REWARDED FOR BEING REMOTE: HOW *UNITED STATES V. NEWMAN* IMPROPERLY NARROWS LIABILITY FOR TIPPEES

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Over fifty percent of Americans invest in the stock market,[1] and almost twice as many people choose to invest in stocks rather than in commercial banks.[2] In order to encourage the formation of capital, these investors must have confidence in the stability and fairness of the stock market.[3] Illegal insider trading undermines investor confidence because individuals in possession of nonpublic information use it improperly to their advantage, such as "buying or selling a security, in breach of a fiduciary duty or other relationship . . . while in possession of material, nonpublic information."[4]

To discourage this activity and encourage transparency, Congress and the United States Securities and Exchange Commission (SEC) have enacted laws and regulations prohibiting the use of material, nonpublic information for personal profit.[5] Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 10b–5 broadly

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1. Cam Merritt, *What is the Percentage of Americans Who Invest in the Stock Market?*, ZACKS INV. RES., http://finance.zacks.com/percentage-americans-invest-stock-market-6880.html (last visited Oct. 12, 2016). In April 2007, before the economic crisis, approximately sixty-five percent of Americans invested in the market, compared to approximately fifty-three percent of Americans in 2012. *Id.*

2. Thomas C. Newkirk, *Speech by SEC Staff: Insider Trading—A U.S. Perspective*, U.S. SEC. & EX. COMMISSION (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

3. Michelle Lodge, *Investor Confidence Critical: Exchange CEO*, CNBC (July 20, 2010, 3:22 PM ET), http://www.cnbc.com/id/38328025.

4. *Insider Trading*, U.S. SEC. & EX. COMMISSION, http://www.sec.gov/answers/insider.htm (last modified Jan. 15, 2013). Insider trading is not illegal if the trades are reported to the SEC, the information is not material and nonpublic, and the trader is not determined to be in breach of a fiduciary duty. *Id.*

5. Newkirk, *supra* note 2.

prohibit the use of fraud "in connection with the purchase or sale of any security."[6]

News stories regarding insider trading most commonly report about corporate insiders that trade for their own benefit.[7] However, the concept of insider trading is not only limited to the insider, who directly learns of such information as a consequence of his or her position. Liability may also extend to "tippees"—people who learn of inside information directly from the insider, or indirectly from an intermediary party, and who in turn use that information to trade and profit.[8] In those cases, the insider and intermediaries become the "tippers," and the chain of people who learn of the information become the "downstream tippees."[9]

Insider trading may be both a criminal and a civil offense.[10] Some notable differences between the two are the standard of proof required and the potential punishment imposed.[11] Criminal violations require a greater burden of proof—beyond a reasonable doubt—and are punishable by imprisonment.[12] Prosecuting tippees for criminal insider

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6. *Id.* The general federal securities laws do not have a statutory prohibition against insider trading. Robert Khuzami, *Statement on the Application of Insider Trading Law to Trading by Members of Congress and Their Staffs*, U.S. SEC. & EX. COMMISSION (Dec. 1, 2011), https://www.sec.gov/news/testimony/2011/ts120111rsk.htm. As a result, Section 10(b) is a "catch-all" provision for fraud that is used to prohibit the use of "'any manipulative or deceptive device'" when it is used "'in connection with the purchase or sale of any security.'" United States v. Newman, 773 F.3d 438, 445 (2d Cir. 2014) (quoting 15 U.S.C. § 78j(b) (2012)). Although Section 10(b) and Rule 10b-5 do not expressly address insider trading, these anti-fraud provisions have at times been applied to insider trading cases by the courts. Newkirk, *supra* note 2. Still, "the development of insider trading law has not progressed with logical precision as the reach of the anti-fraud provisions to cover insider trading has expanded and contracted over time." *Id.*

7. *See, e.g.*, *Hedge Fund Manager Spared Prison for Insider Trading*, REUTERS (Mar. 1, 2016, 4:16 PM EST), http://www.reuters.com/article/usa-insidertrading-barai-idUSL2N1690V9 (reporting on a former hedge fund manager who gained $3.91 million as a result of insider trading); David Kirk, *Going Inside for Insider Trading*, SUBJECT TO INQUIRY (Sept. 11, 2014), http://www.subjecttoinquiry.com/enforcement/Corruption-2/going-inside-for-insider-trading/ (explaining the significance of insider trading sentences for recent cases in the U.S. and U.K.); Kevin McCoy, *Ex-Goldman Sachs Employee Charged with Insider Trading*, USA TODAY (Nov. 25, 2015, 1:53 PM EST), http://www.usatoday.com/story/money/2015/11/25/ex-goldman-sachs-employee-charged-insider-trading/76373370/ (reporting on a Goldman Sachs employee charged with profiting in amounts of more than $460,000 through insider trading). Notable insiders that illegally traded for their own benefit include Mathew Martoma, Matthew Kluger, and Raj Rajaratnam. Kirk, *supra*.

8. *See* Reem Heakal, *Defining Illegal Insider Trading*, INVESTOPEDIA (July 26, 2013), http://www.investopedia.com/articles/03/100803.asp (explaining the insider trading scheme and how tippees are subject to liability).

9. Christopher M. Matthews, *Court Case May Help Define 'Insider Trading,'* WALL ST. J. (Apr. 20, 2014, 5:47 PM ET), http://www.wsj.com/articles/SB10001424052702304626304579508002188325992.

10. Newkirk, *supra* note 2.

11. *Id.*

12. *Id.*

trading violations is particularly challenging because two of the elements—a relationship between the tipper and tippee, and the tippee's knowledge of a personal benefit to the insider—are difficult to prove beyond a reasonable doubt.[13] As the SEC notes, trading stock is legal and it is "only what is in the mind of the trader that can make this legal activity a prohibited act of insider trading."[14] There is often also a lack of direct evidence, which makes a case almost entirely circumstantial "[u]nless the insider trader confesses his knowledge in some admissible form."[15]

In its December 2014 decision of *United States v. Newman*, the Second Circuit significantly narrowed the standard for imposing criminal liability on individuals who receive material, nonpublic information from company insiders. The court stated that a tippee must have knowledge of the confidential information and a "meaningfully close personal relationship" with the tipper in order to conclude there was a personal benefit.[16] Both the knowledge and meaningfully close relationship standards are a departure from prior caselaw and improperly narrow the scope of tippee liability. The new standards significantly limit the SEC's efforts to prosecute tippees who receive inside information. Although the SEC increased the number of cases filed since 2010 and created a Market Abuse Unit to detect "complex insider trading schemes" based on suspicious patterns and relationships among market participants,[17] the process of establishing tipper or tippee liability is complicated due to the difficulty of proving scienter and a violation of a duty of trust.[18] The Second Circuit's decision could also influence other federal courts to impose a similar standard.

Part I of this Article covers the history of tippee liability for insider trading, including the Supreme Court's standard for scienter prior to

13. *Id.* Proving a criminal insider trading violation requires establishing that the tippees "knew that the tippers received a personal benefit for their disclosure." United States v. Newman, 773 F.3d 438, 451 (2d Cir. 2014). A personal benefit may be inferred if there is "evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter.'" *Id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)). In the case of Rengan Rajaratnam, lawyers "argued prosecutors lacked evidence [he] . . . knew any inside information was disclosed for a personal benefit." *Fund Founder Raj Rajaratnam's Brother Rengan Faces US Insider Trading Trial*, ECON. TIMES (June 16, 2014, 11:10 AM IST), http://economictimes.indiatimes.com/news/international/business/fund-founder-raj-rajaratnams-brother-rengan-faces-us-insider-tradingtrial/articleshow/36647704.cms [hereinafter *Fund Founder*].

14. Newkirk, *supra* note 2.

15. *Id.*

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

17. Khuzami, *supra* note 6.

18. *Id.*

the *Newman* decision. Part II contains a more in-depth analysis of the *Newman* court's rationale in arriving at its decision, and Part III presents arguments for why the decision improperly narrowed liability. Part IV offers suggestions for a tippee liability standard going forward, and Part V provides concluding remarks regarding the *Newman* decision.

I. HISTORY OF SCIENTER IN TIPPEE LIABILITY CASES

Over the past thirty-five years, two theories of insider trading liability have developed—classical and misappropriation.[19] Under the classical theory, which the *Newman* court applied,[20] corporate insiders violate Section 10(b) of the Exchange Act and SEC Rule 10b–5 by trading on the basis of material, nonpublic information or disclosing such information to others for their own benefit, thereby breaching their fiduciary duty to the company and shareholders.[21] The duty breached specifically refers to the "'trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position within that corporation.'"[22] For example, a corporate officer, director, or employee breaches this duty when sharing material, nonpublic information with friends, associates, and family if these individuals subsequently trade on the basis of that information.[23] According to the SEC, a tippee who

19. Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323–24 (2009) (The classical theory was established in Chiarella v. United States, 445 U.S. 222 (1980) and the misappropriation theory later emerged in United States v. O'Hagan, 521 U.S. 642 (1997)). The classical theory imposes liability to insiders trading "on the basis of material, nonpublic information." *Newman*, 773 F.3d at 445. The misappropriation theory overlaps with the classical theory and expands to include outsiders who have no fiduciary relationship with the corporation or the shareholders, but have a relationship with the person who is the source of the confidential information. *Id.* at 445–46 (citing *O'Hagan*, 521 U.S. at 652–53; United States v. Libera, 989 F.2d 596, 599–600 (2d Cir. 1993)).

20. SEC v. Payton, 97 F. Supp. 3d 558, 561 (S.D.N.Y. 2015) (stating that "in *Newman*, a case . . . premised on the classical theory of insider trading, the Second Circuit held that the remote tippee . . . had to be aware that the original tipper had received a benefit" because that would indicate that the remote tippee knew "he was participating in a fraud").

21. *Id.* Illegal insider trading involves buying or selling securities by corporate insiders or tippees when the information is shared or traded in breach of a fiduciary relationship or relationship of trust, and such activity is not reported to the SEC. *Insider Trading*, *supra* note 4. To breach the fiduciary duty under the classical theory, the information disclosed must be both material and nonpublic. *Id*.

22. *Newman*, 773 F.3d at 445 (quoting *Chiarella*, 445 U.S. at 228).

23. *Insider Trading*, *supra* note 4. Due to the informational disparity between the public and the friends or family members of the insider, such a disclosure is harmful to the investing public and breaches the duty of the tipper to the company. *Id*. The insider has a duty to abstain from trading and refrain from sharing confidential information, or to report any disclosed information

receives this information can also be held liable for insider trading if trades are made on the basis of that information and "the tippee knew or should have known of the tipper's breach of duty in disclosing the information."[24] This knowledge requirement was not always so clearly stated, but has developed over time.

An early Supreme Court case that addressed the question of tippee knowledge was the 1976 decision of *Ernst & Ernst v. Hochfelder*.[25] In that case, the Court found that no civil liability under Section 10(b) could be imposed for merely negligent conduct.[26] Although "[t]he Commission contend[ed] . . . that subsections (b) and (c) of Rule 10b–5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior," the Court ultimately found that "such a reading [could not] be harmonized with the administrative history of the Rule, a history making clear that when the Commission adopted the Rule it was intended to apply only to activities that involved scienter."[27] For that reason, the Court was "unwilling to extend the scope of the statute to negligent conduct."[28] The Court primarily relied upon the legislative history of the Exchange Act, finding "no indication . . . that [Section] 10(b) was intended to proscribe conduct not involving scienter."[29] Instead, the Court looked at statements made by the drafters of the section, particularly those referring to the section as a "'catchall' clause" for manipulation and therefore found it "difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions."[30] The *Hochfelder* decision also cited the lower court in *Hochfelder v. Midwest Stock Exchange*,[31] in which the Seventh Circuit held that in a charge for aiding and abetting a breach of duty, someone who "'should have had knowledge of the fraud'"—but did not only due to a failure to inquire—was liable.[32] The Supreme Court ultimately dismissed this argument for aiding and abetting securities fraud, stating that the only relevant

in order to prevent an unfair advantage. *Newman*, 773 F.3d at 445 (quoting *Chiarella*, 445 U.S. at 228–29).

24. Khuzami, *supra* note 6 (footnote omitted).
25. 425 U.S. 185 (1976).
26. *Id.* at 214.
27. *Id.* at 212 (footnote omitted).
28. *Id.* at 214 (footnote omitted).
29. *Id.* at 202.
30. *Id.* at 203 (footnote omitted).
31. 503 F.2d 364 (7th Cir. 1974).
32. *Hochfelder*, 425 U.S. at 191 n.7 (quoting Hochfelder v. Midwest Stock Exch., 503 F.2d 364, 374 (7th Cir. 1974)) (emphasis added).

inquiry for civil liability was whether the tippee had "an intent to deceive, manipulate, or defraud."[33]

Although the *Hochfelder* decision stated that negligence was not sufficient to impose civil liability under Section 10(b), the Court did not specifically address the possibility where someone likely knew a personal benefit was received, but was not certain. It is possible that there is some intermediary level of intention above negligence, but not quite reaching knowledge, where the tippee protects him or herself by avoiding learning the full details of the tipper's breach. The Court did not foreclose the possibility that recklessness may be sufficient, stating that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. . . . [But] [w]e need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under [Section] 10(b) and Rule 10b–5."[34]

Seven years later, in the 1983 Supreme Court case of *Dirks v. SEC*,[35] the Court was more direct when it held that if "the tippee knows or *should know* that there has been a breach" of nonpublic information, then he has satisfied the "knowledge" element of liability.[36] The Court found that the concept of a fiduciary breach extended to the tippee in such circumstances.[37] After *Dirks*, there was some uncertainty about how to prove elements as "subjective and ambiguous" as fiduciary duty and personal gain.[38] Articles that analyzed the decision found that the Court was too narrow and placed "virtually no limits on the analyst-tippee's use—or misuse—of inside information" and essentially gave

33. *Id.*

34. *Id.* at 193 n.12. The Court declined to decide whether scienter was required under Section 10(b) and Rule 10b–5 because the case "concern[ed] an action for damages." *Id.*

35. 463 U.S. 646 (1983).

36. *Id.* at 660 (emphasis added) (footnote omitted). Ultimately, the defendants in the case were not held liable because the tippers received no personal benefit. *Id.* at 665–67.

37. *Id.* at 660. In *Dirks*, the tippee "did not 'breach a duty' because he did not reveal confidential information in exchange for personal benefit—he was trying to expose accounting fraud." Jason Halper, Bob Loeb & Marc Shapiro, *United States Supreme Court Poised to Address Standard for Insider Trading Following Second Circuit's Decision in* United States v. Newman, JD SUPRA BUS. ADVISOR (Aug. 4, 2015), http://www.jdsupra.com/legalnews/united-states-supreme-court-poised-to-14159/.

38. *See* David C. Phelan, Note, *Securities Regulation—Dirks v. SEC: Tippee Liability After* Chiarella v. United States, 59 TUL. L. REV. 502, 514–15 (1984) ("Unless the insider in some sense sells the information, it is not clear how the tippee will know whether the insider has or has not received some benefit from the disclosure."). The Second Circuit's *Obus* decision later stated that the question of whether a tippee knows or should have known of the breach "is a fact-specific inquiry turning on the tippee's own knowledge and sophistication, and on whether the tipper's conduct raised red flags that confidential information was being transmitted improperly." SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012).

the tippee a license to use the information for his own personal benefit, provided that the insider did not breach his fiduciary duty.[39]

A more recent case decided in the same circuit court as *Newman* is *SEC v. Obus*.[40] In *Obus*, the court stated that scienter was established if "'reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care'" could be shown.[41] It further reconciled the *Hochfelder* holding with the Second Circuit's standard by explaining that, to be held liable, a person "must know or be *reckless* in not knowing that the conduct was deceptive."[42]

The *Obus* holding appears to draw a distinction between conduct that is negligent and conduct that is reckless, the latter being sufficient to impose tippee liability. Further, the court in *Obus* reasoned that the *Dirks* standard for scienter referred to the knowledge of the tipper's breach, while the *Hochfelder* requirement of intentional, rather than negligent, "conduct pertain[ed] to the tippee's *eventual use of the tip* through trading . . . [t]hus, tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained . . . improperly . . . and if the tippee intentionally or recklessly *traded*."[43] Therefore, prior to the *Newman* decision, both the most recent Supreme Court case of *Dirks* and the most recent Second Circuit case of *Obus* found that a "should have known" knowledge standard for the tipper's breach was sufficient to establish the tippee's liability.

II. THE NEWMAN *DECISION*

In 2012, defendants Todd Newman and Anthony Chiasson were charged with "securities fraud, in violation of sections 10(b) and 32 of the Exchange Act, SEC Rules 10b–5 and 105b–2, and 18 U.S.C. § 2," as well as conspiracy to commit securities fraud in the Southern District of New York (SDNY).[44] According to the government, financial analysts received nonpublic earnings information from corporate insiders at

39. *See, e.g.*, Bruce A. Hiler, Dirks v. SEC—*A Study in Cause and Effect*, 43 MD. L. REV. 292, 340–41 (1984) ("Once the analyst receives the information without a breach of the insider's duty, he is free to use it in whatever matter he sees fit; unless of course he independently violates the prohibitions of the securities laws.").

40. 693 F.3d 276 (2d Cir. 2012).

41. *Id.* at 286 (quoting SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998)).

42. *Id.* (emphasis added).

43. *Id.* at 288 (emphasis added).

44. United States v. Newman, 773 F.3d 438, 441, 443 (2d Cir. 2014). The defendants were charged criminally for their willful participation in a scheme to trade based on insider information in violation of Section 10(b) and Rule 10b–5. *Id.* at 442.

Dell and NVIDIA and shared the information with their portfolio managers, Newman and Chiasson.[45] The defendants then traded Dell and NVIDIA stock on the basis of this information, resulting in a profit to them of $4 million and $68 million, respectively.[46] A jury found the defendants guilty on all charges.[47] Newman and Chiasson subsequently appealed the decision on multiple grounds, the most notable being sufficiency of the evidence and erroneous jury instructions.[48]

Attorneys for the appellants argued that the government "*must* show that [the tippees] *knew* the tippers were somehow compensated for the tips and that the judge's instruction was erroneous."[49] The attorneys further argued that even if Newman and Chiasson used inside information, they did not "seek [it] out or knowingly" do so.[50] The government disagreed, arguing that the correct standard was instead that the tippees "were aware" that the tipper disclosed the information "in breach of a fiduciary duty," regardless of whether they sought out such information or knew it was nonpublic.[51] The government's standard left open the possibility that the tippees could have inferred a breach occurred by the insider and should therefore be liable for trading on the basis of the confidential information.[52]

The government also argued that the timing, frequency, and specificity of the information disclosed were so suspicious that the defendants "must have known, or deliberately avoided knowing," that the tips came from insiders for a personal benefit.[53] The court disagreed, holding that because analysts could accurately predict the financial information and because the defendants had no close personal relationship with the insider, "the inference that defendants knew, or *should have known*, that the information originated with a corporate insider was unwarranted."[54]

The court further held that in order to find a tippee liable for a Rule 10b–5 violation, the government must prove beyond a reasonable doubt that: (1) the insider had a fiduciary duty; (2) the insider breached that duty by disclosing confidential information in exchange

45. *Id.* at 443. Dell and NVIDIA are both publicly traded technology companies. Anthony Chiasson, Initial Decision Release No. 589, 2014 WL 1512024, at *5 (Apr. 18, 2014).
46. *Newman*, 773 F.3d at 443.
47. *Id.* at 442.
48. *Id.* at 445.
49. Matthews, *supra* note 9 (emphasis added).
50. *Id.*
51. *Id.*
52. *Id.*
53. *Newman*, 773 F.3d at 454.
54. *Id.* at 455 (emphasis added).

for personal benefit; (3) the tippee had knowledge of the insider's breach of duty, where knowledge means that the tippee knew the information was both "confidential and divulged for [the] personal benefit" of the insider; and (4) the tippee used the inside information to trade or tip off someone else for the tippee's own benefit.[55]

In defining the mental state required for securities fraud, the court relied on the *Hochfelder* definition that "the defendant acted with scienter, which is defined as 'a mental state embracing intent to deceive, manipulate or defraud.'"[56] Further, the court found that "willfully" is the appropriate standard in a criminal case, which entails "a realization on the defendant's part that he was doing a wrongful act under the securities laws."[57] Still, the *Newman* decision failed to address reckless behavior in its discussion of scienter, as established in *Obus*.

The Second Circuit found that "Newman and Chiasson were several steps removed from the corporate insiders" and that the evidence failed to show that "either was aware of the source of the inside information."[58] Because tippee liability derives from the insider's breach of a fiduciary duty, the court found that the tippee must have "knowledge that the insider disclosed confidential information in exchange for [a] personal benefit."[59] Ultimately, the defendants' convictions were reversed because the government could not provide the following: (1) sufficient evidence that a personal benefit was provided to the insider for the tip;[60] or (2) evidence that the defendants knew the information was improperly obtained.[61]

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55. *Id.* at 450. The court stated: "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*." *Id.* at 447. The insider's breach results from exchanging confidential information for a personal benefit, and thereby triggers liability under Rule 10b–5. *Id.* at 448.

56. *Id.* at 447 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 183, 193 n.12 (1976)).

57. *Id.* (quoting United States v. Cassese, 428 F.3d 92, 98 (2d Cir. 2005)) (internal quotation marks omitted).

58. *Id.* at 443. Newman was three levels removed from the insider releasing Dell's information, and Chiasson was four levels removed from that insider. *Id.* They were both four levels removed from the NVIDIA insider. *Id.*

59. *Id.* at 449 ("[W]e 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.").

60. *Id.* at 442. This heightened the burden to establish a fiduciary breach. Quinn Emanuel Urquhart & Sullivan, LLP, *Insider Trading After* United States v. Newman*, the Second Circuit's Landmark Decision Limiting Liability of Downstream Recipients of Insider Information*, JD SUPRA BUS. ADVISOR (May 4, 2015), http://www.jdsupra.com/legalnews/insider-trading-after-united-states-v-n-52554 [hereinafter Quinn Emanuel].

61. *Newman*, 773 F.3d at 442–43.

The primary justification for narrowing the knowledge standard was that the tippees were so far removed from the insider. The court observed that the case represented "the doctrinal novelty of its recent insider trading prosecutions, which are increasingly targeted at remote tippees many levels removed from corporate insiders."[62] The court further noted that prior cases were not as complicated because they "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."[63]

As its final rationale for establishing its own standard, the court reasoned that neither the court nor the government could find a case "in which tippees as remote as Newman and Chiasson ha[d] been held criminally liable for insider trading."[64] However, in *Obus* the court reasoned that "chains of tipping are not uncommon" and scienter is established if the final tippee knew or should have known that there was an insider breach, or if there was conscious avoidance of knowledge.[65] Turning a blind eye to the information's source or the insider's benefit would not relieve the tippee of liability.[66] In *Obus*, the Second Circuit did not limit this definition of conscious avoidance to parties that had close relationships or in any way indicate that tippee remoteness was a factor.[67] Two years later, in *Newman*, the court did not consider this precedent language, but instead concluded that remote tippees could not be included in the tipping chain.[68] It may be more difficult to prove that remote tippees should have had knowledge of the breach, but the standard certainly does not change simply because there are multiple participants involved in the tippee chain of liability. Remoteness is not a factor stated in either *Dirks* or *Obus* in deciding whether a tippee had knowledge or consciously avoided knowledge.[69]

62. *Id.* at 448.

63. *Id.* Convictions must be based on a breach of a fiduciary duty, rather than purely on "informational asymmetries." *Id.* at 449.

64. *Id.* at 448.

65. SEC v. Obus, 693 F.3d 276, 288–89 (2d Cir. 2012) (citing SEC v. Musella, 678 F.Supp. 1060, 1063 (S.D.N.Y. 1988)).

66. *Id.* at 289.

67. *Id.* at 287.

68. *Newman*, 773 F.3d at 449.

69. *Obus*, 693 F.3d at 288–89.

III. A CONFUSING NEW STANDARD AND ITS IMPACT

A. Knowledge

The court in *Newman* overstepped Supreme Court precedent in its analysis of the knowledge element for imposing liability under Section 10(b). The court set forth a confusing standard by wavering between stating "the inference that defendants knew, or *should have known*, that the information originated with a corporate insider,"[70] and that "the [g]overnment had to prove beyond a reasonable doubt that Newman and Chiasson *knew* that the tippers received a personal benefit."[71] Further, the court rejected the government's theory of constructive knowledge, but "did not foreclose constructive knowledge as a basis for liability in future cases involving 'overwhelmingly suspicious' information,"[72] which further added to the confusion.

The government argued that "Newman and Chiasson knew, or *deliberately avoided* knowing" of the personal benefit to insiders; however, the court stated that "no rational jury would find that the tips were so overwhelmingly suspicious that [the defendants] . . . knew or *consciously avoided* knowing."[73] Although the court addressed conscious avoidance in passing, it omitted the phrase from every tippee liability definition of the enumerated elements.[74]

The court acknowledged the precedent established by *Dirks*, stating, "the Supreme Court was quite clear in [that] . . . a tippee is liable only if he knows or *should have known* of the breach."[75] The court repeated this same language later in the opinion stating that "the inference that [the] defendants knew, or *should have known* . . . [was] unwarranted,"[76] and that a jury could not have found that they "knew, or *deliberately avoided* knowing."[77]

Despite acknowledging that deliberately avoiding knowledge of the tipper's breach may subject the tippee to liability, the court omitted the "should have known" language from its standard in the following instances: (1) "the [g]overnment must prove beyond a reasonable doubt that the tippee *knew* that an insider disclosed confidential

70. *Newman*, 773 F.3d at 455 (emphasis added).
71. *Id.* at 450–51 (emphasis added).
72. Quinn Emanuel, *supra* note 60.
73. *Newman*, 773 F.3d at 455 (emphasis added).
74. *Id.* at 448, 450.
75. *Id.* at 447 (emphasis added).
76. *Id.* at 455 (emphasis added).
77. *Id.* (emphasis added).

information";[78] (2) "the [g]overnment presented no evidence that Newman and Chiasson *knew* that they were trading";[79] (3) "the [g]overnment cannot meet its burden of showing that the tippee *knew* of a breach";[80] (4) "the [g]overnment must prove each of the following elements . . . [including that] the tippee *knew* of the tipper's breach, that is, he *knew* the information was confidential and divulged for personal benefit";[81] and (5) "the [g]overnment is required to prove beyond a reasonable doubt that Newman and Chiasson *knew* that the insiders received a personal benefit."[82] This emphasis on knowledge and frequent omission of the possibility that the defendants "should have known," particularly in the enumerated elements, is inconsistent with insider trading precedent.

The court should have instead simply reiterated the "should have known" standard set forth in *Dirks* and clarified under what conditions remote tippees would, and would not, satisfy the standard for consciously avoiding knowledge. Such a murky standard will undermine the public policy of extending insider trading laws to tippees.[83] Excluding remote tippees, regardless of how much they consciously avoided knowledge, threatens confidence in the markets and may reduce investment activities by the rest of the public.[84]

The decision has already impacted other courts. Subsequent cases have confirmed that, as a consequence of the decision, knowledge *must* be proven in the Second Circuit; however there is uncertainty in whether this applies to other courts.[85] For example, in *United States v.*

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78. *Id.* at 442 (emphasis added).

79. *Id.* (emphasis added).

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

81. *Id.* at 450 (emphasis added).

82. *Id.* at 453 (emphasis added).

83. Andrew C. Whitman, *The Supreme Court Should Overturn* U.S. v. Newman *and Recognize a New Type of Insider Trading Liability*, AM. CRIM. L. REV. (Jan. 20, 2015), http://www.americancriminallawreview.com/aclr-online/supreme-court-should-overturn-us-v-newman-and-recognize-new-type-insider-trading-liability. Not holding tippees liable for consciously avoiding knowledge may encourage fraudsters to circumvent liability, whereby remote tippees will continue to improperly use information but will purposely avoid learning about the personal benefit or fiduciary duties of the insider. *Id.* In this case, "all but the dumbest of traders (and the dumbest belong in prison for their stupidity alone) will thank their tipper for his information, but never inquire how he learned his critical tip." John C. Coffee, Jr., *Ignorance Is Now Bliss: But What Can the Government Do?*, CLS BLUE SKY BLOG (Jan. 27, 2015), http://clsbluesky.law.columbia.edu/2015/01/27/ignorance-is-now-bliss-but-what-can-the-government-do-2.

84. Whitman, *supra* note 83.

85. *See, e.g.*, United States v. Salman, 792 F.3d 1087, 1091 n.2 (9th Cir. 2015) (finding that the court in *Newman* held "even a remote tippee must have some knowledge of the personal benefit (however defined) that the inside tipper received for disclosing inside information"); SEC v. Jafar, No. 13-CV-4645 (JPO), 2015 WL 3604228, at *3 (S.D.N.Y. 2015) ("In *Newman*, . . . tippee liability demands that the tippees *knew* of the breach of duty by the tipper . . . ."); SEC v. Payton, 97 F. Supp.

Salman,[86] the Ninth Circuit stated that *Newman* was a result of the government "fail[ing] to present sufficient evidence that [the tippees] *knew* the information they received had been disclosed in breach of a fiduciary duty."[87] Although the court in *Salman* did not explicitly follow *Newman* and instead reiterated the *Dirks* "should know" standard, the knowledge requirement was "not at issue . . . because the jury was instructed that it had to find that [the tippee] '*knew* that [the insider] personally benefitted in some way.'"[88] Therefore, despite the Ninth Circuit stating that the *Dirks* "should know" standard would in theory be followed, the jury was instructed according to the *Newman* knowledge standard.

Just six weeks after the *Newman* decision, a judge in the SDNY "vacate[d] the previously accepted guilty pleas of four defendants that traded on confidential information regarding an IBM transaction," even though the case was decided under the misappropriation theory, rather than the classical theory.[89] The judge rejected the government's argument that the *Newman* decision would only impact classical theory cases and found that a tippee must know of the tipper's personal benefit in misappropriation cases as well.[90] The judge further stated that "even assuming *arguendo* that the [g]overnment is correct that the cited language in *Newman* is dicta, it is not just any dicta, but emphatic dicta which must be given the utmost consideration."[91] This suggests that the holding is very influential even on matters that were not at issue in the case, and that the government may be further limited to pursuing only clear acts of deception and fraud where knowledge can be proven, while excluding cases of suspicious circumstances.[92]

There have been two subsequent cases that chose to address the possibility of conscious avoidance. In *SEC v. Payton*,[93] the court found

3d 558, 562 (S.D.N.Y. 2015) (stating that in *Newman* a tippee could "only be prosecuted for trading on inside information [when] . . . the tippee knew of the tipper's breach").

86. 792 F.3d 1087 (9th Cir. 2015).

87. *Id.* at 1090 (emphasis added).

88. *Id.* at 1091 n.2, 1091–92 (emphasis added).

89. Lucy Hynes, Matthew McGinnis & Stacylyn Dewey, *The Shifting Landscape of Insider Trading Law Following* United States v. Newman, SEEKING ALPHA (Feb. 18, 2015, 11:36 AM ET), http://seekingalpha.com/article/2926816-the-shifting-landscape-of-insider-trading-law-following-united-states-v-newman (discussing United States v. Conradt, No. 12 CR. 887 (ALC), 2015 WL 480419 (S.D.N.Y. 2015)).

90. *Conradt*, 2015 WL 480419 at *1. The court found that "as indicated in *Newman*, the controlling rule of law in the Second Circuit is that 'the elements of tipping liability are the same'" under both theories. *Id.* (quoting United States v. Newman, 773 F.3d 438, 446 (2d Cir. 2014)).

91. *Id.* (alteration in original).

92. Hynes, McGinnis & Dewey, *supra* note 89.

93. 97 F. Supp. 3d 558 (S.D.N.Y. 2015). The decision cites the *Newman* case as requiring that a remote tippee "be *aware* that the original tipper had received a benefit . . . for otherwise the

that the defendants did not ask how a tipper came to know inside information, and as a result the court could "draw an adverse inference from their conscious avoidance of details about the source of the inside information and nature of the initial disclosure."[94] Likewise, in *SEC v. Jafar*,[95] the court held that civil liability was possible if the defendant "knew or should have known" the tipper received a benefit.[96] Still, the *Newman* decision provides a confusing standard going forward, and, as some have noted, makes it difficult to prove tippee liability:

> [S]hort of a wiretap or a complicit cooperating informant, it is difficult to conceive of what types of evidence would be sufficient to establish knowledge of the tipper's benefit with respect to a tippee who was four or five degrees removed from the original source, as was the case with Chiasson and Newman.[97]

Seven other federal circuits—the First, Third, Fifth, Sixth, Seventh, Ninth, and Tenth—also impose liability in cases where the tippee should have known there was a breach, similar to *Dirks*.[98] The Supreme Court has not ruled on the issue of whether recklessness is sufficient for a Section 10(b) violation.[99] In *Obus*, however, the Second Circuit, in

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remote tippee would not know whether he was participating in [the] fraud." *Id.* at 561 (emphasis added).

94. *Id.* at 564 (citing SEC v. Obus, 693 F.3d 276, 288–89 (2d Cir. 2012) (stating that "tippee liability may also result from conscious avoidance"); SEC v. Musella, 678 F. Supp. 1060, 1063 (S.D.N.Y. 1988) (stating that downstream tippees "should have known that fiduciary duties were being breached" but consciously avoided asking questions)).

95. No. 13-CV-4645 (JPO), 2015 WL 3604228 (S.D.N.Y. June 8, 2015).

96. *Id.* at *4.

97. Jodi L. Avergun & Douglas H. Fischer, *United States: Friends with Benefits: Second Circuit Overturns Newman and Chiasson Convictions and Raises the Government's Burden in Insider Trading Cases Against Tippees*, MONDAQ (Dec. 23, 2014), http://www.mondaq.com/unitedstates/x/362380/Corporate+Crime/Friends+With+Benefits+Second+Circuit+Overturns+Newman+And+Chiasson+Convictions+And+Raises+The+Governments+Burden+In+Insider+Trading+Cases+Against+Tippees.

98. *E.g.*, WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1056 (9th Cir. 2011); SEC v. Cuban, 620 F.3d 551, 554 (5th Cir. 2010); United States v. Hughes, 505 F.3d 578, 593 (6th Cir. 2007); SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992); Rothberg v. Rosenbloom, 771 F.2d 818, 826 (3d Cir. 1985); SEC v. Binette, 679 F. Supp. 2d 153, 160 (D. Mass. 2010). The Fourth Circuit does not directly address the issue of knowledge avoidance, although it follows the misappropriation theory. *E.g.*, United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995), *abrogated by* United States v. O'Hagan, 521 U.S. 642 (1997). The Eleventh Circuit defines scienter as either an objective test of notice or unjust enrichment. *E.g.*, SEC v. Yun, 327 F.3d 1263, 1276–77 n.29 (11th Cir. 2003). The Eighth, Federal, and D.C. Circuits do not specifically address the knowledge requirement for tippee liability. *E.g.*, Laventhall v. Gen. Dynamics Corp., 704 F.2d 407, 414 (8th Cir. 1983). Although the *Salman* court reiterated the standard set forth in *Newman*, it also stated that the decision was not binding on the Ninth Circuit, and reiterated the *Dirks* "should know" knowledge standard as well. United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015).

99. *Obus*, 693 F.3d at 286 (citing SEC v. U.S. Envtl., Inc., 155 F.3d 107, 111 (2d Cir. 1998)).

addition to eleven circuits, found that recklessness is sufficient and is shown through "'conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care.'"[100] Given the Second Circuit's influence,[101] other courts will likely continue to follow the most recent *Newman* decision, making it more difficult to prosecute insider trading cases. The decision may also limit the SEC's ability to settle with remote tippees if the defendants are confident that the SEC can produce nothing more than circumstantial evidence.[102]

B. Personal Benefit

While the *Newman* court focused almost exclusively on the sufficiency of the evidence for knowledge, it also commented on the personal benefit element, though it was not directly at issue in the case.[103] The court considered whether friendship could constitute a personal benefit to the insider and imposed a new standard 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."[104] The *Newman* court held that "[p]roviding career advice was not a sufficient personal benefit to the insider . . . because it 'was little more than the encouragement one would generally expect of a fellow alumnus or casual acquaintance' and had started long before the insider provided any insider information."[105] This "meaningfully close" standard is not grounded in any precedent. The standard seems to suggest that a *quid pro quo* is necessary and that friendships or familial relationships alone are not automatically considered personal benefits.[106]

The courts in *Dirks* and *Obus* both set forth a broader definition of personal benefit. The *Dirks* Court reasoned that a personal benefit

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

101. *See* Roberta S. Karmel, *The Second Circuit's Role in Expanding the SEC's Jurisdiction Abroad*, 65 ST. JOHN'S L. REV. 743, 743 (1991) ("The Second Circuit has had such a profound impact on securities law that it has been referred to in this context as the 'Mother Court' . . . [because] New York City is the financial center of the United States and the securities industry and its legal advisors are located there." (footnote omitted)).

102. Avergun & Fischer, *supra* note 97.

103. United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014).

104. *Id.*

105. Jon Eisenberg, *"Friends" Who Trade on Inside Information: How* United States v. Newman *Changes the Law*, K&L GATES (Apr. 20, 2015), http://www.klgates.com/friends-who-trade-on-inside-information-how-united-states-v-newman-changes-the-law-04-20-2015/#_edn15 (footnote omitted) (quoting *Newman*, 773 F.3d at 453).

106. Hynes, McGinnis & Dewey, *supra* note 89.

could be "a pecuniary gain or a reputational benefit that will translate into future earnings," but also provided that there is a breach of duty "when an insider makes a gift of confidential information to a trading relative or friend."[107] Likewise, the *Obus* court reasoned that a personal benefit "includes not only 'pecuniary gain,' such as a cut of the take or a gratuity from the tippee, but also a 'reputational benefit' . . . from simply 'mak[ing] a gift of conditional information to a trading relative or friend.'"[108] Neither case contained any reference to the "meaningfully close" language used in *Newman*. The court in *United States v. Whitman*,[109] a case which the SDNY decided two years prior to *Newman*, also failed to reference the meaningfully close relationship standard for a personal benefit. Instead, the *Whitman* court stated: "The element of self-dealing, in the form of a personal benefit—whether immediate or anticipated, and whether substantial or very modest—must be present."[110]

The *Newman* decision unceremoniously departed from precedent Supreme Court cases such as *Hochfelder* and *Dirks*, as well as *Obus*, the prior Second Circuit case.[111] The decision was reversed because the government failed to present testimony or other evidence that the defendants knew they were trading on inside information. The court, however, discussed personal benefits anyway. Regarding the *Newman* decision, "[s]trictly speaking, everything else was dicta—but the decision is so strongly worded that no district court will dare consider it only dicta."[112]

In *Jafar*, a subsequent case, the court found that *Newman* imposed a standard where "the mere fact of a casual or social friendship is not enough; there must be evidence of the relationship between tipper and immediate tippee that 'suggests a *quid pro quo* from the [immediate tippee].'"[113] The court recognized that the *Newman* definition is potentially at odds with the *Dirks* definition of a personal benefit and that it may be difficult for lower courts to reconcile both standards in future holdings, because *Newman* sets forth a "potentially more

107. Dirks v. SEC, 463 U.S. 646, 663–64 (1983).
108. SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) (quoting *Dirks*, 463 U.S. at 663–64).
109. 904 F. Supp. 2d 363 (S.D.N.Y. 2012).
110. *Id.* at 371 (emphasis added) (footnote omitted).
111. Coffee, *supra* note 83.
112. *Id.* Since *Obus* does not reference a personal benefit element for tippee liability, it is uncertain whether *Obus* or *Newman* will control in the future because *Newman* did not overrule *Obus*. *Id.*
113. SEC v. Jafar, No. 13-CV-4645 JPO, 2015 WL 3604228, at *5 (S.D.N.Y. June 8, 2015) (quoting United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014)).

onerous standard for a personal benefit."[114] In *Payton*, the court more directly contrasted the two standards:

> *Dirks* states that there are "objective facts and circumstances that often justify such an inference [of personal benefit]" and then lists a number of different relationship-types as examples.[115] In listing them as examples, the *Dirks* decision seems to distinguish a *quid pro quo* relationship from instances where an insider makes a "gift" of confidential information to a relative or friend; whereas, the *Newman* decision suggests that the latter type of relationship (i.e. mere friendship) can lead to an inference of personal benefit only where there is evidence that it is generally akin to *quid pro quo*.[116]

The *Newman* standard makes it more difficult to infer that friendships, and even familial relationships, are themselves personal benefits to an insider. Instead of proving that the exchange of inside information between friends and family likely personally benefits the insider, the government must now present evidence showing there is a meaningfully close personal relationship and a "*quid pro quo* that will eventually translate into a concrete pecuniary benefit for the insider."[117] Such a standard is significantly more difficult to prove, especially considering there is no guidance by the Supreme Court, the Second Circuit, or any other court regarding what constitutes a meaningfully close personal relationship. Subsequent courts have had to decide the meaning of the standard for themselves.

For example, in *United States v. Gupta*,[118] the court found that the standard was met since the parties were "'very close friend[s],' . . . Gupta was on a short list of five to ten people allowed to speak with Rajaratnam at the end of the trading day . . . [, and] they were close business associates with a considerable history of exchanging financial favors."[119] The pecuniary gain component was met because the tipper, Gupta, and tippee, Rajaratnam, had a history of sharing tips, and Rajaratnam's trading activity "had the potential to increase the value of Gupta's . . . shares" in the security at issue.[120]

114. *Id.* at *5 n.3.
115. SEC v. Payton, 97 F. Supp. 3d 558, 563 n.2 (S.D.N.Y. 2015) (citing Dirks v. SEC, 463 U.S. 646, 664 (1983)).
116. *Id.* (citing *Newman*, 773 F.3d at 452).
117. Eisenberg, *supra* note 105.
118. 111 F. Supp. 3d 557 (S.D.N.Y. 2015).
119. *Id.* at 560.
120. *Id.* at 561.

Although the circumstances of *Gupta* clearly met the personal benefit requirement, it is not clear how the test would apply to lesser-involved tippers. For example, a tipper may receive the benefit of an improved relationship by sharing information with family members, but may have done so for the first time or shared such information without expecting anything monetary in return. It is uncertain how the *Newman* definition would apply to such a relationship that clearly benefits the tipper when there is no explicit *quid pro quo* arrangement or expectation.

In contrast to *Gupta*, the *Salman* court declined to find that *Newman* required a "tangible benefit in exchange for the inside information."[121] The defendant argued that *Newman* held "a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit."[122] Although the court disagreed with this interpretation, it noted the confusion surrounding the personal benefit definition by stating that it declined to follow *Newman* "[t]o the extent *Newman* can be read to go so far."[123] The court explained that such a standard was a "depart[ure] from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend.'"[124] The court held that a personal benefit existed when the tipper made a "gift of market-sensitive information" to his brother purely to "'benefit' his brother and to 'fulfill[] whatever needs he had.'"[125] The Ninth Circuit therefore acknowledged that *Newman* could be interpreted to require a narrower definition of personal benefit, but the court disagreed with such an interpretation. It is possible that the *Salman* decision establishes a

121. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).

122. *Id.*

123. *Id.*

124. *Id.* (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)). Otherwise, "a corporate insider or other person in possession of confidential and proprietary information would be free to disclose that information to her relatives, and they would be free to trade on it, provided only that she asked for no tangible compensation in return." *Id.* at 1094. Interestingly, Judge Jed Rakoff from the SDNY authored the *Salman* decision while he was "sitting by designation in the Ninth Circuit." Brian E. Casey, *Why* Newman *Might Not Be Headed to the Supreme Court*, LEXOLOGY (Aug. 11, 2015), http://www.lexology.com/library/detail.aspx?g=eca5af5c-9565-41a4-be57-96491184fd6a.
"Judge Rakoff could not have ignored *Newman*'s precedential effect in his day job as a district court judge in the Second Circuit, [but] by moonlighting as a Ninth Circuit judge, he created the arguable circuit split that the Justice Department then relied on repeatedly . . . [for] its petition." *Id.*

125. *Salman*, 792 F.3d at 1092–94.

circuit split between the Ninth and Second Circuits, depending on how the language in each case is interpreted.[126]

Likewise, in *United States v. Riley*,[127] the SDNY found that a tip given to maintain or enhance a relationship could be considered a personal benefit because "[i]f a tip maintains or furthers a friendship, and is not simply incidental to the friendship, that is circumstantial evidence that the friendship is a *quid pro quo* relationship."[128] However, it also concedes that "a court *could* rule that merely maintaining or furthering a friendship is not a sufficient personal benefit."[129]

The inconsistent applications of the rule in subsequent cases indicate a need to either clarify the definition of what constitutes a meaningfully close personal relationship, and therefore a personal benefit, or to eliminate the new definition created by *Newman* altogether.

C. Supreme Court Petition and Denial of Certiorari

As a response to the reversal in *Newman*, on July 30, 2015, the Department of Justice (DOJ) filed a petition for a writ of certiorari with the United States Supreme Court and "ask[ed] for a definition of 'personal benefit,'" rather than an affirmation of Newman's and Chiasson's convictions.[130] The government decided it was more likely to get the case reconsidered on that ground, rather than sufficiency of the evidence with regards to knowledge, because there "was no evidence that tied Newman and Chiasson to the transfer of the information."[131]

Specifically, the government asked if the Second Circuit "erroneously departed from [the Supreme] Court's decision in *Dirks* by holding that liability under a gifting theory requires 'proof of a meaningfully close personal relationship that generates an exchange that . . . represents at least a potential gain of a pecuniary or similarly

126. John F. Libby & Jacqueline C. Wolff, *Are the Circuits A-Splitting? The Ninth Circuit Declines to Follow the Second Circuit's Insider Trading Decision in* U.S. v. Newman, LEXOLOGY (Aug. 5, 2015), http://www.lexology.com/library/detail.aspx?g=f2fd320a-584e-4fad-b308-b05c43e1e3bf.

127. 90 F. Supp. 3d 176 (S.D.N.Y. 2015).

128. *Id.* at 186.

129. *Id.* (emphasis added) (footnote omitted).

130. Walter Pavlo, *DOJ Takes* Newman *Decision to SCOTUS: What's in Request and What's Not*, FORBES (Aug. 5, 2015, 8:45 AM), http://www.forbes.com/sites/walterpavlo/2015/08/05/doj-takes-newman-decision-to-scotus-whats-in-request-and-whats-not/; Petition for a Writ of Certiorari at 26, United States v. Newman, 136 S. Ct. 242 (2015) (No. 15-137) ("The Court should correct the Second Circuit's erroneous redefinition of personal benefit.").

131. Pavlo, *supra* note 130 (stating that, instead, the defendants were too close to a group that "exchanged information they knew was illegal").

valuable nature.'"[132] To support its justification for reviewing the decision, the government cited the *Salman* circuit split.[133] This indicates that the government finds the *Newman* decision to be in conflict with both Supreme Court precedent and the analysis performed by other circuit courts.

On October 5, 2015, the Supreme Court declined to review the decision.[134] This denial may have a negative impact on future tippee liability cases and may "make it more difficult for prosecutors to bring criminal cases when corporate executives pass on an inside tip to a friend or a relative expecting nothing special in return."[135] Due to the denial of certiorari, the unclear standard applied in *Newman* is left open for interpretation by other courts.

IV. SUGGESTIONS FOR INSTILLING CONFIDENCE IN THE MARKET

A. Strict Liability—Using Rule 14e–3 and International Law as a Guide

Most of the analysis in *Newman* focused on whether the defendants had knowledge of the insider's breach. This analysis is cumbersome and inconsistent amongst the courts. In addition, since it is so difficult to prove knowledge, individuals who are well aware that they are trading on the basis of nonpublic information may slip through the cracks and continue to conduct illegal trades as long as they are careful to be far removed from the source of information. An alternative to the knowledge requirement is to remove the scienter requirement for insider trading violations under Section 10(b) altogether and instead impose strict liability on anyone who trades on the basis of nonpublic information.

Imposing strict liability for fraudulent conduct in securities markets is not unprecedented. Section 14(e) of the Exchange Act and SEC Rule 14e–3(d) are other antifraud measures that forbid the sharing of material, nonpublic information related to a tender offer with

132. Petition for a Writ of Certiorari at I.

133. Libby & Wolff, *supra* note 126.

134. Matthew Goldstein & Adam Liptak, *Supreme Court Denies Request to Hear Insider Trading Case*, N.Y. TIMES (Oct. 5, 2015), http://www.nytimes.com/2015/10/06/business/dealbook/supreme-court-denies-request-to-hear-insider-trading-case.html?referer=. It was surprising that the Supreme Court did not grant certiorari, given that the Solicitor General filed the petition and the "Court grants certiorari in nearly three out of four cases filed by the Solicitor General." Halper, Loeb & Shapiro, *supra* note 37.

135. Goldstein & Liptak, *supra* note 134.

anyone other than those directly involved in the transaction.[136] A violation of these provisions only requires that the tipping occur through a communication between tipper and tippee, thereby "reach[ing] intermediate tippees, regardless of whether they trade on the basis of the information, if such intermediate tippee knows or *has reason to know* the information is nonpublic and . . . has been acquired . . . from the offering person."[137] The primary difference between a Rule 10b–5 and a Rule 14e–3(d) violation is that "Rule 14e–3(d) does *not impose a scienter requirement* as does Rule 10b–5. . . . A tipper *need not know* that the tippee will use the information to his advantage," provided that the court finds it was reasonably foreseeable that the tippee would trade on the basis of that information.[138] This supports the policy of either disclosing any nonpublic information received or abstaining from trading on the basis of it.[139] Adopting a strict liability standard would also simplify the analysis by removing the "breach of fiduciary duty" requirement.[140] Other strict liability provisions include Section 11 of the Securities Act of 1933, which holds violators strictly liable if "any part of [a] registration statement . . . contain[s] an untrue statement of a material fact or omit[s] to state a material fact,"[141] and Section 12(a)(2),[142] which holds people liable for selling a security "by means of a prospectus[,] or [any] oral communication" that contains materially untrue facts.[143]

136. Securities Exchange Act of 1934, 15 U.S.C. § 78n(e) (2012) ("It shall be unlawful for any person to . . . engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . ."); 17 C.F.R. § 240.14e–3(d)(1) (2014) ("[I]t shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person . . . .").

137. MICHAEL KEENAN & LAWRENCE J. WHITE, MERGERS AND ACQUISITIONS: ISSUES FROM THE MID-CENTURY MERGER WAVE 145 (1982) (emphasis added) (citing 17 C.F.R. § 240.14e–3(d)(2)(iv) (finding a person liable if he is "in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired" from an insider)).

138. *Id.* (emphasis added).

139. MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES 3-75 (2008). Relying on prior decisions such as *Hochfelder*, some have argued that scienter is required under Rule 14e–3, but "[t]hese decisions . . . primarily construed Section 10(b), not the more expansive language of Section 14(e)." *Id.* at 3-76.

140. *Id.* at 3-80 (explaining that "[i]n *United States v. O'Hagan*[,] the Supreme Court held that under the circumstances at bar the SEC did not exceed its rulemaking authority under Section 14(e) by adopting Rule 14e-3(a) without requiring a showing that there existed a breach of fiduciary duty" (footnotes omitted)).

141. Securities Act of 1933, 15 U.S.C. § 77k(a) (2012).

142. Notably, section 12(a)(2) does not apply in situations where a plaintiff obtained securities in a private transaction. Yung v. Lee, 432 F.3d 142, 149 (2d Cir. 2005) (referencing Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995)).

143. Securities Act of 1933, 15 U.S.C. § 77l(a)(2) (2012).

This alternative would require modifying the securities regulation legislation in the United States. Many countries outside the United States have more defined legislation that provides limitations for insider trading law, rather than relying primarily on caselaw.[144] For example, the United Kingdom's statutes are aimed at the result of the trading activity—the change in "price or value of any security"—rather than the intent of the tippee.[145] In addition, most countries "have rejected the U.S. fiduciary relationship (or relationship of trust and confidence) model to define the scope of illegal insider trading and tipping."[146] Instead, jurisdictions including the United Kingdom,[147] France,[148] Germany, Italy, the Canadian province of Ontario,[149] and Mexico use a standard that "prohibits insider trading by those who have unequal access to the material nonpublic information," regardless of whether the tippees receive information from insiders or from other downstream intermediary tippees.[150] This suggests a strict liability standard for any insider trading by tippees when they are in possession of insider information. If the United States transitioned to a stricter standard for insider trading, legislators could base their statutory language on international models already in place. However, given the heavy reliance that the U.S. legal system places on caselaw and its interpretation of statutory law, it is unlikely that strict liability for tippee trading could be implemented anytime soon.[151]

144. Marc I. Steinberg, *Insider Trading—A Comparative Perspective*, IMF.ORG 16 (2002), https://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/steinb.pdf.

145. *Id.* (footnote omitted). In the United Kingdom, inside information is defined as information related to the issuer of the investment that "is not generally available," and which "if generally available, be likely to have a significant effect on the price of the qualifying investments." Financial Services and Markets Act 2000, c. 8, s. 118C(2).

146. Steinberg, *supra* note 144, at 21 (footnote omitted).

147. Financial Services and Markets Act 2000, c. 8, s. 118(4)(a) (stating that market abuse encompasses situations in which a person's behavior is "based on information which is not generally available to those using the market[,] but which, if available . . . would be . . . relevant when deciding the terms on which transactions in qualifying investments should be effected").

148. Art. L. 465-1 C.M.F. [translated by Legifrance] (Any company outsider "who knowingly obtains inside information . . . of an issuer whose securities are traded on a regulated market . . . and either directly or indirectly carries out or facilitates a transaction or discloses said information . . . to a third party before the public has knowledge thereof, shall incur a penalty." Note that here the "knowingly" standard refers to the tippee's knowledge that the information was *obtained*, rather than the *Newman* standard which refers to the tippee's knowledge of the insider's *breach* of duty.).

149. *Securities Act*, R.S.O. 1990, c. S5, s. 76(1) ("No person or company in a special relationship with an issuer shall purchase or sell securities of the issuer with the knowledge of a material fact or material change . . . that has not been generally disclosed.").

150. Steinberg, *supra* note 144, at 23–24.

151. *See, e.g.*, POM Wonderful LLC v. Coca-Cola Co., 134 S. Ct. 2228, 2231 (2014) ("[T]his is a statutory interpretation case; and analysis of the statutory text, aided by established interpretation rules, controls."); BedRoc Ltd., LLC v. United States, 541 U.S. 176, 183 (2004) ("The

B. Consolidating and Simplifying the Classical and Misappropriation Theories

Given the novelty of a strict liability standard for Rule 10b–5 violations, and the amount of pushback it would likely face from critics and corporate interests, a more plausible alternative may be to simplify the analysis already used by the courts. As a starting point, it would be best to consolidate the two theories of insider trading or to only adopt a classical theory in the future, given that *Dirks* is the most recent Supreme Court case that has ruled on the issue.

In *Newman*, the government argued that in a classical case, the breach occurs because confidential information is taken, but in a misappropriation case, the confidential information violates the "source's right to exclusive use of the information," rather than violating a duty to shareholders.[152] Under the misappropriation theory, no knowledge of a personal benefit is required to impose liability.[153] The court in *Newman* sought to treat both theories the same, but there is still a question as to whether the decision applies to misappropriation cases.[154]

The courts overcomplicate the standards and theories involved in insider trading cases. The distinctions between the misappropriation and classical theory oftentimes serve as artificial distractions to the real analysis of whether a tippee improperly used material, nonpublic information to the detriment of the investing public. Both courts in *Obus* and *Newman* supported such a consolidation, with the latter court stating that "[t]he elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory."[155]

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preeminent canon of statutory interpretation requires us to 'presume that [the] legislature says in a statute what it means and means in a statute what it says there.'") (citing Connecticut Nat. Bank v. Germain, 503 U.S. 249, 253–54, (1992)); Neal v. United States, 516 U.S. 284, 285 (1996) ("[S]tare decisis requires that the Court adhere to [a Supreme Court case] in the absence of intervening statutory changes casting doubt on the case's interpretation."); Helvering v. Hallock, 309 U.S. 106, 119 (1940) ("[S]tare decisis embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations.").

152. Hynes, McGinnis & Dewey, *supra* note 89.

153. *Id.*

154. *Id.* ("The DOJ moved quickly to blunt *Newman*'s impact, arguing that it only applies to 'classical' insider trading, and not the IBM cases or others brought under the 'misappropriation' theory. . . .").

155. United States v. Newman, 773 F.3d 438, 446 (2d Cir. 2014) (citing SEC v. Obus, 693 F.3d 276, 285–86 (2d Cir. 2012) (finding that although *Dirks* was a classical theory case, "the same analysis governs in a misappropriation case")).

Even under a consolidated view of the theories, the *Newman* decision contained a lengthy analysis of whether a fiduciary duty was breached and whether the tippee knew of the breach.[156] If strict liability is too harsh or unrealistic, courts should at least simplify the analysis of tippee liability to do the following: (1) include "should have known," or conscious avoidance, as sufficient to satisfy the tippee scienter element;[157] (2) specify particular types of familial relationships and friendships that may automatically satisfy the personal benefit test;[158] and (3) develop clear factors for determining whether other relationships are sufficient to satisfy the personal benefit test. When making determinations regarding evidence that will satisfy the "should have known" or conscious avoidance requirement, courts must take into consideration the level of sophistication of the defendants. Circumstantial evidence may indicate that tippers and tippees are in a mutually beneficial arrangement where no one asks too many questions, and tippees can thereby avoid liability. More consideration should be given to such sophistication in the future.[159]

Ideally, rather than focusing on whether the insider personally benefitted, or whether the tippee knew or should have known of the insider's benefit, courts should be more concerned with whether confidential information was used by anyone to gain an unfair advantage over the rest of the investing public. However, given the current analysis undertaken by the courts, it will be easier for courts to continue using the *Dirks* standard with a few modifications, such as clarifying what types of factors will most influence the court's findings.

156. *Id.* ("The test for determining whether the corporate insider has breached his fiduciary duty 'is whether the insider personally will benefit, directly or indirectly, from his disclosure.'" (quoting Dirks v. SEC, 463 U.S. 646, 662 (1983))).

157. Even before *Dirks*, the Second Circuit stated that if "tippees knew or should have known of the corporate source and nonpublic nature of the information . . . [, they] were under a duty not to trade without publicly disclosing it." Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 201 (2006).

158. It is likely that someone receives a benefit of an improved relationship by sharing information with close friends and family and therefore a personal benefit "need not be pecuniary." Judith G. Greenberg, *Insider Trading and Family Values*, 4 WM. & MARY J. WOMEN & L. 303, 341 n.185 (1998) (citing *Dirks*, 463 U.S. at 663–64).

159. The *Newman* court only referenced that the defendants were sophisticated traders in passing, and failed to fully dissect their potential for consciously avoiding knowledge. *Newman*, 773 F.3d at 443–44. "[T]he [g]overnment 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. . . ." *Id.*

V. CONCLUSION

As a result of *Newman*, and other courts that have relied on its language, proposals have been made for expanding insider trading laws and eliminating the personal benefit requirement altogether or prohibiting any trades on the basis of nonpublic information.[160] Although this is not likely possible in the near future, it does indicate some legislators' dissatisfaction with the *Newman* decision. Whether decided on the basis of the personal benefit prong of the analysis or the sufficiency of evidence showing that the defendants had knowledge, the court failed to follow the *Dirks* decision and the long line of cases before it. As it currently stands, it is unclear whether the decision extends to misappropriation theory cases and civil offenses.[161]

The *Newman* decision narrows insider trading liability even more than cases such as *Dirks* and *Obus* and consequently limits the ability of the SEC and DOJ to "aggressively pursue[] remote tippees [due to] increasingly vague articulations of what constitutes a 'personal benefit.'"[162] Furthermore, it wavers in its definition of scienter and fails to clearly indicate that conscious avoidance is sufficient for finding a tippee liable.

Rather than complicating the analysis for finding liability in a case where millions of dollars in fraudulent profits were earned, the court should have focused on simplifying the analysis and making the markets more stable for future investors so that capital formation continues. If the courts continue to reward those who improperly use nonpublic information simply because they are remote from the insider or consciously avoid knowing too much, then investors may be discouraged from trading and companies may no longer have quick access to capital. It is in the best interest of all market participants to establish a more predictable and realistic set of securities laws so that tippees intending to commit fraud are effectively discouraged, or subsequently prosecuted, for their actions.

160. Quinn Emanuel, *supra* note 60. The bills are in the early stages, but if passed would "vastly redefine the contours of tipper–tippee liability . . . and insider trading liability." *Id.*

161. Judge Jed. S. Rakoff "avoided answering a key post-*Newman* question: whether *Newman* applies to criminal prosecutions only, or also to SEC civil enforcement actions." *Id.* In the context of the *Payton* decision, the judge held that regardless of *Newman*'s application to civil cases, "the SEC's complaint satisfied *Newman* by alleging 'a meaningfully close personal relationship' and that the tipper 'disclosed the inside information for a personal benefit sufficient to satisfy the *Newman* standard.'" *Id.* (quoting SEC v. Payton, 97 F. Supp. 3d 558, 564 (S.D.N.Y. 2015)).

162. Halper, Loeb & Shapiro, *supra* note 37.