NEW YORK UNIVERSITY
JOURNAL OF LAW & BUSINESS

VOLUME 19 | SPRING 2023 | NUMBER 2

THE LAW OF INSIDER TRADING: LEGAL THEORIES, COMMON DEFENSES, AND BEST PRACTICES FOR ENSURING COMPLIANCE

BRADLEY J. BONDI* & MICHAEL D. WHEATLEY**

INTRODUCTION 341
I. LEGAL OVERVIEW 342
A. *Background on Insider Trading* 342
B. *Liability for a Company or Fund Based on Conduct of Employees* 344
C. *Theories of Insider Trading* 347

* Bradley J. Bondi is a litigation partner and Global Co-Chair of the Investigations and White Collar Defense practice at Paul Hastings LLP in Washington, D.C. and New York. He was named national MVP for white collar in 2019, 2020, and 2022 by Law360. He focuses on SEC and DOJ enforcement defense, insider trading investigations and compliance, complex civil and criminal litigation, and internal investigations. Mr. Bondi also serves as a Visiting Clinical Professor at Yale Law School and an adjunct professor at Georgetown University Law Center and George Mason University Antonin Scalia Law School. In addition to his trial and appellate advocacy and scholarship related to insider trading law, Mr. Bondi has been engaged as an expert witness in insider-trading cases. A hyperlink to his bio can be found at http://www.paulhastings.com/professionals/bradbondi.

** Michael D. Wheatley is a litigation counsel and member of the Investigations and White Collar Defense practice at Paul Hastings LLP in Washington, D.C. He focuses on SEC and DOJ enforcement defense, investment adviser and broker-dealer compliance, complex civil and criminal litigation, and internal investigations.

This article builds on a previous article published in this Journal and authored by Bradley J. Bondi and Steven D. Lofchie. *See* Bradley J. Bondi and Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J. L. & BUS. 151, 153 (2011). The authors wish to thank Ronald E. Pantalena III and Traci Zeller for their valuable assistance with this piece.

1. *"Classical" Theory* 348
2. *"Tipper-Tippee" Theory* 349
3. *"Misappropriation" Theory* 351
4. *"Outsider Trading" or the "Affirmative Misrepresentation" Theory* 352
5. *"Shadow Trading" Theory* 354

D. *Rule 10b5-1: Definition of "on the basis of"* 356
E. *Rule 10b5-2: Definition of Duty of Trust or Confidence* 359
F. *Potential Criminal Charges Associated with Insider Trading* 360
G. *Insider Trading in the Debt Markets, Credit Derivatives, and Distressed Loan Markets* 362
H. *Insider Trading in the Commodity Futures and Derivatives Markets* 366

II. INSIDER TRADING IN DIGITAL ASSET MARKETS 367
III. LEGAL AND FACTUAL DEFENSES 370

A. *Public versus Nonpublic Information* 371
1. *The Test of Whether Information Is Public* 372
2. *The Means by Which Information Becomes Public* 376
3. *Fully Public versus Partially Public* 377
4. *Information that Was Never Nonpublic* 378
5. *Information Relayed through Expert Networks* 380

B. *Materiality* 382
C. *Breach of a Duty* 390
1. *Duty under the Classical and Tipper-Tippee Theories* 391
2. *Duty under the Misappropriation Theory* 393

IV. COMPLIANCE PRACTICES TO ADDRESS INSIDER TRADING 400

A. *Insider Trading – Information Barriers* 401
B. *Expert Network Procedures* 401
1. *Expert Network Compliance Program* 401
2. *Expert-Specific Procedures* 402
3. *Pre-Approvals* 402
4. *Documentation of Meetings* 403
5. *Follow-Up Communications* 404

C. *Alternative Data Procedures* 405
D. *Other Procedures* 406
1. *Supervision* 406

2. *Surveillance* 406
3. *Culture of Compliance or so-called "Speak-up" Culture* 407
4. *Training* 407
5. *Documentation* 407
CONCLUSION 408

INTRODUCTION

Developments in insider trading case law and novel criminal prosecutions and SEC enforcement have prompted new questions about the extent of the government's authority to bring insider trading charges and have prompted doubts among market participants about whether their conduct is permissible. For example, the Supreme Court has resolved circuit splits regarding key elements of insider trading and the remedies available to the SEC. Additionally, an SEC enforcement action charged an individual with insider trading on a new theory of "shadow trading" and raised questions about the breadth of the breach-of-duty element of insider trading liability. Further, investment firms' new approaches to gathering data also have prompted both enforcement actions and regulatory guidance addressing permissible methods of information gathering and questions regarding whether information has entered the public domain.

Investment firms and public companies should be attuned to these developments and tailor their policies, procedures, controls, and codes of ethics to the risks relevant to their firms. As a first line of defense, firms should ensure that robust and comprehensive compliance programs are in place to reduce the risk of potential insider trading. Regardless of the quality of any firm's compliance procedures, however, institutional investors, financial services personnel, and corporate executives may be suspected of, or even face criminal and civil charges for, insider trading. To assist firms and individuals in considering and weighing possible defenses against actions brought by the Department of Justice ("DOJ") or the Securities and Exchange Commission ("SEC"), this Article proceeds as follows: Part I provides the background on insider trading; Part II summarizes the law regarding insider trading; Part III discusses some of the general legal and factual defenses that may be raised to charges of insider trading, depending on

the facts and circumstances of the case; and finally, Part IV provides guidelines for establishing and maintaining an effective compliance program to minimize the risks of insider trading liability.

Any firm or individual that becomes the subject of an insider trading investigation should recognize that the law of insider trading is nuanced and highly dependent upon the facts and circumstances of a particular case. This Article analyzes the current law of insider trading and describes some of the key defenses that may be raised in consultation with counsel.

I.
Legal Overview

A. *Background on Insider Trading*

There is no federal statute that explicitly prohibits insider trading. Instead, the prohibitions against insider trading have developed through a series of Supreme Court cases applying the general anti-fraud provisions of the Securities Exchange Act of 1934 ("Exchange Act") to fact-intensive allegations of illicit trading.

In general terms, the law established through these cases prohibits trading a security on the basis of material nonpublic information, where the trader has breached a duty of trust or confidence owed to either an issuer, the issuer's shareholders, or the source of the information, and where the trader is aware of the breach.[1] Implicit in its name, the law of insider *trading* prohibits actual *trading* in a security while in possession of material nonpublic information; the law does not prohibit refraining from trading while in possession of such information.[2]

The *sine qua non* of any insider trading claim is material nonpublic information. As a general matter, information that is "public" cannot form the basis of an insider trading claim. This tenet encompasses not only publicly distributed information, but also information that an investor personally devel-

1. *See* 17 C.F.R. §§ 240.10b5-1, 240.10b5-2 (2023). If trading relates to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *See* 17 C.F.R. § 240.14e-3 (2023).

2. *Cf.* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (holding only purchasers and sellers of securities have standing to sue for damages under 10b-5).

oped from independent observation of the public world. For example, watching trucks from a public road as they leave a warehouse (to help ascertain the level of demand for a product) cannot form the basis of an insider trading claim. Likewise, to adequately state a cause of action for insider trading, the information at issue must be "material." The Supreme Court has said that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[3] This standard requires a showing that there is a substantial likelihood that the fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[4] One federal circuit court has added an additional gloss to this materiality standard by analyzing whether the information would have been material to reasonable investors *within the particular market* in which the trading occurred.[5]

The materiality of certain information often becomes a central question in insider trading cases involving an institutional investor. In general, an investor that assembles multiple pieces of *non-material* information to reach a material conclusion has not violated insider trading laws, regardless of whether the information obtained was nonpublic.[6] Indeed, institutional investors, such as hedge funds, often piece together bits of public and nonpublic, *non-material* information to understand the broader position of a particular company. This practice commonly is referred to as the "mosaic" theory of investing, and it can serve as the basis of a defense to insider trading charges, particularly where the SEC asserts that an investor, who may have inadvertently obtained information from

---

3. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (articulating materiality standard in shareholder voting context); Basic, Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (expressly adopting the standard of materiality from *TSC Indus.*, 426 U.S. 438, for the context of Rule 10b-5).

4. *TSC Indus.*, 426 U.S. at 449.

5. *See* United States v. Litvak, 889 F.3d 56, 65 (2d Cir. 2018).

6. To be sure, if all the non-material information was obtained through improper means (i.e., with knowledge of the breach of a duty to the source of the information), a court may view the information in the aggregate as a "material" whole and thus hold that the conduct constitutes insider trading, assuming all of the other elements are met. This possibility may be especially likely if all of the improperly obtained non-material nonpublic information derives from a single source.

a tipper who breached his fiduciary duty, traded on that information.[7]

B. *Liability for a Company or Fund Based on Conduct of Employees*

Although the law of insider trading is focused on the actions of individuals, a company or fund may face criminal and civil liability if management explicitly or implicitly consents to an individual's conduct such that the acts of the wrongdoer-employee are deemed to have occurred within the scope of employment.[8] For example, under Section 21A of the Exchange Act, a company or fund that employs a tipper (i.e., an employee who shares information with someone outside the firm) or tippee (i.e., an employee who receives the material nonpublic information and then trades) may itself be liable for a civil penalty of up to the greater of either three times the direct profits of the trade or $1,000,000.[9]

The company or fund also may be required to disgorge ill-gotten gains obtained through illegal insider trading, although the Supreme Court's decision in *Liu v. SEC* curtailed the SEC's historically broad disgorgement remedy. In *Liu*, the Supreme Court explained the limits of the SEC's disgorgement power. Addressing issues left unresolved by the Court's earlier deci-

---

7. *See, e.g.*, State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 854 (2d Cir. 1981) (citing Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980)); *see also* Andrew Ross Sorkin, *Just Tidbits, or Material Facts for Insider Trading*, N.Y. TIMES (Nov. 29, 2010, 8:56 PM), https://archive.nytimes.com/dealbook.nytimes.com/2010/11/29/just-tidbits-or-material-facts-for-insider-trading/?ref=business (discussing mosaic theory as a defense employed by Raj Rajaratnam, founder of the Galleon Group).

8. *See, e.g.*, SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 812–13 (2d Cir. 1975) (holding stock brokerage firm civilly liable for its employees' insider trading on grounds that it placed the traders in a position to engage in insider trading); *see also* RESTATEMENT (SECOND) OF AGENCY § 219(1) (AM. L. INST. 1958) ("A master is subject to liability for the torts of his servants committed while acting in the scope of their employment."). For purposes of vicarious tort liability, however, most courts have taken the view that insider trading is not within the scope of employment. *See, e.g.*, Energy Factors, Inc. v. Nuevo Energy Co., No. 91-CV-4273, 1992 U.S. Dist. LEXIS 10208, at *18 (S.D.N.Y. July 7, 1992) (holding that an employee who trades on or tips material, nonpublic information "must normally be viewed as on a frolic of his own" (quoting O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1194 (S.D.N.Y. 1981))).

9. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(a)(3).

sion in *Kokesh v. SEC*,[10] the Court in *Liu* held that disgorgement is lawful under §78u(d)(5) where such relief "does not exceed a wrongdoer's net profits and is awarded for victims."[11] Before *Liu*, the SEC routinely transferred to the Treasury Department any disgorgement award it obtained in an insider trading case. But *Liu*'s requirement that the disgorgement be "awarded for victims" casts doubt on this practice because courts and the SEC often find it difficult to identify the victims of insider trading. Moreover, insider trading, especially in equities, often is characterized as "victimless" because the illicit trades may have taken place regardless of whether the insider was present in the market.[12]

After *Liu*, Congress amended 15 U.S.C. § 78u—the statute authorizing disgorgement for securities law violations—as part of the National Defense Authorization Act of 2021.[13] The amendment could make it easier for the SEC to obtain disgorgement in insider trading cases, because it added a provision that does not require disgorgement to be "for the benefit of investors."[14] Since the amendment became law, the SEC has argued that the amendment gives courts "greater flexibility to determine where collected disgorgement funds may be distributed."[15] At least one district court has agreed with the SEC and held that "it may order disgorgement and direct that disgorged funds be sent to the Treasury under Section 78u(d)(7)."[16]

10. Kokesh v. SEC, 581 U.S. 445 (2017).

11. Liu v. SEC, 140 S. Ct. 1936, 1940 (2020).

12. *See, e.g.*, Thomas C. Newkirk, Assoc. Dir., Div. Enf't, Sec. & Exch. Comm'n & Melissa A. Robertson, Senior Couns., Div. Enf't, Sec. & Exch. Comm'n, Speech by SEC Staff: Insider Trading – A U.S. Perspective (Sept. 19, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm. In this speech, senior SEC personnel acknowledged that "[w]ith respect to equities trading, it may well be true that public shareholders' transactions would have taken place whether or not an insider was unlawfully in the market." *Id.*

13. *See* The William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, § 6501, 134 Stat. 3388, 4625-26 (2021) (amending 15 U.S.C. § 78u).

14. *Compare* 15 U.S.C. § 78u(d)(5), *with* 15 U.S.C. § 78u(d)(7).

15. SEC v. Spartan Sec. Grp., Ltd, No. 8:19-CV-448-VMC-CPT, 2022 WL 3224008, at *9 (M.D. Fla. Aug. 10, 2022).

16. *Id.* In the alternative, the court held that the balance of the equities favored disgorgement to the Treasury: "Between the money staying with [the defendant], a key player in a [securities fraud scheme], or a fund at the

Despite the difficulties *Liu* theoretically may pose to the SEC's ability to obtain disgorgement in insider trading cases, the practical effect may be limited. Given the SEC's ability to seek penalties and courts' "wide discretion" in devising civil penalties[17] against firms and individuals for securities law violations, the SEC may elect to forego disgorgement in favor of seeking higher penalties.

An employer's liability may be established if it "knew or recklessly disregarded the fact that such [employee] was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."[18] The employer-firm also may be liable if it "knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under Section 15(f) [for registered broker-dealers] or Section 204 of the Investment Advisers Act of 1940 [for registered investment advisers]," and the failure is found to have substantially contributed to, or permitted the occurrence of, the act or acts constituting the violation.[19] Section 204A of the Investment Advisers Act of 1940 requires that registered investment advisers adopt a policy governing the use of material nonpublic information.[20] The SEC has brought enforcement actions against firms that failed to have reasonable policies and procedures to comply with this rule.[21] Further, the SEC's Division of Examinations (formerly known as the Office of Compliance Inspections and Examinations) also has scrutinized firms that lack appropriate

---

Treasury, it is more equitable to order disgorgement." *Id.* at *10. The court cited several other district courts that had taken a similar approach post-*Liu. Id.*

17. SEC v. de Maison, No. 18-2564, 2021 U.S. App. LEXIS 37183, at *7 (2d Cir. Dec. 16, 2021) (summary order).

18. Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(b)(1)(A).

19. H.R. REP. No. 100-910 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6062. The legislative history of the liability penalty provision of Section 21A(b)(1) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78u-1(b)(1)) implies that a firm's failure to adopt prophylactic policies and procedures may result in the firm being deemed reckless and therefore liable for the conduct of employees. *Id.* at 6062; 6073.

20. 15 U.S.C. § 80b-4a.

21. *See* MIO Partners, Inc., Investment Advisers Act Release No. 5912, at 2 (Nov. 19, 2021); Cannell Capital, LLC, Investment Advisers Act Release No. 5541, at 2 (Feb. 4. 2020).

policies, tailored to the firm's own risk profile, concerning material nonpublic information.[22]

In some instances, the SEC has charged financial firms with violating the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder related to employee conduct. For example, in a settled enforcement action, the SEC obtained a $10.9 million fine against Barclays Bank PLC to resolve allegations that an employee traded on the basis of material nonpublic information the employee received from serving as a representative of Barclays on credit committees.[23] The SEC alleged that Barclays' compliance department "failed to . . . enforce policies and procedures to prevent [the employee] from trading [restricted] securities on the basis of material nonpublic information."[24]

C. *Theories of Insider Trading*

The crux of criminal and civil insider trading law derives from Section 10(b) of the Exchange Act — although criminal authorities often utilize additional laws to prosecute insider trading such as those addressing conspiracy and aiding and abetting. According to case law, insider trading violates Section 10(b), which makes it unlawful to "use or employ, in connection with the purchase or sale of any security. . . any manipulative or deceptive device or contrivance in contravention of" rules promulgated by the SEC.[25] Rule 10b-5 under the Exchange Act, adopted pursuant to the SEC's authority under Section 10(b), makes it unlawful to "engage in any act, practice, or course of business which operates or would operate as

22. *See* U.S. SEC. & EXCH. COMM'N, INVESTMENT ADVISER MNPI COMPLIANCE ISSUES, U.S. SEC. & EXCH. COMM'N (2022), https://www.sec.gov/files/code-ethics-risk-alert.pdf [hereinafter "SEC RISK ALERT"]. The Risk Alert indicated that the SEC's Division of Exams had observed investment advisers who "did not appear to adopt or implement reasonably designed written policies and procedures to address the potential risk" of certain practices.

23. *See* Litig. Release, SEC, Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor Committee Information, (May 30, 2007), https://www.sec.gov/litigation/litreleases/2007/lr20132.html.

24. *See* Complaint at 5, SEC v. Barclays Bank PLC, 07 CV 4427 (S.D.N.Y. 2007), https://www.sec.gov/litigation/complaints/2007/comp20132.pdf.

25. 15 U.S.C. § 78j(b).

a fraud or deceit upon any person, in connection with the purchase or sale of any security."[26]

Based upon these provisions, the Supreme Court has long recognized three general theories of insider trading liability, commonly referred to as: (1) the "classical" theory, (2) the "tipper-tippee" theory, and (3) the "misappropriation" theory. Importantly, to fit within any of these three categories, a person (although not necessarily the person actually trading) must have violated a duty of trust or confidence.

In addition to the aforementioned established theories of insider trading, other theories are gaining ground. The Second Circuit has recognized a potential fourth theory, "outsider trading" or the "affirmative misrepresentation" theory, based on an affirmative misrepresentation that does not require a breach of a duty. In 2021, the SEC unveiled a novel theory of "shadow trading," which is an extension of the misappropriation theory.[27] In 2022, a federal district court in California effectively endorsed this theory when it denied the defendant's motion to dismiss, which had argued against such a theory as a matter of law.[28]

1. *"Classical" Theory.*

The "classical" theory of insider trading generally applies when an insider, in violation of a fiduciary duty to his or her company (or to another company to which the insider owed a duty), trades in the securities of the company on the basis of material nonpublic information obtained by reason of the insider's position. [29] As discussed below, the SEC has defined by rule the concept "on the basis of" to mean that the person merely was aware of the nonpublic information at the time of the trade.[30] The classical theory covers situations in which a company executive, board member, or agent, such as an investment banker, trades in the company's securities or in the securities of a potential deal partner before the release of news

26. 17 C.F.R. § 240.10b-5 (2010).

27. *See* Complaint at 1–2, SEC v. Panuwat, No. 4:21-CV-06322 (N.D. Cal. Aug. 17, 2021).

28. *See* Order Denying Motion to Dismiss at 7, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

29. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

30. *See* 17 C.F.R. § 240.10b5-1(b) (2010). For further discussion of the term "on the basis of," see *infra* Section II.D.

about a significant event, such as a tender offer, merger, or earnings announcement.

2. *"Tipper-Tippee" Theory.*

The "tipper-tippee" theory imposes liability when (1) the tipper "has breached his fiduciary duty to the shareholders by disclosing the [material nonpublic] information to the tippee," (2) the tippee "knows or should know that there has been a breach," (3) the tippee uses the information in connection with a securities transaction, and (4) the tipper receives some personal benefit in return.[31]

In 2016, the Supreme Court resolved a circuit split regarding the nuances of the fourth "personal benefit" element. At the center of the circuit split was how to interpret the statement in the Supreme Court's opinion in *Dirks v. SEC* that the personal benefit element may be satisfied when the "insider makes a gift of confidential information to a trading relative or friend."[32] As discussed below, the disagreement between the Second Circuit and the Ninth Circuit regarding *Dirks'* test for analyzing the personal benefit element underscores the nuanced and fact-intensive nature of insider trading analysis.

Dirks was a broker-dealer who received a tip from a former officer of a publicly-traded company that the company was engaged in a massive fraud.[33] Dirks provided this information to his clients, who traded on it. Dirks did not provide any benefit to the corporate officer who tipped him about the fraud.[34] The SEC charged Dirks with insider trading, but the Supreme Court held that Dirks had not engaged in insider trading because the tipper—the former officer of the public company—did not receive a personal benefit in exchange for the information he provided to Dirks. Because the tipper did not receive a personal benefit, there was no breach of fiduciary duty and thus no insider trading liability. Although the Court stated that "a gift of confidential information to a trading friend or relative" satisfies the personal benefit requirement

31. Dirks v. SEC, 463 U.S. 646, 647 (1983).
32. *Id.* at 664.
33. *Id.* at 648–49.
34. *Id.* at 667 ("The tippers received no monetary or personal benefit for revealing [the fraud], nor was their purpose to make a gift of valuable information to Dirks.").

for tipper-tippee liability, that statement was not part of the Court's holding, and the precise meaning of the statement remained an open question.[35]

In 2014, the Second Circuit addressed that question in *United States v. Newman*.[36] *Newman* involved the criminal prosecution of a "cohort of analysts" who allegedly shared confidential information with each other and used that information to trade.[37] The Second Circuit reversed their convictions, and, focusing on the personal benefit element, held that "the mere fact of friendship, particularly of a casual or social nature" did not satisfy the personal benefit prong of *Dirks*.[38] Instead, the Second Circuit held that the personal benefit element is satisfied where there is "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."[39]

Shortly after *Newman*, the Ninth Circuit considered the same issue and disagreed with the Second Circuit.[40] In *United States v. Salman*, Bassam Salman was convicted of insider trading after receiving tips from his future brother-in-law Michael Kara, who, in turn, had received the information from his brother. Kara's brother was an investment banker who had access to material nonpublic information.[41] At trial, the government established the personal benefit element by demonstrating that the brothers had a "mutually beneficial relationship" because the investment banking brother gave Kara confidential information "to benefit him" and to "fulfill [ ] whatever needs he had."[42] Salman relied on *Newman* to rebut the existence of a personal benefit. He argued that the "evidence of a friendship or familial relationship" between Kara and his brother was insufficient to satisfy the personal benefit prong because after *Newman*, the "exchange of information must include at least a potential gain of a pecuniary or similarly valua-

35. *Id.* at 665–67.
36. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
37. *Id.* at 442.
38. *Id.* at 452.
39. *Id.*
40. United States v. Salman, 792 F.3d 1087 (9th Cir. 2015).
41. *Id.* at 1088–90.
42. *Id.* (internal quotation marks omitted).

ble nature."[43] The Ninth Circuit rejected this argument and expressly declined to follow *Newman*.[44] Instead, the court reverted to the description of a personal benefit in *Dirks* and held that disclosing confidential information to a family member was "precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned."[45]

The Supreme Court granted certiorari to address the "tension" resulting from the *Newman* and *Salman* decisions. In affirming the Ninth Circuit's opinion in *Salman*, the Court "adhere[d] to *Dirks*," and reinforced the rule from *Dirks* that "a tipper breaches a fiduciary duty by making a gift of confidential information to a 'trading relative.'"[46] The unanimous Court held 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 . . . we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*."[47] Although *Salman* seemingly brought clarity to the tipper-tippee theory by reinforcing the language in *Dirks*, the Court did leave some questions unanswered. For example, the Court did not address the SEC's argument that this "gift theory" applies to a gift to any person, not just to a trading friend or relative. Subsequent Second Circuit opinions suggest that *Salman* did not entirely abrogate *Newman*.[48] The personal benefit element remains fertile ground for legal debate.

3. *"Misappropriation" Theory.*

The "misappropriation" theory applies to situations in which a person, who is not an insider, lawfully comes into possession of material nonpublic information, but nevertheless

43. *Id.* at 1093.
44. *Id.*
45. *Id.* at 1092.
46. Salman v. United States, 580 U.S. 39, 48–49 (2016).
47. *Id.* at 50.
48. *See* United States v. Martoma, 894 F.3d 64, 71 (2d Cir. 2017). After initially holding that the Supreme Court's *Salman* opinion abrogated *Newman*, the Second Circuit issued an amended opinion in which it stated that it need not make that determination to resolve the *Martoma* case: "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*." *Id.*

breaches a duty of trust or confidence (as further discussed below) owed to the source of the information by trading on the basis of such information or by conveying the information to another person to trade.[49]

4. *"Outsider Trading" or the "Affirmative Misrepresentation" Theory.*

In 2009, the Second Circuit recognized a novel form of insider trading—referred to by some commentators as the "outsider trading" or the "affirmative misrepresentation" theory—that does not require a breach of a fiduciary duty. In *SEC v. Dorozhko*, the Second Circuit held that neither Supreme Court nor Second Circuit precedent imposed a fiduciary duty requirement on the ordinary meaning of "deceptive" where the alleged fraud is an affirmative misrepresentation rather than a non-disclosure.[50] This holding created controversy, because it marked the first time a court had recognized insider trading without finding a breach of a fiduciary duty.[51]

The case arose from an unusual set of facts. Oleksandr Dorozhko allegedly hacked into Thomson Financial's secure computer system, where he accessed the third-quarter earnings of IMS Health, Inc. ("IMS") before they were released to the public.[52] Dorozhko then purchased a substantial volume of put options expiring within two weeks.[53] When the financial results were finally publicized, Dorozhko profited by selling the put options of IMS he had purchased previously.[54]

The SEC alleged that Dorozhko committed insider trading by affirmatively misrepresenting himself (i.e., hacking into the computer system) to gain access to material nonpublic information about IMS that he used to trade.[55] The United States District Court for the Southern District of New York denied the SEC's motion for a preliminary injunction to freeze the proceeds of Dorozhko's transactions, holding that the SEC had not shown that it likely would succeed on the merits of a

---

49. United States v. O'Hagan, 521 U.S. 642, 652 (1997).
50. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009).
51. *See* Michael D. Wheatley, *Apologia for the Second Circuit's Opinion in* SEC v. Dorozhko, 7 J.L. ECON. & POL'Y 25, 25 (2010).
52. SEC v. Dorozhko, 606 F. Supp. 2d 321, 325–26 (S.D.N.Y. 2008).
53. *Id.* at 326.
54. *Id.* at 326–27.
55. *Dorozhko*, 574 F.3d at 49 (2d Cir. 2009).

claimed violation of Section 10(b) of the Exchange Act.[56] Relying on insider trading law precedent, the district court determined that the "deceptive device" element of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder requires a breach of fiduciary duty.[57] Because Dorozhko, a hacker, did not owe a fiduciary duty either to the source of the information or to those persons with whom he had transacted, the court determined that he was not liable under Section 10(b).[58]

On appeal, the Second Circuit held that an affirmative misrepresentation in connection with the purchase or sale of a security is a "distinct species of fraud" that violates the securities laws, regardless of the existence of a fiduciary duty.[59] Absent a fiduciary duty to disclose or abstain from trading, the defendant still had an affirmative obligation not to mislead someone.[60] The court stated:

"[M]isrepresenting 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. . . . [I]t 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."[61]

The case was remanded to the district court to resolve whether Dorozhko's hacking constituted a deceitful affirmative misrepresentation. On remand, the district court granted the SEC's unopposed motion for summary judgment.[62]

56. *Dorozhko*, 606 F. Supp. 2d at 343 (S.D.N.Y. 2008).

57. *Dorozhko*, 574 F.3d at 47–48 (2d Cir. 2009) (citing Chiarella v. United States, 445 U.S. 222, 235 (1980) (finding that "there can be no fraud absent a duty to speak") and United States v. O'Hagan, 521 U.S. 642, 653 (1997) (finding that defendant violated duty to law firm and its clients by misappropriating and trading based on material nonpublic information)).

58. *Dorozhko*, 606 F. Supp. 2d at 324 (S.D.N.Y. 2008).

59. *Dorozhko*, 574 F.3d at 49 (2d Cir. 2009).

60. *Id.* (distinguishing insider trading in abrogation of a duty to disclose or abstain from trading from affirmative representations of those who are under no duty other than one not to mislead (citing Basic, Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988))).

61. *Id.* at 51.

62. SEC v. Dorozhko, No. 07-CV-9606 (NRB) (S.D.N.Y. Mar. 24, 2010) (order of J. Buchwald), http://law.du.edu/documents/corporate-governance/sec-and-governance/dorozhko/SEC-v-Dorozhko.pdf. In granting the motion for summary judgment, the district court directed Dorozhko to disgorge illegal gains of $286,456.59 and $6,903.94 in prejudgment interest; the

Despite the unusual facts that led to the Second Circuit's controversial *Dorozhko* opinion, the "affirmative misrepresentation" theory has been applied outside the computer hacking context. In private securities litigation, a district court applied *Dorozhko*'s "affirmative misrepresentation" test to deny an executive's motion to dismiss shareholders' securities fraud allegations. The plaintiffs were shareholders of a company that acquired the executive's company. In seeking to dismiss allegations that the executive failed to disclose or misrepresented information regarding his bonus compensation resulting from the acquisition, the executive argued that he did not owe a fiduciary duty to the shareholders of the acquiring company. The district court agreed that the absence of a fiduciary duty required it to dismiss claims based on alleged *omissions* of material facts relating the executive's bonus arrangement. Citing *Dorozhko*, the district court denied the defendant's motion to dismiss claims based on alleged "false or misleading statements" to the acquiring company's shareholders because "no fiduciary obligation is necessary to proceed with such claims."[63] The DOJ, SEC, and even private plaintiffs may continue to find new applications for the "affirmative misrepresentation" theory.

5. *"Shadow Trading" Theory*

In 2021, the SEC brought a novel enforcement action against Matthew Panuwat based on the so-called "shadow trading" theory of insider trading.[64] The SEC alleged that Panuwat, while still employed by biopharmaceutical firm

---

court also barred him from future violations of federal securities laws. *Id.* Dorozhko's counsel, Charles A. Ross, had told the court that he was unable to contact his client and therefore did not oppose the motion. *See* Yin Wilczek, *Court Grants SEC Summary Judgment in Ukrainian Hacker Insider Trading Case*, BLOOMBERG L. (Mar. 26, 2010, 2:27 PM), https://news.bloomberglaw.com/securities-law/court-grants-sec-summary-judgment-in-ukrainian-hacker-insider-trading-case.

63. In re Bank of Am. Corp. Sec., Derivative, & Emp. Ret. Income Sec. Act (ERISA) Litig., 757 F. Supp. 2d 260, 288 (S.D.N.Y. 2010).

64. *See* Complaint at 1–2, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Aug. 17, 2021). At oral argument on the motion to dismiss, the SEC conceded that there were "no other cases where the material nonpublic information at issue involved a third party." *See* Order Denying Motion to Dismiss at 20, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

Medivation, received material nonpublic information that Medivation would be acquired by Pfizer. The SEC alleged that, after receiving this information, Panuwat purchased out-of-the-money, short-term stock options in Incyte Corporation, another biopharmaceutical company whose shares Panuwat believed would increase once the Pfizer/Medivation acquisition was announced. According to the SEC's complaint, Panuwat knew that the acquisition of Medivation could positively affect Incyte's stock price because Panuwat had reviewed presentations authored by bankers that discussed Medivation's peer companies and the acquisition of Medivation by a large pharmaceutical company would make Medivation's peer companies more valuable acquisition targets. In addition, the SEC alleged that Panuwat knew that a previous merger involving different pharmaceutical companies positively affected the stock price of Medivation and Incyte. When the acquisition was publicly announced, both Medivation's and Incyte's stock prices rose considerably, and Panuwat earned $107,066 as a result of his option purchases. The SEC alleged that Panuwat's "undisclosed, self-serving use of Medivation's information to purchase securities, in breach of his duty of trust and confidence, defrauded Medivation and undermined the integrity of, and investor confidence in, the securities markets."[65]

In moving to dismiss the complaint, Panuwat argued that information about the Pfizer/Medivation acquisition was not material to *Incyte*, the company in whose securities Panuwat had traded.[66] The district court rejected Panuwat's argument and concluded that Section 10(b) and Rule 10b-5 "cast a wide net, prohibiting insider trading of 'any security' using 'any manipulative or deceptive device.' "[67] Panuwat also argued that he had not breached his duty to *Medivation* by trading in the securities of Incyte.[68] The court rejected this argument too. The district court pointed to Medivation's insider trading policy which prohibited trading in "securities of another publicly

---

65. Complaint at 8, ¶ 34, SEC v. Panuwat, No. 3:21-CV-06322 (N.D. Cal. Aug. 17, 2021).

66. *See* Motion to Dismiss at 9–10, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Nov. 1, 2021).

67. *See* Order Denying Motion to Dismiss at 7, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26.

68. *See* Motion to Dismiss at 11–12, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Nov. 1, 2021).

traded company" and enumerated a non-exhaustive list of prohibited trades.[69] The district court found that the SEC adequately alleged a breach of duty because the insider trading policy could be interpreted to prohibit Panuwat from trading in Incyte's securities.[70]

After *Panuwat*, it is unclear whether, absent the court's interpretation of Medivation's insider trading policy, the court would have identified the duty necessary for the SEC's complaint to survive a motion to dismiss. Thus, this case suggests that company policies and procedures may inadvertently impose on employee's duties and obligations that go beyond the requirements of the federal securities laws. These additional duties and obligations may unintentionally expose employees to insider trading liability. Counsel for firms should give careful consideration to this risk when drafting firm policies and consider whether these policies could be read broadly to impose duties that extend beyond the requirements of the federal securities laws.

In sum, the legal framework surrounding insider trading is nuanced and comes from a multiplicity of legal sources. Different types of firms may be more likely to be charged under particular theories. For example, an issuer or investment bank more commonly may be charged under the classical theory, while an institutional investor more likely may be charged under the tipper-tippee theory. In any case, the methods to prevent insider trading and the legal issues to consider in the event of an insider trading charge require careful and detailed analysis of the particular facts.

D. *Rule 10b5-1: Definition of "on the basis of"*

In 2000, the SEC defined by rule the concept of trading "on the basis of" material nonpublic information. Under Rule 10b5-1, "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made

69. *See* Order Denying Motion to Dismiss at 9, SEC v. Panuwat, No. 21-CV-06322 (N.D. Cal. Jan. 14, 2022), ECF No. 26 (quoting Medivation's company policy).
70. *See id.*

the purchase or sale."[71] With a few exceptions, a trader's other motivations for making the trade are generally not a defense if he was aware of the material nonpublic information at the time of the trade.

Importantly, Rule 10b5-1 expressly provides three affirmative defenses. The trader has not traded "on the basis of" material nonpublic information if he demonstrates that, "[b]efore becoming aware of the information," he (1) entered into a binding contract to purchase or sell the security, (2) instructed another person to purchase or sell the security for the instructing person's account, or (3) adopted a written plan for trading securities (a so-called "10b5-1 plan").[72] These affirmative defenses turn on the trader's ability to show that he already had plans to execute the trade *before* learning of the material nonpublic information.[73]

With respect to 10b5-1 plans, insider trading occurs, as the name suggests, where there has been "trading." It is not an insider trading violation for a person to halt or suspend a plan and thereby *avoid* trading,[74] although repeatedly stopping and restarting a 10b5-1 plan would be viewed with skepticism by the SEC and such modifications to the plan are subject to a "cooling off" requirement adopted by the SEC in 2022 and discussed below.[75]

---

71. 17 C.F.R. § 240.10b5-1(b) (2000).

72. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2000).

73. *See* Press Release, U.S. Sec. & Exch. Comm'n, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), https://www.sec.gov/news/press/2010/2010-197.htm (describing SEC settlement of an insider trading suit against former Countrywide CEO Angelo Mozilo, who established four 10b5-1 plans to sell options in Countrywide's stock while aware of material nonpublic information about increasing risk due to the poor performance of loans Countrywide originated).

74. *Exchange Act Rules: Questions and Answers of General Applicability, Question 120.17*, U.S. SEC. & EXCH. COMM'N (Mar. 31, 2020), https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.

75. *See, e.g.*, Linda Chatman Thomsen, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), http://www.sec.gov/news/speech/2007/spch101007lct.htm (stating generally that the SEC is scrutinizing 10b5-1 plans to identify potential abuses where executives may be trading on inside information by using such plans for cover); Linda Chatman Thomsen, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Remarks at the 2007 Corporate

In a 2022 SEC enforcement action, the SEC underscored the importance of adopting a Rule 10b5-1 plan *before* becoming aware of material nonpublic information.[76] The SEC alleged that two executives of Cheetah Mobile, Inc. learned about a trend of declining revenue.[77] According to the SEC, the executives did not disclose the trend to investors, and the executives entered into a trading plan to sell some of their Cheetah Mobile securities.[78] The SEC alleged that the executives sold 96,000 Cheetah Mobile shares pursuant to the trading plan and before the company disclosed the negative revenue trend to investors.[79] In the settlement, the executives agreed to pay hundreds of thousands of dollars in civil penalties and to comply with significant restrictions on their ability to transact in Cheetah Mobile's securities.[80]

Citing concerns about perceived "gaps" in Rule 10b5-1 "that allow corporate insiders to unfairly exploit informational asymmetries," the SEC in 2022 adopted amendments to Rule 10b5-1 that impose additional requirements that an insider must meet before qualifying for the affirmative defenses.[81] To prevent insiders from adopting plans while they are in possession of material nonpublic information, the amendments require officers and directors to certify that they are not aware of any material nonpublic information when they enter into a plan.[82] The amendments also impose a mandatory "cooling off" period prohibiting officers and directors from trading pursuant to a new plan until the later of 90 days after the adoption of the plan or two business days following the disclosure of the issuer's quarterly financial results for the quarter in which the plan was adopted.[83] Importantly, the cooling off requirement applies to the adoption of a "modified trading ar-

---

Counsel Institute (Mar. 8, 2007), https://www.sec.gov/news/speech/2007/spch030807lct2.htm.

76. *See* In the Matter of Sheng Fu and Ming Xu, Securities Act Release No. 11104, Exchange Act Release No. 95847, at 7 (Sept. 21, 2022), https://www.sec.gov/litigation/admin/2022/33-11104.pdf.

77. *See id.* at 2.

78. *See id.* at 6–7.

79. *See id.* at 7–8.

80. *See id.* at 9–12.

81. *See* Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80362 (Dec. 29, 2022).

82. *See* 87 Fed. Reg. at 80373.

83. *See* 87 Fed. Reg. at 80369.

rangement," and the SEC considers cancelling a trade to be an adoption of a modification to a trading arrangement.[84] In other words, executives who cancel trades will have to wait at least 90 days from the cancellation before they can trade pursuant to a new plan. Perhaps to further discourage terminating a plan to *avoid* trading, the amendments also require issuers to disclose insiders' adoption *and termination* of Rule 10b5-1 trading plans in their Forms 10-Q and 10-K. Although, as discussed above, the termination of a plan cannot lead to insider trading liability because no trade has occurred, the SEC expects that the amendments requiring an issuer to disclose that an insider has terminated a plan will "affect the behavior of insiders by drawing scrutiny of investors and other market participants to trading practices of insiders."[85] The amendments also prohibit insiders from having overlapping trading plans and limit single-trade plans to one plan per twelve month period. Issuers also must disclose in their Form 10-K whether they have adopted insider trading policies and procedures that govern insiders' purchase and sale of securities.[86]

E. *Rule 10b5-2: Definition of Duty of Trust or Confidence*

In 2000, the SEC defined by rule a non-exhaustive list of the relationships that would establish a duty of trust or confidence for purposes of the misappropriation theory.[87] Under Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient "agrees to maintain the information in confidence"; (2) the source and recipient "have a history, pattern, or practice of sharing confidences," such that the recipient knew or reasonably should have known the source expected the information to be kept in confidence; or (3) where the source is the "spouse, parent, child, or sibling" of the recipient.[88] Although the validity of this rule was questioned by

84. 87 Fed. Reg. at 80366.
85. 87 Fed. Reg. at 80396.
86. *See* 87 Fed. Reg. at 80409.
87. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) (adopting, among other things, Regulation FD and Exchange Act Rule 10b5-2).
88. 17 C.F.R. § 240.10b5-2(b)(1)–(3) (2010).

the Fifth Circuit in *SEC v. Cuban*,[89] the rule remains valid in other circuits and has been reaffirmed by the Second Circuit.[90] Therefore, when designing compliance procedures, it is prudent to continue to view the duty of trust or confidence through the lens of Rule 10b5-2.

F. *Potential Criminal Charges Associated with Insider Trading*

Section 32 of the Exchange Act makes it a crime to willfully violate any provision of the Exchange Act or rule enacted thereunder, including Rule 10b-5.[91] Thus, the DOJ and the SEC can both pursue insider trading violations.

The DOJ may also bring charges that the SEC cannot. These charges include conspiracy, mail and wire fraud, false statements to investigators, and perjury. Importantly, none of the aforementioned charges requires the government to establish the elements of insider trading,[92] which could make it easier for the DOJ to obtain a criminal conviction against someone in a situation arising from an insider trading investigation than for the SEC to prevail in a traditional insider trading enforcement action.[93]

Firms also should be aware of Section 807 of the Sarbanes-Oxley Act ("SOX 807"), which makes it a crime to defraud anyone in connection with a security or to obtain, by fraud, money or property in connection with the purchase or sale of

---

89. SEC v. Cuban, 620 F.3d 551, 555–58 (5th Cir. 2010) (noting, but leaving open, the question of whether Rule 10b5-2 goes beyond the scope of Section 10(b) of the Exchange Act).

90. *See* United States v. Chow, 993 F.3d 125 (2d Cir. 2021).

91. *See* Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff.

92. The statutory bases for such charges are 18 U.S.C. § 371 (conspiracy against the United States), 18 U.S.C. § 1001(a) (false statements to investigators), 18 U.S.C. § 1341 (mail fraud), 18 U.S.C. § 1343 (wire fraud), and 18 U.S.C. § 1621 (perjury). *Compare* Indictment at 5–6, 11–12, United States v. Binette, No. 3:10-cr-30036-MAP (D. Mass. Oct. 14, 2010) (alleging defendants committed insider trading, in violation of 15 U.S.C. §§ 78j(b), 78f(a)), *with* Redacted Superseding Indictment, United States v. Stewart, 323 F. Supp. 2d 606, 624–34 (S.D.N.Y. 2004) (alleging that, in connection with a stock trade, defendants made false statements in violation of 18 U.S.C. § 1001(a), committed perjury in violation of 18 U.S.C. § 1621, and conspired to obstruct justice in violation of 18 U.S.C. § 371, but *not* alleging insider trading).

93. *See* Karen Woody, *The New Insider Trading*, 52 ARIZ. ST. L.J. 594, 639–40 (2020).

a security.[94] On its face, SOX 807 appears broader than Rule 10b-5 in important ways. The language of § 1348(1) does not include the requirement that there be a "purchase" or "sale" of a security, only that the violation be "in connection" with a security—a vague requirement that may, in itself, be subject to legal challenge. Like Rule 10b-5, SOX 807 also imposes liability for any attempt "to execute[] a scheme or artifice" to defraud.[95] Moreover, the government may argue from the face of the statute that "materiality" in the context of SOX 807 should be judged from the perspective of a reasonable employer, rather than that of a reasonable investor.[96]

In a significant case applying SOX 807, the Second Circuit highlighted the differences between Section 10(b) insider trading and SOX 807 insider trading. In *United States v. Blaszczak*, the government charged several hedge fund partners with insider trading after they received and traded on nonpublic information obtained from a former government agency official regarding upcoming agency decisions. The Second Circuit held that the personal benefit test established in *Dirks* does not apply to SOX 807. In analyzing this element, the Second Circuit observed that neither Section 10(b) nor SOX 807 contain, in their statutory text, a "personal benefit" requirement. Rather, the personal benefit test is a "judge-made doctrine premised on the Exchange Act's statutory purpose," which, according to *Dirks*, is to "[eliminate] [the] use of inside information for personal advantage."[97] The Second Circuit reasoned that SOX 807 does not have a similar statutory context, and it declined to extend *Dirks*' personal benefit test to SOX 807. The Supreme Court later vacated the Second Circuit's opinion and remanded the case for further consideration in light of a 2020 Supreme Court case that cast doubt on

94. Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348.

95. 18 U.S.C. § 1348(1).

96. *See* United States v. Mahaffy, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *39–42 (E.D.N.Y. Aug. 2, 2006) (stating that materiality is satisfied where an employee's misrepresentation or omission "would naturally tend to lead or is capable of leading a reasonable employer to change its conduct" (quoting United States v. Rybicki, 354 F.3d 124, 145 (2d Cir. 2003))).

97. United States v. Blaszczak, 947 F.3d 19, 35 (2d Cir. 2019) [hereinafter *Blaszczak I*] (quoting Dirks v. SEC, 463 U.S. 646, 662 (1983)), *cert. granted, vacated*, 141 S. Ct. 1040 (2021), *and sub nom.* Olan v. United States, 141 S. Ct. 1040 (2021), *vacated in part*, No. 18-2811 2022 U.S. App. LEXIS 35638 (2d Cir. Dec. 27, 2022).

whether the information at issue in *Blaszczak* was "property" that satisfied the necessary elements of the alleged criminal fraud.[98] On remand, the Second Circuit majority opinion did not revisit the personal benefit issue, but a thoughtful concurrence highlighted the anomaly that a criminal conviction for tipper-tippee insider trading prosecuted under SOX 807 does not require proof of a personal benefit element, whereas proof of a personal benefit is required "when the government seeks criminal or civil penalties for insider trading under Section 10(b) of the [Exchange Act and Rule 10b-5 thereunder]."[99] It remains to be seen whether other circuits will adopt the Second Circuit's approach to the personal benefit element in the context of SOX 807. Although serious questions remain about the constitutionality of SOX 807 and the applicability of the personal benefit requirement, SOX 807 presents a potentially powerful tool for criminal prosecutors.[100]

G. *Insider Trading in the Debt Markets, Credit Derivatives, and Distressed Loan Markets*

Historically, regulators have focused on insider trading in equity markets rather than in debt or credit derivatives markets. The ability to transfer credit risk through credit default swaps ("CDS") and the volatility of the fixed income markets, however, have drawn attention to insider trading in debt markets.[101] As a result, the SEC has brought more insider trading cases relating to debt market activities.

---

98. *See* Blaszcak v. United States, 141 S. Ct. 1040 (2021) (remanding on basis of Kelly v. United States, 140 S. Ct. 1565 (2020)).

99. United States v. Blaszczak, Nos. 18-2811, 18-2825, 18-2867, 18-2878, 2022 WL 17926047, at *13 (2d Cir. Dec. 27, 2022) (Walker, J. concurring) [hereinafter *Blaszczak II*]. In contrast, the dissent dismissed concerns about an anomaly between the requirements for securities fraud under SOX 807 and Section 10(b) and Rule 10b-5. In the dissent's view, SOX 807 was intended to give prosecutors new tools to prosecute financial crime, not to be a carbon copy of the Section 10(b) securities fraud statute. *See id.* at *25–27.

100. For additional discussion regarding the breadth of SOX 807 and the flexibility it affords prosecutors, see Sandra Moser & Justin Weitz, *18 U.S.C. § 1348—A Workhouse Statute for Prosecutors*, 66 DEP'T OF JUST. J. FED. L. & PRAC. 111 (2018).

101. This attention may have been precipitated, at least partially, by a buy-side publication that questioned whether banks were using inside information obtained as lenders to take advantage of bond investors through the purchase of credit default swaps. *See* CHRIS P. DIALYNAS, PIMCO, "RED

For example, in *SEC v. Marquardt*, the SEC brought and settled an insider trading case against the senior vice president of an investment adviser to a mutual fund, who had traded based on material nonpublic information about significant devaluations to the collateralized debt obligations, collateralized mortgage obligations, and other mortgage-related securities that the fund owned.[102] In *SEC v. Barclays Bank PLC*, the SEC brought and settled an action against Barclays Bank and one of its former proprietary traders in distressed debt for illegally trading bond securities while aware of material nonpublic information.[103] According to the settlement, the trader had misappropriated material nonpublic information he obtained while representing Barclays on several creditor committees, without disclosing the information to the bank's bond trading counterparties or disclosing the bank's trading activities to the sources of his information.[104]

Although the prohibition on insider trading applies as much to debt securities and credit derivatives as it does to equities, the application of the prohibition to the credit markets is particularly complicated for multiple reasons. Unlike the equity markets, the credit markets include similar products that may trade on the public side (debt securities) or on the private side (bank loans), as well as products that may be traded on both the public and private side of a financial institution

ALERT": THE CURRENT ACCOUNT DEFICIT AND CORPORATE BOND SPREADS 13 (2003) (citing to CHRIS P. DIALYNAS, PIMCO, BOND YIELD SPREADS REVISITED AGAIN AND PUBLIC POLICY IMPLICATIONS (2002)). After publication of the 2002 article, a number of trade associations collectively published a statement concerning the prevention of insider trading in the credit markets. *See, e.g.*, JOINT MKT. PRACTICES FORUM, STATEMENT OF PRINCIPLES AND RECOMMENDATIONS REGARDING THE HANDLING OF MATERIAL NONPUBLIC INFORMATION BY CREDIT MARKET PARTICIPANTS (2003). None of these publications has the force of law or creates any safe harbor.

102. SEC v. Marquardt, Litig. Release No. 21383, (Jan. 20, 2010), http://www.sec.gov/litigation/litreleases/2010/lr21383.htm; *see also* Complaint at ¶ 8, SEC v. Marquardt, No. 10-CV-10073 (D. Mass. Jan. 20, 2010). Given the nature of the securities held by the fund, the investment adviser valued the assets internally based on certain pre-determined methods as there was no readily-available market price.

103. SEC v. Barclays Bank PLC and Steven J. Landzberg, Litig. Release No. 20132, (May 30, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20132.htm. The SEC settled the case with the defendants for nearly $11 million. *See id.*

104. *Id.*

(credit default swaps). For example, structured debt securities such as collateralized loan obligations ("CLOs") are composed of underlying loans for which material nonpublic information is often shared with loan traders. Determining whether material nonpublic information about particular loans *within* the CLO equates to material nonpublic information *about* the CLO securities is often a challenging task that could depend upon such facts as the concentration of the loans for which material nonpublic information is known and the risk of default of the CLO tranche of the investment.

The SEC has brought insider trading cases involving the credit default swap market. In *SEC v. Rorech*, the SEC brought an action against a salesman at Deutsche Bank Securities for sharing information about the restructuring of an upcoming bond issuance with a hedge fund portfolio manager, who then purchased CDS covering the particular bonds.[105] Because the price of the CDS was based on the price of the underlying bonds, the SEC argued that they were "security-based swap agreements" covered under the antifraud provisions of the securities laws.[106] Although the court held that insider trading had not occurred because the information shared was not prohibited and the SEC did not show that the parties had engaged in any deceptive acts, the court found that the CDS were "security-based swap agreements" and therefore subject to insider trading prohibitions.[107]

The question of whether a CDS constitutes a security was largely resolved by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). In Dodd-Frank, Congress amended Section 2(a) of the Securities Act and Section 3(a)(10) of the Exchange Act to include "security-based swaps" in the definition of a security.[108]

Distressed loan trading also has received considerable attention from regulators. The primary and secondary markets

105. SEC v. Rorech, 720 F. Supp. 2d 367, 371 (S.D.N.Y. 2010); *see also* Complaint at ¶¶ 12–13, SEC v. Rorech, No. 09-CIV-4329 (S.D.N.Y. May 5, 2009) (arguing that a CDS is a type of credit derivative security, traded over the counter).

106. *Rorech*, 720 F. Supp. 2d at 405.

107. *Id.* at 405–06.

108. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 761(a)(6), 768(a)(1), 124 Stat. 1376, 1755, 1800 (2010) (codified as amended at 15 U.S.C §§ 77b, 78c).

for distressed bank debt have grown dramatically. Distressed bank debt is generally not viewed as a security, at least when traded between dealers or commercial lenders. If the bank note has a maturity of less than nine months, the note is expressly exempted from the definition of a security under Section 3(a)(3) of the Securities Act (unless the context otherwise requires).[109] For longer-term bank debt, courts have determined that the Securities Act's use of the phrase "any note" in the definition of a security generally does not apply to those notes issued in a consumer or commercial context, including consumer financing, home mortgages, or short-term notes secured by a lien on a small business or its assets, among others.[110] Nevertheless, courts recognize that greater scrutiny is often needed to assess whether a note may be characterized as a commercial loan or whether it is more appropriately viewed as a security in specific contexts.

In the seminal case *Reves v. Ernst & Young*, the Supreme Court articulated several factors that courts must consider in determining whether a note displays the economic substance of a security for purposes of applying insider trading and other securities laws. In general, instruments that are sold to raise capital, purchased for investment purposes rather than personal consumption, commonly traded, perceived by the public to be a security, or that fall outside other regulatory frameworks (such as banking regulations) may be considered securities.[111]

Effective walls are critical for participants in the distressed loan trading market. Traders at a firm that trades in distressed bank debt who receive inside information should be walled off from the traders of high-yield debt securities (subject to in-

---

109. Although section 2(a)(1) of the Securities Act lists "note" among the definition of "security," 15 U.S.C. § 77b(a)(1) (2006), section 3(a)(3) exempts short-term instruments, including "[a]ny note, draft, bill of exchange, or banker's acceptance," with a maturity of nine months or less from this definition. § 77c(a)(3).

110. *See* Reves v. Ernst & Young, 494 U.S. 56, 65 (1990) (citing Exch. Nat'l Bank of Chi. v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

111. *See id.* at 66–67 (adopting a four-part "family resemblance" test to determine the nature of specific instruments for purposes of applying the securities laws).

sider trading laws), even though the two areas are closely related from a business standpoint.[112]

H. *Insider Trading in the Commodity Futures and Derivatives Markets*

In contrast to the broad prohibition against insider trading found in the securities laws, insider trading is considered an accepted and integral practice in the commodity futures and derivatives markets. Not only does the Commodity Exchange Act (the "CEA") lack a prohibition against insider trading in commodities (except with respect to certain individuals connected with the regulation, self-regulation, or exchange governance of those markets),[113] the CEA actually accepts insider trading as a means to facilitate efficient pricing of commodities.[114]

This divergence in regulatory treatment towards insider trading in the two markets is due to fundamental differences between the equities and commodity futures markets. The purpose of the securities markets centers on capital formation, which in turn gives rise to a number of obligations, including

---

112. Some firms conduct bank debt trading, but do not access the inside information to which they may be entitled as a holder of the debt. This allows them to continue to trade on the public side, subject to their being able to demonstrate that they did not access the inside information. Other firms are careful to ensure that any nonpublic information they obtain on the private side is *not* material to any public securities they purchase.

113. *See* Commodity Exchange Act §9(d), (e), 7 U.S.C. §13(d), (e) (2006) (prohibiting Commissioners and Commission employees and members or employees of any governing board of trade, registered entity, or registered futures association to trade on the basis of material nonpublic information obtained through special access related to the performance of their duties); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1737–1739 (2010) (codified as amended at 7 U.S.C. § 6(c)) (prohibiting the use of nonpublic information by "any employee or agent of any department or agency of the Federal government" for personal gain by entering into or offering to enter into a futures contract, option on futures contract, or swap, or assisting another person to do the same).

114. *See* Sharon Brown-Hruska & Robert S. Zwirb, *Legal Clarity and Regulatory Discretion — Exploring the Law and Economics of Insider Trading in Derivatives Markets*, 2 Cap. Mkts. L.J. 245, 254 (2007) (observing that commodities markets, and related futures markets, "*rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

those of a fiduciary nature. In contrast, the purpose of the commodity futures and derivatives markets is to provide a forum for price discovery and risk management. These latter markets, as a joint report by the SEC and Commodity Futures Trading Commission ("CFTC") acknowledged, "permit hedgers to use their nonpublic material information to protect themselves against risks to their commodity positions."[115] In other words, commodity futures and derivatives markets exist to facilitate trading based on information generated by participants' inside knowledge.[116]

As the CFTC has recognized, "it would defeat the market's basic economic function—the hedging of risk—to question whether trading on knowledge of one's own position were permissible."[117] In contrast to the often implied premise within securities law that investors should have equal access to material market information and that insiders owe a fiduciary duty, there is no similar expectation in the commodity futures and derivatives markets that market participants have, or even should have, equal access to nonpublic information, or that corporate officials and personnel have a similar fiduciary duty with respect to their counterparties.[118]

II.
Insider Trading in Digital Asset Markets

With the precipitous rise of digital assets, including cryptocurrencies, coins, fungible and non-fungible tokens ("NFTs"), and the exchanges on which such assets change hands, the DOJ and SEC actively have sought ways to curtail what they view as illicit trading on the basis of material nonpublic information. Despite the SEC's assertions to the con-

---

115. U.S. Commodity Futures Trading Comm'n & U.S. Sec. & Exch. Comm'n, A Joint Report of the SEC and the CFTC on Harmonization of Regulation 7, (2009), http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf.

116. Brown-Hruska & Zwirb, *supra* note 114, at 254 (observing that such markets "*rely upon* individuals and entities that have privileged information . . . to trade on their information in the commodities markets, whether on behalf of themselves or their firm").

117. U.S. Commodity Futures Trading Comm'n, A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material, Nonpublic Information 8 (1984).

118. *Id.* at 53–54.

trary, significant questions remain regarding whether such crypto assets are securities pursuant to the Supreme Court's *Howey* test.[119] While those securities-related questions await resolution, the DOJ, which, as discussed above, can bring wire fraud charges, has more flexibility to bring cases related to crypto assets. A pair of cases illustrates the point.

In *United States v. Chastain*, the DOJ brought criminal charges against a former product manager at an online crypto marketplace. According to the indictment, the marketplace's website often highlighted certain NFTs.[120] Being featured on the website typically resulted in the NFT increasing in value, and information about which NFTs were scheduled to be featured on the website was considered confidential business information. The indictment alleged that the defendant learned which NFTs would be featured on the marketplace's website and then used that information to secretly purchase the NFTs—or NFTs by the same creator—before they were featured. According to the indictment, after the NFTs were featured on the website, the defendant sold them for a profit. The indictment further alleged that the defendant had signed a confidentiality agreement with his employer in which he acknowledged that he had an obligation to maintain the confidentiality of certain business information that he received in connection with his work.

The DOJ charged the defendant with violating wire fraud[121] and anti-money laundering[122] laws. Despite announcing that the case was the first ever prosecution of a "digital asset *insider trading* scheme,"[123] the DOJ did not allege that the defendant committed criminal securities fraud in violation of Section 10(b) of the Exchange Act. In other words, the DOJ

---

119. *See, e.g.*, William Hinman, Director, Sec. & Exch. Comm'n Division of Corporation Finance, Digital Asset Transactions: When Howey Met Gary (Plastic), Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), https://www.sec.gov/news/speech/speech-hinman-061418.

120. Indictment ¶ 7, United States v. Chastain, No. 22-CR-305 (S.D.N.Y. May 31, 2022), https://www.justice.gov/usao-sdny/press-release/file/1509701/download.

121. 18 U.S.C. § 1343.

122. 18 U.S.C. § 1956(a)(1)(B)(i).

123. U.S. Dep't of Justice, *Former Employee Of NFT Marketplace Charged In First Ever Digital Asset Insider Trading Scheme* (June 1, 2022), https://www.justice.gov/usao-sdny/pr/former-employee-nft-marketplace-charged-first-ever-digital-asset-insider-trading-scheme (emphasis added).

alleged that the defendant traded on the basis of material nonpublic information in violation of a duty, but it did not allege that the trading involved a *security*, which is an essential allegation to bring a case pursuant to SOX 807 or Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Shortly after the DOJ announced the Chastain indictment, the SEC announced that it had filed a securities fraud complaint involving analogous facts. In SEC v. Wahi, the SEC alleged that a former product manager at one of the largest crypto asset trading platforms provided material nonpublic information to his brother and his friend who then traded on it.[124] According to the SEC, the trading platform had a practice of announcing to the public via social media when a new digital asset would be listed on the platform. The prices of the digital assets typically increased after these announcements. The SEC's complaint alleged that the defendant was responsible for supporting and coordinating the platform's listing announcements and therefore had confidential information about upcoming listings. The complaint further alleged that the product manager violated a duty by breaching his agreement not to disclose confidential information—such as listing information—to family or friends. The SEC alleged that the defendant's friend and brother knew, or should have known, that the defendant was providing them with confidential information in violation of his duty to his employer. Unlike in *Chastain*, the SEC had to allege that the trading involved a security. To satisfy this element, the SEC alleged that at least nine of the crypto assets in which the brother and friend traded met the definition of a security. The SEC's complaint contains detailed allegations regarding how those assets satisfy the elements of the Supreme Court's *Howey* test.

The law in this area is far from settled. Securities law, commodities law, and criminal law will continue to evolve with the rise of decentralized finance ("DeFi") and the use of smart contracts on blockchains. Legal issues relating to the definition of a security, materiality, personal benefit, the scope of the wire fraud and money-laundering statutes, and the limita-

124. *See* Complaint ¶ 1, Sec. & Exch. Comm'n v. Wahi, No. 2:22-CV-1009 (W.D. Wa. July 21, 2022).

tions of criminal and civil venue are anticipated to flood the courts in the coming months and years.[125]

III.
LEGAL AND FACTUAL DEFENSES

Because insider trading law has developed in the courts, it is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of liability. Inevitably, new legal and factual defenses accompany those new and expansive prosecutorial theories.[126]

The DOJ and SEC bear the burden of proving that an insider possessed material nonpublic information on which the insider traded. Even as the law evolves, facts play a critical role in any insider trading case. The presence or absence of certain facts can make a tremendous difference in the outcome of a case.

In *SEC v. Zachariah*, the SEC lost its case against the defendant, a corporate board member, because the SEC could not prove that the CEO actually relayed certain information to the defendant before the defendant executed the trades in ques-

125. *See, e.g.*, Indictment at 1–6, 8, United States v. Bankman-Fried, No. 22-CR-673 (S.D.N.Y. filed Dec. 13, 2022) (alleging in indictment that the founder of the FTX cryptocurrency exchange committed wire fraud, commodities fraud, securities fraud, and money laundering violations); SEC v. LBRY, Inc., No. 21-CV-260-PB, 2022 WL 16744741, at *8 (D.N.H. Nov. 7, 2022) (granting the SEC's motion for summary judgment for allegedly conducting an unregistered securities offering and holding that LBRY's LBC tokens were securities under the *Howey* test); Complaint, SEC v. Ripple Labs, Inc., No. 20-10832 (S.D.N.Y. Dec. 22, 2020); SEC v. Telegram Grp. Inc., 448 F. Supp. 3d 352 (S.D.N.Y. 2020); SEC v. Kik Interactive Inc., 492 F. Supp. 3d 169 (S.D.N.Y. 2020).

126. The SEC often moves quickly to file cases and freeze assets, even before details regarding the exchange of inside information is known. *See, e.g.*, Complaint ¶¶ 1–2, SEC v. One or More Unknown Purchasers of Martek Biosciences Corp., No. 10-Civ-9527, 2010 WL 5523571, at *1 (S.D.N.Y. Dec. 22, 2010) (charging unidentified persons with insider trading violations based on purchases of a large volume of Martek call options days before a takeover announcement, resulting in unrealized profits of $1.2 million); Complaint ¶ 1, SEC v. One or More Unknown Purchasers of Options of InterMune, Inc., No. 10-Civ-9560, 2010 WL 5523583, at *1 (S.D.N.Y Dec. 23, 2010) (filing insider trading charges against unknown individuals who purchased call options days before a positive news release regarding one of InterMune's drugs, resulting in unrealized profits of over $900,000).

tion.[127] The defendant had a pattern of trading the company's stock before joining its board and actually placed trades during a specified "black-out" period.[128] The SEC, however, introduced no direct or circumstantial evidence that the defendant and the CEO spoke prior to the trades.[129] Further, the SEC could not show that the defendant received inside information from any other source.[130]

In another high-profile case, the SEC lost a long battle against Heartland Advisors when the district court granted summary judgment for the defendants because the court found that the timing and amount of the trades alone were insufficient, without more, to prove insider trading.[131]

Although highly dependent on the facts and circumstances of the particular case, legal and factual defenses generally turn on the *prima facie* elements of a cause of action for insider trading—that is, trading a security while in possession of material nonpublic information that was conveyed or obtained in breach of a duty. Therefore, it is instructive to evaluate possible defenses in the context of the elements of a cause of action.

A. *Public versus Nonpublic Information*

Under each theory of insider trading, the government must establish that the person traded with the requisite scienter while in possession of "nonpublic" information. Although the concept might seem simplistic on its face, the dividing line between public and nonpublic information is porous. Due to the prevalence of online message boards, social networking, and blogs, information and rumors about companies can spread quickly to millions of interconnected investors. In some cases, those rumors are leaked by company insiders. So-called

---

127. *See* SEC v. Zachariah, No. 08-60698, 2010 WL 11505090, at *27 (S.D. Fla. Dec. 20, 2010).

128. *Id.* at *2, *5.

129. *Id.* at *27–28.

130. *Id.*

131. *See* SEC v. Heartland Advisors, Inc., No. 03-C-1427, 2006 WL 2547090, at *3-4 (E.D. Wis. Aug. 31, 2006); *see also* Memorandum Opinion and Order, SEC v. Garcia, No. 10 CV 5268 (N.D. Ill. Dec. 28, 2011) (granting summary judgment to Defendant Sanchez, explaining that the SEC could not rely on speculation without identifying the information Sanchez received and the source of that information).

watchdog groups, such as WikiLeaks or other whistleblowers, have generated a new level of uncertainty as to what information is considered "nonpublic."

The distinction between public and nonpublic information generally depends on both how the information is disseminated and the source of the information. At one end of the spectrum is the classic case of information disclosed by a company through official channels of communications, such as the filing of a Form 8-K, subsequent dissemination of a press release, or disclosure in a quarterly or annual filing.[132] At the other end of the spectrum are cases involving leaks to the media, anonymous postings on message boards, or rumors circulating in online chat rooms—each of which raises a question of whether the information, which may have been closely guarded by the company, is now public.

1. *The Test of Whether Information Is Public.*

As an initial matter, determining the point *when* information is considered to be in the public realm is critical for understanding *whether* the information is public. Courts have established two tests for determining when information is considered public. Under the first test, information has reached the public realm when it has been disclosed "in a manner sufficient to insure its availability to the investing public."[133] For example, courts routinely find that information contained in reports filed with the SEC is public information.[134]

Under the second test, information is public when trading has caused the "information to be fully impounded into the price of the particular stock."[135] In *United States v. Rajaratnam*, the United States District Court for the Southern District of New York explained this second test:

132. For this reason, company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

133. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968) (en banc).

134. *See* Emerson v. Mut. Fund Series Tr., 393 F. Supp. 3d 220, 247-48 (E.D.N.Y. 2019); *see also In re* Keyspan Corp. Sec. Litig., 383 F. Supp. 2d 358, 378 (E.D.N.Y. 2003) (dismissing allegations premised on the nondisclosure of information that was actually disclosed in Forms 8-K, 10-K, and 10-Q).

135. United States v. Rajaratnam, 802 F.Supp.2d 491, 498 (S.D.N.Y. 2011) (citing United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993)).

> "[I]nformation may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people know of it. That is because once the information is fully impounded into the price, such information can no longer be misused by trading because no further profit can be made."[136]

Although this second approach, inspired by the efficient market theory, seems more sophisticated in taking account of new forms of online media and communications, the SEC has clung to the first test, arguing that information becomes public only by a "public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group."[137]

Courts have provided little guidance to explain when information is "available to the investing public," what constitutes "appropriate" media, or when information is "fully impounded into the price" of the stock. Further, the opinions construing those concepts may be outdated when applied to new media and technology. For example, in *SEC v. Texas Gulf Sulfur*, a case decided in 1968, the Second Circuit held that information contained in a press release was not public shortly after the press release was made. Instead, the court stated that insiders "should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape."[138] Courts have found differing periods of time sufficient for information to become public, ranging from fifteen minutes to a day, or even several days after the information has been released.[139]

---

136. *Id.*

137. *In re* Certain Trad. in the Common Stock of Faberge, Inc., 45 S.E.C. 249, 256 (May 25, 1973); *see also* SEC v. Davis, Litig. Release No. 18322 (Sept. 4, 2003) (charging consultant with insider trading for tipping clients of embargoed information relating to the Treasury's halt of long bond sales); *see also* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) ("Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.").

138. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968)

139. *See* Billard v. Rockwell Int'l Corp., 526 F. Supp. 218, 220 (S.D.N.Y. 1981) (stating that Rockwell would have fulfilled its disclosure duty by waiting fifteen minutes between announcing the favorable information and ac-

In 2000, the SEC provided some limited guidance through Regulation FD (Fair Disclosure) by allowing companies to utilize their websites to distribute information to the public. Regulation FD states that information on a company's website will be considered public information where such a disclosure is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[140] In other words, posting information on a website that requires a subscription or membership does not constitute the public realm for purposes of Regulation FD. Now, in the age of powerful internet search engines, information posted on a corporation's website or disseminated through electronic press releases might be seen near-instantly by thousands of potential investors and hundreds of news organizations, who may be monitoring the company's website using electronic means. Additionally, information disseminated through social media, such as Twitter, can be "pushed" to the public, meaning that social media followers will receive news and other alerts on their mobile devices with the latest information rather than having to seek it out manually using a search engine.

In 2008, citing the rapid "development and proliferation of company websites since 2000" and the expectation of "continued technological advances," the SEC published updated guidance regarding the distribution of information on company websites. The guidance states that whether information distributed through a company website has become public depends on the steps that the company has taken to make investors, the market, and the media aware of the channels of distribution it expects to use.[141] Thus, a company that issues a Form 8-K to inform the public that it intends to distribute company information via social media likely has satisfied its obligations

---

cepting tendered shares); *cf.* SEC v. Ingoldsby, No. 88-1001-MA, 1990 U.S. Dist. LEXIS 11383, at *5 (D. Mass. May 15, 1990) (holding that the investing public had fully digested the importance of the announcement at issue nine days after its release).

140. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) (adopting, among other rules, Regulation FD and Exchange Act Rule 10b5-2), http://www.sec.gov/rules/final/33-7881.htm.

141. *See* Commission Guidance on the Use of Company Web Sites, Release No. 34-58288 (Aug. 7, 2008).

under Regulation FD and the information distributed via social media can be considered public.

The prolific rise of social media to disclose corporate information tested the boundaries of the SEC's 2008 guidance. In 2013, the SEC issued a rare Section 21(a) report of investigation after it investigated Netflix, Inc.'s practice of disclosing company information via social media.[142] The SEC's investigation focused on a post on the Netflix CEO's personal Facebook page announcing that Netflix had streamed 1 billion hours of content in June 2013. Because Netflix had not previously announced this information, the SEC investigated whether the CEO's statement constituted a selective, nonpublic disclosure in violation of Regulation FD. Ultimately, the SEC did not bring an enforcement action against Netflix. Instead, the SEC emphasized that Regulation FD applies with equal force to disclosures made through social media and that issuers must take steps to alert investors and the markets of the "channels it will use for the dissemination of material, nonpublic information," such as issuing a Form 8-K indicating that investors should look to the company's social media sites for disclosure of such information.

Since the Netflix investigation, the SEC has not brought any other enforcement actions alleging that a company disclosure via social media constituted a selective disclosure in violation of Regulation FD. Indeed, a 2022 case suggests that the SEC has returned its Regulation FD focus to disclosures by company insiders to select industry participants through more intimate interactions, such as one-on-one phone calls.[143] The lack of cases concerning social media announcements is perhaps due to the continued increase in popularity and acceptance of social media as a means of effectively disseminating information to the public. For example, some public company CEOs have tens of millions of social media followers, many of whom are members of mainstream media organizations capable of re-broadcasting a single CEO social media post with a simple thumb tap on a mobile device. This method of distrib-

142. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc. and Reed Hastings, Exchange Act Release No. 69279 (Apr. 2, 2013).

143. *See* Press Release, U.S. Sec. & Exch. Comm'n, AT&T Settles SEC Charge of Selectively Disclosing Material Information to Wall St. Analysts (Dec. 5, 2022), https://www.sec.gov/news/press-release/2022-215.

uting information arguably is much more effective at reaching the investing public than a Form 8-K filed with the SEC and a corresponding press release issued through traditional media organizations. For this reason, cataloguing how broadly information is disseminated and how quickly information is spread and repeated by various social media followers or news outlets can be a useful tool for determining the point at which information has become "public." Counsel seeking to demonstrate that information is public should examine social media websites for posts containing the information and should take special note of the number and type of individuals and entities that "follow" the individual or entity that posted the information. Counsel also should examine the secondary and tertiary dissemination of the information through "likes," "retweets," "reposts," and "replies," for example.

2. *The Means by Which Information Becomes Public.*

Another aspect of nonpublic information is whether the information made its way into the public realm through means other than a corporate disclosure. In other words, can the spreading by rumors, postings on message boards, or leaks from insiders, convert otherwise nonpublic information into public information, even if the company guarded against the release of that information? Some courts have been reluctant to deem the circulation of rumors or "talk to the street," as constituting public disclosure, even if the rumors or talks are accurate, widespread, and reported in the media.[144]

In defending against an insider trading allegation, it is important to determine whether the alleged "inside information" made its way into the public domain prior to alleged insider trading. Information can reach the public domain through a variety of traditional means, including corporate disclosures,

144. *See, e.g.*, SEC v. Mayhew, 121 F.3d 44, 51 (2d Cir. 1997) (determining that the "nonpublic" element of an insider trading charge was satisfied because material nonpublic information was conveyed by a corporate insider, which was more reliable and specific than rumors in the press about a probable merger, despite the existence of such rumors). *But see* SEC v. Rorech, 720 F. Supp. 2d 367, 411 (S.D.N.Y. 2010) (refusing to find liability for illegal tipping and trading when a bond trader shared information about possible advice that his investment banking firm might make regarding a bond offering restructuring, which the court noted was widely discussed in the marketplace).

press releases, media interviews, analyst and investor conference calls, analyst reports, and television programs. In addition, new forms of electronic communication, such as online message boards, blogs, chatrooms, social media (e.g., Twitter, Facebook, and Reddit), professional networking websites (e.g., LinkedIn, Plaxo, and Chamber), and specialized websites focused on leaked information (e.g., WikiLeaks[145]) can place information in the public domain. If "trading has caused the information to be fully impounded into the price of the particular stock,"[146] the information arguably is no longer "nonpublic" from an economic perspective, regardless of how many people actually saw the information.[147]

3. *Fully Public vs. Partially Public.*

Difficult conceptual questions arise when additional pieces of the information remain nonpublic or when an insider provides certainty to a public rumor in a nonpublic manner. Courts have held that disclosure of partial information does not constitute public dissemination for the remaining nonpublic portion of the information.[148]

In some instances, a person may be held liable for insider trading after obtaining nonpublic information that is more specific than a general rumor already widely circulating within the public domain. For example, in *United States v. Mylett*, the Second Circuit, in a divided opinion, determined that the defendant traded on the basis of material nonpublic information after a corporate insider privately confirmed the reported rumor of an upcoming transaction and then identified the company that would be acquired.[149] In upholding the defendant's criminal conviction, the court acknowledged the existence of public rumors about the possible acquisition but explained that the information conveyed by the insider was "substantially

145. WikiLeaks describes itself as an "uncensorable system for untraceable mass document leaking." Stephen Moss, *Julian Assange: The Whistleblower*, GUARDIAN (London), July 13, 2010, § G2, at 6.

146. United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).

147. *See id.* ("The issue is not the number of people who possess [the information] but whether their trading has caused the information to be fully impounded into the price of the particular stock.").

148. *See, e.g.*, United States v. Royer, 549 F.3d 886, 891, 898–99 (2d Cir. 2008).

149. United States v. Mylett, 97 F.3d 663, 665–66 (2d Cir. 1996).

more specific than that in the newspaper."[150] Distinguishing from mere predictions by an insider that subsequently come true, the court explained that the information conveyed by the insider was "qualified, supported, and credible" and would have had "great value to a would-be trader."[151]

In *United States v. Royer*, a criminal insider trading case, the Second Circuit further examined whether information is nonpublic when elements of that information are available in the public domain.[152] In *Royer*, a former FBI agent used confidential, nonpublic information pertaining to certain companies and executives under investigation to short the stock of those companies.[153] The defendants argued that "much of the information" was public.[154] In upholding the convictions, the Second Circuit explained that the district court correctly stated the law when it instructed the jury that "the fact that information may be found publicly if one knows where to look does not make the information 'public' for securities trading purposes unless it is readily available, broadly disseminated, or the like," although the Second Circuit observed that the instruction "might not be universally appropriate."[155] Indeed, this instruction seems outdated because an internet search engine arguably can make even a single post of information on an obscure website "readily available."

4. *Information that Was Never Nonpublic.*

On other occasions, information may not be broadly disseminated, but nevertheless can be considered public. For instance, observing a CEO walking into the official building of a rival company should not constitute nonpublic information, even though an investor may ascertain correctly that merger talks are progressing, especially where one of the companies is rumored to be for sale.[156] Similarly, for example, a company

150. *Id.* at 666.

151. *Id.* at 667; *see also* SEC v. Mayhew, 121 F.3d 44, 50–51 (2d Cir. 1997).

152. *See Royer*, 549 F.3d at 897–98.

153. *Id.* at 896–97.

154. *Id.* at 897.

155. *Id.* at 897–98.

156. The SEC, however, has taken an aggressive view of the concept of nonpublic information. *See, e.g.*, Complaint at ¶¶ 34-38, SEC v. Steffes, 805 F. Supp. 2d 601 (N.D. Ill. 2011), 2010 WL 4018839 (alleging that freight rail yard employees and four family members violated insider trading laws when

might closely guard the nonpublic sales projections of its key product, but the number of trucks leaving the key factory and entering onto a public highway is not "nonpublic."[157] Institutional investors may rely on information available to the public eye, even if that information is not yet reflected in the price of the stock.[158]

In the context of understanding whether information is nonpublic, it is important to recognize that the "information" upon which an insider trading case is based need not originate from the company that is the subject of the trading itself. Using the misappropriation theory, courts have expanded the scope of insider trading to cover material nonpublic information about a security. In the landmark case *United States v. Winans*, columnist R. Foster Winans was charged with a scheme to trade securities based on information misappropriated from his employer, The Wall Street Journal.[159] Winans authored the famous "Heard on the Street" column and relayed confidential information about the timing and content of upcoming articles to his conspirators, who traded on the information prior to the news hitting the press.[160] Winans also placed trades in his own account based on his inside knowledge.[161] The court held that Winans's actions constituted a fraud against his employer in breach of a fiduciary duty, which duty did not need to be explicit under any federal or state law, but was inherent in the employer-employee relationship.[162]

Short sellers may be vulnerable to insider trading enforcement actions based on their interactions with journalists and with the SEC. If a short seller provides negative information about public companies to media outlets and receives insight

---

the employees observed unusual daytime tours by people in business attire, surmised that the company was being acquired, and informed family members, all of whom traded on the information).

157. It is difficult to identify cases describing situations where a person traded on entirely "public" information because those situations usually do not result in the SEC instituting an enforcement action.

158. In defending an insider trading case based on information asserted by prosecutors to be nonpublic, counsel should consider the extent to which information could be gathered by any member of the public or seen with the naked eye.

159. United States v. Winans, 612 F. Supp. 827, 829 (S.D.N.Y. 1985).

160. *Id.* at 829, 833–34.

161. *Id.* at 831–32.

162. *Id.* at 843–44.

into the timing and nature of ensuing news articles, that short seller may have received material nonpublic information for purposes of insider trading—i.e., the fact of an upcoming negative news story on the company may be both material to the company's stock and nonpublic and the reporter's disclosure of the fact of the upcoming publications and/or timing may be a breach of a duty to the publisher.[163] Similarly, if a short seller receives and trades on the basis of information from the staff of the SEC's Division of Enforcement about the initiation of an investigation based on information supplied by the short seller to the SEC, the short seller may have committed insider trading—i.e., the fact of a non-public SEC investigation of a company may be material, and an SEC lawyer's disclosure regarding an investigation of the company (inadvertent or intentional) may be a breach of the lawyer's duty to the SEC or a breach of the short seller's agreement with the SEC to keep information about the investigation confidential.

Counsel should be familiar with the evolving case law defining "nonpublic" information and be well versed in the various forms of electronic media. An exhaustive search of all forms of media should be conducted to determine whether the alleged nonpublic information already has reached the public realm. Economic analysis may be useful evidence to show that the public aspects of the information (whether it be anonymous reports, rumors, or leaked information) were fully absorbed into the price of the stock and that any remaining nonpublic aspects had little to no effect on the stock price (and thus, may not be material, as discussed below).

5. *Information Relayed through Expert Networks.*

Expert networks create a particular concern with regards to the conveyance of nonpublic information. The term "expert network" refers to firms that are in the business of connecting clients, principally institutional investors, with persons who may be experts in a client's area of interest. Experts can include academics, scientists, engineers, doctors, lawyers, suppliers, and even former employees of the company of interest. Networks are used to save investors the time, cost, and uncertainty associated with obtaining specialized knowledge on their own. Expert networks can be a valuable and legitimate re-

---

163. *See id.* at 814, 840 n.7.

search tool that facilitates efficient access by clients to persons with relevant expertise.

There is nothing inherently improper about expert networks or obtaining advice from experts through such networks.[164] But as is true in other investing contexts, a legitimate source of information can be misused. The principal concern with expert networks is that they could convey nonpublic information. Indeed, their raison d'être is to convey information that is not readily available to the public. When such nonpublic information is also material and obtained through a breach of a duty to the source, the information could trigger a violation of insider trading law.

As mentioned at the beginning of this Article, the federal government has investigated the use of expert networks by hedge funds and other institutional investors to determine whether some networks are being used as a conduit for the conveyance of material nonpublic information to investors.[165] The conduct of investors who use these networks, however legitimate, could draw the attention of government enforcement officials which attention, in turn, can have negative consequences for firms, including the possibility of putting them out of business. Responding to a government investigation can be costly and time-consuming, and if the investigation becomes public, the firm could suffer significant reputational damage, and again be put out of business regardless of whether the firm is ultimately charged with, or found guilty of, any wrongdoing.

In light of these developments, robust and comprehensive compliance programs are essential as a first line of defense against government scrutiny. If properly executed, compliance programs can demonstrate to authorities that a firm has taken

---

164. *See* Azam Ahmed & Peter Lattman, *Insider Inquiry Steps Up Its Focus on Hedge Funds*, N.Y. TIMES, Feb. 8, 2011, at A1 (quoting Preet Bharara, U.S. Attorney for the Southern District of New York, as confirming at a Feb. 8, 2011 press conference that there is nothing inherently wrong with hedge funds or expert networking firms, while committing to prosecute those who have "galloped over the line" to engage in illegal insider trading).

165. *See* SEC v. Mark Anthony Longoria, SEC Litig. Release No. 21836, 2011 WL 334798 (S.D.N.Y. Feb. 3, 2011) (charging two expert network employees and four consultants with insider trading for illegally tipping hedge funds and other investors who gained nearly $6 million in trading profits and losses avoided).

appropriate steps to guard against potential wrongdoing, such as the potential receipt of material nonpublic information from an expert network, thereby showing that further investigation is unlikely to reveal violations. Strong compliance programs can reduce the likelihood of employees engaging in wrongdoing and ensure that if an investigation nonetheless results, relevant information is organized in a way that allows a firm to respond quickly. Finally, the presence of a strong and effective compliance program can dissuade the DOJ and the SEC from charging the firm itself, even if particular employees have violated the law.[166] Guidelines for developing compliance policies and procedures to ensure appropriate interaction with experts and expert networks, and to address insider trading generally, are discussed in Part IV, below.

B. *Materiality*

In addition to proving that the information was nonpublic, the government must prove that the information on which an individual traded was "material." The Supreme Court has set forth two definitions for materiality in the context of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.[167]

166. *See, e.g.*, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934, Exchange Act Release No. 44,969, 76 SEC Docket 220 (Oct. 23, 2001), http://www.sec.gov/litigation/investreport/34-44969.htm#P54_10935 (declining to press charges against a company because of its internal efforts to uncover and put a halt to internal wrongdoing).

167. Importantly, the materiality standard applicable to Section 807 is likely lower than the standard for materiality under Section 10(b). In *Neder v. United States*, 527 U.S. 1, 22 (1999), the Supreme Court interpreted the materiality standard relevant to the federal mail fraud, wire fraud, and bank fraud statutes. The Court cited with approval the Restatement (Second) of Torts § 538 (1977), which states that a matter is material if: (a) a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question; or (b) the maker of the representation knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action, although a reasonable man would not so regard it. The language of SOX 807 mirrors the bank fraud statute, suggesting that SOX 807 includes the same materiality element as the bank fraud statute. Compared with the objective "reasonable investor" standard applicable to Section 10(b) materiality, the standard of materiality applied to SOX 807 cases arguably is lower and subjective. *See* Wendy Gerwick Couture, *Criminal Securities Fraud and the Lower Materiality Standard*, SEC. REG. L.J. 77, 79–81 (2013).

In the context of an undisclosed fact, the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* held that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[168] The Court explained that, to fulfill the materiality requirement, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[169] The Court acknowledged that certain information concerning corporate developments could well be of "dubious significance,"[170] so the Court was careful not to set a standard of materiality so low that it would lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making."[171]

The test is not whether a fact might have some hypothetical significance. Instead, the materiality standard requires a showing that there is a substantial likelihood that, under all the circumstances, a fact "would have assumed actual significance in the deliberations of a reasonable investor."[172] Some courts have looked to the market price as a determinant of materiality, explaining that the standard set forth in *TSC Industries* requires the information to be "reasonably certain to have a substantial effect on the market price of the security."[173]

In the context of contingent or speculative events such as mergers, acquisitions, and bankruptcies, the Supreme Court set forth an additional test for materiality. In *Basic v. Levinson*, the Court held that materiality depends upon "balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[174] Following *Basic*, an event with a rela-

168. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988).

169. *TSC Indus.*, 426 U.S. at 449.

170. *Id.* at 448.

171. *Id.* at 448–49.

172. SEC v. Hoover, 903 F. Supp. 1135, 1140 (S.D. Tex. 1995) (emphasis added) (citing Justin Indus. v. Choctaw Sec., L.P., 920 F.2d 262, 267 (5th Cir. 1990)).

173. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980) (citing SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977)).

174. Basic, Inc. v. Levinson, 485 U.S. 224, 238–39 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968)).

tively low probability, such as an upcoming merger, could have a significant impact on a small company and thus be deemed material.[175] Conversely, information regarding a similar type of event could be ruled immaterial in the context of a major, diversified company.[176]

In 1999, the staff of the SEC issued Staff Accounting Bulletin No. 99 ("SAB 99") to provide guidance on the materiality of financial misstatements.[177] SAB 99 rejected the prevailing view at the time that, to be material, the financial misstatement had to exceed five percent of the company's net income.[178] In its place, the SEC's staff interjected the more ambiguous con-

175. SEC v. Geon Indus., Inc., 531 F.2d 39, 47–48 (2d Cir. 1976) ("Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high."), *cited with approval* in *Basic*, 485 U.S. at 238–39; *see also* United States v. Cusimano, 123 F.3d 83 (2d Cir. 1997); *infra* note 185 and accompanying text. Indeed, a large portion of the SEC's insider trading cases concern information "tipped" or misappropriated surrounding an upcoming merger. *See infra* note 181 and accompanying text.

176. *See Hoover*, 903 F. Supp. at 1148 (concluding that the low magnitude of a revised year-end earnings estimate rendered the information immaterial as a matter of law); *see also Elkind*, 635 F.2d at 166 (finding that general information about slowing sales that was commonly known among analysts, coupled with a general comment that preliminary earnings would be released in a week, did not constitute material information). The SEC's Division of Enforcement tends to take a broad view of materiality. *See, e.g.*, SEC v. General Electric Co., Litig. Release No. 21166, 96 SEC Docket 1700 (Aug. 4, 2009) (SEC contending that General Electric overstated income because certain accounting policies it used did not comply with GAAP); In the Matter of Citigroup Inc., Respondent, Exchange Act Release No. 57970, 93 SEC Docket 1323 (June 16, 2008) (SEC contending that Citigroup materially misstated its financial results as a result of improper accounting methods used for certain bond swaps and other transactions).

177. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45150 (Aug. 12, 1999).

178. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MKTS. REGULATION 128 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf ("For many years, the rule of thumb was that, in determining the scope of an audit, a potential error exceeding five percent of annual pre-tax income would be considered material. In evaluating a misstatement, an error that exceeded ten percent of pre-tax income was considered material, while the materiality of an error between five percent and ten percent of pre-tax income was assessed, based on various qualitative factors.").

cept of "qualitative materiality." According to SAB 99's qualitative test, a misstatement below the five percent quantitative threshold can be material under certain circumstances, such as when it leads to financial results that meet earnings targets or criteria for awarding management bonuses, concerns a significant segment of the company's business, affects compliance with regulations, affects the company's compliance with loan covenants, or conceals an unlawful transaction.[179] Although the SEC often cites SAB 99 in its pleadings, the bulletin is not the adopted view of the SEC (i.e., the Commission has not voted on it). It is merely an official interpretation of the staff and, therefore, should not be given undue authoritative weight.

Aside from SAB 99, the SEC generally views information about major corporate events as being material.[180] In 2000, the SEC, through rulemaking in Regulation FD, set out several types of information that should be "reviewed carefully to determine whether they are material," including: "(1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or loss of a contract); (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities—e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships."[181] Despite this guidance, a materiality determination should not be made by relying solely on this list without consideration of special

179. SEC Staff Accounting Bulletin No. 99, *supra* note 180.

180. *See* Securities and Exchange Commission, *Form 8-K*, available at https://www.sec.gov/about/forms/form8-k.pdf (last visited Mar. 1, 2023).

181. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000)

circumstances.[182] Determining materiality must be done on a case by case basis.[183]

Materiality is judged from the objective standpoint of a "reasonable investor," and courts often refer to the reasonable investors as the "average investor."[184] Still, the SEC often argues that specific investor behavior is indicative of materiality, and some courts have agreed.

For example, the court in *SEC v. Thrasher* determined that the tippee's investment behavior and his payment to the tipper for the information constituted adequate circumstantial evidence that the information was material.[185] Nevertheless, when defending against an insider trading case, attention should be focused on the objective standard of materiality, not the subjective and potentially erroneous view of the person trading on the information. Indeed, if materiality hinged on the subjective view of the defendant, the element of materiality arguably would be eliminated, as a person trading following the receipt of information could be deemed to view that information as significant, even if, in fact, the information was neither objectively material nor relevant to the investor's decision.

Although information need not be certain to be material, information is not deemed material if it is highly speculative

---

182. *See* SEC v. Cuban, 620 F.3d 551, 554–55, 558 (5th Cir. 2010) (vacating the district court's dismissal of the suit and remanding for determination of whether trading on material nonpublic information obtained under a confidentiality agreement established liability in the context of a fiduciary relationship).

183. *See, e.g.*, Basic, Inc. v. Levinson, 485 U.S. 224, 238–40 (1988) (endorsing a fact-specific approach to determining the materiality of information regarding merger discussions); United States v. Smith, 155 F.3d 1051, 1066 (9th Cir. 1998) (stating that determining materiality requires a "nuanced, case-by-case approach").

184. *See, e.g.*, DeMaria v. Andersen, 318 F.3d 170, 181 (2d Cir. 2003) ("[W]e conclude that the erroneous information would not have misled the *average investor* in light of the accurate information contained in the prospectus. . . . A *reasonable investor* would have either noticed the discrepancy and relied upon the detailed financial data included later in the EDGAR Prospectus or believed that ILife's publishing revenue was less than it actually was.") (emphasis added); Acito v. IMCERA Grp., Inc., 47 F.3d 47, 52 (2d Cir. 1995) (reciting the "total mix" standard for materiality and concluding that certain reports "were not material to the average investor.").

185. SEC v. Thrasher, 152 F. Supp. 2d 291, 301 (S.D.N.Y. 2001).

and unreliable.[186] As the Second Circuit wrote in *SEC v. Monarch Fund*, "[c]ertainly the ability of a court to find a violation of the securities laws diminishes in proportion to the extent that the disclosed information is so general that the recipient thereof is still 'undertaking a substantial economic risk that his tempting target will prove to be a white elephant.'"[187] For this reason, the court in *SEC v. Rorech* deemed that discussions between a high-yield bond salesperson and a hedge fund portfolio manager regarding plans to modify a particular bond offering were immaterial because the information was inherently speculative in nature.[188]

In determining whether information is material, courts do not view the information in isolation. Instead, courts view the information in the context in which it was conveyed. For example, in *SEC v. Happ*, a member of the Board of Directors of Galileo Corporation was held liable for insider trading when he sold his shares after receiving information during a Board meeting that the company was facing potential financial concerns and later received a message from Galileo's CEO requesting a meeting to discuss company difficulties.[189] The court found that such information could be deemed material because Happ was a sophisticated investor, he had the benefit of the information shared during the Board meeting, and the call from the CEO was out of the ordinary.[190]

The context in which information is conveyed was central to the Second Circuit's opinion in *United States v. Litvak* evaluating the materiality requirement.[191] Although the case did not involve insider trading, the court's discussion of the "reasonable investor" standard could have implications for alleged insider trading in securities that are traded on platforms other than national stock exchanges, such as debt securities traded

---

186. *See* Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir. 1991) (characterizing information based on subjective analysis or extrapolation as "soft information" and, as such, too speculative and unreliable to be considered material and subject to disclosure requirements).

187. SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979) (quoting United States v. Chiarella, 588 F.2d 1358, 1366-67 (2d Cir. 1978), *cert. granted*, 441 U.S. 942 (1979)).

188. SEC v. Rorech, 720 F. Supp. 2d 367, 410–11 (S.D.N.Y. 2010).

189. SEC v. Happ, 392 F.3d 12, 21–23 (1st Cir. 2004).

190. *Id.* at 22.

191. 889 F.3d 56 (2d Cir. 2018).

among institutional investors. The case involved alleged material misrepresentations made by a bond trader who bought and sold residential mortgage-backed securities ("RMBS"), which are marketed to large, sophisticated financial institutions. RMBS are not traded on an exchange like NASDAQ or the New York Stock Exchange. When analyzing the materiality of the alleged misstatements, the Second Circuit acknowledged that "[t]he standard of a 'reasonable investor' . . . is an objective one" but added that the "standard may vary with the nature of the traders involved in the particular market." The Second Circuit analyzed the materiality of the information at issue in the case in the context of an "objective investor in the RMBS market."[192] This interpretation could raise the standard for the government to demonstrate the materiality of information in certain markets and could provide an opportunity for defense counsel to argue that information is immaterial.

Information that is seemingly vague can be material. In *United States v. Cusimano*, a statement that "something was happening" between AT&T and a target company was determined to be material where several individuals had set up a scheme to obtain insider information from AT&T and where AT&T's interest was a significant event for the target company.[193] In another case, *SEC v. Meyhew*, a tip that a company was seeking an investment partner was deemed material, despite the fact that the potential partner was not identified and no further details about the merger were provided, because the information came from an insider who said that merger discussions were serious.[194] Courts, however, have deemed information not to be material where the information was only slightly different from prior projections and where the news, when broadly released, did not significantly affect the market.[195]

The law of materiality becomes even murkier when an investor aggregates pieces of information (often both nonpublic and public) to reach a nonpublic conclusion. As a general

192. *Id.* at 69 (emphasis added).
193. United States v. Cusimano, 123 F.3d 83, 88 (2d Cir. 1997).
194. SEC v. Mayhew, 121 F.3d 44, 51–52 (2d Cir. 1997).
195. Here, the company's Form 10-Q disclosed that it expected earnings to be 10% lower than the previous year and the individual learned that the company's earnings would actually be up to two percentage points lower than disclosed. *See* SEC v. Hoover, 903 F. Supp. 1135, 1144–46 (S.D. Tex. 1995)

matter, piecing together fragments of nonmaterial information to understand the broader position of a company (the so-called "mosaic" theory of investing, as discussed above) does not violate insider trading laws and can be used as a defense to an insider trading charge.[196] However, counsel should be cognizant of a situation where material, nonpublic information has been artificially broken into smaller pieces—similar to structuring in the money laundering context—to avoid a particular piece from being deemed material. In such circumstances, a court might treat the pieces of information in the aggregate as collectively material.[197]

---

196. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d. Cir. 1980) ("A skilled analyst may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information."); *see also* SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 14 (2d. Cir. 1977) (explaining that "corporate management may reveal to securities analysts or other inquirers non-public information that merely fills 'interstices in analysis' or tests 'the meaning of public information'"). The SEC staff states:

> An issuer . . . would not be conveying such [i.e. material] information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information. It would not violate Regulation FD to reveal this type of data even if, when added to the analyst's own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer.

U.S. SEC. & EXCH. COMM'N, COMPLIANCE AND DISCLOSURE INTERPRETATION 101.03 (2009).

Similarly, the Chartered Financial Analyst Institute's Standards of Practice Handbook states:

> A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the 'mosaic theory,' financial analysts are free to act on this collection, or mosaic, of information without risking violation.

CHARTERED FIN. ANALYST INST., STANDARDS OF PRACTICE HANDBOOK 62 (2014), https://www.cfainstitute.org/-/media/documents/code/code-ethics-standards/standards-practice-handbook-11th-ed-eff-July-2014-corr-sept-2014.pdf.

197. United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996) (upholding criminal conviction for insider trading when the defendant "was never told about the acquisition and did no more than piece together evidence ob-

In defending against a claim that information is material, counsel should look to the point, albeit uncertain, when the information ultimately reached the public domain to determine what other information was released about the company, the industry, and the overall market. Often, companies combine the release of information, particularly bad news, with other information to minimize the effect on the stock price. This combination also makes it difficult to determine whether any particular piece of information affected the stock price in a significant way. Economic analysis is key for both the government, which has the burden of proof, and also for the defendant, who often can demonstrate other reasons for a stock's movement. The SEC and DOJ often cannot prove that the piece of information at issue in a case was material because so many other pieces of information about the company reached the marketplace at the same, or nearly the same, time. In addition, defense counsel should move to exclude any expert testimony offered by the government to establish materiality that does not control for other variables at the time the information was made public.[198]

C. *Breach of a Duty*

Whether an individual has violated a duty depends on the particular theory of insider trading that the government is asserting. As discussed above, there are three traditional theories[199] of insider trading liability: the "classical" theory, the "tipper-tippee" theory, and the "misappropriation" theory, each with slight variations on the duty element. The government has the burden of proving that a person trading on a tip

tained while working for" the acquirer); SEC v. Steffes, 805 F. Supp. 2d 601 (N.D. Ill. 2011) (denying motion to dismiss SEC's insider trading enforcement action under a "classical" theory where employees pieced together information from inside the company that led them to believe it was about to be sold); SEC v. Binette, 679 F. Supp. 2d 153, 159 (D. Mass. 2010) ("A defendant may be liable under the misappropriation theory when he pieces together incomplete fragments of confidential information provided through his employment to identify likely acquisition targets and then trades stock in those target companies.").

198. *See* Daubert v. Merrell Dow Pharm., 509 U.S. 579, 580 (1993) (stating the factors to be considered in the admissibility of expert testimony).

199. As discussed *supra* Section II.C.4, the so-called "outsider trading" or "affirmative misrepresentation" theory of insider trading articulated by the Second Circuit in *SEC v. Dorozhko* does not require a breach of a duty.

knew or should have known that there was a breach of a duty by the source of the information.[200]

1. *Duty under the Classical and Tipper-Tippee Theories.*

The duty element is essentially the same under both the classical and tipper-tippee theories. Under the classical theory, the fiduciary duty owed by the corporate insider is often evident from the individual's position in the company or as an agent of that company, and the nature of the information. The fiduciary duty to abstain from trading on material nonpublic information applies to "officers, directors, and other permanent insiders of a corporation . . . [and] to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation."[201]

Similarly, under "tipper-tippee" liability, the initial tipper breaches his or her fiduciary duty to the corporation by disclosing material nonpublic information to an outsider in violation of the tipper's fiduciary duty to the company and in return for a personal benefit.[202] Such benefit may arise through "a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings" or by making a "gift of confidential information to a trading relative or friend."[203]

200. Dirks v. SEC, 463 U.S. 646, 647, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and tippee knows or should know there has been a breach."); *see also* SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995) (quoting *Dirks*, 463 U.S. at 660). If trading is with respect to a planned or existing tender offer, Rule 14e-3 makes trading unlawful without regard to whether any fiduciary duty exists. *Id.* at 635.

201. United States v. O'Hagan, 521 U.S. 642, 652 (1997) (citing *Dirks*, 463 U.S. at 655 n.14); *see also* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessman concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider").

202. SEC v. Ingram, 694 F. Supp. 1437, 1440 n.3 (C.D. Cal. 1988) (relying on *Dirks*, 463 U.S. at 646, for the proposition that "the individual must have expressly or impliedly entered into a fiduciary relationship with the issuer.").

203. *Dirks*, 463 U.S. at 663–64. *See* discussion *supra* notes 31–48 regarding the broad view of "personal benefit" generally claimed by the SEC and upheld by courts.

Whether an insider has breached a fiduciary duty depends on the specific facts and circumstances and often turns on the person's knowledge and intent. An insider arguably may convey nonpublic information to an outsider without violating a fiduciary duty if it is done with the good-faith intent to benefit the company or if the insider honestly believes the information is already public.[204] However, if it appears that the insider also received a personal benefit, which is an element of the violation, or if the insider is reckless[205] in sharing the information, then courts are likely to find a breach of a fiduciary duty.[206]

As mentioned, liability for a tippee depends on whether the tippee was aware of the breach of a fiduciary duty, which often is established through circumstantial evidence. Courts generally look to whether the tippee was aware of the source of the information. A tippee who is aware that the material nonpublic information came from an insider is viewed by the courts as knowing that the insider breached a duty by selectively disclosing the information, as opposed to disclosing through an official corporate channel.[207]

The more difficult scenario arises when there is no direct evidence that the tippee knew the source of the information. In those circumstances, courts often look to the same facts that establish that the tippee knew the information was nonpublic, such as subsequent actions of the tippee upon learning the information. Did the tippee make what would be viewed as an

---

204. Company insiders "are presumed to know when information is undisclosed." SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

205. *See, e.g.*, McLean v. Alexander, 599 F.2d 1190, 1197 (3d Cir. 1979); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979); Hoffman v. Estabrook & Co., 587 F.2d 509, 516 (1st Cir. 1978); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Cook v. Avien, Inc., 573 F.2d 685, 692 (1st Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co. 570 F.2d 38, 44-47 (2d Cir. 1978); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977).

206. *Id.*

207. *See, e.g.*, SEC v. Musella, 578 F. Supp. 425, 431–32, 442 (S.D.N.Y. 1984) (finding a corporate bond trader liable as a tippee for obtaining information about a pending tender offer from his friend who was employed by the law firm representing the acquiring company); *see also* SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995) (finding the tippee liable because he knew that information he received from the CEO of an acquiring company was improper).

unusual investment (e.g., using futures or out-of-the-money options, liquidating a retirement portfolio to make the investment, or making an extraordinarily large purchase)?

In defending against an allegation of insider trading, counsel should pay particular attention to the government's proof of the tippee's knowledge of the breach of a duty. Each defendant-tippee in a chain who receives material nonpublic information must know or have reason to know of the breach of the fiduciary duty to be liable for insider trading.[208] In many cases, beyond the first few tippees in a large chain, the evidence in this regard is scarce at best.[209]

2. *Duty under the Misappropriation Theory.*

Under the misappropriation theory, liability for insider trading is broadly premised on "a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[210] The linchpin for the government in the misappropriation theory is the establishment of a fiduciary duty or relationship of trust and confidence. Depending on the facts of the case, courts have found that such a duty or relationship exists in the following circumstances and relationships: lawyer-

---

208. *See, e.g.*, Complaint at 5, SEC v. Gowrish, No. 09-CV-5883 (N.D. Cal. Dec. 16, 2009) (where the SEC did not charge the brother of an insider trader, but rather named him as a relief defendant, even though he allowed the defendant to trade in his account and split the profits from the trades; he was never aware that the trades were executed on the basis of inside information); *see also* Complaint at 7, SEC v. Tang, No. 09-CV-05146-JCS (N.D. Cal. Oct. 30, 2009) (where the SEC did not charge fifteen relief defendants for insider trading even though they were family members with accounts in which the illegal trading occurred).

209. *See, e.g.*, Complaint at 2–4, SEC v. Stephanou, No. 09-CV-1043 (S.D.N.Y. Feb. 5, 2009). The SEC charged a UBS investment banker for tipping about material nonpublic information regarding the acquisition of a construction materials firm and a healthcare company. *See id.* at 1–4. His close family friend traded on the information in both cases and, in turn, "either tipped four family members with that information or traded in their accounts on the basis of that information." *See id.* at 4. Though those family members may have traded themselves, SEC did not charge these individuals. *See id.* at 1–2.

210. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

client,[211] director-corporation,[212] employee-employer,[213] busi-

211. *Id.* In *O'Hagan*, a law firm partner obtained material nonpublic information from his firm when it represented Grand Met in its contemplated tender offer for Pillsbury. *Id.* at 647–48. Mr. Hagan did not participate in the representation of Grand Met, but instead he obtained the information despite the efforts of Grand Met and his law firm to keep the information confidential. *Id.* Nevertheless, the Supreme Court found that O'Hagan violated the duty that he owed to his law firm when he misappropriated the information and used it to purchase a large number of Pillsbury call options and shares, making a profit of more than $4.3 million. *Id.*

212. SEC v. Talbot, 530 F.3d 1085, 1087–88 (9th Cir. 2008) (holding that a director of a public company misappropriated nonpublic information about a proposed acquisition of which he learned during a board of directors meeting of his company). The Ninth Circuit remanded the case to the district court for a determination of whether the information was material. *Id.* at 1097–98.

213. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024, 1028 (2d Cir. 1986) (affirming United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985)); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (affirming lower court decision that found defendant breached a fiduciary duty to his employer and its clients when he traded on the basis of confidential information obtained during the course of his employment); United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (reversing dismissal of an indictment against the defendant by finding that the defendant employee violated his duty to his employer brokerage firm and the firm's clients by misappropriating confidential information and concealing it when he was under a duty to disclose); *Winans*, 612 F. Supp. at 844–45 (holding that the defendant owed a fiduciary duty to his employer not to disclose contents of material nonpublic information he obtained in the course of his employment).

ness partners,[214] accountant/tax planner-client,[215] doctor-patient,[216] and familial.[217]

The SEC set forth in Rule 10b5-2 a non-exhaustive list of the relationships that would establish a duty of trust or confidence under a theory of misappropriation.[218] According to Rule 10b5-2, a duty of trust or confidence arises between a recipient of material nonpublic information and the source when: (1) the recipient of the information "agrees to maintain

214. SEC v. Peters, 735 F. Supp. 1505, 1520 (D. Kan. 1990) (applying the misappropriation theory in the context of a business partnership), *rev'd on other grounds*, 978 F.2d 1162 (10th Cir. 1992); SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessmen concerning a proposed joint venture between their respective companies created a fiduciary duty because the two men were "long time friends and business associates").

215. SEC v. Kornman, 391 F. Supp. 2d 477, 489 (N.D. Tex. 2005) (noting that defendant's knowledge regarding estate and tax planning may indicate that a duty of trust had developed between defendant and the two corporate executives from whom he obtained information about upcoming acquisitions and buy-outs).

216. United States v. Willis, 737 F. Supp. 269, 271, 277 (S.D.N.Y. 1990) (holding that a psychiatrist could be convicted for trading on the basis of material nonpublic information that he learned in the course of treating his patient, the wife of a corporate executive; explaining that the doctor had adequate notice that it would "be unlawful for him to disclose his patient's information and use it to trade in securities for his personal benefit").

217. *See* SEC v. Yun, 327 F.3d 1263, 1272–74 (11th Cir. 2003) (holding that the defendant spouse owed her husband, an executive at the issuer, a duty of loyalty and confidentiality not to disclose material nonpublic information related to revised earnings information he relayed to her); SEC v. Lenfest, 949 F. Supp. 341, 345 (E.D. Pa. 1996) (denying defendant's motion for summary judgment due to her potential liability for trading based on material nonpublic information that she obtained in confidence from her husband, the board member of a merger target); United States v. Reed, 601 F. Supp. 685, 718 (S.D.N.Y. 1985) (denying defendant's motion to dismiss, holding that sufficient facts existed for a jury to decide that defendant, the son of a corporate director, misappropriated information concerning a potential acquisition involving his father's company in violation of a confidential relationship with his father), *rev'd on other grounds,* 773 F.2d 477 (2d Cir. 1985). *But see* United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (holding that prosecutors failed to establish a "functional equivalent of a fiduciary relationship" between the wife who shared information about a family business transaction and her husband, who relayed the information to his stockbroker who traded on the information).

218. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000), http://www.sec.gov/rules/final/33-7881.htm.

information in confidence"; (2) two individuals 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"; and (3) an individual receives "material nonpublic information from certain enumerated close family members," including "spouses, parents, children, and siblings."[219]

In attempting to clarify what relationships would indicate a duty of trust and confidence, the SEC may have exceeded the constitutional bounds of its authority with Rule 10b5-2. The district court in *SEC v. Cuban* held that Rule 10b5-2 was an unconstitutional exercise of the SEC's power, stating that the SEC "cannot by rule predicate liability on an agreement that lacks the necessary component of an obligation not to trade on or otherwise use confidential information for personal benefit."[220] The court held that finding liability on a mere agreement to maintain information in confidence exceeds the SEC's authority under Section 10(b) to proscribe deceptive conduct.[221] Additionally, the district court held that Rule 10b5-2(b)(3), which creates a presumption of a duty of trust or confidence for the enumerated family members, is an unconstitutional shift in the government's burden in a criminal case because the government always must carry the burden to prove each element of an insider trading offense.[222]

Certain business interactions may seem ripe for insider trading opportunities, yet they do not give rise to a duty to not trade under the elements established by the Supreme Court in *O'Hagan*. Consider the following scenario: an investment banker may contact a hedge fund regarding a deal and relay

---

219. 17 C.F.R. § 240.10b5-2(b)(1), § 240.10b5-2(b)(3) (2010). The enumerated family members in the rule are presumed to create a duty of trust and confidence, but the SEC recognizes that it is a rebuttable presumption. *Id.*

220. SEC v. Cuban, 634 F. Supp. 2d 713, 729 (N.D. Tex. 2009). On appeal, the Fifth Circuit questioned but did not address the validity of Rule 10b5-2(b)(1). *See* SEC v. Cuban, 620 F.3d 551, 555, 558 (5th Cir. 2010). The *Cuban* case also illustrates a situation where a fiduciary duty or a relationship of trust or confidence is not apparent.

221. *Cuban*, 634 F. Supp. 2d at 730–31.

222. *Id.*; s*ee also Chestman*, 947 F.2d at 567 (holding that prosecutors failed to establish their case because they did not prove that a "functional equivalent of a fiduciary relationship" existed between husband and wife).

material nonpublic information about an issuer in the course of the discussion. The hedge fund later trades in the issuer's stock on the basis of the information. Is the hedge fund liable for misappropriating the information to trade for its benefit? The answer depends on whether the hedge fund owes a duty to the investment bank or to its clients. Courts have held that arm's-length negotiations do not constitute a relationship of trust or confidence.[223] Even an agreement to keep the deal confidential may not give rise to a duty to not trade.[224] Unless it can be shown that the investment bank and hedge fund had an established relationship of trust or confidence before their discussions, it might be difficult to establish the legal elements of insider trading.

In this situation, the investment bank nevertheless clearly has a duty to the issuer to ensure that the information is maintained in confidence by any potential investors. Thus, the investment bank should not disclose the information to an investor unless the bank obtains the investor's agreement to keep the information confidential and not to trade on it. When the

---

223. *See, e.g.*, United States v. Cassese, 273 F. Supp. 2d 481, 485–86 (S.D.N.Y. 2003) (finding that negotiations between defendant and a competitor constituted potential arm's length business dealings rather than a fiduciary relationship). *But see* SEC v. Lund, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983) (holding that discussion between Lund and another businessman concerning a proposed joint venture between their respective companies created a fiduciary duty that made Lund a "temporary insider"; observing that the two men were "long time friends and business associates").

224. *See, e.g.*, Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (upholding dismissal of claims brought against defendant Morgan Stanley for trading in stock of its client's potential takeover target based on confidential information received in the course of merger discussions). In *Walton*, the court determined that the defendant did not have a relationship with the issuer other than through discussions about the possible deal, explaining that "although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan Stanley owed no duty to observe that confidence." *Id.* Where a confidentiality agreement exists, the relevant factor is whether the parties had a relationship of trust and confidence outside of the particular discussions at issue. *See also Cuban*, 620 F.3d at 557–58 (reversing the district court's dismissal of the case for further proceedings to evaluate whether the understanding between the CEO and Cuban went beyond a "simple confidentiality agreement"). Note, however, that the SEC maintained in *Cuban* that a confidentiality agreement itself created a duty to disclose or refrain from trading based on information received under the agreement. *Id.* at 552–53.

bank discloses the information without having obtained a confidentiality agreement or having gone through proper procedures the hedge fund, which may be the recipient of information it did not seek, is put in a difficult situation. On the one hand, if the fund trades in the securities of the company that are the subject of the unwanted disclosure, the SEC or a prosecutor might argue that the fund has committed insider trading under a misappropriation theory, pointing to some expectation of confidentiality based on a pattern of interactions between the investment bank and the hedge fund.[225] On the other hand, if the fund is forced to refrain from trading in the relevant securities—particularly where it would have traded the relevant securities absent a call from the bank—the hedge fund's refraining from trading may be in breach of the adviser's fiduciary obligation to trade for the benefit of its investors, and the fund could not justify its failure to trade because the hedge fund has no obligation to the bank or the underlying company.

In short, a hedge fund seeking to stay out of the government's crosshairs does not want to receive unwanted information concerning securities of companies that it trades. To avoid receiving such information, funds may put banks or other agents on notice that they should not supply such information without first requesting appropriate consent to supply the information.

The Panuwat case discussed above demonstrates that the SEC may seek to establish the existence of a duty in misappropriation cases by referring to insiders' agreements to comply with company policies regarding insider trading, even if those policies are stricter than the federal securities laws. In Panuwat, the SEC alleged that the defendant engaged in insider trading when he learned that his employer was about to be acquired and then traded in the securities of an industry peer, believing that the peer company's stock price would rise on news of the acquisition. In response, the defendant argued

225. *See, e.g.*, *Cuban*, 634 F. Supp. 2d at 727–29; *see also supra* text accompanying note 127. Failing to prove an agreement to maintain the information in confidence and not trade, an aggressive SEC lawyer or prosecutor might try to argue that the hedge fund somehow tricked the investment bank into divulging the information by making an affirmative misrepresentation. *See* SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009); *see also supra* text accompanying notes 50–51.

that he did not owe a duty to the peer company and therefore his trading in that company's securities did not satisfy the breach-of-duty element. The SEC argued that the defendant's duty arose from his own employer's insider trading policy, which broadly prohibited trading on the basis of material nonpublic information, even if the trades related to another publicly-traded company. The district court agreed with the SEC and ruled that the defendant had breached a duty by violating his employer's policy not to trade in the securities of another company on the basis of material nonpublic information.[226]

Although the misappropriation theory is used to establish liability, it also can be raised as a defense by insiders who provide inside information to someone who ultimately trades. For example, in a situation where a corporate executive provides material nonpublic information to a family member, friend, or business associate who trades, the corporate executive may cite Rule 10b5-2 to argue that he and the recipient of the information 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."[227] In this example, the corporate executive might not be liable for tipping the recipient, yet the recipient could be liable for insider trading based on the misappropriation theory.

There are several cases where the facts could support a tipper-tippee theory of liability, but the government proceeded instead under the misappropriation theory. For example, in *United States v. Corbin*, a district court found that the misappropriation theory applied where a tippee received information from a friend who had breached his duty of confidentiality to his wife.[228] The friend and his wife had an express agreement to keep information that the wife learned from her company confidential, and they had a duty based on a history, pattern, or practice of sharing confidences.[229] In SEC v. Stum-

226. *See* Order Denying Motion to Dismiss, SEC v. Panuwat, Case No. 4:21-CV-06322-WHO (N.D. Cal. Jan. 14, 2022), ECF No. 26.

227. Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716, 51730 (Aug. 24, 2000), https://www.sec.gov/rules/final/33-7881.htm.

228. United States v. Corbin, 729 F. Supp. 2d 607, 615–16 (S.D.N.Y. 2010).

229. *Id.*

mer, the defendant settled with the SEC on insider trading charges after he misappropriated material nonpublic information by guessing the password to his brother-in-law's computer.[230] Stummer's brother-in-law was a director of the private equity firm that was rumored to be involved in a potential acquisition, and Stummer logged into the private equity firm's network to research and obtain confidential information on which he traded.[231]

IV.
COMPLIANCE PRACTICES TO ADDRESS INSIDER TRADING[232]

Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including experts and expert networks. For funds, such compliance procedures should also address their interaction with investment dealers or others that might have agency duties to a public company. Effective policies and procedures should address: (1) the implementation of information barriers between the firm's public and private sides; (2) the selection of expert networks and experts, including the firm's due diligence, screening, and approval process before a network or expert is engaged; (3) the interaction with investment dealers and experts, including identification of personnel designated to interact with them, the manner in which the interaction is to occur, and the documentation of that interaction; and (4) the monitoring, surveillance, and supervision of the interaction between the firm and investment dealers or experts, and of trading with issuers that are subjects of such interactions. All employees at the firm should be

230. SEC v. Stummer, Litig. Release No. 20,529, 93 SEC Docket 115 (Apr. 17, 2008) (announcing the settlement of the action); Complaint at 2, 5, SEC v. Stummer, No. 08-CIV-3671 (S.D.N.Y. Apr. 17, 2008).

231. Complaint at 4–5, SEC v. Stummer, No. 08-CIV-3671 (S.D.N.Y. Apr. 17, 2008).

232. This article focuses on issues involving the DOJ and the SEC. There are steps that can be taken to protect against a private action by a counterparty. For example, private parties to a transaction sometimes enter into so-called "big boy" letters whereby they agree, in essence, not to sue each other for violating insider trading laws. These agreements might protect a party against a private lawsuit from a counterparty, but they provide little protection against a government enforcement action or criminal prosecution.

trained thoroughly on the laws governing insider trading and the firm's policies and procedures. The firm should create a culture wherein employees are encouraged to report to compliance or legal personnel any unusual or problematic activity, as well as any information that arguably constitutes material nonpublic information. Firms should document both the processes implemented and the steps personnel take in compliance with these processes, thereby creating a detailed record of the firm's efforts to meet its legal and regulatory obligations.

A. *Insider Trading – Information Barriers*

Firms should implement adequate information barriers between their public and private lines of business. Employees who have acquired or who, in the course of their normal business dealings, are likely to acquire material nonpublic information (i.e., private-side employees) should be screened from communications with employees involved in trading (i.e., public-side employees). Furthermore, persons in a position to make trading decisions should be trained in distinguishing "nonpublic" information from "public" information.

Public-facing employees must understand the need to inform compliance or legal personnel promptly when they are exposed, for any reason, to material nonpublic information and to refrain from sharing such information or otherwise using or relying upon it. Moreover, the line between legitimate, public information and material nonpublic information is frequently unclear. Therefore, it is critical for public-facing employees to understand that, where there is any doubt as to whether information may be material nonpublic information, or where red flags may be present, the employee must consult with appropriate compliance or legal personnel promptly. The employee should not share, use, or rely on such information unless and until such information is approved following a review by compliance and legal personnel.

B. *Expert Network Procedures*

1. *Expert Network Compliance Program.*

Firms that use expert networks should consider instituting a review and approval process to document that the expert network being used employs reasonable practices and compli-

ance efforts. In particular, firms should ensure that the expert network employs a strong screening process. Firms should ask who at the network approves experts, what background check processes are employed with regard to experts, and whether the process is documented adequately. Furthermore, firms should consider inquiring about the contractual arrangements between the expert network and their experts, including compensation structure and any representations and warranties provided. A firm's compliance or legal personnel should review and approve use of the network.

2. *Expert-Specific Procedures.*

In addition to the expert network's compliance program, firms should screen experts independently. Firms should perform at least basic background checks (e.g., use public search engines) on all experts utilized. Any potential "red flags" that appear in the background check, such as disciplinary and regulatory actions, could be reviewed by a member of the firm's compliance or legal team before any discussions with the expert occur. Consideration should be given to criteria that might cause firms to prohibit the use of an expert, or at the very least, subject such approval to stricter scrutiny or involve more senior reviewers within the firm. One important consideration is whether the firm should prohibit the use of experts who were employed within a certain time frame at a company in which the firm is considering investing. Experts who were recently employed by, or affiliated with, the company at issue may have been exposed to material nonpublic information. Even if the former employees do not possess material nonpublic information, government investigators may view such experts with suspicion.

3. *Pre-Approvals.*

Employees should not hold any discussions with experts unless and until they have first received approval from their supervisor and the firm. The approval should be documented appropriately and reflect the expected scope of the discussions as well as the general purpose behind the use of such experts.

4. *Documentation of Meetings.*

Firms should document all discussions or meetings with experts. These records should include, at a minimum, who participated, the expert's current place of employment, the expert's basis of knowledge, and the topics covered. Firms also should consider whether to require a member of the compliance or legal team to participate in certain discussions with experts, particularly with experts who may have had direct involvement with a relevant issue.

Furthermore, dealings with particular experts should be conditioned on the expert providing certain commitments prior to or at the opening of the meetings. Firms also may consider requiring that all discussions with an expert begin with a script in which the expert assents to the following points:

- that the expert understands that the client does not wish to receive material nonpublic information;
- that the expert has not breached, and will not breach, any confidential agreement, policy obligation, or legal duty that the expert has to any party;
- that no one else has breached a legal duty in providing information to the expert;
- that the expert is not an employee, affiliate, or supplier of the company that will be discussed on the call;[233]
- that the expert did not pay an employee, affiliate, or supplier of the company at issue to obtain the information;
- to the extent possible, an acknowledgement that the information the expert plans to provide was not obtained directly or indirectly by anyone who would not be able to assent to each of the foregoing representations.

At the end of the meeting, firms should obtain confirmation that nothing discussed during the meeting changed the assent obtained at the beginning of the meeting.

Supervisors should review and approve all documentation from meetings with expert networks. Firms also may wish to

233. If the expert is an employee, affiliate, or supplier of the company, the firm should obtain confirmation from the company as to the company's knowledge and approval of the expert's activities and any limitations thereon.

consider routine review of such information by a member of the firm's compliance or legal teams. Moreover, all employees who may engage in discussions with experts and those employees' supervisors should be trained to identify problematic answers to scripts or other issues noted during these meetings and should understand the importance of promptly directing issues to the attention of compliance or legal personnel for review. Information should not be shared or otherwise used or relied upon pending completion of the review process and, if applicable, the approval process. This protocol is especially important with respect to any information that is flagged as problematic and in need of further review.

Securities of relevant issuers should be added to the firm's watch list to ensure appropriate monitoring of future trading therein. In light of *Panuwat*, the watch list may need to include securities of issuers in similar industries as those discussed during calls with consultants.[234]

5. *Follow-Up Communications.*

Communications with experts should be made only through approved means of communication that are tracked by the firm. Firms should prohibit employees from using informal means of communication when interacting with experts. Communications through text messaging, instant messaging, and social networking are difficult for firms to monitor, lend themselves to informality, and can easily be taken out of context. Their informality makes them easy targets for enforcement authorities seeking evidence of inappropriate behavior. Accordingly, employees should be instructed to communicate by phone or in person with experts using the compliance procedures outlined in this Section B.

If there are any electronic communications with experts, those communications should be conducted over firm-approved messaging channels and reviewed by compliance personnel or the employee's supervisor. If a message is ambiguous, firms should consider follow-up written communications to clarify the intent of the message. At the very least, firms should document the meaning of an ambiguous phrase to avoid confusion later after memories have dimmed.

---

234. *See* SEC RISK ALERT, *supra* note 22, at 3.

C. *Alternative Data Procedures*

The SEC increasingly has become interested in financial firms' use of so-called alternative data or "alt data." This data is derived from non-traditional sources outside of a company's public filings, such as "information gleaned from satellite and drone imagery [ ] . . . , analyses of aggregate credit card transactions, social media and internet search data, geolocation data from consumers' mobile phones, and email data obtained from apps and tools that consumers may utilize."[235]

In 2021, the SEC settled an enforcement action brought against a data aggregator, App Annie Inc., and its founder alleging securities fraud related to the sale and use of alternative data. Although the SEC did not allege insider trading, the matter has implications for investment firms who purchase and rely on alternative data.[236] App Annie gathered mobile app data from the apps of publicly-traded companies. App Annie then sold that data to investment firms and encouraged the firms to make investment decisions using the data. The SEC alleged that App Annie and its founder violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by making material misrepresentations about how App Annie derived the data it made available to subscribers and misrepresented that it had internal controls and processes to prevent the misuse of confidential information and to comply with the federal securities laws. According to the SEC, App Annie's misrepresentations induced securities trading firms to subscribe to App Annie's services and to use App Annie's data to purchase and sell securities. In particular, the SEC alleged that App Annie did not have a documented policy to exclude confidential information from the data it provided to subscribers, and, once it adopted such a policy, did not take sufficient measures to ensure that the policy was implemented company-wide.[237]

The App Annie case highlights the risk that investment firms might receive material nonpublic information from alt data sources. Firms that purchase alt data should take precautions to avoid receiving material nonpublic information. These precautions include: (1) adopting policies and procedures tai-

---

235. *See id.*

236. *See* App Annie Inc., Exchange Act Release No. 92975 (Sept. 14, 2021), https://www.sec.gov/litigation/admin/2021/34-92975.pdf.

237. *Id.*

lored the use of alt data; (2) consistently conducting and memorializing diligence processes; (3) implementing policies and procedures to assess the terms, conditions, or legal obligations related to the collection or provision of the data, including processes for employees to follow when they learn about potential red flags involving the source of alt data; and (4) maintaining documentation to demonstrate that the firms' policies have been consistently applied to alt data providers.[238]

D. *Other Procedures*

1. *Supervision.*

Investment firms' supervisory programs should be ongoing and tailored to the particularities of a firm's respective business. Supervisors should meet regularly with supervised persons and be informed fully of the person's conduct and the business being conducted. Firms' supervisory procedures should include appropriate documentation of applicable processes, including: (1) monitoring of employees' compliance with procedures; (2) supervisory approval; and (3) trade monitoring and review. As noted, the purpose of supervisory documentation is to document compliance with internal firm processes. Such documentation should not, however, include conclusions regarding factual findings or other evidence obtained during a supervisory review. Instead, such matters should be discussed with legal or compliance personnel, who should take responsibility for documenting any reviews, findings, or conclusions with respect thereto.

2. *Surveillance.*

Internal surveillance programs should closely monitor the firm's trading positions and strategies. Surveillance should not be limited to firm proprietary accounts but also should include trading that occurs in customer accounts and employees' personal trading accounts.[239] These surveillance systems should monitor for, among other things: (1) significant gains and avoidance of large losses; (2) patterns of trades in advance of

238. SEC RISK ALERT, *supra* note 22, at 2–3.

239. *See* Investment Advisers Act of 1940 Rule 204A-1, 17 C.F.R. § 275.204A-1 (2016) (requiring investment advisers' codes of conduct to contain "provisions that require all your access persons to report, and you to review, their personal securities transactions and holdings periodically").

market moving news; (3) unusual trading methods, products, and the like; and (4) trades outside the firm's strategy. The firm should investigate any triggering events and document the resulting investigation, including any reasonable explanations for the conduct. Although supervisory personnel and traders should be consulted during any such investigation, the investigation should be led by the firm's compliance or legal personnel or outside counsel. All trading in securities related to any expert discussions should be subject to ongoing surveillance.

3. *Culture of Compliance or so-called "Speak-up" Culture.*

Compliance programs should encourage employees to voice concerns and question conduct where doubt exists as to the propriety of trading on certain information. Even firms with the most well-designed and well-operated compliance programs will find it difficult to safeguard themselves completely from all regulatory problems. Creating an atmosphere in which employees feel comfortable raising legal and compliance questions helps firms ensure that they are taking a broad view on regulatory concerns.

4. *Training.*

Training programs should be robust, regular, and well-documented, including topics covered and attendance. Such programs should focus on: (1) the substance of the law; (2) the substance of the firm's procedures; and (3) the need to self-report or flag problematic issues for further discussion and review.

To the extent possible, training programs should avoid abstract analysis and instead reflect and address real life activities and behaviors faced by firm personnel. Firms should consider more focused training programs for individuals who will communicate directly with experts and those individuals' supervisors. Training should emphasize the need to reach out immediately to compliance and legal personnel with any doubts as to whether certain information can be used.

5. *Documentation.*

It is important to be able to demonstrate to government investigators the extent to which a firm strives to comply with

the law. For this reason, a firm should maintain consistent and thorough documentation of its compliance program. Firms should be able to show examiners and investigators that they have taken steps to inform employees of appropriate policies and procedures, actively followed through in implementing and enforcing the policies and procedures, and consistently investigated red flags and other unusual matters.

CONCLUSION

The law of insider trading is nuanced and highly dependent on the facts and circumstances of a particular case. Different theories of insider trading may be more relevant to different groups of companies and financial services firms. Because the law has developed in the courts, however, insider trading law is fluid and continues to evolve as markets grow, technology changes, and the DOJ and SEC press new theories of insider trading. Inevitably accompanying those new and expansive prosecution theories are new legal and factual defenses that should be considered.

The first line of defense to insider trading is a strong compliance program. Companies and financial services firms must establish policies and procedures to address insider trading and interactions with potential tippers, including, where applicable, experts and expert networks. For funds, such compliance procedures also should address their interaction with investment dealers or others that may have agency duties to a public company.

The consequences for noncompliance with the laws pertaining to insider trading can be devastating. The DOJ may bring a criminal prosecution, resulting in a significant prison sentence and fine if an individual defendant is found guilty. The SEC may bring an enforcement action seeking disgorgement of ill-gotten gains (or losses avoided), a civil monetary penalty, and certain professional bars. A strong compliance program is not only essential for preventing insider trading but also provides defenses to charges and serves as a mitigating factor in the event of any prosecution or enforcement action.