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## The SEC's Neglected Weapon: A Proposed Amendment to Section 17(a)(3) and the Application of Negligent Insider Trading

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# THE SEC’S NEGLECTED WEAPON: A PROPOSED AMENDMENT TO SECTION 17(A)(3) AND THE APPLICATION OF NEGLIGENT INSIDER TRADING

Marc I. Steinberg\* & Abel Ramirez, Jr.\*\*

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## INTRODUCTION

As the key enforcement provisions of the Securities Exchange Act of 1934, Section 10(b)<sup>1</sup> and the corresponding Rule 10b-5<sup>2</sup> are widely considered to be the Securities and Exchange Commission's (SEC) foremost tools in policing insider trading.<sup>3</sup> As a result of the authority granted by these provisions, the SEC has relied heavily on Section 10(b) and its corresponding rules when pursuing insider trading claims.<sup>4</sup> While these provisions are

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1. 15 U.S.C. § 78j(b) (2016). Section 10(b) provides:

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

...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement[] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. 17 C.F.R. § 240.10b-5 (2016). Rule 10b-5 provides:

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.

3. See generally MARCI STEINBERG & WILLIAM WANG, *INSIDER TRADING* (3d ed. 2010) (reviewing heightened SEC scrutiny of insider trading).

4. See *Salman v. United States*, 137 S.Ct. 420 (2016) (affirming conviction of tippee of material nonpublic information under Section 10(b) adhering to its holding in *Dirks*); *United States v. O'Hagan*, 521 U.S. 642 (1997) (holding that a conviction under Section 10(b) can be upheld under a misappropriation theory); *Dirks v. SEC*, 463 U.S. 646, 665 (1983) (finding that a tippee was not in violation of Section 10(b) because he had no duty that would have required him to disclose the information he used to trade); *Chiarella v. United States*, 445 U.S. 222 (1980) (reversing conviction under Section 10(b) because alleged violator was not a corporate insider and, under the charges set forth, did not have a duty to disclose prior to trading); See also Rule 14e-3, 17 C.F.R. § 240.14e-3 (2016) (prohibiting transactions in securities on the basis of material, nonpublic information in connection with a tender offer).

standard in prosecuting insider trading enforcement actions, the standard of culpability that the SEC must prove to successfully prosecute an insider trading claim under these provisions is quite demanding.<sup>5</sup> In view of several losses in recent insider trading enforcement actions,<sup>6</sup> the SEC, when appropriate, should consider bringing these actions under a different statute than Section 10(b) — one that requires proof of a lesser standard of culpability.

In order to successfully establish a claim under Section 10(b) (as well as Rule 14e-3),<sup>7</sup> the plaintiff must prove (among other elements) that the

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5. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (concluding that “manipulative,” “device,” and “contrivance” in § 10(b) “connote[] intentional or willful conduct designed to deceive or defraud investors”); See also *Dirks*, 463 U.S. at 666 n.27 (“[T]o constitute a violation of Rule 10b-5, there must be fraud”); *Chiarella*, 445 U.S. at 234–35 (“Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”).

6. See, e.g., *SEC v. Bauer*, 723 F.3d 758 (7th Cir. 2013) (reversing a grant of summary judgment for the SEC because a material issue of fact existed as to whether the materiality and scienter requirements were met); *SEC v. Moshayedi*, Civil Action No. 12-cv-01179 (C.D. Cal. Jun. 6, 2014) (finding for defendant on all claims made by the SEC); *SEC v. Yang*, Case No. 12-cv-02473 (N.D. Ill. May 27, 2014) (finding in favor of defendants on insider trading claims); *SEC v. Steffes*, Case No. 1:10-cv-06266 (N.D. Ill. Jan 27, 2014) (finding defendants not guilty of insider trading when the SEC’s evidence was merely inferential); *SEC v. Schwacho*, Civil Action No. 1:12-cv-0022557 (N.D. Ga. Jan 7, 2014) (finding that there was not enough evidence to prove that Schwacho misappropriated insider information and that he had obtained material, nonpublic information when overhearing telephone calls); *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. 2010) (finding for defendant on insider trading claims); John Carreyrou, *Mark Cuban Cleared in Insider-Trading Case*, WALL ST. J. (Oct. 26, 2013) <http://www.wsj.com/articles/SB1000142405270230368040457913977408> 1561730 [<https://perma.cc/KAW9-XS9H>]; see also *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) (reversing and vacating criminal conviction based on unlawful tipping and trading).

7. Under the enabling provision of Section 14(e) of the Exchange Act, the SEC adopted Rule 14e-3 in order to establish the “disclose or abstain from trading rule” in regard to tender offers. Securities Exchange Act Release No. 17120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980) (internal quotation marks omitted). In this limited context, the proscriptions against trading and tipping on material confidential information are far more onerous than under Section 10(b): Rule 14e-3 applies this disclose-or-abstain provision when a defendant possesses material and nonpublic information that relates to a tender offer where the person knows or has reason to know the information is nonpublic and was received directly or indirectly from the offeror, the subject corporation, any of their affiliated persons, or any person acting on behalf of either company. Rule 14e-3(a), (d), 17 C.F.R. § 240.14e-3(a), (d). Moreover, the rule contains a broad anti-tipping provision. Under Rule 14e-3, a person who knows or has reason to know “that she is in possession of material nonpublic information regarding a tender offer directly or indirectly from the” offeror (bidder), target corporation, or an intermediary can neither trade nor tip the securities of the respective company prior to adequate public disclosure (and absorption) of such information into the public securities markets. *Id.* See *O’Hagan*, 521 U.S. at 645 (upholding Rule 14e-3 as a “proper exercise of the SEC’s prophylactic power under §14(e)” and finding that these

defendant acted with “scienter”<sup>8</sup> as the requisite *mens rea*.<sup>9</sup> In the context of insider trading, this means that, in order for liability to attach, the SEC must establish that an insider was aware of material and nonpublic information at the time that the insider traded.<sup>10</sup> Further, one who knowingly conveys such information to others in breach of one’s fiduciary duty is also deemed to have the requisite scienter.<sup>11</sup>

Currently, a void exists in the spectrum of liability for insider trading causes of action. In other words, when the SEC pursues a cause of action against a defendant purchaser under Section 10(b) and Rule 10b-5 for an insider trading violation, there are only two possible outcomes – liability for intentional insider trading (i.e., a court holds that the defendant committed insider trading by acting with scienter), or a complete lack of liability (i.e., a

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provisions applied to *O’Hagan* in addition to Section 10(b) charges). In addition, a tippee of material and nonpublic information related to a tender offer who knows, or has reason to know, that the subject information has come directly or indirectly from an offeror, target corporation, or intermediary similarly cannot trade or tip on the stock of the respective company prior to adequate public disclosure (and absorption) of this information into the public securities markets. § 240.14e-3(a), (d). Because of the narrow scope of Rule 14e-3, as applying only in the tender offer context, insider trading proceedings have been primarily pursued under Section 10(b) and Rule 10b-5. See *Chiarella*, 445 U.S. at 226 (“Section 10(b) was designed as a catch-all clause to prevent fraudulent practices.”); see also Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2016) (defining the situations in which the misappropriation theory applies to charges under Rule 10b-5); See generally A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* (2012) (surveying the extensive, diverse use of Rule 10b-5). “Rule 10b5-2 clarifies how the misappropriation theory applies to certain non-business relationships. This rule provides that a person receiving confidential information under circumstances specified in the rule would owe a duty of trust or confidence and thus could be liable under the misappropriation theory.” SEC, *Fast Answers: Insider Trading* (Jan. 15, 2013), <http://www.sec.gov/answers/insider.htm> [<https://perma.cc/7P4L-CBFD>]; STEINBERG & WANG, *supra* note 3, at § 5.4.3.

8. Scienter is defined as “a mental state embracing intent to deceive, manipulate, or defraud.” *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980) (quoting *Ernst & Ernst*, 425 U.S. at 193 n.12).

9. See, e.g., *id.* at 680.

10. See generally Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2016) (“Rule 10b5-1 provides that a person trades on the basis of material nonpublic information if a trader is ‘aware’ of the material nonpublic information when making the purchase or sale.”). *Fast Answers: Insider Trading*, *supra* note 7; STEINBERG & WANG, *supra* note 3, at § 4.4.5.

11. See *Salman*, 137 S.Ct. 420 (applying rationale of *Dirks*); *Dirks*, 463 U.S. 646 (holding that the duty of tippees to disclose or abstain from trading depends on whether the tipper has herself breached a fiduciary duty); *U.S. v. Newman*, 664 F.2d 12 (2d. Cir. 1981) (upholding an indictment on the grounds that the defendants had allegedly misappropriated material and nonpublic information entrusted to them by their employers and clients); *Newman*, 773 F.3d at 446 (“The elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory.”) (internal citations omitted); see also *Chiarella*, 445 U.S. 222 (reversing conviction of *Chiarella* because he did not have a duty to disclose).

court rules that the defendant did not commit intentional insider trading). In contrast to various offenses that typically maintain varying levels of liability enumerated by statute, the only potential outcomes for insider trading liability in the purchaser context are on opposite sides of the liability spectrum, thus creating a gap that allows “grey-area” inside traders to avoid liability.<sup>12</sup> Therefore, when pursuing insider trading against purchasers under Section 10(b), the SEC faces the challenging requirement of proving the defendant’s intentional or knowing misconduct.<sup>13</sup>

The SEC’s task of proving liability would be significantly lessened (and presumably more successful) if it could pursue insider trading claims that require proof of a lesser mental state, namely, that of negligence. Indeed, there is such a provision that grants the SEC with this power: Section 17(a)(3) of the Securities Act of 1933.<sup>14</sup> Unlike claims of insider trading brought under Section 10(b) and Rule 10b-5, which require the SEC to prove scienter,<sup>15</sup> insider trading may be pursued by the Commission under Section 17(a)(3) based upon negligence.<sup>16</sup> To date, the SEC occasionally has invoked this provision against negligent sellers who allegedly have engaged in illegal insider trading.<sup>17</sup>

Although Section 17(a) is not an unheard of statute to invoke in insider trading proceedings (as well as with respect to other alleged misconduct involving securities<sup>18</sup>), it has been primarily used as a supplement to, and in

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12. See *supra* note 6.

13. “The words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.” *Ernst & Ernst*, 425 U.S. at 197.

14. 15 U.S.C. § 77q(a)(3)(2016). Section 17(a)(3) provides:

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15. See *Aaron*, 446 U.S. at 691 (“Rule 10b–5 must . . . be restricted to conduct involving scienter.”).

16. See *id.* at 697 (noting that § 17(a)(3) “focuses upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible”). In criminal cases (even for Section 17(a)(3)), intent must be shown. See 15 U.S.C. § 78ff (punishing knowing and willful conduct).

17. See, e.g., Bolan, Exchange Act Release No. 75066, 2015 SEC LEXIS 2201 (May 28, 2015) at n.2. (“Scienter is not required to prove a violation of Section 17(a)(3). Instead, a violation of this section may be established by showing negligent conduct.”) (internal citations omitted).

18. See *SEC v. Lyon*, 529 F.Supp.2d 444 (S.D.N.Y. 2008) (finding that SEC sufficiently pled claim that investors violated Section 17(a) of the Securities Act by purchasing private investments in public equities (PIPE) securities, then taking short sale positions in PIPE issuers’ publicly traded stock, where SEC alleged that investors agreed to be bound by

conjunction with, Rule 10b-5 as an additional cause of action to prosecute “scheme” liability.<sup>19</sup> For the most part, these enforcement actions invoked Section 17(a)(1) which, like Rule 10b-5, requires that scienter be proven.<sup>20</sup> Thus, a specific definition of negligence in the context of insider trading has received scant attention.<sup>21</sup>

Section 17(a)(3) has been widely neglected as a weapon in the SEC’s arsenal against insider trading. Section 17(a)(3) carries the potential of providing the SEC with an advantage that is not afforded by Section 10(b), Rule 10b-5, or Rule 14e-3 — the authority to prosecute insider trading claims premised on the lesser mental state of negligence (namely, that a defendant should have known that her acts would be used to perpetrate an insider trading violation, a substantially lighter burden than the scienter requirement of Rule 10b-5). Thus, Section 17(a)(3) would cast a wider net to enforce insider trading regulations against a new category of defendants: negligent inside traders as well as negligent tippers and tippees.<sup>22</sup> However, despite the power granted under Section 17(a)(3) to pursue negligent insider trading claims, the elements of such a cause of action have yet to be sufficiently formulated. Further, the current language of Section 17(a)(3) limits the power of such a cause of action to only negligent (or more culpable) inside traders that offer or sell<sup>23</sup> securities in a transaction that ultimately results in a fraud “upon the purchaser,”<sup>24</sup> thereby ensnaring a substantially smaller

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confidentiality clauses contained in documents they received in connection with PIPE offerings).

19. See *Freeman v. Decio*, 584 F.2d 186, 190 (7th Cir. 1978) (“The SEC has also used its full panoply of powers to police insider trading through enforcement actions and civil actions. The agency has relied . . . on Section 17(a) of the 1933 Act. . .”); *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1149 (N.D. Ill. 2003) (“It has long been established that ‘insider trading’ in the literal and classic sense—trading in a corporation’s stock by a corporate insider on the basis of material nonpublic information—violates Securities Act § 17(a) . . .”); see also, *U.S. v. Naftalin*, 441 U.S. 768 (1979) (involving a fraudulent short sale of securities under § 17(a)(1)); Marc I. Steinberg, *Section 17(a) of the Securities Act After Naftalin and Redington*, 68 GEO L.J. 163 (1979) (discussing the use of Section 17(a) to prosecute schemes instead of Section 10(b)).

20. See *Aaron*, 446 U.S. at 697 (holding that Section 17(a)(3) “quite plainly focuses upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible”).

21. See generally *U.S. v. Evans*, 486 F.3d 315 (7th Cir. 2007) (suggesting, in dicta, that tippee liability can exist where the tip is merely a “careless” passing on of information: “Unlike Dirks, Gianamore was not a whistleblower. Instead, he was an insider acting either carelessly or negligently by giving his friend material insider information that the friend then traded on.”).

22. See *Aaron*, 446 U.S. at 697 (“[T]he language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3).”).

23. 15 U.S.C. § 77q(a).

24. 15 U.S.C. § 77q(a)(3); see also *Naftalin*, 441 U.S. 768 (holding that Section 17(a)

segment of insider trading defendants.<sup>25</sup>

A literal interpretation of Section 17(a)(3)'s language limits the government's ability to bring a claim of insider trading under this statute to one scenario – the one in which a defendant offers or sells securities to a purchaser who is unaware that the seller/defendant is privy to material, nonpublic information that would typically be considered “bad news” (e.g., a subject company's losses that have yet to be publicly announced). Therefore, based on the statute's language, requiring an act which operates as a fraud “upon the purchaser,” Section 17(a)(3) does not provide authority to the government to bring a claim of insider trading where the subject defendant is “the purchaser” (namely, the scenario in which the insider purchases her company's stock while being privy to material, nonpublic information that would typically be considered “good news” such as impressive profits that have yet to be publicly announced). As a result of this limitation in the text of the statute, the SEC is granted authority to prosecute only a fraction of negligent insider trading violations – those in which the defendant was the alleged seller (or offeror to sell).

Why does there exist an inequality of potential defendants that are susceptible to causes of action for negligent insider trading under the language of Section 17(a)(3)? With such a potentially powerful weapon at its disposal, the SEC would be significantly more empowered if it were granted the authority to prosecute a full spectrum of insider trading violations, including those that currently reside in the void between “no violation” and “intentional violation” (when pursued under Section 10(b) and Rule 10b-5). In the SEC's continuing “war” on insider trading,<sup>26</sup> a broader application of Section 17(a)(3) to include purchasers in addition to sellers, as well as including a concise definition of negligent insider trading, would enable the SEC to more vigilantly combat insider trading.

The objective of this article is to propose a method that will allow regulators to bridge the gap that currently exists in the context of insider trading liability. In order to accomplish this task, this article will: 1) discuss

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applies to frauds against brokers and investors).

25. The typical scenario in which an inside trader sells securities is when the insider attempts to avoid losses on securities that are already owned. When the inside trader is aware of material and nonpublic information at the time of the trade, a fraud has resulted “upon the purchaser” (Section 17(a)(3)). However, the most common insider trading causes of action regard the inside trader who *purchases* securities in an attempt to profit based on material and nonpublic information. Thus, the fraud that results is *upon the seller*.

26. See DAVID A. VISE & STEVE COLL, *EAGLE ON THE STREET* (1991) (providing a historical account of the SEC's “war” on insider trading); see also STEINBERG & WANG, *supra* note 3, at § 7.3; Peter J. Henning, *S.E.C.'s Losing Streak in Court Puts Agency in Spotlight*, N.Y. TIMES (Feb. 10, 2014) (discussing the SEC's current losing streak and the difficulties in its attempts at enforcing insider trading).

the potential untapped resource of Section 17(a)(3) with respect to SEC enforcement of insider trading abuse; 2) discuss the theoretical concept of negligent insider trading; and 3) suggest a solution to remedy this disparate treatment – a legislative amendment to Section 17(a)(3) that would broaden the scope of this statute to apply to both sellers and purchasers.

This article also suggests an interpretation of the proposed statute that would enable the SEC to pursue negligent misconduct in the context of insider trading committed by those who improperly use material and nonpublic information (without having to establish the Rule 10b-5 scienter element). Further, the word “indirectly,” as it is used in the introductory paragraph of Section 17(a), may be construed to alter the scope and application of the statute by broadening the range of misconduct that would be subject to prosecution under this provision. If interpreted as developed herein, the effect of this term would allow the SEC to pursue insider trading violations based on negligence against those who improperly use material and nonpublic information or who misappropriate such information.

In order to address the rationale behind the proposed legislative amendment, and thereby focus on the amended Section 17(a)(3) as a potential weapon in the SEC’s arsenal, it is necessary to discuss the history and evolution of judicial interpretation of the specific language within the current statute. Thereafter, a proposed interpretation of the statute’s yet-to-be-amended language as applied in the context of insider trading will be provided. Finally, the article will discuss several insider trading cases, in which the SEC incurred losses under Rule 10b-5, but may have tasted victory under the yet-to-be amended Section 17(a)(3).

## I. OVERVIEW OF INSIDER TRADING

Based on Supreme Court precedent, insider trading is defined as purchasing or selling a security, in breach of a fiduciary duty or similar relationship of trust and confidence, while aware of material, nonpublic information regarding the subject corporation or the market for its securities.<sup>27</sup> The unlawfulness of insider trading is premised on the notion that insider trading is a type of securities fraud<sup>28</sup> based on the inherent unfairness that results when fiduciaries and other specific persons,<sup>29</sup> who are

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27. *Chiarella*, 445 U.S. at 230; *O’Hagan*, 521 U.S. at 652; *Dirks*, 463 U.S. at 647.

28. *Chiarella*, 445 U.S. at 226-30.

29. Early case law, in which the SEC pursued claims of insider trading under Section 10(b), was primarily focused on the most basic of insider trading situations – direct sales or purchases, by a defendant company’s directors or its officers, of securities issued by that same company, where the defendant willfully failed to disclose material nonpublic information about the company’s affairs, when such information affected the value of those securities.

aware of material and nonpublic information, reap profits or avoid losses to the detriment of investors who trade securities without being privy to such information.<sup>30</sup> Insider trading involves a transaction in which someone “deceives” by omission when there exists a duty to disclose.<sup>31</sup> The “omission” in an insider trading transaction occurs when a party engages in a securities transaction while being aware of material and nonpublic information (e.g., information that would likely impact the price of the security and result in either a profit or an avoidance of loss), and that party fails to adequately disclose such information.<sup>32</sup> This breach of duty to

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*See, e.g., In re Ward La France Truck Corp.*, Exchange Act Release No. 3445 (Jun. 10, 1943); *Speed v. Transamerica*, 99 F.Supp. 808, 829 (D. Del. 1951). Subsequent case law has expanded the scope of Section 10(b)'s application to claims of insider trading while simultaneously refining the legal theories upon which a claim for insider trading may be premised.

Although the elements of an insider trading violation under Section 10(b) are not legislatively enumerated, three Supreme Court rulings have established definitive elements: *United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983) and *Chiarella v. United States*, 445 U.S. 222 (1980). Essentially, proscribed insider trading occurs under Section 10(b) when a defendant: (1) is aware of material and nonpublic information regarding a company or its securities, and (2) is bound by a fiduciary duty (or similar relationship of trust or confidence), (3) to either that company's shareholders or to the source of the information, and (4) purchases or sells (or engages in tipping of) the company's securities prior to that information being disseminated and absorbed by the investing public. The Supreme Court's most recent decision, *United States v. Salman*, 137 S.Ct. 420 (2016), adheres to its holding in *Dirks*.

30.

[T]he Commission defined the category of ‘insiders’ subject to a disclose-or-abstain obligation according to two factors: “[F]irst, 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.”

*Chiarella*, 445 U.S. at 249 (quoting *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (footnote omitted)).

31. An omission is misleading if it creates “an impression of a state of facts that differs in a material way from the one that actually exists.” *Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002); *see also New Jersey Carpenters Health Fund v. Royal Bank of Scotland Group, PLC*, 709 F.3d 109, 126 (2d. Cir. 2013) (finding “[a] reasonable investor can independently analyze how a security will perform in the market, but she cannot compensate for the fact that she has not received what she was told to expect”); *Dodona I, LLC v. Goldman, Sachs & Co.*, 847 F. Supp. 2d 624, 648 (S.D.N.Y. 2012) (finding “[u]ltimately, an incomplete or misleading disclosure may be just as damaging as total concealment”); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 944 (7th Cir. 1989) (holding that “incomplete disclosures, or ‘half-truths,’ implicate a duty to disclose whatever additional information is necessary to rectify the misleading statements”).

32. Materiality is determined based upon whether there is a “substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Basic, Inc. v.*

disclose has resulted in two principal bases of Section 10(b) liability: the classical “special relationship” theory and the misappropriation theory.<sup>33</sup>

### A. *The Classical “Special Relationship” Theory*

The classical “special relationship” theory of insider trading “holds that a corporate insider (such as an officer or director) violates Section 10(b) and Rule 10b-5 by trading on the corporation’s securities on the basis of material, nonpublic information about the corporation.”<sup>34</sup> Under the classical “special relationship” theory of insider trading under Section 10(b), a fiduciary duty exists between a company’s shareholders and corporate insiders (e.g., directors and officers).<sup>35</sup> This fiduciary duty gives rise “to a duty to disclose or abstain from trading because of the necessity of preventing a corporate insider from taking advantage of uninformed stockholders.”<sup>36</sup> Thus, the fraudulent act in a classical “special relationship” insider trading transaction is premised on a fraudulent omission by a corporate insider when she sells her subject company’s stock to (or purchases from) her subject company’s shareholders in breach of the duty owed. The Supreme Court has embraced the classical “special relationship” theory under Rule 10b-5.<sup>37</sup> Under this

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Levinson, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). Information is material if “there is a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) a substantial likelihood existed that a reasonable investor would have viewed the total mix of information made available to be significantly altered by disclosure of the fact.” *Longman v. Food Lion, Inc.*, 197 F.3d 675, 683 (4th Cir. 1999); *See also* *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011) (finding that in order to satisfy the materiality requirement, there must be “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”); *Dunn v. Borta*, 369 F.3d 421, 427 (4th Cir. 2004) (holding that the reasonable investor standard requires “a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]”); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (holding that “[b]efore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public”).

33. *SEC v. Cuban*, 620 F.3d 551, 554-55 (5<sup>th</sup> Cir. 2010); *SEC v. Cherif*, 933 F.2d 403, 408-09 (7<sup>th</sup> Cir. 1991); *STEINBERG & WANG*, *supra* note 3, at §§ 5.2-5.4.

34. *Newman*, 773 F.3d at 445.

35. *Dirks*, 463 U.S. at 654.

36. *Newman*, 773 F.3d at 446 (finding “[t]he elements of tipping liability are the same, regardless of whether the tipper’s duty arises under the ‘classical’ or the ‘misappropriation’ theory”) (internal citations omitted).

37. *Chiarella*, 445 U.S. 222. In regard to insider status, the Supreme Court’s decision in *Dirks*, despite its restrictive holding, adopted the principle of the “quasi-insider.” This approach focuses on those persons who may constructively be considered an “insider” with a

theory, the counterparty to the transaction is the victim of the deception because, by engaging in this transaction, the counterparty has been deceived into believing that the insider does not have information “known to [her] by virtue of [her] position” that, if known to the shareholder, “would affect [his] investment judgment.”<sup>38</sup>

Hence, a fundamental principle, recognized at least since the SEC’s decision in *In re Cady, Roberts & Co* over fifty years ago, is that an “insider” and, in certain circumstances, the insider’s “tippee” must either: (1) disclose the material and nonpublic information that is in his possession prior to trading; or (2) abstain from trading altogether.<sup>39</sup> The holding in *Cady* (in which the SEC alleged liability under Section 17(a) along with Section 10(b)), and later refined in *Chiarella*, established the classical “special relationship” theory of insider trading.<sup>40</sup> Generally, the classical theory focuses on trading by corporate fiduciaries in the securities of their own corporations.<sup>41</sup> Under this approach, a person violates Rule 10b-5 when he

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fiduciary duty to disclose material nonpublic information or abstain from trading. The Court expounded this principle by stating:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . [W]hen such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

*Dirks*, 463 U.S. at 677 n.14 (internal citations omitted). Hence, the Court declined to confine the classical insider trading proscription to directors and officers of the company. Rather, under the Court’s rationale, “individuals enjoying a special relationship with the corporation, such as accountants, attorneys, consultants, and underwriters, may be viewed as insiders when they trade on material nonpublic information that they legitimately received during the course of that relationship.” MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAWS* 387-88 (6<sup>th</sup> ed. 2014).

38. *Chiarella*, 445 U.S. at 227; see also STEINBERG, *supra* note 37.

39. 40 SEC at 911.

40. 445 U.S. at 227.

41. See *Dirks*, 463 U.S. 646 (concerning an officer of a broker-dealer specializing in providing investment analysis of insurance company securities to institutional investors who was charged with aiding and abetting violations of § 10(b) of the Exchange Act and SEC Rule 10b-5 for providing material nonpublic information about an insurance company to clients and investors, who relied on such information in selling their holdings thereof); see also SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995) (quoting *Cherif*, 933 F.2d at 408) (“Under the classical theory, a person violates [Rule 10b-5] when he or she buys or sells securities on the basis of material, non-public information and at the same time is an insider of the corporation whose securities are traded.”).

is an insider of a corporation, and, in breach of his fiduciary duty owed to the corporation and its shareholders, buys or sells securities of that corporation while being aware of material and nonpublic information.<sup>42</sup> In other words, the classical “special relationship” theory only imposes liability when an inside trader is a corporate insider (e.g., director, control person, or officer) or a temporary insider of the company (e.g., investment banker or legal counsel) whose securities the insider has traded. Under this theory, such an inside trader breaches a fiduciary duty owed to the company’s shareholders. Thus, in *Chiarella v. United States*, the Supreme Court reasoned that liability for trading based on material nonpublic information arises under Section 10(b) if there exists a “duty to disclose arising from a relationship of trust and confidence between parties to a transaction.”<sup>43</sup>

### 1. Insider is the Purchaser (“Good News” Scenario)

When an insider commits an insider trading offense by purchasing stock, the typical scenario that occurs under the classical “special relationship” theory of insider trading is the “good news” scenario – the insider becomes aware of material and nonpublic information that is expected to cause the price of the stock to increase in value (i.e., bullish information) and then purchases securities with the intent of profiting from the increase in the securities’ value. Information that is typically “good news” includes higher profits, launch of a new product, receipt of a lucrative contract, or a profitable acquisition or disposition. As the more recognized, and more commonly prosecuted scenario of insider trading violations, Rule 10b-5 is invoked when the corporate insider purchases a subject company’s securities without disclosing the favorable inside information about the company’s affairs to the investing public as well as to the party selling the subject securities.

### 2. Insider is the Seller (“Bad News” Scenario)

When an insider commits an insider trading offense by selling stock, the typical scenario that occurs under the classical “special relationship” theory of insider trading is the “bad news” scenario — the insider becomes aware of material and non-public information that is expected to cause the price of the stock to decrease in value (i.e., bearish information) and sells

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42. *Chiarella*, 445 U.S. at 227-28; see also 17 C.F.R. § 240.10b5-1, *supra* note 10.

43. *Chiarella*, 445 U.S. at 230; see also *id.* at 235 (rejecting the equal access rationale and holding that “[A] duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information”).

securities in order to avoid a loss from the decrease in the securities' value. Information that is typically "bad news" includes lower profits, increased debt, loss of a major contract, or a government enforcement action.<sup>44</sup> As the

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44. Two relatively recent insider trading cases that involve both buys ("Good News" Scenario) and sales ("Bad News" Scenario) are the cases involving the hedge fund, Galleon Management. The civil case, *SEC v. Galleon Mgmt., LP* (683 F. Supp. 2d 316 (S.D.N.Y. Feb. 9, 2010)), and the corresponding criminal case against Galleon founder, Raj Rajaratnam, *U.S. v. Rajaratnam*, (802 F.Supp.2d 491 (S.D.N.Y. Aug. 11, 2011)), involved an insider trading scheme estimated to have generated approximately \$45 million in both profits and savings. Among several other various stocks traded (both long and short), Rajaratnam was convicted of insider trading for short selling the stock of the microprocessor manufacturing company, Intel, based on material and nonpublic information.

In both cases, Rajaratnam, was found to have received material nonpublic information from his personal friend, Rajiv Goel. Goel was a managing director with Intel's treasury group – Intel Capital, which made proprietary equity investments in various technology companies. In one particular instance, Goel spoke to Rajaratnam and told him to short sell Intel stock because, based on Goel's personal knowledge of the company's financial status, he was aware that Intel's earnings would be below expectations. In return, Goel asked that Rajaratnam place similar trades in Goel's personal brokerage account (to which Rajaratnam was an authorized manager) in order to falsely suggest that the trades in the account were not placed directly by Goel (which would have been a violation of Goel's fiduciary duty owed to Intel).

On April 9, 2007, one week before Intel's scheduled Q1 2007 earnings announcement, Rajaratnam and Galleon sold short 1,000,000 shares of Intel stock at \$20.14 per share. Rajaratnam also fulfilled the requested trades in Goel's personal brokerage account. When Intel ultimately released its Q1 2007 earnings, Rajaratnam and Galleon profited from the trades in the amount of \$1.3 million, and avoided losses in the amount of \$917,000.

The court found the subject of the confidential information discussed between Rajaratnam and Goel to be "material." *Rajaratnam*, 802 F.Supp.2d 491. The court also found that Goel, a corporate insider based on his employment position with Intel, had violated his fiduciary duty to his employer by communicating the information to Rajaratnam. *Id.* As a result, both Rajaratnam and Goel were held to have violated Rule 10b-5's prohibition of trading based on material nonpublic information. *Id.*

While possessing or even sometimes trading based on material nonpublic information is not necessarily a violation of the law, the court described how Rule 10b-5 was violated in this instance by both: (1) the trader and (2) the tipper.

Section 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a 'deceptive device' under § 10(b) . . . because a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. The ambit of Rule 10b-5's prohibition on insider trading extends beyond the insiders who themselves have a fiduciary duty but also to the 'tippee' recipients of insider information from those who are insiders. An individual is liable as a tippee under Rule 10b-5 if: (1) the tippee received material nonpublic information regarding a publicly traded company from a tipper; (2) the tippee traded securities while in possession of the information; (3) the tippee knew that the tipper had violated a fiduciary duty when

less recognized, and less commonly prosecuted scenario of insider trading violations, Rule 10b-5 is invoked when the corporate insider sells a subject company's securities without disclosing the unfavorable inside information about the company's affairs to the investing public as well as to the party purchasing the subject securities.<sup>45</sup> Under the language of Section 17(a)(3), liability for negligent insider trading is limited to only this less-common scenario.<sup>46</sup>

### B. *The Misappropriation Theory*

An alternative theory of insider trading liability under Section 10(b) is the "misappropriation theory," which extends liability to certain "outsiders" who do not have a fiduciary relationship to the subject company or its shareholders.<sup>47</sup> Liability under the misappropriation theory attaches where such an "outsider" (such as an attorney or investment banker) obtains material and nonpublic information about the company and subsequently breaches a fiduciary duty to the source of that information by using the information for personal gain — either directly, by trading based on the information, or indirectly, by passing the information on to others.<sup>48</sup> In other words, such conduct rises to the level of fraudulent insider trading because

the information was provided; and (4) the tippee benefitted from the disclosure of the information.

*Id.*, at 497-98 (internal quotations removed).

45. 17 C.F.R. § 240.10b-5.

46. Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit *upon the purchaser*.

15 U.S.C. § 77q(a) (emphasis added).

47. *Newman*, 773 F.3d at 445-46.

48. *O'Hagan*, 521 U.S. at 652 ("The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of information."); *see also Dirks*, 463 U.S. at 664 (explaining that a fraud may also be committed when the person possessing the confidential information does not, herself, trade based on the information, but rather provides the information as a gift to "a trading relative or friend").

the misappropriator's conduct is deceptive by feigning "loyalty to the principal while secretly converting the principal's information for personal gain."<sup>49</sup>

In contrast to the classical "special relationship" theory, the misappropriation theory extends liability to a trader who is not a corporate insider (as under the classical "special relationship" theory). When an inside trader does not owe a fiduciary duty to the shareholders of the company whose stock is traded and he/she has not obtained the information from one who has breached such a duty, there can be no insider trading liability under the classical "special relationship" theory.<sup>50</sup> However, in such circumstances, liability may still be premised on the "misappropriation" theory of insider trading. Under this theory, liability is based on deception of the source of the information, rather than on deception of the shareholders (as with the classical "special relationship" theory).<sup>51</sup>

Under the misappropriation theory of insider trading liability, the inside trader does not owe a duty to disclose to the counterparty of the insider trading transaction but, rather, to the source of the information. Rather than premising liability on the direct fiduciary relationship between a company's shareholders and typical insiders (as would occur under the classical "special relationship theory"), the misappropriation theory premises liability "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."<sup>52</sup> In other words, the inside trader's improperly-motivated, undisclosed, and self-serving use of a subject company's material inside information, in breach of a duty of loyalty and confidentiality to the source of the information, constitutes deceptive conduct under Section 10(b) when it is used to purchase or sell securities.<sup>53</sup>

The Supreme Court gave its approbation to the misappropriation theory in *United States v. O'Hagan*.<sup>54</sup> In this case, the defendant, James O'Hagan, was a partner of a national law firm that represented the bidding company, Grand Metropolitan PLC, in a contemplated tender offer of Pillsbury

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49. SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) (quoting *O'Hagan*, 521 U.S. at 653).

50. *Chiarella*, 445 U.S. at 231-35.

51. See *O'Hagan*, 521 U.S. at 652-53 ("[T]he misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information."); STEINBERG & WANG, *supra* note 3, at § 5.4.

52. Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP L. 1, 19-20 (1998) (quoting *O'Hagan*, 521 U.S. at 652).

53. *O'Hagan*, 521 U.S. at 652; *United States v. Gansman*, 657 F.3d 85, 88 (2d Cir. 2011); SEC v. Talbot, 530 F.3d 1085, 1091 (9th Cir. 2006); SEC v. Rocklage 470 F.3d 1, 5 (1st Cir. 2006).

54. 521 U.S. 642 (1997).

Company common stock.<sup>55</sup> O'Hagan was not personally involved in the representation; however, he learned about the proposed deal and purchased shares and options of the target company before the deal was made public with the expectation that the value of the shares would increase once the information about the deal was made public.<sup>56</sup> Because O'Hagan's law firm represented the bidding company, he did not owe a fiduciary duty to the target company's stockholders and therefore could not be prosecuted under the classical theory of insider trading.<sup>57</sup> Nevertheless, the Court held that O'Hagan was liable under the misappropriation theory because he had deceived both his law firm and its client by feigning loyalty to them while secretly converting information obtained from them into personal gain.<sup>58</sup> As a result, the Supreme Court held that a trader commits fraud in connection with a securities transaction, and thereby violates Section 10(b), when the trader misappropriates material and nonpublic information for the purpose of engaging in a securities transaction, in breach of a duty owed to the source of the information.<sup>59</sup>

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55. *Id.* at 647. Unfortunately, attorneys allegedly have engaged in unlawful insider trading with some frequency. *See, e.g.*, *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. March 31, 1989) (denying motion to dismiss charge against former law firm partner for misusing confidential client information); *Santarlas*, Exchange Act Release No. 62,460, [2010 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 89,060 (Jul. 7, 2010) (settlement) (suspending an attorney from practice because he entered into a scheme to trade on non-public information); *U.S. v. Grossman*, 843 F.2d 78, 79 (2d Cir. 1988) (holding that the district court did not abuse its discretion in refusing to dismiss an indictment of an attorney on securities fraud charges for insider trading); *See also* MARC I. STEINBERG, ATTORNEY LIABILITY AFTER SARBANES-OXLEY § 11.02 (2016) (discussing attorney liability for insider trading).

56. *O'Hagan*, 521 U.S. at 647–48. *See also id.* at 653 n. 5 (“The Government could not have prosecuted O'Hagan under the classical theory, for O'Hagan was not an ‘insider’ of Pillsbury, the corporation in whose stock he traded. Although an ‘outsider’ with respect to Pillsbury, O'Hagan had an intimate association with, and was found to have traded on confidential information from, Dorsey & Whitney, counsel to tender offeror Grand Met. Under the misappropriation theory, O'Hagan's securities trading does not escape Exchange Act sanction, as it would under [the dissent's reasoning], simply because he was associated with, and gained nonpublic information from, the bidder, rather than the target.”).

57. *Id.* at 653 n. 5; *see also Newman*, 773 F.3d at 445-46 (citing *Obus*, 693 F.3d at 285) (“Liability may attach where an ‘outsider’ possesses material non-public information about a corporation and another person uses that information to trade in breach of a duty owed to the owner. In other words, such conduct violates Section 10(b) because the misappropriator engages in deception by pretending ‘loyalty to the principal while secretly converting the principal's information for personal gain.’”) (internal citations omitted).

58. *See O'Hagan*, 521 U.S. at 653–55; *see also Maio*, 51 F.3d at 631 (quoting *Cherif*, 933 F.2d at 410) (“Under misappropriation theory a person violates Rule 10b-5 by ‘misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship . . .’”).

59. Compare *O'Hagan*, 521 U.S. at 644-46 with the Supreme Court's classical “special relationship” theory adopted in *Chiarella*, *supra* notes 34-46 and accompanying text, which established that a “duty to disclose arising from a relationship of trust and confidence between

### C. Tipping

Insider trading liability under Section 10(b) and Rule 10b-5 extends beyond the primary parties of an insider trading transaction, applying to any party that disseminates material inside information (“tippers”) and any party that receives such information (“tippees”), if knowingly and improperly done for personal gain or to convey a gift.<sup>60</sup> Because insider trading liability is premised on the breach of a requisite duty, “[a]n insider’s disclosure is improper when corporate information, intended to be available only for corporate purposes, is used for personal advantage.”<sup>61</sup> This breach occurs when an inside tipper conveys material nonpublic information with the intent to personally benefit, or to provide a gift to the tippee-recipient. A tippee incurs liability under Section 10(b) when he utilizes this information knowing of the inside tipper’s breach.<sup>62</sup>

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parties to a transaction” exists only when directors, officers, and other insiders engage in trades of their respective company’s securities. *Chiarella*, 445 U.S. at 230.

60. See *Dirks*, 463 U.S. at 659 (“Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they [also] may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.”); accord, *Salman v. United States*, 137 S.Ct. 420 (2016); see also *Hernandez v. U.S.*, 450 F.Supp.2d 1112, 1118 (C.D. Cal. Jun. 1, 2006) (“[U]nder the standard set forth in *Dirks*” a tippee can be liable under Section 10(b) and Rule 10(b)-5 “if the tippee had knowledge of the insider-tipper’s personal gain.”); *U.S. v. Santoro*, 647 F.Supp. 153, 170-71 (E.D.N.Y. 1986) (“An allegation that the tippee knew of the tipper’s breach necessarily charges that the tippee knew that the tipper was acting for personal gain.”) *rev’d on other grounds sub nom.* *United States v. Davidoff*, 845 F.2d 1151 (2d Cir. 1988).

61. *Maio*, 51 F.3d at 632.

62. See *Salman*, 137 S.Ct. at 428 (stating that the tippee violated Section 10(b) “by trading on the information with full knowledge that it had been improperly disclosed”). A relatively recent case involving insider tipping is *SEC v. Gupta*, No. 11-CV-7566, 2013 WL 3784138 (S.D.N.Y. Jul. 17, 2013). This case is one of several causes of action associated with the hedge fund, Galleon Management. See *supra* note 44. This specific case involved an insider trading scheme in which former Goldman Sachs board member Rajat K. Gupta illegally tipped corporate secrets to former Galleon Management hedge fund manager, Raj Rajaratnam that were used by Rajaratnam to generate approximately \$23 million in both profits and savings. *Gupta*, 2013 WL 3784138 at \*1.

According to the SEC’s complaint, while serving on the boards of Goldman Sachs and Proctor & Gamble, Gupta had a variety of business dealings with Rajaratnam and stood to benefit from his relationship with him. *Id.* Therefore, in order to gain favor with Rajaratnam, Gupta illegally tipped Rajaratnam with material and nonpublic information that Gupta obtained during his official duties at Goldman Sachs and Proctor & Gamble. *Id.* The information concerned the quarterly earnings of both companies, as well as a yet unrealized \$5 billion investment that Goldman Sachs had anticipated to receive from Berkshire Hathaway at the height of the financial crisis. *Id.* As a result, the SEC alleged that Rajaratnam was responsible for various trades among certain Galleon funds based on Gupta’s inside information, and further shared the information with associates at Galleon who were also

Unlawful “tipping” under Section 10(b) is premised on whether the tipper breached a fiduciary duty (or a relationship of trust and confidence) by communicating the subject information to his tippee(s) and whether the subject tippee(s) knew of the breach.<sup>63</sup> Without such a fiduciary breach, a tippee is entitled to lawfully trade and/or tip without incurring liability under Section 10(b).<sup>64</sup> According to the Supreme Court, in order for liability to attach to a tipper/tippee in relation to intentional insider trading, an insider is deemed to have breached his fiduciary duty by tipping the subject information when the insider is motivated by the expectation of receiving a personal benefit.<sup>65</sup> Typically, the “personal benefit” in question is of a pecuniary nature, such as cash or an elevation in social or professional status that carries the realistic potential to result in future financial benefits.<sup>66</sup>

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responsible for trading based on Gupta’s inside information ahead of public announcements by the respective companies. *Id.*

The court found the confidential information discussed between Rajaratnam and Gupta to be “material.” *Id.* at \*4. The court also found that Gupta, a corporate insider based on his employment position with Goldman Sachs, had violated his fiduciary duty to his employer by communicating the information to Rajaratnam. *Id.* at \*11. As a result, both Rajaratnam and Gupta were held to have violated Rule 10b-5’s prohibition of trading based on material nonpublic information. *Id.*

On June 15, 2012, in a parallel criminal case arising out of the same facts, Gupta was convicted of one count of conspiracy to commit securities fraud and three counts of securities fraud. *U.S. v. Gupta*, 904 F. Supp. 2d 349 (S.D.N.Y. Oct. 24, 2012), *aff’d*, 747 F.3d 111 (2d Cir. 2014). On October 24, 2012, Gupta was sentenced to two years in prison and one year of supervised release and ordered to pay a \$5 million criminal fine. On February 25, 2013, the court ordered Gupta to pay Goldman restitution of approximately \$6.2 million. *Id.* On July 17, 2013, the SEC obtained a final judgment ordering Gupta to pay a \$13.9 million penalty and also permanently barring him from serving as an officer or director of a public company. *Gupta*, 2013 WL 3784138. Gupta unsuccessfully appealed his conviction. *Gupta*, 904 F. Supp. 2d 349.

63. *Salman*, 137 S.Ct. at 428. The Supreme Court’s “should have known” language in *Dirks* is puzzling as that language suggests negligent culpability is sufficient for Section 10(b) liability. But, such cannot be the case as Section 10(b) requires scienter to be proven. The Court’s language in *Salman* supports this rationale. *See supra* notes 8-11 and accompanying text.

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

65. *Id.* at 663-64.

66. *Id.* The Court held that, in addition to the primary parties to an inside trading transaction, tippers and tippees may also be subject to Section 10(b)’s insider trading prohibition depending upon whether the tipper will gain a personal benefit from his tip. *Id.* Absent some personal gain, there has been no breach of duty to stockholders. *Id.* And, absent a breach by the insider, there is no derivative breach by the tippee. *Id.* In this case, Raymond Dirks, a security analyst, received confidential information from a former officer of an insurance company called Equity Funding Corporation (EFC). *Id.* The former officer informed Dirks that EFC’s stock was grossly over-valued and that the company’s assets were overstated, due primarily to a high number of fraudulent policies that the company had issued. *Id.* at 649. While attempting to ascertain the truth of the allegations, Dirks communicated the information to (1) the Wall Street Journal and (2) several of his institutional clients. *Id.* In

Further, a personal benefit is deemed to have resulted when the insider conveys the subject information as a gift: the gift of tipping the material and nonpublic information is likened to trading by the insider himself with the transfer to the tippee-recipient of the profits generated from the trades.<sup>67</sup>

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regard to the Wall Street Journal, Dirks convinced the publication to write a series of articles that exposed EFC's fraud. *Id.* In regard to the clients of his firm, Dirks advised them (while investigating EFC's fraud, but before the Wall Street Journal published the story) to sell their outstanding holdings in EFC. *Id.* Acting on the information that Dirks provided, these clients sold large amounts of EFC stock in order to avoid the potential losses that would be incurred when the company's fraud were to become public and thus likely cause the price of EFC's stock to decline. *Id.* The allegations were confirmed soon after, and EFC subsequently went into bankruptcy. In response to Dirks's acts of communicating the material and nonpublic information regarding EFC to his firm's clients, the SEC brought suit against Dirks, alleging that he violated Rule 10b-5. *Id.* at 650-51. Subsequently, the Supreme Court held that Dirks did not violate Section 10(b) since the EFC insider had not acted with an improper motive in conveying the information to Dirks. Rather, his motivation was to provide the information to Dirks in order to obtain his aid in exposing the fraud. *Id.* at 666. Further, the Supreme Court held that a tippee's duty to disclose or abstain "is derivative from that of the insider's duty." *Id.* at 659. Thus, a tippee is only liable under Section 10(b) or Rule 10b-5 for trading on the basis of material and nonpublic information if the inside tipper breached a fiduciary duty in disclosing to the tippee. *See* *Salman v. United States*, 137 S.Ct. 420 (2016) (applying *Dirks*); *U.S. v. Carpenter*, 791 F.2d 1024, 1031 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) (holding that an individual engages in "misappropriation" for purposes of insider trading laws when he engages in "conduct constituting secreting, stealing, [or] purloining. . . [of] material nonpublic information in breach of an employer-imposed fiduciary duty of confidentiality."). In determining whether the disclosure constituted such a breach of duty, the Court considered whether the inside tipper personally benefitted directly or indirectly from the disclosure to the tippee. *Dirks*, 463 U.S. at 662 (concluding that "[a]bsent some personal gain [to the corporate insider], there has been no breach of duty to stockholders"). The Court stated that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain." *Id.* at 659-60 (emphasis added); *see also* *SEC v. Switzer*, 590 F. Supp. 756, 765 (W.D. Okla. Jul 2, 1984) (holding that the Supreme Court's decision in *Dirks* "pointed out that, unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such fiduciary relationship").

67. *Dirks*, 463 U.S. at 664. Each theory of insider trading also may incur different elements for tipping liability. For instance, under the classical "special relationship" theory of insider trading, fraudulent insider trading occurs when a corporate insider trades in the securities of the company to which the corporate insider owes a fiduciary duty when the trades are made on the basis of material and nonpublic information. *O'Hagan*, 521 U.S. at 651-52. This theory applies not only to officers, directors, and other permanent insiders of a company but applies also to temporary "quasi-insiders" who may become fiduciaries of the company as a result of their capacity in service to the company (e.g., attorneys, accountants, consultants, etc.). *Id.* at 652. Under the misappropriation theory of insider trading, if a person who is liable for misappropriating confidential information subsequently "tips" another person, the "tippee" also is liable under Section 10(b) and Rule 10b-5 if the tippee trades on the basis of the information if the tippee was aware of the tipper's breach of fiduciary duty to the tipper's source of the information. *Id.* The *Dirks* court held that, to be liable under Section 10(b), "an inside tipper must gain some personal advantage in order for an outside tippee to be liable for

Liability for tipping related to insider trading hinges on establishing that the tipper-defendant gained a personal benefit from her actions.<sup>68</sup> As an essential element of tipping liability, the requirement of the knowing receipt of a personal benefit is a significant cause of the existing void that exists as this element mandates that the defendant act intentionally.<sup>69</sup> To fill this void of liability, a cause of action for insider trading-related tipping should exist between “no liability” and “intentional liability” that requires proof of a defendant’s negligence.

## II. AN UNTAPPED REMEDY — SECTION 17(A) OF THE SECURITIES ACT

### A. Overview

Similar to Section 10(b), the language of Section 17(a) of the Securities Act does not specifically proscribe insider trading.<sup>70</sup> With some frequency, the SEC has pursued insider trading enforcement actions based upon the authority granted by this statute, and, in particular, ordinarily under Section 17(a)(1).<sup>71</sup> Congress enacted the Securities Act in direct response to the market crash of 1929 in order to promote investor protection, help ensure fair dealing, and enhance ethical business standards of honesty and fair

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trading on material nonpublic information.” *SEC v. Adler*, 137 F.3d 1325, 1334 (11th Cir. 1998).

68. *Dirks*, 463 U.S. at 664.

69. *See id.* (noting that an inference of personal benefit may be drawn based on, *inter alia*, “an intention to benefit the particular recipient”).

70. *See supra* note 46 for the text of the statute.

71. Like Section 10(b), Section 17(a)(1) requires proof of the defendant’s scienter. *See Aaron*, 446 U.S. at 695-96 (1980) (determining that the statutory language of 17(a)(1) implies a scienter requirement). Without invoking any specific clause, the SEC has alleged violations of Section 17(a) in several landmark insider trading cases. In *Dirks*, the SEC held that Dirks, by tipping, had aided and abetted the Section 17(a) violations of his selling tippees. *See Dirks*, 463 U.S. at 650-51. Although the D.C. Circuit affirmed the SEC’s censure of Dirks and the Supreme Court reversed the censure, neither court separately discussed the application of Section 17(a); instead, both focused on the application of Section 10(b) and Rule 10b-5. *Id.* at 653-67; *Dirks v. SEC*, 681 F.2d 824, 833-846 (D.C. Cir. 1982). In *Cady, Roberts & Co.*, the SEC held that the insider trading defendants violated both Section 17(a) and Section 10(b). 40 SEC at 911.

For examples of more recent proceedings in which the SEC alleged that an insider trading defendant violated Section 17(a), see *Rocklage*, 470 F.3d 1; *Adler*, 137 F.3d 1325; *Maio*, 51 F.3d 623; *SEC v. Aragon Capital Mgmt., LLC*, 672 F. Supp. 2d 421 (S.D.N.Y. Nov. 24, 2009); *Cuban*, 634 F. Supp. 2d 713; *SEC v. Anton*, 2009 WL 1109324 (E.D. Pa. Apr. 23, 2009); *Lyon*, 529 F. Supp. 2d 444; *SEC v. Svoboda*, 409 F. Supp. 2d 331 (S.D.N.Y. Jan. 3, 2006); *Causey*, Litigation Release No. 18776, 83 SEC Docket 850, 2004 WL 1531843 (Jul. 8, 2004).

dealing in regard to securities transactions.<sup>72</sup> As discussed above, Section 17(a)(3) forbids “any person in the offer or sale of any securities” from engaging in any practice or transaction that would “directly or indirectly . . . operate as a fraud or deceit upon the purchaser.”<sup>73</sup> Based on this language, the SEC has invoked Section 17(a)(3) to a minimal extent in its pursuit of alleged insider trading violators.<sup>74</sup> Perhaps surprisingly, to date, courts have given relatively little attention to the effect of this statute’s application to insider trading. In those instances where courts have analyzed the application of Section 17(a)(3), they frequently do so concurrently, and with deference to, prior interpretations of Rule 10b-5<sup>75</sup> — perhaps under the incorrect perception that the two provisions are substantially similar.<sup>76</sup>

Although a few courts have treated the three subsections of Section 17(a) as all being applicable to the same types of misconduct in the offer or sale of securities, courts generally have interpreted the three subsections as proscribing different types of misconduct.<sup>77</sup> Specifically, most courts agree that subsections (a)(1) and (a)(3) are applicable to scenarios involving

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72. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (noting that a fundamental purpose of the Securities Act of 1933 “was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry”) (citing H.R. Rep. No. 85, 73d Cong., 1st Sess. 2), quoted in *Wilko v. Swan*, 346 U.S. 427, 430 (1953). See also *Naftalin*, 441 U.S. 768 (explaining that the Securities Act was passed in the aftermath of the market crash in 1929 “to achieve a high standard of business ethics . . . in every aspect of the securities industry”) (quoting *Capital Gains Bureau*, 375 U.S. at 186-87); *Ernst & Ernst*, 425 U.S. at 195 (“The Securities Act of 1933 . . . was designed to . . . protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing.”).

73. 15 U.S.C. § 77q(a)(3). See *supra* note 46 for the text of the entire statute.

74. There have been a small number of insider trading cases in which a defendant agreed to settle to a lesser charge of negligence under Section 17(a)(3). See, e.g., *In re Bolan*, 2015 SEC LEXIS 2201; *SEC v. Shared Med. Sys. Corp.*, Litig. Rel. No. 14130, 56 SEC Docket 2624, 1994 SEC LEXIS 1947 (June 22, 1994).

75. See *Maio*, 51 F.3d at 631 (applying concurrently Section 17(a)(3) and Rule 10b-5).

76. See *Aragon*, 672 F. Supp. 2d at 432 (“The elements required to establish violations of Sections 10(b) and 17(a) are ‘essentially the same.’”) (quoting *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999)), *aff’d in part, vacated in part*, 650 F.3d 156 (2d Cir. 2011); see also *Wright v. Schock*, 571 F. Supp. 642, 662 (N.D. Cal. 1983) (“The scienter requirement is the same in the two [S]ections [10(b) and 17(a)].”) (citing and misinterpreting *Aaron*), *aff’d on other grounds*, 742 F.2d 541 (9th Cir. 1984).

77. See, e.g., *Monarch Funding Corp.*, 192 F.3d at 308 (“Essentially the same elements [as those required to show a violation of section 10(b) and Rule 10b-5] are required under Section 17(a)(1)-(3) in connection with the offer or sale of a security[.]”); see also *In re John P. Flannery & James D. Hopkins*, No. 3-14081 at 16 n.86 (SEC Dec. 15, 2014) (stating that Section 17(a) “is in many respects broader than [S]ection 10(b), the Section 17(a) claims could survive even absent deceptive conduct by the defendant himself”) (citing *Klamberg v. Roth*, 473 F. Supp. 544, 556 (S.D.N.Y. Jun 22, 1979)), *rev’d on other grounds*, 810 F.3d 1 (1st Cir. 2015).

“scheme” liability, as subsection (a)(1) prohibits employing “any device, scheme, or artifice to defraud”<sup>78</sup> and subsection (a)(3) prohibits engaging in “any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”<sup>79</sup> On the other hand, subsection (a)(2) is applicable to scenarios involving misrepresentation and half-truth liability, thus making it unlawful to obtain money or property by means of any materially false statement or half-truth of a material fact.<sup>80</sup>

Despite the Supreme Court’s interpretation of Section 17(a)(3) that the statute encompasses negligent conduct,<sup>81</sup> it has been underutilized, and when rarely invoked, courts have often analyzed it concurrently with Rule 10b-5.<sup>82</sup> While the language of Section 17(a)(2) and (a)(3) resemble provisions in Rule 10b-5, the Supreme Court has concluded in *Aaron v. SEC* that although a scienter requirement applies to Section 10(b) and Section 17(a)(1), there is no such requirement of scienter with respect to Section 17(a)(2) and (3).<sup>83</sup> In *Aaron*, the Supreme Court held that, in order to prove a violation of Section 17(a)(3) of the Securities Act, the SEC need only prove that the defendant

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78. 15 U.S.C. § 77q(a)(1); see *Aaron*, 446 U.S. 680 (applying § 17(a)(1) to petitioner’s scheme to defraud potential investors); *Naftalin*, 441 U.S. 768 (applying § 17(a)(1) to respondent’s scheme to defraud brokers).

79. 15 U.S.C. § 77q(a)(3).

80. See, e.g., *SEC v. Kelly*, 817 F. Supp. 2d 340, 343-45 (S.D.N.Y. Sept. 22, 2011) (“To succeed on a misstatement claim under . . . Section 17(a)(2), the SEC must prove that the defendant *made* materially false statements or omissions.”) (emphasis in original) (citations omitted); see also *SEC v. Bank of America Corp.*, 2014 WL 2777434 (W.D.N.C. Mar. 31 2014) (applying 17(a)(2) to defendant banks who knowingly failed to disclose to investors the risks associated with mortgage backed securities), *aff’d*, *SEC v. Bank of America Corp.*, 2014 WL 2778498 (W.D.N.C. 2014).

81. *Aaron*, 446 U.S. at 696-97.

82. See generally *Monarch Funding Corp.*, 192 F.3d at 308; *Maio*, 51 F.3d 623; *Aragon*, 672 F. Supp. 2d at 432; *Wright*, 571 F. Supp. At 662 (“The scienter requirement is the same in the two [S]ections [10(b) and 17(a)].”).

83. 446 U.S. at 695-97; see also *SEC v. GLT Dain Rascher, Inc.*, 254 F.3d 852, 856 (9th Cir. 2001); *SEC v. Hughes Capital Corp.*, 124 F.3d 449, 454 (3d Cir. 1997); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996), *cert. denied*, 522 U.S. 812 (1997); *Svoboda*, 409 F. Supp. 2d at 342 (“[T]he facts underlying their Section 10(b) convictions [of two insider trading defendants] establish civil liability under Section 17(a). . . . The Second Circuit has explained that ‘essentially the same elements’ are required to prove fraud under Section 17(a) as are required under Section 10(b), ‘though no showing of scienter is required for the SEC to obtain an injunction under subsections (a)(2) or (a)(3) [of Section 17].’”) (citing *Monarch Funding Corp.*, 192 F.3d at 308); *SEC v. Soroosh*, 1997 WL 487434 (N.D. Cal. Aug. 5, 1997) (insider trading case), *aff’d*, 166 F.3d 343 (9th Cir. 1998) (unpublished decision); John H. Sturc & Catherine W. Cummer, *Possession v. Use for Insider Trading Liability*, 12 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR 6, Jun. 1998, at 3 (“Thus, in theory, liability could be imposed under Section 17(a) for a kind of ‘negligent’ trading while in possession of inside information.”).

acted with negligence.<sup>84</sup> According to the Court, Section 17(a)(3) “quite plainly focuses upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.”<sup>85</sup> As a result, the combined use of each of these individual provisions provides the SEC with the ability to enforce violations of securities laws and pursue causes of action based on different standards of mental culpability — either the higher standard of scienter or the lower standard of negligence, depending on the facts and circumstances presented.<sup>86</sup> However, the use of Section 17(a)’s provisions has been primarily focused on enforcement of schemes involving fraud or market manipulation — not insider trading.<sup>87</sup> One may wonder why has the SEC neglected to use this powerful weapon in its “war” on insider trading.<sup>88</sup>

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84. *Aaron*, 446 U.S. at 697.

85. *Id.* Further, the Supreme Court held that Section 17(a)(3) “does not require a ‘showing [of] deliberate dishonesty as a condition precedent to protecting investors.’” *Id.* (quoting *Capital Gains Research Bureau*, 375 U.S. at 200).

86. See *supra* notes 7-26 and accompanying text; see also *Corey v. Bache & Co.*, 355 F.Supp. 1123 (S.D. W.Va. Mar. 12, 1973) (decided prior to the Supreme Court’s decision in *Aaron*, explaining that Section 17(a) and Rule 10b-5 may be applied “to negligent as well as intentional representations”).

87. See *SEC v. Geotek*, 426 F.Supp. 715 (1976), *aff’d* 590 F.2d 785 (applying negligence standard, i.e., ordinary care or due diligence, in resolving claims asserted by Commission in statutory enforcement proceedings, specifically, claims that defendants made material misstatements and/or omissions in prospectuses, limited partnership agreements and management agreements as well as in offering circulars and program agreements for joint ventures and in certain program receipts and disbursement financial statements and that certified public accountant made material misrepresentations and/or omissions in its audit certifications of the financial statements). *In re John P. Flannery & James D. Hopkins* was a case where the SEC found the respondent, John P. Flannery liable under Section 17(a)(3) as a result of the defendants’ lack of adequate disclosure in two letters to investors for which the defendant was “negligent with respect to his contributions to and approval of . . .” No. 3-14081 (SEC Dec. 15, 2014) at 45, *rev’d on other grounds*, 810 F.3d 1 (1<sup>st</sup> Cir. 2015). Although Flannery was not shown to have acted with scienter, he was found liable for negligently misleading investors based on the fact that the Commission found that “the danger of misleading investors was *not* so obvious that Flannery ‘must have been’ aware of it.” *Id.* at 45 (emphasis added) (citing *SEC v. Platforms Wireless Intern. Corp.*, 617 F.3d 1072, 1093-94 (9<sup>th</sup> Cir. 2010)). In its decision, the Commission found that, contrary to Section 10(b), Section 17(a) does not contain language that requires the proscribed conduct to be “manipulative or deceptive.” *Id.* In other words, there is “no textual basis” for concluding that Section 17(a) requires that the defendant’s violative conduct itself be “manipulative or deceptive” as is required under Rule 10b-5. Furthermore, the Commission stated that, based on the Supreme Court’s holding in *Ernst & Ernst*, the words “manipulative or deceptive” in conjunction with “device or contrivance” strongly suggest that Section 10(b)’s sole purpose is “to proscribe knowing or intentional’ — rather than negligent — misconduct.” *Id.* at 22-23 (citing *Ernst & Ernst*, 425 U.S. at 197). Subsequently, the First Circuit overturned the ruling and held that the agency’s decision was “not supported by substantial evidence.” *Flannery v. SEC*, 810 F.3d 1, 4 (1<sup>st</sup> Cir. 2015).

88. See *supra* note 26.

### B. *Differences Between Section 10(b) and Section 17(a)*

Although Section 17(a) and the more familiar Section 10(b) share many similarities in language and structure, the two provisions are different in important ways.<sup>89</sup> Section 10(b) of the Exchange Act and Rule 10b-5 cover proscribed misconduct “in connection with the purchase or sale of any security.”<sup>90</sup> In contrast, liability under Section 17(a) is limited to acts “in the offer or sale of any securities.”<sup>91</sup> The result of this contrasting language is that Section 10(b) is interpreted to apply to purchases and sales while Section 17(a) is interpreted to apply to sales or offers to sell only.<sup>92</sup>

The wording of Section 17(a) is further different than the wording of Section 10(b).<sup>93</sup> Contrary to Section 10(b), Section 17(a) does not contain language that requires the proscribed conduct to be “manipulative or deceptive.” In other words, as stated by the SEC, there is “no textual basis for concluding that Rule 10b-5’s requirement that the defendant’s violative

89. Note that the parameters of Rule 10b-5 are confined by the statute upon which it is based – namely, Section 10(b); see *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-73 (1977) (“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.’”) (quoting *Ernst & Ernst*, 425 U.S. at 213-14); see generally Ralph C. Ferrara and Marc I. Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. Pa. L. Rev. 263 (1980). While essentially the same elements are required to prove fraud under both Section 17(a) and Section 10(b), there is no requirement to prove scienter under Section 17(a)(2) or (a)(3). See *Aaron*, 446 U.S. at 696-97.

90. 15 U.S.C. § 78j.

91. 15 U.S.C. § 77q(a).

92. See, e.g., *SEC v. Namer*, 2004 WL 2199471, at \*9-\*10 (S.D.N.Y. Sept. 30, 2004); *SEC v. Roor*, 2004 WL 1933578, at \*13-\*15 (S.D.N.Y. Aug. 30, 2004); *SEC v. McCaskey*, 2001 WL 1029053, at \*4-\*5 (S.D.N.Y. Sept. 6, 2001). In his treatise *Fundamentals of Securities Regulation* (1988), Professor Louis Loss, the premier securities scholar of his era, commented that Section 17(a):

refers to fraud or misrepresentation “in the offer or sale of any securities.” It is perhaps arguable that this does not limit the application of the Section to cases of fraud by *sellers* as distinct from fraud by *buyers* of securities—that it was intended merely to make it clear that § 17(a), in contrast to the mail fraud statute, is restricted to the securities field. However, the Commission has never sought to apply § 17(a) except against fraudulent *sellers*.

*Id.* at 839 (emphasis in original). Although this argument may be viable with respect to Section 17(a)(1) and 17(a)(2), it is not regarding Section 17(a)(3) due to that provision’s clear language that the fraud or deceit must be “upon the purchaser.” 15 U.S.C. § 77q(a)(3).

93. See *In re Cady*, 40 SEC. at 911 n.11:

The language of Rule 10b-5 is broader in several respects than that of Section 17(a) of the Securities Act. Thus, while Section 17(a) prohibits fraudulent or deceptive practices “in the offer or sale” of any security, Rule 10b-5 prohibits such activities “in connection with the purchase or sale” of any security.

conduct itself be ‘manipulative or deceptive’ also applies to Section 17(a).”<sup>94</sup> Based on the wording of Section 17(a), the Supreme Court has held that, while scienter is the required *mens rea* for a violation under Section 17(a)(1), it is not the case for violations of Section 17(a)(2) and (a)(3).<sup>95</sup> Rather, a showing of negligence is sufficient to establish a violation under these provisions.<sup>96</sup>

### C. Proposed Amendment

The SEC thus is empowered to institute a claim of insider trading against a defendant under Section 17(a)(2) and 17(a)(3) without the requirement of proving that the defendant acted knowingly or intentionally – in other words, that the defendant acted negligently.<sup>97</sup> However, Section 17(a)(2) is not an effective weapon against insider trading due to its narrow application to “untrue statement” liability.<sup>98</sup> That statute is inapplicable to the insider trading scenario since a typical insider trade is not premised on an affirmative “untrue statement.” Rather, it is assessed on “scheme” liability or the trader’s omission of a statement. Insider trading involves nondisclosure rather than the making of affirmative statements.<sup>99</sup>

The scope of Section 17(a)(3) covers fraudulent sales but does not cover fraudulent purchases. Thus, Section 17(a)(3) reaches defendants who constructively defraud purchasers, but Section 17(a)(3)’s scope does not cover defendants that defraud sellers.<sup>100</sup> Section 17(a)(3)’s scope also

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94. *In re Flannery*, No. 3-14081 (Dec. 15, 2014), *rev'd on other grounds*, 810 F.3d 1 (1<sup>st</sup> Cir. 2015). However, this is not accurate for Section 17(a)(1). Also, this is not to suggest that Section 17(a) reaches breaches of fiduciary duty where there is no disclosure deficiency. *See generally Santa Fe Indus.*, 430 U.S. 462; *Rocklage*, 470 F.3d 1.

95. *Aaron*, 446 U.S. at 697.

96. *Id.*

97. Note that Section 17(a)(2) normally is inapplicable to insider trading as the defendant trader or tippee does not make a statement. Hence, because Section 17(a)(2) focuses on material misrepresentations and half-truths, that provision does not extend to deceptive conduct based on silence. *See generally In re Flannery*, Release No. 3981, 2014 WL 7145625, *rev'd on other grounds*, 810 F.3d 1 (1<sup>st</sup> Cir. 2015). *See supra* note 87.

98. *See generally* STEINBERG & WANG, *supra* note 3.

99. *Contra Dirks*, 47 SEC 434, 448 n. 51 (1981) (“And all of our findings against Dirks [a tippee/tipper] are made under both those Sections [17(a)(2) and 17(a)(3)].”), *rev'd on other grounds*, 463 U.S. 646 (1983). *But cf.* SEC v. Davis, 689 F. Supp. 767, 773-74 (S.D. Ohio Mar. 29, 1988) (refusing to dismiss a complaint against insider trading defendant based in part on Sections 17(a)(2) and 17(a)(3)—defendant did not argue specifically that Section 17(a)(2) did not apply).

100. *See Aaron*, 446 U.S. 680 (reading the language of § 17(a) to indicate that scienter is not required under § 17(a)(2) and (3)). It should also be noted that Section 17(a) is modeled on the federal mail fraud statute, 18 U.S.C. § 1341 (enacted 1872). Robert A. Prentice, *Scheme Liability: Does it Have a Future After Stoneridge?*, 2009 WISC. L. REV. 351, 365 n.

extends to tipping that constructively defrauds purchasers. Accordingly, a tip that generates a defendant's sale (resulting from bearish inside information known as the "bad news" scenario), could violate the statute while a tip that induces a defendant's purchase (resulting from bullish inside information known as the "good news" scenario), would not violate the statute.

With a minimal legislative amendment to modify Section 17(a)'s language to more closely resemble the language of Rule 10b-5, Section 17(a)(3) would allow the SEC to cast a wider net to enforce insider trading violations against a broader range of misconduct. Firstly, the word "offer" should be replaced in the text preceding all three clauses of Section 17(a) with "purchase" (as in Section 10(b)). By doing so, Section 17(a) will be applicable to scenarios in which misconduct is engaged in by means of either a purchase or a sale, thereby broadening the statute's current scope of liability (which is limited only to misconduct perpetrated by means of an "offer or sale"). Secondly, adding the phrase "or the offer thereof" following the revised language of "purchase or sale of any securities," Section 17(a)(3) will be applicable to scenarios in which misconduct occurred irrespective of whether the contemplated transaction is completed. Thirdly, the language of Section 17(a)(3) should be amended by replacing the words "fraud . . . upon the purchaser" with "fraud . . . upon any person" (as in Rule 10b-5(c)). Pursuant to the proposed amendment, Section 17(a)(3) would then be applicable to scenarios in which any person, regardless of whether he or she was a purchaser or seller, was a victim of negligent deficient disclosure committed by means of either a purchase or sale, further broadening Section 17(a)(3)'s scope. Thus, the suggested amended version of Section 17(a) reads:

It shall be unlawful for any person in the purchase or sale of any securities, or the offer thereof, by the use of any means or

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77. See also *In re Cady supra* note 93, at 837-39. Applying language in that statute similar to Section 17(a), the Second Circuit has held that the statute does not require that "the defendant must receive the same money or property that the deceived party lost, but only that the party deceived must lose money or property." *United States v. Evans*, 844 F.2d 36, 39-40 (2d Cir. 1988); See also *Kelling v. United States*, 193 F.2d 299 (10th Cir. 1951) (concluding that in prosecution on counts charging violations of Section 17(a), which prohibits employment of any device, scheme or artifice to defraud in sale of securities by use of means of transportation or communication in interstate commerce or by use of mails directly or *indirectly*, and § 1341 of Title 18, which prohibits use of mails to execute scheme or artifice to defraud or obtain money by fraudulent representations, evidence sustained findings that defendants knowingly made false representations for purpose of effectuating a scheme to defraud, that representations were relied on causing loss and that defendant used means and instruments of transportation in commerce and the mails in perpetrating certain frauds).

instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any person. s courts have declined to imply a private remedy for violations of Section 17(a).<sup>101</sup>

With these changes to the statute, the amended Section 17(a)(3) would broaden the statute's scope of liability as a government right of action. The impact of the proposed statute would not implicate private rights of action, as courts have declined to imply a private remedy for violations of Section 17(a).<sup>102</sup> Consequently, the concern that expanding the scope of an antifraud statute would facilitate the onset of private claims does not arise under the proposed amendment.<sup>103</sup>

In addition to being similar to the language of Rule 10b-5(c), the resulting language of the proposed amendment would also resemble Section 206 of the Investment Advisers Act of 1940, which provides in pertinent part:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly -

- (1) to employ any device, scheme, or artifice to defraud any client

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101. 15 U.S.C. § 77q.

102. No private right of action exists for a violation of Section 17(a)(3). While several older cases imply such a private right of action, (*See, e.g.*, *Newman v. Prior*, 518 F.2d 97, 99 (4<sup>th</sup> Cir. 1975)), subsequent court decisions have consistently declined to follow suit. *See, e.g.*, *Finkel v. Stratton Corp.*, 962 F.2d 169 (2d Cir. 1992); *Bath v. Bushkin, Gaims, Gaines & Jones*, 913 F.2d 817 (10<sup>th</sup> Cir. 1990); *Sears v. Likens*, 912 F.2d 889 (7<sup>th</sup> Cir. 1990); *Newcome v. Esrey*, 862 F. 2d 1099 (4<sup>th</sup> Cir. 1988); *Currie v. Cayman Res. Corp.*, 835 F.2d 780 (11<sup>th</sup> Cir. 1988); *Krause v. Prettyman*, 827 F.2d 346 (8<sup>th</sup> Cir. 1987); *In re Washington Pub. Power Supply Sec. Litig.*, 823 F.2d 1349 (9<sup>th</sup> Cir. 1987) (*en banc*).

103. *See Landry v. All Am. Assurance Co.*, 688 F.2d 381, 391 (5<sup>th</sup> Cir. 1982) (“[I]t would appear that the *Cort* test as applied to § 17(a) of the Securities Act of 1933 points away from the implication of a private cause of action. This, together with the Supreme Court's conservative interpretation of the test in recent years, leads us to the conclusion that the district court correctly dismissed this theory of relief [thereby denying the existence of a § 17(a) private right of action]”). *See also Cort v. Ash*, 422 US 66 (1975) (establishing a four-prong test for determining whether a private right of action can be inferred under a particular statute); Marc I. Steinberg, *Implied Private Rights of Action Under Federal Law*, 55 NOTRE DAME L. REV. 33 (1979) (discussing alterations made to the *Cort* test by subsequent Supreme Court case law).

or prospective client; [or]

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . .<sup>104</sup>

Although this statute is applicable only to investment advisers, its language is substantially similar to Section 17(a). Furthermore, court interpretations of Section 206(2) hold that a violation of this statute “may rest on a finding of simple negligence.”<sup>105</sup> In this manner, Section 206 is broader than Section 10(b). For instance, unlike Section 10(b), which is limited to situations involving deception or manipulation in connection with the purchase or sale of a security, Section 206 may extend to negligent conduct that is deemed to constitute constructive fraud.<sup>106</sup>

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104. 15 U.S.C. § 80b-6.

105. SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *Capital Gains Research Bureau*, 375 U.S. at 191). *Capital Gains Research Bureau* is a significant case in regard to the interpretation of the Investment Advisers Act. 375 U.S. 180. According to the House Report on the Investment Advisers Act, one of the goals of the Advisers Act was “to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful.” H.R. Rep. No. 2639, at 28 (1940). In order to achieve this goal, Congress enacted a handful of broad antifraud provisions intended to eliminate conflicts of interest through full disclosure. See SEC, FINANCIAL PLANNERS: REPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION TO THE HOUSE COMMITTEE ON ENERGY AND COMMERCE’S SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE, at A-7 (1988). However, the Advisers Act did not originally define the fiduciary duty nor the standard of care that investment advisers owed to their clients. This changed in 1963 when the Supreme Court interpreted the Advisers Act as, in fact, establishing federal fiduciary standards for investment advisers. *Capital Gains Research Bureau*, 375 U.S. 180. Drawing on the Act’s “broad proscription against any practice which operates as a fraud or deceit upon” the client, as well as Congress’s intent to “preserve the personalized character of the services of investment advisers and to eliminate conflicts of interest between the investment adviser and the clients,” the Court concluded that the Advisers Act “reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship. . . .” *Id.* at 191–92 (internal quotations and alterations omitted); see also *Transamerica Mortg. Adv., Inc. v. Lewis*, 444 U.S. 11, 17 (1979) (“As we have previously recognized, § 206 [of the Investment Advisers Act of 1940] establishes ‘federal fiduciary standards’ to govern the conduct of investment advisers. . . .”) (internal citations omitted); see also 17 C.F.R. § 204(4)-8 (2007); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers, 72 Fed. Reg. 44,756 (Aug. 9, 2007) (stating that § 204(4)-8 “prohibits advisers to pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those pooled vehicles”). Under this rule, the SEC has indicated that it will apply a negligence standard. *Id.* at 44,759.

106. As a general matter, the SEC may bring an enforcement action under Section 206 even if there is no actual injury to a client or investor. See, e.g., SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985) (“Violations of the antifraud provisions of Sections 206 of the Investment Advisers Act also do not depend on actual injury to any client.”).

Based on Section 17(a)(3)'s current statutory language, buttressed by the comparable language of Section 206(2), Section 17(a)(3) now provides the SEC with authority in certain circumstances to pursue negligent inside traders<sup>107</sup> — namely, when a person negligently sells securities to a purchaser while the seller is in possession of adverse material nonpublic information (as contrasted with intentional insider trading, in which a person trades while aware of material, nonpublic information regarding the security).<sup>108</sup> The wherewithal to bring insider trading charges based on negligence represents a significantly lighter burden than the scienter requirement of Section 10(b) and Rule 10b-5.<sup>109</sup> Therefore, Section 17(a)(3)'s lower mental culpability level, accompanied with the suggested amendment, would provide the SEC with an important enforcement tool whenever the applicable facts are insufficient to prove scienter.

#### D. *The Proposed Amendment Will Not Lead to Vexatious Litigation*

Critics of the proposed amendment to Section 17(a)(3) may contend that the proposed amendment, by encompassing negligent insider trading, would open the floodgates for plaintiff-investors to bring nuisance claims. As discussed above, this argument is untenable; contrary to Section 10(b), no private right of action exists for a violation of Section 17(a)(3). Although a number of older cases implied such a private right of action,<sup>110</sup> subsequent appellate court decisions have consistently declined to imply a private remedy.<sup>111</sup> Applying the Supreme Court's strict statutory construction to implied rights of action,<sup>112</sup> lower courts — for well over three decades —

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107. See *Svoboda*, 409 F. Supp. 2d at 342.

108. See *supra* notes 8-25 and accompanying text; see also 17 C.F.R. § 240.10b5-1 (2000), which provides:

(a) *General*. The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and 17 C.F.R. § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

109. See *Aaron*, 446 U.S. at 701 (requiring a showing of “scienter,” or intent, in Section 10(b) and Rule 10b-5 enforcement actions).

110. See, e.g., *Newman*, 518 F.2d at 99 (4th Cir. 1975); *Valles Salgado v. Piedmont Capital Corp.*, 452 F. Supp. 853, 857 (D.P.R. 1978); *Osborne v. Mallory*, 86 F. Supp. 869, 879 (S.D.N.Y. 1949).

111. See, e.g., *supra* note 101.

112. See *Transamerica*, 444 U.S. 11 (construing two sections of the Investment Advisers Act of 1940 strictly in finding a limited private remedy); see also *Cort*, 422 U.S. 66 (holding that no private cause of action is implied from a criminal statute prohibiting certain expenditures in corporate elections).

have held that Congress did not intend to create a private right of action under Section 17(a).<sup>113</sup>

### III. NEGLIGENCE INSIDER TRADING UNDER SECTION 17(A)(3)

As set forth above, negligence is sufficient to constitute a violation of Section 17(a)(3).<sup>114</sup> The language of Section 17(a)(3) prohibits engaging in “any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.”<sup>115</sup> Therefore, pursuant to Section 17(a)(3)’s current language, the SEC must prove that a negligent offer or sale occurred when the defendant was in possession of material and nonpublic information, thereby acting as a fraud “upon the purchaser.”<sup>116</sup> Such misconduct ordinarily occurs where the alleged violator sells securities in order to avoid a loss (i.e., the “bad news” situation).

Liability for negligent insider trading is premised upon a combination of three legal concepts: (1) common law negligence;<sup>117</sup> (2) constructive negligent fraud<sup>118</sup> (as interpreted by case law in which the SEC has invoked

113. See, e.g., *Landry*, 688 F.2d at 391.

114. See *Aaron*, 446 U.S. 680 (holding the SEC does not need to establish scienter under Section 17(a)(3)).

115. 15 U.S.C. § 77q(a)(3).

116. See Russell G. Ryan, *Recent SEC Insider Trading Settlements Reflect Promising Signs of Flexibility*, 20 INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR 4, Apr. 2006, at 2 (“In cases when the unlawful [insider] trade was a sale of securities, the SEC typically adds a charge under Section 17(a) of the Securities Act of 1933 . . .”).

117. Black’s Law Dictionary defines “Negligence” as:

The failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregarding of others’ rights; the doing of what a reasonable and prudent person would not do under the particular circumstances, or the failure to do what such a person would do under the circumstances.

*Negligence*, BLACK’S LAW DICTIONARY (10th ed. 2014).

118. Black’s Law Dictionary defines “Fraud” as:

2. A reckless misrepresentation made without justified belief in its truth to induce another person to act.
3. A tort arising from a knowing or reckless misrepresentation or *concealment of material fact* made to induce another to act to his or her detriment . . .
4. Unconscionable dealing . . . the unfair use of the power arising out of the parties’ relative positions and resulting in an unconscionable bargain.

*Fraud*, BLACK’S LAW DICTIONARY (10th ed. 2014) (emphasis added)). Further, the subentry of *constructive fraud* is defined as “1. Unintentional deception or misrepresentation that causes injury to another.” *Id.*

Section 17(a)(3)<sup>119</sup>); and (3) case law that has established the elements of unlawful insider trading.<sup>120</sup> Although Section 17(a)(3) is limited to the “offer or sale of any securities,” the statute is clear in its prohibition of “any transaction” that “operates or would operate as a fraud or deceit.”<sup>121</sup> Since an improper insider trade is a “transaction” that “operates or would operate as a fraud or deceit,” insider trading falls within the category of transactions that Section 17(a)(3) prohibits (albeit limited only to sales). Accordingly, as held by the Supreme Court, an actionable disclosure deficiency under Section 17(a)(3) is subject to a *mens rea* of negligence<sup>122</sup> and focuses “upon the effect of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.”<sup>123</sup> Thus, in addition to

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119. See *Bank of America Corp.*, 2014 WL 2777434. The SEC filed a complaint against several subsidiaries of Bank of America based on allegations of material misrepresentations and omissions made by the defendants in a prospectus and prospectus supplement issued for residential mortgage backed securities offered and underwritten by the defendants. *Id.* at \*4. In 2008, the defendants offered and underwrote certificates that provided investors a right of payment from a pool of residential mortgages. *Id.* at \*2. The final loan pool included 1,191 adjustable rate mortgages, each of which generally consisted of a principal of more than \$417,000. *Id.* at \*3, n. 1. Prior to filing the prospectus and prospectus supplement in January of 2008, the defendants provided preliminary information to investing banks claiming that approximately seventy percent of the final loan pool of the securities had been originated from the “‘wholesale channel,’ or third party mortgage brokers.” *Id.* at \*1. However, when the defendants later filed the prospectus and prospectus supplement, the defendants contradicted their description of the mortgage characteristics by stating that only “some” of the mortgages contained in the final loan pool had been originated in the wholesale channel as opposed to the original description of “approximately seventy percent” having been originated. *Id.* In fact, seventy-two percent of the mortgages originated in the wholesale channel, representing a high degree of risk to investors. *Id.* at \*3. As a result, the SEC alleged that, by failing to disclose the true nature of the loans that comprised the loan pool, and by failing to disclose the potential risks associated with this type of security, the defendants had acted negligently. *Id.* at \*4. The defendants filed a motion to dismiss the charges alleged by the SEC based on the argument that the Complaint failed to plead sufficient facts to establish negligence (as the sufficient *mens rea* under Section 17(a)(3)). *Id.* at \*8. In denying the defendants’ motion, the court addressed the sufficiency of the SEC’s allegations to satisfy the negligence requirement of Section 17(a)(3). *Id.* Specifically, the court held that the SEC adequately alleged sufficient facts under Section 17(a)(3) that defendants had negligently misrepresented and failed to disclose information that the defendants “knew or reasonably should have known . . . was material.” *Id.* at \*11.

120. See *supra* notes 34-67 and accompanying text.

121. 15 U.S.C. § 77q(a)(3).

122. See, e.g., *Naftalin*, 441 U.S. 768 (finding no ambiguity in the wording of Section 17(a) and reversing the appellate court’s decision).

123. *Aaron*, 446 U.S. at 697 (emphasis omitted). Further, “[t]his reading follows directly from *Capital Gains*, which attributed to a similarly worded provision in § 206(2) of the Investment Advisers Act of 1940 a meaning that does not require a ‘showing [of] deliberate dishonesty as a condition precedent to protecting investors.’” *Id.* (quoting *Capital Gains Research Bureau*, 375 U.S. at 200). The Supreme Court has also stated that “Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed ‘not

prosecuting insider trading claims under Rule 10b-5 — where scienter must be proven — the current version of Section 17(a)(3) empowers the SEC to pursue a negligent insider trading cause of action against defendants who engage in proscribed conduct in the “offer or sale” of securities (such as an insider who sells stock in order to avoid a loss — the “bad news” scenario).<sup>124</sup>

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technically and restrictively, but flexibly to effectuate its remedial purpose.” *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *Capital Gains Research Bureau*, 375 U.S. at 195).

124. One insider trading case in which the insider was the seller and the SEC failed to successfully prosecute under Rule 10b-5, but may have successfully prosecuted under the current version of Section 17(a)(3) under a theory of negligence, is *SEC v. Moshayedi*, (Civil Action No. 12-cv-01179 (C.D. Cal Jun. 6, 2014)). In *Moshayedi*, the SEC brought an insider trading suit against Manouchehr Moshayedi, the co-founder and CEO of STEC Inc., a company that manufactures and sells computer storage devices. The alleged insider trades that Moshayedi transacted were in advance of a STEC secondary offering in which, according to the SEC, Moshayedi sold a substantial portion of his company’s stock while in possession of material and nonpublic information regarding one of STEC’s largest customers.

According to the SEC’s complaint: during an eight-month period beginning in January 2009, STEC stock increased in price over 800 percent due to increased profits and sales margins. During this period, STEC also announced an agreement with its largest customer, EMC Corp., to supply STEC’s top-selling product – flash drives. Moshayedi and his brother Mark allegedly planned to take advantage of the stock’s price increase by selling a large block of their shares in a secondary offering that was scheduled to coincide with the release of STEC’s second-quarter results. Complaint, *SEC v. Moshayedi*, Civil Action No. 12-CV-01179, at 2-3.

Shortly before the secondary offering, EMC informed Moshayedi that it would not enter into another similar agreement with STEC for the third quarter of 2009. Moshayedi also received an internal report indicating that EMC’s actual demand for the flash drives in the last two quarters of the year would not be sufficient to ensure that STEC would meet guidance or the consensus analyst estimates. The SEC alleged that, after learning these facts, Moshayedi engaged in a “fraudulent scheme to conceal” EMC’s actual demand so that the planned secondary offering could proceed. The “scheme to conceal” consisted of a secret deal with EMC in which EMC committed to purchase a larger quantity of flash drives from STEC (allegedly more than was required or necessary) in the third quarter of 2009 at a substantial discount. After this deal was in place, Moshayedi announced guidance for the third quarter that met the consensus estimate. That guidance included proceeds from the secret deal that were more than twice as much as EMC’s forecasted demand for the quarter. The SEC alleged that these guidance numbers were only possible because of the secret deal between STEC and EMC. *Id.* at 3-4.

The secondary offering proceeded as scheduled. Moshayedi and his brothers each sold 4.5 million shares of STEC stock. Three months later, in connection with the release of its third quarter earnings results, STEC disclosed that EMC had not disposed of a substantial amount of inventory purchased from STEC, and would therefore, possibly continue to carry unsold inventory of STEC product into 2010. Subsequently, the price of STEC stock dropped 38.9 percent from nearly \$23 per share to just above \$14. *Id.* at 4.

Moshayedi disputed the Commission’s claims and stated that there was nothing inappropriate about the alleged “secret deal.” Moshayedi claimed that the deal was not entered into for the purpose of fabricating guidance numbers. Rather, he asserted that the deal provided STEC with knowledge regarding EMC’s purchasing ability. During closing

Pursuant to Section 17(a)(3), the SEC may pursue negligent insider trading causes of action, but only against a person — in breach of a duty owed — that negligently sells (or offers to sell) securities, or tips a third party when such person possesses material and nonpublic information.<sup>125</sup> As such, the elements of a negligent insider trading cause of action, enforceable under the current version of Section 17(a)(3), are: (1) selling (or offering to sell) a security (2) in breach of a fiduciary duty or other relationship of trust and confidence (3) that occurs as a result of (4) a negligent (5) failure to adequately disclose (6) material and nonpublic information (7) that (either directly or indirectly) results in a “fraud or deceit upon the purchaser.”<sup>126</sup>

A. “Possession” v. “Awareness” in the Context of Negligent Insider

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arguments, Moshayedi’s lawyer argued that Moshayedi did not enter into the “side agreement” to profit from the secondary offering, but instead to “avoid the chaos of [the customer] ordering late in the quarter.” Edvard Pettersson & Maurice Possley, *SEC Loses Latest Insider-Trading Trial to Former STEC CEO*, BLOOMBERG (Jun. 7, 2014, 12:01 AM), <http://bloomberg.com/news/2014-06-06/sec-loses-latest-insider-trading-trial-to-former-stec-ceo.html> [<https://perma.cc/8E2S-S8DS>].

Ultimately, a jury rejected the SEC’s claims and found Moshayedi not liable for insider trading. The jury’s decision rested on a contradiction between EMC’s notice to STEC that it would not enter into another contract and the fact that, at the time, Moshayedi was engaged in negotiations with EMC, which went on for a considerable period, over a separate and unrelated contract. While EMC’s notice to STEC regarding the purchase of flash drives does state it would not enter into another agreement, the jury concluded that the notice was simply a negotiating tactic used in the context of ongoing negotiations.

Although the SEC failed to successfully prosecute Moshayedi under a theory of scienter, an argument can be made that Moshayedi *negligently* traded based on material and nonpublic information. The argument is as follows: Moshayedi, as CEO of STEC, Inc., owed a duty to STEC, Inc. to avoid self-dealing. Although a jury held that Moshayedi did not intentionally breach the duty to STEC to avoid self-dealing, Moshayedi’s sale of STEC stock in the secondary offering may be viewed as self-dealing because he allegedly took advantage of, and profited from, a fabricated increase in the price of STEC stock, regardless of whether or not it was intentional. Further, the purchasers of Moshayedi’s stock were prejudiced based on Moshayedi’s failure to disclose the material and nonpublic information that he possessed. This failure to disclose resulted in the purchasers losing money once the price of the stock declined. Thus, without the disclosure of material and nonpublic information in the impersonal trading markets, constructive fraud was committed “upon the purchaser.” Therefore, Moshayedi’s alleged actions remain susceptible to enforcement under both the current and the yet-to-be-amended version of Section 17(a)(3). Regardless of the fact that he did not intentionally trade the STEC stock based on material and nonpublic information, the allegations suggest that, under the authority of the current version of Section 17(a)(3), Moshayedi’s actions “in the offer or sale of . . . securities . . . indirectly . . . operate[d] as a fraud or deceit upon the purchaser.” 15 U.S.C. § 77q(a)(3). This liability is unchanged under the authority of the yet-to-be-amended version of Section 17(a)(3), which would still invoke liability since Moshayedi’s alleged actions “in the purchase or sale of . . . securities . . . indirectly . . . operate[d] as a fraud or deceit upon any person.”

125. 15 U.S.C. § 77q(a)(3).

126. *Id.*

### *Trading*

Contrasted with Section 10(b), which has an “awareness” requirement,<sup>127</sup> “possession” of material and nonpublic information is the proper standard for a cause of action for negligent insider trading under Section 17(a)(3).<sup>128</sup> With respect to Section 10(b), in order to be held liable for insider trading, a defendant must do more than merely “possess” material and nonpublic information.<sup>129</sup> Rather, pursuant to Rule 10b5-1, the scienter requirement of Section 10(b) is deemed to be fulfilled with proof that the defendant purchased or sold securities while “aware” of material nonpublic information at the time of the purchase or sale.<sup>130</sup> Thus, Rule 10b5-1 posits that one who is aware of material and nonpublic information at the time of the purchase or sale will inevitably make use of such information.<sup>131</sup>

It follows that a cause of action for negligent insider trading cannot logically support the requisite level of culpability for intentional insider trading under Section 10(b), because, by definition, the “awareness” standard maintains the implication of willful intent. Thus, in order to pursue a cause of action for negligent insider trading, the “awareness” element of intentional insider trading must be abandoned in order to conform to a lesser culpability standard upon which negligent causes of action are based. This is satisfied with the “possession” standard – namely, when a defendant improperly trades or tips while possessing information that the defendant knows, or should know, is material and nonpublic.

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127. 17 C.F.R. § 240.10b5-1; *see also* discussion *supra* note 10 and accompanying text.

128. Sturc & Cummer, *supra* note 83.

129. *See* US v. Smith, 155 F.3d 1051, 1067 (9th Cir. 1998) (adopting the “use” rather than “possession” standard); *see also* Adler, 137 F.3d at 1337 (holding that Section 10(b)’s scienter requirement mandates proof that, when the defendant traded the subject securities, they actually *used* the material and nonpublic information, rather than merely *possess* it). In the past, the SEC has opined that mere “possession,” rather than “use,” of the material nonpublic information is sufficient to trigger liability under Section 10(b). *See* Report of the Investigation in the Matter of Sterling Drug, Inc., Securities Exchange Act Release No. 14675 (Apr. 18, 1978) (asserting that “[i]f an insider sells his securities while in possession of material adverse non-public information, such an insider is taking advantage of his position to the detriment of the public”). The Second Circuit has also endorsed the “possession” standard by stating that “material information can not [sic] lay idle in the human brain.” *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993). *But see Gansman*, 657 F.3d at 92 (stating “In prosecuting a putative ‘tipper’ under the misappropriation theory of insider trading, the government must prove as an element of the offense that the tipper conveyed material nonpublic information to his ‘tippee’ with the understanding that it would be *used* for securities trading purposes.”) (emphasis added).

130. Final Rule: Selective Disclosure and Insider Trading, Securities Exchange Act Release No. 34-43154 (2000).

131. *Supra* note 122.

B. *The Misappropriation Theory and the Language of Section 17(a)(3)*

If construed in a remedial manner, application of the misappropriation theory in the Section 17(a)(3) context effectuates a broad reach of insider trading liability based on negligence. As discussed above, the misappropriation theory premises liability on deception of the source of the information, rather than on deception of shareholders — as with the classical “special relationship” theory.<sup>132</sup> By contrast, a more expansive application of the misappropriation theory within the context of Section 17(a)(3) may be invoked by focusing on the statute’s use of the word “indirectly.”

Section 17(a)(3) addresses the proscription against deficient disclosure in the “offer or sale” setting. When Section 17(a)(3) is viewed in its entirety, with the inclusion of the statute’s introductory paragraph, the word “indirectly” alters the scope of the provision by broadening the range of potential defendants that come within its reach — regardless of the proposed amendment.

It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly— . . . (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.<sup>133</sup>

The inclusion of the word “indirectly” encompasses any transaction, practice, or course of business committed by a person that indirectly operates or would operate as a fraud or deceit upon a purchaser.<sup>134</sup> In the context of

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132. See *supra* notes 47-59 and accompanying text.

133. 15 U.S.C. § 77q(a).

134. See *SEC v. Syron*, 934 F. Supp. 2d 609, 639-40 (S.D.N.Y. Mar. 28, 2013) (holding that the SEC failed to allege that defendants personally gained money or property from the employer’s stock offering, but acknowledging that liability may exist when the money is obtained “indirectly” or in a “highly roundabout manner”) (emphasis added); see also *SEC v. Mudd*, 885 F. Supp. 2d 654, 668-71 (S.D.N.Y. Aug. 10, 2012) (showing SEC sufficiently pleading that Federal National Mortgage Association’s (FNMA) Chief Executive Officer (CEO) and Chief Risk Officer (CRO) directly or indirectly obtained money or property by means of false statements regarding percentage of loans that fell into FNMA’s subprime and low-documentation loan descriptions because each received a bonus that was tied to both FNMA’s performance and their own personal performance in attaining individual year-end goals and that their false statements in the offer and sale of FNMA securities were sufficient to state a claim under the antifraud section of the Securities Act); *SEC v. Stoker*, 865 F. Supp. 2d 457, 463-64 (S.D.N.Y. Jun. 6, 2012) (demonstrating the SEC sufficiently pleading that broker-dealer’s director, acting as its agent, facilitated a fraud in violation of antifraud section of the Securities Act; the Act clearly provided that violation could occur if defendant obtained funds either “directly or indirectly” and SEC alleged that director had obtained millions of

insider trading, one theory by which a defendant can be held liable as a result of an “indirect” violation of insider trading laws is the misappropriation theory.<sup>135</sup>

Although the securities laws do not define the term “indirectly,” congressional history suggests that insider trading provisions — especially those regarding the misappropriation theory — are intended to have a flexible scope,<sup>136</sup> thus, lending credibility to the proposed amendment as well as the theory of negligent insider trading. An example of the intended scope of insider trading provisions comes from the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988.<sup>137</sup> This Act, among other things: (1) expanded the scope of civil penalties to control persons who fail to take adequate steps to prevent insider trading;<sup>138</sup> (2) granted the SEC authority to award payments to persons who provide information regarding insider trading violations; and, most notably for purposes of this article, (3) established a private right of action for buyers and sellers of securities against culpable inside traders if they traded “contemporaneously” with such inside traders.<sup>139</sup> Accordingly, under this rationale, misappropriation of material

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dollars for his employer while acting as its agent, or, alternatively, that director had personally obtained money indirectly from structuring and marketing fraudulent collateralized debt obligations (CDOs)).

135. See *supra* notes 47-59 and accompanying text.

136. See H.R. REP. No. 100-910, at 27-28 (1988) (“Despite the absence of explicit statutory language for private rights of action outside of the contemporaneous trader plaintiff situation, the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders. In the view of the Committee, Section 10(b), Rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded or harmed by a violation of any provision of this title or the rules or regulations thereunder by another person’s purchasing or selling a security while in the possession of material, nonpublic information, or communicating such information to others.”).

137. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified at 15 U.S.C. §78t-1, §78u-1).

138. 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. For further discussion, see STEINBERG & WANG, *supra* note 3, at § 6.3.

139. 15 U.S.C. §78t-1 (a). This legislation overturned the Second Circuit’s decision in *Moss v. Morgan Stanley* holding that contemporaneous traders did not have a private right of action under Section 10(b). 719 F.2d 5 (2d Cir. 1983). The court reasoned that the culpable misappropriator did not breach a duty owed to such traders. See H.R. REP. NO. 100-910, *supra* note 135, at 26-27. The term “contemporaneous” has caused a fair amount of controversy. See, e.g., *In re Fed. Nat’l Mortg. Ass’n Secs., Derivative, & “ERISA” Litig.*, 503 F. Supp. 2d 25, 47 (D.D.C. Jul. 31, 2007) (citing cases in which the respective court required the plaintiffs’ trades to occur within the same day as the insider trading transaction); *but see In re Cell Therapeutics, Inc. Class Action Litig.*, No. 2:10-cv-00414-MJP, 2011 WL 444676, at \*9 (W.D. Wash. Feb. 4, 2011) (stating that the Ninth Circuit has not defined “contemporaneous,” however “two business days is sufficiently close in time to satisfy the term.”).

nonpublic information in breach of a fiduciary duty owed to the source of the information indirectly operates as a deceit or fraud upon contemporaneous traders, including purchasers who sell their securities “contemporaneously” with an inside tipper or his tippee.<sup>140</sup> Hence, an inside trader or his tippee in the “bad news” misappropriation context<sup>141</sup> “victimizes” contemporaneous purchasers within the meaning of Section 17(a)(3).<sup>142</sup>

### C. *The Effect of the Proposed Amendment*

In *Aaron*, the Supreme Court held that, in order to prove a violation of Section 17(a)(3), the SEC is only required to prove that the defendant was negligent.<sup>143</sup> Invoking Section 17(a)(3), the focus is on the fraudulent effect of the defendant’s conduct on purchasers of the subject securities.<sup>144</sup> Nonetheless, under the current version of Section 17(a)(3), there remains a class of defendants that escape liability for negligent insider trading — those persons who, acting with negligence, purchase the subject securities or engage in tipping in regard thereto.

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140. See H.R. REP. NO. 100-910, *supra* note 135, at 25-28; 134 CONG. REV. S17, 219 (daily ed. Oct. 21, 1988) (statement of Sen. Heinz) (stating that “this legislation provides those who have been harmed by insider trading [namely, contemporaneous traders] with an express private right of action . . .”).

141. See 134 CONG. REC. S17, 220 (daily ed. Oct. 21, 1988) (statement of Sen. Garn) (stating that private investors should have a right to recover when they have been victimized by insider trading violations based on the misappropriation theory).

142. See *supra* notes 135-36. Notably, the House Report “recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders.” H.R. REP. NO. 100-910, *supra* note 135, at 27. The Report thereafter provided the following example:

The most prominent example of the non-contemporaneous trader suit which came to the attention of the Committee involved a suit filed by Anheuser-Busch Companies, Inc. against Paul Thayer, a former director of the corporation. . . . In that case, the plaintiff alleged that it was defrauded not as a result of trading with the defendant, but by having information secretly stolen and by having the subsequent trading on the information concealed. According to the complaint in this case, prior to public dissemination, the tipper disclosed to several parties the plans of Anheuser-Busch to acquire Campbell Taggart, Inc. The alleged misappropriation of Anheuser-Busch’s confidential information proximately caused a significant increase in the market price of Campbell Taggart stock before Anheuser-Busch announced its offer. This forced Anheuser-Busch to raise its tender offer price, and the company eventually paid approximately \$80 million more as a result of the illegal insider trading. Clearly, in such a case, the plaintiff corporation was a victim of the defendant’s misappropriation . . . .

*Id.* at 28.

143. 446 U.S. at 701-02.

144. *Aaron*, 446 U.S. at 697. See generally *In re Bolan*, 2015 SEC LEXIS 2201.

Under the statute's current scope, liability attaches solely to the defendant that engages in misconduct via an "offer or sale."<sup>145</sup> By replacing the phrase "offer or sale" in the text preceding all three clauses of Section 17(a) with "purchase or sale" (as in Section 10(b) and Rule 10b-5), Section 17(a)(2) and 17(a)(3) will, in effect, be applicable to negligent misconduct, regardless of whether such misconduct was perpetrated by means of a purchase or a sale. Also, in Section 17(a)(3), by replacing the words "the purchaser" with "any person" (as in Rule 10b-5(c)), that provision would extend to situations in which any actor, regardless of whether such person was a purchaser or seller, engaged in misconduct by means of either a purchase or sale, thus broadening Section 17(a)(3)'s current scope of liability. This amended version of Section 17(a)(3) would broaden the statute's scope of liability, with minimal alterations to its overall language.

D. *Insider Trading Cases Based on Negligence That the SEC May Have Successfully Pursued Under the Proposed Amendment of Section 17(a)(3)*

1. *SEC v. Switzer*

In *SEC v. Switzer*, the SEC brought an insider trading suit against the University of Oklahoma football coach Barry Switzer alleging that Coach Switzer was liable under Rule 10b-5.<sup>146</sup> The alleged insider trades that Coach Switzer transacted were a result of information that he overheard from an acquaintance who was an insider of the company whose stock Switzer purchased.<sup>147</sup> However, the court held that neither Coach Switzer nor the insider-tipper were liable for insider trading because the tipper had not willfully breached a fiduciary duty for a personal benefit.<sup>148</sup>

The facts of *SEC v. Switzer* are as follows: Texas International Company (TIC) was a publicly-held company that explored and developed

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145. 15 U.S.C. § 77q(a).

146. *Switzer*, 590 F.Supp. at 762. Coach Switzer also was the coach of the last Dallas Cowboys team to win the Super Bowl – in 1996.

147. *Id.*

148. *Id.* at 766. In order to be held liable for negligent insider trading under the current version of Section 17(a)(3), the insider trades and tips must have been based on material and nonpublic information that operated as a "fraud or deceit upon the purchaser." 15 U.S.C. §78u-1(a)(3). In this scenario, Platt, the insider, provided the inadvertent tip that resulted in Coach Switzer's purchase and subsequent profit. *Switzer*, 590 F.Supp. at 766. Therefore, neither Platt nor Coach Switzer can be susceptible to liability under the current version of Section 17(a)(3) because the facts of this scenario did not result in a "fraud upon the purchaser."

oil and natural gas properties.<sup>149</sup> Four days prior to the public announcement of a merger between TIC and Phoenix Resources Company (Phoenix), a majority-owned subsidiary which was also a publicly-traded company, Coach Switzer attended a track meet at the University of Oklahoma.<sup>150</sup> Also attending the track meet was George Platt — the Chairman of the Board and the Chief Executive Officer of TIC who also served on the board of directors of Phoenix.<sup>151</sup> During the track meet, Switzer overheard Platt talking to Platt's wife about the forthcoming merger.<sup>152</sup> In response to the information that he overheard, Switzer informed several other associates who collectively purchased shares of Phoenix stock and profited from the purchase.<sup>153</sup> Thereafter, the SEC brought suit against Coach Switzer and Platt for insider trading violations under Section 10(b) and Rule 10b-5.<sup>154</sup> Specifically, the SEC alleged that Platt improperly tipped Coach Switzer (in breach of Platt's fiduciary duty to Phoenix as an undisputed insider) and that Coach Switzer improperly purchased Phoenix stock.<sup>155</sup> Applying the Supreme Court's

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149. *Id.* at 759.

150. *Id.* at 761.

151. *Id.*

152. *Id.* at 762.

153. *Id.* at 763.

154. *Id.* at 764.

155. *Id.* at 766. In regard to Platt as tipper, Platt was an insider of both TIC and Phoenix, and, accordingly, had an affirmative duty to disclose or abstain. *Id.* However, the court held that, despite the fact that Coach Switzer profited from material nonpublic information that he received from Platt, Platt did not violate Section 10(b) and Rule 10b-5 because Platt did not intentionally provide the information to Coach Switzer, nor did he personally benefit from the disclosure. *Id.* In finding that Platt had not violated Section 10(b) and Rule 10b-5, the court referenced the Supreme Court's holding in *Dirks* by stating that "only when a disclosure is made for an 'improper purpose' will such a 'tip' constitute a breach of an insider's duty. . . ." *Id.* Further, the court stated "[i]n *Dirks*, the court held that a disclosure is made for an 'improper purpose' when an insider personally will benefit, directly or indirectly, from his disclosure." *Id.* (quoting *Dirks*, 463 U.S. at 662). Thus, since Platt did not intentionally disclose the material and nonpublic information to Coach Switzer regarding the merger between TIC and Phoenix and because he did not personally benefit from the disclosure, the court held that Platt was not liable for insider trading under Section 10(b) and Rule 10b-5. *Id.*

In regard to Coach Switzer as a tippee, he was obviously not an insider of either TIC or Phoenix because he was not employed by either company, nor did he maintain any position of trust or confidence. *Id.* at 765. In finding that Coach Switzer had not breached any derivative fiduciary duty owed to Phoenix's shareholders derived from Platt's fiduciary duty owed to Phoenix's shareholders, and thus did not violate Section 10(b) and Rule 10b-5, the court again referenced the Supreme Court's holding in *Dirks* by stating, "only when there has been a breach of an insider's duty which the 'tippee' knew or should have known constituted such a breach will there be 'tippee' liability sufficient to constitute a violation of § 10(b) and Commission Rule 10b-5." *Id.* at 766.

Further, the court stated that "'absent a breach by the insider [to his stockholders], there is no derivative breach [by the tippee]." *Id.* (quoting *Dirks*, 463 U.S. at 662). Thus, since Platt (as the insider) did not intentionally breach a duty to the TIC and Phoenix

*Dirks* test, the court held that neither Coach Switzer nor Platt were liable for insider trading.<sup>156</sup>

Although the *Switzer* court may have properly applied the *Dirks* standard by finding that neither party intentionally violated Section 10(b), the facts of this case, on their face, may suggest that the conduct of the parties merited the levying of sanctions under a theory of negligence. Irrespective of the fact that there was a finding of no intentional wrongdoing, one party (Coach Switzer) was granted an unfair advantage to profit from material inside information that he received from a corporate insider when that insider acted negligently by communicating this sensitive information at a public track meet.<sup>157</sup>

By amending Section 17(a)(3), the SEC would have authority to pursue negligent insider trading causes of action against a defendant such as Platt. A negligent insider trading cause of action under the proposed version of Section 17(a)(3) would have provided the SEC with the wherewithal to prosecute the prohibited act of insider trading against subject persons involved in that scenario who either “directly or indirectly” engaged in any practice that operated “as a fraud or deceit upon any person.” Based on the circumstances of this situation, Platt negligently failed to take reasonable precautions to protect information that he “knew or reasonably should have known was material,” and as a direct result of Platt’s failure to take such precautions, Coach Switzer financially benefitted from confidential information that he knew came from a reliable inside source.

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stockholders, Coach Switzer (as tippee) could not have committed a derivative breach. *Id.* at 767.

156. *Id.* at 767.

157. In contrast to prior lower court case law (*see, e.g.,* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980)), the Supreme Court’s holding in *Dirks* also established that a “loose-lipped” corporate insider such as Platt will not be held liable for insider trading if the insider discloses material nonpublic information regarding the company to whose stockholders the corporate insider owes a fiduciary duty if the insider did not intend for the disclosure of information to be a gift or to result in a personal benefit to the insider. 463 U.S. at 662 (1983). However, despite this limitation of liability, it is only reasonable to suggest that a corporate insider (such as Platt) who talks loudly in a public place (such as a track meet) about information that is material and nonpublic regarding a sensitive and confidential corporate matter should be held liable, especially when such information is overheard and is the basis for the ensuing trades.

Note, moreover, that SEC Regulation FD, which is not part of the insider trading statutory regimen, generally prohibits selective disclosure. *See* Regulation FD, 17 C.F.R. § 243.100 (prohibiting selective disclosure) *et seq.*; Securities Exchange Release No. 43,154 (2000) (commenting on the prohibition of selective disclosure); Marc I. Steinberg and Jason B. Myers, *Lurking in the Shadows: The Hidden Issues of the Securities and Exchange Commission’s Regulation FD*, 27 J. CORP L. 173 (2002) (discussing the prohibition of selective disclosure).

## 2. *U.S. v. Conradt*

In *U.S. v. Conradt*, the government brought a criminal prosecution for insider trading against five defendants (four traders at Euro-Pacific and one of the trader's roommates, an equities analyst) for allegedly trading based on material and nonpublic information regarding IBM Corp.'s \$1.2 billion acquisition of software company SPSS Inc.<sup>158</sup> The indictment alleged that the information originated from an associate at an outside law firm, Michael Dallas.<sup>159</sup> Dallas had been working on the IBM deal and disseminated the inside information to Trent Martin, an equities analyst.<sup>160</sup> After receiving the tip, Martin allegedly passed it along to his roommate, the defendant Thomas Conradt, who was one of the Euro-Pacific traders.<sup>161</sup> Conradt subsequently tipped three other traders, all of whom allegedly traded on the information.<sup>162</sup> As a result, the government relied on the misappropriation theory in its cause of action despite the fact that the government's indictment contained no obvious allegations that the law firm associate who provided the inside information received any "objective, consequential" personal benefit representing the potential of a pecuniary gain in exchange for that disclosure.<sup>163</sup>

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158. *U.S. v. Conradt*, No. 12-CR-887, 2015 WL 480419 (S.D.N.Y., Nov. 28, 2012).

159. Indictment at 3, *U.S. v. Conradt*, No. 12-CR-887, 2015 WL 480419 (S.D.N.Y., Nov. 28, 2012).

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* The further facts of *United States v. Conradt* are: four of the five defendants entered guilty pleas. No. 12-CR-887, 2015 WL 480419 at \*1. The day after the Second Circuit's ruling in *Newman*, (773 F.3d 438), the court scheduled a status conference to determine whether the Second Circuit's ruling affected the guilty pleas of the four former traders and Martin who admitted to an insider trading scheme. *Id.* The court advised all of the parties that, in light of the *Newman* decision, the Court was inclined to vacate those guilty pleas as legally insufficient as a result of the Second Circuit's "clarification of the personal benefit and tippee knowledge requirements of tipping liability for insider trading." *Id.* at \*1-\*2. Although the government recognized that *Newman* had stated that the tests for insider trading were the same under the classical and misappropriation theories, the government opposed undoing the defendants' guilty pleas, arguing that any reference to the misappropriation theory in *Newman* was dicta and that prior Second Circuit decisions have held that the misappropriation theory does not require the tipper to receive any personal benefit to be liable for insider trading. *Id.* After hearing from the parties during the hearing, Judge Carter indicated that he had serious doubts about whether there was a sufficient factual basis for the guilty pleas but agreed to the Government's request to prepare briefing on the issue seeking to distinguish *Conradt* from *Newman* on the basis that the initial tipper in *Conradt* was not a corporate insider. *Id.* at \*1.

On January 12, 2015, the government filed a brief supporting the sufficiency of the defendants' guilty pleas, arguing that the Second Circuit's holding in *Newman* was limited to cases brought under the so-called "classical" theory of insider-trading liability — cases in

A negligent insider trading cause of action under the proposed amended Section 17(a)(3) would have provided the SEC with the authority to impose

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which the tipper is a corporate insider, who owes fiduciary duties to the corporation and its shareholders. See Government's Memorandum of Law in Support of the Sufficiency of the Defendants' Guilty Pleas, *Conradt*, No. 12-CR-887 (S.D.N.Y. Jan. 12, 2015), ECF No. 153. Because the case at bar was brought under the "misappropriation" theory of insider trading, in which the tipper is a corporate outsider who misappropriates confidential information in breach of a fiduciary duty owed to the source of the information, the Government contended that *Newman* should not apply. *Id.* at 1.

On January 22, 2015, the Court rejected the government's invitation to limit the Second Circuit's decision in *Newman* to classical insider-trading cases. *Conradt*, 2015 WL 480419, at \*2. In doing so, the Court first noted that both *Newman* and an earlier Second Circuit decision, *Obus*, 693 F.3d 276, make clear that "the elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." *Id.* at \*2 (quoting *Newman*, 773 F.3d at 446). The Court also noted that "even if *Newman* did not specifically resolve the issue" the "emphatic dicta" in *Newman* addressing the issue was part of a "meticulous and conscientious effort by the Second Circuit to clarify the state of insider-trading law" and should be given effect. *Id.* Further, the Court indicated that it disagreed with the government's position on the merits, as well as the government's reliance on earlier Second Circuit case law — particularly *U.S. v. Libera*, 989 F.2d 596 (2d Cir. 1993) — finding that such case law is consistent with *Newman*'s holding and that "the relevant language from [*Libera*] . . . has itself been construed to be mere implication in dicta." *Conradt*, 2015 WL 480419, at \*3 n.1. As a result, the Court vacated the four defendants' guilty pleas and noted that it will later address two other motions to dismiss on the basis of *Newman*. *Id.*

Shortly after that ruling, on January 28, 2015, the assistant U.S. Attorney wrote to the Court and requested permission to drop the charges against all five defendants, conceding that the recent Second Circuit opinion "substantially changed the law pertaining to insider trading." See Exhibit 5, Reply Affidavit of Samuel J. Lieberman in Support of Respondent Gregory T. Bolan, Jr.'s Motion for Summary Disposition, In the Matter of Gregory T. Bolan, Jr. and Joseph C. Ruggieri (SEC received Feb. 9, 2015). At a hearing the following day, the assistant U.S. Attorney told the Court that, in light of the *Newman* Court's "new, heightened standard" the government no longer had "the requisite evidence to establish one of the elements of the crime" (referring to the newly clarified personal benefit requirement). He further stated that, if the Second Circuit's decision should be reversed in the future, the government would consider charging all five defendants again (assuming that the statute of limitations has not run). As a result, the Court granted the government's request to dismiss the causes of action against all five defendants without prejudice. See Ed Beeson, Judge to Dismiss IBM Insider Trading Case at Feds Request, *Law 360* (Jan. 29, 2015). Significantly, the U.S. Supreme Court in *Salman*, 137 S.Ct. 420 (2016), subsequently rejected the Second Circuit's rationale in *Newman*, thereby leaving open the possibility that these charges may be reinstated by the government.

Notably, prior to the criminal prosecution, the SEC instituted an enforcement action based on the misappropriation theory against these individuals. *SEC v. Conradt*, 947 F.Supp.2d 406 (S.D.N.Y. Jun. 4, 2013). Handing down its ruling prior to the Second Circuit's decision in *Newman*, the district court denied the motions to dismiss. *Id.* Subsequently, a number of the defendants entered into settlements with the SEC and then sought to have these settlements vacated after *Newman* was decided. *SEC v. Conradt*, 309 F.R.D. 186 (S.D.N.Y. Jul. 23, 2015). The district court denied the motions. See *id.* (holding investors did not show the exceptional circumstances needed to support relief from consent judgments).

insider trading liability against any of the parties involved in this scenario that “negligently” engaged in “a fraud or deceit.”<sup>164</sup> As alleged, Dallas, an attorney whose law firm was retained to help effectuate IBM’s contemplated acquisition of SPSS Inc., carelessly disclosed material and nonpublic information that he “knew or reasonably should have known was material,” in breach of the duty of trust and confidentiality he owed to the source of the information — IBM.<sup>165</sup> The information that Dallas carelessly disclosed carried with it “a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) would have viewed the total mix of information made available to be significantly altered by disclosure of the fact.”<sup>166</sup> As a result, Conratt, Weishaus, and the traders gained possession of this material and nonpublic information, and subsequently tipped and/or traded based on this information. Therefore, Conratt’s tip, and the subsequent trades by his tippees, resulted from material and nonpublic information that they gained (directly or indirectly) from Dallas, who breached a duty of confidentiality to IBM by divulging this confidential information. Such misconduct would have subjected these individuals to SEC enforcement action under the proposed amended Section 17(a)(3).<sup>167</sup>

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164. Important to the context of these circumstances is the relationship between Dallas and Martin. Based on the SEC’s original complaint, Dallas and Martin “frequently shared both personal and professional confidences.” Complaint at 6, *SEC v. Conratt*, 947 F.Supp.2d 406 (S.D.N.Y. filed Nov. 29, 2012). However, “each knew or reasonably should have known that the other expected such information to be maintained in confidence.” *Id.* Thus, similar to the application of the proposed amended Section 17(a)(3) to the facts of *Switzer*, the facts of *U.S. v. Conratt* should invoke liability for a negligent breach of duty of trust and confidentiality that Dallas owed to IBM. A negligent insider trading cause of action under the yet-to-be-amended Section 17(a)(3) would have provided the SEC with the authority to enforce the prohibited act of insider trading against the law firm associate. Based on the circumstances of this situation, Dallas negligently failed to take reasonable precautions to protect information that he “knew or reasonably should have known was material.” See *Bank of America*, *supra* note 118 (providing a discussion of the case). As a direct result of Dallas’s failure to take such precautions, Conratt, Weishaus, and others engaged in transactions that operated as a “fraud or deceit.” 15 U.S.C. § 77q(a)(3).

165. Indictment at 3, *U.S. v. Conratt*, No. 12-CR-887, 2015 WL 480419 (S.D.N.Y., Nov. 28, 2012).

166. *Longman*, 197 F.3d at 683 (4th Cir. 1999); see also *Dirks*, 463 U.S. at 667 n. 27 (concluding that “to constitute a violation of Rule 10b–5, there must be fraud”).

167. In order to be held liable for negligent insider trading under the current version of Section 17(a)(3), the insider trades and tips must have been based on material and nonpublic information that resulted in a “fraud or deceit upon the purchaser.” 15 U.S.C. § 77q(a)(3). In this scenario, Dallas and Conratt provided the inadvertent tips that resulted in the traders’ purchases and subsequent profits. Therefore, Dallas, Conratt, Weishaus, and the traders cannot be susceptible to liability under the current version of Section 17(a)(3) because this conduct allegedly perpetrated fraud upon sellers.

For Dallas, Conratt, Weishaus, and the traders to be held liable under the yet-to-be-

### 3. *In the Matter of Gregory T. Bolan, Jr.*

In the *Bolan* proceeding, the SEC settled administrative cease-and-desist proceedings under various statutes, including Section 17(a)(3), against a research analyst at Wells Fargo.<sup>168</sup> The SEC alleged that the defendant communicated notice of a stock's rating downgrade to a trader (Ruggieri — a Wells Fargo senior trader), who proceeded to trade on the information before it was made public.<sup>169</sup> Because Bolan did not act with scienter, he did not violate Section 10(b).<sup>170</sup> He nonetheless allegedly violated Section 17(a)(3) by breaching his duty to his employer when he “should have known that he was providing notice to Ruggieri . . . of material nonpublic information . . . .”<sup>171</sup> The SEC ultimately settled with Bolan based on negligent insider trading under Section 17(a)(3).<sup>172</sup> However, due to the provision's limiting language, the settlement only regarded the insider tips that resulted in sales.<sup>173</sup>

Under the proposed version of Section 17(a)(3), the SEC would have had the authority to institute an enforcement action alleging negligent insider trading against Bolan that involved the subject purchases as well as sales. Based on the language of the yet-to-be-amended Section 17(a)(3), elements of a negligent insider trading cause of action are: (1) buying or selling (or the offer of) a security (2) in breach of a fiduciary duty or other relationship of trust and confidence (3) that occurs as a result of (4) a negligent (5) failure to adequately disclose (6) material and nonpublic information (7) that the defendant knew or should have known was material (8) that (either directly

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amended Section 17(a)(3), the insider trades and tips must have been based on material and nonpublic information that resulted in a “fraud or deceit upon *any person*.” By amending Section 17(a)(3), the SEC would be granted authority to pursue negligent insider trading causes of action against defendants, such as the ones in this case, who cannot be successfully prosecuted for insider trading under the current statute. A negligent insider trading cause of action under the proposed version of Section 17(a)(3) would have provided the SEC with the authority to enforce the prohibited act of insider trading against any of the parties involved in this scenario who either “directly or indirectly” engaged in any transaction or practice that operated “as a fraud or deceit upon *any person*.”

168. *In re Bolan*, 2015 SEC LEXIS 2201.

169. *Id.* at \*4 (The PRXL rating was downgraded by Bolan as a direct result of Bolan's research).

170. *Id.*

171. *Id.* at \*8.

172. *Id.*

173. In order to be held liable for negligent insider trading under the current version of Section 17(a)(3), the insider trades and tips must have been based on material and nonpublic information that resulted in a “fraud or deceit upon the purchaser.” 15 U.S.C. § 77q(a)(3). In this scenario, Bolan's tips resulted in Ruggieri's trades that were both purchases and sales. Therefore, both Bolan and Ruggieri were susceptible to liability under the current version of Section 17(a)(3) for Ruggieri's sales.

or indirectly) results in a “fraud or deceit upon any person.”

As alleged, Bolan, an analyst at Wells Fargo who was entrusted to keep research confidential until publicly disseminated, carelessly disclosed material and nonpublic information that he “reasonably should have known was material,” in breach of the duty of trust and confidentiality that he owed to Wells Fargo as an employee of the company. As a result, Bolan’s tippee became privy to material and nonpublic information and subsequently traded while in possession of this information. Therefore, Bolan’s tips and Ruggieri’s trades were a direct result of the material and nonpublic information that they gained. Accordingly, both Bolan and his tippee would be subject to SEC enforcement action under the yet-to-be-amended Section 17(a)(3).

### CONCLUSION

Liability for negligent insider trading under Section 17(a)(3) should be an important objective in the federal regulation of insider trading. Throughout the history of insider trading litigation, liability has frequently hinged upon the crucial element of scienter. Due to this required element, negligent actors engaging in purchases (or tipping in regard thereto) have avoided liability despite the fact that, as a result of their negligence, they gained an unfair advantage to reap profits to the detriment of investors who sold securities without being privy to such information. With respect to insider purchases and tips, two classifications of insider trading liability are currently recognized: (1) a defendant did not commit insider trading; and (2) a defendant committed insider trading by acting with scienter. These classifications are on opposite sides of the spectrum. The proposed amendment to Section 17(a)(3) bridges this gap by providing the SEC with the authority to pursue negligent misconduct in both the purchase and sale contexts.

If the SEC had the ability to pursue claims of negligent insider trading under Section 17(a)(3), it only stands to reason that the SEC would gain an upper hand in its current “war” on insider trading. The SEC would be able to pursue a higher number of insider trading cases with the less rigorous burden of proving negligence. A likely effect of this newly-granted authority would be the enhancement of market integrity through elimination of the senseless mental culpability distinctions that currently reside in the void of insider trading liability.

