TIPPING THE SCALES AGAINST INSIDER TRADING: ADOPTING A PRESUMPTION OF PERSONAL BENEFIT TO CLARIFY *DIRKS*

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In this Article, Professor Colombo anticipates the Supreme Court's recent 8-0 decision in Salman v. United States (2016).

The appropriate standard to assess tipper-tippee liability for insider trading has been unsettled ever since the Court last spoke on the issue, in Dirks v. SEC (1983). This is due to Dirks's unclear language, which appeared to articulate an unworkable standard predicated upon "personal benefit." The lower courts have struggled to define this concept.

The Ninth Circuit adopted an approach in which the personal benefit was essentially presumed, so long as the tips in question were made to a friend or relative. The Second Circuit, conversely, demanded that some tangible, material quid-pro-quo be demonstrated.

Professor Colombo argues the optimal approach forward is one that largely dispenses of the personal benefit test. Diving deep into the facts of Dirks, Professor Colombo notes that the tipper in the case (who was exonerated by the Court) was actually a whistleblower. As such, Dirks can be read as holding that, absent evidence of good faith whistleblowing activity, unauthorized tipping is presumptively done for personal benefit and, consequently, unlawful.

The Supreme Court decision in Salman closely follows Professor Colombo's analysis. The Court held that a personal benefit can readily be inferred when a tipper gives inside information to a "trading relative or friend."

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I. INTRODUCTION

A cliché that maintains its usefulness is that "bad cases make bad law."[1] It covers a variety of situations, all capturing the essential truth that peculiar fact patterns run a heightened risk of churning out ill-advised precedent.[2] *Dirks v. SEC* is one such case.[3]

By its own admission, the Supreme Court referred to the factual record in *Dirks* as an "unusual one."[4] Elsewhere, the Court opined that the case presented "extraordinary facts" in contrast to "more typical situation[s]."[5] And, it is from this case that we have the governing standard for tipper-tippee insider trading liability.[6]

To make matters worse, insider trading law itself has a curious pedigree.[7] Although Congress failed to explicitly prohibit the practice in the Securities Act of 1933 ("1933 Securities Act")[8] and Securities Exchange Act of 1934 ("1934 Securities Exchange Act")[9] (collectively, the "Securities Acts"), the Securities and Exchange Commission ("SEC") has successfully persuaded the courts that Rule 10b-5's prohibition on fraud in the purchase or sale of securities reaches insider trading as well.[10]

Not surprisingly, all of this has worked to generate considerable confusion over the parameters of insider trading under federal law in the United States.[11] Ultimately, a full-blown circuit split erupted, with the First Circuit,[12] Second Circuit,[13] and Ninth Circuit[14] Courts of Appeals coming to very different conclusions in interpreting *Dirks*.

On January 19, 2016, the Supreme Court granted a writ of certiorari in the matter of *Salman v. United States* to resolve this split.[15] The

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1. Clarke v. Organ, 329 S.W.2d 670, 676 (Mo. 1959).
2. *See* Dellapenta v. Dellapenta, 838 P.2d 1153, 1167 (Wyo. 1992) (Cardine, J., dissenting).
3. 463 U.S. 646 (1983).
4. *Id.* at 658 n.18.
5. *Id.* at 662.
6. *See, e.g.*, *id.* at 663-64.
7. *See* Carol B. Swanson, *Insider Trading Madness: Rule 10b-5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 158 (2003) ("The Law is an Ass.").
8. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)).
9. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).
10. *See* Swanson, *supra* note 7, at 158-77.
11. *See generally* Eric Engle, *Insider Trading: Incoherent in Theory, Inefficient in Practice*, 32 OKLA. CITY U. L. REV. 37 (2007).
12. *See* United States v. Parigian, 824 F.3d 5, 15-16 (1st Cir. 2016).
13. *See* United States v. Newman, 773 F.3d 438, 447-51 (2d Cir. 2014).
14. *See* United States v. Salman, 792 F.3d 1087, 1091-94 (9th Cir. 2015).
15. 792 F.3d 1087, *cert. granted*, 136 S. Ct. 899 (2016).

specific issue upon which the Court granted certiorari was Question 1 of the certiorari petition, which read, in its entirety, as follows:

> Does the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC*, 463 U.S. 646 (1983), require proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, No. 15-137 (U.S. Oct. 5, 2015), or is it enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case?[16]

This will be the first time that the Supreme Court addresses the standard for tipper-tippee liability as laid down in *Dirks* over thirty years ago.[17] It affords the Court a ripe opportunity to clarify an area of the law that has befuddled lower courts for decades. In this Article, I proffer a proposed clarification—a standard for tipper-tippee liability that is both more workable and normatively attractive, while also remaining faithful to Supreme Court precedent.[18] The standard is based upon a presumption of personal benefit, rebuttable via the showing of good-faith, whistle-blowing conduct.[19]

Part II of this Article provides a brief background of the U.S. federal securities regime and its prohibition on insider trading.[20] Part III discusses the *Dirks* decision, and Part IV explores the three recent circuit court decisions interpreting *Dirks* referenced above.[21] Finally, in Part V, I set forth a proposal for addressing the confusion that *Dirks* has engendered and resolving the aforementioned circuit split.[22]

II. BACKGROUND

A. Rule 10b-5 of the Securities Exchange Act of 1934

As I and others have explained elsewhere, the history of federal securities regulation is a familiar one.[23] Following the stock market crash of 1929 and the ensuing Great Depression, Franklin D. Roosevelt was elected president on a platform that, in part, called for the moral and

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16. Petition for Writ of Certiorari at i, *Salman*, 136 S. Ct. 899 (No. 15-628).
17. Dirks v. SEC, 463 U.S. 646, 662-64 (1983).
18. *See infra* Part V.B.
19. *See infra* Part V.B.
20. *See infra* Part II.
21. *See infra* Parts III–IV.
22. *See infra* Part V.B.
23. *See* Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 65-72 (2009). Much of what follows is taken from this article.

ethical reform of Wall Street.[24] With the help of his vaunted "brain trust," Roosevelt worked with Congress to federalize the regulation of securities via the Securities Acts.[25]

The federal approach to securities regulation was striking for its novelty. Contrary to the prevailing approach taken by the states, the federal Securities Acts were built around mandatory disclosure, rather than merit regulation.[26] As untruthful disclosure is arguably worse than no disclosure at all, the Securities Acts also included several antifraud measures aimed at bolstering the reliability of securities market disclosures, whether mandatory or voluntary.[27] At the forefront of these measures, and critical to our inquiry, was section 10(b) of the 1934 Securities Exchange Act.[28]

Via section 10(b), Congress authorized the SEC to promulgate "rules and regulations" necessary to combat manipulation and deception in the securities markets.[29] In the Act's own words:

> 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—
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> . . . .
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> (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, . . . 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.[30]

24. *See* Ronald J. Colombo, *Buy, Sell, or Hold? Analyst Fraud from Economic and Natural Law Perspectives*, 73 BROOK. L. REV. 91, 119-20 (2007); John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015, 1036 (2001).

25. *See* Colombo, *supra* note 24, at 120-22; Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1215, 1223-35 (1999).

26. *See* Colombo, *supra* note 24, at 122-23; *see also* Henry Klehm III, Comment, *Contractual Shifting of Defense Costs in Private Offering Securities Litigation*, 136 U. PA. L. REV. 971, 973-76 (1988).

27. *See* Colombo, *supra* note 24, at 122; Klehm, *supra* note 26, at 975-76; *see also* Kun Young Chang, *Multinational Enforcement of U.S. Securities Laws: The Need for the Clear and Restrained Scope of Extraterritorial Subject-Matter Jurisdiction*, 9 FORDHAM J. CORP. & FIN. L. 89, 93 (2003).

28. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012); *see* Kent Greenfield, *The Unjustified Absence of Federal Fraud Protection in the Labor Market*, 107 YALE L.J. 715, 726 & n.50 (1997).

29. 15 U.S.C. § 78j(b).

30. *Id.*

Eight years later—in 1942—the SEC wielded the authority bestowed upon it under section 10(b) and promulgated Rule 10b-5.[31]

Rule 10b-5 attempts to circumscribe the widest range of conduct subject to prohibition under section 10(b) by broadly enjoining any fraud or deceit in connection with the purchase or sale of any security.[32] The text of Rule 10b-5, in its entirety, reads as follows:

> 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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,
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> in connection with the purchase or sale of any security.[33]

The SEC has been aggressive in its use of Rule 10b-5 to combat securities fraud, especially in the context of insider trading, as discussed below.[34] This has led to a string of both remarkable victories and stinging defeats in the nation's courts—exemplified by its successes and failures at the Supreme Court itself.[35] At the heart of many of the SEC's losses has been the fundamental principle of administrative law that "the language of the statute must control the interpretation of the Rule."[36] As the Supreme Court has explained:

> The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute."[37]

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31. 17 C.F.R. § 240.10b-5 (1992); *see* Mary Ellen P. Dooley, *An Implied Right Of Contribution Under Rule 10b-5: An Essential Element of Attaining the Goals of the Securities Exchange Act of 1934*, FORDHAM L. REV., May 1993, at S185, S193. The story of Rule 10b-5 is famously retold by one of its drafters in Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. (A.B.A.) 891, 921-23 (1967).

32. *See* 17 C.F.R. § 240.10b-5.

33. *Id.*

34. *See infra* Parts II.B, III–IV; *see also* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 920-45 (2003).

35. *See* Pritchard, *supra* note 34, at 920-45.

36. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977).

37. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-14 (1976) (quoting Dixon v. United States, 381 U.S. 68, 74 (1965)).

Thus, to the apparent chagrin of the SEC on several occasions, the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under § 10(b)."[38] As such, conduct that could plausibly be read as prohibited by Rule 10b-5 but not falling within the parameters of section 10(b) is not unlawful, despite the SEC's wishes to the contrary.[39]

B. Insider Trading

Perhaps nowhere has the SEC been more aggressive in its crusade against securities fraud than with regard to insider trading.[40] It is to that subject that we now turn.

In its 1961 decision *In re Cady, Roberts & Co.*,[41] the SEC, for the first time, held exchanged-based insider trading to be a subset of federal securities fraud.[42] As per the SEC in *In re Cady, Roberts & Co.*, the act of willfully trading upon material, nonpublic information constitutes the offence of insider trading, and, concomitantly, violates Rule 10b-5's prohibition against securities fraud.[43] This decision ushered in the "disclose or abstain" rule: an individual in possession of material, nonpublic information must abstain from trading upon such information or disclose it to his or her trading party in order to avoid running afoul of Rule 10b-5.[44]

Predicated upon principles of simple fairness, the SEC's disclose or abstain rule announced in *In re Cady, Roberts & Co.* enjoyed success in the federal courts as well, including an important victory before an en banc panel of the Second Circuit Court of Appeals in *SEC v. Texas Gulf*

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38. *Id.* at 214; *see, e.g.*, Chiarella v. United States, 445 U.S. 222, 227, 231-35 (1980) (rejecting the SEC's "disclose or abstain" rule because it goes beyond the prohibition of "fraud" as circumscribed by § 10(b)).

39. *See Chiarella*, 445 U.S. at 234-35.

40. By "aggressive," I do not refer to the SEC's relative priorities but rather to its tendency to ambitiously "push the envelope" by making arguments and bringing cases that test the limits of the securities laws. *See* Lisa Rachlin, *Recent Developments in the Duty Requirement Under the Misappropriation Theory: A Critique of* Cuban*'s Unintended Consequences*, 11 U.C. DAVIS BUS. L.J. 67, 71-72, 74 (2010).

41. 40 S.E.C. 907 (1961).

42. *See* Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1320-21 (1999). Prior to *In re Cady, Roberts & Co.*, the Eastern District of Pennsylvania held that Rule 10b-5 prohibited insider trading in the context of a face-to-face securities transaction. *See* Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 800-01 (E.D. Pa. 1947).

43. *See In re Cady, Roberts & Co.*, 40 S.E.C. at 910-13.

44. *See* Donald C. Langevoort, *Words from on High About Rule 10b-5:* Chiarella*'s History,* Central Bank*'s Future*, 20 DEL. J. CORP. L. 865, 871 (1995).

Sulphur Co.[45] The curtain came crashing down, however, in 1980, when the Supreme Court rendered its decision in *Chiarella v. United States*.[46]

In *Chiarella*, the Court held that Rule 10b-5 does not support the SEC's cherished disclose or abstain rule.[47] Adverting to the enabling legislation upon which Rule 10b-5 was promulgated and invoking the administrative law principles mentioned previously,[48] the Court pointed out that the text of section 10(b) of the 1934 Securities Exchange Act concerns itself with "fraud" specifically and not unfairness generally.[49] Although everything that is fraudulent is most likely unfair, not everything that is unfair is simultaneously fraudulent.[50] Consequently, the SEC's use of Rule 10b-5 to prohibit insider trading on the basis of material, nonpublic information—without more—fell outside the parameters established by Congress in its enactment of section 10(b).[51]

The Supreme Court proceeded to explain that in order to prohibit insider trading on the basis of section 10(b) and Rule 10b-5, the nondisclosure of information (on the part of the trader) must somehow be *fraudulent*.[52] And, the only time that silence (nondisclosure) would be deemed fraudulent would be in situations where a duty to disclose already existed.[53] Such a duty is present when the trader is an agent of his or her counterparty, a fiduciary of his or her counterparty, or "a person in whom [his or her counterparty] had placed their trust and confidence."[54]

Nearly twenty years later, the SEC recovered some of the ground it lost in *Chiarella*, in *United States v. O'Hagan*.[55] Although the Supreme Court in *O'Hagan* did not retreat from its position that Rule 10b-5's prohibition on insider trading must involve fraudulent conduct, it dramatically widened the scope of potential defendants by adopting the "misappropriation theory" of insider trading.[56] Pursuant to the misappropriation theory, the fraud essential to a finding of unlawful insider trading need not be limited to one's conduct vis-à-vis his or

45. 401 F.2d 833, 842-43 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).
46. 445 U.S. 222, 231-35 (1980).
47. *See id.* at 234-35.
48. *Id.* at 232-35; *see supra* text accompanying notes 36-39.
49. *Chiarella*, 445 U.S. at 232-35.
50. *See id.* at 232.
51. *See id.* at 232-35.
52. *See id.* at 235.
53. *Id.*
54. *Id.* at 232.
55. 521 U.S. 642, 653, 661-62 (1997).
56. *See id.* at 652-53, 665-66.

her trading counterparty but could be committed upon the source of the information.[57]

Taken together, *Chiarella* and *O'Hagan* stand for the proposition that the duty to disclose or abstain from trading generally only applies to the following:

> (1) [P]eople who are recognized fiduciaries . . . or who are otherwise involved in relationship[s] of trust and confidence that are breached for personal gain (deceptive self-dealing); and (2) people who otherwise "feign[ ] fidelity to the source of information" but then misappropriate such information for personal gain (deceptive stealing).[58]

III. *DIRKS* AND TIPPER-TIPPEE LIABILITY

"Tipping" refers to the act by which a "tipper" passes material, nonpublic information along to a "tippee."[59] For reasons that become quickly identifiable, it was long understood that a prohibition on insider trading would be of only the most limited utility without an accompanying ban on tipping.[60] Without a ban on tipping, a considerable loophole in insider trading's circumscription would be laid bare.[61] Thus, when the Supreme Court announced its decision in *Chiarella*, upending decades of the disclose or abstain rule, it was nevertheless careful to account for the precedent against tipping.[62] As the Court explained:

> "Tippees" of corporate insiders have been held liable under § 10(b) because they 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. The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty.[63]

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57. *See id.* at 652.

58. Bruce W. Klaw, *Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory*, 7 WM. & MARY BUS. L. REV. 275, 288-89 (2016) (quoting *O'Hagan*, 521 U.S. at 655).

59. *See Tippee*, BLACK'S LAW DICTIONARY (9th ed. 2009); *Tipper*, BLACK'S LAW DICTIONARY, *supra*.

60. *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 191 (2006).

61. *See id.* at 205.

62. *See id.* at 204.

63. Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980) (citation omitted) (citing Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974)); Comment Letter on Material, Non-Public Information from Subcommittees on Broker-Dealer Matters and on Rule 10b-5, Am. Bar Ass'n Section of Corp., Banking, and Bus. Law, to Harvey L. Pitt, Exec. Assistant to the Chairman, SEC (Oct. 15, 1973), *in* NO. 233 BUREAU OF NAT'L AFFAIRS, SECURITIES REGULATION & LAW REPORT D–1 to D–2 (1974).

The Supreme Court provided a more thorough exposition of its view of tipper-tippee liability just three years later in *Dirks v. SEC*[64]—the Court's first, and to this day its only, major pronouncement on tipping.[65] Indeed, since 1983, the Court has only cited this seminal case seven times[66] and only engaged in any substantive discussion of *Dirks* two times.[67]

As mentioned at the outset of this Article, the fact pattern presented in *Dirks* is an odd one.[68] Given the centrality of *Dirks* to our examination, its salient facts should be presented in full.

Raymond Dirks was an investment analyst who specialized in covering insurance company securities.[69] On March 6, 1973, Ronald Secrist, a former officer of Equity Funding of America ("Equity Funding") (a life insurance and mutual fund company) contacted Dirks with material, nonpublic information.[70] Secrist disclosed to Dirks that Equity Funding had "vastly overstated" its assets due to "fraudulent corporate practices."[71] Secrist "urged Dirks to verify the fraud and disclose it publicly."[72]

Dirks's subsequent investigation corroborated Secrist's allegations of fraud.[73] During this time, "[n]either Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors."[74] Not surprisingly, some of these clients and investors sold their holdings in Equity Funding, and, on account of this,

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64. 463 U.S. 646, 665-67 (1983).

65. *See id.*

66. Halliburton Co. v. Erica P. John Fund. Inc., 134 S. Ct. 2398, 2418 (2014); Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 145 n.8 (2011); United States v. O'Hagan, 521 U.S. 642, 652 (1997); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 172 (1994); Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988); Carpenter v. United States, 484 U.S. 19, 26 (1987); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 311 n.21 (1985).

67. *See O'Hagan*, 521 U.S. at 663 (acknowledging that *Dirks* expressly left open the question of the misappropriation theory's validity in certain circumstances); *Bateman Eichler, Hill Richards, Inc.*, 472 U.S. at 311 n.21 (quoting extensively from *Dirks* in support of the proposition that "[a] tippee generally has a duty to disclose or to abstain from trading on material nonpublic information only when he knows or should know that his insider source 'has breached his fiduciary duty to the shareholders by disclosing the information'—in other words, where the insider has sought to 'benefit, directly or indirectly, from his disclosure'").

68. *See supra* text accompanying notes 1-5.

69. *See Dirks*, 463 U.S. at 648.

70. *Id.* at 648-49.

71. *Id.* at 649.

72. *Id.*

73. *See id.*

74. *Id.*

the SEC brought insider trading charges against Dirks.[75] In a hearing before one of its own administrative law judges, the SEC found Dirks guilty of aiding and abetting violations of the Securities Acts by virtue of his conduct as a "tippee" who subsequently tipped others.[76] Dirks sought review in federal court, and his case ultimately landed before the Supreme Court.[77]

The Supreme Court initiated its discussion by reviewing its then-recent decision in *Chiarella* regarding the fundamental elements of insider trading.[78] Namely, that which makes insider trading wrongful (and a violation of Rule 10b-5, properly understood) is, at its core, a breach of a duty to disclose imposed by virtue of a fiduciary relationship of "trust and confidence."[79] As *O'Hagan* had not yet been decided, the fiduciary relationship referred to in *Dirks* was that between the purchaser and the seller of the security in question;[80] post-*O'Hagan*, this duty can be found between the trader in possession of material, nonpublic information and the source of that information.[81]

The Court proceeded to question how this breach of duty could be shown in the context of a "typical tippee," who has no fiduciary relationship with his or her trading counterparties.[82]

The SEC pressed for a rule by which tippees who knowingly receive "non-public, material information from insiders become 'subject to the same duty as [the] insiders.'"[83] However, the Court rejected this position, noting how it ran contrary to the Court's holding in *Chiarella*.[84] For, once again, the Court observed, the SEC's proposed rule would impose a duty of disclosure upon someone simply because of his or her

75. *See id.* at 649-51.

76. *See id.* at 650-51. Given Dirks's role in exposing Equity Funding's fraud, the SEC merely censured him. *See id.* at 651-52.

77. *See id.* at 652.

78. *See id.* at 653-54.

79. *Id.* at 653-55.

80. *See id.* at 654-55.

81. *See* Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 276-78, 281-87 (2003) (discussing courts' attempts to reconcile misappropriation theory with tipper-tippee liability).

82. *See Dirks*, 463 U.S. at 655. In its discussion, the Court made clear that information "revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation" presents an entirely different situation. *See id.* at n.14. Such persons are properly deemed fiduciaries by virtue of their relationship with the corporation. *Id.* Consequently, when they divulge material, nonpublic information to someone else, they are more properly viewed as tippers themselves. *Id.*

83. *Id.* at 655-56 (alteration in original) (quoting Dirks, Exchange Act Release No. 17480, 21 SEC Docket 1410 n.42 (Jan. 22, 1981)).

84. *Id.* at 656.

possession of material, non-public information.[85] The SEC's justification, that the information was received from a tipper who in fact had such a duty, was deemed unavailing.[86] And rightly so, as fiduciary duties are ordinarily not so contagious. Although fiduciary duties are imposed in a variety of circumstances, merely communicating with someone who is a fiduciary is not one of them.[87]

Further, the Court questioned the policy implications of the SEC's proposed rule.[88] Foremost among these, it threatened to inhibit the critical work of market analysts, "which the SEC itself recognizes is necessary to the preservation of a healthy market."[89]

Nevertheless, in line with many other courts and commentators, the Supreme Court did acknowledge that "[t]he need for a ban on some tippee trading is clear."[90] The starting point for any such ban should be the uncontroversial proposition that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[91] In other words, an individual ought not be able to do indirectly what he or she is prohibited from doing directly.[92] Hearkening again back to *Chiarella*, the Court recalled its previous observation that a tippee's liability "has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."[93]

Now needing to expand upon its dicta in *Chiarella*, the Court in *Dirks* proceeded to flesh out its theory of tipper-tippee liability in detail.[94] It began by reasoning that at its foundation, tipper-tippee liability, as with all insider trading liability, must be predicated upon a breach of a fiduciary duty.[95] Within the context of *Dirks*'s facts, and pre-*O'Hagan*, this duty would be the insider's duty to not trade upon and to

85. *See id.*
86. *See id.* at 656-58.
87. *See id.* at 656 n.15; *see also* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1412-13, 1450-52, 1483-85 (2002) (discussing different types of fiduciary relationships, why they exist in certain circumstances, and how courts impose them).
88. *See Dirks*, 463 U.S. at 658.
89. *Id.*
90. *Id.* at 659; *see supra* text accompanying notes 59-63.
91. *Dirks*, 463 U.S. at 659.
92. *See id.*
93. *Id.* (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)); *see supra* text accompanying note 63.
94. *See Dirks*, 463 U.S. at 660.
95. *See id.*

maintain the confidentiality of, material, nonpublic information.[96] So as a threshold matter, absent any such breach on the part of the insider, there can be no liability on the part of anyone to whom the insider may have revealed material, nonpublic information.[97]

But, wouldn't the divulgence of material, nonpublic information on the part of an insider always constitute a breach of his or her fiduciary duties to the corporation?[98] Well, no. One could posit a revelation that was duly authorized.[99] One could also posit a revelation that was made unknowingly (such as an inadvertent slip of the tongue, or even the discussion of information that the insider erroneously believed to be already public).[100] And, as in the case of *Dirks*, and to which we shall shortly turn, one could imagine the revelation of a whistleblower.[101]

In order to navigate this thicket of possible circumstances, the Supreme Court formulated what has come to be known as the "personal benefit" test.[102] To the Court, whether an insider's disclosure amounts to a breach of fiduciary duty "depends in large part on the purpose of the disclosure,"[103] and the presence (or absence) of personal benefit sheds light on such purpose.[104] Put differently, absent direct evidence of intent—an unlikely convenience—courts should turn to "objective criteria" to assess an actor's purpose.[105] As the Court explained, the finding of an improper purpose could turn upon "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings,"[106] or whether "an insider makes a gift of confidential information to a trading relative or friend."[107] These findings, in turn, could be further bolstered by certain "objective facts and circumstances," such as "a relationship between the insider and the

96. *See id.*

97. *See id.* at 661.

98. *See id.* at 661-62.

99. This is what prompted the SEC's promulgation of Regulation FD. *See* Selective Disclosure and Insider Trading, Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51716 n.7 (Aug. 24, 2000) ("As discussed in the Proposing Release, in light of the 'personal benefit' test set forth in the Supreme Court's decision in *Dirks v. SEC*, 463 U.S. 646 (1983), many have viewed issuer selective disclosures to analysts as protected from insider trading liability.").

100. *See Dirks*, 463 U.S. at 662.

101. *See infra* text accompanying notes 120-23.

102. *See, e.g.*, A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 859 (2015).

103. *Dirks*, 463 U.S. at 662.

104. *See id.*

105. *Id.* at 663.

106. *Id.*

107. *Id.* at 664.

recipient that suggests a *quid pro quo* . . . or an intention to benefit the particular recipient."[108]

In what has come to be quite an understatement, the Court acknowledged that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."[109] Nevertheless, the Court maintained "it is essential" to have this as "a guiding principle," lest we abrogate the concept of genuine fraud that is at the core of the Court's insider trading jurisprudence.[110]

Finally, in order for insider trading liability to attach, it must also be shown that the tippee "knows or should know" that the tipper is breaching his or her fiduciary duties in disclosing the information.[111] This satisfies the fundamental requirement of scienter and had already been conceded by the SEC.[112] In applying its newly announced rule to the facts before it, the Court found that the insider trading judgment against Dirks needed to be reversed.[113]

Before proceeding, it must be recognized that in *Dirks* there are, at a minimum, two sets of tippers and tippees: Secrist (as a tipper) and Dirks (as a tippee), and, subsequently, Dirks (as a tipper), and Dirks's clients (as tippees).[114] The Court analyzed these sets in reverse order.[115]

With regard to viewing Dirks as the tipper and his clients as tippees, the Court indicated that this was a non-starter, as it was "undisputed that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders."[116] Nor was he an underwriter, accountant, lawyer, consultant or anyone else working on Equity Funding's behalf, and therefore was not in a position "that induced the shareholders or officers of Equity Funding to repose trust or confidence in him."[117] Although the case was decided years before *O'Hagan*, the Court also observed that Dirks did not "misappropriate or illegally obtain the information about Equity Funding."[118] For all these reasons, Dirks did not possess a fiduciary duty of his own to preserve the confidentiality of the material, nonpublic information that came into his

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108. *Id.*
109. *See id.*
110. *See id.*
111. *Id.* at 660.
112. *See id.* n.19.
113. *Id.* at 667.
114. *See id.* at 649-50.
115. *See id.* at 665-67.
116. *Id.* at 665.
117. *See id.*
118. *Id.* at 665.

possession, and as such could not be liable as a tipper, nor serve to establish tipper-tippee liability.[119]

With regard to the Secrist-Dirks transmittal of information, the problem with the SEC's case here was the fact that Secrist, the initial source of the material, nonpublic information in question, violated no fiduciary duties in disclosing it.[120] Nor did the employees of Equity Funding who corroborated the information when questioned by Dirks.[121] For, it was undisputed that Secrist and others, corroborating tippers "received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks."[122] Indeed, as the facts "clearly indicate[d], the tippers were motivated by a desire to expose the fraud."[123] And, in the absence of a breach, *ab initio*, a tipping case against Dirks (or anyone else for that matter) simply could not be built.[124]

As indicated, *Dirks*, decided back in 1983, was the Court's last (and only) tipper-tippee liability case.[125] Moreover, the Court has not substantively expounded upon its holding in *Dirks* since then.[126] A major issue that has confounded the lower courts is how to apply the personal benefit test, a subject to which we shall turn shortly.[127] Before doing so, however, we should first address the interplay of *Dirks* and *O'Hagan* and the idea of predicating tipper-tippee liability upon the misappropriation theory.

With perhaps only one exception,[128] the Supreme Court decided *Dirks* within the paradigm of "classical insider trading theory" as set forth in *Chiarella*.[129] As such, the Court's examples and reasoning revolved around situations involving genuine corporate insiders with fiduciary duties of trust and confidence—insiders who owe duties to the shareholders of the very companies in which they are trading securities.[130]

As indicated, however, *O'Hagan* dramatically expanded the scope of insider trading, holding that insider trading liability extends also to

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119. *See id.*
120. *See id.* at 666.
121. *Id.*
122. *Id.* at 667.
123. *Id.*
124. *See id.*
125. *See supra* text accompanying notes 64-67.
126. *See supra* text accompanying notes 66-67.
127. *See infra* Part IV.
128. *See supra* text accompanying note 118.
129. *See* United States v. O'Hagan, 521 U.S. 642, 651-52 (1997).
130. *See id.*

those who breach a duty of trust and confidence to the *source* of the material, nonpublic information.[131] This implicates situations where the "insider" does not necessarily owe a duty to the shareholders with which he or she is trading.[132] As in the *O'Hagan* case itself, misappropriation theory covers the (mis)conduct of an attorney who, learning about an upcoming tender offer to be launched by one of his firm's clients, proceeds to purchase securities in the *target* company of the upcoming tender offer.[133] That is, the attorney does not purchase securities in his firm's client (to whom he owes a duty of trust and confidence) but in another company to whom he owes no duty of trust and confidence.[134] This would not constitute insider trading under *Chiarella*'s classical theory, but it does under misappropriation theory.[135] For the attorney in this example had no right to use ("misappropriate") his client's private information (regarding the tender offer) for his own personal gain.[136] In doing so, the attorney violated his duties to his client, and did so in connection (ultimately) with the purchase or sale of securities.[137]

Although courts have rather uniformly agreed that misappropriation theory can serve as the basis of tipper-tippee liability, they have had difficulty in explaining how.[138] Most pertinent to our inquiry, the courts have had particular difficulty in determining how to apply the *Dirks* personal benefit test, if at all, to cases of tipping arising under misappropriation theory.[139]

The reason for this, according to some commentators, is that "[m]isappropriation theory does not easily fit tippee cases."[140] The SEC, not enamored with the personal benefit test to begin with, has pushed this argument as follows:

> The SEC's argument proceeds in two steps. First, the SEC points out that the benefit requirement is inextricably linked to determining whether an insider has breached a duty to corporate shareholders. Second, the SEC notes that the distinguishing feature of

131. *See supra* text accompanying notes 55-58.
132. *O'Hagan*, 521 U.S. at 652-53.
133. *See id.* at 653.
134. *See id.* at 652-53.
135. *See id.* at 652-53, 653 n.5.
136. *See id.* at 652-53.
137. *See id.*
138. *See* Ebaugh, *supra* note 81, at 281-87.
139. *See id.*
140. 4 ALAN R. BROMBERG ET AL., BROMBERG AND LOWENFELS ON SECURITIES FRAUD § 6:563 (2d ed. 2012); *see also* 3C HAROLD S. BLUMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 19:45 (2016). *But see* 5C ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 12:128 (2011) ("Tippees fit easily within the ambit of the misappropriation theory . . . .").

> misappropriation theory cases is that the outsider owes no fiduciary duty to the corporate shareholders. Put together, the SEC contends, it is unnecessary in misappropriation cases that it show that an outsider intended to benefit from his disclosure; since outsiders owe no duty to corporate shareholders to begin with, applying the *Dirks* test to determine if there was a breach of a duty to those same shareholders would be nonsensical.[141]

The SEC has had some success with this position, prevailing in at least some district courts.[142] But, apparently none have explained their reasoning in much detail.[143] As the Eleventh Circuit Court of Appeals proclaimed when it surveyed the case law in 2003, "[n]one of these courts . . . [have given] the issue more than perfunctory thought."[144]

Indeed, upon close examination, the SEC's argument does not appear to hold much water. It is true that, as the SEC argues, "the benefit requirement is inextricably linked to determining whether an insider has breached a duty," but this need not be circumscribed as a "duty to corporate shareholders."[145] For historical (indeed, chronological) reasons already discussed, the *Dirks* decision was rendered within the then-prevailing (and sole) paradigm of insider trading set forth in *Chiarella*.[146] So, naturally, when the Court in *Dirks* referred to duties and breaches of duty, it did so via references to corporate shareholders.[147] But, after *O'Hagan*, in which duties of trust and confidence, for the purposes of insider trading, were extended beyond the confines of corporate shareholders alone, it no longer makes sense to press the argument that "the benefit requirement is inextricably linked to determining whether an insider has breached a duty *to corporate shareholders*" as the SEC has done.[148] Indeed, a superior articulation of the case law, and one that harmonizes rather than bifurcates the Supreme Court's insider trading precedent,[149] would be reformulated as "the benefit requirement is inextricably linked to determining whether an

141. BROMBERG ET AL., *supra* note 140, § 6:563 (quoting SEC v. Yun, 327 F.3d 1263, 1275 (11th Cir. 2003)).
142. *See id.*
143. *Id.*
144. *Yun*, 327 F.3d at 1275.
145. *See id.*
146. *See supra* text accompanying notes 129-30.
147. *See supra* text accompanying notes 129-30.
148. *See Yun*, 327 F.3d at 1275-76 (emphasis added).
149. *See id.* ("[W]e think the SEC is unduly dichotomizing the two theories of insider trading liability. . . . The Supreme Court, however, has indicated that we should attempt to synthesize, rather than polarize, insider trading law.").

insider has breached a duty *to anyone*."[150] Indeed, such reformulation would comport well with all existing precedent, for even under misappropriation theory, scienter remains an element.[151] An inadvertent disclosure to a tippee, or one for whistleblowing purposes, as in *Dirks*, by one who would otherwise be a misappropriator would not constitute insider trading even after *O'Hagan*.[152] Not coincidentally, in both situations, the presence of a personal benefit on the part of the tipper would be lacking.[153]

In short, the personal benefit test should best be understood as applicable to both classical and misappropriation theory insider trading cases. There is no compelling, principled argument to apply the test to one category of insider trading cases and not the other. For the test goes to the tipper's motivations in disclosing the material, nonpublic information that he or she has come to possess, and this factor would appear relevant in both classical and misappropriation insider trading cases.[154]

IV. THE PERSONAL BENEFIT TEST

In *Dirks*, the Supreme Court was not exactly pellucid in articulating the personal benefit required to sustain a tipper-tippee insider trading case.[155] The Court suggested several "objective criteria" that could be used to show this benefit, but the criteria do not fit together all that well.[156] Over the course of a few sentences, the Court identified the

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150. *See id.* at 1275.

151. *See* Michael D. Monico & Jacqueline S. Jacobson, *Supreme Court Turns Insider Trading Inside Out*, CHAMPION, Dec. 1997, at 12, 15.

152. *See* United States v. O'Hagan, 521 U.S. 642, 665-66 (1997).

153. *See id.* at 663; Dirks v. SEC, 463 U.S. 646, 662 (1983).

154. Perhaps, the personal benefit controversy in misappropriation cases is largely one of semantics. For, as one leading commentator has explained:

> There can be no legitimate reason for disclosure when the original source misappropriated the inside information. For this reason, the second part of the second element [personal benefit] is not needed under those facts. Thus, the entire second *Dirks* element in misappropriation cases should be that the original source, at the time of the misappropriation, breached his duty to the person or entity from which he misappropriated the inside information.

JACOBS, *supra* note 140, § 12:132. In other words, if one (fairly) conceptualizes misappropriation as encompassing an improper purpose, it would be largely redundant to insist that one also demonstrate a personal benefit in order to confirm that the disclosure of information was done in breach of a duty. But, redundancy, unless it is a certainty in every conceivable basis, is not, I posit, a good reason to dispense with a test that can serve an important purpose in even a small number of situations. *See infra* Part V.B.

155. *See Dirks*, 463 U.S. at 663-64.

156. *See id.*

following possible (and somewhat contradictory) factors as potentially demonstrative of "a direct or indirect personal benefit":

- "a pecuniary gain";
- "a reputational benefit that will translate into future earnings";
- "a relationship between the insider [tipper] and the recipient [tippee] that suggest a *quid pro quo*";
- "an intention to benefit the particular recipient"; and
- "when an insider [tipper] makes a gift of confidential information to a trading relative or friend [tippee]."[157]

The list, above, raises a number of questions that lower courts have struggled to answer.[158] Most revolve around the fact that, ordinarily speaking, making a "gift" is considered the opposite of pursuing personal "pecuniary gain."[159] This language is difficult to reconcile, and the lower courts have splintered in their approach.[160]

As mentioned earlier, in 2016, contrary interpretations of the personal benefit test by the Second and Ninth Circuits prompted the Supreme Court to grant certiorari to resolve the issue.[161] Later in 2016, a First Circuit Court of Appeals decision on the subject was added to these conflicting cases.[162] Placed on a continuum, the Second Circuit can be said to represent the strictest or most demanding interpretation of personal benefit, and the Ninth Circuit the most lenient or least demanding interpretation, with the First Circuit occupying a position between the two (although closer to the Ninth Circuit's interpretation).[163] Let us review these cases in turn and in chronological order.

A. United States v. Newman

In *United States v. Newman*, the Second Circuit Court of Appeals held, in pertinent part, that there is no breach of fiduciary duty on the part of the tipper (and, thus, no insider trading liability),[164] unless the tipper "is in effect selling the information to its recipient for cash,

157. *See id.*
158. *See* United States v. Salman, 792 F.3d 1087, 1091-94 (9th Cir. 2015); United States v. Newman, 773 F.3d 438, 447-48, 452 (2d Cir. 2014).
159. *See Salman*, 792 F.3d at 1093-94; *Newman*, 773 F.3d at 452.
160. *See Salman*, 792 F.3d at 1093-94; *Newman*, 773 F.3d at 452; *see also* United States v. Parigian, 824 F.3d 5, 15-16 (1st Cir. 2016).
161. *See supra* text accompanying notes 11-16.
162. *See Parigian*, 824 F.3d at 15-16.
163. *See id.*; *Salman*, 792 F.3d at 1094; *Newman*, 773 F.3d at 452.
164. 773 F.3d at 450.

reciprocal information, or other things of value for himself."[165] With respect to the Supreme Court's language (and some of the Second Circuit's own language) regarding the propriety of inferring a personal benefit on the divulgence of information to a "trading relative or friend,"[166] the Second Circuit declared that "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 valuable nature."[167] As if it were not being clear enough, the Second Circuit quickly added that the only relationships able to support tipper-tippee liability predicated upon "gift[s]" and "friendship" would be those "that suggest[] a *quid pro quo*" dynamic.[168] What emerges from *Newman*, therefore, is a personal benefit standard focused heavily (arguably exclusively) on objective, material advantages flowing or reasonably expected to flow to the tipper as a result of his or her tipping.[169]

The government-plaintiff in *Newman* was unable to demonstrate such benefits, and for that reason the Second Circuit ordered defendants' insider trading indictments to be dismissed.[170] The government offered evidence of (1) longstanding professional relationships (as business school and, later, work colleagues) in which "career advice and assistance" was sought and provided over a year before any of the information in question was exchanged;[171] and (2) the relationship of "family friends" who "met through church and occasionally socialized together."[172] Viewing "the evidence in the light most favorable to the Government, crediting every inference that could have been drawn in the Government's favor, and deferring to the jury's assessment of witness credibility and its assessment of the weight of the evidence,"[173] the court concluded that the record was insufficient to sustain an insider trading conviction.[174] "In short," the court said, "the bare facts in support of the Government's theory of the case are as consistent with an inference of

165. *Id.* (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).
166. *See id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).
167. *Id.*
168. *Id.* (quoting *Jiau*, 734 F.3d at 153).
169. *See id.*
170. *See id.* at 452-55.
171. *Id.* at 452-53.
172. *Id.* at 452.
173. *Id.* at 451 (quoting United States v. Coplan, 703 F.3d 46, 62 (2d Cir. 2012)).
174. *Id.* at 451, 455.

innocence as one of guilt."[175] Consequently, the government had failed to establish guilt beyond a reasonable doubt.[176]

B. United States v. Salman

As indicated, the Ninth Circuit Court of Appeals reached a contrary interpretation of *Dirks*'s personal benefit standard.[177] Aware of the *Newman* precedent less than one year earlier, the Ninth Circuit nevertheless declined to follow it in *United States v. Salman*.[178]

In *Salman*, the Ninth Circuit dutifully acknowledged that the Supreme Court began its insider trading analysis in *Dirks* by declaring "pecuniary gain or a reputational benefit" as a basis of tipper-tippee liability.[179] But, the Ninth Circuit quickly observed the Supreme Court's additional statement that "*[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend*" (emphasis supplied by the Ninth Circuit).[180] The Ninth Circuit took this latter passage from *Dirks* as a separate, legitimate ground upon which an insider trading conviction could be proven and applied it to the facts in *Salman*.[181]

As in *Newman*, there was no clear evidence of personal enrichment or gain flowing from the tipper's disclosure of material, nonpublic information in *Salman*.[182] Moreover, whereas in *Newman* the government argued that such gain could be inferred from the facts, in *Salman* it appears as though no such evidence was offered at all.[183] Rather, the insider trading convictions in *Salman* rested squarely upon the allegation that the tippers made their disclosures to the tippees "as a gift of market-sensitive information"[184]—"[s]pecifically, [the tipper] testified that he disclosed the material nonpublic information for the purpose of benefitting and providing for his brother [the tippee]."[185] As the court concluded, proof that this occurred or "[p]roof that the insider

175. *Id.* at 455.
176. *Id.*
177. *See* United States v. Salman, 792 F.3d 1087, 1093-94 (9th Cir. 2015). Interestingly, the Ninth Circuit decision was authored by Senior District Court Judge Jed S. Rakoff of the Southern District of New York, sitting by designation. *Id.* at 1088 n.*.
178. *Id.* at 1093-94.
179. *Id.* at 1091-92 (quoting Dirks v. SEC, 463 U.S. 646, 663 (1983)).
180. *Id.* at 1092 (quoting *Dirks*, 463 U.S. at 664).
181. *See id.*
182. *See id.* at 1093.
183. *See id.* at 1094; United States v. Newman, 773 F.3d 438, 454 (2d Cir. 2014).
184. *See Salman*, 792 F.3d at 1094.
185. *Id.*

disclosed material nonpublic information with the intent to benefit a trading relative or friend[,] is sufficient to establish the breach of fiduciary duty element of insider trading."[186]

Thus, whereas the Second Circuit stressed the apparent indispensability of some showing of tangible, reciprocal, personal gain (whether immediate or delayed), the Ninth Circuit dispensed with this ingredient altogether.[187] To the Ninth Circuit, as per *Salman*, the gifting of information to a trading relative or friend, even if wholly gratuitous, satisfies the personal benefit element of tipper-tippee liability set forth in *Dirks*.[188]

C. United States v. Parigian

A middle road approach to tipper-tippee liability, albeit one that veers toward the West Coast, has been provided by the First Circuit Court of Appeals in *United States v. Parigian*.[189] Decided in 2016, with the benefit of both *Newman* and *Salman* to draw from, the First Circuit announced an interpretation of *Dirks* that is strict in form but apparently lenient in application.[190]

In *Parigian*, "Douglas Parigian made in excess of $200,000 trading in securities" acting upon "obviously nonpublic information that a golfing buddy [Eric McPhail] received from a corporate insider."[191] Briefly, let us observe that, as in *Dirks*, there are two sets of tippers and tippees here in *Parigian*: (1) the corporate insider (as tipper) and McPhail (as tippee), and (2) McPhail (as tipper) and Parigian (as tippee).[192] It appears to be uncontested that the corporate insider's disclosure of information to McPhail constituted unlawful tipping.[193] That entails a host of important repercussions, most significantly that, unlike the situation in *Dirks*, McPhail could potentially be liable were he to (as he did in fact do) disclose this same information to someone else.[194] For, a person receiving an unlawful tip "may also be liable . . . if

186. *Id.* The court harmlessly skipped a step here: proof of this intent demonstrates that the tip was made for a personal benefit, and the existence of a personal benefit motivating the disclosure of nonpublic, material information constitutes a breach of the tipper's fiduciary duty toward the source of that information (in a misappropriation case) or to the corporation's shareholders (in a classical case of insider trading).

187. *See id.* at 1093-94.

188. *Id.* at 1094.

189. *See* 824 F.3d 5, 15-16 (1st Cir. 2016).

190. *See id.*

191. *Id.* at 7.

192. *See id.* at 8-9.

193. *See id.* at 7-8.

194. *See id.* at 8-9.

[he or] she . . . turns around and tips another person."[195] In short, if the conditions for tipper-tippee liability are met between the original source of the material, nonpublic information (in this case, the corporate insider) and the tippee (in this case, McPhail), tipper-tippee liability will also attach if the conditions for such liability are met between the original tippee turned subsequent tipper (in this case, McPhail) and the person he or she tips (in this case, Parigian).[196]

As *Parigian* stood on appeal before the First Circuit, questions regarding McPhail's role as a potential tipper for purposes of insider trading liability were not raised or not properly preserved.[197] Consequently, the First Circuit did not grapple with whether the conditions for tipper-tippee liability would have been met were McPhail himself to have traded upon the information he received from his corporate-insider friend—that was assumed as given.[198] Instead, the bulk of the court's focus was on whether McPhail's tips to Parigian, and Parigian's subsequent trading, gave rise to liability on the part of Parigian.[199] Of most relevance to us was the court's discussion and application of *Dirks*'s personal benefit test.[200]

As a threshold matter, the court was ambivalent about whether the personal benefit test was even applicable to a tipper-tippee insider trading case predicated upon misappropriation.[201] This is reflective of the broader controversy over that question discussed earlier.[202] The court noted that in its precedent the First Circuit "dodged the question" by expressing doubts over the test's applicability, while at the same time finding that, if in fact necessary, a personal benefit to the tipper had been established.[203] The court in *Parigian* doubled-down on this dodge: not only did the court once again eschew a clear position on the necessity of showing a personal benefit in a misappropriation case, but the court also avoided taking a clear position on what constituted a personal benefit.[204]

Regarding the latter (and for us, more pertinent) inquiry, the First Circuit, quoting an earlier case that had come before it, explained that

195. *See* Coles, *supra* note 60, at 198.
196. *See Parigian*, 824 F.3d at 8-9; Coles, *supra* note 60, at 198-207.
197. *See Parigian*, 824 F.3d at 12-13.
198. *See id.* at 8-9 (discussing that McPhail apparently did not trade upon the inside information).
199. *See id.* at 10-16.
200. *See id.* at 15-16.
201. *See id.* at 15.
202. *See supra* text accompanying notes 139-53.
203. *See Parigian*, 824 F.3d at 15.
204. *See id.* at 15-16.

"the mere giving of a gift to a relative or friend is a sufficient personal benefit."[205] The court noted, however, that the Second Circuit in *Newman* "recently adopted a more discriminating definition" of personal benefit.[206] It also noted the *Salman* case, commenting that the Ninth Circuit's approach to personal benefit "seemed to align itself more closely" with the First Circuit's.[207]

As mentioned, the First Circuit in *Parigian* ultimately failed to squarely stake out its position on personal benefit.[208] For, after recounting its own precedent, along with that of its sister circuits, the court ruled as follows:

> How this [circuit split] will all play out, we do not venture to say because, as a three-judge panel, we are bound to follow this circuit's currently controlling precedent. We therefore hold that the indictment's allegations of a friendship between McPhail and Parigian plus an expectation that the tippees would treat McPhail to a golf outing and assorted luxury entertainment is enough to allege a benefit if a benefit is required.[209]

As can be seen, the First Circuit equivocates here twice: first, on the issue of whether a personal benefit is even necessary in a misappropriation case such as this one;[210] and, second, and perhaps less obviously, as to whether this personal benefit must include some tangible, material benefit (or promise thereof) to the tipper.[211]

Regarding the second equivocation, note how the court first points out that it is bound by controlling precedent—precedent previously identified as holding that "the mere giving of a gift to a relative or friend is a sufficient personal benefit."[212] But, in applying that precedent, the court couples its observation of "a friendship between McPhail and Parigian" with the additional observation that there also existed "an expectation that the tippees would treat McPhail to a golf outing and assorted luxury entertainment," which was "enough to allege a benefit if a benefit is required."[213]

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205. *See id.* at 15 (quoting SEC v. Rocklage, 470 F.3d 1, 7 n.4 (1st Cir. 2006)).
206. *See id.* at 16.
207. *Id.*
208. *See id.* at 15-16.
209. *Id.* at 16.
210. *Id.* at 15-16.
211. *See id.*
212. *See id.* at 15 (quoting SEC v. Rocklage, 470 F.3d 1, 7 n.4 (1st Cir. 2006)).
213. *Id.* at 15-16.

If one digs deeper into the opinion, one can shed some light on what "assorted luxury entertainment" refers to.[214] For, earlier in its decision, the court explained:

> There is no allegation that McPhail himself engaged in trading. Rather, the indictment posits that he solicited "getting paid back" by Parigian and the others with wine, steak, and visits to a massage parlor. Parigian assured him that "I will take you for a nice dinner at Grill 23." Another tipped trader offered McPhail a free golf outing.[215]

So in return for material, nonpublic information that helped him ring up $200,000 in trading gains, Parigian promised McPhail "a nice dinner."[216] As the saying used to go, that and a quarter will get you a cup of coffee.[217] In other words, that is quite a thin reed upon which to rest a finding of personal benefit. It drives home the point, I suggest, that what really satisfied the personal benefit element in *Parigian* was the gift of information on the part of McPhail to a trading friend.[218] The superfluous observation that McPhail was promised assorted luxuries was, I posit, a mere fig leaf used to justify a finding of personal benefit on the basis of friendship alone.[219]

V. A REINTERPRETATION OF *DIRKS*

A. Approaches to Interpreting Precedent

As indicated, the convoluted history and evolution of insider trading law has given rise, unsurprisingly, to a number of messy problems.[220] This has prompted some to call for a full-scale legislative fix—a statutory overhaul of federal insider trading law.[221] Although that would certainly be welcome, there is little indication that this is going to happen any time soon. In the meantime, the Supreme Court has a golden opportunity, this upcoming term, to ameliorate at least one aspect of insider trading law: the conditions under which tipper-tippee liability

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214. *See id.* at 9, 16.
215. *Id.* at 9.
216. *Id.* at 7, 9.
217. *See* eslobrown, *That and a Quarter Will Get You a Cup of Coffee*, CLICHÉ LIST (May 31, 2011), http://www.clichelist.net/that-and-a-quarter-will-get-you-a-cup-of-coffee. But, not at Starbucks. And, not in 2016.
218. *See Parigian*, 824 F.3d at 7-9.
219. *Id.* at 15-16.
220. *See supra* notes 7-15 and accompanying text.
221. *See, e.g.*, Klaw, *supra* note 58, at 298.

attach[222] and, more specifically, how the personal benefit test ought to be applied.[223] This can be done, I suggest, by a modest reinterpretation of *Dirks*, as occasioned by the Supreme Court's review of *Salman*.

As a threshold matter, I feel compelled to confess that I am generally not one for unduly imaginative or creative interpretations of the law, and what follows could be criticized as such. But, battles over interpretative methods ordinarily focus on questions of statutory or constitutional texts.[224] And, for good reason: how to best interpret a given piece of legislation or constitutional provision implicates incredibly weighty concerns ranging from the proper role of the judiciary to our understanding of government power in general.[225] Although, there are, of course, serious debates over how best to engage in the interpretation of judicial precedent itself,[226] the interests at stake, as important as they undoubtedly are, fall, I suggest, within a lower order of magnitude.

Admittedly, insider trading jurisprudence is built upon a statutory foundation: section 10(b) of the 1934 Securities Exchange Act.[227] However, as has been made clear, the prohibition on insider trading, and the accompanying prohibition on tipping, is already several steps removed from the statutory text.[228] This has led some scholars to refer to the rules circumscribing insider trading in the United States "as a species of federal common law."[229] As such, I hope that all can concede, whatever one's general approach to judicial interpretation, in this context a relatively freer hand in revisiting past decisions and reasoning is more defensible than usual.

To that end, there is a respectable approach to judicial interpretation, endorsed by no less than Ronald Dworkin, pursuant to which precedent can be interpreted via reference to its results more so

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222. *See* Salman v. United States, 136 S. Ct. 899 (2016); *see also* Klaw, *supra* note 58 at 290-91.

223. *See* Petition for Writ of Certiorari, *supra* note 16, at i; *see also* Klaw, *supra* note 58, at 291.

224. *See, e.g.*, Alexander Volokh, *Choosing Interpretive Methods: A Positive Theory of Judges and Everyone Else*, 83 N.Y.U. L. REV. 769, 777-81, 819-23 (2008).

225. *See id.* at 777-79.

226. *See, e.g.*, Barbara K. Bucholtz, *The Interpretive Project and the Problem of Legitimacy*, 11 TEX. WESLEYAN L. REV. 377, 381-84 (2005).

227. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012).

228. *See supra* notes 7-15 and accompanying text.

229. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1207 (1995).

than its explicit reasoning.[230] In other words, it is considered justifiable to formulate a judicial rule from precedent that veers from the rules articulated in the opinions themselves, so long as the rule formulated does in fact fit the facts of the cases concerned.[231] Of course, the strength and persuasiveness of the rule will turn on much more than how well it fits the facts. Whether the reformulated rule will or should prevail shall require an examination of, at a minimum, the correctness of its reasoning and normative appeal.[232]

In what follows, I do not believe I make a full-throttled, ambitious use of this approach to interpreting precedent that prioritizes an examination of what courts have *done* over what courts have *said*. Rather, I believe that my proposed reading of *Dirks* can fit within more traditional, conventional modes of case interpretation. Nevertheless, to the extent that what follows is deemed a tad aggressive, and to the extent that it pushes the proverbial envelope, I invoke the results-based approach to interpretation highlighted above to buttress what I proffer.[233]

B. Interpreting Dirks *as Establishing a Presumption of Personal Benefit*

Much of the consternation surrounding the *Dirks* personal benefit test stems from its ambiguity and imprecision.[234]

The test is ambiguous in that it suggests two contradictory grounds for finding a personal benefit. The first ground is that of self-interest:

- "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings";[235]

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230. *See* Ronald Dworkin, *Hard Cases*, 88 HARV. L. REV. 1057, 1087-1101 (1975); *see also* Mary Massaron Ross, *An Advocate's Toolbox: Techniques to Help Appellate Lawyers Evaluate Precedent and Craft Analytically Precise Arguments*, MICH. B.J., Aug. 2002, at 25, 26 (discussing "reading precedent in terms of the result"); *cf.* Jane Kent Gionfriddo, *Thinking Like a Lawyer: The Heuristics of Case Synthesis*, 40 TEX. TECH L. REV. 1, 9 n.33 (2007) (noting that in situations where some decisions contradict assertions made by the courts, "a lawyer must synthesize the cases by explaining what the courts are doing, even if contradictory to ideas expressed explicitly on the pages of some or all of the decisions").

231. *See* Ross, *supra* note 230, at 26.

232. *See* Dworkin, *supra* note 230, at 1101.

233. *See infra* Part V.B.

234. *See* Dirks v. SEC, 463 U.S. 646, 663-64 (1983).

235. *Id.* at 663.

- "a relationship between the insider and the recipient that suggests a *quid pro quo*."[236]

Conversely, the second ground is that of altruism:

- "an insider makes a gift of confidential information to a trading relative or friend";[237]
- "an intention to benefit the particular recipient."[238]

Moving beyond the irreconcilability of these two grounds, a second layer of difficulty arises with regard to terms like "pecuniary gain," "future earnings," and "*quid pro quo*" on the one hand, and "friend" on the other.[239] With regard to the former list of terms, how much gain, what amount of earnings, and what kind of quid pro quo could be used to justify a valuable tip? To invoke the parlance of contract law, would mere nominal consideration suffice,[240] or must the material benefit flowing to the tipper be adequate consideration (something of "equal" or "reasonabl[y]" proportioned value to the tip itself)?[241] Or, would something in-between suffice?[242] As for the term "friend," is there a standard to be applied to that concept? Would Facebook "friends" suffice?[243] Would mere workplace colleagues, or casual acquaintances qualify?

Our need to resolve these and related questions could be dispensed with if we read *Dirks* as creating a rebuttable presumption of personal benefit. And, this would, I posit, represent not a far leap at all. Indeed, if read as broadly as is reasonable, the situations giving rise to a personal benefit in *Dirks* would cover a vast territory. Essentially, read broadly, *Dirks* could stand for the proposition that (1) a personal benefit presumptively exists in every situation in which someone receives something in return, and (2) a personal benefit presumptively exists in every situation in which someone does not receive something in return. In other words, in almost every situation, we can presume that a personal benefit exists.

By adopting this presumption, we would essentially be inverting the *Dirks* test.[244] We would be presuming that the intentional or knowing revelation of material, nonpublic information to a tippee could ordinarily

236. *Id.* at 664.
237. *Id.*
238. *Id.*
239. *Id.* at 663-64.
240. *See Nominal Consideration*, BLACK'S LAW DICTIONARY, *supra* note 59 ("Consideration that is so insignificant as to bear no relationship to the value of what is being exchanged . . . .").
241. *See Adequate Consideration*, BLACK'S LAW DICTIONARY, *supra* note 59.
242. *See Sufficient Consideration*, BLACK'S LAW DICTIONARY, *supra* note 59.
243. *See* FACEBOOK, https://www.facebook.com (last visited Nov. 26, 2016).
244. *See Dirks*, 463 U.S. at 662-64.

be explained only by either self-interest or altruism.[245] To combat a finding of insider trading under such circumstances, all things being equal, the defendant would bear the burden of asserting an affirmative defense that his or her motivations were otherwise.

How could a defendant possibly mount such a defense? By invoking the very situation that served to exonerate the defendant in *Dirks*: that of the whistleblower.[246] For, in the context of a bona fide whistleblower, the knowing revelation of material, nonpublic information would be motivated by neither self-interest nor the altruism of gift-giving. Rather, it would be motivated by one's sense of civic obligation.[247] Consequently, our reformulation of *Dirks* as establishing a presumption of personal benefit, rebuttable primarily in situations of bona fide whistleblowing,[248] furnishes us with a rule for tipper-tippee liability that is clearer, easier to apply, and (still?) normatively appealing, all while remaining fundamentally faithful to the Supreme Court's precedent in *Dirks*. [249] With regard to the cases, which came before this proposed rule, *Salman* would be upheld and *Newman* would be overruled. This is because, absent any showing of whistleblowing motivation on the part of the defendants in those cases, the presumption of personal benefit would prevail. *A fortiori*, the defendants committed insider trading when they passed along the material, nonpublic information to a tippee.

Finally, it must also be noted that U.S. securities law is no stranger to presumptions. The "fraud-on-the-market" presumption of reliance has become a cornerstone of federal securities fraud litigation.[250] Pursuant to this presumption, investors in an efficient market are presumed to have relied upon a defendant's fraudulent misstatements, omissions, or both, by virtue of their reliance on a security's price.[251]

Arguably striking even closer to home is the fact that the entire edifice of U.S. federal securities law is built upon the assumption of the "reasonable investor."[252] The "reasonable investor" is defined as

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245. *See id.* at 663-64.

246. *See id.* at 667.

247. On a darker note, it could be motivated by a desire for revenge. But, this too would not constitute a personal benefit under *Dirks* as either traditionally interpreted or as re-interpreted here.

248. There are most likely other situations that would qualify to exonerate a defendant under the presumption proposed, but I have admittedly not yet imagined them.

249. *See Dirks*, 463 U.S. at 662-64.

250. *See, e.g.*, Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 133 S. Ct. 1184, 1190 (2013).

251. *See id.* at 1192-93.

252. *See* Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 320 (2009); Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461, 466-67 (2015).

"the idealized, perfectly rational actor of neoclassical economics" who "is presumed to operate rationally to maximize returns in the marketplace."[253] Consequently, the argument can be made that I am not really reinterpreting *Dirks* here at all, but rather simply reading it within the broader context of U.S. securities law generally—a context within which human behavior is already presumed to be driven by self-interest.

VI. CONCLUSION

U.S. securities law suffers from a number of vexing difficulties, one of which is the proper understanding and application of the Supreme Court's personal benefit test as set forth in *Dirks*. With the Court's decision to grant certiorari to revisit this issue in *Salman*, an opportunity exists to clarify matters going forward. This can be done by interpreting *Dirks* as giving rise to a presumption of personal benefit—rebuttable upon a defendant's showing of good faith, whistleblowing activity. This preserves the essential purpose of the personal benefit test: its service as an escape from liability for those tippers who act in good faith and, for the benefit of the market as a whole, to disclose fraud. At the same time, the proposed solution drastically simplifies the application of the personal benefit test, for in the vast majority of tipper-tippee cases its presumption will not be subject to serious challenge. Finally, this solution remains faithful not only to the outcome reached in *Dirks*, but to the broader tradition of securities law, which already presumes that securities market participants act to further their own self-interest.

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253. Lin, *supra* note 252, at 467.