subject to criminal provision. *See United States v. Temple*, 447 F.3d 130, 137 (2d Cir. 2006) ("'Willful' repeatedly has been defined in the criminal context as intentional, purposeful, and voluntary, as distinguished from accidental or negligent").

In sum, we hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit. . . .

The circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips. As to the Dell tips, the Government established that Goyal and Ray were not "close" friends, but had known each other for years, having both attended business school and worked at Dell together. Further, Ray, who wanted to become a Wall Street analyst like Goyal, sought career advice and assistance from Goyal. The evidence further showed that Goyal advised Ray on a range of topics, from discussing the qualifying examination in order to become a financial analyst to editing Ray's résumé and sending it to a Wall Street recruiter, and that some of this assistance began before Ray began to provide tips about Dell's earnings. The evidence also established that Lim and Choi were "family friends" that had met through church and occasionally socialized together. The Government argues that these facts were sufficient to prove that the tippers derived some benefit from the tip. We disagree. If this was a "benefit," practically anything would qualify.

We have observed that "[p]ersonal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, any reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend." *Jiau*, 734 F.3d at 153. This standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature. If that were true, and the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity. To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades "resemble trading by the insider himself followed by a gift of the profits to the recipient," we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. In other words, as Judge Walker noted in *Jiau*, this requires evidence of "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter]." . . .

Here the "career advice" that Goyal gave Ray, the Dell tipper, was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance. See, e.g., J.A.2080 (offering "minor suggestions" on a resume), J.A. 2082 (offering advice prior to an informational interview). Crucially, Goyal testified that he would have given Ray advice without receiving information because he routinely did so for industry colleagues. Although the Government argues that the jury could have reasonably inferred from the evidence that Ray and Goyal swapped career advice for inside information, Ray himself disavowed that any such quid pro quo existed. Further, the evidence showed Goyal began giving Ray "career advice" over a year before Ray began providing any insider information. Thus, it would not be possible under the circumstances for a jury in a criminal trial to find beyond a reasonable doubt that Ray received a personal benefit in exchange for the disclosure of confidential information.

The evidence of personal benefit was even more scant in the NVIDIA chain. Choi and Lim were merely casual acquaintances. The evidence did not establish a history of loans or personal favors between the two. During cross examination, Lim testified that he did not provide anything of value to Choi in exchange for the information. Lim further testified that Choi did not know that Lim was trading NVIDIA stock (and in fact for the relevant period Lim did not trade stock), thus undermining any inference that Choi intended to make a "gift" of the profits earned on any transaction based on confidential information.

Even assuming that the scant evidence described above was sufficient to permit the inference of a personal benefit, which we conclude it was not, the Government presented absolutely no testimony or any other evidence that Newman and Chiasson knew that they were trading on information obtained from insiders, or that those insiders received any benefit in exchange for such disclosures, or even that Newman and Chiasson consciously avoided learning of these facts. As discussed above, the Government is required to prove beyond a reasonable doubt that Newman and Chiasson knew that the insiders received a personal benefit in exchange for disclosing confidential information.

It is largely uncontroverted that Chiasson and Newman, and even their analysts, who testified as cooperating witnesses for the Government, knew next to nothing about the insiders and nothing about what, if any, personal benefit had been provided to them. Adondakis said that he did not know what the relationship between the insider and the first-level tippee was, nor was he aware of any personal benefits exchanged for the information, nor did he communicate any such information to Chiasson. Adondakis testified that he merely told Chiasson that Goyal "was talking to someone within Dell," and that a friend of a friend of Tortora's would be getting NVIDIA information. Adondakis further testified that he did not specifically tell Chiasson that the source of the NVIDIA information worked at NVIDIA. Similarly, Tortora testified that, while he was aware Goyal received information from someone at Dell who had access to "overall" financial numbers, he was not aware of the insider's name, or position, or the circumstances of how Goyal obtained the information. Tortora further testified that he did not know whether Choi received a personal benefit for disclosing inside information regarding NVIDIA.

The Government now invites us to conclude that the jury could have found that the appellants knew the insiders disclosed the information "for some personal reason rather than for no reason at all." But the Supreme Court affirmatively rejected the premise that a tipper who discloses confidential information necessarily does so to receive a personal benefit. *See Dirks*, 463 U.S. at 661–62 ("All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders"). Moreover, it is inconceivable that a jury could conclude, beyond a reasonable doubt, that Newman and Chiasson were aware of a personal benefit, when Adondakis and Tortora, who were more intimately involved in the insider trading scheme as part of the "corrupt" analyst group, disavowed any such knowledge.

Alternatively, the Government contends that the specificity, timing, and frequency of the updates provided to Newman and Chiasson about Dell and NVIDIA were so "overwhelmingly suspicious" that they warranted various material inferences that could support a guilty verdict. Newman and Chiasson received four updates on Dell's earnings numbers in the weeks leading up to its August 2008 earnings announcement. Similarly, Newman and Chiasson received multiple updates on NVIDIA's earnings numbers between the close of the quarter and the company's earnings announcement. The Government argues that given the detailed nature and accuracy of these updates, Newman and Chiasson must have known, or deliberately avoided knowing, that the information originated with corporate insiders, and that those insiders disclosed the information in exchange for a personal benefit. We disagree.

Even viewed in the light most favorable to the Government, the evidence presented at trial undermined the inference of knowledge in several ways. The evidence established that analysts at hedge funds routinely estimate metrics such as revenue, gross margin, operating margin, and earnings per share through legitimate financial modeling using publicly available information and educated assumptions about industry and company trends. For example, on cross-examination, cooperating witness Goyal testified that under his financial model on Dell, when he ran the model in January 2008 without any inside information, he calculated May 2008 quarter results of $16.071 billion revenue, 18.5% gross margin, and $0.38 earnings per share. These estimates came very close to Dell's reported earnings of $16.077 billion revenue; 18.4% gross margin, and $0.38 earnings per share. Appellants also elicited testimony from the cooperating witnesses and investor relations associates that analysts routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements. Goyal testified that he frequently spoke to internal relations departments to run his model by them and ask whether his assumptions were "too high or too low" or in the "ball park," which suggests analysts routinely updated numbers in advance of the earnings announcements. Ray's supervisor confirmed that investor relations departments routinely assisted analysts with developing their models.

Moreover, the evidence established that NVIDIA and Dell's investor relations personnel routinely "leaked" earnings data in advance of quarterly earnings. Appellants introduced examples in which Dell insiders, including the head of Investor Relations, Lynn Tyson, selectively disclosed confidential quarterly financial information arguably similar to the inside information disclosed by Ray and Choi to establish relationships with financial firms who might be in a position to buy Dell's stock. For example, appellants introduced an email Tortora sent Newman summarizing a conversation he had with Tyson in which she suggested "low

12% opex [was] reasonable" for Dell's upcoming quarter and that she was "fairly confident on [operating margin] and [gross margin]."

No reasonable jury could have found beyond a reasonable doubt that Newman and Chiasson knew, or deliberately avoided knowing, that the information originated with corporate insiders. In general, information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source. But in this case, where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.

Moreover, even if detail and specificity could support an inference as to the nature of the source, it cannot, without more, permit an inference as to that source's improper motive for disclosure. That is especially true here, where the evidence showed that corporate insiders at Dell and NVIDIA regularly engaged with analysts and routinely selectively disclosed the same type of information. Thus, in light of the testimony (much of which was adduced from the Government's own witnesses) about the accuracy of the analysts' estimates and the selective disclosures by the companies themselves, no rational jury would find that the tips were so overwhelmingly suspicious that Newman and Chiasson either knew or consciously avoided knowing that the information came from corporate insiders or that those insiders received any personal benefit in exchange for the disclosure. . . .

Consequently, we reverse Newman and Chiasson's convictions and remand with instructions to dismiss the indictment as it pertains to them.

Problem 4-7
Under *Dirks* and *Newman*, what is the mens rea (or "scienter" in securities law parlance) required now for tippee liability? Does the requirement differ depending on whether the case is about civil or criminal liability?

SALMAN v. UNITED STATES, 137 S. Ct. 420 (2016)

JUSTICE ALITO delivered the opinion of the Court.

Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b–5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage. . . .

These persons also may not tip inside information to others for trading. The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty, and the tippee may commit securities fraud by trading in disregard of that knowledge. In *Dirks v. SEC*, 463 U.S. 646 (1983), this Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend."

Petitioner Bassam Salman challenges his convictions for conspiracy and insider trading. Salman received lucrative trading tips from an extended family member, who had received the information from Salman's brother-in-law. Salman then traded on the information. He argues that he cannot be held liable as a tippee because the tipper (his brother-in-law) did not personally receive money or property in exchange for the tips and thus did not personally benefit from them. . . .

Maher Kara was an investment banker in Citigroup's healthcare investment banking group. He dealt with highly confidential information about mergers and acquisitions involving Citigroup's clients. Maher enjoyed a close relationship with his older brother, Mounir Kara (known as Michael). After Maher started at Citigroup, he began discussing aspects of his job with Michael. At first he relied on Michael's chemistry background to help him grasp scientific concepts relevant to his new job. Then, while their father was battling cancer, the brothers discussed companies that dealt with innovative cancer treatment and pain management techniques. Michael began to trade on the information Maher shared with him. At first, Maher was unaware of his brother's trading activity, but eventually he began to suspect that it was taking place.

Ultimately, Maher began to assist Michael's trading by sharing inside information with his brother about pending mergers and acquisitions. Maher sometimes used code words to communicate corporate information to his brother. Other times, he shared inside information about deals he was not working on in order to avoid detection. Without his younger brother's knowledge, Michael fed the information to others—including Salman, Michael's friend and Maher's brother-in-law. By the time the authorities caught on, Salman had made over $1.5 million in profits that he split with another relative who executed trades via a brokerage account on Salman's behalf. . . .

The evidence at trial established that Maher and Michael enjoyed a "very close relationship." Maher "love[d] [his] brother very much," Michael was like "a second father to Maher," and Michael was the best man at Maher's wedding to Salman's sister. Maher testified that he shared inside information with his brother to benefit him and with the expectation that his brother would trade on it. While Maher explained that he disclosed the information in large part to appease Michael (who pestered him incessantly for it), he also testified that he tipped his brother to "help him" and to "fulfil[l] whatever needs he had." For instance, Michael once called Maher and told him that "he needed a favor." Maher offered his brother money but Michael asked for information instead. Maher then disclosed an upcoming acquisition. Ibid. Although he instantly regretted the tip and called his brother back to implore him not to trade, Maher expected his brother to do so anyway.

For his part, Michael told the jury that his brother's tips gave him "timely information that the average person does not have access to" and "access to stocks, options, and what have you, that I can capitalize on, that the average person would never have or dream of." Michael testified that he became friends with Salman when Maher was courting Salman's sister and later began sharing Maher's tips with Salman. As he explained at trial, “any time a major deal came in, [Salman] was the first on my phone list.” Michael also testified that he told Salman that the information was coming from Maher. . . .

While [Salman’s] appeal was pending, the Second Circuit issued its opinion in *United States v. Newman*, 773 F.3d 438 (2014), cert. denied, 577 U.S. —— (2015). There, the Second Circuit reversed the convictions of two portfolio managers who traded on inside information. The Newman defendants were “several steps removed from the corporate insiders” and the court found that “there was no evidence that either was aware of the source of the inside information.” The court acknowledged that *Dirks* and Second Circuit case law allow a factfinder to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend. But the court concluded that, “[t]o the extent” *Dirks* permits “such an inference,” the inference “is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” . . .

[In a footnote, the Court added: “The Second Circuit also reversed the Newman defendants’ convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. This case does not implicate those issues.”]

In this case, Salman contends that an insider’s “gift of confidential information to a trading relative or friend,” is not enough to establish securities fraud. Instead, Salman argues, a tipper does not personally benefit unless the tipper’s goal in disclosing inside information is to obtain money, property, or something of tangible value. He claims that our insider-trading precedents, and the cases those precedents cite, involve situations in which the insider exploited confidential information for the insider’s own “tangible monetary profit.” He suggests that his position is reinforced by our criminal-fraud precedents outside of the insider-trading context, because those cases confirm that a fraudster must personally obtain money or property. More broadly, Salman urges that defining a gift as a personal benefit renders the insider-trading offense indeterminate and overbroad: indeterminate, because liability may turn on facts such as the closeness of the relationship between tipper and tippee and the tipper’s purpose for disclosure; and overbroad, because the Government may avoid having to prove a concrete personal benefit by simply arguing that the tipper meant to give a gift to the tippee. He also argues that we should interpret *Dirks*‘s standard narrowly so as to avoid constitutional concerns. Finally, Salman contends that gift situations create especially troubling problems for remote tippees—that is, tippees who receive inside information from another tippee, rather than the tipper—who may have no knowledge of the relationship between the original tipper and tippee and thus may not know why the tipper made the disclosure. . . .

We adhere to *Dirks*, which easily resolves the narrow issue presented here.

In *Dirks*, we explained that a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper’s fiduciary duty. Whether the tipper breached that duty depends “in large part on the purpose of the disclosure” to the tippee. “[T]he test,” we explained, “is whether the insider personally will benefit, directly or indirectly, from his disclosure.” Thus, the disclosure of confidential information without personal benefit is not enough. In determining whether a tipper derived a personal benefit, we instructed courts to "focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." This personal benefit can "often" be inferred "from objective facts and circumstances," we explained, such as "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient." In particular, we held that "[t]he 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." In such cases, "[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient." We then applied this gift-giving principle to resolve *Dirks* itself, finding it dispositive that the tippers "received no monetary or personal benefit" from their tips to *Dirks*, "nor was their purpose to make a gift of valuable information to Dirks."

Our discussion of gift giving resolves this case. Maher, the tipper, provided inside information to a close relative, his brother Michael. Dirks makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to "a trading relative," and that rule is sufficient to resolve the case at hand. As Salman's counsel acknowledged at oral argument, Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother. It is obvious that Maher would personally benefit in that situation. But Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it. *Dirks* appropriately prohibits that approach, as well. *Cf.* 463 U.S., at 659 (holding that "insiders [are] forbidden" both "from personally using undisclosed corporate information to their advantage" and from "giv[ing] such information to an outsider for the same improper purpose of exploiting the information for their personal gain"). *Dirks* specifies that when a tipper gives inside information to "a trading relative or friend," the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty Salman acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.

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 requirement is inconsistent with *Dirks*. . . .

UNITED STATES v. MARTOMA, 894 F.3d 64 (2d Cir. 2018)

KATZMANN, Chief Judge:

Defendant-appellant Mathew Martoma appeals from a judgment of conviction entered on September 9, 2014 in the United States District Court for the Southern District of New York (Gardephe, J.). Martoma was found guilty, after a jury trial, of one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371 and two counts of securities fraud in violation of 15 U.S.C. §§ 78j(b) & 78ff in connection with an insider trading scheme. After Martoma was convicted, this Court issued a decision in *United States v. Newman*, 773

F.3d 438 (2d Cir. 2014), which elaborated on the Supreme Court's ruling in *Dirks v. S.E.C.*, 463 U.S. 646 (1983), concerning liability for a "tippee" who trades on confidential information obtained from an insider, or a "tipper."

On appeal, Martoma argues that the jury in his case was not properly instructed and that the evidence presented at his trial was insufficient to sustain his conviction. Martoma contends that the jury instructions ran afoul of Newman by allowing the jury to find that a tipper receives a "personal benefit" from gifting inside information even where the tipper and tippee do not share a "meaningfully close personal relationship." He further argues that the evidence at trial was insufficient to sustain a conviction under any theory of personal benefit.

We conclude that the jury instructions are inconsistent with *Newman*. That decision held that a personal benefit in the form of "a gift of confidential information to a trading relative or friend" requires proof that the tipper and tippee share a "meaningfully close personal relationship." *Newman* explained that this standard "requires evidence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].'" Thus, Martoma's jury instructions were erroneous, not because they omitted the term "meaningfully close personal relationship," but because they allowed the jury to convict based solely on evidence of friendship without also requiring either that the tipper and tippee shared a quid pro quo-like relationship or that the tipper intended to benefit the tippee.

We nonetheless conclude that this instructional error did not affect Martoma's substantial rights. At trial, the government presented compelling evidence that at least one tipper shared a relationship suggesting a quid pro quo with Martoma. For the same reason, Martoma's challenge to the sufficiency of the personal-benefit evidence fails. The government also presented sufficient evidence for a rational trier of fact to conclude that at least one tipper received a personal benefit by disclosing inside information with the intention to benefit Martoma. Accordingly, the judgment of the district court is AFFIRMED. . . .

We agree that the jury instructions are inconsistent with *Newman*, though not for the reasons Martoma advances. *Newman* held that a personal benefit in the form of "a gift of confidential information to a trading relative or friend," *see Dirks*, 463 U.S. at 664, requires proof that the tipper and tippee shared what the decision called a "meaningfully close personal relationship." The Court explained that this standard "requires evidence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].'" Thus, Martoma's jury instructions were erroneous, not because they omitted the term "meaningfully close personal relationship," but because they allowed the jury to find a personal benefit in the form of a "gift of confidential information to a trading relative or friend" without requiring the jury to find either that tipper and tippee shared a relationship suggesting a quid pro quo or that the tipper gifted confidential information with the intention to benefit the tippee.

We nonetheless conclude that this instructional error did not affect Martoma's substantial rights. At trial, the government presented compelling evidence that at least one tipper received a different type of personal benefit from disclosing inside information: $70,000 in "consulting fees." This evidence establishes the existence of a relationship suggesting a quid pro quo between the tipper and tippee. For this reason, Martoma's challenge to the sufficiency of the personal-benefit evidence fails. Moreover, the government presented sufficient evidence for a rational trier of fact to conclude that at least one tipper received a personal benefit by disclosing inside information with the intention to benefit Martoma. Accordingly, we AFFIRM the judgment of the district court.

Martoma's convictions stem from an insider trading scheme involving securities of two pharmaceutical companies, Elan Corporation, plc ("Elan") and Wyeth, that were jointly developing an experimental drug called bapineuzumab to treat Alzheimer's disease. Martoma worked as a portfolio manager at S.A.C. Capital Advisors ("SAC"), a hedge fund owned and managed by Steven A. Cohen. In that capacity, Martoma managed an investment portfolio with buying power of between $400 and $500 million that was focused on pharmaceutical and healthcare companies. He also recommended investments to Cohen, who managed SAC's largest portfolio. While at SAC, Martoma began to acquire shares in Elan and Wyeth in his portfolio and recommended that Cohen acquire shares in the companies as well.

In order to obtain information about bapineuzumab, Martoma contacted expert networking firms and arranged paid consultations with doctors knowledgeable about Alzheimer's disease, including two who were working on the bapineuzumab clinical trial. Dr. Sidney Gilman, chair of the safety monitoring committee for the bapineuzumab clinical trial, participated in approximately 43 consultations with Martoma at the rate of around $1,000 per hour. As a member of the safety monitoring committee, Dr. Gilman had an obligation to keep the results of the clinical trial confidential. His consulting contract reiterated that he was not to disclose any confidential information in a consultation. He nevertheless provided Martoma, whom he knew to be an investment manager seeking information to help make securities trading decisions, with confidential updates on the drug's safety that he received during meetings of the safety monitoring committee. Dr. Gilman also shared with Martoma the dates of upcoming safety monitoring committee meetings, which allowed Martoma to schedule consultations with Dr. Gilman shortly after each one. Another consultant, Dr. Joel Ross, one of the principal investigators on the clinical trial, met with Martoma on many occasions between 2006 and July 2008 and charged approximately $1,500 per hour. Like Dr. Gilman, Dr. Ross had an obligation to maintain the confidentiality of information about the bapineuzumab clinical trial. Nevertheless, during their consultations, Dr. Ross provided Martoma with information about the clinical trial, including information about his patients' responses to the drug and the total number of participants in the study, that Dr. Ross recognized was not public.

On June 17, 2008, Elan and Wyeth issued a press release regarding the results of "Phase II" of the bapineuzumab clinical trial. The press release described the preliminary results as "encouraging," with "clinically meaningful benefits in important subgroups" of Alzheimer's patients with certain genetic characteristics, but indicated that the drug had not proven effective in the general population of Alzheimer's patients. The press release further stated that the results of the trials would be presented in greater detail at the International Conference on Alzheimer's Disease to be held on July 29, 2008. Elan's share price increased following the press release.

In mid-July of 2008, the sponsors of the bapineuzumab trial selected Dr. Gilman to present the results at the July 29 conference. It was only at this point that Dr. Gilman was unblinded as to the final efficacy results of the trial. Dr. Gilman was "initially euphoric" about the results, but identified "two major weaknesses in the data" that called into question the efficacy of the drug as compared to the placebo. On July 17, 2008, the day after being unblinded to the results, Dr. Gilman spoke with Martoma for about 90 minutes by telephone about what he had learned. That same day, Martoma purchased a plane ticket to see Dr. Gilman in person at his office in Ann Arbor, Michigan. That meeting occurred two days later, on July 19, 2008. At that meeting, Dr. Gilman showed Martoma a PowerPoint presentation containing the efficacy results and discussed the data with him in detail.

The next morning, Sunday, July 20, Martoma sent Cohen, the owner of SAC, an email with "It's important" in the subject line and asked to speak with him by telephone. The two had a telephone conversation lasting about twenty minutes, after which Martoma emailed Cohen a summary of SAC's Elan and Wyeth holdings. The day after Martoma spoke to Cohen, on July 21, 2008, SAC began to reduce its position in Elan and Wyeth securities and entered into short-sale and options trades that would be profitable if Elan's and Wyeth's stock fell.

Dr. Gilman publicly presented the final results from the bapineuzumab trial at the International Conference on Alzheimer's Disease in the afternoon of July 29, 2008. Elan's share price began to decline during Dr. Gilman's presentation and at the close of trading the next day, the share prices of Elan's and Wyeth had declined by about 42% and 12%, respectively. The trades that Martoma and Cohen made in advance of the announcement resulted in approximately $80.3 million in gains and $194.6 million in averted losses for SAC. Martoma personally received a $9 million bonus based in large part on his trading activity in Elan and Wyeth.

At Martoma's trial, the district court instructed the jury on the personal benefit element of insider trading law as follows:

> If you find that Dr. Gilman or Dr. Ross disclosed material, non-public information to Mr. Martoma, you must then determine whether the government proved beyond a reasonable doubt that Dr. Gilman and Dr. Ross received or anticipated receiving some personal benefit, direct or indirect, from disclosing the material, non-public information at issue.
>
> The benefit may, but need not be, financial or tangible in nature; it could include obtaining some future advantage, developing or maintaining a business contact or a friendship, or enhancing the tipper's reputation.
>
> A finding as to benefit should be based on all the objective facts and inferences presented in the case. You may find that Dr. Gilman or Dr. Ross received a direct or indirect personal benefit from providing inside information to Mr. Martoma if you find that Dr. Gilman or Dr. Ross gave the information to Mr. Martoma with the intention of benefiting themselves in some manner, or with the intention of conferring a benefit on Mr. Martoma, or as a gift with the goal of maintaining or developing a personal friendship or a useful networking contact. . . .

The government now takes the position that *Salman* fully abrogated *Newman*'s interpretation of the personal benefit element, whereas Martoma argues that *Newman*'s "meaningfully close personal relationship" standard survived *Salman*. However, because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*. At trial, the government presented compelling evidence that Dr. Gilman received a different type of personal benefit: $70,000 in consulting fees, which can be seen either as evidence of a quid pro quo-like relationship, or simply advance payments for the tips of inside information that Dr. Gilman went on to supply. The government also introduced sufficient evidence to prove Dr. Gilman received a personal benefit by disclosing inside information with the intention to benefit Martoma. We accordingly conclude that Martoma has provided no basis for his judgment of conviction to be vacated or reversed. . . .

We have applied *Dirks* to uphold a wide variety of personal benefits. We held that a jury could infer a personal benefit from the fact that a tipper "hoped to curry favor with his boss," *Obus*, 693 F.3d at 292, and from the fact that another tipper and the tippee "were friends from college," *id.* at 291. We found evidence of a personal benefit sufficient where the tippee gave one tipper "an iPhone, live lobsters, a gift card, and a jar of honey," and where the tippee had another tipper admitted into an investment club where the tipper "had the opportunity to access information that could yield future pecuniary gain" (even though he never realized that opportunity). *Jiau*, 734 F.3d at 153. In another case, we held that the government "need not show that the tipper expected or received a specific or tangible benefit in exchange for the tip," and that the personal benefit element is satisfied where there is evidence that the tipper "intend[ed] to benefit the . . . recipient." *S.E.C. v. Warde*, 151 F.3d 42, 48 (2d Cir. 1998).

As we understand the dissent, our core disagreement is over whether intent to benefit is a standalone personal benefit under *Dirks*. The dissent argues that it is not, claiming instead that the correct formulation is a "relationship . . . that suggests . . . an intention to benefit" the tippee. The key sentence of *Dirks* is admittedly ambiguous, and we acknowledge that the dissent has offered a plausible reading. *See* 463 U.S. at 664 ("For example, there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient."). But that is not the only reading. The comma separating the "intention to benefit" and "relationship . . . suggesting a quid pro quo" phrases can be read to sever any connection between them. The sentence, so understood, effectively reads, "there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or there may be an intention to benefit the particular recipient." And that is the reading this Court adopted in *Warde*, where we read the "intention to benefit" language independently of the language of relationships: "The 'benefit' element of § 10(b) is satisfied when the tipper 'intend[s] to benefit the ... recipient' or 'makes a gift of confidential information to a trading relative or friend.'" We adhere to *Warde*.

Our understanding is also more consonant with *Dirks* as a whole. Because the existence of a breach "depends in large part on the purpose of the disclosure," it makes perfect sense to permit the government to prove a personal benefit with objective evidence of the tipper's intent, without requiring in every case some additional evidence of the tipper-tippee relationship. *Cf. United States v. Falcone*, 257 F.3d 226, 230 (2d Cir. 2001) (Sotomayor, J.) (explaining that "the key factor" in proving a personal benefit is "the tipper's intent in providing the information”). For example, suppose a tipper discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this. Under the dissent’s approach, this plain evidence that the tipper intended to benefit the tippee would be insufficient to show a breach of the tipper’s fiduciary duty to the firm due to the lack of a personal relationship. *Dirks* and *Warde* do not demand such a result. Rather, the statement “you can make a lot of money by trading on this,” following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the insider’s fiduciary duty.

We are not persuaded by our dissenting colleague’s arguments to the contrary. The dissent contends that proof that the tipper had an intent to benefit the tippee does not prove that the tipper truly “received” a personal benefit. The dissent would evidently have there be proof of something more concrete. However, as we have explained, it is settled law that personal benefits may be indirect and intangible and need not be pecuniary at all. The tipper’s intention to benefit the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose. That is precisely what, under *Dirks*, the personal benefit element is designed to test. Is evidence that an insider intended to benefit an outsider with valuable confidential information any less probative of the absence of a legitimate corporate purpose than evidence that the tippee gave the tipper trivialities like shellfish and a gift card?

The dissent argues that its formulation is more faithful to the personal benefit standard because evidence of a relationship suggesting an intent to benefit the tippee “provides reason to believe that the tipper benefits by benefitting, since the tipper is understood as contributing to a relationship from which both tipper and tippee benefit,” a rationale that does not apply where there has been no proof of a relationship. We disagree. That rationale would justify a personal benefit in the form of a relationship suggesting an intention to benefit both tipper and tippee, from which it is straightforward to infer that the tipper personally benefited from the tip. But what *Dirks* in fact refers to is an intention to benefit the tippee alone. Whichever way *Dirks* is read, it recognizes that purposely benefitting the tippee with inside information proves that the tipper has received a personal benefit in breach of a fiduciary duty. The question is whether *Dirks* requires that to be proved with evidence of a relationship or not. We think it clear that the answer is no. And although few reported decisions have relied on the intent to benefit theory, its legitimacy has until today been uncontroversial. To take an example close to home, it featured in the jury instructions in this very case and no objection was raised, nor was any challenge to this language pressed on appeal.

Finally, we are warned that this approach creates a “subjective” test and allows for convictions based on sheer speculation into the tipper’s motives. These fears are unwarranted. Intent elements are everywhere in our law and are generally proved with circumstantial evidence. . . . Insider trading is no different. A factfinder may infer the tipper intended to benefit the tippee from the sort of objective evidence that is commonly offered in insider trading cases. To return to the example above, the statement “you can make a lot of money by trading on this” is strong circumstantial evidence of the tipper’s intention to benefit the tippee. And the requirement of proof beyond a reasonable doubt remains a formidable barrier to convictions resting on speculation….

It is against that background that we must assess how *Newman* affected this Court's insider trading law. The central question in *Newman* was an issue of scienter on which our district courts had been split: whether a tippee must be aware, not only that the tipper breached a fiduciary duty in disclosing inside information, but also that the tipper received a personal benefit. The Court persuasively explained that both were required. *Id.* at 449 ("[A] tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit."). This important teaching of *Newman* is not before us. We observe that, unlike the defendants in *Newman*, Martoma received confidential information directly from the tipper, and he does not claim that he was unaware of any personal benefit Dr. Gilman received. *Cf. id.* at 448 ("In *Jiau*, the defendant knew about the benefit because she provided it.").

Newman's second holding is the focus of this appeal. After resolving the scienter question, *Newman* considered the sufficiency of the personal benefit evidence for two tippers, where the government relied chiefly on evidence that they were friendly with their tippees. The first tipper and tippee were not "close" friends but "had known each other for years, having both attended business school and worked at Dell together," and the tippee had provided modest "career advice and assistance" to the tipper. The second tipper and tippee were "family friends" that "had met through church and occasionally socialized together." The government argued that these relationships were "sufficient to prove that the tippers derived some benefit from the tip."

The *Newman* panel rejected the government's argument, holding that the personal benefit "standard, although permissive, does not suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature." As the *Newman* Court reasoned, if that were enough, then "practically anything would qualify," and "the personal benefit requirement would be a nullity." And in the sentence that forms the basis of Martoma's argument on appeal, *Newman* stated as follows:

> To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of the profits to the recipient,' we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship . . .

On the facts before it, the *Newman* Court found that standard had not been satisfied.

Martoma focuses on this single sentence of *Newman* to argue that a jury may not infer that a tipper received a personal benefit from gifting confidential information in the absence of a "meaningfully close personal relationship." The term "meaningfully close personal relationship" is new to our insider trading jurisprudence, and, viewed in isolation, it might admit multiple interpretations. But *Newman* provided substantial guidance. Immediately after introducing the "meaningfully close personal relationship" concept, *Newman* held that it "requires evidence of 'a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].'" As explained above, each of these is an independently sufficient basis to infer a personal benefit under *Dirks* and its progeny. *See, e.g., Jiau*, 734 F.3d at 153 (quid pro quo-like relationship). In other words, *Newman* cabined the gift theory using two other freestanding personal benefits that have long been recognized by our case law. And although the dissent urges in strong terms that this reading is mistaken or even improper, its dispute is in truth with the plain language of *Dirks*, as construed by *Warde*. We do no more than read literally *Newman*'s own explanation of its novel standard in light of these decisions, thereby fulfilling our legitimate function to construe and give effect to prior panel decisions.

With that understanding of *Newman*, we conclude that the personal benefit jury instructions in Martoma's trial, issued prior to that decision, were erroneous. The instructions allowed the jury to find a personal benefit based solely on the conclusion that Dr. Gilman tipped Martoma in order to "develop[ ] or maintain[ ] ... a friendship." Under *Newman*, this articulation of the gift theory is incomplete. A properly instructed jury would have been informed that it could find a personal benefit based on a "gift of confidential information to a trading relative or friend" only if it also found that Dr. Gilman and Martoma shared a relationship suggesting a quid pro quo or that Dr. Gilman intended to benefit Martoma with the inside information. But, of course, there was no error in the district court's instructions that the jury could also find a personal benefit based on either of those two factors alone, i.e., if it concluded that Dr. Gilman disclosed confidential information "with the intention of conferring a benefit on Mr. Martoma," or "with the intention of benefiting [himself] in some manner." Each of these personal benefits is unaffected by *Newman*'s interpretation of the gift theory, and neither requires proof that Dr. Gilman and Martoma share any type of "personal relationship."

Although the jury instructions were inaccurate, we conclude that the error did not affect Martoma's substantial rights. The government produced compelling evidence that Dr. Gilman, the tipper, "entered into a relationship of quid pro quo" with Martoma. Dr. Gilman, over the course of approximately 18 months and 43 paid consultation sessions for which he billed $1,000 an hour, regularly and intentionally provided Martoma with confidential information from the bapineuzumab clinical trial. Martoma kept coming back, specifically scheduling consultation sessions so that they would occur shortly after the safety monitoring committee meetings, when Dr. Gilman would have new information to pass along. Starting at least in August 2007, Dr. Gilman would reschedule his conversations with Martoma if he had no new information to reveal at the time they were scheduled to meet. By that point, the consulting relationship between Dr. Gilman and Martoma involved no legitimate service; as Dr. Gilman testified at trial, "the purpose of those consultations was for [him] to disclose to [Martoma] confidential information about the results . . . of the last Safety Monitoring Committee [meeting]." And because Martoma continued to see Dr. Gilman to receive confidential information, Dr. Gilman continued to receive consulting fees. The fact that Dr. Gilman did not specifically bill for his July 17 and 19, 2008 conversations with Martoma in which Dr. Gilman divulged the final drug efficacy data is also of no moment because, as he admitted at trial, doing so "would [have been] tantamount to confessing that [he] was . . . giving [Martoma] inside information." In the context of their ongoing "relationship of quid pro quo," Dr. Gilman's disclosures of confidential information were designed to "make good on the substantial pecuniary benefit he had already earned," *Dirks*, 463 U.S. at 663, and as a result, "it is clear beyond a reasonable doubt that a rational jury would have found [Martoma] guilty absent [any] error." *Mahaffy*, 693 F.3d at 136.

The dissent argues that under our analysis, a fact-finder must always find that tipper and tippee had a quid pro quo-like relationship whenever a tip is exchanged within a paid consulting relationship. Not so. We merely hold that on the compelling facts of this case, it is clear beyond a reasonable doubt that a properly instructed jury would have found Martoma guilty. Nor does our decision mean that a tipper who accidentally or unknowingly reveals inside information can be found guilty. Such a tipper would be protected by the requirement that the tipper know (or is reckless in not knowing) that the information is material and non-public, or by the requirement that the tipper expect the tippee to trade. . . .

Moreover, even if a jury were inclined to accept Martoma's argument that there was no quid pro quo-like relationship because Dr. Gilman did not bill Martoma for two key sessions, a rational jury could nonetheless find that Dr. Gilman personally benefited by disclosing inside information with the "intention to benefit" Martoma. We think a jury can often infer that a corporate insider receives a personal benefit (i.e., breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it. Here, as previously noted, Dr. Gilman knew that Martoma was an investment manager who was seeking information on which to base securities trading decisions. And Dr. Gilman plainly understood the valuable nature of the information about the bapineuzumab clinical trial, as Martoma had previously paid him $1,000 per hour over the course of 43 consultations to convey his knowledge on the subject, and had visited Dr. Gilman in his Ann Arbor office to receive the key drug efficacy results firsthand. From these facts, a reasonable jury could infer that Dr. Gilman personally benefited by conveying inside information about the trial with the purpose of benefiting Martoma, even if it was not persuaded that the two had a relationship suggesting a quid pro quo (or a personal relationship, for that matter).

POOLER, Circuit Judge:

I respectfully dissent. . . .

The only time *Dirks* refers to an "intention to benefit" is when it discusses the need to prove "a relationship between the insider and the recipient that suggests . . . an intention to benefit the particular recipient." Reading "intention to benefit" out of context, my colleagues assert that, under *Dirks*, an intention can be inferred without any objective evidence about relationships. But *Dirks* does not say that, and it has never been applied to allow such a freestanding inference of intent in this Circuit or elsewhere. *Salman*, 137 S. Ct. at 427 (applying gift theory to sibling relationship); *Jiau*, 734 F.3d at 153 (discussing gift theory as relationship-based before finding quid pro quo); *Obus*, 693 F.3d at 285 (discussing "trading relative or friend" standard); *United States v. Bray*, 853 F.3d 18, 26–27 (1st Cir. 2017) ("good friends"); *United States v. Parigian*, 824 F.3d 5, 16 (1st Cir. 2016) (friendship and quid pro quo); *S.E.C. v. Rocklage*, 470 F.3d 1, 7 n.4 (1st Cir. 2006) (siblings); *S.E.C. v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) ("reconciliation" between friends and reputational benefit); *S.E.C. v. Maio*, 51 F.3d 623, 632–33 (7th Cir. 1995) (exchange of favors within a friendship); *S.E.C. v. Yun*, 327 F.3d 1263, 1280 (11th Cir. 2003) ("a friend and frequent partner in real estate deals"). . . .

None of these puzzles is presented if one reads the relevant sentence in *Dirks* the way I have suggested. It is easy to understand why the *Dirks* court would have mentioned a relationship suggesting an intention to benefit, an objective circumstance, when it was providing examples of objective facts and circumstances.

Unlike a standalone intention to benefit, a relationship suggesting an intention to benefit provides reason to believe that the tipper benefits by benefitting, since the tipper is understood as contributing to a relationship from which both tipper and tippee benefit. *See supra* at 8. And the focus on relationships rather than bare intentions fits neatly with *Dirks*'s cabining of the gift theory to disclosures to "trading relative[s] or friend[s]."

This cannot be so, my colleagues protest. They ask us to imagine a situation where a tipper "discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this." Wouldn't it be absurd if this perfect stranger could not be held liable for insider trading if he went ahead and traded on this information? No, it would not be. At least, not if one takes the personal benefit rule seriously. Ex hypothesi, the fictional tipper in their scenario receives absolutely nothing in return for his disclosure, except, I suppose, the warmth that comes with knowing that somebody else might have made some money because of his actions (or perhaps the schadenfreude that comes with knowing that shareholders were defrauded). But if those sorts of "benefits" were enough, then every disclosure of inside information without affirmative indication of a pure heart would be presumptively beneficial to the tipper. *Dirks* rejected that possibility, and every appellate court to have considered the issue, including us, has consistently done the same. That is the law whether we like or not, but, for what it's worth, I see no reason to worry that truly random acts of enrichment can go unpunished. . . .

So what about Rajat Gupta after all of these rulings? As it turns out, none of the fomenting in insider trading law was of help to him. See the following opinion rejecting a second challenge to Gupta's conviction.

GUPTA v. UNITED STATES, 913 F.3d 81 (2d Cir. 2019)

Per Curiam:

[Rajat] Gupta's convictions of engaging in and conspiring to engage in an insider trading scheme were based on evidence that on several occasions Gupta, while serving on boards of directors of various companies, disclosed material nonpublic information about those companies to his friend and business associate Raj Rajaratnam, founder of the Galleon Group ("Galleon"), a family of hedge funds that invested billions of dollars for its principals and clients, *see Gupta I*, 747 F.3d at 116, 121. In his direct appeal from the judgment of conviction, Gupta principally challenged the admission in evidence of certain wiretap evidence and challenged the exclusion of certain evidence he sought to introduce. We rejected all of Gupta's contentions and affirmed the judgment. Gupta did not challenge the sufficiency of the evidence to convict him or any of the instructions to the jury.

After Gupta's appeal had been decided, this Court decided [*United States v.*] *Newman*, 773 F.3d at 438, in which we reversed the insider trading convictions of two tippees.

In his present § 2255 motion, Gupta quotes the following parts of the trial court's instructions to the jury at his trial:

> First, [the government must prove that] on or about the date alleged, Mr. Gupta engaged in an insider trading scheme, in that, in anticipation of receiving at least some modest benefit in return, he provided to Mr. Rajaratnam the material non-public information specified in the count you are considering. . . .
>
> [A]s to the benefit that the defendant anticipated receiving, the benefit does not need to be financial or to be tangible in nature. It could include, for example, maintaining a good relationship with a frequent business partner, or obtaining future financial benefits.

He contends that

> [t]he instruction thus began by emphasizing, in a formulation plainly invalid following Newman, that "the benefit does not need to be financial or to be tangible in nature." By way of example, the district court continued, "maintaining a good relationship" with Rajaratnam would suffice. The instruction thus permitted, consistent with the government's theory, proof and arguments in the case, a guilty verdict based on the relationship, alone, as the benefit.

(*Id.* at 10–11 (emphasis in original).) Gupta contends that his convictions should be vacated on the ground that *Newman*, "[b]y contrast, . . . held that a personal benefit must take the form of an 'exchange'—a quid pro quo—in which the alleged tipper receives an 'objective, consequential . . . gain of a pecuniary or similarly valuable nature,' or at least the opportunity for such gain." (*Id.* at 11 (quoting *Newman*, 773 F.3d at 452)). We disagree. . . .

[T]he trial court's reference to a good relationship with a frequent business partner was consistent with the Supreme Court's discussion in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255, 77 L. Ed. 2d 911 (1983), as to what may properly be considered a tipper's anticipated personal benefit sufficient to warrant his conviction of insider trading. In *Dirks*, noting that "a purpose of the securities laws was to eliminate use of inside information for personal advantage," *id.* at 662, 103 S. Ct. 3255 (internal quotation marks omitted), the Court stated that the test for whether that purpose has been contravened is "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 663, 103 S. Ct. 3255. The Court also stated that an inference of such a benefit may be warranted by the circumstance of "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient." *Id.* at 664, 103 S. Ct. 3255. Where the recipient of the tip is the tipper's "frequent" "business" partner, the tipper's anticipation of a quid pro quo is easily inferable. . . .

Indeed, the lack of need for proof of the tipper's financial or tangible gain was highlighted as well by the *Dirks* Court's illustration that

> [t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

463 U.S. at 664, 103 S. Ct. 3255; *see also United States v. Martoma*, 894 F.3d 64, 75 (2d Cir. 2018) ("The tipper's intention to benefit the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose.").

Finally, the trial court's instruction that the benefit to Gupta need not have been financial or tangible, although contrary to the formulation given in *Newman*, could not have constituted prejudice to Gupta because it was correct. The *Newman* formulation was expressly rejected by the Supreme Court in *Salman v. United States*, ––– U.S. ––––, 137 S. Ct. 420, 196 L. Ed. 2d 351 (2016), as that Court noted that

> [t]o 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, *Newman*, 773 F.3d at 452, . . . this requirement is inconsistent with *Dirks*.

137 S. Ct. at 428. Thus, in the wake of *Salman*, we have stated that "it is settled law that personal benefits may be indirect and intangible and need not be pecuniary at all." *United States v. Martoma*, 894 F.3d at 75. . . .

[T]he record as a whole, viewed in the light most favorable to the government, contained ample evidence that Gupta and Rajaratnam were business associates. . . .

There was ample evidence to permit the jury to find that Gupta intended Rajaratnam to trade on the basis of the confidential information Gupta passed to him and that Gupta personally benefitted in one of the ways envisioned in *Dirks*. . . .

Problem 4-8
You are an attorney at a major New York law firm. In light of *Newman, Salman*, and *Martoma*, advise Sally—a client who runs a hedge fund—when she can and cannot trade on the basis of nonpublic information she learns about publicly traded companies. The first task in preparing this advice, of course, is to distill where these cases have left the law of insider trading with regard to the elements of proof needed to establish tippee liability.

As if matters needed to get more complicated, the Second Circuit in the next case recently gave approval to a new DOJ theory that insider trading can be prosecuted under a different securities fraud statute, 18 U.S.C. § 1348, without all of the requirements found in the case law under Rule 10b-5. It remains to be seen whether the government will continue to press this somewhat breathtaking move in insider trading doctrine, and whether it will survive review in the courts beyond this single panel of Second Circuit judges.

UNITED STATES v. BLASZCZAK, 947 F.3d 19 (2d Cir. 2019) [*vacated in part in light of* Kelly v. U.S., 2021 WL 78043 (2021)]

RICHARD J. SULLIVAN, Circuit Judge:

…Defendants David Blaszczak, Theodore Huber, Robert Olan, and Christopher Worrall were charged with [wire fraud and securities fraud for] misappropriating confidential nonpublic information from the Centers for Medicare & Medicaid Services ("CMS"). The indictment principally alleged that CMS employees, including Worrall, disclosed the agency's confidential information to Blaszczak, a "political intelligence" consultant for hedge funds, who in turn tipped the information to Huber and Olan, employees of the healthcare-focused hedge fund Deerfield Management Company, L.P. ("Deerfield"), which traded on it. . . .

Defendants now challenge their convictions on various grounds. For the reasons set forth below, we reject these challenges. In doing so, we hold, *inter alia*, that (1) confidential government information such as the CMS information at issue here may constitute "property" in the hands of the government for purposes of the wire fraud and Title 18 securities fraud statutes, and (2) the "personal-benefit" test established in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255, 77 L. Ed. 2d 911 (1983), does not apply to these Title 18 fraud statutes.

At various times between 2009 and 2014, Olan, Huber, and fellow Deerfield partner Jordan Fogel – a cooperating witness who pleaded guilty and testified at trial – approached Blaszczak for the purpose of obtaining so-called "predecisional" information concerning CMS's contemplated rules and regulations. The three Deerfield partners knew that Blaszczak, who had worked at CMS before becoming a consultant for hedge funds, enjoyed unique access to the agency's predecisional information through his inside sources at the agency. Because other consultants did not have access to Blaszczak's sources, the Deerfield partners counted him as a particularly lucrative fount of illegal market "edge."

This illegal market edge first paid off for the three Deerfield partners in July 2009, after Blaszczak passed them nonpublic CMS information concerning both the timing and substance of an upcoming proposed CMS rule change that would reduce the reimbursement rate for certain radiation oncology treatments. The Deerfield partners sought to maximize this market edge by trading while "the information wasn't known to others, and ... wasn't public." In late June 2009, Olan, Huber, and Fogel directed Deerfield to enter orders shorting approximately $33 million worth of stock in radiation-device manufacturer Varian Medical Systems ("Varian"), a company that would be hurt by CMS's proposed rule. Blaszczak's information was consistent with the proposed rule that CMS ultimately announced on July 1, 2009, and as a result of the Varian trade, Deerfield made $2.76 million in profits.

Deerfield again traded on confidential CMS information obtained from Blaszczak in 2012. This time, Blaszczak obtained the predecisional information at issue from Worrall, a CMS employee who had previously worked with Blaszczak at the agency and remained friends with him after Blaszczak left CMS to become a hedge fund consultant. Blaszczak met Worrall at CMS's headquarters in Maryland on May 8, 2012; the following day, Blaszczak emailed Fogel to set up a phone call so that he could update him on one of Fogel's "favorite topics." On the call, Blaszczak provided Fogel with predecisional CMS information about additional radiation oncology reimbursement rate changes. Fogel, in turn, shared this information with Huber and Olan, and together the three of them relied on it – in combination with other confidential CMS information that Blaszczak passed them over the next few weeks – in recommending that Deerfield short millions of dollars in the shares of companies that would be hurt by the reimbursement changes. Deerfield earned profits of $2.73 million from trades relating to this radiation oncology rule, which was publicly announced on July 6, 2012.

In February 2013, shortly after Fogel moved to a different group within Deerfield, he reached out to Blaszczak in the hopes of "re-ignit[ing] the Blaszczak-Fogel money printing machine." As Fogel testified at trial, the "Blaszczak-Fogel money printing machine" meant that "Blaszczak had a long history of providing [Fogel] and [his] teammates nonpublic information that [they] could trade on, and it was a great asset to get edge for investments."

Fogel did not have to wait long for the machine to reignite. In June 2013, Blaszczak told Fogel that he expected CMS to propose cutting the reimbursement rate for end-stage renal disease ("ESRD") treatments by 12 percent. Although Blaszczak did not reveal the source of his information to Fogel, the prediction was so specific – and so different from the market consensus – that Fogel believed it came "from a credible source inside of CMS." Still, Fogel remained anxious about the outlier status of Blaszczak's prediction and continued to check in with him about his level of certainty. On June 25, 2013, less than a week before CMS announced the ESRD rule, Blaszczak told Fogel that there was "[n]o change in [his] numbers" and that he was "pretty confident" in his information. *Id.* at 2024. Fogel again took this to mean that Blaszczak obtained the information from a reliable inside source, and further inferred that the public announcement of the proposed rate cut (the timing of which was also nonpublic) was around the corner and thus less likely to change. On the basis of this confidential nonpublic information, Fogel directed Deerfield to enter orders shorting stock in Fresenius Medical Care, a public company that would be hurt by the reimbursement rate cuts. CMS publicly announced the 12 percent rate cut on July 1, 2013, and Deerfield earned approximately $860,000 in profits from the trade.

Blaszczak continued to provide Fogel with predecisional CMS information in advance of CMS's announcement of the final ESRD rule on November 22, 2013. In particular, Blaszczak informed Fogel that the final ESRD rule would keep the 12 percent rate cut but would be phased in over three to four years. Based on that information, Fogel recommended that Deerfield enter orders to short stock in Fresenius and DaVita Healthcare Partners Inc. Deerfield did so, earning profits of approximately $791,000. Immediately after CMS announced the final ESRD rule, Fogel emailed his colleagues at Deerfield to praise Blaszczak for his ESRD reimbursement predictions: "I told u guys blazcack [sic] is the man. ... [H]e has crushed it on these two rules both times round."

Around the same time that Blaszczak was tipping confidential CMS information to his contacts at Deerfield, he also provided similar information to Christopher Plaford, a portfolio manager at the hedge fund Visium. After subsequently pleading guilty pursuant to a cooperation agreement, Plaford testified that he used Blaszczak as a political-intelligence consultant from around 2010 to 2013, during which time Blaszczak would provide him with both public and nonpublic information concerning the healthcare industry. Plaford, like the Deerfield partners, especially valued Blaszczak's nonpublic CMS information due to the market edge it gave him. Indeed, Plaford considered Blaszczak's CMS information to be "much more accurate" than the information provided by other consultants, since it came "directly from the horse's mouth," meaning Blaszczak's friends and former colleagues at CMS.

In May 2013, for example, Blaszczak tipped Plaford that he expected CMS to propose cutting the reimbursement rate for home healthcare coverage by between three and three-and-a-half percent per year between 2014 and 2017. In the ensuing weeks, Plaford arranged phone calls with Blaszczak to discuss the sources of his information and thus his level of certainty, an issue that Plaford did not want to discuss over email "because it was potentially incriminating." On the phone call, Blaszczak told Plaford that he had a "high conviction" that his information was accurate because he was "interacting directly with his counterparties in CMS [who] were working on the rule, and they were telling him ... [what] the cut would be." Based on Blaszczak's information, Plaford directed Visium to maintain its short positions for Amedisys Inc. and Gentiva Health Services Inc., and to buy put-options in those companies. Following CMS's June 27, 2013 announcement of the proposed home healthcare rule, which included a three-and-a-half percent annual rate cut consistent with Blaszczak's information, Visium earned approximately $330,000 in trading profits. . . .

[The jury acquitted the Defendants on the Title 15 securities fraud charges.]

Defendants argue that their convictions for fraud under Title 18 must be reversed because there was insufficient evidence to prove that they engaged in a scheme to defraud CMS of "property." 18 U.S.C. §§ 1343, 1348. The gravamen of their argument is that a government agency's confidential information is not "property" in the hands of the agency under the Supreme Court's decision in *Cleveland v. United States*, 531 U.S. 12, 121 S. Ct. 365, 148 L. Ed. 2d 221 (2000), because the agency has a "purely regulatory" interest in such information, *id.* at 22, 121 S. Ct. 365. . . .

Here, we find it most significant that CMS possesses a "right to exclude" that is comparable to the proprietary right recognized in *Carpenter*. Like the private news company in *Carpenter*, CMS has a "property right in keeping confidential and making exclusive use" of its nonpublic predecisional information. *Carpenter*, 484 U.S. at 26, 108 S. Ct. 316. In stark contrast to a state's right to issue or deny a poker license – a "paradigmatic exercise[ ] of the [state's] traditional police powers" – CMS's right to exclude the public from accessing its confidential predecisional information squarely implicates the government's role as property holder, not as sovereign. *Cleveland*, 531 U.S. at 23, 121 S. Ct. 365. . . .

Furthermore, although we do not read *Cleveland* as strictly requiring the government's property interest to be "economic" in nature, the government presented evidence that CMS *does* have an economic interest in its confidential predecisional information. For example, the evidence at trial established that CMS invests time and resources into generating and maintaining the confidentiality of its nonpublic predecisional information – resources that are devalued when the information is leaked to members of the public. *See Carpenter*, 484 U.S. at 26, 108 S. Ct. 316; *see also, e.g.*, *Middendorf*, 2018 WL 3443117, at *9 (concluding that a statutory non-profit's confidential inspection lists were "certainly something of value to the [non-profit], which invested time and resources into their creation" (internal quotation marks omitted)). Relatedly, the selective leaking of confidential CMS information risks hampering the agency's decision-making process. Although this risk obviously implicates CMS's regulatory interests, it also implicates CMS's economic interest in making efficient use of its limited time and resources. As former CMS Director Dr. Jonathan Blum testified, leaks of confidential information could result in unbalanced lobbying efforts, which would in turn impede the agency's efficient functioning by making it "more difficult to manage the process flow and to convince [Blum's] superiors of the right course for the Medicare program." Leaks may also require the agency to "tighten up" its internal information-sharing processes, again with the result that the agency would become less efficient. . . .

We therefore hold that, in general, confidential government information may constitute government "property" for purposes of 18 U.S.C. §§ 1343 and 1348, and that here, there was sufficient evidence to establish that the CMS information at issue was "property" in the hands of CMS. . . .

Under *Dirks*, an insider may not be convicted of Title 15 securities fraud unless the government proves that he breached a duty of trust and confidence by disclosing material, nonpublic information in exchange for a "personal benefit." 463 U.S. at 663, 103 S. Ct. 3255. Similarly, a tippee may not be convicted of such fraud unless he utilized the inside information knowing that it had been obtained in breach of the insider's duty. *See United States v. Newman*, 773 F.3d 438, 447–49 (2d Cir. 2014), *abrogated on other grounds by Salman v. United States*, ––– U.S. ––––, 137 S. Ct. 420, 196 L. Ed. 2d 351 (2016). Here, Defendants claim that the district court erred by not instructing the jury that *Dirks*'s personal-benefit test also applied to the wire fraud and Title 18 securities fraud counts. In essence, Defendants argue that the term "defraud" should be construed to have the same meaning across the Title 18 fraud provisions and Rule 10b-5, so that the elements of insider-trading fraud are the same under each of these provisions. We disagree. . . .

While the Title 18 fraud statutes and Title 15 fraud provisions . . . share similar text and proscribe similar theories of fraud, these common features have little to do with the personal-benefit test. Rather, the personal-benefit test is a judge-made doctrine premised on the Exchange Act's statutory purpose. As *Dirks* explained, in order to protect the free flow of information into the securities markets, Congress enacted the Title 15 fraud provisions with the limited "purpose of ... eliminat[ing] [the] use of inside information for *personal advantage*." 463 U.S. at 662, 103 S. Ct. 3255 (emphasis added) (internal quotation marks omitted). *Dirks* effectuated this purpose by holding that an insider could not breach his fiduciary duties by tipping confidential information unless he did so in exchange for a personal benefit. *Id.* at 662–64, 103 S. Ct. 3255; *see also Chestman*, 947 F.2d at 581 (Winter, *J.*, concurring in part and dissenting in part) (observing that whereas the theory of fraud recognized in *Carpenter* "is derived from the law of theft or embezzlement," the "*Dirks* rule is derived from securities law, and ... [is] influenced by the need to allow persons to profit from generating information about firms so that the pricing of securities is efficient"); *United States v. Pinto-Thomaz*, 352 F. Supp. 3d 287, 298 (S.D.N.Y. 2018) (Rakoff, *J.*) ("Although [the *Dirks* personal-benefit test] was novel law, the Court reasoned that this test was consistent with the 'purpose of the [Title 15] securities laws ... to eliminate use of inside information for personal advantage.' " (quoting *Dirks*, 463 U.S. at 662, 103 S. Ct. 3255)).

But once untethered from the statutory context in which it arose, the personal-benefit test finds no support in the embezzlement theory of fraud recognized in *Carpenter*. In the context of embezzlement, there is no additional requirement that an insider breach a duty to the owner of the property, since "it is impossible for a person to embezzle the money of another without committing a fraud upon him." *Grin*, 187 U.S. at 189, 23 S. Ct. 98. Because a breach of duty is thus inherent in *Carpenter*'s formulation of embezzlement, there is likewise no additional requirement that the government prove a breach of duty in a specific manner, let alone through evidence that an insider tipped confidential information in exchange for a personal benefit. . . .

Our conclusion is the same for both the wire fraud and Title 18 securities fraud statutes. While it is true that Section 1348 of Title 18, unlike the wire fraud statute, concerns the general subject matter of securities law, Section 1348 and the Exchange Act do not share the same statutory purpose. *See United States v. Mills*, 850 F.3d 693, 699 (4th Cir. 2017) ("The doctrine of *in pari materia* is inapplicable when statutes have different purposes."). Indeed, Section 1348 was added to the criminal code by the Sarbanes-Oxley Act of 2002 in large part to overcome the "technical legal requirements" of the Title 15 fraud provisions. . . . In particular, Congress intended for Section 1348 to "supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes." S. Rep. No. 107-146, at 14. Given that Section 1348 was intended to provide prosecutors with a different—and broader—enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions, we decline to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud.

Finally, Defendants argue that we should extend *Dirks* beyond the Title 15 fraud provisions because otherwise the government may avoid the personal-benefit test altogether by prosecuting insider-trading fraud with less difficulty under the Title 18 fraud statutes – particularly the Title 18 securities fraud statute, which (unlike the wire fraud statute) does not require proof that wires were used to carry out the fraud. But whatever the force of this argument as a policy matter, we may not rest our interpretation of the Title 18 fraud provisions "on such enforcement policy considerations." *O'Hagan*, 521 U.S. at 678 n.25, 117 S. Ct. 2199. . . . Congress was certainly authorized to enact a broader securities fraud provision, and it is not the place of courts to check that decision on policy grounds.

Problem 4-9
If the decision in *Blaszczak* holds up in the Second Circuit and elsewhere, will the government now be able to prosecute all tipper-tippee insider trading cases without having to be concerned at all with the personal benefit element?

G. Statutory Reform of Insider Trading Law?

The debate about insider trading law following decisions in *Newman, Salman*, and related cases has reinvigorated a longstanding conversation about whether U.S. law would be better off with a statutory prohibition on insider trading in place of judicial construction of Rule 10b-5. To think about that question, consider the following examples: a recent House Bill that has passed and is now before the Senate, and an existing statute in another jurisdiction (Hong Kong).

H. R. 2534

IN THE SENATE OF THE UNITED STATES

DECEMBER 9, 2019

Received; read twice and referred to the Committee on Banking, Housing, and Urban Affairs

AN ACT

To amend the Securities Exchange Act of 1934 to prohibit certain securities trading and related communications by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1 SHORT TITLE.

This Act may be cited as the "Insider Trading Prohibition Act".

SEC. 2. PROHIBITION ON INSIDER TRADING.

(a) IN GENERAL.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended by inserting after section 16 the following new section:

"SEC. 16A. PROHIBITION ON INSIDER TRADING.

"(a) PROHIBITION AGAINST TRADING SECURITIES WHILE AWARE OF MATERIAL, NONPUBLIC INFORMATION.—It shall be unlawful for any person, directly or indirectly, to purchase, sell, or enter into, or cause the purchase or sale of or entry into, any security, security-based swap, or security-based swap agreement, while aware of material, nonpublic information relating to such security, security-based swap, or security-based swap agreement, or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any such security, security-based swap, or security-based swap agreement, if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.

"(b) PROHIBITION AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION.—It shall be unlawful for any person whose own purchase or sale of a security, security-based swap, or entry into a security-based swap agreement would violate subsection (a), wrongfully to communicate material, nonpublic information relating to such security, security-based swap, or security-based swap agreement, or any nonpublic information, from whatever source, that has, or would reasonably be expected to have, a material effect on the market price of any such security, security-based swap, or security-based swap agreement, to any other person if—

“(1) the other person—

“(A) purchases, sells, or causes the purchase or sale of, any security or security-based swap or enters into or causes the entry into any security-based swap agreement, to which such communication relates; or

“(B) communicates the information to another person who makes or causes such a purchase, sale, or entry while aware of such information; and

“(2) such a purchase, sale, or entry while aware of such information is reasonably foreseeable.

“(c) STANDARD AND KNOWLEDGE REQUIREMENT.—

“(1) STANDARD.—For purposes of this section, trading while aware of material, nonpublic information under subsection (a) or communicating material nonpublic information under subsection (b) is wrongful only if the information has been obtained by, or its communication or use would constitute, directly or indirectly—

“(A) theft, bribery, misrepresentation, or espionage (through electronic or other means);

“(B) a violation of any Federal law protecting computer data or the intellectual property or privacy of computer users;

“(C) conversion, misappropriation, or other unauthorized and deceptive taking of such information; or

“(D) a breach of any fiduciary duty, a breach of a confidentiality agreement, a breach of contract, a breach of any code of conduct or ethics policy, or a breach of any other personal or other relationship of trust and confidence for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend).

“(2) KNOWLEDGE REQUIREMENT.—It shall not be necessary that the person trading while aware of such information (as proscribed by subsection (a)), or making the communication (as proscribed by subsection (b)), knows the specific means by which the information was obtained or communicated, or whether any personal benefit was paid or promised by or to any person in the chain of communication, so long as the person trading while aware of such information or making the communication, as the case may be, was aware, consciously avoided being aware, or recklessly disregarded that such information was wrongfully obtained, improperly used, or wrongfully communicated.

“(d) DERIVATIVE LIABILITY.—Except as provided in section 20(a), no person shall be liable under this section solely by reason of the fact that such person controls or employs a person who has violated this section, if such controlling person or employer did not participate in, or directly or indirectly induce the acts constituting a violation of this section.

"(e) AFFIRMATIVE DEFENSES.—

"(1) IN GENERAL.—The Commission may, by rule or by order, exempt any person, security, or transaction, or any class of persons, securities, or transactions, from any or all of the provisions of this section, upon such terms and conditions as it considers necessary or appropriate in furtherance of the purposes of this title.

"(2) DIRECTED TRADING.—The prohibitions of this section shall not apply to any person who acts at the specific direction of, and solely for the account of another person whose own securities trading, or communications of material, nonpublic information, would be lawful under this section. . . .

Hong Kong Ordinance CAP 571, section 270. Insider Dealing.

(1) Insider dealing in relation to a listed corporation takes place

(a) when a person connected with the corporation and having information which he knows is inside information in relation to the corporation

(i) deals in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or

(ii) counsels or procures another person to deal in such listed securities or derivatives, knowing or having reasonable cause to believe that the other person will deal in them;

(b) when a person who is contemplating or has contemplated making, whether with or without another person, a take-over offer for the corporation and who knows that the information that the offer is contemplated or is no longer contemplated is inside information in relation to the corporation

(i) deals in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, otherwise than for the purpose of the take-over; or

(ii) counsels or procures another person to deal in such listed securities or derivatives, otherwise than for the purpose of the take-over;

(c) when a person connected with the corporation and knowing that any information is inside information in relation to the corporation, discloses the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives;

(d) when a person who is contemplating or has contemplated making, whether with or without another person, a take-over offer for the corporation and who knows that the information that the offer is contemplated or is no longer contemplated is inside information in relation to the corporation, discloses the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives;

(e) when a person who has information which he knows is inside information in relation to the corporation and which he received, directly or indirectly, from a person whom he knows is connected with the corporation and whom he knows or has reasonable cause to believe held the information as a result of being connected with the corporation

(i) deals in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or

(ii) counsels or procures another person to deal in such listed securities or derivatives; or

(f) when a person having received, directly or indirectly, from a person whom he knows or has reasonable cause to believe is contemplating or is no longer contemplating making a take-over offer for the corporation, information to that effect which he knows is inside information in relation to the corporation

(i) deals in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives; or

(ii) counsels or procures another person to deal in such listed securities or derivatives.

(2) Insider dealing in relation to a listed corporation also takes place when a person who knowingly has inside information in relation to the corporation in any of the circumstances described in subsection (1)

(a) counsels or procures another person to deal in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, knowing or having reasonable cause to believe that the other person will deal in such listed securities or derivatives outside Hong Kong on a stock market other than a recognized stock market; or

(b) discloses the inside information to another person knowing or having reasonable cause to believe that the other person or some other person will make use of the inside information for the purpose of dealing, or of counselling or procuring any other person to deal, in the listed securities of the corporation or their derivatives, or in the listed securities of a related corporation of the corporation or their derivatives, outside Hong Kong on a stock market other than a recognized stock market.