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# Federal Securities Law: Insider Trading

**Michael V. Seitzinger**

Legislative Attorney

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## Summary

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

The decision by the U.S. Court of Appeals for the Second Circuit (Second Circuit) in *United States v. Newman* has brought increased attention to the issue of insider trading. In its December 10, 2014, decision, the Second Circuit overturned two high-profile convictions for insider trading. The court did not simply vacate the convictions; it remanded for the district court to “dismiss the indictment with prejudice,” thereby forbidding the government from refileing the case. The Second Circuit held that the evidence against two stock fund analysts could not sustain a guilty verdict because the government did not adequately show that the alleged insiders received personal benefits for providing information to the stock fund analysts and that the government did not present evidence that the defendants knew that they were trading on inside information obtained from insiders who were violating their fiduciary duties. The U.S. Attorney for the Southern District of New York asked the Second Circuit to reconsider the ruling, but on April 3, 2015, the Second Circuit denied the U.S. Attorney's request. On July 30, 2015, the U.S. Department of Justice asked the Supreme Court to review the Second Circuit decision. On October 5, 2015, the U.S. Supreme Court declined to hear the *Newman* insider trading appeal.

On July 6, 2015, a case decided by the U.S. Court of Appeals for the Ninth Circuit may have further complicated insider trading law. The case affirmed a lower court decision finding a breach of fiduciary duty and creation of a personal benefit in a family insider trading situation, holding that the “gift” of inside information was sufficient to create liability for insider trading.

Several bills, including H.R. 1173, H.R. 1625, and S. 702, have been introduced in the 114<sup>th</sup> Congress to attempt to prevent the type of securities trading allowed by the *Newman* decision. This report will be updated as warranted.

## Contents

Overview of Federal Statutes Related to Insider Trading.....	1
Securities Exchange Act of 1934 .....	1
Insider Trading Sanctions Act of 1984.....	2
Insider Trading and Securities Fraud Enforcement Act of 1988.....	2
Stop Trading on Congressional Knowledge (STOCK) Act of 2012 .....	3
Examples of Penalties for Insider Trading .....	3
Selected Regulations .....	3
Selected Decisions That Have Used Section 10(b) and Rule 10b-5 to Prosecute Insider Trading Violations .....	4
<i>United States v. Newman</i> .....	8
Post- <i>Newman</i> Decision.....	11
Congressional Interest in the <i>Newman</i> Decision.....	13

## Contacts

Author Contact Information .....	13
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# Overview of Federal Statutes Related to Insider Trading

Insider trading in securities may occur when a person in possession of material nonpublic information about a company trades in the company's securities and makes a profit or avoids a loss. Federal statutes have provisions which either specifically forbid insider trading or have been interpreted by courts to prohibit insider trading.

## Securities Exchange Act of 1934

One provision in the Securities Exchange Act of 1934<sup>1</sup> is specifically designed to discourage insiders in the corporation from taking advantage of their inside information in the trading of the corporation's securities. Section 16 of the 1934 Act<sup>2</sup> places sanctions on insiders who use inside information in making short-swing profits. For purposes of this provision, an insider is defined as any "person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security ... which is registered ... or who is a director or an officer of the issuer...." Every person meeting the insider definition must file a report with the Securities and Exchange Commission (SEC) at the time of the registration of the security on a national securities exchange or by the effective date of a filed registration statement or within 10 days after he becomes a beneficial owner, director, or officer. If there has been a change in the ownership of the security or if there has been a purchase or sale of a security-based swap agreement involving the equity security, the insider must file the report before the end of the second business day following the day on which the transaction has been executed.<sup>3</sup>

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

Section 10(b)<sup>4</sup> of the 1934 Act and SEC Rule 10b-5<sup>5</sup> are used in most cases of insider trading violations, as well as in other kinds of alleged securities fraud. Section 10(b) is the 1934 Act's general antifraud provision. Although it does not refer to specific types of fraud or to specific types of insiders, one of its most frequent applications over the years has been to insider trading. The statute 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)...

(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

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<sup>1</sup> 15 U.S.C. §§78a *et seq.*

<sup>2</sup> 15 U.S.C. §78p.

<sup>3</sup> 15 U.S.C. §78p(a).

<sup>4</sup> 15 U.S.C. §78j(b).

<sup>5</sup> 17 C.F.R. §240.10b-5.

such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(c)...

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

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

## Insider Trading Sanctions Act of 1984

The Insider Trading Sanctions Act of 1984<sup>6</sup> was enacted because of the belief that

[i]nsider trading threatens ... markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules. This legislation provides increased sanctions against insider trading in order to increase deterrence of violations.

“Insider trading” is the term used to refer to trading in the securities markets while in possession of “material” information (generally, information that would be important to an investor in making a decision to buy or sell a security) that is not available to the general public.<sup>7</sup>

The act provides that, if the commission believes that any person has bought or sold a security while in possession of material nonpublic information, the commission may bring an action in U.S. district court to seek a civil penalty. The penalty may be up to three times the profit gained or loss avoided.<sup>8</sup>

## Insider Trading and Securities Fraud Enforcement Act of 1988

After a number of hearings and considerable debate in the 100<sup>th</sup> Congress, the President signed the Insider Trading and Securities Fraud Enforcement Act of 1988.<sup>9</sup> This act expanded the scope of civil penalties to control persons who fail to take adequate steps to prevent insider trading.<sup>10</sup>

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<sup>6</sup> P.L. 98-376, codified in a number of provisions of 15 U.S.C. §§78a *et seq.*

<sup>7</sup> H.Rept. 98-355, at 2 (1984).

<sup>8</sup> 15 U.S.C. §78u-1(a)(2).

<sup>9</sup> P.L. 100-704, codified in a number of provisions of the federal securities laws.

<sup>10</sup> 15 U.S.C. §78u-1(a)(3) imposed on a person controlling the violator a penalty of the greater of \$1,000,000 or three times the profit gained or loss avoided. Limitations on the liability of controlling persons may be found at 15 U.S.C. §78u-1(b).

The act, among other things, also established a private right of action for buyers or sellers of securities against the inside trader if they traded contemporaneously with the insider.<sup>11</sup>

## Stop Trading on Congressional Knowledge (STOCK) Act of 2012

The STOCK Act,<sup>12</sup> signed into law on April 4, 2012, makes clear that insider trading prohibitions apply to Members of Congress, congressional staff, and other federal officials. According to Section 3 of the STOCK Act,

[A] Member of Congress and an employee of Congress may not use nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities as a means for making a private profit.

Section 9 of the STOCK Act places this prohibition on other federal officials and also affirms the non-exemption from insider trading prohibitions for these officials:

Executive branch employees, judicial officers, and judicial employees are not exempt from the insider trading prohibitions arising under the securities laws, including section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

The STOCK Act also has provisions concerning financial disclosure reporting requirements for legislative and executive branch officials.<sup>13</sup>

## Examples of Penalties for Insider Trading

There are both civil and criminal penalties<sup>14</sup> for insider trading, and the penalties can vary depending on what statutes a trader is found guilty of violating. For example, 15 U.S.C. Section 78u-1 sets out the civil penalties for securities transactions while in possession of material nonpublic information. As mentioned above, the penalty can be up to three times the profit gained or loss avoided. However, willful violations of other provisions, such as Section 10(b), the general antifraud securities statute, may result in other significant penalties. These penalties for each willful violation of a securities statute by an individual include fines up to \$5 million and/or imprisonment up to 20 years; a business may be fined up to \$25 million.<sup>15</sup>

## Selected Regulations

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

Rule 10b5-1<sup>16</sup> prohibits trading “on the basis of” material nonpublic information. This rule states that one of the proscribed activities under Section 10(b) and Rule 10b-5 is securities trading “on

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<sup>11</sup> 15 U.S.C. §78t-1.

<sup>12</sup> P.L. 112-105, codified in provisions and notes of several titles of the U.S. Code, particularly in Titles 5 and 15.

<sup>13</sup> For more information on the STOCK Act, see CRS Report R42495, *The STOCK Act, Insider Trading, and Public Financial Reporting by Federal Officials*, by Jack Maskell.

<sup>14</sup> The SEC typically seeks the civil penalties, and the Department of Justice typically seeks the criminal penalties.

<sup>15</sup> 15 U.S. C. §78ff.

<sup>16</sup> 17 C.F.R. §240.10b5-1.

the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed” to the issuer of the security, shareholders of the issuer, or another who is the source of the inside information. The regulation defines “on the basis of” as having a kind of knowledge requirement:

[A] purchase or sale of a security of an issuer is “on the basis of” material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

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

Rule 10b5-2<sup>17</sup> sets out duties of trust or confidence in misappropriation insider trading cases. The misappropriation theory of insider trading is a fairly recent development in securities law. Under the classical theory of insider trading, a corporate insider is prohibited from trading that corporation’s securities if the trade is based on inside information and if the trader has a duty of trust and confidence to the corporation’s shareholders. In contrast to classical insider trading, the misappropriation theory finds liable a person not actually a corporate insider but who has instead been provided inside information in confidence and who breaches a fiduciary duty to the source of the information in order to gain profit or avoid loss in the securities market. Rule 10b5-2 sets out examples of what is meant by “duties of trust or confidence.” They include a person’s agreement to maintain the disclosed information in confidence; a person’s history with the discloser of the inside information indicating an expectation that the recipient of the information will keep the information in confidence; and a person’s receiving information from a spouse or close relative, unless the recipient can show that he neither knew nor should have reasonably known or agreed that he would keep the information confidential.

Regulation FD<sup>18</sup> is another SEC rule which may concern a prohibition on insider trading. Regulation FD addresses selective disclosure. It provides that, when an issuer or any person acting on behalf of the issuer discloses material nonpublic information to certain enumerated persons (typically securities market professionals and holders of the securities), it must disclose that information to the public. The disclosure of the material nonpublic information to the public must be made simultaneously with the intentional disclosure to the enumerated persons or as promptly as possible to the public in the case of a non-intentional disclosure to the enumerated persons.

## **Selected Decisions That Have Used Section 10(b) and Rule 10b-5 to Prosecute Insider Trading Violations**

There are numerous cases that have used Section 10(b) and Rule 10b-5 to prosecute insider trading violations. What follows is a brief discussion of a few of the most important of these cases.

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<sup>17</sup> 17 C.F.R. §240.10b5-2.

<sup>18</sup> 17 C.F.R. §243.100–243.103.

Although it was decided 25 years before the enactment of the Securities Exchange Act, *Strong v. Repide*<sup>19</sup> illustrates that the common law rule of fiduciary duty, which is arguably the idea driving the case law imposing penalties for insider trading, prohibits a company insider from profiting from knowledge that he alone knows about the company. The Court stated,

A director upon whose action the value of the shares depends cannot avail of his knowledge of what his own action will be to acquire shares from those whom he intentionally keeps in ignorance of his expected action and the resulting value of the shares.

This is a rule of common law....

Even though a director may not be under the obligation of a fiduciary nature to disclose to a shareholder his knowledge affecting the value of the shares, that duty may exist in special cases, and did exist upon the facts in this case.

In an administrative broker-dealer disciplinary proceeding, *In re Cady Roberts & Co.*,<sup>20</sup> the SEC held that Section 10(b) and Rule 10b-5 prohibited insider trading by a person, in this case a broker-dealer, who may not actually be within the corporation whose stock has been traded but who has received privileged information about the corporation from someone within the corporation.

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

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

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

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

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<sup>19</sup> 213 U.S. 419 (1909).

<sup>20</sup> 40 SEC 907 (1961).

Thus, it appears that this case established that Section 10(b) and Rule 10b-5 extend beyond officers, directors, and major stockholders to others who receive information from a corporate source.

*Securities and Exchange Commission v. Texas Gulf Sulphur*,<sup>21</sup> a 1968 decision by the U.S. Court of Appeals for the Second Circuit (Second Circuit), supported the SEC's ruling in *Cady Roberts* by suggesting that anyone in possession of inside information must either publicly disclose the information or not trade the particular stock until the information becomes public.

The U.S. Supreme Court appears, however, in 1980 to have somewhat modified *Texas Gulf Sulphur* by indicating that, for there to be a fraud actionable under Rule 10b-5, there must be a duty to disclose arising from a relationship of trust and confidence between parties to the transaction. *Chiarella v. United States*<sup>22</sup> alleged a violation of Rule 10b-5 by an employee of a financial printer. The employee, who was involved in printing materials related to corporate takeover bids, deduced the names of the target companies from information contained in documents delivered to the printer by the acquiring companies. Without disclosing his knowledge, the employee purchased stock in the target companies and sold the shares immediately after the information was made public, realizing a profit of \$30,000. The lower courts found a violation of Rule 10b-5 and convicted the employee of the print company for willfully failing to inform the sellers of the target company securities that he knew of an imminent takeover bid that would increase the value of their stock.

The Supreme Court reversed. According to the Court, the employee in this situation did not have a duty to disclose the information. He was not a corporate insider and he received no confidential information. In addition, no duty arose from the relationship between the printing company employee and the sellers of the target companies' securities. The Court held that a duty to disclose under Section 10(b) and Rule 10b-5 does not arise from the mere possession of nonpublic market information.<sup>23</sup>

*Dirks v. Securities and Exchange Commission*<sup>24</sup> went perhaps a little further than *Chiarella* in the direction of indicating that noncorporate persons with inside information are not always liable when trading on inside information. This case involved an officer of a broker-dealer who specialized in providing investment analysis of insurance company securities to institutional investors. He received information that the assets of an insurance company were greatly

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<sup>21</sup> 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>22</sup> 445 U.S. 222 (1980).

<sup>23</sup> Concurring and dissenting opinions in *Chiarella* suggest that, if the misappropriation theory of securities fraud had been presented, *Chiarella*, a financial printer employee who deduced information from the printing materials related to takeover bids and then traded based on the information, might have been found guilty under it. Chief Justice Burger believed that the employee's conviction should have been affirmed because the "evidence shows beyond all doubt that *Chiarella*, working literally in the shadows of the warning signs [stating employer's confidentiality policy] in the printshop misappropriated—stole, to put it bluntly—nonpublic information entrusted to him in the utmost confidence." *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting). Although Justice Brennan disagreed with the Chief Justice's view of the evidence, he agreed that a "person violates section 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." *Id.* at 239 (Brennan, J., concurring). Justice Blackmun, with whom Justice Marshall joined, wrote that, even without resting *Chiarella*'s conviction on a misappropriation theory, he should have been convicted because he had "purloined" information (Blackmun, J., dissenting, *id.* at 246-252). Justice Stevens, who concurred in the opinion of the Court, wrote separately, emphasizing the "fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future." (Stevens, J., concurring, *id.* at 238).

<sup>24</sup> 463 U.S. 646 (1983).

overstated because of fraudulent corporate practices and that regulatory agencies had not acted on these charges made by company employees. Although the officer of the broker-dealer did not himself trade the stock, some of his customers did, based on information that they received from him. The price of the stock fell, and the SEC began investigations, eventually finding that the officer had violated Rule 10b-5 by repeating the allegations of fraud to investors who later sold their stock in the insurance company. However, because of his role in uncovering the fraud, he received only a censure from the SEC.

The Supreme Court found that no violation of Section 10(b) had occurred. In order to find a violation of Section 10(b) by a corporate insider, two elements are necessary, according to the Court: the existence of a relationship affording access to inside information intended to be available only for a corporate purpose and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. However, the duty arises from a fiduciary relationship; in addition, there must be manipulation or deception to bring about a breach of the fiduciary duty. Here, according to the Court, the insider did not trade on the inside information, nor did he make secret profits. For the officer of the broker-dealer to have the duty to disclose inside information or to abstain from trading, the officer must have breached his fiduciary duty. Since he had no duty to abstain from using inside information, he had no pre-existing fiduciary duty to the insurance company's shareholders and, therefore, did not violate Section 10(b) or rule 10b-5.

Seven years after *Dirks*, the Supreme Court decided another landmark securities case, *Carpenter v. United States*.<sup>25</sup> Although the case did not find the defendants guilty under the misappropriation theory of securities fraud, it did discuss the issue. In the *Carpenter* case, R. Foster Winans, a former writer for the *Wall Street Journal's* "Heard on the Street" column, and others were charged with violations of Section 10(b) and Rule 10b-5. They were also charged with violating the federal mail and wire fraud statutes<sup>26</sup> and with conspiracy.<sup>27</sup> In researching information to be used in his column, Winans interviewed corporate executives, but none of the information that he obtained contained corporate inside information. Because of its perceived quality and integrity, the column had the potential for affecting the prices of the stocks that it discussed.

The *Wall Street Journal's* official policy was that, before publication, the contents of the column were its confidential information. Despite being familiar with the rule, Winans agreed to give Peter Brant and Kenneth Felis, both employees of Kidder Peabody, advance information about the columns. Brant, Felis, and another conspirator, David Clark, bought and sold stocks based on the probable impact of the information that would later appear in Winans's columns. The profits from these trades over a four-month period amounted to \$690,000. Kidder Peabody's compliance department eventually noticed correlations between the Winans columns and the Clark and Felis accounts. The SEC began an investigation; Winans and his roommate, David Carpenter, revealed the scheme; and the indictments followed.

The lower courts found that Winans had knowingly breached a duty of confidentiality by misappropriating prepublication information. They found that this misappropriation had violated Section 10(b) and Rule 10b-5 because the deliberate breach by Winans of his duty of confidentiality was a fraud and deceit on the newspaper. The lower courts also held that Winans had fraudulently misappropriated property within the meaning of the mail and wire fraud statutes. The parties found guilty filed for *certiorari* to challenge the lower courts' conclusions.

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<sup>25</sup> 484 U.S. 19 (1987).

<sup>26</sup> 18 U.S.C. §§1341 and 1343.

<sup>27</sup> 18 U.S.C. §371.

The Supreme Court was evenly divided<sup>28</sup> concerning the convictions under the securities laws and therefore affirmed the lower courts' judgment. The Court did not elaborate on the issue of whether Winans's activities violated the securities laws. The Court affirmed the lower courts' judgment with respect to the mail and wire fraud convictions.

Ten years later, in *United States v. O'Hagan*, the Supreme Court legitimated the misappropriation theory of securities fraud by finding O'Hagan guilty of Section 10(b) and Rule 10b-5 violations. O'Hagan was a partner in a Minneapolis law firm, which represented Grand Met, a large diversified law firm based in London. Grand Met was interested in acquiring Pillsbury. O'Hagan purchased call options for and stock in Pillsbury after he learned of Grand Met's interest. After the tender offer was publicly announced, Pillsbury stock immediately rose. O'Hagan exercised his options and liquidated his stock, realizing a profit of over \$4 million.

The SEC indicted O'Hagan on 57 counts, including securities fraud under Section 10(b) and Rule 10b-5. A jury convicted him on all of the counts, but the U.S. Court of Appeals for the Eighth Circuit (Eighth Circuit) reversed,<sup>29</sup> holding, among other things, that the misappropriation theory is inconsistent with Section 10(b). The Supreme Court reversed the Eighth Circuit.<sup>30</sup>

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

[T]he fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.... A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he derives the source of the information and simultaneously harms members of the investing public....<sup>31</sup>

## *United States v. Newman*

A decision late in 2014 by the U.S. Court of Appeals for the Second Circuit has brought increased attention to the issue of insider trading. Some commenters have gone so far as to indicate that the decision has "upended the government's campaign" against insider trading, referring to successes that the U.S. Attorney for the Southern District of New York has had in prosecutions over the past few years.<sup>32</sup>

In its decision, *United States v. Newman*,<sup>33</sup> the Second Circuit overturned two high-profile convictions for insider trading. The court did not simply vacate the convictions; it remanded for the district court to "dismiss the indictment with prejudice," thereby forbidding the government from refileing the case. In March 2015 the U.S. Attorney for the Southern District of New York

<sup>28</sup> Because of Justice Powell's retirement, there were only eight members of the Court at the time of the decision.

<sup>29</sup> 92 F.3d 612 (8<sup>th</sup> Cir. 1996).

<sup>30</sup> 521 U.S. 642 (1997).

<sup>31</sup> *Id.* at 656.

<sup>32</sup> [http://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions/?\\_r=0](http://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions/?_r=0).

<sup>33</sup> 773 F.3d 438 (2d Cir. 2014).

asked the Second Circuit to reconsider its ruling, but in April 2015 the Second Circuit denied the U.S. Attorney's request.<sup>34</sup>

The Office of the U.S. Attorney for the Southern District of New York brought charges against various hedge fund and investment fund analysts, including Newman and Chiasson, charging them with insider trading for allegedly obtaining material nonpublic information from employees of publicly traded technology companies and then passing that information to the portfolio managers at their companies. Defendants-appellants Newman and Chiasson appealed their May 2013 convictions from the lower court (U.S. District Court for the Southern District of New York) on two general bases—insufficiency of evidence and failure to instruct the jury that to convict the defendants it had to find that a tippee (one who receives inside information) knew that the insider disclosed financial information in exchange for a personal benefit.

The Second Circuit held that the evidence could not sustain a guilty verdict because the government did not adequately show that the alleged insiders received personal benefits for providing information to Newman and Chiasson. In addition, according to the court, the government did not present evidence that the defendants knew that they were trading on inside information obtained from insiders who were violating their fiduciary duties.

The Second Circuit's decision in the *Newman* case turned on a close examination of the Supreme Court's *Dirks* decision. As mentioned above, *Dirks* held that, in order to find a tipper (one who provides inside information to others) liable for violating federal securities laws, the insider must have a fiduciary duty to the company whose information he discloses and he must have received a personal benefit from the disclosure. The tippee's duty to abstain from trading derives from the insider's fiduciary duty and benefit. If the insider did not commit a breach of fiduciary duty resulting in a personal benefit from the disclosure, then the tippee, according to the Supreme Court, cannot be found liable because liability occurs only when the insider has breached a fiduciary duty and the tippee knows or should know that there has been a breach of a fiduciary duty.

In its analysis of the law concerning insider trading, the Second Circuit found that the lower court's instructions to the jury were erroneous. According to the Second Circuit, to sustain an insider trading conviction against a tippee, the government must prove the following elements beyond a reasonable doubt: (1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by disclosing confidential information to a tippee in exchange for a personal benefit; (3) the tippee knew that the information was confidential and that it was disclosed for personal benefit; and (4) the tippee nevertheless used that information to trade in a security or to tip another for personal benefit. In contrast, the lower court instructed the jury that the government had to prove (1) the insiders had a fiduciary or other relationship of trust and confidence with their corporations; (2) the insiders breached that duty by disclosing material nonpublic information; (3) the insiders personally benefited from the disclosure; (4) the defendant knew that the information he had received had been disclosed in violation of a duty; and (5) the defendant used the information to buy a security.

The Second Circuit found that, in adhering to the lower court's jury instructions, a reasonable juror might conclude that a defendant could be found guilty of insider trading just because the defendant knew that the insider had disclosed information that was required to be confidential. This is not an accurate reading of the decision in *Dirks*, the Second Circuit indicated.

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<sup>34</sup> No. 13-1837 (L) (2d Cir. April 3, 2015).

But a breach of the duty of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper “is in effect selling the information to its recipient for cash, reciprocal information, or other thing of value for himself....” *Dirks*, 463 U.S. at 664 (quotation omitted). Thus, the district court was required to instruct the jury that the Government had to prove *beyond a reasonable doubt* [emphasis added] that Newman and Chiasson knew that the tippers received a personal benefit for their disclosure.<sup>35</sup>

In addition to its conclusion that the district court provided inaccurate instructions to the jury, the Second Circuit found that the government, though it was entitled to prove its case through circumstantial evidence, could not “demonstrate” each element of the charged offense beyond a reasonable doubt. The Second Circuit’s language concerning the government’s not meeting this mark is somewhat strong.

[I]f the evidence [presented] “is nonexistent or so meager,” ... such that it “gives equal or nearly equal circumstantial support to a theory of guilt and a theory of innocence, then a reasonable jury must necessarily entertain a reasonable doubt....” Because few events in the life of an individual are more important than a criminal conviction, we continue to consider the “beyond a reasonable doubt” requirement with utmost seriousness.... Here, we find that the Government’s evidence failed to reach that threshold, even when viewed in the light most favorable to it.<sup>36</sup>

The circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips.

Based on its analysis of the *Dirks* decision, the Second Circuit’s reasoning in *Newman* may not be especially surprising. However, the decision has resulted in a great deal of discussion. On the one hand, there appears to be concern that the decision is a blow to prosecutors and will make it more difficult for the government to obtain convictions against persons charged with insider trading. On the other hand, there is praise that needless government prosecutions may have been curtailed. One article states:

Two camps [have] formed: Prosecutors who complained that the ruling will tie their hands in pursuing Wall Street crime, and defense lawyers who expressed delight after years of lamenting what they saw as government overreach. From both sides, a consensus emerged that the ruling would have a chilling effect on insider trading prosecutions.<sup>37</sup>

On July 30, 2015, the U.S. Department of Justice asked the Supreme Court to review the Second Circuit decision.<sup>38</sup> On October 5, 2015, the U.S. Supreme Court declined to hear the *Newman* insider trading appeal.<sup>39</sup>

<sup>35</sup> 773 F.3d at 450.

<sup>36</sup> 773 F.3d at 451.

<sup>37</sup> B. Protes and M. Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, NEW YORK TIMES (December 10, 2014), located at [http://dealbook.nytimes.com/2014/12/10/appeals-court-overturms-2-insider-trading-convictions/?\\_r=1](http://dealbook.nytimes.com/2014/12/10/appeals-court-overturms-2-insider-trading-convictions/?_r=1).

It is possible that the *Newman* decision may affect only criminal insider trading cases brought by the government and may not have the same kind of impact on the proof needed to convict a person for civil violations related to insider trading. On April 6, 2015, a judge in the U.S. District Court for the Southern District of New York allowed the SEC to pursue a civil enforcement action in *Securities and Exchange Commission v. Payton* after the SEC had dropped the criminal insider trading charges in the wake of the *Newman* decision. See Kleinberg Kaplan, *Civil Insider Trading Case Survives Newman*, located at <http://kkwc.com/publications/civil-insider-trading-case-survives-newman/>.

<sup>38</sup> [http://www.nytimes.com/2015/07/31/business/dealbook/us-asks-supreme-court-to-review-insider-trading-ruling.html?\\_r=0](http://www.nytimes.com/2015/07/31/business/dealbook/us-asks-supreme-court-to-review-insider-trading-ruling.html?_r=0).

<sup>39</sup> <http://www.law360.com/articles/708238/breaking-supreme-court-rejects-newman-insider-trading-appeal>.

## Post-Newman Decision

On July 6, 2015, the U.S. Court of Appeals for the Ninth Circuit (Ninth Circuit) decided a case that may further complicate the law of insider trading. In *United States v. Salman (Salman)*,<sup>40</sup> defendant Bassam Yacoub Salman appealed his conviction by jury trial for conspiracy and insider trading. He argued that the evidence against him was insufficient to sustain his conviction according to the Second Circuit's standard set out in *Newman*, and he urged the Ninth Circuit to adopt the *Newman* standard.

The case involved insider trading in Salman's extended family. In 2002, Salman's future brother-in-law Maher Kara began working with Citigroup's investment banking group focused on health care. Maher discussed his work with his older brother Michael, who traded on information that Maher provided him. Maher continued to provide inside information to Michael, including information about upcoming mergers. Salman became close to Michael and traded on inside information that Michael provided him. Salman also shared the information with other family members, and they split the profits. The government presented evidence showing that Salman knew that he was receiving inside information. Maher testified that he gave his brother Michael inside information to benefit him. The government also showed that Salman knew how close Michael and Maher were. Salman, charged with securities fraud and conspiracy to commit securities fraud, defended on appeal that the government's evidence was insufficient under the standard announced in *Newman*; that is, that there was insufficient evidence to find that Maher disclosed information to Michael in exchange for a personal benefit or that, if he did, Salman knew of the benefit.

The Ninth Circuit in its analysis<sup>41</sup> looked to the *Dirks* case, particularly the *Dirks* discussion of the "personal benefit" requirement for tippee liability. In examining what the *Dirks* case had to say about what "personal benefit" means, the Ninth Circuit focused on the Court's statement that "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."<sup>42</sup> The Ninth Circuit went on to state concerning the *Dirks* quote:

The last-quoted holding of *Dirks* governs this case. Maher's disclosure of confidential information to Michael, knowing that he intended to trade on it, was precisely the "gift of confidential information to a trading relative" that *Dirks* envisioned. Indeed, Maher himself testified that, by providing Michael with inside information, he intended to "benefit" his brother and to "fulfill [] whatever needs he had."

Salman argued that the Second Circuit in *Newman* interpreted *Dirks* to require that more than mere evidence of a friendship or family relationship between tipper and tippee is sufficient to find that a personal benefit was received in exchange for inside information. Salman particularly focused on the *Newman* language indicating that, for there to be liability for the exchange of inside information, there must be "at least a potential gain of a pecuniary or similarly valuable nature." The Ninth Circuit disagreed and stated some possible opposition to the *Newman* decision:

<sup>40</sup> 792 F.3d 1087 (9<sup>th</sup> Cir. 2015).

<sup>41</sup> Judge Jed S. Rakoff, who is Senior Judge of the U.S. District Court for the Southern District Court of New York, wrote this Ninth Circuit decision. Judge Rakoff sits on a few Ninth Circuit panels each year and was assigned by lot to the *Salman* appeal.

<sup>42</sup> 792 F.3d at 1092, quoting from *Dirks*, 463 U.S. at 664.

To the extent *Newman* can be read to go so far, we decline to follow it. Doing so would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an “insider makes a gift of confidential information to a trading relative or friend.” *Dirks*, 463 U.S. at 664. Indeed, *Newman* itself recognized that the “personal benefit is broadly defined to include not only pecuniary gain, but also, *inter alia*,...the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.”<sup>43</sup>

The Ninth Circuit found that the evidence presented by the government was more than enough for a “jury to find both that the inside information was disclosed in breach of a fiduciary duty, and that Salman knew of that breach at the time he traded on it”<sup>44</sup> and affirmed the lower court’s decision convicting Salman of securities fraud and conspiracy to commit securities fraud.

The Ninth Circuit *Salman* decision and the Second Circuit *Newman* decision appear to have different views of what is necessary for finding insider trading violations. Some commenters have wondered whether the *Newman* decision is compatible with the Supreme Court’s treatment of tippee liability in *Dirks*. Judge Rakoff, the author of the *Salman* decision, appears to be one of these questioners. For example, in an April 2015 U.S. District Court for the Southern District of New York decision, *Securities and Exchange Commission v. Payton*,<sup>45</sup> Judge Rakoff discussed a possible incompatibility between the two cases, keeping in mind that *Dirks* is a civil case and *Newman* is a criminal case:

In *Dirks*, a civil case, the Supreme Court defined a personal benefit as

“a pecuniary gain or a reputational benefit that will translate into future earnings.... 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*, 463 U.S. at 663-64 (emphasis supplied). It is arguably unclear whether the italicized sentence modifies the prior reference to “pecuniary gain or...future earnings,” or is an independent stand-alone possibility. However, in *Newman*, a criminal case, the Second Circuit held that, to the extent *Dirks* suggests that a benefit may be inferred from a personal relationship, “such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly viable nature.” 773 F.3d at 452. *Whether this is the required reading of Dirks may not be obvious*, [footnote omitted] *and it may not be so easy for a lower court, which is bound to follow both decisions, to reconcile the two* [emphasis added].<sup>46</sup>

The possible incompatibility between *Newman* and *Salman*, coupled with the Supreme Court’s rejection of the *Newman* appeal, arguably creates something of a split in the federal circuit courts.<sup>47</sup> This may lead to some confusion in prosecuting insider trading cases.

<sup>43</sup> *Id.* at 1093-94.

<sup>44</sup> *Id.* at 1094.

<sup>45</sup> No. 14 Civ. 4644 (S.D.N.Y. April 6, 2015).

<sup>46</sup> *Id.*, slip op. at 10-11.

<sup>47</sup> For more information on the possible federal circuit split, see CRS Legal Sidebar WSLG1353, *Circuit Split on Insider Trading Law*, by Michael V. Seitzinger.

## Congressional Interest in the *Newman* Decision

At least three bills have been introduced in the 114<sup>th</sup> Congress in an attempt to prevent the type of securities trading allowed by the *Newman* decision. Two of the bills would amend Section 10, the general antifraud provision of the Securities Exchange Act, and one of the bills would add a new provision, Section 16A, to the Securities Exchange Act.

H.R. 1173, referred to the House Committee on Financial Services, would add subsection (d) to Section 10. It would hold a person liable for violating the insider trading prohibition laid out in Section 2(a) of the bill if the person intentionally discloses “without a legitimate business purpose” information that he knows or should know is material information and inside information. The bill lists factors defining “should know” as including the person’s financial sophistication, knowledge of and experience in financial matters, position in the company, and assets under management.

H.R. 1625, referred to the House Committee on Financial Services, would add new Section 16A to the Securities Exchange Act. The section would prohibit the trading of securities if a person has material nonpublic information about the securities or knows or recklessly disregards that the information has been wrongfully obtained or that the securities transaction would be a wrongful use of the information. The section would also prohibit a person from communicating material nonpublic information about securities to others if others engage in securities transactions based on the communication and the securities transactions were reasonably foreseeable. The standard for wrongfulness of a communication is based on information that has been obtained by such activities as theft, violation of a federal law protecting computer data, or breach of a fiduciary duty. Specific knowledge of how the information was obtained is not necessary for a violation so long as the person trading was aware that or recklessly disregarded that the information was wrongfully obtained or communicated. The SEC may by rule provide for exemptions from the prohibitions if the exemptions are not inconsistent with the purposes of the section.

S. 702, referred to the Senate Committee on Banking, Housing, and Urban Affairs, would add subsection (d) to Section 10 of the Securities Exchange Act. It would prohibit securities transactions on the basis of material information that a person knows or has reason to know is not publicly available. It would also prohibit knowingly or recklessly communicating information that is not publicly available if it is reasonably foreseeable that the communication is likely to result in a securities transaction. “Not publicly available” does not include information that a person has independently developed from publicly available sources. The SEC may provide for exemptions if it determines that they are necessary or appropriate in the public interest and consistent with the protection of investors.

### Author Contact Information

Michael V. Seitzinger  
Legislative Attorney  
mseitzinger@crs.loc.gov, 7-7895