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Federal Securities Law: Insider Trading

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Summary

Insider trading in securities may occur when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. Certain federal statutes have provisions that have been used to prosecute insider trading violations. For example, Section 16 of the Securities Exchange Act of 1934 requires the disgorgement of short-swing profits by named insiders—directors, officers, and 10% shareholders. The 1934 Act's general antifraud provision, Section 10(b), is frequently used in the prosecution of insider traders. Although the statute does not specifically mention insider trading but, instead, forbids the use of "manipulative or deceptive" means in buying or selling securities, case law has clarified that insider trading is the type of fraud that is prohibited by Section 10(b). Securities and Exchange Commission (SEC) rules issued to implement Section 10(b), particularly Rule 10b-5, have also been frequently invoked in insider trading prosecutions. With the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress enacted legislation that imposed up to treble damages (and in some cases the greater of $1 million or up to treble damages) on persons found guilty of insider trading. More recently, the Stop Trading on Congressional Knowledge (STOCK) Act of 2012 (P.L. 112-105) explicitly stated that there is no exemption from the insider trading prohibitions for Members of Congress, congressional employees, or any federal officials. As noted above, SEC Rule 10b-5 is the most frequently used SEC rule in lawsuits that charge violations of insider trading prohibitions. However, other SEC rules, some of which specifically target insider trading, are also important.

There are numerous cases in which Section 10(b) and Rule 10b-5 have been used to prosecute insider trading violations. The most recent case of note is the Supreme Court's decision in *Salman v. United States*. On December 6, 2016, the Court unanimously upheld the conviction of Bassam Yacoub Salman for insider trading on tips that he had received from his brother-in-law. The Court agreed with federal prosecutors that a trader can be guilty of violating insider trading prohibitions even if the insider did not receive a tangible benefit, such as money or property, for passing the tip so long as the trader and insider are friends or relatives.

No bill concerning insider trading appears to have been introduced in the 115th Congress to date. However, several bills, including H.R. 1173, H.R. 1625, and S. 702, were introduced in the 114th Congress before the Supreme Court's *Salman* decision. The *Salman* decision appears not to go as far as these bills would have in prohibiting the acts of trading in securities with inside information and disclosing inside information.

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Introduction

Insider trading in securities may occur when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. Federal statutes have provisions that either specifically forbid insider trading or have been interpreted by courts to prohibit insider trading. This report discusses some of the key statutes as well as regulations issued by the Securities and Exchange Commission (SEC or Commission) to implement the statutes. The report also discusses some of the most pertinent court decisions on insider trading.

Overview of Federal Statutes Related to Insider Trading

Securities Act of 1933

The Securities Act of 1933[1] (1933 Act) makes it illegal to offer or sell securities[2] to the public unless the securities have been registered with the SEC.[3] A registration statement becomes effective 20 days after it is filed with the Commission, unless it is delayed or suspended.[4] Registration under the 1933 Act covers only the securities actually being offered and only for the purposes of the offering in the registration statement. The registration statement consists of two parts: the prospectus, provided to every purchaser of the securities, and Part II, containing information and exhibits that do not have to be provided to purchasers but are available for inspection. Section 7 of the 1933 Act, referring to Schedule A,[5] sets forth the information that must be contained in the registration statement.[6] This schedule requires a great deal of information, such as the underwriters, the specific type of business, significant shareholders, debt and assets of the company, and opinions as to the legality of the stock issue. Section 10(a) of the 1933 Act specifies the information which the prospectus must contain.[7] There are also numerous regulations issued by the Commission which provide additional details about the registration process under the 1933 Act.[8]

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[1] 15 U.S.C. §§ 77a-77aa.

[2] The term "security" is defined very broadly in 15 U.S.C. § 77b(1) as:

> any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[3] 15 U.S.C. § 77e.

[4] *Id*. § 77h(a).

[5] *Id*. § 77aa.

[6] *Id*. § 77g.

[7] *Id*. § 77j(a).

[8] *See, e.g.*, 17 C.F.R. Parts 230, 231, and 239.

Certain transactions and securities are exempted from the registration process. The exempted transactions include private placements, intrastate offerings, and small offerings.[9] Among the exempted securities are government securities, bank securities, and short-term commercial paper; all securities for which it is believed that other, adequate means of government regulation exist.[10]

Securities Exchange Act of 1934

The Securities Exchange Act of 1934[11] (1934 Act) is concerned with several different topics, one of which is the ongoing process of required disclosure by covered publicly traded companies to the investing public through the filing of periodic and updated reports with the Commission.[12] Any issuer[13] that has a class of securities traded on a national securities exchange or, in certain circumstances, has total assets exceeding $10 million and a class of equity securities held of record[14] by 2,000 shareholders or 500 shareholders who are not accredited investors[15] must register with the SEC under the 1934 Act.[16] Every issuer required to register under the 1934 Act must also file periodic and other reports with the SEC.[17] Section 12 of the 1934 Act requires the filing of a detailed statement about the company when the company first registers.[18] Section 13, in turn, requires a registered company to file annual and quarterly reports with the SEC.[19] These reports must contain essentially all material information, financial and otherwise, about the company—information that the investing public would need in making an informed decision about whether to invest in the company. Section 14 contains requirements about proxy solicitation.[20] Some exemptions from these reporting requirements are provided.[21] The Commission has issued extensive regulations to specify information that these reports must provide.[22]

Failure to disclose material information is actionable. For example, Section 18(a) of the Securities Exchange Act grants an express private right of action to investors who have been injured by reliance upon material misstatements or omissions of facts in reports that have been filed with the SEC.[23] Section 10(b) of the 1934 Act,[24] the general antifraud provision, and Rule 10b-5,[25] issued

[9] 15 U.S.C. § 77d.

[10] *Id*. § 77c.

[11] *Id*. §§ 78a-oo.

[12] *Id*. § 78m.

[13] For purposes of this report, an "issuer" is a legal entity that issues publicly traded securities to fund its operations and is required to file material information through annual and other reports with the SEC.

[14] The phrase "held of record" refers to the entity that a company lists in its records as the registered holder of a security.

[15] In general, an "accredited investor" is an institutional investor or an individual with significant financial means and sophisticated investment knowledge. *See* 17 C.F.R. § 230.501.

[16] 15 U.S.C. § 78*l*. As stated earlier, the 1933 Act requires the registration of a particular *offering* of securities. The 1934 Act requires the registration of a *class* of securities.

[17] 15 U.S.C. §§ 78*l*, 78m, and 78n.

[18] *Id*. § 78*l*.

[19] *Id*. § 78m.

[20] *Id*. § 78n.

[21] *Id*. § 78*l*.

[22] *See, e.g.*, 17 C.F.R. Parts 240, 241, and 249.

[23] 15 U.S.C. § 78r(a).

[24] *Id*. § 78j(b).

by the SEC to carry out the statutory fraud prohibition, provide for a cause of action for injuries caused by omissions, misrepresentations, or manipulations of material facts in statements filed with the SEC, as well as in statements other than those filed with the SEC.[26]

One provision in the 1934 Act[27] is specifically designed to discourage insiders in the corporation from taking advantage of their inside information in the trading of the corporation's securities. Section 16 of the 1934 Act[28] places sanctions on insiders who use inside information in making short-swing profits.[29] For purposes of this provision, an insider is defined as any "person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security . . . which is registered . . . or who is a director or an officer of the issuer . . . ."[30] Every person who qualifies as an insider under this definition must file a report with the SEC at the time of the security's registration on a national securities exchange or by the effective date of a filed registration statement or within 10 days after he becomes a beneficial owner, director, or officer.[31] If there has been a change in the ownership of the security or if there has been a purchase or sale of a security-based swap agreement involving the equity security, the insider must file the report before the end of the second business day following the day on which the transaction has been executed.[32]

To prevent the unfair use of inside information, Section 16(b) permits the company or any security holder to sue on behalf of the company to recover any profit that the person realizes from any purchase and sale or sale and purchase of any equity security of the company within a period of less than six months.[33]

Section 10(b) and Rule 10b-5 are used in most cases of insider trading violations, as well as in other kinds of alleged securities fraud. (Some of the major cases are discussed below.) Although Section 10(b) does not refer to specific types of fraud or specific types of insiders, one of its most frequent applications over the years has been to insider trading. The statute states, in relevant part:

> It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. . . .[34]

(...continued)

[25] 17 C.F.R. § 240.10b-5.

[26] *See, e.g., State Teachers Ret. Bd. v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981);*Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977).

[27] 15 U.S.C. §§ 78a *et seq*.

[28] *Id*. § 78p.

[29] "Short-swing profits" are profits from the purchase and sale of a security within six months.

[30] *Id*. § 78p(a)(1).

[31] *Id*. § 78p(a)(2).

[32] *Id*. § 78p(a)(2)(C).

[33] *Id*. § 78p(b).

[34] *Id*. § 78j(b).

Rule 10b-5, mentioned later along with other SEC regulations that focus more specifically on insider trading, is the general SEC rule used in many securities fraud cases. The rule states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[35]

Insider Trading Sanctions Act of 1984

According to the House report on the bill, the Insider Trading Sanctions Act of 1984[36] was enacted because:

> Insider trading threatens . . . markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules. This legislation provides increased sanctions against insider trading in order to increase deterrence of violations.
>
> "Insider trading" is the term used to refer to trading in the securities markets while in possession of "material" information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public.[37]

The 1984 Act provides that, if the Commission believes that any person has bought or sold a security while in possession of material, nonpublic information, the Commission may bring an action in federal district court seeking a civil penalty. The penalty may be up to three times the profit gained or loss avoided.[38]

Insider Trading and Securities Fraud Enforcement Act of 1988

After a number of hearings and considerable debate in the 100th Congress, President Reagan signed the Insider Trading and Securities Fraud Enforcement Act of 1988.[39] This act expanded the scope of civil penalties that may be imposed against officers and directors who fail to take adequate steps to prevent insider trading.[40] Among other things, the 1988 Act also established a

[35] 17 C.F.R. § 240.10b-5.

[36] P.L. 98-376, 98 Stat. 1264 (Aug. 10, 1984) (codified, as amended, in 15 U.S.C. §§ 78a *et seq*.)

[37] H. REPT. 98-355, at 2 (1984).

[38] 15 U.S.C. § 78u-1(a)(2).

[39] P.L. 100-704, 102 Stat. 4677 (Nov. 19, 1988) (codified, as amended, in a number of provisions of the federal securities laws).

[40] 15 U.S.C. § 78u-1(a)(3) imposes on a person controlling the violator a penalty of the greater of $1 million or three times the profit gained or loss avoided. Limitations on the liability of controlling persons may be found at 15 U.S.C. § 78u-1(b).

private right of action against the inside trader for buyers or sellers of securities who traded contemporaneously with the insider.[41]

Stop Trading on Congressional Knowledge (STOCK) Act of 2012

The STOCK Act,[42] signed into law on April 4, 2012, affirms that insider trading prohibitions apply to Members of Congress, congressional staff, and other federal officials.[43]

The STOCK Act also has provisions concerning financial disclosure reporting requirements for legislative and executive branch officials.[44]

Examples of Penalties for Insider Trading

There are both civil and criminal penalties[45] for insider trading, and the penalties can vary depending on what statutes a trader is found guilty of violating. The 1934 Act sets out the civil penalties for engaging in securities transactions while in possession of material nonpublic information.[46] As mentioned above, the penalty can be up to three times the profit gained or loss avoided. However, willful violations of other provisions, such as Section 10(b), the general antifraud securities provision, may result in other significant penalties, including fines up to $5 million and/or imprisonment for up to 20 years for individuals and fines up to $25 million for businesses.[47]

Selected Regulations

As stated above, SEC Rule 10b-5, which implements Section 10(b) of the Securities Exchange Act, is apparently the most frequently used SEC rule in lawsuits that charge violations of insider trading prohibitions. However, other SEC rules, some of which specifically target insider trading, are also important.

Rule 10b5-1 prohibits trading "on the basis of" material nonpublic information.[48] This rule states that one of the proscribed activities under Section 10(b) and Rule 10b-5 is securities trading "on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed" to the issuer of the security, shareholders of the issuer, or another who is the source of the inside information.[49] The regulation defines "on the basis of" to have a kind of knowledge requirement:

[41] 15 U.S.C. § 78t-1.

[42] P.L. 112-105, 126 Stat. 291 (Dec. 3, 2012) (codified in provisions and notes of several titles of the U.S. Code, particularly in Titles 5 and 15).

[43] *See* 15 U.S.C. § 78u-1(g) for duty of Members and employees of Congress and 15 U.S.C. § 78u-1(h) for duty of other federal officials.

[44] For more information on the STOCK Act, see CRS Report R42495, *The STOCK Act, Insider Trading, and Public Financial Reporting by Federal Officials*, coordinated by (name redacted)

[45] The SEC typically seeks the civil penalties, and the Department of Justice typically seeks the criminal penalties.

[46] *See, e.g.,* 15 U.S.C. § 78u-1.

[47] *Id*. § 78ff.

[48] 17 C.F.R. § 240.10b5-1.

[49] *Id*. § 240.10b5-1(a).

> [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 the purchase or sale.[50]

Various affirmative defenses are allowed under the rule, such as the alleged violator's demonstrating that he had entered into a binding contract to buy or sell the security, had instructed another person to buy or sell the security for his account, or had adopted a written plan for trading securities *before* becoming aware of the material nonpublic information.[51]

Rule 10b5-2 sets out duties of trust or confidence in insider trading cases based on the misappropriation of inside information.[52] The misappropriation theory of insider trading is a fairly recent development in securities law. Under the classical theory of insider trading, a corporate insider is prohibited from trading that corporation's securities if the trade is based on inside information and the trader has a fiduciary duty to the corporation's shareholders. In contrast to classical insider trading, the misappropriation theory may hold liable a person who is not actually a corporate insider but has instead been provided inside information in confidence and who breaches a fiduciary duty to the source of the information in order to gain profit or avoid loss in the securities market. Rule 10b5-2 sets out examples of what is meant by "duties of trust or confidence." Such duties include a person's agreement to maintain the disclosed information in confidence; a person's history with the discloser of the inside information indicating an expectation that the recipient of the information will keep the information in confidence; and a person's receiving information from a spouse or close relative, unless the recipient can show that he neither knew nor should have reasonably known or agreed that he would keep the information confidential.[53]

Regulation FD is another SEC rule that could prohibit insider trading.[54] Regulation FD addresses selective disclosure. It provides that, when an issuer or any person acting on behalf of an issuer discloses material nonpublic information to certain enumerated persons (typically, securities market professionals and holders of the securities), that issuer or person acting on behalf of the issuer must disclose the information to the public. This disclosure must be made simultaneously with the intentional disclosure to the enumerated persons or as promptly as possible after the disclosure, in the case of a non-intentional disclosure to the enumerated persons.[55]

Selected Decisions Illustrating the Use of Section 10(b) and Rule 10b-5 to Prosecute Insider Trading Violations

There are numerous cases and administrative proceedings in which Section 10(b) and Rule 10b-5 have been used to prosecute insider trading violations. The following is a brief discussion of some of the most notable of these cases and proceedings.

[50] *Id*. § 240.10b5-1(b).

[51] *Id*. § 240.10b5-1(c).

[52] *Id*. § 240.10b5-2.

[53] *Id*. § 240.10b5-2(b).

[54] *Id*. §§ 243.100-243.103.

[55] *Id*. § 243.100(a).

Strong v. Repide

Although it was decided 25 years before the enactment of the Securities Exchange Act, *Strong v. Repide*[56] illustrates that the common law rule of fiduciary duty, which is arguably the idea driving the case law imposing penalties for insider trading, prohibits a company insider from profiting from knowledge that he alone has about the company. According to the Court, a corporate director may not generally have an obligation of a fiduciary nature to disclose to a shareholder the director's knowledge affecting the value of the shares.[57] However, the Court believed that such a duty can exist in special cases and did, in fact, exist in this case because the fraudulent concealment of the identity of a stock purchaser would have affected the value of the stock in question. To wit, the Court stated: "Concealing his identity when procuring the purchase of the stock, by his agent, was in itself strong evidence of fraud on the part of the defendant."[58] The Court went on to state: "The case before us seems a plain one for holding that, under the circumstances detailed, there was a legal obligation on the part of the defendant to make these disclosures."[59]

In the Matter of Cady Roberts & Co.

In an administrative disciplinary proceeding, *In the Matter of Cady Roberts & Co.*,[60] the SEC held that Section 10(b) and Rule 10b-5 prohibited insider trading by a person, in this case a broker-dealer, who may not be within the corporation whose stock has been traded, but who has received privileged information about the corporation from someone within the corporation.

The case concerned a partner in a brokerage firm who, after receiving a message from a director of the Curtiss-Wright corporation stating that the board of directors had voted to cut the dividend, placed orders to sell some Curtiss-Wright stock before news of the dividend cut was disseminated to the public.[61] The broker was not a corporate insider (i.e., he was not an officer, director, or significant shareholder). However, the SEC held that the broker's conduct violated at least clause (3) of the above-quoted SEC Rule 10b-5 in that the conduct operated as a fraud or deceit on the purchasers and, thus, there was no need to decide the scope of clauses (1) and (2).[62] In determining that there was a violation of clause (3), the SEC appears to have found fraud committed on both the company and on persons on the other side of the market, noting:

> Analytically, the obligation [not to trade on inside information] rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus, it is our task here to identify those persons who are in a special relationship with a

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[56] 213 U.S. 419 (1909).

[57] *Id*. at 431.

[58] *Id.* at 432-33.

[59] *Id*. at 434.

[60] 40 SEC 907 (1961).

[61] *Id.* at 908-09.

[62] *Id.* at 913.

> company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.[63]

The SEC rejected the broker's argument that the obligation to disclose material information exists only in situations involving face-to-face dealings on the grounds that:

> [i]t would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions. If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of the information.[64]

Thus, it appears that this case established that Section 10(b) and Rule 10b-5 extend beyond officers, directors, and major stockholders to others (in this case, a broker-dealer) who receive information from a corporate source. Later cases, discussed below, appear to support this view.

Securities and Exchange Commission v. Texas Gulf Sulphur

Securities and Exchange Commission v. Texas Gulf Sulphur,[65] a 1968 decision by the U.S. Court of Appeals for the Second Circuit (Second Circuit), effectively supported the SEC's ruling in *Cady Roberts* by suggesting that anyone in possession of inside information must either publicly disclose the information or not trade the particular stock until the information becomes public. According to the Second Circuit:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[66]

Chiarella v. United States

The U.S. Supreme Court appears, however, in 1980 to have somewhat modified the rule of *Texas Gulf Sulphur* by indicating that, for a fraud to be actionable under Rule 10b-5, there must be a duty to disclose arising from a relationship of trust and confidence between parties to the transaction.[67] *Chiarella v. United States* involved an alleged violation of Rule 10b-5 by an employee of a financial printer.[68] The employee, who was involved in printing materials related to corporate takeover bids, deduced the names of the target companies from information contained in documents delivered to the printer by the acquiring companies.[69] Without disclosing his knowledge, the employee purchased stock in the target companies and sold the shares immediately after the information was made public, realizing a profit of $30,000.[70] The Second Circuit held that a violation of Rule 10b-5 had occurred and convicted the employee for willfully

[63] *Id.* at 912.

[64] *Id*. at 914.

[65] 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[66] *Id*. at 848.

[67] 445 U.S. 222 (1980).

[68] *Id*.

[69] *Id*. at 224.

[70] *Id*.

failing to inform the sellers of the target company securities that he knew of an imminent takeover bid that would increase the value of their stock.[71]

The Supreme Court reversed.[72] According to the Court, an employee in this situation did not have a duty to disclose the information.[73] He was not a corporate insider, and he received no confidential information.[74] In addition, no duty arose from the relationship between the printing company employee and the sellers of the target companies' securities.[75] The Court held that a duty to disclose under Section 10(b) and Rule 10b-5 does not arise from the mere possession of nonpublic market information.[76]

Dirks v. Securities and Exchange Commission

Dirks v. Securities and Exchange Commission[77] could be seen to have gone a little further than *Chiarella* by indicating that persons not within a corporation who possess inside information are not always liable when trading on this information. The case involved an officer of a broker-dealer who specialized in providing investment analysis of insurance company securities to institutional investors.[78] He received information that the assets of an insurance company were greatly overstated because of fraudulent corporate practices and that regulatory agencies had not acted on charges made by company employees.[79] Although the officer of the broker-dealer did not himself trade the stock, some of his customers did, based on information they received from him.[80] The price of the stock fell, and the SEC began investigations, eventually finding that the officer had violated Rule 10b-5 by repeating the allegations of fraud to investors who later sold their stock in the insurance company.[81] However, because of his role in uncovering the fraud, he received only a censure from the SEC.[82]

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[71] *See* United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978).

[72] 445 U.S. 222 (1980).

[73] *Id*. at 235.

[74] *Id*. at 236.

[75] *Id*.

[76] *Id*. at 235-37. Concurring and dissenting opinions in *Chiarella* suggest that, if the misappropriation theory of securities fraud had been presented, the employee might have been found guilty under it. Chief Justice Burger opined that the employee's conviction should have been affirmed because the "evidence shows beyond all doubt that Chiarella, working literally in the shadows of the warning signs [stating the employer's confidentiality policy] in the printshop misappropriated—stole, to put it bluntly—nonpublic information entrusted to him in the utmost confidence." *Id*. at 245 (Burger, C.J., dissenting). Although Justice Brennan disagreed with the Chief Justice's view of the evidence, he agreed that a "person violates section 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." *Id.* at 239 (Brennan, J., concurring). Justice Blackmun, with whom Justice Marshall joined, wrote that, even without resting Chiarella's conviction on a misappropriation theory, he should have been convicted because he had "purloined" information. *Id*. at 246-52 (Blackmun, J., dissenting). Justice Stevens, who concurred in the opinion of the Court, wrote separately, emphasizing the "fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future." *Id*. at 238 (Stevens, J., concurring).

[77] 463 U.S. 646 (1983).

[78] *Id.* at 648.

[79] *Id*. at 649.

[80] *Id*. at 650.

[81] *Id.* at 651.

[82] *Id.* at 652.

On appeal, the Supreme Court held that no violation of Section 10(b) had occurred in this case.[83] In order to find a violation of Section 10(b) by a corporate insider, two elements are necessary, according to the Court: (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (2) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.[84] However, the duty arises from a fiduciary relationship, in the Court's view.[85] In addition, there must be manipulation or deception to bring about a breach of the fiduciary duty.[86] Here, according to the Court, the insider did not trade on the inside information, nor did he make secret profits.[87] For the officer of the broker-dealer to have a duty to disclose inside information or abstain from trading, the officer must have a fiduciary duty and must have breached that fiduciary duty.[88] The officer in this case had no duty to abstain from using inside information because he had no pre-existing fiduciary duty to the insurance company's shareholders.[89] Therefore, he did not violate Section 10(b) or Rule 10b-5.[90]

Carpenter v. United States

Seven years after *Dirks*, the Supreme Court decided another landmark securities case, *Carpenter v. United States*.[91] In this case, although the Court did not find the defendants guilty under the misappropriation theory of securities fraud, it did discuss the issue.[92] The case arose when R. Foster Winans, a former writer for the *Wall Street Journal's* "Heard on the Street" column, and others were charged with violations of Section 10(b) and Rule 10b-5.[93] They were also charged with violating the federal mail and wire fraud statutes[94] and conspiracy.[95] In researching information to be used in his column, Winans interviewed corporate executives, but none of the information he obtained was said to have involved corporate inside information.[96] Because of its perceived quality and integrity, the column had the potential for affecting the prices of the stocks that it discussed.[97]

The *Wall Street Journal's* official policy was that, before publication, the contents of the column were its confidential information.[98] However, despite being familiar with this rule, Winans agreed to give Peter Brant and Kenneth Felis, both employees of Kidder Peabody, advance information about the columns.[99] Brant, Felis, and another person, David Clark, bought and sold stocks based

[83] *Id.* at 667.

[84] *Id.* at 660.

[85] *Id.* at 664.

[86] *Id.* at 663.

[87] *Id.* at 665.

[88] *Id*. at 666.

[89] *Id.*

[90] *Id*.

[91] 484 U.S. 19 (1987).

[92] *Id.* at 23-24.

[93] *Id.* at 93.

[94] 18 U.S.C. §§ 1341. 1343.

[95] *Id*. § 371.

[96] 484 U.S. at 19, 22-23.

[97] *Id.* at 22.

[98] *Id*. at 23.

[99] *Id*.

on the probable effects of the information that would later appear in Winans's columns.[100] The profits from these trades over a four-month period amounted to $690,000.[101] Kidder Peabody's compliance department eventually noticed correlations between the Winans columns and the Clark and Felis accounts.[102] The SEC began an investigation; Winans and his roommate, David Carpenter, revealed the scheme, and indictments followed.[103]

The Second Circuit held that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information.[104] It found that this misappropriation had violated Section 10(b) and Rule 10b-5 because Winans's deliberate breach of his duty of confidentiality was a fraud and deceit on the newspaper.[105] The Second Circuit also held that Winans had fraudulently misappropriated property within the meaning of the mail and wire fraud statutes.[106]

In reviewing the Second Circuit's decision, the Supreme Court was evenly divided concerning these convictions under the securities laws and therefore affirmed, by a vote of four to four, the Second Circuit's opinion.[107] The Court did not elaborate on whether Winans's activities violated the securities laws. It also affirmed the Second Circuit's judgment with respect to the mail and wire fraud convictions without elaboration.[108]

United States v. O'Hagan

Ten years later, in *United States v. O'Hagan*, the Supreme Court legitimated the misappropriation theory of securities fraud by finding James O'Hagan guilty of violating Section 10(b) and Rule 10b-5.[109] O'Hagan was a partner in a Minneapolis law firm that represented Grand Metropolitan PLC (Grand Met), a company based in London. Grand Met was interested in acquiring Pillsbury Company (Pillsbury).[110] O'Hagan purchased call options for and stock in Pillsbury after he learned of Grand Met's interest.[111] After the tender offer was publicly announced, Pillsbury stock immediately rose.[112] O'Hagan exercised his options and liquidated his stock, realizing a profit of over $4 million.[113]

The SEC indicted O'Hagan on 57 counts, including securities fraud under Section 10(b) and Rule 10b-5.[114] A jury convicted him on all of the counts,[115] but the U.S. Court of Appeals for the Eighth Circuit (Eighth Circuit) reversed, holding, among other things, that the misappropriation theory is

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[100] *Id.*

[101] *Id.*

[102] *Id.*

[103] *Id.* at 22-24.

[104] United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

[105] *Id.* at 1031.

[106] *Id.* at 1034-35.

[107] Because of Justice Powell's retirement, there were only eight Justices on the Court at the time of the decision.

[108] 484 U.S. at 25-26.

[109] 521 U.S. 642 (1997).

[110] *Id.* at 647.

[111] *Id.* at 647-48.

[112] *Id.* at 647.

[113] *Id.* at 648.

[114] *Id.* at 648-49.

[115] *Id.* at 649.

inconsistent with Section 10(b).[116] The Supreme Court subsequently reversed the Eighth Circuit.[117]

In its decision with respect to the misappropriation theory, the Court found that O'Hagan's fiduciary status and his willful intent to violate that status were sufficient to find him guilty of misappropriating confidential information:

> [T]he fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information . . . . A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.[118]

United States v. Newman

A decision late in 2014 by the Second Circuit recently brought increased attention to the issue of insider trading. In this decision, *United States v. Newman*, the Second Circuit overturned two high-profile convictions for insider trading.[119] The Second Circuit held that the evidence against Todd Newman and Anthony Chiasson, who were analysts for hedge funds and investment funds, could not sustain a guilty verdict.[120] According to the Second Circuit, the government had not adequately shown that the alleged insiders, who were employees of publicly traded technology companies, received personal benefits for providing information to Newman and Chiasson.[121] In addition, according to the court, the government had not presented evidence that the defendants knew that they were trading on inside information obtained from insiders who were violating their fiduciary duties.[122] According to some commenters, this decision "upended the government's campaign" against insider trading because it held that the government must show that the insiders, who in this case allegedly passed on inside information, received personal benefits, presumably of a tangible nature, in order to obtain conviction.[123] Although the federal government sought review of the Second Circuit's decision in *Newman* from the Supreme Court,[124] the High Court declined to hear the case.[125]

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[116] 92 F.3d 612 (8th Cir. 1996).

[117] 521 U.S. 642 (1997).

[118] *Id*. at 656.

[119] 773 F.3d 438 (2d Cir. 2014).

[120] *Id*. at 442.

[121] *Id.* at 449-52.

[122] *Id.* at 451-53.

[123] Ben Protess & Matthew Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, DEALBOOK (Dec. 10, 2014), https://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions.

[124] Alexandra Stevenson & Matthew Goldstein, *U.S. Asks Supreme Court to Review Insider Trade Ruling*, N.Y. TIMES (July 30, 2015), https://www.nytimes.com/2015/07/31/business/dealbook/us-asks-supreme-court-to-review-insider-trading-ruling.html?_r=1.

[125] 136 S. Ct. 242 (2015).

Salman v. United States

As mentioned above, the Second Circuit's *Newman* decision required proof of a tangible benefit. However, in its 2015 decision in *United States v. Salman*, the Ninth Circuit found that it is enough to show that the insider and the tippee (the one who receives inside information) share a close family relationship.[126] The Ninth Circuit took specific note of the Supreme Court's statement in *Dirks v. Securities and Exchange Commission*, discussed above, that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist *when an insider makes a gift of confidential information to a trading relative or friend*."[127] Salman appealed the Ninth Circuit's decision to the Supreme Court, which granted review.

On December 6, 2016, the U.S. Supreme Court in *Salman v. United States* sided with the Ninth Circuit, unanimously upholding the conviction of Bassam Yacoub Salman for insider trading on tips that he had received from his brother-in-law.[128] The Court agreed with federal prosecutors that a trader can be guilty of violating insider trading prohibitions even if the insider did not receive a tangible benefit, such as money or property, for passing the tip so long as the trader and insider are friends or relatives. In so doing, the Court resolved a difference of opinion between the U.S. Courts of Appeals for the Second and Ninth Circuits concerning what the government must prove in prosecuting insider trading cases.

In its *Salman* decision, the Supreme Court held that the Ninth Circuit had properly applied *Dirks* in affirming Salman's conviction.[129] The Court first looked to the trial court evidence that had established there were close family and friendship relationships among Salman and others involved in the case.[130] With these close relationships in mind, the Court found that *Dirks* easily resolved the issue at hand, reiterating the *Dirks* Court's statement that "a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or 'makes a gift of confidential information to a trading relative or friend.'"[131]

According to the Court in *Salman*, when an individual disclosed confidential information to his brother with the expectation that his brother would trade on it, that individual breached his fiduciary duty to his employer, Citigroup, and its clients.[132] Then, when Salman, as a tippee, traded on this information, knowing that it had been improperly disclosed, he too breached a duty of trust and confidence to Citigroup and its clients.[133] According to the Court, it is not necessary that the tipper receive something of a tangible nature; rather, the breach of the fiduciary duty to a trading relative or friend suffices to meet the standard laid out in *Dirks*.[134]

[126] 792 F.3d 1087 (9th Cir. 2015).

[127] *Id.* at 1093 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983) (emphasis added)).

[128] —U.S.—, 137 S. Ct. 420 (2016).

[129] *Id*.

[130] *Id.* at 423-25.

[131] *Id*. at 428.

[132] *Id.* at 428-29.

[133] *Id*. at 429.

[134] *Id.* at 428-29.

Congressional Interest in Insider Trading

No bills concerning insider trading appear to have been introduced, to date, in the 115th Congress. However, before the Supreme Court's *Salman* decision, at least three bills were introduced in the 114th Congress in an attempt to prevent the type of securities trading that would appear to have been allowed under the *Newman* decision.

Two of the bills would have amended Section 10, the general antifraud provision of the Securities Exchange Act, and one of the bills would have added a new provision, Section 16A, to the Securities Exchange Act.

H.R. 1173, 114th Congress, referred to the House Committee on Financial Services, would have added a new subsection (d) to Section 10. This new subsection would have held a person liable for violating the insider trading prohibition laid out in Section 2(a) of the bill if the person intentionally disclosed "without a legitimate business purpose" information he knew or should have known is material information and inside information. The bill would have defined "should know" to include various factors, such as the person's financial sophistication, knowledge of and experience in financial matters, position in the company, and assets under management.

H.R. 1625, 114th Congress, also referred to the House Committee on Financial Services, would have added a new Section 16A to the Securities Exchange Act. This section would have prohibited the trading of securities if a person had material nonpublic information about the securities or knew or recklessly disregarded that the information was wrongfully obtained or that the securities transaction would involve a wrongful use of the information. The section would also have prohibited a person from communicating material nonpublic information about securities to others if: (1) others engaged in securities transactions based on the communication and (2) the securities transactions were reasonably foreseeable. The standard for the wrongfulness of a communication is based on information that has been obtained by activities such as theft, breach of a fiduciary duty, or violation of a federal law protecting computer data. Specific knowledge of how the information was obtained is not necessary for a violation so long as the person trading was aware or recklessly disregarded that the information was wrongfully obtained or communicated. The bill would also have authorized the SEC to provide exemptions from these prohibitions by rule if the exemptions were not inconsistent with the purposes of the section.

S. 702, 114th Congress, referred to the Senate Committee on Banking, Housing, and Urban Affairs, would have added a new subsection (d) to Section 10 of the Securities Exchange Act. This new subsection would have prohibited securities transactions on the basis of material information that a person knew or had reason to know was not publicly available. It also would have prohibited knowingly or recklessly communicating information that was not publicly available if it was reasonably foreseeable that the communication was likely to result in a securities transaction. "Not publicly available" would have been defined in such a way that it would not have included information that a person had independently developed from publicly available sources. The SEC would also have been authorized to provide for exemptions by regulations if it determined that such regulations were necessary or appropriate in the public interest and consistent with the protection of investors.

The Supreme Court's decision in *Salman* may accomplish at least part of the goals of the legislation proposed in the 114th Congress. However, the *Salman* decision does not appear to go as far as the bills in prohibiting the act of trading in securities with inside information and disclosing inside information. *Salman* addressed the issue of whether it is necessary for a tipper to receive something of a tangible nature when providing inside information to a trading relative or friend. However, the bills are not limited to relatives and friends; instead, they appear to prohibit in a broad way the trading of securities by any person who knows or should know that he possesses inside information.

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