The Remote Tippee Dilemma: Resolving Tippee Liability More Than Thirty Years After Dirks v. SEC

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COMMENT

THE REMOTE TIPTEE DILEMMA: RESOLVING TIPTEE LIABILITY MORE THAN THIRTY YEARS AFTER DIRKS V. SEC

TABLE OF CONTENTS

I. INTRODUCTION .................................................................................................................. 110
II. THE FOUNDATIONS OF INSIDER TRADING ................................................................. 112
   B. From Legislative Acorn to Judicial Oak, Insider Trading Defined ..................... 116
III. THE EVOLUTION OF TIPPER AND TIPSEE LIABILITY IN THE HIGHEST COURT ................................................................. 117
   A. The Beginning: “Equal Access” to Information Theory...................................... 118
   B. The Rise of the “Classical Theory” of Insider Trading................................... 120
   C. The “Misappropriation Theory” and the Divide Among the Circuits ............... 123
   D. U.S. v. Newman’s “Clarification” Regarding Tippee Liability ......................... 125
IV. CONGRESS SHOULD ADOPT A NEW TIPSEE LIABILITY STANDARD ......................................................... 128
   A. Considerations on Remote Tippees and the Securities Market Structure After Newman ................................................................. 128
   C. Recent Bills By Congress Addressing Insider Trading .................................. 133
   D. A New Liability Standard For Remote Tippees ............................................ 138
V. CONCLUSION ..................................................................................................................... 141

109
I. INTRODUCTION

Imagine an investment firm hired your client as a junior financial analyst because of his previous employment as an intern at Exxon's financial department. Your client's new employers made it clear his previous "connections" would be instrumental to their firm, but he did not give substantial thought to the comment and instead assumed that Exxon experience is tremendous on any resume. One month into the job, your client began getting pushed by other junior financial analysts to reach out to his previous coworkers for details on Exxon's financial performance before the next quarterly report. Your client did not want to lose his first job with a decent paycheck, so he contacted a former coworker and managed to attain such information from him.

As the year progressed, your client became accustomed to acquiring Exxon's "insider" information and sending it to other junior financial analysts who eventually provided it to a senior analyst. Later, your client found out that the executive of the firm has been profiting by trading based on the Exxon information your client provided to the other analysts. Eventually your client's worst nightmare materializes: the investment firm is under the investigation of the Securities Exchange Commission (SEC). He begins wondering, "Am I liable? Are my superiors liable? To whom are they liable?"

The executive's conduct goes by the peculiar description of "layering" and conscious avoidance.1 Unfortunately, the scenario

1. One attorney has summarized the effect of the Second Circuit's decision in United States v. Newman, 773 F.3d 438 (2d Cir. 2014), by stating, "So long as you are in the dark about the circumstances of the individual providing the information, you are in the clear." Robert M. Appleton, Attorneys React To 2nd Circ.'s Insider Trading Ruling, LAW 360 (Dec. 10, 2014, 4:44 PM) (Layering can be defined by its plain meaning i.e., the act of being several persons (layers) away from the corporate insider who misappropriates the material, nonpublic information.).

2. United States v. Svoboda, 347 F.3d 471, 480 (2d Cir. 2003) (internal citations omitted). Conscious avoidance is the act of avoiding the truth, and the Svoboda court gave the following definition as it pertains to jury instructions: "A conscious avoidance instruction 'may only be given if (1) the defendant asserts the lack of some specific aspect of knowledge required for conviction, and (2) the appropriate factual predicate for the charge exists, i.e., "the evidence is such that a rational juror may reach [the] conclusion beyond a reasonable doubt...that [the defendant] was aware of a high probability [of the fact in dispute] and consciously avoided confirming that fact[.]"'... The second prong of this test thus has two
THE REMOTE TIPPEE DILEMMA

above is not a far-fetched hypothetical. In fact, the hypothetical is analogous to the facts in the Second Circuit’s recent decision in United States v Newman, which has taken the legal world in securities by storm. The Newman decision has already had a substantial impact on insider trading cases.

Understanding the history of the laws governing securities regulation is critical not only to attorneys and those dealing in the securities market but also necessary for the advancement of securities regulation. In the above hypothetical, the Exxon insider (i.e., tipper) and your client (i.e., tippee) would be liable under the current state of insider trading laws. Yet, the executive (i.e., remote tippee) would possibly not be liable even though he is committing the more blameworthy form of securities fraud that insider trading laws originally sought to prevent. This Comment addresses the issue of remote tippees by suggesting a new liability standard that Congress should adopt, which is centered on the remote tippee’s actual or constructive knowledge.

Part II of this Comment provides a brief background on insider-trading laws including the Securities Act of 1933 (‘33 Act), the Securities Exchange Act of 1934 (‘34 Act), and SEC Rule 10b-5. Part


5. “The ruling has since been used by 12 criminal defendants in the Southern District of New York in requests to overturn convictions, vacate guilty pleas, dismiss charges or receive leniency at sentencing.” Stendahl, supra note 4.


7. Chief Justice Burger stated in his dissenting opinion, “The history of the statute and of the Rule also supports this reading. The antifraud provisions were designed in large measure ‘to assure that dealing in securities is fair and without undue preferences or advantages among investors.’” Chiarella, 445 U.S. at 241 (Burger, J. dissenting) (citing H.R. CONF. REP. NO. 94-229, at 91 (1975), as reprinted in 1975 U.S.C.C.A.N. 321, 323.
III will explain previous key cases to demonstrate the evolution of tipper and tippee liability before *U.S. v. Newman* as well as the changes caused by that decision. Part IV explains the effects of current insider-trading laws and potential changes by Congress’s recently proposed bills. Finally, Part IV suggests a new standard for tippee liability that Congress should adopt in order to prevent culpable remote tippees from escaping securities fraud liability.

II. THE FOUNDATIONS OF INSIDER TRADING

A. *The Securities Act of 1933 and the Securities Exchange Act of 1934*

The ‘33 Act was passed after the stock market crash of 1929 and in the midst of the Great Depression. Congress’s goal was to protect investors by providing regulations that required “full and fair disclosure” of all “material” information, which means a comprehensive disclosure of information that a prospective buyer would want to know before making a decision.

For the most part, the ‘33 Act was narrow and provided several anti-fraud provisions. For example, section 12(a)(2) created civil liability for any individual who sold a security through a prospectus or oral communication that contained a material misstatement or omission. Another example is section 17(a), which created liability for fraudulent or deceitful sale of securities through the use of

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12. The term prospectus is defined as any “notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” 15 U.S.C. § 77b(a)(10) (2012).
interstate commerce.\textsuperscript{14} However, after a year Congress realized the failures of the limited '33 Act and the need for an administrative agency to regulate stock market practices and enforce federal securities laws; thus, the '34 Act was born.\textsuperscript{15}

In contrast to the '33 Act, the '34 Act was broad and designed to create an administrative agency\textsuperscript{16} to regulate the transaction of securities in the secondary market.\textsuperscript{17} Congress stated that one of the main goals of the '34 Act was “to assure that dealing in securities is fair and without undue preferences or advantages among investors.”\textsuperscript{18} Whether Congress’s intention has been maintained as securities regulation has evolved is discussed in Part III.

The '34 Act’s direct regulation of the secondary market includes disclosure requirements as in the '33 Act, but the pivotal sections are 10(b)\textsuperscript{19} and 16(a) and (b).\textsuperscript{20} Section 10(b) has now become the foundation of insider trading cases and its contrast in detail to section 16 is peculiar in its extensive and controversial requirements.\textsuperscript{21} Section 16 has specific language and strict requirements that compel directors, officers, and principal stockholders of a corporation, whose

\begin{itemize}
  \item 14. 15 U.S.C. § 77q(a) (2012); see also Sarkar, supra note 13.
  \item 17. The secondary market includes transactions after the initial public offering by the issuer such as the purchase or sale of security from another investor. Deepa Sarkar, Securities Act of 1934, CORNELL UNIVERSITY SCHOOL OF LAW, http://www.law.cornell.edu/wex/securities_exchange_act_of_1934 (last visited Mar. 24, 2015).
  \item 19. See 15 U.S.C. § 78j(b) (2012); see also Dessent, supra note 9.
  \item 21. Dessent, supra note 9, at 1146-48. The author states that a “startling comparison” arises between detail in § 10(b) and § 16. Furthermore, he comments that even though Rule 10b-5, the SEC’s offspring of 10(b), has been “characterized as an anti-fraud provision, Rule 10b-5 has been used to bar insider trading without ever speaking of those terms. The legislative history gives some indication that insider trading is without ever speaking of those terms. The legislative history gives some indication that insider trading is one of the evils the section was intended to address, but there is little evidence of what types of insider trading would be considered manipulative or deceptive within the meaning of the section.”
\end{itemize}
shares are traded on a national securities exchange, to file statements with the SEC within ten days of becoming a beneficial owner, director, or officer of such corporation.\(^\text{22}\) In addition, section 16 prevents the "unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer" by precluding such persons from realizing any profit from the purchase or sale of a security, within less than six months, irrespective of intentions.\(^\text{23}\) Furthermore, section 16 creates conditions limiting any sales if the seller does not own the security sold or does not deliver it within twenty days.\(^\text{24}\) On the other hand, section 10(b) has the following broad language:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange — (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.\(^\text{25}\)

This small paragraph is the entire foundation for insider trading cases.\(^\text{26}\) Section 10(b) has been described by the courts as a "catch-all provision" even though the provision itself, and Rule 10b-5, do not explicitly ban insider trading.\(^\text{27}\) It was not until 1948 that the SEC, under the authority of section 10(b), created Rule 10b-5 allowing federal district and circuit courts to begin "facilitat[ing] pro-

\(^{26}\) In the following section (Part I, B), Justice Rehnquist writing the majority opinion in Blue Chips v. Manor Drug Stores expresses a similar view regarding § 10(b) and the expansion of securities regulation built upon its brief and ambiguous language. See generally Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
\(^{27}\) Newman, 773 F.3d at 445 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202–06).
prosecutorial efforts against insider trading." Similar to section 10(b), 10b-5 is brief with little context and it states:

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

The history behind Rule 10b-5 is that members of the SEC gathered around and passed a note with the 10b-5 language written on it and "tossed it on the table, indicating approval" after hearing of a company president who was defrauding his own shareholders by purchasing their stock after he had told them the company was doing poorly. Furthermore, in a rather humorous recollection, the Rule 10b-5 draftsman stated, "Nobody said anything except Sumner Pike [an SEC committee member] who said, ‘Well . . . we are against fraud aren’t we?’ That is how it happened.”

Today, the expanded state of insider trading regulation is a result of the SEC and courts’ expansive interpretation of the statute, and not of the language as originally passed by the ‘34 Act. Regardless, understanding the legislative foundation will put into perspective how the current state and continuing development of insider trading regulation are expanding the original intentions of the ‘34 Act in order to adjust to the evolving securities market.

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31. *Israels, supra* note 29, at 1587 (citing a quote from Milton Freeman at a Conference of Codification of the Federal Securities Laws, see n.9).
B. From Legislative Acorn to Judicial Oak, Insider Trading Defined

Today, a person committing fraud in the securities market can be held liable under one of the two established theories of insider trading: the "classical theory" and the "misappropriation theory." This section previews these laws in their present form before Part III's explanation on how these theories were formed.

The two theories are centered on the notion that insider trading is a form of securities fraud that section 10(b) and Rule 10b-5 were created to prevent. The classical theory holds that a corporate insider violates section 10(b) and Rule 10b-5 when he trades in the corporation's securities on the basis of nonpublic, material information. The violation is based on the concept that there is a fiduciary duty between shareholder(s) of a corporation and those who obtain the information because of their position within the corporation i.e., corporate insider. As a result of the fiduciary duty, corporate insiders have a duty to either abstain from trading or disclose such information. If the corporate insider trades or fails to disclose material, nonpublic information then that "qualifies as a 'deceptive device'" under section 10(b).

The Supreme Court has a history of avoiding the second theory, known as the misappropriation theory. While the classical theory creates liability for corporate insiders, the misappropriation theory expands liability to corporate outsiders. Specifically, the misappropriation theory holds that an outsider is liable if he or she possesses material, nonpublic information about a corporation and uses that information to trade in breach of a "duty" owed to the source of that information.

36. Id.
37. Id. at 228-30.
39. See Dessent, supra note 9, at 1164-90, for the author's detailed coverage of the misappropriation theory's history in the courts.
41. Id. at 652–53.
While the misappropriation theory had mostly been ignored by Supreme Court cases, both theories are now accepted and applied for tipper and tippee liability i.e., liability for the person divulging (tipper) or receiving (tippee) material, nonpublic information and trading on the basis of that information.\textsuperscript{42} With regard to the expanded scope of insider trading, the late Justice Rehnquist famously stated, "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."\textsuperscript{43} The current contention has been caused by a recent surprise by the Second Circuit and its decision on tippee liability.\textsuperscript{44} For this reason, the rest of this Comment will focus on the evolution of tipper and tippee liability with particular attention to the latter.

III. THE EVOLUTION OF TIPPER AND TIPPEE LIABILITY IN THE HIGHEST COURT

Incredibly, since the landmark case \textit{Dirks} v. \textit{S.E.C.}, there have only been two Supreme Court cases within the past five years to even mention \textit{Dirks}.\textsuperscript{45} Even more surprising, neither of those cases discusses the misappropriation theory for tipper or tippee liability.\textsuperscript{46} One might infer the Supreme Court believed there was no need to address the misappropriation theory as applied to remote tippees, or perhaps that the Court was sending a message to Congress. Irrespective of the reason, this section explains the development of tipper and tippee liability in the Supreme Court.

\textsuperscript{42} Id. at 652-54.
\textsuperscript{43} \textit{Blue Chips}, 421 U.S. at 737.
\textsuperscript{44} See Newman, 773 F.3d 438.
A. The Beginning: "Equal Access" to Information Theory

Justice Blackmun once referred to the Second Circuit as the, "justifiably esteemed panel . . . [and] the 'Mother Court' in this area of the law." As will be shown below, Justice Blackmun's comment is more than appropriate.

The Second Circuit's decision in SEC v. Texas Gulf Sulphur Co. was one of the earliest pivotal cases on insider trading that went "beyond the common law and into the realm of § 10(b)." In Texas Gulf, the SEC sought an appeal to convict all fourteen Defendants including Texas Gulf Sulphur Co. rather than only the two individuals that the lower court convicted. In a dramatic turnaround, the Court reversed many of the dismissed complaints against the defendants and found liability on the basis of a broad interpretation of section 10(b) violations. Out of the defendants, five were officers and employees who knew about a recent successful drilling venture (i.e., material, nonpublic information) from Texas Gulf Sulphur Co. but still accepted the company's stock options rather than disclosing the information or rejecting the stock options.

The Court acknowledged the SEC's previous administrative decision, In the Matter of Cady, Roberts, and Co., which limited liability to insiders such as "directors or management officers" or those "who may not be termed strictly an 'insider' within the meaning of § 16(b)." However, the Court went beyond the test established in

47. Blue Chips Stamp, 421 U.S. at 762.
48. The article, Joe Six-Pack, does an expansive job of explaining all the case law evolution in a more detailed manner. Please see generally Joe Six-Pack for a deeper background of numerous lower court decisions. See generally Dessent, supra note 9, at 1160 (citing SEC v. Tex. Gulf Sulphur Co. 401 F.2d 833, 848 (2d Cir. 1968)).
49. Tex. Gulf, 401 F.2d at 839-42.
50. Id. at 842-43.
51. Id. at 844.
52. Id. at 848. The author of Joe Six-Pack best summarizes the SEC's administrative decision, In the Matter of Cady, Roberts, and Co., that creates the "traditional insider" and "non-traditional insider" distinction. The summary states, "Traditional insiders were typically identified as directors, officers, or controlling shareholders who had always been considered such under common law. However, the SEC extended Rule 10b-5's duty to 'disclose inside information or abstain from trading,' to all persons who enjoy 'a relationship giving access, directly or
THE REMOTE TIPPEE DILEMMA

Cady and held that, "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading ... while such inside information remains undisclosed."\(^{53}\) Thus, liability was expanded to "anyone in possession" of material, nonpublic information — including non-insiders even if there was no breach of fiduciary duty.\(^{54}\) As a result, the Court overturned a geologist's dismissal and held that he violated section 10(b) for tipping material information regarding a successful drilling venture, but the Court did not consider the liability of the various tippees since they were not listed as defendants.\(^{55}\)

In essence, *Texas Gulf* held that the "core of Rule 10b-5" is that "all investors should have equal access to the rewards of participation in securities transactions" and that "members of the investing public should be subject to identical market risks . . . ."\(^{56}\) The standard set forth by *Texas Gulf* has been recognized as the equal access theory, and the SEC advanced this theory for many years until the Supreme Court said otherwise.\(^{57}\)

It would not be until several years later that the Supreme Court severely limited *Texas Gulf* by narrowing the right to a private cause of action under 10b-5 to purchasers or sellers.\(^{58}\) Yet, because the Supreme Court did not directly reject the equal access theory, the Second Circuit would again implement it to uphold a conviction in *U.S. v. Chiarella*.\(^{59}\) The Second Circuit reiterated that any "corporate insider or not who regularly receives material nonpublic information may not use that information to trade in securities without incurring an indirectly, to information intended to be available only for a corporate purpose."

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Dessent, *supra* note 9 at 1159.
56. *Id.* at 851-52.
57. See generally *Chiarella*, 445 U.S. 222.
58. While the Court narrowed who could bring a cause of action, it never explicitly rejected the Equal Access Theory, which left it open for the SEC to use for a few more years until *Chiarella v. United States*. See *Blue Chips Stamp*, 421 U.S. at 731.
59. See *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978).
affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."60 Thus, though refined, the equal access theory lived on, but it would only do so for two more years.

B. The Rise of the "Classical Theory" of Insider Trading

In 1980, the Second Circuit's Chiarella decision was the first major case to reach the Supreme Court.61 In Chiarella, there was no tipper since the information was taken by the tippee who was providing printing services for acquiring corporations.62 In fact, the acquiring corporations had left all names, including target corporations, out of printing until the night before the final printing.63 Even so, the printer found out the names of the target companies and bought and sold shares without revealing his misuse of the information, which gave him a relatively small profit in slightly over a year.64

While there was an opportunity for the Court to side with the S.E.C. and broaden section 10(b) and Rule 10b-5 to punish misuse of material, nonpublic information, the Court declined to do so.65 Instead, the Court clarified that section 10(b) had no legislative history that suggested there was a general duty to everyone to not act on material, nonpublic information.66 Furthermore, the Court indicated that duty has never been expanded so that it "departs radically from the established doctrine that duty arises from a specific relationship between two parties . . . [and a duty] should not be undertaken absent some explicit evidence of congressional intent."67

In the end, the Supreme Court held that there must be fraud, and if there is no duty to speak then fraud cannot be established.68 The Court held that the lower court "failed" to find a relationship that establishes a duty (to disclose or abstain) and that basing its decision

60. Id.
61. See generally Chiarella, 445 U.S. 222.
62. Id. at 224.
63. Id. at 224.
64. Id. at 224.
65. See id. at 234-35.
67. Id. at 233.
68. Id. at 235.
solely on equal access to information was flawed. In essence, the Court closed the door on the equal access theory and parity-of-information rule by holding that possession of material, nonpublic information does not create the duty to disclose. Furthermore, the Court would not consider a duty to the source of the information simply on the grounds that it was not submitted to the jury.

It is interesting to note that in a footnote to Chiarella, the Court states that tippees "have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider." However, the Court would not substantively address tippees and instead laid the foundation for shifting the basis of insider trading laws from equal access to duty, particularly on the duty of corporate insiders.

At the same time, however, Chief Justice Burger wrote a lengthy dissent that supported a less restrictive section 10(b) interpretation: "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." The following year, the Second Circuit and SEC embraced the theory espoused by the late Chief Justice and "indicted... a registered securities trader and analyst, and charged him with violating §10(b) and Rule10b-5 for his role in purchasing shares in tender offer target companies based on undisclosed information about pending, but secret, mergers and acquisitions." The misappropriation theory

69. Id. at 231-32.
70. Justice Blackmun clarifies the distinction between equal access and parity-of-information by stating, "there is a significant conceptual distinction between parity of information and parity of access to material information. The latter gives free rein to certain kinds of informational advantages that the former might foreclose, such as those that result from differences in diligence or acumen. Indeed, by limiting opportunities for profit from manipulation of confidential connections or resort to stealth, equal access helps to ensure that advantages obtained by honest means reap their full reward." Id. at 252 n.2 (Blackmun, J., dissenting).
72. Id. at 236.
73. Id. at 252 n.12.
74. See id. at 235.
75. Dessent, supra note 9, at 1166 (citing Chiarella, 445 U.S. at 240 (Burger, C.J., dissenting)).
began to expand to other circuits but was not recognized until much later by the Supreme Court.

Just three years after *Chiarella*, another pivotal case made its way to the Supreme Court: *Dirks v. S.E.C.* Dirks was an officer of a broker-dealer firm focused on providing investment analysis. When he discovered information of potential fraud in a company involved with his broker-dealer firm, Dirks began an investigation. During the investigation, Dirks reached out to management who denied any fraud; however, some employees actually corroborated the fraud charges. While continuing the investigation, he discussed the charges with investors and clients who eventually sold their shares in the company, including some investors who liquidated more than $16 million in stock. As a result, the SEC charged Dirks with aiding and abetting fraud and argued that regardless of the tipper’s “occupation or motivation,” the tipper has a duty to refrain from trading or disclosing material, nonpublic information.

The Supreme Court held that the test for tippers is “whether the insider personally will benefit, directly or indirectly, from his disclosure [to the tippee]. Absent some personal gain, there has been no breach of duty to stockholders.” As a result, tippee liability is established because of the breach of fiduciary duty of the tipper who disclosed material, nonpublic information for personal gain.

The Court elaborated that a tippee “assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the

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76. Ironically, the Second Circuit case was titled *U.S. v. Newman* but has no relation to the recent decision by the same Court under the same name, which is the basis of this Comment. Dessent, *supra* note 9, at 1167-68 (citing United States v. Newman 664 F.2d 12 (2d Cir. 1981), cert. denied, United States v. Mahaffy, 693 F.3d 113 (2d Cir. 2012)).


78. *Id.* at 648.

79. *Id.* at 649.

80. *Id.*

81. *Id.*


83. *Id.* at 662.

84. *Id.* at 659.
The remote tippee knows or should know that there has been a breach.\footnote{See Dirks, 463 U.S. at 666-67.} The Court did not directly state that the tippee must know or should know of the personal benefit, but stated that the "tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information."\footnote{See Dirks, 463 U.S. 646.} The holding made it clear that Dirks was not liable because the person who disclosed the information to him was a whistleblower and not tipping for personal benefit in breach of fiduciary duty.\footnote{See Dirks, 463 U.S. at 646.} Consequently, the Court left open the question regarding remote tippees and the personal knowledge requirement.\footnote{See Dirks, 463 U.S. 19 (1987).}

C. The "Misappropriation Theory" and the Divide Among the Circuits

The next three relevant Supreme Court cases\footnote{Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164 (1994); Basic Inc. v. Levinson, 485 U.S. 224 (1988); Carpenter v. United States, 484 U.S. 19 (1987).} set the stage for another landmark case,\footnote{United States v. O'Hagan, 521 U.S. 642 (1997).} which finally addressed the misappropriation theory. In 1987, the Supreme Court held — in a plurality opinion — that trading on information confidential to a newspaper source prior to being released to the public is sufficient for mail and wire fraud; thus, affirming the lower court.\footnote{See Carpenter, 484 U.S. at 28.} Instead of directly addressing the misappropriation theory, the Court recognized it was "evenly divided" on the theory and upheld the conviction solely on mail and wire fraud.\footnote{Id. at 24; see also Dessent, supra note 9, at 1174.}

Between 1986 and 1991, the Third, Seventh, and Ninth Circuits joined the Second Circuit in holding that the misappropriation theory is viable under section 10(b).\footnote{See Dessent, supra note 9, at 1178-79 (citing Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), cert. denied, 481 U.S. 1017 (1987); SEC v. Cherif, 933}
Court again reviewed another section 10(b) case, but the Court focused only on material misrepresentations and the fraud on the market theory associated with misrepresentations.94 Several years later, the Supreme Court held that private individuals cannot bring an “aiding and abetting” cause of action under section 10(b), again refusing to address the misappropriation theory.95 It took the rejection of the misappropriation theory in the Fourth and Eighth Circuit Courts for the Supreme Court to finally address the theory.96

The landmark Supreme Court case came in 1997 and this time, the Court did not avoid the misappropriation theory.97 In United States v. O'Hagan, O'Hagan was a firm partner, who was retained to represent a company in their potential tender offer for common stock in Pillsbury Company.98 Both the company and the law firm took actions to protect confidentiality issues, and O'Hagan was at no point working on the representation.99 While representation was still ongoing, O'Hagan began purchasing options that gave him the right to purchase shares, and he eventually purchased 5,000 shares.100 Once the company announced its tender offer for Pillsbury, O'Hagan sold both his options and stock, resulting in a profit over $4.3 million.101

Eventually, the S.E.C. began an investigation and charged O'Hagan with defrauding his law firm and the firm's client.102 In reversing an Eight Circuit dismissal of criminal charges, the Court responded clearly by stating that criminal liability on the basis of the misappropriation theory is valid under section 10(b) and Rule 10b-5.103 The Court elaborated that an individual commits fraud under section 10(b) and Rule 10b-5 when he “misappropriates confidential information for securities trading purposes, in breach of a duty owed

F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992); and SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).

94. See Levinson, 485 U.S. at 241-45.
96. Dessent, supra note 9, at 1184-87.
97. See O'Hagan, 521 U.S. at 647.
98. Id.
99. Id.
100. Id. at 647-48.
101. Id. at 648.
102. Id.
to the source of the information." Therefore, the fiduciary relationship in the misappropriation theory is between the entrusted individual and the person(s) or company who gave the individual material nonpublic information, as opposed to the classical theory's fiduciary relationship between the corporate insider and the shareholders. The Court made a vital observation that the misappropriation theory was created to protect the securities market against fraud even by those who have access to material, nonpublic information, but do not owe a fiduciary duty to a corporation or shareholders.

Lastly, the Court affirmed the Dirks standard that "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." Again, as in Dirks, the Court at no point expanded or implied that knowledge of a personal benefit standard to the tipper is required for tippees to be held liable. This vital point sets the stage for the Second Circuit's controversial case, and the focus of this Comment.


While there has been no protesting in the streets by the general public or legal community, most individuals in the securities practice and field have been surprised by the Second Circuit's U.S. v. Newman decision. Yet, it was only a matter of time before a case with the ideal fact pattern challenged the gray area of law on insider trading. The Second Circuit's decision could force the Supreme Court to elaborate on remote tippee liability under the misappropriation theory. The more probable scenario is for the Supreme Court to wait for substantial circuit splits or allow Congress to resolve the issue.

104. Id. at 652.
105. Id. at 651-52.
106. Id. at 653.
107. Id. at 675 (quoting Dirks, 463 U.S. at 660).
108. See O'Hogan, 521 U.S. 642.
Although, if Congress is feeling pressure and is attempting to pass some bills, then there is a strong chance the Supreme Court is aware of the issue raised by the "Mother Court's" decision.

In *U.S. v. Newman*, the Government argued that Newman, a portfolio manager at a hedge fund called Diamondback Capital Management (Diamondback), and Chiasson, a hedge fund co-founder of Level Global Investors (Global), participated in an insider trading scheme along with several insider analysts. One of the corporate insiders was a Dell employee who had access to Dell's financial information and would — for eight quarters — disclose those consolidated earnings. The earnings information was then disclosed to an investor outside of Dell, who would then disclose that confidential information to employees of Newman and Chiasson's respective firms, which eventually reached the Defendants. The Dell insider disclosed the confidential information even though he was trained and warned about Dell's strict policies that prohibited disclosure of any confidential information, especially unannounced earning numbers.

The Government argued that another insider, who worked for NVIDIA Corporation, was also involved in the insider trading scheme. The NVIDIA insider disclosed the confidential information, which few individuals in the corporation could access, to a long-time church friend. Similar to the Dell confidential information, the NVIDIA confidential information was disclosed to another investor before being disclosed to employees of Newman and Chiasson who eventually provided the information to the Defendants. In both instances, the insider's disclosed confidential information was passed along through several layers of either friends

112. *Id*. at 5.
113. *Id*. at 5-6.
114. *Id*. at 9-10.
115. *Id*. at 12-14.
or other investors before reaching Newman and Chiasson (remote tippees) and their respective employees.\(^\text{118}\)

Next, the Government asserted that both corporate insiders personally benefitted from the disclosure of confidential information i.e., material nonpublic information.\(^\text{119}\) The Dell insider's alleged benefit for tipping the material nonpublic information was career advice and assistance from the investor, who was experienced in the area of work the Dell insider sought.\(^\text{120}\) As for the NVIDIA insider, his personal benefit was maintaining the close friendship with his church friend (immediate tippee).\(^\text{121}\)

The Second Circuit in *Newman* quickly rejected the Government's understanding of tippee liability and stated that the following was the actual test the Supreme Court had expressed earlier:

> [W]e hold that to sustain an insider trading conviction against a tippee, the Government must prove each of the following elements beyond a reasonable doubt: that (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.\(^\text{122}\)

In its reasoning, the Second Circuit maintained that the "Government relie[d] on dicta in a number of our decisions post-*Dirks*, in which we have described the elements of tippee liability without specifically stating that the Government must prove that the tippee knew that the corporate insider who disclosed confidential information did so for his own personal benefit."\(^\text{123}\) The Court believed that the Government was trying to re-establish the ban on tippee trading that *Dirks* rejected and would not accept the

\(^{118}\) Id. at 5-14.

\(^{119}\) Id. at 14-17.

\(^{120}\) Id. at 14-15.

\(^{121}\) Id. at 16-17.

\(^{122}\) *Newman*, 773 F.3d at 450.

\(^{123}\) Id. at 447.
Government’s interpretation of Dirks. Instead, the Court expressly stated that the tippee’s derived liability must be based on a personal benefit to the tipper that is “objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature[,]” which requires evidence of the tipper-tippee relationship that implies a quid pro quo from the tippee, or an intention to benefit the tippee.

Furthermore, the Second Circuit repeated that an insider’s disclosure of confidential information alone is not a breach, and without establishing that the tippee knows of a personal benefit to the tipper, there cannot be proof of knowledge about the breach of fiduciary duty. Lastly, the Court struck down the equal access theory that had been left open for years and stated, “[I]n both Chiarella and Dirks, the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries” and that “nothing in the law requires a symmetry of information in the nation’s securities markets.” While the Court did make some major clarifications, it still knowingly left open the remote tippee question.

IV. CONGRESS SHOULD ADOPT A NEW TIPPEE LIABILITY STANDARD

A. Considerations on Remote Tippees and the Securities Market Structure After Newman

As shown in Part III, many of the decisions that eventually reached the Supreme Court originated from the Second Circuit, which makes Justice Blackmun’s previously mentioned “Mother Circuit” quote understandable. Assuming that the Second Circuit is aware of its influence in securities regulation, one is left wondering why the Court did not use Newman as a vehicle to provide a complete answer to the issue of remote tippees.

124. See id.
125. Newman, 773 F.3d at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).
126. Id. at 448.
127. Id. at 449.
128. See Newman, 773 F.3d 438.
The *Newman* Court explicitly acknowledged that its previous decisions “involved tippees who directly participated in the tipper’s breach . . . or tippees who were explicitly apprised of the tipper’s gain by an intermediary tippee.” 129 Yet, instead of defining remote tippee liability, the Court interpreted previous Supreme Court decisions to “clarify” that tippees must have knowledge of the personal benefit to the tipper. 130 The decision not only ignored the question as to remote tippees but also raised the standard for holding any tippees liable. 131 The Court’s failure to address the distinction between tippees and remote tippees, while at the same time increasing the difficulty to prosecute any tippees, is perplexing especially when the Court recognized that its precedent has not addressed the issue. 132

The Government offered the Second Circuit the opportunity to address remote tippees when it argued in its brief that the jury instruction on conscious avoidance was correct. 133 One of the cases the Government cited is *U.S. v. Svoboda*, which states that “[a] conscious avoidance instruction ‘may only be given if (1) the defendant asserts the lack of some specific aspect of knowledge required for conviction, . . . and (2) the appropriate factual predicate for the charge exists . . . .’” 134 Specifically, the second prong of the exam requires two elements “evidence that the defendant (1) was aware of a high probability of the disputed fact and (2) deliberately avoided confirming that fact.” 135

In *Svoboda*, the defendants were long-time friends who were found guilty of engaging in a conspiracy to commit securities fraud. 136 One of the defendants worked for a bank as a credit policy officer and because of his position had access to confidential information regarding the bank’s clients. 137 He then passed the information to the

129. *Id.* at 448 (citing United States v. Jiau, 734 F.3d 147, 150 (2d Cir. 2013)).
130. *See id.* at 450.
131. *See id.*
132. *See id.* at 448.
134. United States v. Svoboda, 347 F.3d 471, 480 (2d Cir. 2003) (citing United States v. Ferrarini 219 F.3d 145, 154 (2d Cir. 2000)).
135. *Id.*
136. *Id.* at 475.
137. *Svoboda*, 347 F.3d at 475.
second defendant who traded on the basis of that information.\footnote{Id.} Similar to its prior precedent the \textit{Newman} court referenced, the tipper and tippee relationship in \textit{Svoboda} was direct (i.e., one friend was the informed insider and the other friend was the person who traded on the basis of the material, nonpublic information).\footnote{Id.}

For this reason, the Second Circuit had no problem finding that the second defendant knew the information was confidential as a result of the first defendant’s position.\footnote{Id. at 480-81.} Furthermore, the Court found that the timing, as well as the high return on the trades, was so suspicious that the lack of actual knowledge was the result of consciously avoiding confirming the fact.\footnote{Svoboda, 347 F.3d at 480-81.}

In \textit{Newman}, the Government argued there was more than sufficient evidence to prove a rational juror could have found the defendant had knowledge of a high probability that he received tips of confidential information in violation of a duty but consciously avoided confirming it.\footnote{Brief for the United States, \textit{supra} note 111, at 70.} The Government stated that Newman’s analyst told Newman of his source at Dell, and that the insider was an accounting manager at the company.\footnote{Id. at 70 (citing Tr. 160-61 and GX 805).} In addition, the Government contended that Newman received “specific tips concerning Dell’s . . . revenues and gross margins before the information was publicly announced, which Newman — a sophisticated hedge fund manager — knew was confidential.”\footnote{Id.}

The Government also indicated that Newman, on numerous occasions, received material nonpublic information before quarterly earnings announcements and knew that his analyst’s contact could only be contacted at night or on weekends.\footnote{Id. at 70.} Lastly, the profits made on the trades stemming from the inside information amounted to
approximately $4 million for Newman and $68 million for Chiasson. 146

There are several similarities between Newman and Svoboda. As in Svoboda, Newman denied actual knowledge of the unlawful source of information and made significant profits within a suspicious time of receiving the material, nonpublic information. 147 However, the key difference is that unlike the defendants in Svoboda, there was no direct relationship between the tipper and the tippee. 148 In Svoboda, the defendants were long-time friends; hence, there was an inference that the defendant must have had actual knowledge or consciously avoided confirming that the information was unlawful as a result of a breach of duty by his friend. 149

In contrast, in Newman, there is an attenuated chain of material nonpublic information, which was passed down from a corporate insider to an analyst to Newman’s analyst before actually reaching Newman. 150 Although the chain connecting the tipper and eventual tippee was indirect, the timeliness and extraordinary profit created on the basis of the information was so overwhelmingly suspicious that — as the Government 151 contended — a sophisticated hedge fund manager like Newman should have had actual knowledge that the source of the information was unlawful, or if not, he consciously avoided confirming so.

The chance for the Second Circuit to address remote tippees and constructive knowledge could not have been more opportune for the Court — yet it declined to do so. 152 Instead, the Second Circuit briefly addressed conscious avoidance towards the end of its opinion when it stated that the Government provided “absolutely no testimony or any other evidence that Newman... knew... [he was] trading on information obtained from insiders... or even that that Newman...
consciously avoided learning of these facts."\textsuperscript{153} The Court briefly explained that the evidence demonstrated that insiders regularly provided selective disclosures to analysts, and that apart from the Government’s own witnesses, no rational jury “would find that the tips were so overwhelmingly suspicious” that Newman consciously avoided knowledge of the source or beneficiary of the information.\textsuperscript{154} The Court’s decision to make a strong statement against the suspiciousness of the tips is surprising. If anything, the facts of this case seemed perfect for the “Mother Court” to clarify and include liability for remote tippees. After all, if there is no liability for a sophisticated hedge fund manager, then what is the purpose of Rule 10b-5?


The issue with the Newman holding goes beyond duty, equal access to information, or proving the tippee was aware of the personal benefit. Instead, it reverts to the fundamental balance between securities market efficiency and confidentiality.\textsuperscript{155} By not addressing remote tippees and instead raising the standard for liability, it is submitted that the Court has harmed the securities market by weakening the protection of confidentiality, which in turn harms the efficiency of the securities market. Some of the potential harms to efficiency include: (a) delayed buying and selling because of increased concerns that selective disclosures are occurring and other investors who have relationships with insiders can attain confidential information; (b) firms have to find rigorous and costly methods of protecting information from unauthorized selective disclosures; and (c) enforcement against inside trading dampened by higher standard causing more risk and unfairness in the market.

\begin{thebibliography}{9}
\bibitem{153} Newman, 773 F.3d at 453.
\bibitem{154} Id. at 454-55.
\bibitem{155} The Second Circuit in Newman acknowledges this balance between confidentiality and efficiency by stating, “[B]oth Chiarella and Dirks, the Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation’s interests in confidentiality while promoting efficiency in the nation’s securities markets.” Id. at 449.
\end{thebibliography}
The distinction between tippee and remote tippee should be trivial as it pertains to liability because in the end the result is the same fraud: trading on material, nonpublic information at the expense of shareholder(s) and/or the corporation itself. However, while the consequences to the securities market are the same fraud, sophisticated remote tippees are more culpable, and securities regulation should recognize that important distinction. Currently, courts base liability on a duty regardless of whether it is a worker in a printing company or a sophisticated hedge fund manager. But that strict adherence and interpretation of duty — as the focus of liability — allows for the possibility of tippees to create layers between themselves in order to break the chain of duty and can then consciously avoid confirming the source of the information.

Once a sophisticated remote tippee can establish a system to acquire material, nonpublic information without knowing the source of the information, the tippee can no longer be liable under current insider trading precedent. The reason is because the tippee no longer has a duty to the source of the information and is unaware of any benefits the tipper might have gained. In a nation were elaborate and fraudulent schemes are discovered often, it seems surprising the courts are unwilling to extend tippee liability to the most egregious fraud caused by sophisticated remote tippees.

The consequence is that the confidential information of a corporation is no longer protected, and the securities market is only efficient for those with the resources and sophistication to avoid liability.

C. Recent Bills By Congress Addressing Insider Trading

Several Congress members have already taken notice of the *Newman* decision and have proposed their own solutions regarding insider trading. Congressional action, rather than SEC or court action, is a step in the right direction. This is because Congress consists of elected representatives with a system of checks and balances, albeit a tedious and lengthy system at times. There is one bill currently pending in the Senate, and two in the House of

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Representatives. This section will briefly review those bills and analyze potential problems that should be addressed as they make their way through the legislative process.

First is Senate Bill 702, titled “Stop Illegal Insider Trading Act,” and co-authored by Senator Jack Reed and Senator Bob Menendez. Senator Reed’s website states Senate Bill 702 intends to define insider trading with a “bright line rule: if a person trades a security on the basis of material information that he or she knows or has reason to know is not publicly available, then he or she has engaged in unlawful insider trading.”

Specifically, Senate Bill 702’s main language reads as follows:

(d)(1)(A) To purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available.
(B) To knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of subparagraph (A).

The bill’s failure to include express language regarding a fiduciary duty or breach of fiduciary duty is the bill’s most glaring omission. In fact, the authors purposefully omitted all duty language, indicating “it would be irrelevant whether a trader knew of a source’s fiduciary duty or whether the source derived any personal benefit for tipping the inside information.”

The Section (d)(1)(A) language, which reads “has reason to know is not publicly available[,]” shifts the focus from duty to knowledge, and creates the opportunity for tippee liability to be based solely on

158. Id.
160. Id.
162. See S. 702.
163. Reed & Menendez Introduce Bill to Clearly Define and Ban Unlawful Insider Trading, supra note 158.
constructive knowledge. The Senate bill is in essence the purest form of the equal access theory — no trading on any material, nonpublic information — that Justice Burger advocated in his dissent against the Chiarella majority. The shift from duty to knowledge (i.e., the equal access theory) is clear with the authors’ emphasis on "whether the trader knew or had reason to know that he or she had an unfair advantage..." While the emphasis on knowledge, including constructive knowledge, is the first step in holding remote tippees liable, the elimination of duty fosters an inefficient securities market and forces, extensive confirmation of lawful information when not all "financial unfairness constitutes fraudulent activity under § 10(b)."

The next bill is H.R. 1625 titled "Insider Trading Prohibition Act," and is authored by Congressman Jim Himes. Congressman Himes describes H.R. 1625 as providing "a clear, consistent definition of insider trading that will improve the fairness and integrity of the markets. Confidence is a critical ingredient of effective and efficient markets, and this bill will provide ordinary investors with the confidence they need to invest in our markets." The language of the bill amends section 16 of the '34 Act to read:

(a) Prohibition Against Trading Securities While In Possession Of Material, Nonpublic Information. — It shall be unlawful for any person, directly or indirectly, to purchase, sell, ... if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase, sale, or entry would constitute a wrongful use of such information.

(b) Prohibition Against The Wrongful Communication Of Certain Material, Nonpublic Information. — It shall be unlawful for any person [to] ... wrongfully to communicate material, nonpublic information relating to such security ... to any other person if —

164. S. 702,
166. Reed & Menendez Introduce Bill to Clearly Define and Ban Unlawful Insider Trading, supra note 158.
169. Id.
(1) the other person —
   (A) purchases, sells, or causes the purchase or sale of, any
       security or security-based swap or enters into or causes the entry
       into any security-based swap agreement, to which such
       communication relates; or
   (B) communicates the information to another person who makes
       or causes such a purchase, sale, or entry while in possession of such
       information; and
(2) such a purchase, sale, or entry while in possession of such
information is reasonably foreseeable.

(c) Standard and Knowledge Requirement. — [Discussed below]
(2) Knowledge Requirement. — It shall not be necessary that the
person trading while in possession of such information
... or making the communication... know the specific means by which
the information was obtained or communicated, or whether any
personal benefit was paid or promised by or to any person in the
chain of communication, so long as the person trading while in
possession of such information or making the communication, as
the case may be, was aware, or recklessly disregarded that such
information was wrongfully obtained or communicated.170

The language of H.R. 1625 is more thorough and specific than
Senate Bill 702. Like Senate Bill 702, it contains constructive
knowledge language — “person knows, or recklessly disregards” —
but unlike Senate Bill 702, it retains the duty element, rather than
omitting it and shifting the focus entirely from duty to knowledge.171

In section (c)(1)(C), the bill defines “wrongfully” as “conversion,
misappropriation, or other unauthorized and deceptive taking of such
information, or a breach of any fiduciary duty or any other personal or
other relationship of trust and confidence.”172

H.R. 1625 is an improvement. Its language, “other relationship of
trust and confidence[.]”173 is more aligned with the misappropriation
theory’s “duty to the source of the information” holding since the
broad language presumably includes the fiduciary duty to an employer
who provides confidential information to his employee.174 The

171. Id.
172. Id.
173. Id.
weakness with the bill’s language is its failure to define “recklessly disregard” in the context of the securities market. This omission creates ambiguity as to which types of remote tippees would be liable. For example, would an average individual who overhears material, nonpublic information and buys stocks for the first time on the basis of that information be liable? What if the tippee is a sophisticated hedge fund manager who trusts his sources to not base their analysis on unlawful information? The ambiguity in the language will only create a new line of case law with conflicting decisions on which tippees showed reckless disregard.

The final bill is H.R. 1173, titled “Ban Insider Trading Act of 2015,” and is authored by Congressman Stephen F. Lynch. Congressman Lynch describes his bill as the need to “prohibi[t] the use of material inside information outright, the Ban Insider Trading Act of 2015 will better safeguard the integrity of our markets by protecting powerful information from being abused at the expense of average investors.”

The relevant language of the bill is as follows:

(d) Trading On Material Inside Information. —
“(1) IN GENERAL. — To purchase or sell any security, or any securities-based swap agreement, based on information that the person knows or, considering factors including financial sophistication, knowledge of and experience in financial matters, position in a company, and amount of assets under management, should know is material information and inside information.

As with the bills mentioned above, H.R. 1173 uses the language “should know” to include constructive knowledge. The main difference is that constructive knowledge is measured through factors such as financial sophistication, assets controlled, and position in company, which helps distinguish remote tippee liability between the financially unsophisticated individual and the sophisticated hedge

175. See H.R.1625.
177. Id.
179. Id.
However, the language of the bill is slightly unclear on whether the focus of liability is duty or knowledge, as it only mentions breach of a fiduciary duty in the section defining "inside information." Instead, duty should be expressly included in the main language of the bill to avoid reverting back to the equal access theory.

All three of the bills have potential, but each requires clarification to eliminate the ambiguity or other issues mentioned above. The silver lining is that both sides of Congress are aware of the tippee liability issue that *Newman* brought to attention, and both are taking steps to remedy that uncertain area of securities regulation. The following section suggests a test that is a hybrid of the established case law and proposed Congressional bills.

### D. A New Liability Standard For Remote Tippees

To protect confidentiality and the efficiency of the securities market, Congress should consider amending one of its current proposed bills to solve the remote tippee issue by shifting the focus from derived duty from the tipper to the actual or constructive knowledge of the tippee.

Accordingly, the standard should be: "Tippee liability is based on the individual(s) knowledge of the breach of a fiduciary duty by the tipper to the source of the material, nonpublic information. Thus, a tippee is liable if he or she, (1) had such actual or constructive knowledge; (2) that the material, nonpublic information was acquired in breach of a fiduciary duty to the source of that confidential information; and (3) still trades on the basis of that information before it is properly disclosed to the public."

Here, "constructive knowledge" is defined as "information that the individual knew or should have known based on his or her own personal or professional experience such as his or her current position or job; financial or securities sophistication; and/or previous or current degree of trades." As for "fiduciary duty to source of information," it would resemble the *O'Hagan* holding but include any fiduciary

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180. See id.
181. See id.
duties created by special relationships, including that of a sophisticated hedge fund manager or an investor and the general securities market. Under this test, the employee of the printing services shop in Chiarella would have had a fiduciary duty to the source of information, which in that case was a company that entrusted the printing employee with takeover bids data.\(^{183}\)

However, imagine if the Chiarella facts were expanded to include a neighbor of the printer, who has little knowledge of securities. Imagine the neighbor learns about the takeover bids of the company through common neighborly small talk in the driveway, and passes this confidential information to his brother. Furthermore, the brother (i.e., remote tippee) has twenty years of investing experience and owns an investing firm. Once he learns about material, nonpublic information, he trades on the basis of that knowledge. O'Hagan's holding\(^ {184} \) would not be sufficient in this case because here the outsider owes no duty to anyone from the company and is not the direct tippee of the printer.

The result would be different under the test proposed here. Under this test, the brother's experience and sophistication imparts upon him a responsibility — based on constructive knowledge — to discover whether the takeover bid information was material, nonpublic information obtained by someone's breach of fiduciary duty. He could easily confirm his suspicion by asking colleagues or his own analysts about the information's value and if it is available to the public. If he discovered it was material, nonpublic information, he would have to abstain from trading because his sophistication creates him into, in essence, a non-traditional and temporary insider.\(^ {185} \)

Now consider the hypothetical mentioned in the Introduction regarding your client, the junior analyst who was hired for his inside knowledge rather than experience at Exxon mobile. There is no doubt that Exxon's corporate insider, who gave your client material, nonpublic information would be liable under current securities law. Your client, even though he is less culpable, would also be liable under this new test since he failed to properly disclose the confidential information to the SEC or the source.

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185. Tex. Gulf, 401 F.2d at 848.
Yet, unlike the holdings in *Newman* or *O'Hagan*, the executive of the firm (i.e., remote tippee) who traded on the basis of the confidential information would not escape liability simply because: (a) he had no direct duty to the source of the information; (b) had no actual knowledge of the breach of fiduciary; or (c) was unaware of any personal benefit, if any, gained by the tipper. Instead, the executive of the firm would have the constructive knowledge that the information was acquired by a breach of fiduciary duty because of his experience as an executive and his sophistication in securities. The executive would know that the type of information his analysts were basing their projections on was not public information and would be aware of the reasons they hired your client in the first place. This sophisticated remote tippee would be a non-traditional and temporary insider who is liable because he traded on basis of the confidential information acquired by breach of fiduciary duty to the source, and he had constructive knowledge of such fact.

Similarly, Newman and Chiasson would be liable under this test because their sophistication and experience should have reasonably created red flags surrounding several suspicious facts within the information, such as: the exact accuracy of the earnings predictions; the time and date of their source’s ability to communicate such data; and the degree of profitability from his subsequent trades.  

It is difficult to imagine that such a sophisticated remote tippee could deny having constructive knowledge after receiving such quality and timely information unless of course the tippee is consciously avoiding confirming the facts regarding the lawfulness of the information. But there is no doubt that, other than the tippers, these sophisticated remote tippees are, and should remain, the most culpable of securities fraud. This test prevents such sophisticated remote tippees from turning a blind eye to the legality of the information they encounter. In short, raising the standard for liability as *Newman* did was not the proper solution and only worsened the remote tippee issue.

V. CONCLUSION

The result in *Newman* has major implications on trading in the securities market, confidentiality, and the overall health of the economy. It was not surprising when the Supreme Court denied certiorari, given the Court’s history of reviewing few insider trading cases involving the misappropriation theory. Now the future of remote tippee liability is in the hands of Congress, who is better suited to provide the necessary changes. It is appropriate to rely on Congress to shape remote tippee liability because it is both more representative of the public than the Supreme Court and has the checks and balances to provide discussion on the balance between confidentiality and securities market efficiency.

The SEC has also become more vocal about alternations to the current standard. With regard to brokers giving advice, the Chairwoman has stated that she would prefer a uniform standard of fiduciary duty, and that the SEC has the authority to create such standard. Of course, the SEC might not feel as strongly about tippee liability to the point it executes such unilateral authority. Regardless, the Newman decision has significantly changed the landscape of insider trading, and Congress should have the final word on such change.

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