# NOTES

# Insider Trading and the Primacy of the Legislature: *Beyond Two* Martomas

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## ABSTRACT

*When the U.S. Supreme Court adopted the "personal benefit" requirement for insider trading liability, the Court explained that the objective test would help courts to identify improper disclosures of material nonpublic information. In* Dirks v. SEC*, the Court focused the inquiry on whether the tipper disclosed the confidential information for a personal gain, and it listed several examples that would create an inference of a personal benefit to the insider. A chief basis for the requirement was to draw a clear line between permissible and impermissible disclosures. After all, the Court did not want to render impermissible the pursuit itself of informational advantage, especially because securities analysts routinely "ferret out" nonpublic information to make trading judgments, and this is healthy for the market in the aggregate. But the personal benefit requirement has been stretched and contorted since its inception in 1983. And many contend that it has been (or should be) rendered obsolete. Just in the past six years, the Second Circuit has changed its interpretation of the personal benefit requirement three times—in only two cases. In a rare and curious move in* United States v. Martoma*, the Second Circuit affirmed the court below in one opinion, only to amend it with another opinion—using a different rationale—several months later. After* Martoma II*, the original personal benefit requirement seems to have been rendered functionally obsolete in the Second Circuit.*

*Recent scholarship has criticized the state of insider trading law, and some have proposed a number of new tests. In this Note, however, I argue that the Second Circuit's doctrinal shifts illustrate that the insider trading doctrine needs reform. Specifically, I argue that statutory language defining the insider trading prohibition is warranted. On the one hand, a regime that authorizes both civil and criminal liability for insider trading, despite uncertainty as to what circumstances may elicit prosecution, runs up against the rule of legality and other rule of law principles, such as notice, predictability, and legitimacy. But, on the other hand, fairly obvious instances of improper trading escape*

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*prosecution under the doctrine altogether. For instance, hedge funds rely on obtaining "edge" from nonpublic information, sometimes provided from illegal tipping chains. But prosecutors tend to avoid cases against remote tippees. The Second Circuit's subjective inquiry after* Martoma II *may make it easier to prosecute those involved in tipping chains. Whether or not this is a positive outcome, legislation should define a manageable and comprehensive standard for prosecutors in all jurisdictions to follow.*

*While some have argued that data on "real" insider trading—or, the cases that enforcers actually bring—detract from the proposition that new legislation is required, in this Note I emphasize that uncertainty about the outer bounds of the doctrine leaves enforcers both with a lack of clarity about what facts will lead to a prevailing prosecution as well as an unacceptable degree of discretion to employ in isolated cases. For prosecutors, market participants, and analysts especially, this uncertainty takes its toll. But it need not. The passage of long-awaited legislation could easily clarify this common-law crime.*

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## INTRODUCTION

The insider trading case against S.A.C. Capital Advisors portfolio manager, Mathew Martoma, sparked no shortage of intrigue in the popular press.[1] The indictment against Martoma, and the trial that followed, illustrated a vivid story of greed and the exploitation of market-moving, confidential information to reap millions of dollars in profit[2]—what is known as the "most lucrative insider-trading scheme in history."[3] In short, Martoma arranged for paid consultations with a doctor on the clinical trial team of an experimental Alzheimer's drug to obtain material nonpublic information ("MNPI").[4] He learned of the drug's performance weaknesses ahead of public announcement and executed trades through his hedge fund that resulted in $275 million in profit.[5] Ultimately, Martoma was convicted of two counts of securities fraud and one count of conspiracy, ordered to forfeit $9.4 million (the size of his bonus), and sentenced to 9 years in prison.[6]

But the Martoma case is significant beyond its factual precedence. On appeal, the case shepherded yet another shift in the law of insider trading, which has resulted in a further weakening of the "personal benefit requirement" that the Supreme Court introduced in *Dirks v. SEC*.[7] In *Dirks*, the Court held that a recipient of MNPI (or "tippee") can be liable for trading on the information only when the provider of the information (or "tipper") breached a fiduciary duty to the shareholders of the corporation and the tippee knew or should have known about it.[8] And the test to understand when the tipper breaches his duty is "whether the [tipper] personally will benefit, directly or indirectly, from his disclosure."[9] To find a personal benefit, lower courts must consider objective facts and circumstances.[10] Since the Court decided *Dirks*, the personal benefit requirement has been the subject of a considerable degree of controversy.[11]

[1] *See, e.g.*, Patrick Radden Keefe, *The Empire of Edge*, NEW YORKER (Oct. 6, 2014), https://www.newyorker.com/magazine/2014/10/13/empire-edge [https://perma.cc/K8NB-5V3R]; *see also* Jim Forkin, *Mathew Martoma Sentenced to 9 Years, Will Appeal*, CNBC (Sept. 8, 2014, 6:39 P.M.), https://www.cnbc.com/2014/09/08/martoma-ordered-to-forfeit-938-million.html [https://perma.cc/G7U6-QQBH]; Christopher M. Matthews, *Martoma Sentenced to Nine Years in Insider-Trading Case*, WALL ST. J. (Sept. 8, 2014, 7:18 P.M.), https://www.wsj.com/articles/martoma-sentenced-to-nine-years-1410208845 [https://perma.cc/8RUN-WAGV]; Alexandra Stevenson, *Mathew Martoma's Insider Trading Conviction Is Upheld*, N.Y. TIMES: DEALBOOK (Aug. 23, 2017), https://www.nytimes.com/2017/08/23/business/dealbook/mathew-martoma-insider-trading-conviction-upheld.html [https://perma.cc/P52A-LH8C].

[2] *See* Indictment, United States v. Martoma, No. 12-cr-00973 (S.D.N.Y. Jan. 9, 2014), ECF No. 7.

[3] Keefe, *supra* note 1.

[4] United States v. Martoma (*Martoma II*), 894 F.3d 64, 68–69 (2d Cir. 2018).

[5] *Id.* at 69–70.

[6] *Id.* at 70; *see also* Matthews, *supra* note 1; Stevenson, *supra* note 1.

[7] 463 U.S. 646 (1983).

[8] *Id.* at 660.

[9] *Id.* at 662.

[10] *Id.* at 664.

[11] *See, e.g.*, Jonathan D. Glater, *Insiders, Outsiders, & Fair Access: Identifying Culpable Insider Trading*, 83 BROOK. L. REV. 1393, 1394 (2018) (commenting on the obsolescence of the personal benefit test as a "doctrinal contortion"); Michael D. Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519, 524–525 (2017) (noting that the personal benefit test was an "imperfect

On appeal before the Second Circuit, Martoma challenged his conviction and argued that in light of the court's disposition of an intervening case—*United States v. Newman*[12]—his jury had been improperly instructed regarding the personal benefit standard.[13] To that end, Martoma pointed to restrictive language in *Newman* that suggested a "meaningfully close personal relationship" between a tipper and tippee is required in order to show that a tipper received a personal benefit from providing inside information as a gift to a tippee.[14] Still, a majority of the panel affirmed his conviction, and its initial opinion explained that all the government needs to show in "gifting" cases is that the tipper disclosed the information with "the expectation that the recipient would trade on it."[15] Moreover, the panel suggested that another intervening case before the Supreme Court—*Salman v. United States*[16]—undermined and overruled *Newman*'s "meaningfully close personal relationship" requirement, which signified no need for en banc review to decide Martoma's case.[17] But several months later, the majority receded from its initial rationale and issued an amended opinion affirming Martoma's conviction on a different basis.[18]

In *Martoma II*, Chief Judge Katzmann reinterpreted *Newman* instead of overruling it.[19] The *Dirks* Court provided numerous examples that would illustrate a personal benefit accrued to the tipper,[20] and in the majority's view, evidence of the tipper's "intention to benefit" the tippee can meet the personal benefit

effort to balance four different . . . rationales for determining when a selective disclosure should trigger insider trading liability" and arguing that a personal benefit "should no longer be a required element"); Donna M. Nagy, *Beyond* Dirks*: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1, 7 (2016) (arguing that four developments in corporate and securities law "pave the way for a clearer doctrine . . . , whether or not [a tipper's] breach [of fiduciary duty] resulted in a personal benefit to the tipper"); Katherine Drummonds, Note, *Resuscitating* Dirks: *How the* Salman *Gift Theory of Tipper-Tippee Personal Benefit Would Improve Insider Trading Law*, 53 AM. CRIM. L. REV. 833, 835 (2016) (arguing that the Ninth Circuit's "gift theory" of personal benefit will improve prosecutorial discretion); A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 859 (2015); Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 211 (2006) (noting that "the lower courts' expansive application of the *Dirks* personal benefit and tippee knowledge requirements have led to the de facto demise of *Dirks*"); Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 268 (2003) (arguing that all district courts should apply the personal benefit test in cases brought under the misappropriation theory, just as under the classical theory, of tipper-tippee liability); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 213–14 (1991) (discussing the personal benefit requirement); Laurie Ann Black et al., Dirks v. SEC*: A Gain for Dirks, A Loss for the Market*, 35 MERCER L. REV. 981, 997 (1984) (criticizing the personal benefit test as simultaneously over- and under-inclusive).

[12] 773 F.3d 438 (2d Cir. 2014).

[13] United States v. Martoma (*Martoma I*), 869 F.3d 58, 65 (2d Cir. 2017).

[14] *Id.*

[15] *Id.* at 70.

[16] 137 S. Ct. 420 (2016).

[17] *Martoma I*, 869 F.3d at 69.

[18] United States v. Martoma (*Martoma II*), 894 F.3d 64 (2d Cir. 2018).

[19] *See id.*

[20] Dirks v. SEC, 463 U.S. 646, 664 (1983).

requirement on its own.[21] Furthermore, the court isolated *Newman*'s meaningfully-close-personal-relationship requirement to the gift theory, and it deemed the "intention to benefit" basis of meeting the personal benefit requirement unaffected by *Newman*.[22] Judge Pooler dissented in both *Martoma I*[23] and *Martoma II*.[24] In the latter, she explained how the majority's test would undermine the *Dirks* directive to consider objective facts and circumstances in finding a personal benefit.[25] For Judge Pooler, the intention-based test creates problems because it allows prosecutors to meet the personal benefit test without demonstrating that the tipper actually benefits from the disclosure.[26] Moreover, the origins of the majority's test are in "derogation of circuit precedent"[27]—the panel overruled *Newman* and rewrote the doctrine without the proper authority to do so.[28]

The Second Circuit's new subjective test renders the objective personal benefit requirement functionally obsolete. Not only is the Second Circuit's ultimate disposition of *United States v. Martoma* contrary to circuit and Supreme Court precedent, but also it reveals results-oriented reasoning that introduces greater uncertainty into the legal doctrine. The majority's shift in *Martoma II* poses concerns about the rule of law and, specifically, the principles of notice, predictability, and legitimacy. While the new standard may make it easier to pursue insider trading charges,[29] the doctrine's needless uncertainty has consequences for market participants, defendants, and enforcers alike.

This Note examines the Second Circuit's decisions in *United States v. Martoma* to illustrate why Congress should define an insider trading prohibition by statute. Part I provides the history and doctrinal development of insider trading law, and it examines recent judicial shifts in greater detail. Part II critiques the Second Circuit's decisions in *United States v. Martoma*. It discusses the majority's error, explains how the court's resolution introduces substantial uncertainty into the doctrine, and suggests the consequences that should be expected. Part III argues that legislation is warranted, and it notes that, ultimately, a broad coalition of actors supports a statutory prohibition on insider trading,[30] even though the

[21] *Martoma II*, 894 F.3d at 76.

[22] *Id.* at 78.

[23] *See Martoma I*, 869 F.3d at 75–82 (Pooler, J., dissenting).

[24] *See Martoma II*, 894 F.3d at 80–88 (Pooler, J., dissenting).

[25] *Id.* at 83–84.

[26] *See id.*

[27] *Id.* at 80.

[28] *See id.*

[29] *See* Peter J. Henning, *How a Ruling on Insider Trading Could Affect the Chris Collins Case*, N.Y. TIMES: DEALBOOK (Aug. 28, 2018), https://www.nytimes.com/2018/08/28/business/dealbook/how-a-ruling-on-insider-trading-could-affect-the-chris-collins-case.html [https://perma.cc/9YKX-9D9V] (noting that the intention to benefit test of *United States v. Martoma* "made life a bit easier for" prosecutors and SEC enforcers).

[30] *See, e.g.*, John P. Anderson, *Insider Trading and the Myth of Market Confidence*, CLS BLUE SKY BLOG (Oct. 10, 2018), http://clsbluesky.law.columbia.edu/2018/10/10/insider-trading-and-the-myth-of-market-confidence/ [https://perma.cc/4QMF-YWSS]; Preet Bharara & Robert J. Jackson, Jr., Opinion, *Insider Trading Laws Haven't Kept Up with the Crooks*, N.Y. TIMES (Oct. 9, 2018), https://www.

exact contours of any proscription remain disputed.[31] The Note concludes with an acknowledgement of its own shortcomings—while a specific Rule 10b-5 enforcement framework is not explored and defended in depth, any statutory insider trading prohibition must clarify the personal benefit required to create an inference of a tipper's wrongful disclosure.[32] To that end, this Note shares some brief thoughts about the U.S. House of Representative's recent passage of the Insider Trading Prohibition Act of 2019.

## I. INSIDER TRADING ORTHODOXY AND RECENT SHIFTS

### A. *Doctrinal Foundation and the Classical Theory of Liability*

The prohibition on insider trading can trace its origins to § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 (1942), promulgated thereunder.[33] Generally, § 10(b) grants the Securities and Exchange Commission ("SEC") rulemaking authority to prohibit "any manipulative or deceptive device or contrivance" and makes the use of those devices illegal.[34] Rule 10b-5—the SEC's first exercise of this authority[35]—prohibits anyone from employing a scheme to defraud, making an untrue statement or omitting a statement of material fact, or engaging in fraud or deceit in connection with the purchase or sale of a security.[36] Nowhere in § 10(b) or Rule 10b-5, however, is there any discussion of what constitutes insider trading.[37]

nytimes.com/2018/10/09/opinion/sec-insider-trading-united-states.html [https://perma.cc/C2KW-GML2]; Jared S. Buskin & Harry Sandick, *What Was Decided Before Has Been Decided Again: The Amended Opinion in* Martoma *Cuts Back On The Initial Decision, But Still Affirms*, PATTERSON BELKNAP (June 26, 2018), https://www.pbwt.com/second-circuit-blog/what-was-decided-before-has-been-decided-again-the-amended-opinion-in-martoma-cuts-back-on-the-initial-decision-but-still-affirms [https://perma.cc/C9Z5-WGGL] ("In this regard, the decision reflects the continuing uncertainty that is created by the absence of a statute that specifically addresses insider trading. . . . [T] he question of what should be permitted and prohibited would be resolved most constructively by the legislative branch.").

[31] *See* Rahul Mukhi et al., *What to Know About Pending Insider Trading Legislation*, LAW360 (July 15, 2019), https://www.law360.com/articles/1177627/what-to-know-about-pending-insider-trading-legislation [https://perma.cc/2827-NUD3].

[32] Ultimately, this Note focuses on the personal benefit requirement of tipper-tippee liability vis-à-vis insider trading enforcement under Rule 10b-5. To that end, discussion of Rule 14e-3, § 17(a) of the Securities Act, and §§ 16, 20(d) of the Securities Exchange Act are, for the most part, omitted.

[33] 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

[34] 15 U.S.C. § 78j(b).

[35] Bradley Larkin, Note, *Breaking Up the Focus on Relationships for Nonpecuniary Insider Trading Personal Benefits*, 88 FORDHAM L. REV. 267, 277 (2019).

[36] 17 C.F.R. § 240.10b-5.

[37] Indeed, Congress has never defined the prohibition on insider trading, JAMES D. COX ET AL., SECURITIES REGULATION 905 (8th ed. 2017), and scholars have noted the lack of historical evidence surrounding § 10(b) to suggest that elected members never intended for the insider trading doctrine that emerged thereafter. *See* Donald C. Langevoort, *Fine Distinctions in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 435 (2013) [hereinafter Langevoort, *Fine Distinctions*] (citing Steve Thel, *the Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990)); STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 23–28 (1999) (observing that there is scant legislative history indicating that Congress intended the kind of sweeping regime we

The modern federal insider trading prohibition began with the SEC's administrative enforcement action, *In re Cady, Roberts & Co*.[38] This case involved a broker who received information from his partner, who himself was a director in a company that was going to announce a dividend reduction.[39] The broker soon sold shares of the company's stock in a number of accounts ahead of a public announcement.[40] While the SEC found that the broker's conduct violated the securities laws,[41] the significance of the case comes from Chairman William Cary's reasoning: "insiders must disclose material facts . . . known to them by virtue of their position but . . . not known to persons with whom they deal and which, if known, would affect their investing judgment."[42] If the insider cannot disclose, then "the alternative is to forego the transaction."[43] *Cady, Roberts* reveals an early—and at times recurring—motivation in insider trading jurisprudence: what became known as "disclose or abstain" is appropriate as a general duty on the open market because of the "inherent unfairness" of a transaction between a possessor of insider information and an outside investor.[44] Framed in this way, the prohibition reflects a commitment to protecting the unsuspecting investors of the "buying public" who are harmed by the "misuse of special information."[45]

The Second Circuit adopted and reinforced Chairman Cary's understanding of the prohibition in *SEC v. Texas Gulf Sulphur Co*.[46] This case involved insiders at a mining company that had found evidence of valuable ore deposits in Canada.[47] A number of insiders acquired (and eventually sold) company stock and stock-options as they became aware of drilling test results, but before public announcement of the company's discovery.[48] The SEC filed an enforcement action against the insiders alleging Rule 10b-5 violations for purchasing company stock on the basis of MNPI.[49] On appeal, the Second Circuit adopted and defined a broad "dis

have today). For instance, Professor Bainbridge notes that there is only one oft-cited passage supporting the proposition that Congress intended for a judicially-defined insider trading prohibition, which in context, he argues, is misplaced. BAINBRIDGE, *supra* at 26 (quoting S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934)). Furthermore, the SEC did not discuss insider trading, and provided little guidance, when it promulgated Rule 10b-5 in 1942. *See* Securities Exchange Act Release No. 3230 (May 21, 1942), 7 Fed. Reg. 3804 (1942).

[38] 40 S.E.C. 907 (1961). *See also* BAINBRIDGE, *supra* note 37, at 41.

[39] *Cady, Roberts*, 40 S.E.C. at 909.

[40] *Id.* at 909–10.

[41] *Id.* at 912 (finding a violation of Rule 10b-5 and § 17(a) of the Securities Act of 1933).

[42] *Id.* at 911.

[43] *Id.*

[44] *Id.* at 912; *see* COX ET AL., *supra* note 37, at 906 (*Cady, Roberts* "premised the necessary finding of fraud on the unfairness of allowing insiders to profit from their special access to sensitive information."); Glater, *supra* note 11, at 1404 (The "intuition underlying the opinion is that the transaction . . . was unfair.").

[45] *Cady, Roberts*, 40 S.E.C. at 913.

[46] SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968) (en banc).

[47] *Id.* at 843.

[48] *Id.* at 844–47.

[49] *Id.* at 842–43.

close or abstain" rule,[50] although in these circumstances, the court was actually requiring the insider to abstain from trading.[51] The foundation for its conclusion, the court explained, was its finding that Congress intended "that all members of the investing public should be subject to identical market risks."[52] To that end, the court cited the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[53] Finally, the court reinforced the notion that the prohibition on insider trading stems from the inherent unfairness of the practice: "The insiders here were not trading on an equal footing with the outside investors."[54]

While the thrust of the Second Circuit's Equal-Access Rule continues to find supporters,[55] the Supreme Court in *Chiarella v. United States*[56] expressly rejected the notion that the mere possession of material nonpublic information triggers a general "disclose or abstain" duty.[57] In *Chiarella*, an employee of a financial printer deduced the names of target companies in takeover documents he handled at work.[58] Without disclosing his knowledge, he purchased stock in the targets and sold after the takeover bids were made public.[59] The Court held that when a Rule 10b-5 action is based on the nondisclosure of MNPI, "there can be no fraud absent a duty to speak."[60] Instead of premising liability on an insider's possession of the information, the Court focused on the nature of the relationship between the insider and the other side of the transaction.[61] The Court noted that Chiarella was not an insider and that he received no confidential information from the target company.[62] Indeed, the Court emphasized that he was a "complete stranger" and that "he was not a person in whom the sellers had placed their trust and confidence."[63] By drawing upon a distinction between insiders and outsiders, the Court in *Chiarella* defined the circumstances of the "classical" theory of insider trading liability—when a corporate insider[64] trades on MNPI acquired in the

[50] *Id.* at 848.

[51] *See* BAINBRIDGE, *supra* note 37, at 46.

[52] *Texas Gulf Sulfur Co.*, 401 F.2d at 851–52.

[53] *Id.* at 848.

[54] *Id.* at 852.

[55] *See, e.g.*, Glater, *supra* note 11, at 1421 (arguing that the Court should "recognize fairness explicitly to guide identification of wrongful insider trading" as well as that the concept of fairness continues to influence courts, but "invisibly").

[56] Chiarella v. United States, 445 U.S. 222 (1980).

[57] *Id.* at 233 (discussing and rejecting a parity-of-information rule).

[58] *Id.* at 224.

[59] *Id.*

[60] *Id.* at 235.

[61] *See* BAINBRIDGE, *supra* note 37, at 52.

[62] *Chiarella*, 445 U.S. at 231.

[63] *Id.* at 232–33.

[64] Or a "temporary insider." *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (discussing the classical theory); Sari Rosenfeld, Note, *The Ever-Changing Scope of Insider Trading Liability for Tippees in the Second Circuit*, 8 MICH. BUS. & ENTREPRENEURIAL L. REV. 403, 406 (2019) ("The

course of her employment and in breach of her fiduciary obligations.[65]

*Chiarella* reveals the insider trading doctrine's shift away from the principle of fairness towards the relational nexus of trust as the primary touchstone of Rule 10b-5 liability. In other words, the Court emphasized an alternative method of understanding the fraudulent and deceptive nature of the violation—the breach of fiduciary duty. Framed in this way, trading on information with which an insider was trusted is deceptive in that it misleads shareholders whose expectation is confidentiality, loyalty, and non-trading.[66] This idea is at the core of what makes insider trading violative of Rule 10b-5, and so necessarily "deceptive." After all, if the insider's trade is anonymous and communicates nothing beyond the trade itself, who is deceived, and how?[67] *Chiarella* preserved the idea that insider trading is a fraud, but—again—it substituted a policy of instinctual fairness for a cabined framework of fiduciary obligation.

### *B. Tippers, Tippees, and the Rise of the "Personal Benefit" Test*

Just a few years after the Supreme Court announced the centrality of fiduciary duty for insider trading liability in *Chiarella*, the Court inserted an additional requirement into the doctrine in a case involving the tipping of MNPI. In *Dirks v. SEC*,[68] a securities analyst (Raymond Dirks), who worked for a broker-dealer, received information from a former employee of Equity Funding of America.[69] The employee disclosed a massive fraud, and Dirks investigated.[70] Convinced of the allegations, Dirks shared the news with the *Wall Street Journal* and the SEC, but he also encouraged clients and investors to sell shares of the company, which they did.[71] To his surprise, Dirks was charged, *inter alia*, with a Rule 10b-5 violation for tipping the information on which others could trade, and he was ultimately censured.[72]

The Supreme Court reversed. Recognizing that a typical tippee is unlike a typical insider in that the tippee does not automatically owe a fiduciary duty to the shareholders of the corporation,[73] the Court held that a tippee's liability is

Classical Theory also applies to a temporary insider, who can be held liable by trading for profit on information gained while he was in a fiduciary relationship with the issuer.").

[65] *See O'Hagan*, 521 U.S. at 651–52.

[66] Others, however, do not draw this distinction. Instead, the distinction is without difference: The Court's move in *Chiarella* reflects an underlying acceptance of the idea that insiders' secret self-enrichment is itself wrongful; the practice threatens the "official identity of the public markets as open and fair." Langevoort, *Fine Distinctions*, *supra* note 37, at 434. Thus, at its core the prohibition has been, and will continue to be, about fairness.

[67] *See id.*

[68] Dirks v. SEC, 463 U.S. 646 (1983).

[69] *Id.* at 648.

[70] *Id.* at 648–49.

[71] *Id.* at 649–50.

[72] *Id.* at 650–51, 653.

[73] *But see id.* at 655 n.14 (discussing the special circumstances in which an outsider, such as an accountant, lawyer, or banker, temporarily acquires fiduciary duties to the shareholders of a corporation to keep their corporate information confidential).

derivative of the tipper's breach of fiduciary duty in disclosing MNPI to the tippee.[74] Moreover, the Court emphasized that the tippee does not inherit the duty to disclose or abstain simply because the tippee *received* the MNPI, but rather because it has been *disclosed* improperly—and the tippee knew or should have known that there was a breach of duty.[75] To assess whether the information was disclosed improperly, the Court explained that the test is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[76] Of course, a pecuniary gain or reputational benefit will demonstrate impropriety, the Court said.[77] But the Court provided other examples that would elicit an inference of a personal benefit to the insider-tipper: a relationship that suggests a *quid pro quo* between the tipper and tippee or "an intention to benefit the particular recipient."[78] Furthermore, a violation occurs when an insider makes a gift of confidential information to a trading relative or friend.[79] Either way, the critical inquiry rests on objective facts and circumstances.[80]

Ultimately, the Court found that the former employee did not receive a personal benefit and did not intend to make a gift of information to Dirks by exposing the fraud; Dirks had no duty to disclose or abstain from using the information he acquired.[81] Indeed, the employee's disclosure was not wrongful—ostensibly, his motive for outing the fraud was altruistic.[82] Underlying the Court's opinion in *Dirks* was a reaffirmation of the idea that the prohibition on insider trading does not focus on the information *per se*, but rather on the conduct of those who trade on or tip the MNPI.[83] But this is a fine distinction that is, at times, hard to appreciate. The Court noted that securities analysts and other market participants often "ferret out" nonpublic information in order to make trading judgments, and this activity is healthy and ought to be encouraged.[84] Imposing potential liability based on the mere possession of MNPI would chill the essential function of analysts.[85] To this the Court explained that clarity is essential: "Unless the parties have some guidance as to where the line is between permissible and impermissible disclosure and uses, neither corporate insiders nor analysts can be sure when the line is crossed."[86]

[74] *Id.* at 659.
[75] *Id.* at 660.
[76] *Id.* at 662.
[77] *Id.*
[78] *Id.* at 664.
[79] *Id.*
[80] *Id.*
[81] *Id.* at 667.
[82] *See id.*
[83] *Id.* at 662–63 (citing In re Investors Management Co., 44 S.E.C. 633 (1971)).
[84] *Id.* at 658; *see also id.* nn.17–18.
[85] *Cf. id.* at 658.
[86] *Id.* at 658 n.17 (citing Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959)). Discussing this dynamic later in the opinion, the Court expressed that insiders may act consistently with their fiduciary duties even though their disclosure affects the market—they may incorrectly believe information to be already

Partly for this reason, the Court adopted the personal benefit requirement.[87]

### *C. The Misappropriation Theory of Liability*

Despite the Court's doctrinal retrenchment in *Chiarella* and *Dirks*, Congress gave the SEC's insider trading enforcement regime teeth with the passage of two pieces of legislation: The Insider Trading Sanctions Act of 1984[88] ("ITSA") and the Insider Trading and Securities Fraud Enforcement Act of 1988[89] ("ITSFEA"). Among other things, ITSA endorsed treble damages and increased the maximum criminal fine for violation of the Exchange Act to $100,000, and ITSFEA established a private cause of action for insider trading victims.[90] ITSFEA also increased the maximum fine to $1 million and set the maximum term of incarceration for insider trading to ten years.[91]

But, curiously, neither act defined insider trading or suggested substantive changes to the doctrine.[92] This was in conflict with the hopes of Securities Subcommittee Chairman Alphonse D'Amato (R., N.Y.) during the debates over ITSA. For a time, Senator D'Amato argued in favor of defining insider trading, including endorsing the misappropriation theory of liability in the process. He noted the problem of doctrinal uncertainty and the persistence of abusive practices. But controversy over the contours of insider trading's definition as well as disagreement about the underlying need to define the standard (and eschew a flexible approach in the courts) scuttled D'Amato's effort. While concurring in the need to prohibit insider trading in its many manifestations, Congress demonstrated its reticence in the ITSA to legislate a standard—preferring, instead, to have the SEC and the courts take the lead. The legislative history was little different in 1988.[93]

While Congress was unable to endorse the misappropriation theory in the 1980s, the Supreme Court was prepared to adopt it in the 1997 case, *United States v. O'Hagan*.[94] The facts are not important for the purposes of this Note, but the law is.[95] In *O'Hagan*, the Court explained that a violation of § 10(b) and Rule

public or immaterial. *Id.* at 662. Accordingly, the Court explained that a test is necessary to approximate the purpose of the disclosure. *Id.*

[87] *See* Larkin, *supra* note 35, 279–80 (observing that the Supreme Court adopted the personal benefit requirement for the purpose of drawing a line between permissible and impermissible trades).

[88] Pub. L. No. 98-376, 98 Stat. 1264 (1984).

[89] Pub. L. No. 100-704, 102 Stat. 4677 (1988).

[90] *See* Pub. L. No. 98-376, 98 Stat. 1264 (1984); Pub. L. No. 100-704, 102 Stat. 4677 (1988); *see also* Larkin, *supra* note 35, at 280–81.

[91] Larkin, *supra* note 35, at 280–81.

[92] For a comprehensive discussion of ITSA's policy formation process and legislative history, see 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 2:13, Westlaw (database updated April 2019).

[93] *See id.* § 2:14.

[94] United States v. O'Hagan, 521 U.S. 642 (1997).

[95] Still, to satisfy the curious reader: *O'Hagan* involved a partner at a law firm that was representing a British entity in planning a tender offer for the shares of the Pillsbury Company. *Id.* at 647. Learning of the representation and the tender offer plans, the partner surreptitiously purchased call options for Pillsbury stock. *Id.* at 647–48. The partner was charged with, *inter alia*, a 10b-5 violation, and the

10b-5 can occur under the misappropriation theory when an individual "misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information."[96] While the classical theory of liability derives from the insider's duties to the shareholders, the misappropriation theory of liability focuses on an outsider's conduct, whether or not a fiduciary duty pre-exists.[97] The Court noted that misappropriation is deceptive in a critical respect—the fiduciary "who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain' . . . 'dupes' or defrauds the principal."[98] But the conduct is only deceptive to the source of the information so long as the outsider fails to disclose his intentions.[99] Ultimately, the Court's adoption of the misappropriation theory was an important expansion of the SEC's power, and some scholars have contended that the misappropriation theory has overtaken, if not completely replaced, the traditional theory of liability.[100]

### *D. Rules and Regulations: The SEC Prunes the Landscape*

After the Court's retrenchment in *Chiarella* and *Dirks*, and its expansionism in *O'Hagan*, the SEC soon adopted two significant new rules that changed the insider trading landscape. The first rule is Regulation Fair Disclosure ("Reg FD"). The SEC promulgated Reg FD in August 2000, and the rule trained on prohibiting the common practice of selective disclosure of material information to certain market participants, such as institutional investors, who would trade on the information without disclosing it to the rest of the buying public.[101] Reg FD requires Exchange Act reporting issuers or their agents to disclose MNPI to the rest of the public whenever it has been shared with any person who is a market professional or might buy or sell the company's shares.[102] A strong policy consideration underlying the SEC's adoption of this disclosure rule was its assessment of ordinary investors' expectations of what constituted fair play in the markets,[103] and the SEC noted its belief that all investors should have access to an issuer's material disclosures at the same time.[104] But the SEC was careful not to define

prosecutor urged his conviction for defrauding the sources of the information, his law firm and its client. *Id.* at 648–49.

[96] *Id.* at 652–53.

[97] *Id.* at 652 ("[T]he misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.").

[98] *Id.* at 653–54.

[99] *See id.* at 654–55.

[100] *See, e.g.*, LANGEVOORT, *supra* note 92, at § 6.1 & n.4.5; *see also* United States v. Pinto-Thomaz, 352 F.Supp.3d 287, 297 n.3 (S.D.N.Y. 2018) (Rakoff, J.) ("While the 'classical theory' may still be occasionally employed even today, it is hard to imagine an insider trading case that does not fit comfortably within the confines of the misappropriation theory."); COX ET AL., *supra* note 37, at 931–32.

[101] *See* Guttentag, *supra* note 11, at 541–43.

[102] 17 C.F.R. § 243.100(a); *see also* Guttentag, *supra* note 11, at 541–42.

[103] *See* Guttentag, *supra* note 11, at 542.

[104] Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,591 (proposed Dec. 28, 1999) (to be codified at 17 C.F.R. §§ 243.100–.103).

selective disclosure as a fraudulent behavior,[105] and it tailored the rule to include significant safeguards.[106] Ultimately, scholars have noted the ambiguous effects of Reg FD on reducing information asymmetries.[107]

The second rule was Rule 10b5-2, which provided a non-exclusive definition of circumstances in which a person would have a duty of trust or confidence for misappropriation cases.[108] In particular, Rule 10b5-2 provides three circumstances: (1) "[w]henever a person agrees to maintain information in confidence"; (2) whenever there is a "history, pattern, or practice of sharing confidences" between the communicator of the information and the recipient, and the communicator expects the recipient to maintain its confidentiality; and (3) whenever the person receives the information from a spouse, parent, child, or sibling, yet this a rebuttable presumption.[109] Though the Second Circuit in *United States v. Chestman* held that the relationship between the recipient and the source of information must be "the functional equivalent of a fiduciary relationship" to result in liability,[110] the SEC eviscerated this distinction with Rule 10b5-2. Indeed, the SEC's adoption of the rule in August 2000 illustrates its hostility to the fiduciary relationship requirement entirely. It is unclear whether courts will tolerate the expansionism of Rule 10b5-2.[111]

### *E. Recent Judicial Shifts*

In the last six years, the insider trading doctrine has continued its metamorphosis. Recent cases have considered tipper-tippee liability and passed on questions related to the relationship between the recipient and the source of MNPI as well as the gift theory. Of note is the Second Circuit's disregard for the objective personal benefit requirement and its willingness to challenge precedent in pursuit of "results-oriented reasoning."[112] This Section presents recent shifts.

[105] *Cf.* Guttentag, *supra* note 11, at 543; *see* John P. Anderson, *Poetic Expansions of Insider Trading Liability*, 43 J. CORP. L. 367, 373 (2018) (critiquing Michael Guttentag's suggestion that Reg FD created duties "the violation of which would serve to predicate Section 10(b) insider trading liability").

[106] *See* Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881 (Aug. 15, 2000) (noting, among other things, that Reg FD did not authorize a private cause of action, that only senior officials and those who regularly communicate with securities market professionals or securities holders are covered under the obligation, and that personnel will not be second-guessed regarding materiality calls unless intentional or reckless).

[107] *E.g.*, Jill E. Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 125–26 (Stephen M. Bainbridge ed., 2013) (noting on the one hand that smaller firms especially have reduced overall disclosure and information quality has deteriorated, while on the other hand analysts have reported increased reliance on public disclosures).

[108] 17 C.F.R. § 240.10b5-2.

[109] *Id.* § 240.10b5-2(b).

[110] United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

[111] *See, e.g.*, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

[112] *Cf.* Stephen M. Bainbridge, *Regulating Insider Trading in the Post-Fiduciary Duty Era*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 86–87 (Stephen M. Bainbridge ed., 2013) (discussing Donna Nagy's suggestion that the Supreme Court's willingness to contort fiduciary principles has

In 2014, the Second Circuit attempted a more stringent standard of liability for remote tippees. In *United States v. Newman*, the government brought cases against two remote tippees who profited on information that they received from an attenuated tipping chain.[113] The information originated from two insiders. One was an insider at Dell who shared MNPI with a friend and former coworker who left to work on Wall Street, and the other was an insider at NVIDIA who shared MNPI with a friend from church.[114] The friends did not trade on the information, but rather they shared it with others who eventually passed it on to hedge fund managers who did trade.[115] The hedge fund managers were prosecuted, and they raised in their defense the lack of a personal benefit to the original sources of the information.[116] The Government alleged that friendship alone was enough to suggest a personal benefit between the tippers and the tippees of the information under the gift theory.[117] The court first explained that a tippee can only be liable "if he knows or should have known of the [tipper's] breach."[118] Then the court held that in the absence of proof of a "meaningfully close personal relationship," there can be no liability when a tipper makes a gift of information to a tippee.[119] Furthermore, the court held the meaningfully close personal relationship must generate an exchange that is "objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[120]

But the heightened standard did not last for long. In 2016, the Supreme Court addressed what had become a circuit split on this question—is evidence of a close family relationship sufficient to draw an inference of personal benefit to the tipper under the gift theory? In *Salman v. United States*, the Court explained in a unanimous decision that *Newman* was inconsistent with *Dirks* in that an inference of personal benefit to the tipper does *not* require independent evidence of pecuniary gain;[121] the personal benefit requirement is met simply because the gift of information was made to a "trading relative or friend" or, here, a close family member.[122] In other words, the Court repudiated *Newman*'s second holding, but it implicitly preserved the requirement that a meaningfully close personal relationship is necessary to infer that a gift of information satisfies the personal benefit

emboldened lower courts to approach new issues with results-oriented reasoning). To this point, the Second Circuit has demonstrated recently that it is prepared to grant greater doctrinal flexibility *ex post*, even if at the expense of other values, such as doctrinal consistency and predictability. *See infra*.

[113] United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).

[114] *Id.*

[115] *Id.*

[116] *Id.* at 442.

[117] *Id.* at 454.

[118] *Id.* at 447. Indeed, the scienter question produced a central holding of *Newman*. The *Newman* court explained that a tippee must be aware not only that the tipper breached a fiduciary duty in disclosing inside information, but also that the tipper received a personal benefit of some kind. *Id.* at 447–51; *see also* United States v. Martoma (*Martoma II*), 894 F.3d 64, 76 (2d Cir. 2018).

[119] *Newman*, 773 F.3d at 452.

[120] *Id.*

[121] Salman v. United States, 137 S. Ct. 420, 428 (2016).

[122] *Id.* at 427–28.

requirement.[123] Still, by affirming the Ninth Circuit with simple reassertion of *Dirks*, which "easily resolves" the case,[124] the Court left additional questions unresolved. For instance, is there liability for gifts of information to those without a meaningfully close personal relationship to the tipper?

The Second Circuit answered this question—in two different, inconsistent opinions—in *United States v. Martoma*.[125] In this case, Mathew Martoma, a hedge fund manager, was convicted of one count of conspiracy to commit securities fraud and two counts of securities fraud for misappropriating MNPI from pharmaceutical companies and trading ahead of public announcements of clinic trial results regarding the development of an experimental drug.[126] Martoma arranged for consultations with a doctor on the drug's clinical trial team,[127] and the doctor revealed data to Martoma regarding the drug's weaknesses ten days before that information became public.[128] While the doctor was ordinarily paid a consulting fee, he received no compensation during the meetings at which the relevant information was shared.[129] Martoma was able to avert $194.6 million in losses and to gain $80.3 million from short sales.[130] After Martoma was convicted, *Newman* was issued, so Martoma appealed. Martoma argued that the jury instructions he received were erroneous because they did not account for *Newman*'s meaningfully close personal relationship requirement.[131]

Writing for the majority in *Martoma I*, Chief Judge Katzmann provided an initial rationale for upholding Martoma's conviction. The panel explained that the gift theory was only one way of inferring a personal benefit to the tipper as part of an overall inquiry that asks whether there was an improper disclosure of MNPI to the tippee.[132] The court thus pointed out that *Newman* got it wrong: *Dirks* does not support a categorical rule requiring a meaningfully close personal relationship to prove that an insider benefits from gifting information to the tippee.[133] But the majority realized that it could not overrule circuit precedent without en banc review.[134] So it read the Supreme Court's opinion in *Salman* to have "fundamentally altered the analysis underlying *Newman's* 'meaningfully close personal relationship' requirement."[135] Accordingly, the court held that an insider or tipper

[123] *See* Recent Case, United States v. Martoma—*Second Circuit Redefines Personal Benefit Requirement for Insider Trading*, 132 HARV. L. REV. 1730, 1731 (2019) [hereinafter HLR, *Martoma*].

[124] *Salman*, 137 S. Ct. at 427.

[125] United States v. Martoma (*Martoma I*), 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, United States v. Martoma (*Martoma II*), 894 F.3d 64 (2d Cir. 2018), *cert. denied*, 139 S. Ct. 2665 (2019).

[126] *Martoma II*, 894 F.3d at 68–69.

[127] *Id.* at 69.

[128] *Id.* at 69–70.

[129] *Id.* at 78.

[130] *Id.* at 70.

[131] *Martoma I*, 869 F.3d at 64.

[132] *Id.* at 67–68.

[133] *Id.* at 68.

[134] *See id.*

[135] *Id.* at 69.

personally benefits when information is disclosed with the expectation that the tippee would trade on it, whether or not there was a meaningfully close personal relationship.[136] Martoma petitioned for en banc review.[137]

But, before ruling on the petition, Chief Judge Katzmann issued an amended and superseding opinion that reinterpreted *Newman* instead of overruling it. In *Martoma II*, the court read *Dirks* for the proposition that the government can prove a personal benefit to the insider or tipper through a gift, a relationship that suggests a *quid pro quo*, or an intention to benefit the tippee.[138] Understanding the commas in the applicable language of *Dirks* to sever connection between the examples of personal benefits, the majority thus understood there to be three separate theories of liability.[139] Although *Newman* had required a meaningfully close personal relationship under the gift theory, the *Martoma II* court explained that such a relationship is unnecessary in order to find a tippee liable where there is evidence that the tipper had intended to benefit the tippee.[140] Accordingly, under *Martoma II*, evidence of the tipper's intention to benefit a recipient with MNPI is sufficient to meet the personal benefit requirement.

As in *Martoma I*, Judge Pooler dissented. In *Martoma II*, the dissent suggested that the majority's formulation undermines the objective personal benefit requirement by heralding a subjective inquiry.[141] The core disagreement was over whether "intent to benefit" can itself suggest a personal benefit under *Dirks*. Judge Pooler read *Dirks* to require there to be objective evidence of a *relationship* that suggests an intent to benefit the tippee for liability to arise.[142] Intent to benefit by itself, she explained, is insufficient to meet the personal benefit requirement.[143] Moreover, she criticized the majority for intimating that the personal benefit requirement is merely a guide to prosecutors[144]—"[w]hatever the insider's purpose in disclosing the information, '[a]bsent some personal gain [to the insider], there has been no breach of duty to stockholders.'"[145] For Judge Pooler, proving a

[136] *Id.* at 70.

[137] Petition for Rehearing or Rehearing En Banc for Defendant-Appellant, *Martoma II*, 894 F.3d 64 (No. 14-3599).

[138] *Martoma II*, 894 F.3d at 76.

[139] *Id.* at 74 (citing SEC v. Warde, 151 F.3d 42, 48 (2d Cir. 1998)). The applicable language is the following:

> There are objective facts and circumstances that often justify [an inference of direct or indirect personal gain to the insider]. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, *or an intention to benefit the particular recipient*. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend.

Dirks v. SEC, 463 U.S. 646, 664 (1983) (second emphasis added). Note that the majority divorced the "intention to benefit" theory from any grounding in relationship.

[140] *Martoma II*, 894 F.3d at 75.

[141] *Id.* at 83–84 (Pooler, J., dissenting).

[142] *Id.* at 84 (noting that the majority reads "intention to benefit" out of context).

[143] *Id.* at 85 ("Intending to benefit somebody is not in itself a benefit.").

[144] *Id.*

[145] *Id.* (quoting *Dirks*, 463 U.S. at 662).

personal benefit must be taken seriously, otherwise every disclosure of inside information by itself would be presumptively beneficial to the tipper, and this is a result *Dirks* expressly rejected.[146] More troubling, the dissent suggested, is the conflict between the majority's opinions in *Martoma I* and *Martoma II*. In the former, it "candidly acknowledged" that it was abrogating circuit precedent, whereas in the latter the majority rendered *Newman* a "relic";[147] the court thus "stealth overruled" prior precedent.[148]

## II. THE INSIDER TRADING REGIME NEEDS REFORM

### A. *The Second Circuit's Disposition of* United States v. Martoma *Reveals Results-Oriented Reasoning Unfaithful to the Policy Consensus of* Dirks

Since Chairman Cary identified insider trading as a species of fraud in *Cady, Roberts*, the precise contours of the misconduct have been in flux. The experience of *United States v. Martoma* is no exception. In that case, the majority and the dissent disagreed over whether the personal benefit requirement could be satisfied in cases involving the gift of MNPI by using evidence to suggest that the tipper intended to benefit the tippee, whether or not they had a pre-existing (or even "meaningfully close") personal relationship. This may seem to be a narrow matter. But the tension reveals an underlying dispute about the policy bases the *Dirks* Court considered to justify adoption of the personal benefit requirement *ab initio*. These considerations go to the heart of what the insider trading prohibition is attempting to accomplish.

Michael Guttentag has suggested that the Court implicitly provided four distinct justifications for adopting the personal benefit requirement.[149] These are:

> (1) that requiring proof of a personal benefit establishes objective criteria, (2) that a personal benefit test allows company executives to continue to make selective disclosures for legitimate business purposes, (3) that receipt of a personal benefit shows that the person making the selective disclosure (the "tipper") was attempting to circumvent the prohibition against insider trading, and (4) that receipt of a personal benefit is a required element for finding either that a deception or a fiduciary duty breach has occurred.[150]

He observed that the sharp disagreement between the majority and the dissent in *Martoma I* (which is not substantially different from that of *Martoma II*)

[146] *Id.* at 86.

[147] *Id.* at 86–87, 80.

[148] *See* HLR, *Martoma*, *supra* note 123, at 1733–34.

[149] Guttentag, *supra* note 11, at 526. Ultimately, Guttentag argues against the continued adherence to the personal benefit requirement. *Id.* at 524–26. He credits two changes in particular that followed *Dirks*—the passage of Regulation Fair Disclosure and the Court's decision in *O'Hagan*—for the proposition that a personal benefit should no longer be a required element. *Id.* at 526. *But see* Anderson, *supra* note 105, at 373 (characterizing Guttentag's arguments as controversial and poetic).

[150] Guttentag, *supra* note 11, at 526.

demonstrates the former's view that the circumvention rationale (3) is the most persuasive and the latter's view that objective facts and circumstances (1) determine whether selective disclosure is wrongful.[151] Objective criteria are necessary, according to the latter justification, for instrumental reasons—after all, "the SEC and the court are not required to read the parties' minds."[152] Additionally, Donald Langevoort has noted that one of the reasons the personal benefit requirement was imposed is because it provides "an objective test for determining whether there has been the requisite notice to the tippee"[153]—notice that the information is being disclosed in breach of fiduciary duty. So, the objective criteria policy justification is mainly about providing notice and achieving some degree of certainty, especially since subjective intentions are often difficult to ascertain.[154]

These observations are useful. Understanding the *Martoma II* disagreement between the majority and the dissent in this light, we can see that the majority's erosion of an objective personal benefit requirement, in favor of an intention-focused inquiry, reflects its assessment of the various policy rationales as well as its understanding of the broader purpose of § 10(b)—to prevent fraud (or, in this case, perceived instances of wrongful disclosures). Recall that the *Martoma II* majority explained that its understanding of "intention to benefit" is "more consonant with *Dirks* as a whole" because an intention to benefit is probative of a breach of fiduciary duty and, thus, wrongful disclosure.[155] Ultimately, the court does not believe that identifying personal benefits is a "central focus of insider trading law";[156] instead, the inquiry is about identifying an illegitimate purpose when disclosure is made.[157] But purpose-oriented reasoning can easily become results-oriented reasoning. The personal benefit requirement was crafted with this concern in mind.[158] The *Dirks* Court attempted to integrate many policy rationales in one test; striking a balance was its motivation.[159]

Thus, the majority's interpretation in *Martoma II* is unfaithful to the Court's precedent. By treating an "intention to benefit the particular recipient" as an independent basis to meet the personal benefit requirement, the Second Circuit has achieved a substantive change to tipping liability that is in conflict with the Court's focus on objective circumstances.[160] Its interpretation will lead to an expansion of potential cases in the Second Circuit, since only a subjective

[151] *Id.* at 540–41.

[152] Dirks v. SEC, 463 U.S. 646, 663 (1983).

[153] LANGEVOORT, *supra* note 92, § 4:3 n.8.

[154] *See* Guttentag, *supra* note 11, at 527–29.

[155] United States v. Martoma (*Martoma II*), 894 F.3d 64, 75 (2d Cir. 2018).

[156] *Id.* at 73.

[157] *Id.* at 75.

[158] *See* Dirks v. SEC, 463 U.S. 646, 663–64, 664 n.23 (1983).

[159] *See* Guttentag, *supra* note 11, 525–37; *see generally* Pritchard, *supra* note 11.

[160] Jessica Hostert, Note, *Great Expectations, Good Intentions, and the Appearance of the Personal Benefit in Insider Trading: Why the Stage Needs Reset After* Martoma, 43 S. ILL. U. L.J. 703, 728 (2019).

intention will be necessary to demonstrate a personal benefit.[161] Notwithstanding the majority's dismissal of concern about the subjective test,[162] there is a genuine problem that the "intention to benefit" test authorizes circular reasoning—"personal benefit" fails to have any independent meaning.[163] But this significantly weakens the focus on relationships and the nexus of trust that helps establish wrongful disclosure. Now, the breach of fiduciary duty can be assumed.[164]

A modified example from the majority opinion is instructive here. Suppose a tipper discloses valuable information to a homeless person—a "perfect stranger"[165]—and the tipper says "you can make a lot of money by trading on this."[166] The information is clearly a gift. For the *Martoma II* court, the statement following the disclosure of valuable information "suggests an intention to benefit the tippee," and in the court's view, this is "in breach of the insider's fiduciary duty."[167] But the court is assuming that the disclosure was made for "personal ends," and it relies on this assumption to do the work of rendering a free-standing intention to benefit a breach of fiduciary duty. This does not follow, however, as it may when a tipper discloses information to his brother,[168] which the Court has noted is like trading on the information himself and providing a gift of the proceeds.[169] The reason the latter is different from the former is because the preexisting relationship between the tipper and the tippee does the work: it raises an inference of wrongful disclosure. Evidence suggesting an intention to benefit a particular recipient, however, does not raise a strong inference of personal benefit to the tipper, without more, no matter what our intuition may be about the ultimate result to the defendant.[170]

[161] *Id.* at 728–29.

[162] United States v. Martoma (*Martoma II*), 894 F.3d 64, 76 (2d Cir. 2018) ("These fears are unwarranted. Intent elements are everywhere in our law and are generally proved with circumstantial evidence. . . . Insider trading is no different.").

[163] *See id.* at 88 (Pooler, J., dissenting).

[164] *See* Hostert, *supra* note 160, at 729 ("Without the personal benefit requirement, the breach of fiduciary duty is essentially assumed, making it easy for the SEC and Department of Justice to establish illegal insider trading.").

[165] *Martoma II*, 894 F.3d at 75.

[166] *See id.*

[167] *Id.*

[168] *See, e.g.*, Salman v. United States, 137 S. Ct. 420 (2016).

[169] Dirks v. SEC, 463 U.S. 646, 664 (1983) ("The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.").

[170] *Accord* Abigail Bush, Note, *A Friend in Need May Get You in Trouble for Insider Trading Indeed: An Argument for the Meaningfully Close Personal Relationship Definition of Friendship Under the Gift Theory*, 107 GEO. L.J. ONLINE 1, 7 (2018), https://georgetownlawjournal.org/articles/265/friend-need-may-get/pdf [https://perma.cc/E9UY-KUVZ] ("Although a tipper could ultimately benefit from gifting information to tippees with whom he is not close in some circumstances, it cannot be inferred that the tipper does so generally."). Note, here, how plausible it is to find our tipper in violation of the insider trading proscription—his intent to benefit the homeless person seems to confirm his guilt. But, if the personal benefit requirement is to have any meaning, then the tipper's intention, without a corresponding objective circumstance illustrating how the tipper, indirectly or directly, *benefits*, must be insufficient to carry the day.

Why must this be so? Consider a different example. An analyst at an investment bank is aggregating and evaluating information to form recommendations about the public companies he follows. In the course of his research, he interviews mid-level officers, one of whom was fond of him. "Because I like you," the officer reveals some information about the company's growth prospects, and the analyst forms a recommendation on which a colleague trades. Reg FD expressly prohibits these kinds of selective disclosures, unless the information is disseminated to the public thereafter. But the rule is careful not to define the conduct as a fraud. Rule 101(c) of Reg FD excludes from coverage under the rule any tipping "in breach of a duty of trust or confidence to the issuer."[171] Moreover, § 102 of Reg FD provides that no "failure to make a public disclosure required solely by [Reg FD] shall be deemed to be a violation of Rule 10b-5."[172] Notwithstanding Reg FD concerns, it is unclear how the officer's intention to benefit the analyst, without more, resulted in a personal benefit to the officer, the tipper. And was this a wrongful disclosure? The *Dirks* Court anticipated precisely these types of communications when it rejected the notion that knowingly *receiving* material nonpublic information could give rise to a duty to disclose or abstain from trading.[173] What if the officer had not alerted the analyst of his intention to benefit him, but there were other circumstantial evidence suggesting his fondness? Reliance on free-standing tipper intentions raises problems for identifying the tippee's scienter, too.

Other examples illustrate why this standard goes beyond *Dirks*.[174] For instance, what if the officer in the previous example had been a whistleblower? Suppose that during the course of his conversation with the analyst, he disclosed a number of fraudulent practices at the company. Crediting the officer, the analyst developed a sell recommendation, and colleagues traded. As it turns out, the officer had been silenced at the company, and he wanted the information to get out to a star analyst. Liability? These are roughly the facts of *Dirks*, which remains good law. Neither the tipper nor the tippee could be liable, whether or not there were circumstantial evidence of the tipper's intention to benefit the tippee, because the tipper's disclosure was *not* wrongful—at least according to the Supreme Court.

The *Martoma II* court's interpretation of *Dirks* is incorrect in that it is unfaithful to the spirit of the Court's opinion and the various policy bases justifying adoption of the personal benefit requirement. The court's disposition suggests results- and policy-oriented reasoning.

[171] 17 C.F.R. § 243.101(c).

[172] 17 C.F.R. § 243.102.

[173] *Dirks*, 463 U.S. at 658–59.

[174] *See* John C. Coffee, Jr., *Tippees and Tippers: The Impact of* Martoma II, CLS BLUE SKY BLOG (July 23, 2018), http://clsbluesky.law.columbia.edu/2018/07/23/tippees-and-tippers%C2%AD%C2%AD-the-impact-of-martoma-ii/#ednref17 [https://perma.cc/P66C-CU32] (discussing the implications of *United States v. Martoma* and applying the Second Circuit's revised standard to five different hypothetical examples of insider trading).

### *B. The Second Circuit's Inconsistency between* Martoma I *and* Martoma II *Introduces Substantial Uncertainty About Insider Trading Liability*

Insider trading law lacks clarity and consistency. This is in part because the prohibition's doctrine lacks an organizing principle—there is no statute that defines insider trading. Instead, the SEC read § 10(b) and Rule 10b-5 in *Cady, Roberts* to proscribe the practice because of its "inherent unfairness." But the Supreme Court has routinely admonished the SEC: mere possession of material nonpublic information will not do as a basis for liability; there must be fraudulent deception, and so the fiduciary breach and personal benefit requirements emerged. Despite these setbacks, the SEC has continued to bring cases and adopt rules reflecting its preferred equal-access theory. Ultimately, the SEC wants doctrinal flexibility to support its enforcement discretion. But such a regime is unjust when unbounded by statute. *United States v. Martoma* helps to illustrate why.

In *Martoma I*, the majority candidly acknowledged that it was abrogating *Newman*, which held that there must be a meaningfully close personal relationship to infer a personal benefit to the tipper in gift-giving cases.[175] To justify its choice, it explained that the Supreme Court in *Salman* had called into question the validity of the Second Circuit's holding in *Newman*, which relieved it of needing en banc review to change the standard.[176] But in *Martoma II* the majority declined to abrogate *Newman*; instead, it reinterpreted insider trading law "more subtly."[177] Nevertheless, the court heralded a substantive change that the majority did not have the power to implement without en banc review.

The *Martoma II* court's move—"stealth overruling"—poses rule of law concerns.[178] "Stealth overruling" is the phenomenon where a judge "disingenuous[ly] . . . depriv[es] precedents of their force" by "fail[ing] to extend a precedent to its logical conclusion."[179] Stealth overruling is a direct challenge to the bedrock principle of *stare decisis*.[180] More specifically, stealth overruling has negative consequences for the principles of notice, predictability, and legitimacy.

Without advanced warning, the public cannot understand what conduct will violate the law. Despite what many may think about the class of defendants in insider trading cases, insufficient notice of crime violates our shared intuitions about justice as well as the foundational principle of legality: *nullum crimen sine lege*. The principle is best expressed in the following way: "there must be no crime or punishment except in accordance with fixed, reasonably specific, and

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

[176] *See* United States v. Martoma (*Martoma I*), 869 F.3d 58, 68–69 (2d Cir. 2017).

[177] United States v. Martoma (*Martoma II*), 894 F.3d 64, 83 (2d Cir. 2018) (Pooler, J., dissenting).

[178] The observation is not my own. *See generally* HLR, *Martoma*, *supra* note 123.

[179] *Id.* at 1730 (quoting Barry Friedman, *The Wages of Stealth Overruling (With Particular Attention to* United States v. Arizona*)*, 99 GEO. L.J. 1, 9 (2010)).

[180] *See* H.C. Black, *The Principle of Stare Decisis*, 34 U. PA. L. REV. 745, 745 (1886) ("The policy of the courts, and the principle upon which rests the authority of judicial decisions as precedents in subsequent litigations, is embodied in the maxim, *Stare decisis et non quieta movere*—to abide by the precedents and not to disturb settled points.").

fairly ascertainable preestablished law."[181] This concern is amplified in the criminal context, where the rule of lenity requires that ambiguity be resolved in favor of defendants when construing a statute.[182] Moreover, a lack of understanding about what the law *is* usually means that there is limited consensus about what that law *will be*. Accordingly, affected parties cannot predict with any degree of certainty whether their conduct is permissible or illegal.[183] This has a deterrence consequence. Market participants cannot conform their conduct, such as their trading decisions and informational disclosures, to ostensible rules when those rules are subject to change. Furthermore, when courts ignore prior precedent with interpretations that approximate their new policy priorities, the public loses faith in the legitimacy of the legal and political systems. The *Martoma II* court's stealth overruling implicates all of these concerns, and it reveals the need for legislative reform.[184]

It is true that insider trading defendants evoke little sympathy.[185] And, despite reticence to define a standard,[186] Congress favors insider trading enforcement actions.[187] Indeed, big wins against hedge fund traders provide political spoils, and they reinforce narratives and fictions about public confidence in, and the integrity of, the stock market that themselves fuel the enforcement regime.[188] As Michael Perino noted, "[i]nsider trading embodies a revulsion for elite special

[181] JOHN P. ANDERSON, INSIDER TRADING 89 (2018) (quoting DAVID A. J. RICHARDS, THE MORAL CRITICISM OF LAW 195 (1977)).

[182] *See* ANTONIN SCALIA, A MATTER OF INTERPRETATION 29 (Amy Gutmann ed., 1997) (discussing the ancient principle that directs judges to construe ambiguous criminal statutes narrowly).

[183] Anderson, *supra* note 105, at 374 ("Citizens expect and deserve advance notice of precisely what conduct will violate the criminal law so they can guide their actions to reliably avoid the associated reputational and penal sanctions.").

[184] *See infra* Part III. *See also* Anderson, *supra* note 105, at 374 ("Justice therefore demands that the criminal law be expanded by legislative action, not poetic license.").

[185] *But see* John Dobson, *Who Are the Real Victims of Insider Trading? Why Current Insider-Trading Law Is Unethical*, 31 BUS. & PROF. ETHICS J. 441, 441 (2012) (concluding that those who are prosecuted under the vagaries of § 10(b) and Rule 10b-5 are the ultimate victims).

[186] Congress has periodically declined to change the substantive parameters of the Rule 10b-5 insider trading enforcement regime, and it has noted the same. Recall that the debates over the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 took up this very issue. *See supra* Section I.C. But in the House Report on the latter legislation, the House Committee on Energy and Commerce specifically refused to alter the parameters outlined by the Supreme Court and circuit courts. *See* H.R. REP. NO. 100-910, at 11 (1988) ("[T]he Committee does not intend to alter the substantive law with respect to insider trading with this legislation.").

[187] *See, e.g.*, H.R. REP. NO. 100-910, at 7 (1988) ("The Insider Trading and Securities Fraud Enforcement Act of 1988 represents the response of this Committee to a series of revelations over the last two years concerning serious episodes of abusive and illegal practices on Wall Street. In the view of the Committee, the present enforcement framework should be strengthened to curtail continuing insider trading and other market abuses.").

[188] Bainbridge, *supra* note 112, at 83; *see also* Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 644 (2010) (arguing that the SEC exercises its enforcement power to further political objectives and maximize its appeal to Congress).

privileges. Concerns about it similarly reflect our perennially ambivalent attitudes regarding the morality and mores of securities market professionals."[189]

But uncertainty about legal requirements has adverse consequences for more groups than just traders and market participants. Prosecutors, or enforcers more generally, are harmed, too. This is because their jobs are complicated by the thorny legal landscape. Urska Velikonja has explained that institutional incentives often motivate enforcers at the SEC.[190] This is as true of their incentives to tout to Congress the number of enforcement actions they bring every fiscal year as it is of their incentives to pursue cases that settle quickly.[191] Likewise, scholars have documented that individual enforcement attorneys are subject to their own incentives that influence the cases that are brought.[192] High-profile cases provide enforcement attorneys with potentially significant rewards, especially since many use government employment to develop their skills and reputations for the private sector.[193] But the more sophisticated defendants are likely to expend considerable financial resources to litigate aggressively. Perino has suggested that this risk-reward dynamic acts as a powerful check on enforcement attorneys, who, if rational, will bring cases only when "evidence of liability or guilt is overwhelming and when the legal standards are certain."[194] He notes further that "[i]f on average enforcement attorneys weigh potential losses more heavily than potential gains, they will have strong incentives to take on only cases that they believe have a strong likelihood of winning."[195]

The *Newman* experience is instructive. Analyzing a dataset of insider trading cases brought between fiscal years 2011 and 2015, Perino reported that before *Newman* only 9.14 percent of cases involved tippees who were three or more levels removed from the source of the information.[196] After *Newman*, neither civil nor criminal enforcers have filed a single action against such remote tippees.[197]

[189] Michael A. Perino, *Real Insider Trading* 8 (St. John's Legal Stud. Res. Paper No. 19-0005, Feb. 20, 2019), https://ssrn.com/abstract=3338536 [https://perma.cc/8D2V-5CN5] (citation omitted).

[190] *See* Urska Velikonja, *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 CORNELL L. REV. 901, 906 (2016) (describing the agency's incentives to inflate their enforcement numbers in a variety of ways).

[191] *See id.* at 967–70 (noting that the SEC staff focuses on cases that can be investigated and prosecuted quickly). *But see id.* (observing that the SEC has an incentive not to bring contested case that drain resources, such as those alleging violations of the anti-fraud provisions). More generally, Professor Velikonja has documented the extent to which political influences shape the enforcement choices of the SEC. *See* Urska Velikonja, *Politics in Securities Enforcement*, 50 GA. L. REV. 17, 21–26 (2015) (discussing sources of political pressure on agency action, such as institutionalized annual reporting requirements as well as other extensive oversight expectations, and indicating that the SEC is often required to justify its existence by pointing to high-profile enforcement successes).

[192] *See* Perino, *supra* note 189, at 18 (discussing SAMUEL W. BUELL, CAPITAL OFFENSES: BUSINESS CRIME AND PUNISHMENT IN AMERICA'S CORPORATE AGE (2016)).

[193] *Id.*

[194] *Id.* at 19.

[195] *Id.* at 22.

[196] *Id.* at 39.

[197] *Id.* But Perino's data may be stale. Helpful research could examine the DOJ's and the SEC's litigation press releases of insider trading enforcement actions brought between FY 2016 and 2019 to

He also described a decreasing success rate the more removed a tippee-defendant is from the source of the information.[198] So, enforcers are less likely to file cases against tippees the more remote they are. But Perino concludes that his review of the data suggests no meaningful doctrinal overreach and little reason for more precise statutory language to define the elements of insider trading liability.[199]

I come to the opposite conclusion. Perino observed a noticeable effect on the case data following *Newman*. *Ex post*, enforcers were unlikely to bring cases against remote tippees in substantial part because of loss aversion.[200] The heightened standard chilled enforcement because it altered enforcers' incentives to pursue difficult cases—especially those against hedge fund defendants involving extended tipping chains. Two years later, *Salman* further adjusted the enforcement landscape, which left additional questions for enforcement attorneys to answer while considering which cases to expend resources investigating. Given these trends, it is likely that the more flexible standard introduced in *Martoma II* will result in at least some increase in cases against remote tippees. Enforcers should have an easier time demonstrating each successive tipper's personal benefit, so enforcers should be expected to internalize this incentive adjustment. But, presumably, uncertainty about the bounds of the "intention to benefit" standard will result in an under-inclusive pool of cases, as enforcers question how juries and Second Circuit courts will receive circumstantial evidence about a tipper's intentions. Therefore, there is an enforcement cost to ambiguity—a gap between the number of cases that ought to be expected and the number of cases that will actually be brought—due solely to doctrinal uncertainty.[201] But this cost is an unnecessary burden for the DOJ and the SEC to bear. Statutory language defining the insider trading prohibition could close the gap by resolving the legal ambiguities that result in periodic judicial shifts. Individual enforcement attorneys would thus have an authorized framework in mind while pursuing insider trading cases, which should result in more efficient enforcement overall.

In review, a final point emerges. *United States v. Martoma* is symptomatic of an enforcement scheme that lacks an organizing principle. The result is a legal doctrine in constant metamorphosis. This Section has described the consequences

update Perino's conclusion. And updated research should consider that *Salman* rolled back part of *Newman*'s heightened standard. Still, the effect of *Newman*, from the available data analysis, is palpable—the Second Circuit's decision led to at least fourteen overturned convictions. *See* John C. Coffee, Jr., Opinion, *How to Get Away with Insider Trading*, N.Y. TIMES (May 23, 2016), https://www.nytimes.com/2016/05/23/opinion/how-to-get-away-with-insider-trading.html [https://perma.cc/347T-JZHT].

[198] Perino, *supra* note 189, at 40.

[199] *Id*. at 7, 64.

[200] *Id*. at 7.

[201] Enforcers at the SEC have limited resources to investigate and prosecute cases. Commentators routinely observe that the number of cases brought is but a fraction of what should be expected. *E.g.*, Kurt N. Schacht, Opinion, *SEC, Strapped for Funds, Can't Police Financial Markets*, THE HILL (July 9, 2018, 9:30 A.M.), https://thehill.com/opinion/finance/396064-sec-strapped-for-funds-cant-protect-investors [https://perma.cc/5FWK-M5K6]. Here, instead, I am exploring the notion that there is an enforcement "deadweight loss" that can be attributed to uncertainty in particular, and this uncertainty is due to the lack of an authorizing statute or rule defining the bounds of the insider trading prohibition.

that ensue from an insider trading regime that is not bounded by statute or rule—from the general impact to the rule of law to the specific effects on defendants, market participants, and enforcers alike. The best response to the Second Circuit's disposition of *Martoma II* is substituting a framework of judicial policy-making for legislative authorization.

## III. LEGISLATIVE ACTION IS WARRANTED

The Insider Trading Doctrine has long been recognized as a collaborative effort among the courts, the SEC, and Congress.[202] Still, Congress has not played an influential role in shaping the substantive law. Largely, the SEC has led, and the Supreme Court has constrained—Congress has preserved the status quo. As Parts I and II have described, the Doctrine remains murky and inconsistent. But it need not be. Congress is the appropriate actor to resolve the many disputes at the core of insider trading liability with legislation to define the prohibition.

First, the legislature is the appropriate forum to consider conflicting policy choices. During public debates, elected officials could consider the existing framework and the variety of objectives underlying the prohibition. For instance, recall that the SEC has favored an equal-access-to-information approach, but the Supreme Court has repudiated this in favor of a framework requiring breach of fiduciary duty. This conflict has influenced the recurrent "possession versus use" debate, where the former is easier for plaintiffs to prove and the latter fits more closely with the misconduct as generally understood.[203] Elected representatives could decide whether a breach of fiduciary duty approach—and a prohibition trained on *using* material nonpublic information improperly—best fits with the conduct the public intuitively disfavors. As a positive consequence, deliberation in Congress would promote all of the principles disserved by the *Martoma* experience—notice, predictability, and legitimacy. Donald Langevoort observed that to him "one of the most likely explanations for instances of insider trading is a failure by the trader or tipper to properly appreciate what the law is, or to apply the law to the facts accurately."[204] A specific standard, defined by statute, could remedy this problem because a statutory prohibition would require Congress to consider the existing elements of the framework and decide what, if any, elements would remain. The result would be a unified insider trading doctrine, applicable in all jurisdictions, that would provide clarity to traders, analysts, prosecutors, and others through advanced notice.

[202] *See* Jill E. Fisch, *Federal Securities Fraud Litigation as a Lawmaking Partnership*, 93 WASH. U. L. REV. 453, 476 (2015) (noting the "lawmaking partnership").

[203] Langevoort, *Fine Distinctions*, *supra* note 37, at 439–40; *see also* Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1332–36 (1999) [hereinafter Langevoort, *Rereading* Cady, Roberts].

[204] Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scienter Requirement*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 60 (Stephen M. Bainbridge ed., 2013).

Also, while the SEC does have authority to promulgate a rule that specifically defines insider trading,[205] the SEC does not have the proper incentive to do so. [206] Thus, Congress is the appropriate actor to define the prohibition. The SEC seeks to preserve its enforcement discretion, and new regulations would only lead to potentially restrictive outcomes in the courts. The SEC, then, welcomes the status quo regime, where it can occasionally press the boundaries of Rule 10b-5 and achieve results like *Martoma*. Additionally, the SEC has historically discouraged Congress from establishing a statutory insider trading prohibition on the grounds that it would create "loopholes" or provide a "blueprint for fraud."[207] The thrust of the argument is that any effort to define the insider trading prohibition with greater precision would allow "opportunists to exploit unintended loopholes and stop just barely short of the proscribed line."[208] But this is true of most, if not all, legal rules. The objective is not an unambiguous version of clarity, but rather specific authorization of a framework, where resolution can turn on the facts and circumstances in light of the statute's purpose.[209] Indeed, the idea is to "create a text that actors and their counsel could actually look at, even if not all answers would be forthcoming."[210] The current framework, by contrast, emanates from a brief Depression-era ban on manipulative or deceptive devices that never anticipated the Rule 10b-5 insider trading prohibition.[211] If the past is prologue, the SEC is unlikely to act, even if it comes to recognize the costs of uncertainty to its own enforcement staff.[212] Thus, hoping for the SEC to provide a comprehensive standard is like waiting for Godot[213]—we will continue to wait. Legislative action could resolve this problem.

Some have suggested that reform should occur in the courts, where the Doctrine has developed since the prohibition's inception.[214] Theoretically, the courts are constrained by precedent, so they cannot achieve the sort of comprehensive reform that is necessary. Notwithstanding, the courts are inappropriate fora to settle deeply-entrenched policy disputes over a federal crime. Principally, this is a separation-of-powers issue. The U.S. Constitution clarifies that all

[205] *See generally* § 10(b) of the Securities Exchange Act of 1934.

[206] Hostert, *supra* note 160, at 745.

[207] *See* United States v. Whitman, 904 F. Supp. 2d 363, 367 n.1 (S.D.N.Y. 2012) (Rakoff, J.) (noting this argument); Langevoort, *Rereading* Cady, Roberts, *supra* note 203, at 1336–40 (discussing the "blueprint for fraud" argument); *see also* William Cary et al., *Insider Trading in Stocks*, 21 BUS. LAW 1009 (1965) (coining the phrase and discussing the federal law of insider trading).

[208] Langevoort, *Rereading* Cady, Roberts, *supra* note 203, at 1337.

[209] *Id.* Furthermore, a statutory prohibition would almost certainly continue to require that the information at issue be "material"—or, information that a reasonable investor would likely consider significant. *See* Basic, Inc. v. Levinson, 485 U.S. 225 (1988). Thus, insiders would continue to face an accepted ambiguity: whether the information they have is significant enough to meet the reasonable person standard articulated in *Basic*. *See* Langevoort, *Rereading* Cady, Roberts, *supra* note 203, at 1337.

[210] Langevoort, *Rereading* Cady, Roberts, *supra* note 203, at 1338.

[211] *See* § 10(b) of the Securities Exchange Act of 1934.

[212] *See supra* Section II.B.

[213] *See generally* SAMUEL BECKETT, WAITING FOR GODO (Grove Press 1994) (1954).

[214] Hostert, *supra* note 160, at 745–46.

legislative power is vested in the Congress,[215] and the power to define crime and punishment is expressly delegated to the Congress.[216] But also, there is a prudential basis: the courts are poorly situated to reconceive a federal crime because the resolution of cases does not permit the kind of comprehensive policy-making that is required for all jurisdictions.

Finally, Congress has prior examples of its own making to consider as possible frameworks for an insider trading proscription. For instance, § 807 of the Sarbanes-Oxley Act added § 1348 to the U.S. Criminal Code, under which some insider traders have been prosecuted.[217] Section 1348 provides a maximum 25-year imprisonment for anyone who "knowingly executes, or attempts to execute, a scheme or artifice" to "defraud" or to "obtain" any money or property using a false or fraudulent representation in connection with the purchase or sale of a security of a reporting company.[218] Stephen Bainbridge has noted that while the legislative history for this provision is sparse, it is clear that Congress intended to increase the penalties for securities fraud and make it easier for prosecutors to prove such cases by eliminating the "technical elements" of existing provisions such as § 10(b) and Rule 10b-5.[219] While § 1348 is unavailable to the SEC, which is responsible for civil enforcement, the statute provides a good example of what Congress could do for a comprehensive insider trading proscription.

In addition, the Stop Trading on Congressional Knowledge ("STOCK") Act of 2012 represents a missed opportunity where Congress could have defined an insider trading prohibition.[220] The STOCK Act was a response to scandals involving congressional members and staff who were communicating MNPI to tippees, including hedge fund traders, while evading prosecution.[221] The STOCK Act conferred a fiduciary duty upon all government employees so that disclosing such information would be a breach,[222] which previously had been "perfectly legal."[223] Donna Nagy has argued that the STOCK Act, in fact, is evidence of Congress's "explicit legislative recognition that the Exchange Act encompasses insider trading prohibitions that arise under § 10(b) and Rule 10b-5."[224] In other words, the STOCK Act suggests Congress's judgment that insider trading law should develop in federal courts inasmuch as it reflects Congress's revulsion for special

[215] U.S. CONST. art. 1.

[216] U.S. CONST. art. 1, § 8.

[217] *See, e.g.*, United States v. Blaszczak, No. 1:17-cr-00357 (S.D.N.Y. 2019).

[218] Sarbanes-Oxley Act of 2002 § 807, Pub. L. No 107-204, 116 Stat. 745 (2002) (to be codified at 18 U.S.C. § 1348).

[219] Bainbridge, *supra* note 112, at 89 (citation omitted).

[220] STOCK Act, Pub. L. No. 112-105, 126 Stat. 291 (2012)

[221] Kendall R. Pauley, Note, *Why* Salman *Is a Game-Changer for the Political Intelligence Industry*, 67 AM. U. L. REV. 603, 606, 637 (2017).

[222] STOCK Act, Pub. L. No. 112-105, § 4 (g)(1), 126 Stat. 291, 292; *see also* Pauley, *supra* note 221, at 636.

[223] *See Congress: Trading Stock on Inside Information*, 60 MINUTES (June 11, 2012), https://www.cbsnews.com/news/congress-trading-stock-on-inside-information/ [https://perma.cc/ET8V-YNGD].

[224] Nagy, *supra* note 11, at 34.

privileges. She observes how prior bills included an "outright statutory proscription against congressional insider trading,"[225] yet the drafters adhered to a more limited breach of fiduciary duty framework.[226] But Congressional leaders were under enormous pressure to act, and to do so quickly.[227] Besides, SEC officials[228] and an influential scholar[229] cautioned against using the opportunity to recast the enforcement regime, and Congress acquiesced. Now that *Newman*, *Salman*, and *Martoma* have muddied the doctrine, Congress could revisit its earlier inclinations.

It is beyond the scope of this Note to argue in favor of a particular framework. Principally, this is because the endeavor would require analysis of a number of other controversies in the law of insider trading under the Rule 10b-5 regime.[230] And more experienced minds, such as those of the Bharara Task Force on Insider Trading, have developed useful proposals.[231] Instead, this Note is attempting to accomplish a much more limited objective: to illustrate why Congressional action to define an insider trading prohibition is necessary.[232]

[225] *Id.* at 35 (citing Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. REV. 1105, 1130–37 (2011)).

[226] *See id.* (quoting S. REP. NO. 112-244, at 9 (2011–2012)).

[227] *See* Pauley, *supra* note 221, at 637.

[228] *See* Nagy, *supra* note 11, at 35 (quoting *The Stop Trading on Cong. Knowledge Act: Hearing on H.R. 1148 Before the H. Comm. on Fin. Servs.*, 112th Cong. 25 (2011) (testimony of SEC Director of Enforcement Robert Khuzami)).

[229] *Id.* (quoting *Insider Trading and Cong. Accountability: Hearing Before the S. Comm. On Homeland Sec. & Gov't Affs.*, 112th Cong. 15 (2011) (testimony of Professor John C. Coffee, Jr.)).

[230] For example, the question of tipper and tippee scienter continues to cause controversy, especially as some courts have suggested liability for recklessness. *See* Langevoort, *Fine Distinctions*, *supra* note 37, at 446–57 (discussing this trend). Moreover, another recent controversy is how some computer hackers, who, for instance, manage to break into a database to steal information on which they trade, may escape insider trading liability because they did not deploy sufficiently deceptive practices. *See* Bharara & Jackson, *supra* note 30; *see also* SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (noting that hackers may be deemed to have violated Rule 10b-5 provided that their theft involves "trickery" or some deceptive conduct).

[231] *See* PREET BHARARA ET AL., REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING (Jan. 2020), https://static1.squarespace.com/static/5e1f2462d354fa5f5bac2699/t/5e2a1e9d12e0c33aefc41303/1579818654541/Report+of+the+Bharara+Task+Force+on+Insider+Trading.pdf [https://perma.cc/CD44-6SMH] (adopting four principles for insider trading reform, proposing model language for future legislation, and concluding that a statutory proscription is the best vehicle for reform); *see also* Bharara & Jackson, *supra* note 30; Phil Brown, *Insider Trading Bans Offer Hope to Enforcers*, INTELLIGIZE (June 20, 2019), https://www.intelligize.com/insider-trading-bans-offer-hope-to-enforcers/ [https://perma.cc/37N5-9UUD] (noting the promise of the Bharara Task Force); Reynolds Holding, *Blue Sky Banter Podcast: John Coffee on the State of Insider Trading Law*, CLS BLUE SKY BLOG (Nov. 8, 2018), http://clsbluesky.law.columbia.edu/2018/11/08/blue-sky-banter-podcast-john-coffee-on-the-state-of-insider-trading-law/ [https://perma.cc/7G25-YYXU] (describing the challenges and the potential of the Bharara Task Force). Also, Professor Langevoort has even provided an admittedly dated example of a statutory prohibition. *See* Langevoort, *Rereading* Cady, Roberts, *supra* note 203, app. at 1341–43 (providing one possible version of a statutory insider trading proscription). Though it may not be appropriate to resolve all of today's controversies, the exercise illustrates that a clearer doctrine is possible.

[232] Accordingly, it is worth acknowledging this Note's shortcoming and the opportunity for further analysis.

To that end, however, current developments in the House of Representatives merit brief discussion—on December 5, 2019, the House passed the Insider Trading Prohibition Act of 2019.[233] The Bill creates a new section to the Securities Exchange Act of 1934, § 16A, and it would make the following revisions. First, the legislation would introduce a moderated possession test: it would be unlawful for a person to trade while aware of MNPI provided that the person knows or recklessly disregards that the information was wrongfully obtained.[234] Second, the Bill would employ the same framework for tipping liability: it would be unlawful for a person who would violate subsection (a) wrongfully to communicate MNPI to another who would either trade or communicate the information to an additional person who would trade, provided that the trading was reasonably foreseeable.[235] Still, for trading under subsection (a) or communicating MNPI under subsection (b), the law would confine instances of "wrongfulness" to: theft, a violation of cybersecurity law, conversion or misappropriation, or a breach of any fiduciary duty, whether or not for personal benefit.[236] Finally, the Bill makes it unnecessary for a trader under subsection (a) or communicator under subsection (b) to know specifically how the information was obtained or communicated, or whether it was for personal benefit, so long as the person knew, consciously avoided knowing, or recklessly disregarded that the information was wrongfully conveyed or used.[237] The legislation would make additional alterations,[238] but they are beyond the core of the substantive insider trading prohibition framework the House endorsed.

This Note sets out the components of the Insider Trading Prohibition Act because the legislation illustrates the benefit of an authoritative text—specification—and the very fact that "[d]rafting a provision that increases the clarity of the law is not hard."[239] Under the Act, affected parties would be more reliably able to predict the impact of their conduct in the market and to conform to the law, and enforcement attorneys should have greater confidence in the cases they investigate and ultimately pursue. Because this Note's analysis is confined to the problems of the current framework, however, it will reserve further comment on the possibility of the new, leaving that to others.[240] Indeed, there is reason to suggest that the legislation is not

[233] Insider Trading Prohibition Act of 2019, H.R. 2534, 116th Cong. (2019), https://www.congress.gov/116/bills/hr2534/BILLS-116hr2534eh.pdf [https://perma.cc/278V-5ULS]; H.R. REP. NO. 116-219 (2019), https://www.congress.gov/116/crpt/ hrpt219/CRPT-116hrpt219.pdf [https://perma.cc/EVZ2-ZGY5]; *see also* Mukhi et al., *supra* note 31; Sylvan Lane, *House Passes Bill to Explicitly Ban Insider Trading*, THE HILL (Dec. 5, 2019, 4:50 P.M.), https://thehill.com/policy/finance/473281-house-passes-bill-to-explicitly-ban-insider-trading [https://perma.cc/USD3-X5LT].

[234] H.R. 2534, § 16A(a).

[235] *Id.* § 16A(b).

[236] *Id.* § 16A(c)(1).

[237] *Id.* § 16A(c)(2).

[238] *See id.* § 16A(d), (e).

[239] Langevoort, *Rereading* Cady, Roberts, *supra* note 203, at 1338.

[240] *E.g.*, Lyle Roberts, Opinion, *The Insider Trading Law is Bad. Will Congress Make it Worse?*, WALL ST. J. (Jan. 9, 2020), https://www.wsj.com/articles/the-insider-trading-law-is-bad-will-congress-make-it-worse-11578614315 [https://perma.cc/KS5S-6GT4] (arguing that H.R. 2534 would increase

in its final form.[241] Ultimately, this Note suggests *that* the House passed the Insider Trading Prohibition Act is powerful evidence of this Note's modest point: reform is necessary.

## CONCLUSION

Political Scientist Herbert Kaufman, discussing the administrative state and statutory interpretation, once wrote to then Professor Robert Katzmann that ambiguity "may be a solvent of disagreement," but it "leads to problems of interpretation later."[242] Indeed, the current insider trading enforcement regime under § 10 (b) and Rule 10b-5 is built upon ambiguity and Congressional inaction, which has resulted in a constantly shifting body of appellate law. This Note discussed *United States v. Martoma* in particular to illustrate the problems within the doctrine and to suggest why reform is necessary. Finally, this Note argued that Congress should use its Article I power to legislate a specific insider trading proscription to enhance clarity and fairness for traders, market participants, enforcers, and others.

confusion about insider trading liability, "perplex investors, give prosecutors too much discretion, and bedevil the courts").

[241] *See* H.R. REP. NO. 116-219, at 26–28 (2019), https://www.congress.gov/116/crpt/hrpt219/CRPT-116hrpt219.pdf [https://perma.cc/Y8DP-9G8E] (reporting the minority views of Committee Republicans who indicate their lack of support for the Bill in its current form because it does not provide a concise enough definition of the insider trading prohibition). Committee Republicans also voiced their concern that the Bill contains a number of ambiguities, including about the requisite personal benefit for tipping liability. *Id.* at 26–27. Fortunately, the Committee Report provides reason to believe that both Democrats and Republicans will work towards the goal of defining a prohibition by statute. *See id.* at 26 ("Committee Republicans are sympathetic to the concerns of the Democrats that there is no statute in this area. To that end, Committee Republicans agreed to voice vote H.R. 2534 out of the Committee with the hope a bipartisan consensus to improve the bill could be achieved.").

[242] *See* Robert A. Katzmann, *War Powers: Towards a New Accommodation*, *in* A QUESTION OF BALANCE 49 (Thomas E. Mann ed., 1990) (citing Letter from Herbert Kaufman to Robert Katzmann, October 5, 1989).