The Dilemma of the Remote Tippee

Kathleen Coles*

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Commentators have long been intrigued by the public's fascination with insider trading scandals. Although the public focus on insider trading has historically gone through cycles, the recent and highly publicized wave of corporate malfeasance epitomized by Enron has also included several high profile instances of alleged insider trading, such as the Martha Stewart debacle. Although Martha Stewart's most notorious problems stemmed from the criminal prosecution arising from her conduct during an investigation by the Securities and Exchange Commission (SEC),[1] the insider trading charges themselves have also been the focus of controversy and have been hotly debated by legal observers.[2] This general controversy and the allegedly flimsy basis for the charges of insider trading[3] have also engaged the interest of the

*. Associate Professor, Northern Illinois University College of Law. J.D., University of Chicago, 1977; M.A., B.A., Oxford University, 1988, 1973; B.A., College of William and Mary, 1971.

1. On March 5, 2004, Martha Stewart was convicted by a jury of conspiracy, making false statements to government investigators, and obstruction of agency proceedings. *See* United States v. Martha Stewart, 323 F. Supp. 2d 606, 609-611 (S.D.N.Y. 2004). The SEC also filed a civil action against Stewart for insider trading, which is still pending. SEC v. Martha Stewart and Peter Bacanovic, 03-CIV-4070 9 (NRB) (S.D.N.Y. June 4, 2003).

2. *See, e.g.*, Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023, 2076 (2005) (contending that the Stewart civil action for insider trading is based on a novel application of current law).

3. *Id.* at 2023-25.

public at large.[4] For example, the "Save Martha" website[5] continues to abound with reader letters and book advertisements about the ins and outs of the insider trading allegations against Stewart.[6] The interest of Joe Q. and Josephine Public in high profile insider trading prosecutions has hence once again been aroused.

It is a premise of this article that Joe Q. and Josephine Public may have a much more direct interest in the future ins and outs of the insider trading regime if the much-vaunted "ownership society"[7] comes to pass and average citizens are dependent on private investment accounts for some or all of the basic retirement funds currently provided to them as a "safety net" by the social security system. If the government retirement safety net is ever removed or narrowed, one would expect that the pressures on Joe and Josephine to invest in securities will intensify—either to fund the private investment accounts or to build supplemental retirement income. Depending on the mix of private accounts and public funds that is eventually allowed or required under any new private account system, one might further anticipate that at least some Joes and Josephines will look to increase their rate of return on investments by undertaking more risk than they should in order to enhance their retirement "nest eggs."[8] Unfortunately, along with these pressures may also come incentives to take shortcuts to a higher rate of return by trading on "hot tips" or confidential information.

Assuming Joe Q. and Josephine Public are either honest-to-a-fault or, at minimum, fearful of liability, they may pause before trading and inquire whether any legal problems could arise from using information received from others that does not seem to be public knowledge. This will not be an easy task. The problems for Joe and Josephine in seeking answers begin with confusing definitions and usage.

Literally, "insider trading" refers to all purchases and sales of securities by "insiders." The term "insiders" is traditionally defined as officers, directors, controlling shareholders, and employees of a corporation whose securities are traded.[9] According to the legal definition, which is both narrower and broader,[10] the

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4. John Small, ed., *SaveMartha*, http://www.savemartha.com/mail-7-17-04.html (last visited Jan. 3, 2006).

5. Small, ed., *SaveMartha*, http://www.savemartha.com/ (last visited Aug. 29, 2005).

6. *Id.*

7. The phrase "ownership society" was coined by the Cato Institute. *See, e.g.*, David Boaz, *Ownership Society*, http://www.cato.org/special/ownership_society/boaz.html (last visited Aug. 29, 2005) (ownership society frees individuals from government handouts and makes them property owners via such measures as private retirement accounts and health savings accounts); Jill Lawrence, *Some Ask Who Belongs in "Ownership Society,"* U.S.A. TODAY, March 22, 2005, at 04A (describing President Bush's vision of an ownership society).

8. *Cf.* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 635 (1996) ("[T]rying to outperform the [stock] market is little more than a form of gambling" for average investors).

9. Under the literal meaning of the term, insider trading thus refers to purchases and sales

term "insider trading" is also used as a short-hand reference to describe the purchase or sale of securities while in possession of material, non-public information.[11] As a means of describing prohibited conduct, however, this legal definition is misleading to the extent that some conduct meeting the definition is not in fact illegal.[12] Moreover, the general concept of "insider" trading in legal terms also encompasses some insiders and outsiders who "tip" or convey nonpublic information to others, whether or not they trade in securities for their own account.[13] Thus, "insiders" include some but not all persons who *receive* inside information directly or indirectly from inside or outside tippers—in other words, "tippees."[14]

If Joe and Josephine delve further, they may learn that it is unlawful to trade on the basis of nonpublic information that they have reason to believe was obtained "improperly."[15] They may also read about the abstain or disclose rule.[16] Unsure what all this means, Joe and Josephine may well decide not to take any chances and simply refrain from trading. However, because trading based on some inside information that has been obtained improperly may not be prohibited,[17] Joe and Josephine may be unnecessarily deterred from consummating perfectly legal securities transactions. Alternatively, when faced with the same lack of clear guidance, Joe and Josephine may forge ahead and buy or sell securities, only to discover themselves in the midst of a costly and potentially perilous investigation by the Securities and Exchange Commission.

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of stock by officers, directors and employees, whether or not the latter are in possession of non-public information. *See* U.S. Securities & Exchange Commission, *Insider Trading* (Apr. 19, 2001), http://www.sec.gov/answers/insider.htm (distinguishing between legal and illegal SEC insider trading). *See infra* note 34 and accompanying text.

10. The legal definition is narrower in that it requires trading on the basis of non-public information, but it is broader in that it includes trading by persons who are not "insiders," as traditionally defined. A significant amount of so-called "insider trading" is actually conducted by "outsiders." *See infra* note 75 and accompanying text.

11. The SEC has defined insider trading for purposes of Rule 10b5-1:

> [A] manipulative and deceptive device [that] include[s], 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.

17 C.F.R. § § 240.10b5-1(a) (2005). For ease of reference, this article refers to material, non-public information as "inside information" or "nonpublic information," unless the wording or context clearly indicate that a narrower meaning is intended.

12. *See infra* Section III.A.

13. WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 1 (1996).

14. *See infra* Section II.

15. *See infra* Section II.C.

16. *See infra* notes 33-35 and accompanying text.

17. *See infra* Section III.A.

The uncertainties facing our hypothetical Joe Q. and Josephine Public are further compounded when either is a "remote tippee," *i.e.*, he or she has received nonpublic information indirectly.[18] Because Joe and Josephine are most likely aware of and understand the restrictions on the use of confidential information that they receive from their employers at work, they are likely, as a practical matter, to face a quandary about whether to proceed with trading in those circumstances where the tip they receive consists of second, third, or fourth-hand information about unrelated companies. Similar to most insider trading laws, the law governing remote tippees is generally confusing and inconsistent.[19]

Through its enforcement policies and legal positions advocated in judicial proceedings, the SEC is constantly pushing the boundaries of the law in an attempt to bring insider trading restrictions quietly and indirectly back to a fairness-based system—a system that has ostensibly been rejected by the Supreme Court.[20] This aggressive and uncertain enforcement policy may increase the risk that Joe and Josephine will become enforcement targets and tends to act further as a deterrent to conduct that may be legal under current law.

The general problems outlined above are by no means limited to remote tippees or to unsophisticated investors, but the treatment of remote tippees tends to highlight the often disingenuous rationales underlying current regulation of insider trading. With rumors emerging that the SEC is poised to pursue a return to a fairness-based regime via case-by-case development,[21] this article joins the chorus of voices calling for judicial, legislative, or regulatory intervention in order to clarify the parameters of prohibited conduct and, ideally, to impose a consistent conceptual basis.[22] Because a fairness-based system serves as the easiest standard of conduct to understand from the point of view of the average investor, this article also joins some other commentators in recommending that the "legalistic" fiduciary-based rationale for insider trading restrictions be replaced with the fairness-based standard originally advocated by the

18. Generally, the term "remote tippee" indicates that a tippee is at least one degree removed from the original tipper. Because the conventions used to refer to specific remote tippees (*e.g.*, third tier remote tippee) can become cumbersome and repetitive when a number of cases are being discussed, this article uses a slightly different formulation, as explained *infra* at notes 95-96 and accompanying text.

19. Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Insider Trading Information is Untenable*, 59 BROOK. L. REV. 149, 151 (1993) (reviewing EMMANUEL GAILLARD, ED. INSIDER TRADING: THE LAWS OF EUROPE, THE UNITED STATES AND JAPAN (1992)).

20. *See infra* Section II.

21. *See Executives May Have Liability Risk When Using Securities Trading Plan*, 37 SEC. REG. & L. REP. 33 (BNA), at 1359 (Aug. 15, 2005) (conference panelist reports SEC staff developing enforcement cases that may be reverting to the possession theory of insider trading).

22. Currently, the two prevailing theories of insider trading liability have different conceptual bases. *See infra* Section I.

SEC and the lower courts.[23] Should comprehensive regulatory, judicial, or legislative reforms not be feasible or forthcoming, this article suggests other alternatives to ameliorate the risks of unfair prosecution or undue deterrence of remote tippees.

To develop this discussion and analysis, Section I begins with an overview of insider trading restrictions, focusing on persons who trade on nonpublic information obtained in breach of fiduciary or quasi-fiduciary duty. Section II initially describes the general legal treatment of tippers and tippees and then focuses specifically on remote tippees. Section III highlights the dilemma of remote tippees attempting to determine whether it will be legal to trade on the basis of "hot tips" and addresses potential reforms in the legal standards governing remote tippees. This discussion is followed by a brief conclusion in Section IV.

I. THE BREACHING SOURCE: OVERVIEW OF INSIDER TRADING RESTRICTIONS ON "CLASSIC INSIDERS" AND MISAPPROPRIATORS OF CONFIDENTIAL INFORMATION

The history and scope of insider trading restrictions have been discussed extensively in numerous articles and treatises.[24] Nevertheless, a general overview is in order here as a guide to readers who are unfamiliar with the topic and to place the role of the remote tippee in context. This section briefly describes the theories and policies underlying insider trading regulation. It also discusses the liability of the ultimate sources of improperly disseminated inside information—the "classic insider" and the misappropriator of confidential information—when they trade for their own account on the basis of inside information. This overview sets the stage for a discussion in Section III of tipper liability and the derivative liability of tippees.

The principal federal regulatory tool for combating insider trading is SEC Rule 10b-5,[25] promulgated under authority of Section 10(b)[26] of the Securities Exchange Act of 1934, as amended.[27] Because insider trading fits uncomfortably within the

23. *See infra* Section IV.

24. *See, e.g.*, DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION (2002); WANG & STEINBERG, *supra* note 13, at 1-4; Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1289-90 (1998).

25. 17 C.F.R. § 240.10b-5.

26. 15 U.S.C. 78j(b) (2000). Section 10(b) states, in relevant part, that it is unlawful for any person directly or indirectly "[t]o use or employ, in connection with the purchase or sale of any security . . . 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." *Id.* In 1980, the SEC adopted Rule 14e-3 to facilitate the regulation of insider trading in conjunction with tender offers. *See infra* notes 59-63 and accompanying text. References to Section 10b-5 in this article should be read to encompass § 10(b) unless the text or context indicate that only the rule is under discussion.

27. Securities and Exchange Act of 1934, 15 U.S.C. 78a et seq. ("1934 Act" or "Exchange Act"). Regulators may proceed against inside traders either through the use of the SEC's civil

language and purpose of Section 10(b) and Rule 10b-5,[28] the historical development of insider trading restrictions has frequently been haphazard and confusing.[29] At the outset, however, the courts and the SEC propounded two principal theories to support regulation of insider trading.[30]

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enforcement powers or by means of criminal prosecution by the Justice Department if the trader "willfully" violated § 10(b) and Rule 10b-5. 15 U.S.C. § 78u(d) (2000) (civil enforcement); 15 U.S.C. §78ff(a) (2000) (criminal enforcement). Other laws under which insider trading has been prosecuted include Section 17(a) of the Securities Act of 1933, the wire and mail fraud statutes and conspiracy laws. *See, e.g.*, Carpenter v. United States, 484 U.S. 19 (1987) (addressing issues arising from mail and wire fraud); United States v. Geibel, 369 F.3d 682 (2d Cir. 2004) (addressing issues arising from conspiracy); SEC v. Maio, 51 F.3d 623, 630 (7th Cir. 1995) (addressing issues arising from violations of Section 17(a) of the Securities Act of 1933).

28. Rule 10b-5, entitled 'Employment of manipulative and deceptive devices," 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.

17 C.F.R. § 240.10b-5. Insider trading has generally been prosecuted as an act or practice that operates as a fraud or deceit. *See, e.g.*, *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (broker's trading on inside information violated Rule 10b-5(c) as a practice that operated as a fraud or deceit on securities purchasers). *See also* Roberta Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 86 (1998) (insider trading can be based on Rule 10b-5(a) or (c)). Because insider trading generally involves trading in complete silence, Rule 10b-5(b) typically does not apply because that subsection relates only to silence/omissions that render statements or representations misleading under the circumstances in which made. *See id.*

29. *See, e.g.*, 3C HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES FRAUD & GENERAL CORPORATE LAW §19:2 at 19-5 (insider trading law "grew like Topsy, case by case"); Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider trading: Why a Property Rights Theory of Inside Information is Untenable*, 59 BROOK. L. REV. 149, 151 (1993) (insider trading law is unclear and confusing at the edges).

30. Although the SEC, courts and Congress have largely focused on the fairness or fiduciary duty theories discussed *infra* in this section, academic commentary has been more wide-ranging and has increasingly been focused on economic analysis. *See* STEPHEN M. BAINBRIDGE, INSIDER TRADING 126 (1999) (modern insider trading debate is almost exclusively conducted in language of economics). Critics of the predominant rationales for insider trading restrictions have argued, for example, that insider trading does not cause economic harm to shareholders. *See, e.g.*, Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1238-1241 (1995). Other critics contend that insider trading is a beneficial means of rewarding corporate managers and helps promote efficient pricing of securities. *See, e.g.*, HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); BAINBRIDGE, *supra*, at 136-39 (discussing Manne's thesis and counter-arguments by its critics). In response to the arguments of critics, proponents of some form of insider trading restriction have focused in part on

The first, and oldest, theory derives from the fiduciary status of corporate insiders when dealing in the securities of the corporation they serve.[31] The SEC alluded to this status in its ground-breaking 1961 decision, *In re Cady, Roberts & Co,*[32] which

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rebutting economic arguments. *See, e.g.*, William W.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?* 54 S. CAL. L. REV. 1217 (1981) (concluding that some persons *will* be harmed by insider trading, though they may be difficult to identify in particular situations). Others have advanced economic arguments *in support* of some form of insider trading restriction. *See, e.g.*, BAINBRIDGE, *supra*, at 164-69 (because of barriers to private enforcement, state may use its regulatory powers in order to protect the economic incentive to produce information of value to society). Turning attention away from economic arguments to the over-all federal regulatory scheme, other proponents of regulation have argued that removal of insider trading restrictions will have an adverse impact on the system mandating disclosure of material information. *See, e.g.*, Karmel, *supra* note 19, at 169–70. Most recently, academic attention has turned to behavioral economics for insights into the validity and proper scope of insider trading regulation. *See, e.g.*, Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC,* 56 STAN. L. REV. 1, 28-30 (citing insider trading as an example of SEC overconfidence in efficacy of regulation). For a general summary of the academic arguments for and against insider trading restrictions, see LANGEVOORT, *supra* note 24, §§ 1.3-1.5. *See also* BAINBRIDGE, *supra*, at 125-46; WANG & STEINBERG, *supra* note 13, §§ 2.2.1-2.4 (discussing economic arguments for and against regulation).

31. The fiduciary rationale for insider trading restrictions has its genesis in the common law tort of deceit and in state common law developments that preceded the promulgation of Rule 10b-5. In general, persons buying and selling property committed the tort of deceit under common law if they affirmatively misrepresented material facts, but not if they possessed material information and were merely silent. RESTATEMENT (SECOND) OF TORTS §§ 525, 551 (West 2005). Several exceptions existed to the "mere silence" rule, and under those exceptions an affirmative duty to disclose material facts was imposed. The clearest duty to disclose arose in transactions between fiduciary and beneficiary. *See* Dalley, *supra* note 24, at 1296-97. Under two early common law theories relating specifically to trading in securities, corporate directors, officers and shareholders were deemed to have an affirmative duty to disclose material information, although the scope and source of that duty was somewhat uncertain. *Id.* at 1297. The first, so-called "minority," rule imposed a duty of disclosure on insiders who dealt with existing shareholders, and possibly with non-shareholders. WANG & STEINBERG, *supra* note 13, § 16.2.3 at 1118-19. Under the second theory, a duty of disclosure was originally imposed only where "special facts" existed, *see, e.g.*, Strong v. Repide, 213 U.S. 419, 434 (1909), but the duty was expanded over time to the point where the special facts doctrine was largely indistinguishable from the "minority rule." WANG & STEINBERG, *supra* note 13, § 16.2.3, at 1124-27. Although the characterization is subject to some dispute, these two common law theories are generally viewed as part of the law of fiduciary obligation, rather than as an aspect of common law fraud. *See id.* at 1109-10. Despite the fact that Rule 10b-5 itself sounds in fraud and deceit, early 10b-5 cases looked to the fiduciary duty-based common law "minority rule" and imposed an affirmative duty of disclosure on corporate insiders trading in the stock of corporations they served. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 939-43 (5th ed. 2004). The early 10b-5cases expressly or implicitly rejected the reasoning of many so-called "majority rule" decisions under state common law, which held that corporate insiders owe a fiduciary duty to the *corporation*, but not to its shareholders. *See* Dalley, *supra* note 24, at 1298-1302.

32. 40 S.E.C. 907 (1961) (disciplining a broker-dealer for selling stock after receiving non-public information from a corporate director about a pending dividend cut).

established the pivotal "abstain or disclose" rule that still epitomizes federal insider trading regulation.[33] Explaining first that corporate officers, directors, and controlling shareholders[34] have an affirmative duty to disclose material information relating to a transaction in securities or to forego the transaction if disclosure would be "improper or unrealistic,"[35] the Commission extrapolated from that duty and applied it to other classes of persons based on 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.[36]

The first factor emphasizes the inside trader's "special relationship" with shareholders of a corporate issuer and appears to refer to the fiduciary duty of loyalty.[37] The second factor emphasizes unfairness to parties with whom the trader deals, whether seller or buyer,[38] but stops short of establishing an express general duty to the investing public.[39]

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33. The abstain or disclose rule was adopted by the federal courts in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). *See infra* notes 40-44 and accompanying text.

34. *Cady, Roberts*, 40 S.E.C. at 911. This article uses the term "classic insiders" or "traditional insiders" to refer to officers, directors, controlling shareholders and employees of the issuer of the securities being traded. Under current analysis, the defendant in *Cady, Roberts* would be treated as a tippee of a classic insider. *See infra* Section II.

35. *Cady, Roberts*, 40 S.E.C. at 911. The Commission acknowledged that some states did not impose a duty of disclosure on insiders, but based its decision on the "increasing number" of jurisdictions that followed the common law minority rule or special facts doctrine described *supra* note 26. *Id.* at 911 n.13.

36. *Id.* at 912.

37. *Id.* *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 8 (1982).

38. One conceptual problem with basing insider trading restrictions on common law fiduciary principles is that insiders may owe duties when they trade with existing shareholders, but arguably do not have a direct fiduciary duty when they sell securities to non-shareholders. *See* WANG & STEINBERG, *supra* note 13, § 16.2.3 at 1115-18. Refusing to incorporate common law distinctions into 10b-5's anti-fraud provisions, the Commission rejected the argument that an insider has no "special duties" to non-stockholders, explaining that such an approach "ignores the plight of the buying public—wholly unprotected from the misuse of special information." *Cady, Roberts*, 40 S.E.C. at 913.

39. In a later passage addressing the fairness rationale in broad terms, the Commission noted that "[i]ntimacy demands restraint lest the uninformed be exploited." *Id.* at 912. The focus on curbing unfair exploitation was linked to a broader goal. Professor Langevoort points out that William Cary, the author of the *Cady, Roberts* decision, was primarily concerned with maintaining investor confidence in the integrity of the U.S. securities markets. Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319,

In early administrative and judicial decisions following *Cady, Roberts,* the first rationale for restricting trading took a back seat in deference to the second and broader rationale, which emphasized the inequity of allowing a person in possession of inside information to trade without disclosing the information.[40] Although not clearly articulated in the *Cady, Roberts* decision, the SEC's unfairness rationale was soon expanded to encompass a broad duty to all participants in the market. In its well-known decision *SEC v. Texas Gulf Sulphur Co.*,[41] the Second Circuit explained that Rule 10b-5 "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[42] By moving toward a general fairness rationale that emphasizes parity of access to information,[43] federal regulators were able to pursue

1325 n.28 (1999).

40. *See supra* note 38 and accompanying text.

41. 401 F.2d 833 (2d Cir. 1968) [hereinafter *TGS*].

42. *Id.* at 848 (citations omitted) (holding that corporate directors, officers and employees violated Rule 10b-5 by trading while in possession of material, nonpublic information relating to a major precious metals strike). Just before the cited passage, the court did refer to traditional fiduciary concepts and the "special facts" doctrine. *Id.* The court in *TGS* did not, however, analyze whether each defendant or category of defendants breached a fiduciary duty. *Id.* Rather, the court stated that "*anyone* in possession of material inside information must either disclose" the information to investors or abstain from trading. *Id.* (emphasis added). The court also went on to emphasize that Congress intended that all investors should be subject to identical market risks. *Id.* at 851-52. Those risks include the risk that evaluative capacity or available capital may vary. *Id.* at 852. Where insiders alone are in a position to evaluate material information because the information is non-public, however, they are not trading on an "equal footing" with outside investors, and the resulting inequities should be corrected. *Id.*

43. Although some courts and commentators refer to the goal of parity of information, the underlying theory is more accurately referred to as parity of *access* to information, since true parity of information is inherently impossible and economically undesirable. *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 354-55 (1979). For the sake of brevity, this article uses the terms "fairness rationale" or "fairness theory" to refer both to the goal of parity of access to information and to its underlying concern for maintaining investor confidence in the integrity of securities markets. *See* LOSS & SELIGMAN, *supra* note 31, at 919 (equity arguments in favor of insider trading restrictions are implicitly based on a public confidence or market integrity theory). The fairness theory has broader applicability than the classic theory, the misappropriation theory, or the latter two theories combined. For example, neither the classic theory or the misappropriation theory would encompass a non-fiduciary who steals inside information or an accidental recipient of nonpublic information such as an eavesdropper. *See* Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1, 22 (1998). Both the non-fiduciary thief and the eavesdropper would, however, be reached by the fairness theory if they traded on the basis of material information they knew or should have known was not public. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238 (2d. Cir. 1974) (describing knowledge requirement and applying *TGS* fairness standard in private action alleging tippee insider trading).

cases in which the person trading had no discernible duty to the issuer or the issuer's shareholders.[44]

Active judicial and regulatory expansion of a broad-based abstain or disclose obligation came to a temporary halt when the Supreme Court decided *Chiarella v. United States*.[45] In reversing the criminal conviction of an employee of a financial printer who traded on non-public information relating to tender offer targets,[46] the Supreme Court in *Chiarella* focused on the first rationale from *Cady, Roberts* and grounded its decision on common law principles governing the legal effect of silence.[47]

Based on those common law principles, the Court stated that liability for silence in connection with the purchase or sale of securities must be premised on a disclosure duty arising from a relationship of trust and confidence between parties.[48] The Supreme Court rejected the Second Circuit's holding that *anyone* who regularly receives inside information is subject to the abstain or disclose rule.[49] Without express evidence of congressional intent to adopt a broad fairness-based rule, Justice Powell, writing for the Court, refused to recognize a general duty between all participants in market transactions not to trade on the basis of inside information.[50] Explaining that there can be no fraud absent a duty to speak, the Court held that no such duty arises from "mere possession of nonpublic market information."[51] The Court acknowledged, in dicta, that traditional corporate insiders, as fiduciaries, have a duty to speak.[52] The Court also accepted the proposition that such a duty runs to both sellers and buyers of securities, even if the latter are not existing shareholders at the time of the transaction.[53]

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44. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd* 484 U.S. 19, 24 (1987) (newspaper reporter misappropriated confidential information from employer re timing and content of financial columns potentially affecting price of securities of corporations discussed therein); In re Blyth & Co., 43 S.E.C. 1037 (1969) (broker-dealer sanctioned for trading on basis of non-public information obtained from Federal Reserve Bank employee re maturity dates, interest rates and other terms of imminent new issues of government securities that affected price of issued and outstanding government securities).

45. 445 U.S. 222 (1980).

46. Chiarella, a "mark-up" man for Pandick Press, was able to deduce the identity of takeover targets from confidential disclosure documents being handled by the printer. *Id.* at 224. After consenting in a civil proceeding to disgorgement of illegal profits obtained from trading, Chiarella was indicted for criminal violations of Rule 10b-5 and was subsequently convicted by a jury. *Id.* at 224-25.

47. 445 U.S. at 226-230. *See supra* note 37.

48. 445 U.S. at 230.

49. *Id.* at 231.

50. *Id.* at 233.

51. *Id.* at 235.

52. *Id.* at 227-28 & n.8. *See supra* note 28.

53. Professor Bainbridge points to a number of passages in *Chiarella* and *Dirks* which

The Court's rejection of the fairness rationale and insistence on a fiduciary-based restriction on insider trading was reaffirmed three years later in *Dirks v. SEC*,[54] another decision written by Justice Powell. In a footnote in *Dirks*, the Supreme Court expanded the categories of persons subject to a direct fiduciary-based duty to abstain or disclose.[55] The Court observed that underwriters, accountants, lawyers, or consultants[56] working for an issuer may become fiduciaries of the issuer's shareholders by entering into a "special confidential relationship" in which they are given access to information "solely for corporate purposes."[57] Under this classical theory analysis, outsiders become "temporary insiders."[58]

The reasoning of *Chiarella* and *Dirks* left a large gap in the SEC's previously targeted enforcement efforts because persons in possession of inside information who did not owe a fiduciary or quasi-fiduciary duty to shareholders of the issuer of the securities were now free to trade and tip.[59] In response to this perceived gap, the SEC pursued two strategies. First, it adopted Rule 14e-3[60] in the tender offer context to preclude trading securities of an acquiring company or a target company on the basis of material, non-public information that the trader knew or had reason to know came from either company.[61] Because Rule 14e-3 was promulgated under Section 14(e) of

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indicate that the duty against self-dealing was at issue, suggesting an underlying property rights rationale for insider trading restrictions. Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU. L. REV. 1589, 1610 (1999).

54. 463 U.S. 646 (1983).

55. *Id.* at 655 n.14. By treating temporary insiders as having breached a direct duty to shareholders of the issuer, the Court avoided the necessity of establishing derivative liability based on a breach of duty by the person who relayed the nonpublic information to them. Seligman, *supra* note 43, at 9. *See infra* Section II.A.

56. Such persons are generally referred to as "temporary insiders" or "constructive insiders." *See Dirks*, 463 U.S. at 655 n. 14 ("temporary insiders"); Seligman, *supra* note 43, at 9 n.54 ("constructive insiders").

57. *Dirks*, 463 U.S. at 655 n.14.

58. The *Chiarella* and *Dirks* fiduciary-based theory has been characterized in various ways. *See* WANG & STEINBERG, *supra* note 13, §5.1, at 281-82 (terms "classical theory," "traditional theory" and "special relationship" theory are synonymous). This article uses the term "classical theory" to refer to restrictions on insider trading by those who owe a fiduciary duty to the issuer of securities being traded or its shareholders, including "classic insiders" and "temporary insiders." *See* United States v. O'Hagan, 521 U.S. 642, 651-52 (1997). *See supra* note 31 and accompanying text.

59. *See, e.g.*, Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1249-50 (1998) (listing examples of transactions based on nonpublic information that would not be prohibited under the classic theory).

60. 17 C.F.R. § 240.14e-3 (2005).

61. Rule 14e-3(a) provides:

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other

the Exchange Act,[62] the SEC was able to avoid the fraud and duty-based jurisprudence under Rule 10b-5[63] and use a broad-based rule to curtail the use of inside information in an area of trading characterized by great temptation and frequent abuse.[64]

Outside the tender offer context, the SEC expanded its enforcement efforts by advancing the "misappropriation theory" that had been initially proposed in two different versions by concurring and dissenting justices in *Chiarella*.[65] Under one version of the theory, Chief Justice Burger argued that any person who misappropriates or converts nonpublic information has an absolute duty to disclose the information or abstain from trading.[66] Under this variation of the

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> person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or
>
> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer,
>
> to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a). In general, the remaining sections of Rule 14e-3 provide safe harbors for trading under various circumstances. *See* 17 C.F.R. § 240.14e-3(b)-(d).

62. 15 U.S.C. § 78n(e) (2000). Section 14(e) of the Exchange Act states in relevant part:

> [It is unlawful for any person] to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Id.

63. United States v. O'Hagan, 521 U.S. 642, 666-76 (1997). The Court held that Rule 14e-3(a), which dispenses with the requirement of specific proof of a breach of fiduciary duty, is a proper exercise of the SEC's prophylactic power under § 14(e) of the Exchange Act. *Id.* at 676. *See also* SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998) (no breach of duty required under 14a-3).

64. *See, e.g.*, SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (describing temptations to take advantage of very large potential profits available from insider trading just before tender offer announced).

65. *See Chiarella*, 445 U.S. at 239-43.

66. *Id.* at 241 (Burger, C.J., dissenting). A majority of the Court declined to address the misappropriation theory in *Chiarella* on the grounds that it had not been properly submitted to the jury. *Id.* at 235-37. A conviction based on the misappropriation theory was challenged in *Carpenter v. United States*, 484 U.S. 19, 24 (1987), but the Court split evenly and did not render an opinion on the issue in that case. *See generally* A.C. Pritchard, *United States v. O'Hagan: Agency Law and*

misappropriation theory, the duty to abstain or disclose arises from the very act of misappropriation; and that duty is owed to those with whom one trades, and is ultimately based on a notion of fair dealing.[67] In a different approach to the misappropriation theory, Justice Stevens suggested that the focus should be on whether criminal liability under Rule 10b-5 could be based on breach of a duty owed to the *source* of entrusted nonpublic information—even if the source did not purchase or sell securities in connection with the breach and therefore would not be in a position to recover damages.[68]

In 1997, in *United States v. O'Hagan*,[69] the Supreme Court granted its imprimatur to Justice Stevens' basic formulation of the misappropriation issue.[70] In an opinion written by Justice Ginsburg, the Court rejected Chief Justice Burger's articulation of a duty owed to traders.[71] The Court, instead, rested its decision on a confusing mix of policy rationales and doctrines,[72] including fiduciary principles

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Justice Powell's Legacy for the Law of Insider Trading, 78 B.U. L. REV. 13, 31-34 (1998) (describing the impact of Justice Powell's retirement on *O'Hagan* and the fate of the misappropriation theory).

67. *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting). Chief Justice Burger construed Rule 10b-5 as reaching "*any* fraudulent scheme." *Id.* at 240. He argued that an investor who trades based on misappropriated nonpublic information possesses an undue advantage that is a form of unjust enrichment and is not based on superior experience, foresight or hard work. *Id.* at 240-41.

68. *Id.* at 238 (Stevens, J., concurring). Justice Stevens concluded that the Court had wisely left the viability of this theory for future resolution. *Id.*

69. 521 U.S. 642 (1997) (upholding criminal conviction of attorney under §§ 10(b) and 14(e) of the Exchange Act for misappropriating nonpublic information concerning tender offer target from his law firm and its client, the acquiring corporation).

70. In the years following *Chiarella*, government regulators began using Justice Stevens' "duty to the source" rationale to pursue a variety of defendants who might otherwise have avoided liability under the classic theory. Federal courts initially responded favorably to these efforts in both civil and criminal cases under § 10(b) and Rule 10b-5. *See, e.g.*, SEC v. Clark, 915 F.2d 439 (9th Cir. 1990) (upholding jury verdict that president of subsidiary corporation misappropriated information from employer planning acquisition and traded in stock of target corporation); SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (upholding injunction against employee of financial printing firm who misappropriated nonpublic information re tender offer targets); United States v. Newman, 664 F.2d 12, 14-15 (2d Cir. 1981) (reversing the dismissal of an indictment of employees of two investment banks on grounds they misappropriated confidential information from banks and their clients and tipped others in exchange for a share of profits). In 1995, however, the Fourth Circuit took a fresh look at the misappropriation theory and concluded that it was inconsistent with the language and purpose of Rule 10b-5. United States v. Bryan, 58 F.3d 933, 944, 950 (4th Cir. 1994) (viewing the fraud-on-the-source theory as an indefensible attempt to pursue parity of information). In *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997), the Eighth Circuit agreed, and the growing split among the circuits as to the viability of the misappropriation theory led the Court to grant certiorari. Pritchard, *supra* note 66, at 36-37. For a discussion of judicial developments leading up to *O'Hagan*, see generally Nagy, *supra* note 59, at 1236-41.

71. *Id.* at 655 n.6 (construing Chief Justice Burger's theory as embracing a disclosure obligation that runs to those with whom the misappropriator trades).

72. *See* Bainbridge, *supra* note 53, at 1632-33; 1645-50 (concluding that *O'Hagan* has

under agency law.[73] While the traditional theory of insider trading regulation is based on the existence of a fiduciary duty of loyalty owed by classic and temporary insiders to shareholders with whom they trade, the *O'Hagan* misappropriation theory focuses on a duty of trust and confidence owed to an entity or person in rightful possession of nonpublic information.[74] Where present, that duty generally precludes an outsider[75] from converting the information for personal use under state law agency principles, although the conversion, in and of itself, would not necessarily constitute a fraud or violate federal securities laws.[76] According to the Court, trading in securities on the

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largely left Rule 10b-5 jurisprudence in a worse state than before and describing various weaknesses and inconsistencies in the opinion). As indicated *infra* in the text accompanying notes 73-79, the Court in *O'Hagan* tied the misappropriation theory to the statutory requirement of fraud and deceit. As part of its reasoning, the Court also stated that nonpublic information belonging to a corporation is property and equated misappropriation of information to embezzlement. *O'Hagan,* 521 U.S. at 654 (citing *Carpenter*, 484 U.S. at 27). Yet, the Court also reintroduced fairness considerations as a policy rationale for recognizing the misappropriation theory. *Id.* at 668. Justice Ginsburg emphasized that the Exchange Act's "animating purpose" is to insure honest markets and promote investor confidence. *Id.* at 658. Recognizing that some informational disparity is inevitable, she nevertheless opined that investors would be hesitant to trade if the market allowed unchecked use of misappropriated nonpublic information. *Id.* Although *O'Hagan* is often cited as an example of a property-based rationale for insider trading regulation under the misappropriation theory, these passages from *O'Hagan* indicate that the Court may have actually shifted back to an underlying fairness rationale, albeit narrower in scope than the standard set in *TGS. See* Seligman, *supra* note 43, at 18 (equity considerations triumphed in *O'Hagan*). For additional critiques of the *O'Hagan* decision, *see, e.g.,* David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 74-80 (1998) (*O'Hagan* may be example of bad facts leading to bad law); Nagy, *supra* note 59, at 1249-64 (Court reached right result for wrong reasons); *see also* Karmel, *supra* note 28, at 108-13 (analyzing strengths and weaknesses of *O'Hagan* and misappropriation theory generally); *but see infra* note 273-74.

73. *See, e.g.,* Pritchard, *supra* note 66, at 47-48 (explaining that *O'Hagan* is well-grounded in agency law); *see also* Seligman, *supra* note 43, at 22 (misappropriation theory reaches agents who deceive principals). In fact, the misappropriation theory has been expanded beyond the agency context to reach other relationships of trust and confidence. *See infra* notes 82-86 and accompanying text.

74. 521 U.S. at 651-53.

75. Although the misappropriation theory is perhaps most useful in providing a basis for pursuing "outsiders," *i.e.*, persons who do not owe a fiduciary duty to the corporation whose shares are traded or its shareholders, the theory may also be used to impose liability on classic and temporary insiders. *See, e.g.,* SEC v. Yun, 327 F.3d 1263, 1277-78 n.31 (11th Cir. 2003) (nearly all classic insider violations can be characterized as misappropriations); Stevens v. O'Brien Envt'l, Energy, Inc., Fed. Sec. L. Rep. ¶ 90,475 at 3 (E.D. Pa. 1999) (insider who trades or tips likely breaches duty to corporate shareholders and corporation and is therefore liable under either theory).

76. To constitute a violation of Rule 10b-5, the conversion must be tied to the purchase or sale of securities. *See infra* note 78. Paradoxically, the treatment of misappropriation as fraud under § 10(b) ordinarily does not give the victimized source any redress under that section because only purchasers and sellers of securities have standing to sue. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (only purchasers and sellers can maintain private damage action); Pritchard, *supra* note 66, at 45.

basis of misappropriated information *is* a "deceptive device or contrivance" in connection with the purchase and sale of a security under Rule 10b-5, when it involves the secret[77] conversion and use of information for personal gain by a fiduciary pretending loyalty to the source.[78] The *O'Hagan* misappropriation theory, therefore, prohibits secretive trading based on misappropriated nonpublic information in breach of a duty of trust and confidence owed to the *source* of information, rather than to a trading party.

The upshot of the two prevailing theories of insider trading restrictions under Rule 10b-5 is that liability, in each instance, must be based on the existence and breach of a fiduciary or quasi-fiduciary duty—albeit for conceptually different purposes.[79] Proof of the existence of a fiduciary duty is relatively uncomplicated under the classic theory when the defendants are traditional insiders,[80] but proof may be more complicated in the case of temporary insiders.[81] Establishing the existence

77. *O'Hagan*, 521 U.S. at 653. The trading on misappropriated information must take place without the knowledge of the source in order to be a "deceptive device." *Id.* at 655. Because the required deception involves feigning loyalty, a fiduciary can avoid a §10(b) violation by disclosing his or her plan to trade on nonpublic information to the source or sources in rightful possession of the information. *Id.* at 655 n.7.

78. *Id.* at 653. In the guise of prohibiting deceptive behavior, the misappropriation theory is consistent with the language and purpose of § 10(b) and Rule 10b-5, according to the Court. *Id.* at 652. Because the outsider's fraud is consummated and the breach of duty occurs when he or she secretly uses misappropriated information to buy or sell securities, the Court further concluded that trading on misappropriated information is "in connection with the purchase and sale of a security" under Section 10(b). *Id.* at 655-59. For analysis and criticism of Justice Ginsberg's "in connection with" analysis, see, e.g., Bainbridge, *supra* note 53, at 1641 n.242 (contending that the minimal contacts between a fraudulent act and a securities transaction required in *O'Hagan* increases the risk that 10b-5 will usurp much of state corporate law); Langevoort, *supra* note 39, at 1323-25 (suggesting that Justice Ginsberg finds harm to securities investors, but does not adequately explain what that harm is); *see also infra* notes 180-182 and accompanying text.

79. *See* Langevoort, *supra* note 37, at 3 (misappropriation theory, unlike classic theory, is not an investor protection device).

80. There may be some question as to whether all employees are classic insiders. *See, e.g.,* SEC v. Fox, 654 F. Supp. 781, 790-91 (N.D. Tex. 1986) (indicating that lower level employees are not insiders); Brudney, *supra* note 43, at 343 (corporate insiders include "executive" employees). *But see* LANGEVOORT, *supra* note 24, § 3:5 (employees are largest group subject to abstain or disclose rule and should generally be considered agents of the corporation, subject to a duty of loyalty, even at a low level in corporate hierarchy).

81. The Court in *Dirks* indicated that an outsider is treated as a temporary insider only if the corporation expects the outsider to keep nonpublic information confidential and the relationship between the corporation and the outsider at least implies a duty of confidentiality. 463 U.S. at 655 n.14; *see also* SEC v. Lund, 570 F. Supp. 1327, 1402-03 (C.D. Cal. 1983) (CEO, who knew or should have known nonpublic information he received from the CEO of another corporation was confidential and disclosed solely for legitimate corporate purpose, was a temporary insider); Shapiro v. Merill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (managing underwriter was temporary insider of corporate issuer). Mere receipt of confidential information is not enough to impose such a duty. United States v. Reed, 601 F. Supp. 685, 700 n.25 (S.D.N.Y. 1985).

of a fiduciary or quasi-fiduciary duty has been most uncertain and controversial under the misappropriation theory, as the SEC has pushed to expand the classes of persons who are deemed to have a duty of trust and confidence substantially beyond the traditional categories of "true" fiduciaries.[82] The Commission's most recent effort in that regard is the promulgation of Rule 10b5-2,[83] which provides that a duty of trust or confidence exists in three enumerated circumstances.[84] Those circumstances include relationships in which a person agrees to maintain information in confidence, in which there is a history, pattern, or practice of sharing confidences, or in which there are close family ties.[85] These categories do not exhaust the situations in which misappropriation in breach of a duty may occur, but a fiduciary duty cannot be imposed unilaterally simply by entrusting another with confidential information.[86]

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82. The classes of persons who owe duties of trust and confidence that may give rise to misappropriation liability include "true" or "hornbook" fiduciaries such as attorney, executor, guardian, trustee, and agency principal. United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1990). *See, e.g.*, SEC v. Peters, 735 F. Supp. 1505, 1508 (D. Kan. 1990) (relationship of trust and confidence existed between partners). Although some courts have expressed reservations about more open-ended relationships of trust and confidence, the categories of persons deemed to have fiduciary or quasi-fiduciary duties under the misappropriation theory has expanded significantly to include, for example, a psychiatrist. *See, e.g.*, United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) (psychiatrist treating insider's wife had fiduciary relationship and breached by misappropriating nonpublic information). *But see* United States v. Chestman, 947 F.2d at 569-70 (refusing to base criminal liability on less rigorous fiduciary standards arising from equity jurisprudence).

83. 17 C.F.R. § 240.10b5-2 (2005).

84. Specifically, Rule 10b5-2(b) states:

> For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:
>
> (1) Whenever a person agrees to maintain information in confidence;
>
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
>
> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id.

85. *Id.* A person receiving nonpublic information from a spouse, parent, child or sibling is presumed to have a relationship of trust and confidence with that relative, but may rebut that presumption by establishing that no such duty existed. *See id.*

86. *See, e.g.*, United States v. Falcone, 257 F.3d 226, 234 (2d Cir. 2001) (citing *Chestman*,

Proof of breach of a fiduciary or fiduciary-like duty is not, of course, the only required element for establishing liability under Rule 10b-5. When a classic insider or misappropriator trades for his or her own account in breach of a duty to shareholders or the source of information, as the case may be, the government must establish by a preponderance of the evidence[87] that the insider was in possession of material,[88] nonpublic information[89] and acted with scienter.[90] Courts are split as to whether the insider or misappropriator must not only possess the nonpublic information, but must also use that information in determining whether or not to buy or sell securities.[91] In addition to restrictions on their ability to trade for their own

947 F.2d at 567) (duty may not be imposed unilaterally and requires express or implied acceptance); Walton v. Morgan Steanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (duty cannot be imposed unilaterally by merely entrusting nonpublic information).

87. *See, e.g.,* SEC v. Moran, 922 F. Supp. 867, 890 (S.D.N.Y. 1984).

88. In general, information is material if there is a substantial likelihood that a reasonable investor would find it significant in deciding whether to trade in securities. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). For a discussion of materiality standards, see, e.g., Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U.L. REV. 1131 (2003).

89. Information is nonpublic until it has been disclosed in a manner that achieves broad dissemination to the investing public or until trading by a few persons "has caused the information to be fully impounded into the price of the . . . stock being traded." SEC v. Sekhri, Fed. Sec. L. Rep. ¶ 91, 963 at 14 (S.D.N.Y. 2002) (citing SEC v. Mayhew, 121 F.3d 44, 50 (2d Cir. 1997)).

90. In general, cases under Rule 10b-5 require "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193-94 n.12 (1997). Most courts recognize that recklessness constitutes scienter in civil cases, though definitions of what constitutes recklessness vary. WANG & STEINBERG, *supra* note 13, § 4.4.2 at 168-69. In applying these general standards to insider trading cases, courts have taken various approaches. Some courts break the scienter requirements into separate elements. *See, e.g.,* State Teachers Ret. Bd. v. Fluor Corp., 654 F.2d 843, 854-55 (2d Cir. 1981). *See generally* LANGEVOORT, *supra* note 24, § 3:13 (observing that courts have not provided a clear definition of scienter); Carol B. Swanson, *Insider Trading Madness: Rule 10B5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 156-58 (2003) (application of *Hochfelder* scienter standards in specialized insider trading area has led to confusion, dysfunction and precarious interpretation).

91. In some circuits, knowing *possession* of nonpublic information is sufficient for liability under Rule 10b-5. *See, e.g.,* United States v. Teicher, 987 F.2d 112 (2d Cir. 1993) (dicta analyzing why knowing possession test is preferable). Other circuits require proof of use of the information in order to impose liability, but allow a strong inference of use to be derived from proof of trading while in knowing possession of nonpublic information. *See, e.g.,* SEC v. Adler, 137 F.3d 1325, 1338-39 (11th Cir. 1998) (concluding that use test best comports with statutory language and Supreme Court precedent). *But see* United States v. Smith, 155 F.3d 1051, 1069 (9th Cir. 1998) (applying a use test, but refusing to allow an inference of use from mere possession in a criminal case). In 2000, the SEC promulgated Rule 10b5-1 to establish an awareness test akin to the knowing possession standard. 17 C.F.R. § 240.10b5-1. Subject to various affirmative defenses in paragraph (c), Rule 10b5-1(b) provides that "a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." *Id.* As with other

account when these elements are met,[92] classic insiders and misappropriators are forbidden from improperly conveying nonpublic information to others, *i.e.*, "tipping," as discussed in the following section.

II. TIPPER AND TIPPEE LIABILITY

Trading for their own account is not the only means by which classic insiders and misappropriators in possession of nonpublic information may breach a fiduciary or quasi-fiduciary duty and thereby violate Rule 10b-5. They may also breach a duty to shareholders or the source of nonpublic information if they relay the information to or "tip" another person for an improper purpose—whether or not they themselves trade.[93] Moreover, the person receiving the tip may also be liable for violating Rule 10b-5 if she trades securities on the basis of the tip or turns around and tips another person.[94] The general circumstances under which tippee liability arises are the subject of this section.

But first, a digression to discuss terminology. Because many of the general legal standards applicable to tippees are the same regardless of whether the tippee received nonpublic information directly or indirectly from a breaching source, some of the discussion in this article relates to cases involving tippees who received nonpublic information indirectly.

To facilitate keeping track of direct and indirect tippees, this article uses the following terminology. *Primary tipper* is used to refer to a source of nonpublic information who tips in breach of a fiduciary or quasi-fiduciary duty. This term encompasses classic and temporary insiders who tip, as well as misappropriators who tip. A *secondary tipper* is a person who receives nonpublic information directly from a primary tipper and then tips another. A *remote tipper* is a person who receives nonpublic information from a secondary tipper or later tipper in a chain of seriatim tips. Since most insider trading cases involve only primary and secondary tippers, this system reduces the number of instances in which it is necessary to use long phrases to refer to the degree of tippee involvement (e.g., fourth tier indirect tippee).[95]

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aspects of insider trading law, commentators differ over the merits of the possession versus use standards. *See, e.g.*, Swanson, *supra* note 90 (concluding that the Rule 10b5-1 awareness standard imposes liability for misconduct that does not constitute fraud); Donna M. Nagy, *The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129 (1999) (concluding that classic insiders should be subject to the possession test, though other categories of traders may not be).

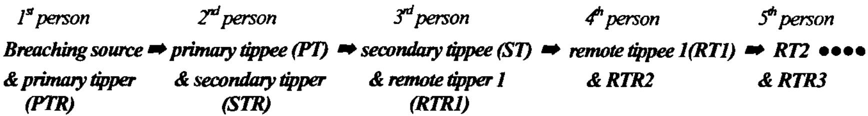
92. In private actions alleging insider trading, plaintiffs must also establish that they incurred losses that were caused by defendants' illegal trades. *See, e.g.*, *In re* Motel 6 Securities Litigation, 161 F. Supp. 2d 227, 242 (S.D.N.Y. 2001).

93. *TGS*, 401 F.2d at 848.

94. *Dirks*, 463 U.S. at 655-56.

95. Because primary and secondary tippees are generally more likely to know the specific identity of the primary tipper/breaching source, the change in terminology also tends to reflect true

Adapting the same system to the recipients of nonpublic information, a *primary tippee* is a person who receives information directly from a primary tipper; a *secondary tippee* is a person who receives information from a secondary tipper; and a *remote tippee* is a person who receives information from a remote tipper. The following diagram illustrates the chain of dissemination of nonpublic information in cases involving tippees.[96]



A. *Direct v. Derivative Theory of Tippee Liability*

When and why should tipping and trading on tips be forbidden? Courts and commentators have advanced different answers. The two principal competing rationales have been a theory of direct liability based on the fairness rationale and a more limited theory of derivative liability based on a duty analysis.[97] The victory of the latter over the former is described below.

Historically, the question of tipper and tippee liability was raised in the very early days of federal insider trading regulation.[98] In the famous *TGS* case,[99] information relating to an impending ore strike was relayed by three insiders directly to at least five primary tippees and indirectly to at least six secondary tippees.[100] On appeal of

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"remoteness" from the source of nonpublic information.

96. At each level, there may be more than one tippee. For example, if a primary tipper tips five friends directly, there are five primary tippers. Where information is passed among a group of friends, particular tippees may receive information both directly and indirectly from a particular tipper in the chain. In those instances, this article classifies the tippee according to the information received directly, rather than indirectly. For example, if the third person in the chain illustrated above received some information from the primary tipper and some information from the secondary tipper, the person is classified as a primary tippee, rather than a secondary tippee.

97. *See Chiarella*, 445 U.S. at 232-33.

98. In *Cady, Roberts*, the defendant in the SEC's administrative proceeding was a primary tippee of a corporate insider. *In re* Cady, Roberts, 40 S.E.C. 907 (1961). In its decision, however, the SEC analyzed the defendant's role under the "special relationship" and fairness analysis described *supra* notes 35-39 and accompanying text. In general, the initial SEC administrative cases alleging insider trading were brought against persons or entities subject to SEC regulation, such as broker-dealers and investment advisers, who received nonpublic information from corporate clients. *See, e.g, id.*; *In re* Investment Mgmt. Co., 44 S.E.C. 633 (1971) (tippees were officers and employees of broker-dealer).

99. *TGS*, 401 F.2d 833. *See supra* notes 41-44 and accompanying text.

100. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 273-75 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 833 (2d Cir. 1968). On various grounds (principally, a perceived lack of materiality), the District Court found that none of the insiders had violated Rule 10b-5 and therefore found it unnecessary to consider whether an insider may be liable for violations of his tippees. *Id.* at 290 n.13.

the trial court's dismissal of the complaint against all but two defendants, the Second Circuit found one of the insider defendants liable for tipping.[101] Because the insider's tippees had not been named as defendants, the court found it unnecessary to decide whether the tippees' conduct violated Rule 10b-5—though the court did note that the tippees' conduct could be equally as reprehensible as the conduct of the insider source.[102] In the course of rendering these remarks, the Second Circuit also indicated, in dicta, that the issue left to be determined was whether the tippees acted with actual or constructive knowledge that the material information they received was not public.[103]

Although the rationale for tippee liability in *TGS* seems to have been based on the subsequently rejected fairness theory, the case is notable here for the presence of two themes that recur in tippee cases. The first theme examined is the use of circumstantial evidence to establish the existence of a tip.[104] The trial court found that one tipper told two primary tippees that TGS stock was "a good buy."[105] Although it could find no direct evidence of other communications between tipper and tippees, the trial court agreed with the SEC's contention that the substantial purchases of TGS stock and options by the primary and secondary tippees were strong circumstantial evidence that the insider/tipper must have relayed more specific information about TGS's resumption of drilling for ore assays to the tippees.[106] The Second Circuit concurred in the lower court's inference that specific information had been relayed by the tipper, but found, unlike the trial court, that the information was material, and its use therefore constituted grounds for holding the insider liable for tipping.[107]

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101. *TGS*, 401 F.2d at 852. The court did not explain the underlying rationale for imposing liability on the tipper. *See id.* at 852-53. As to a second insider/tipper in *TGS*, the court did refer to the tipper's motive, pointing out that he failed to wait until information was widely dispersed and instead "hasten[ed] to insure an advantage [for] himself and [the tippee], his broker son-in-law." *Id.* at 854. Implicitly, the court may hence have been basing liability at least in part on a breach of loyalty arising from self-dealing.

102. *Id.* at 853.

103. *Id.* at 852-53. Thus, the implicit reasoning of *TGS* is that tippees are liable if they are in possession of and trade on the basis of material nonpublic information. This reasoning is consistent with the underlying fairness theory advanced in *TGS*, under which *anyone* in possession of material inside information is potentially subject to the abstain or disclose rule. *Id.* at 848. *See supra* notes 41-44 and accompanying text. As indicated in *supra* note 101, the court's reasoning for holding the tipper liable is not clear.

104. *See, e.g., infra* notes 105-108 and accompanying text.

105. SEC v. TGS, 258 F. Supp. at 284. Implicit in the courts' subsequent inference that more specific information was relayed by the tipper is the assumption that the words "TGS is a good buy" were not sufficient evidence alone to prove that material, nonpublic information was passed on. *Id.*

106. *Id.*

107. *TGS*, 401 F.2d at 852. The second circuit added an additional inference. If the resumption of drilling was to have meaning to the tippees, the court inferred that they must have also been told about the existence of the promising ore-testing site. *Id.*

The other recurrent theme present in *TGS* is the raising of due process arguments at various stages of the regulatory and judicial expansion of 10b-5 liability, as well as the repeated rejection of those arguments.[108] Although they were discussing the broad issue of whether the TGS insiders were precluded from trading (rather than tippee liability), two dissenting justices argued that resolution of the many questions raised in the field of insider trading regulation should be determined by rule-making and should not be applied retroactively.[109]

The dissent observed that "[t]he companies, the securities of which are listed on exchanges, their employees *and investing public alike* should have some knowledge of the rules which will govern their actions. They should not be forced, despite an exercise of the best judgment, to act at their peril or refrain *in terrorem* from acting."[110] The apparent response of the majority was contained in a footnote[111] in which they cryptically observed that even if the insiders were in fact ignorant of the broad scope of Rule 10b-5, that ignorance and mistaken belief as to the applicable law did not insulate them from liability.[112]

Reaffirming and building on the rationale of its fairness-based decision in *TGS*, the Second Circuit in *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[113] reiterated that tippers are liable for relaying nonpublic information to others who then trade.[114] The Second Circuit, in *Shapiro*, also relied on its dicta and reasoning in *TGS* to hold a group of tippees liable for trading on the basis of nonpublic information relayed to them by the tippers.[115] The court held that the tippees knew or should have known of the corporate source and nonpublic nature of the information and were under a duty not to trade without publicly disclosing it.[116] The *Shapiro* case thus helped establish the pre-*Dirks* rule that tippee liability is direct and stems from knowledge that information is non-public.

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108. *See infra* Section IV.

109. *TGS*, 401 F.2d at 875-77 (Moore, C.J., dissenting).

110. *Id.* at 877 (emphasis added).

111. *Id.* at 852 n.15.

112. *Id.* Because the "broad scope" of the rule was not readily apparent until the *TGS* decision itself, the majority's response fails to address the substance of the dissent's concern over retroactive application of new and unclear standards. *See id.* at 875-77.

113. 495 F.2d 228 (2d Cir. 1974) (applying the rule in a private action against non-trading tippers).

114. In *Shapiro*, an officer of Merrill, Lynch who was managing an underwriting of debentures received nonpublic information about an unexpected earnings decline by the debenture issuer. *Id.* at 230. The information passed quickly among other Merrill, Lynch employees and eventually was relayed to Merrill Lynch clients, who sold stock to minimize their losses. *Id.* at 230-33. Emphasizing that the purpose of the abstain or disclose obligation was to ensure that all investors have relatively equal access to information, the court stated that it would frustrate the purpose of the rule to decline to apply it in a private action. *Id.* at 236.

115. *Id.*

116. *Id.* at 237.

More interesting from the standpoint of delineating the debate over the policies underlying tippee liability is *In re Investors Management Co.*,[117] an SEC administrative decision arising out of the same facts as *Shapiro*.[118] Relying again on the fairness theory advanced in *TGS*, the Commission rejected the argument that tippee liability must be based either on the existence of a special relationship between the tippee and the insider or issuer that was the source of nonpublic information or on knowledge of an insider's breach of duty.[119] Instead, the Commission stated that the appropriate test was whether the tippee knew or had reason to know that information received by the tippee was non-public and had been obtained improperly by "selective revelation" or otherwise.[120] Expressly tying liability to the tippee's relationship with the information rather than the source, the SEC observed:

> [O]ne who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions.[121]

The Commission defended what appeared to be a negligence standard in *Investors Management* by pointing to precedent and to considerations of fairness and effective enforcement, as well as the broad remedial purposes of the securities laws.[122] It also explained that the tippee's "reason to know" is determinable from "the surrounding circumstances, including the nature and timing of the information [received]," the manner in which it was acquired, the relationship between the tippee and the source, and the tippee's "sophistication and knowledge of related facts."[123] Although the Commission's underlying fairness rationale was ultimately disavowed by the Supreme Court, aspects of the negligence standard[124] and the focus on circumstantial evidence in tippee cases have survived to the present day.[125]

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117. 44 S.E.C. 633 (1971).

118. *Id.* at 634-37.

119. *Id.* at 644.

120. *Id.* at 641. The knowledge element was part of a three-part test for determining liability under Rule 10b-5 in tipper-tippee cases. *Id.* The other two elements were whether the information relayed was material and non-public and whether the information was a factor in the tippee's decision to effect the transaction. *Id.*

121. *Id.* at 644.

122. *See id.* at nn.23-24. The *Investors Management* decision and the cases cited therein predate the Supreme Court's holding in *Hochfelder* that scienter is required under Rule 10b-5. *See supra* note 90.

123. *Id.* at 644.

124. In reformulating the Commission's test, Commissioner Smith in a concurring opinion tied the knowledge standard to the insider's breach of duty. *See infra* note 127 and accompanying text. The Supreme Court made a similar connection in *Dirks v. SEC*, 463 U.S. 646 (1983). *See infra*

In what turned out to be an influential concurring opinion, Commissioner Smith agreed with the result in *Investors Management*, but objected to the Commission's focus on tying tippee liability to possession of an informational advantage in the marketplace.[126] Commissioner Smith stated that the objective should be to police insiders rather than information, and he proffered an alternative test—whether a tippee knows or has reason to know that material, nonpublic information came into his or her possession as a result of a breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes.[127]

According to Commissioner Smith, such knowledge would make the tippee a participant in the breach of duty at the time he or she acts on the basis of the inside information and would make the test for tippee liability consistent with the evolution of federal regulation of securities fraud, which emphasizes breach of duty.[128] Underlying Commissioner Smith's concern about the purported vagueness[129] of the Commission's fairness approach was a fear that it would penalize or interfere with the quest for information by market analysts and researchers, who perform a valuable function in pressuring corporations to make disclosures, facilitating more informed investing, and prompting more accurate market pricing.[130]

Presaging the ultimate victory of Commissioner Smith's rationale for tippee liability,[131] the Court in *Chiarella v. United States*[132] rejected the fairness rationale as a general basis for liability for fraud under Rule 10b-5, holding that liability for silence must be premised on a disclosure duty arising from a relationship of trust and confidence between parties.[133] Although the defendant in *Chiarella* was not a tippee

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note 151 and accompanying text.

125. *See infra* notes 167-68 and accompanying text.

126. *Id.* at 648 (Smith, Comm'r, concurring). Commissioner Smith contended that the concept of relative informational advantages was too vague to be applied with consistency and that the focus should instead be on insiders and their privies, consistent with common law and other precedents. *Id.*

127. *Id.* at 648, 650. In an alternative formulation, Commissioner Smith stated his belief that tippee liability must be related back to insider conduct by imposing a requirement that the tippee know that nonpublic information was given in breach of a duty by a person having a special relationship to the issuer not to disclose the information. *Id.* at 651.

128. *Id.* at 650. *See supra* note 31.

129. Commissioner Smith contended that the possession standard was overly inclusive. *In re* Investors Management Co., 44 S.E.C. at 649. He pointed out that information advantages are inevitable, although he agreed that the facts in *Investors Management* demonstrated an abuse. *Id.*

130. *Id.*

131. Many aspects of Commissioner Smith's concurring opinion were expressly or implicitly adopted by the Supreme Court in Dirks v. SEC, 463 U.S. 646 (1983). *See infra* note 150 and accompanying text.

132. 445 U.S. 222 (1980).

133. *Id.* at 230.

and was not accused of tipping others,[134] the Court briefly discussed tippees in a footnote to the decision.[135] After stating the holding, but not the rationale, of *Shapiro v. Merrill Lynch*,[136] the Court observed that a tippee's duty to abstain or disclose "has been viewed as arising from his role as a participant after the fact in the [corporate] insider's breach of a fiduciary duty."[137]

The brief dicta in *Chiarella* was not fleshed out until three years later when the Supreme Court directly addressed the scope of tippee liability in *Dirks v. SEC*.[138] In the *Dirks* decision, the Supreme Court reaffirmed its holding in *Chiarella* that there is no general duty to disclose or abstain from trading on inside information and emphasized that any specific duty *must* be based on a fiduciary relationship between shareholders and individuals trading on inside information.[139]

The Court also reiterated that mere possession of inside information does not give rise to the disclose or abstain duty.[140] The Court conceded, however, that its reasoning in *Chiarella* had created "analytical difficulties" for the Commission and courts in their efforts to police tippees who trade on inside information because the

134. Chiarella did not receive a tip from an insider. He pieced together inside information by reviewing confidential documents as part of his job at a financial printer. *Id.* at 224-25. Under current law, he would be viewed as a misappropriator. *See supra* notes 75-79 and accompanying text.

135. *Chiarella*, 445 U.S. at 230 n.12.

136. 495 F.2d 228 (2d Cir. 1974). *See supra* notes 113-15 and accompanying text.

137. *Chiarella*, 445 U.S. at 230 n.12. In support, the Court cited a comment letter by a subcommittee of the American Bar Association Section of Corporation, Banking, and Business Law. *Id.*

138. 463 U.S. 646 (1983). Dirks was a New York investment analyst specializing in insurance company securities. *Id.* at 648. At a meeting, he received non-public information from Ronald Secrist, a former officer of Equity Funding of America, that the insurance company's assets were vastly overstated as a result of massive fraud within the company. *Id.* at 648-49. Dirks conducted his own investigation and obtained corroboration of the fraud from other Equity Funding employees. *Id.* at 649. Although neither Dirks nor the broker-dealer firm of which he was an officer personally owned or traded Equity Funding securities, Dirks relayed non-public information about the fraud to a number of clients and investors over a two-week period. *Id.* Some of the recipients of the information sold substantial holdings of Equity Funding stock before trading in the stock was halted and word of the fraud was publicly disseminated. *Id.* Following a hearing by an administrative law judge, the Commission found that Dirks had aided and abetted in violation of §17(a) of the 1933 Act, §10(b) of the 1934 Act and SEC Rule 10b-5 by relaying material confidential information to investors who later sold their shares of Equity Funding stock. *Id.* at 650-57. In recognition of Dirks' role in exposing the fraud, however, the only penalty imposed on Dirks was censure. *Id.* at 650-51. On appeal, a panel of the Court of Appeals for the District of Columbia Circuit affirmed the SEC's decision. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

139. Dirks v. SEC, 463 U.S. at 654-55. *See supra* notes 45-53 and accompanying text.

140. *Dirks*, 463 U.S. at 656 n.15.

typical tippee has no independent fiduciary duty to a corporation or its shareholders.[141]

In addressing the scope of tippee liability, the Court rejected the SEC's position in *Dirks* that any tippee who knowingly receives confidential information from corporate insiders automatically assumes or inherits a fiduciary duty to disclose the information to shareholders before trading.[142] On the other hand, the Court found the need for a ban on some tippee trading to be "clear" and based that need on a potential gap or loophole that otherwise might allow indirect violations of duty by corporate insiders.[143] Thus, in addition to being forbidden from *personally* using inside information for advantage, insiders as fiduciaries are also precluded from giving such information to an outside tippee "for the same improper purpose of exploiting the information for their personal gain."[144]

To help prevent such indirect violations, transactions of persons who knowingly participate with a fiduciary in a breach of duty are as forbidden as transactions on the fiduciary's own behalf.[145] According to the Court, a fiduciary could otherwise conduct "devious dealings" in the name of others that she could not conduct on her own.[146]

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141. *Id.* at 655.

142. *Id.* at 655-56. The SEC argued that Dirks assumed a fiduciary duty as a result of knowingly receiving confidential information from insiders at Equity Funding. *Id.* As a result of this assumption of duty, Dirks would be prohibited, like the insiders, from trading and from tipping others. *Id.* at 656. Tippees in Dirks' position hence breach their assumed fiduciary duty when they knowingly transmit the inside information to someone who will probably trade on the basis of that information. *Id.* (quoting from 21 S.E.C. Docket 1401, 1410, n.42). The Court construed the SEC's position as an attempt to reintroduce the theory, rejected in *Chiarella*, that the anti-fraud provisions of the securities laws require equal information among all traders. *Id.* Emphasizing again that simply possessing inside information does not trigger the abstain or disclose duty, the Court added that mere receipt of such information from an insider also does not create the requisite "special relationship" between a tippee and shareholders. *Id.* at 656 n.15.

143. *Id.* at 659.

144. *Id.*

145. *Id.* This summary paraphrases the Court's discussion, which draws on general principles applicable to trustees, as discussed in Mosser v. Darrow, 341 U.S. 267, 272 (1951).

146. *Dirks,* 463 U.S. at 659 (citing Mosser v. Darrow, 341 U.S. at 272). *Cf. id.* at 670-71 (Blackmun, J., dissenting) (Court acknowledges that Secrist could not do "by proxy" what he could not do personally); Seligman, *supra* note 43, at 9 (insiders not allowed to use tippees as surrogates or agents). The Court's reasoning—with its focus on indirect or proxy violations by insiders, fear of insider exploitation, and emphasis on tippee participation in the insider's breach for personal gain—implies that the tippee must be part of a co-venture with the insider to consummate a breach of duty. *See, e.g.,* SEC v. Yun, 327 F.3d 1263, 1270 n.15 (11th Cir. 2003) (interpreting "participant after the fact" characterization in *Dirks* as meaning that tippee liability arises when tippee joins tipper in a co-venture to exploit confidential information). *See also* Schein v. Chasen, 478 F.2d 817, 822-24 (2d Cir. 1971), *vacated sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974) (pre-*Dirks* case in which non-trading secondary tipper and two mutual fund tippees were deemed part of "enterprise," "joint venture" and "co-venture" with insider/primary tipper to effect a breach of the insider's fiduciary

The Court's rationale for imposing liability on tippees focused on the tippee's relationship to the insider source of nonpublic information, rather than the use of the information itself. According to the Court, tippees assume a duty to abstain or disclose, not simply because they receive inside information, but because they receive it improperly.[147] Defining what constitutes improper receipt and summing up the tippee's derivative duty in a single two-part rule, the Court, in *Dirks,* stated: "[A] tippee assumes a fiduciary duty to the shareholders . . . to not . . . trade on material nonpublic information *only* when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee *and* the tippee knows or should know that there has been a breach."[148] In short, a tippee's duty not to trade on inside information is derivative of the corporate insider's duty.[149]

Quoting Commissioner Smith's observation that a tippee's duty must relate back to insider responsibility,[150] the Court based ultimate tippee liability on a preliminary and necessary finding that nonpublic information had been disclosed to the tippee in breach of an insider's fiduciary duty.[151] Noting that all disclosures of inside information are not necessarily inconsistent with an insider's duty to shareholders, the Court, in *Dirks,* stated that the test for determining whether the first prong of the two-part test has been met is deciding whether the insider personally will benefit, directly or indirectly, from his disclosure.[152]

The Court conceded that the task of determining whether an insider personally benefits from a particular tip may be difficult, but suggested that courts focus on various objective criteria.[153] As general examples of direct or indirect personal benefit, the Court referred to "a pecuniary gain or a reputational benefit that will translate into future earnings."[154] As a more specific example of facts and

duties to corporate issuer). *But see* LANGEVOORT, *supra* note 24, § 4:7 (active conspiracy between tipper and tippee is not required; concept of "gift" to tippee assumes tippee is passive).

147. *Dirks,* 463 U.S. at 660.

148. *Id.* (emphasis added).

149. *Id.* at 659. Citing *Chiarella,* the Court also characterized the duty to disclose or abstain as arising from the tippee's role as "participant after the fact" in a corporate insider's breach of duty. *Id.*

150. *Id.* at 661. Justice Powell relied heavily on Commissioner Smith's concurring opinion in *In re Investors Management Co.*, 44 S.E.C. 633, 651 (1971) (Smith, Comm'r, concurring), which also based tippee liability on an underlying insider breach of duty. *See supra* notes 127-28 and accompanying text. Justice Powell also shared Commissioner Smith's concerns about the adverse impact of an open-ended fairness theory on the work of financial analysts. *See Dirks,* 463 U.S. at 658-59; *supra* notes 126, 129 and accompanying text.

151. *Dirks,* 463 U.S. at 661. For purposes of applying the test in a variety of contexts, the first inquiry, of course, is whether a particular alleged tipper actually has a duty to keep information confidential. Without a duty, there can be no breach. *See supra* notes 48-53 and accompanying text.

152. *Dirks,* 463 U.S. at 661-62.

153. *Id.* at 664.

154. *Id.* at 663.

circumstances that might justify an inference of personal gain, the Court explained that a relationship might exist between an insider and tippee that would indicate either a quid pro quo from the tippee, or an insider's intent to benefit the tippee.[155] In an apparent third category, the Court added that exploitation of inside information in breach of duty may also exist when insiders make a gift of such information to relatives or friends who then trade.[156] In such instances, the Court stated that "[t]he tip and the trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[157]

Applying the first prong of the two-part test to the facts in *Dirks*, the Court held that neither the primary tipper nor the other insiders at Equity Funding received any monetary or personal benefit from disclosing non-public information to Dirks.[158] Furthermore, the Court found that they did not intend to make a gift of the inside information to Dirks.[159] Rather, the insiders' motive was to expose the fraud.[160] Because the insiders did not breach their fiduciary duty to shareholders, Dirks did not commit a derivative breach and was free to convey the inside information about the fraud at Equity Funding to others without liability under the securities anti-fraud rules.[161]

Because Dirks could not have been a "participant after the fact" in a breach of duty by insiders, the first prong in the *Dirks* test was not met.[162] Hence, the Court did not find it necessary to reach the issue of how to apply the second part of its test for derivative tippee liability—whether the tippee knows or should know of the breach.[163]

B. *Questions Raised by the Prevailing Derivative Theory of Tippee Liability*

After the *Dirks* decision, the law moved from a relatively understandable—albeit potentially over-inclusive—rule to a more complex two-part analysis. The lower courts were then faced with the task of interpreting and applying the new standard.

155. *Id.* at 664.

156. *Id.*

157. *Id.*

158. *Id.* at 665-66.

159. *Id.* at 667.

160. *Id.* at 665-66. In his dissent in *Dirks*, Justice Blackmun complained that the Court had not explained why the good feeling of exposing fraud and the resulting enhancement in reputation were any different from the benefit an insider receives by giving information to a friend or relative. *Id.* at 676 n.13 (Blackmun, J., dissenting). *See also* Jonathan R. Macey, *From Fairness to Contract: the New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 37 n.143 (1984-85) (pointing out that primary tipper's acts could have been motivated by the desire to get a new job and distance himself from fraud or he may have been seeking revenge).

161. *Dirks*, 463 U.S. at 665-66. Dirks was also presumably free to trade for his own account.

162. *Id.* at 667.

163. *See id.* at 660.

One substantial trend in post-*Dirks* litigation has been an exploration of the boundaries of the first prong of the *Dirks* test, particularly the requirement that the tipper act for personal benefit.[164] In general, lower courts have generously applied the already expansive notion of personal benefit inherent in *Dirks*[165] and have eased the standards for both pleading[166] and proving[167] that the primary tipper[168] relayed nonpublic information to a primary tippee for personal gain.

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164. *Id.* at 663.

165. *See, e.g.*, SEC v. Maio, 51 F.3d 623, 633 (7th Cir. 1994) (unless there is some legitimate reason for disclosure, inference that tip was improper gift is "unassailable"); Langevoort, *The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability*, 8 No. 6 INSIGHTS 23, 24 (1994) (*Dirks* allows "fairly amorphous motivations" to establish personal benefit). For the rare case that fails to find personal gain, see SEC v. Maxwell, 341 F. Supp. 2d 941 (S.D. Ohio 2004) (in absence of evidence of pecuniary benefit, history of past favors, or close family or social relationship, court concluded that insider did not tip his barber for personal gain).

166. Several courts have held that specific allegations of personal benefit in pleadings are not required. One court stated, for example, that the "mere fact" of a primary tipper's disclosure of confidential information sufficiently alleges a gift by him, not only to the primary tippee, but also to a secondary and remote tippee. SEC v. Blackman, 2000 WL 868770, at *9 (M.D. Tenn. 2000). One reason given for not requiring specific allegations is that factual circumstances surrounding a tip are not known prior to discovery. *See* Stevens v. O'Brien Environmental Energy, Inc., 1999 WL 310550, at *4 (E.D. Pa. 1999). Another reason is that personal benefit can ordinarily be assumed from the fact of the tip unless there are extraordinary circumstances suggesting the tipper was trying to expose fraud or tipped accidentally or unknowingly. *Id.* at *53. *See also* United States v. Santoro, 647 F. Supp. 153, (E.D.N.Y. 1986), *rev'd*, 845 F.2d 1151 (2d. Cir. 1988) (allegation in indictment that tippee knew of tipper's breach necessarily encompasses charge that tippee knew that tipper was acting for personal gain); United States v. Blackwell, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) (mere allegation in pleadings that insider has disclosed material non-public information suffices to create legal inference that insider intended to provide a gift to the tippee, thus fulfilling the personal benefit requirement). *Cf.* SEC v. Maxwell, 341 F. Supp. 2d 941, 949 (S.D. Ohio 2004) (suggesting that drawing inference of personal benefit from mere allegation of insider disclosure of nonpublic information is inappropriate in deciding motion for summary judgment).

167. Once again, circumstantial evidence is generally employed to establish that the primary tipper was motivated by personal gain in disclosing nonpublic information. *See, e.g.*, SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1994) (evidence of pattern of trading, exchange of past favors, admission by tipper, and failure to offer alternative explanation were sufficient to draw inference of primary tipper's intent to gift primary tippee). Proof of the existence of particular relationships such as close friendships often suffices to establish the personal benefit element. *See, e.g.*, SEC v. Warde, 151 F.3d 42, 49 (2d Cir. 1998) (close friendship between primary tipper and primary tippee allows jury to infer intent to benefit tippee or make gift); SEC v. Rubin, 1993 WL 405428 at *5 (S.D.N.Y. 1993) (evidence of the existence of a customer/broker relationship deemed sufficient alone to create an inference of the customer/tipper's intent to benefit broker/tippee, though other evidence of a quid pro quo and a motive of gratitude also existed). *See generally* LANGEVOORT, *supra* note 24, § 4:6.

168. One court has indicated that there must be proof that secondary and remote tippers relaying information to a remote tippee were motivated by personal gain. *See* SEC v. Palermo, 2001 WL 1160612 *7 (S.D.N.Y. 2001) (indicating that evidence of close friendship was sufficient proof from which to infer a gift to the tippee).

Another significant thread in the post-*Dirks* explication of the law of tippee liability has involved working out the knowledge prong of the *Dirks* test, which raises questions of interpretation and reconciliation with precedents that are unanswered in the *Dirks* opinion itself. Rather than focusing on whether an alleged tippee knew that the information on which he traded was nonpublic, for example, the courts now were faced with the task of developing standards for determining whether the tippee knew or had reason to know that an insider had breached his or her fiduciary duty by relaying the information to the tippee.[169]

One of the first questions posed was how to reconcile what seemed to be a negligence inquiry in *Dirks* with the Court's earlier pronouncement in *Ernst & Ernst v. Hochfelder*[170] that liability for fraud and deceit under Rule 10b-5 must be based on scienter.[171] In some early decisions, the lower courts achieved an apparent reconciliation between *Hochfelder* and *Dirks* by reframing the inquiry to focus on whether the tippee knew or was reckless in not knowing that there was a breach of duty by an insider.[172] But other courts continued to apply the standard from *Dirks* that allowed liability if the tippee had reason to know of a breach of duty.[173]

169. It is not necessary that the tippee owe a duty to the tipper or to the corporate issuer. SEC v. Lambert, 38 F. Supp. 2d 1348, 1351 (S.D. Fla. 1999) (no duty to tippee); SEC v. Maio, 51 F.3d 623, 633 (7th Cir. 1995) (no duty to corporation).

170. 425 U.S. 185 (1976).

171. *See supra* note 90. It is not clear why the Court in *Dirks* used an apparent negligence standard for determining a tippee's knowledge of a tipper's breach of duty. There is some indication from Justice Powell's heavy reliance on Commissioner Smith's concurring opinion in *Investors Management* that the Court may have simply adopted the "reason to know" language without focusing on scienter. *See supra* notes 121 & 127 and accompanying text. *But see* LANGEVOORT, *supra* note 24, § 4:8 ("reason to know" standard may not be a scienter standard, but may simply be a way of determining whether tippee should be subject to fiduciary abstain or disclose obligation in first instance). In general, the Court appears to have believed that a scienter inquiry was unnecessary in *Dirks* because there was no proof of an underlying breach of duty by the tipper on which to base liability in the first instance. *Dirks*, 463 U.S. at 663 n.23.

172. *See, e.g.*, SEC v. Lambert, 38 F. Supp. 2d 1348, 1351 (tippee is liable only when inside tipper breached a fiduciary duty in disclosing material non-public information and tippee knew or recklessly disregarded the fact of tipper's breach); SEC v. Trikilis, 1992 WL 301398 (D.C. Cal. 1992) (SEC must prove defendants knew information was private and obtained in breach of duty or they recklessly disregarded possibility). *See also* SEC v. Sekhri, 2002 WL 31100823 at *12 (S.D.N.Y. 2002) (concluding that primary and secondary tippees knew or were reckless in not knowing that primary tipper provided them with confidential information in breach of tipper's duty to employer).

173. *See, e.g.*, SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1998) (court must find sufficient evidence to support finding that primary tippee knew or should have known that primary tipper violated a relationship of trust by relaying nonpublic information); SEC v. Maio, 51 F.3d 623, 633 (7th Cir. 1994) (tippee had derivative duty if he knew or should have known that primary tipper had provided nonpublic information in violation of fiduciary duty to corporation). The tippee's knowledge element does not have to be plead with particularity. *See* SEC v. Blackwell, 291 F. Supp. 2d 673, 696 (S.D. Ohio 2003).

A further question raised under the *Dirks* knowledge prong is what type of knowledge a tippee must have. *Dirks* states that a tippee must know or have reason to know of the primary tipper's breach of duty and specifically defines breach of duty as disclosure for direct or indirect personal gain.[174] However, most lower courts applying the *Dirks* test have failed to address whether a tippee knew or had reason to know of a primary tipper's direct or indirect personal gain and have spoken only generally of knowledge of breaches of trust or duty.[175] Other courts have further downplayed the requirement of knowledge of breach of duty by repeating or emphasizing that information has been obtained "improperly."[176] Certainly a requirement that the tippee know the legal characterization of the tipper's acts as a "breach of duty" would be unworkable. But a generalized focus on knowledge of "improperly" obtained information could allow liability to be based on improper acts that involve no actual breach of duty by insiders. Although this may or may not be a desirable result, it is inconsistent with the thrust of the *Dirks* opinion to narrow the scope of insider trading regulation.[177]

A third and still-evolving aspect of post-*Dirks* case development has been the application of *Dirks* to misappropriation cases. Courts considering the misappropriation theory before the *United States v. O'Hagan*[178] decision quickly decided that tippees of misappropriators were subject to the two-part *Dirks* test, with some modifications.[179] Following *O'Hagan*, lower courts attempted to integrate the *Dirks* test for tipper/tippee liability with the *O'Hagan* version of the misappropriation theory; but the different conceptual bases of the two Supreme Court decisions created new questions and tensions.[180] The *O'Hagan* decision, for example, stated that a

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174. *Dirks*, 463 U.S. at 660-62. *See supra* notes 148 & 152 and accompanying text.

175. *See, e.g.*, cases cited *supra* note 173; *see also* SEC v. Thrasher, 152 F. Supp. 2d 291, 299 n.6 & 304 (S.D.N.Y. 2001) (SEC does not have to prove remote tippee knew for certain how initial breach of fiduciary duty occurred; to require proof that tippee knew details of primary tipper's involvement would insulate many remote tippers from liability). *But see* State Teachers Ret. Bd. v. Fluor Corp., 592 F. Supp. 592, 594-55 (S.D.N.Y. 1984) (jury instructed to find whether tippee knew or had reason to know information was material and nonpublic and knew or had reason to know tipper communicated information for direct of indirect personal gain). The reason to know standard has also been interpreted broadly to mean tippee awareness that information is confidential. *See* SEC. v. Yun, 327 F.3d 1263, 1269 (11th Cir. 2003).

176. *See, e.g.*, SEC v. Maio, 51 F.3d 623, 633-34 (7th Cir. 1994) (after initially stating that issue is whether tippee knew or should have known that primary tipper provided nonpublic information in violation of fiduciary duty, court repeatedly refers to knowledge that disclosure was "improper"); SEC v. Musella, 748 F. Supp. 1028 (S.D.N.Y. 1989) (issue is whether tippee knew or should have known that he was trading on "improperly" obtained inside information).

177. *See infra* notes 245-49 and accompanying text.

178. 521 U.S. 642, 652 (1997).

179. *See, e.g.*, LANGEVOORT, *supra* note 24, § 6:13.

180. *See supra* notes 72 & 79.

misappropriator who trades on nonpublic information does so "in connection with" the purchase or sale of securities because the misappropriator's breach of duty to the source of the information is consummated when the misappropriator trades secretively.[181] This analysis raises conceptual problems when the misappropriator tips but does not trade, because the secretive conduct does not coincide in time with the tippee's securities transaction.[182]

Although this and other aspects of tippee liability are still in dispute,[183] the parameters of the *Dirks* test are clearer now than they were in 1983 when the case was decided. Moreover, the general impact of judicial interpretation of *Dirks* by the lower courts has been to broaden the test to the point that there has been an implicit return to a fairness-based rule.[184] Under this view, advanced by Professor Langevoort in 1994, the advent of the misappropriation test and the lower courts' expansive application of the *Dirks* personal benefit and tippee knowledge requirements[185] have led to the de facto demise of *Dirks*—at least insofar as that decision promised a more rigorous and predictable structure for analyzing tipper/tippee liability. Although a less stringent stance can be defended as an attempt to reach a more equitable result from the standpoint of other investors in the market,[186] it has raised concerns as applied in cases involving remote tippees, as discussed in the next two sections.

C. *The Application of the Dirks Test to Remote Tippees*

The "participant after the fact" language and the underlying policies in *Dirks v. SEC*[187] indicate that tippee liability would require some form of co-venture with the insider or misappropriator who breached a duty by disclosing nonpublic

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181. *See O'Hagan,* 521 U.S. at 653.

182. *See* Nagy, *supra* note 59, at 1259-64.

183. In another unsettled area, courts have split over the question whether proof of personal benefit under the first prong in *Dirks* is required in misappropriation cases. In SEC v. Sargent, 229 F.3d 68, 76-77 (1st Cir. 2000), for example, the court discussed a number of pre-*O'Hagan* misappropriation cases and concluded that the Second Circuit probably would not require a showing of tipper benefit as a prerequisite for tipper or tippee liability in a misappropriation case. Expressing concern that omitting the tipper benefit requirement could allow an end-run around *Dirks* when the misappropriation theory is used against classic insiders, the Eleventh Circuit held that the SEC must prove that a misappropriator expected to benefit by tipping another. SEC v. Yun, 327 F.3d 1263, 1275-79 (11th Cir. 2003).

184. *See* Langevoort, *supra* note 165, at 23-24

185. *See id.*; *see also* Bainbridge, *supra* note 30, at 1198 (SEC and lower courts viewed fiduciary duty as "mere minor inconvenience" and sought to evade spirit of fiduciary-based rule).

186. *See* Langevoort, *supra* note 165, at 26 (observing that notice and predictability have taken second place behind the goal of "sanction[ing] trading that involves exploitation of status or connections, rather than skill, diligence or even luck").

187. 463 U.S. 646 (1983).

information.[188] Such a co-venture is relatively easy to ascertain when looking at the relationship between the primary tipper, the primary tippee, and most secondary tippees.

As tips pass down a chain of tippees and spread out to "friends of friends," it becomes increasingly likely that a remote tippee will not know the identity of the primary tipper or the primary tippee, much less whether the tipper actually disclosed nonpublic information to the primary tippee for personal gain. It also becomes less likely that the primary tippee intended, or even foresaw, that the remote tippees would receive and trade based on the same tips as the primary tippee.[189] Therefore, following *Dirks*, the question arose whether the lower courts would construe the co-venture concept strictly, consistent with Justice Powell's purpose in retracting the scope of the abstain or disclose duty, or whether the courts would stretch the concept of a co-venture in order to impose liability on remote tippees.

The answer to this question became apparent in *SEC v. Musella*,[190] three related cases illustrating how complex a web can be formed by a spreading group of tippees. The center of the tippee web was Alan Ihne (PTR), manager of office services at Sullivan & Cromwell (S&C), a major New York law firm.[191] Over the course of several months, Ihne misappropriated and disclosed nonpublic information about several acquisitions involving S&C clients to his friend, Joseph Palombo (PT), and to James Stivaletti (PT/STR), who was Palombo's stock broker.[192] In accordance with an agreement among the three, Stivaletti directed securities trades based on the information he received.[193]

Concerned about using his own account for continued trading, Stivaletti recruited Dominick Musella (ST/RTR1), the brother of Stivaletti's college classmate, who agreed to trade stock as directed and split the profits.[194] Musella, in turn, tipped his friend and broker, Albert DeAngelis (RT1/RTR2), who, in turn, tipped John Malizia (RTR2), the son of a close friend.[195] In the meantime, James Stivaletti (PT/STR) and

188. *See supra* notes 142-44 and accompanying text.

189. None of the Supreme Court's insider trading cases, including *Dirks*, refer specifically to remote tippees. *Dirks* focuses on primary tippees, who know the identity of the primary tipper and are generally in a position to know or ascertain the primary tipper's motive. *Dirks*, 463 U.S. at 654-61.

190. 578 F. Supp. 425 (S.D.N.Y. 1984) (Musella I) (action for a preliminary injunction against two defendants); 678 F. Supp. 1060 (S.D.N.Y. 1988) (Musella II) (finding two remote tippees liable for insider trading on summary judgment); 748 F. Supp. 1028 (S.D.N.Y. 1989) (Musella III) (finding remote tippee liable for insider trading).

191. *Musella III*, 748 F. Supp. at 1031.

192. *Id.* at 1031-32.

193. *Id.* at 1032-33.

194. *Id.* at 1031-32. Stivaletti refused to give Ihne's name to Musella; Musella therefore began to call Stivaletti's mysterious source, "The Goose that Laid the Golden Egg." *Id.*

195. *Id.* at 1033-34. Exchanges of nonpublic information took place over time concerning several different S&C clients, and not all defendant/tippees participated in every exchange. *Id.* at

Dominick Musella (ST/RTR1) both tipped John Musella (RT1/RTR2), who was James' client and Dominick's brother.[196] John Musella, in turn, tipped two friends, Edward O'Neill (RT1/RTR2) and Richard Martin (RT1/RTR2), who were both police officers.[197] O'Neill then tipped his broker, Roger Rowe (RT2).[198] In a separate chain of tips, Ihne (PTR) also conveyed nonpublic information about S&C clients to his close friend, James Covello (PT/STR), who tipped his brother Daniel (ST).[199]

In *Musella I*, the SEC sought a preliminary injunction against the Covello brothers.[200] Faced first with defense arguments surrounding the defendants' refusal to respond to SEC questions posed during depositions based on the assertion of their Fifth Amendment privilege against self-incrimination, the trial court pointed to the SEC's inherent difficulties in obtaining proof in civil actions for insider trading.[201] Acknowledging that its decision on the issue might tip the balance, the court nevertheless held that defendants' refusal to testify and produce requested records was a factor for consideration by the court from which it could, and should, draw an adverse inference.[202]

The court then proceeded to weigh other circumstantial evidence against the defendants, including the suspicious timing and patterns of their trades, the close friendship between the defendants and Ihne, the large amounts of money invested, and the fact that defendants only purchased stocks of corporations that were described in Ihne's tips.[203] Based on that evidence, the court concluded that both James Covello and Daniel Covello knew or should have known that the information received from

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1032-35.

196. *Musella II*, 678 F. Supp. at 1061.

197. *Id.*

198. *Id.* at 1061-62. Hence, in the Musella group, there were two primary tippees, two secondary tippees, three RT1s, and two RT2s. There were also two primary tippees in the Covello group.

199. *Musella I*, 578 F. Supp. 425 (S.D.N.Y. 1984).

200. *Id.* at 427.

201. *Id.* at 429. While the civil injunctive action was pending, there was a parallel grand jury investigation exploring criminal charges against defendants. *Id.* at 429-31.

202. *Id.* at 429.

203. Before reaching the facts, the court rejected the SEC's contention that Ihne owed a fiduciary duty to shareholders of the corporate targets whose shares were traded as required under footnote 14 of the *Dirks* decision. *Musella I*, 578 F. Supp. at 436-39. *See supra* note 51 and accompanying text. The court agreed, however, with the contention that Ihne owed a fiduciary duty to his employer, S&C, and its clients, not to trade on the basis of misappropriated market information. *See Musella I*, 578 F. Supp. at 436-39. Although the analysis is somewhat confusing, the court then proceeded without explanation to apply the *Dirks* two-part test for derivative tippee liability, basing the requisite breach of duty on the misappropriation theory. *Id.* at 439.

Ihne was improperly obtained.[204] Accordingly, the court granted the SEC's motion for a preliminary injunction.[205]

In *Musella III*, the SEC moved for summary judgment against two remote tippees in the Musella group of defendants: Edward O'Neill (RT1/RTR2) and Richard Martin (RT1/RTR2).[206] In response to defense arguments, the court acknowledged that O'Neill and Martin did not know Ihne, the primary tipper, nor did they know Palombo (PT) or Dominick Musella (ST).[207] Based on various admissions by the defendants and inferences drawn from circumstantial evidence,[208] the court concluded that the defendants were trading on the basis of nonpublic information and not their brokers' recommendations.[209] The harder question, according to the court, was whether defendants knew or should have known that whoever the insider source was, he had breached a fiduciary duty.[210]

The court, again, adduced circumstantial evidence to infer such knowledge.[211] The evidence on which the court placed the greatest emphasis was the fact that defendants made the deliberate decision not to ask their tipper, Musella, about his confidential sources.[212] The court stated that it could not accept that a conscious avoidance of knowledge defeats scienter in a stock fraud case, and that to hold

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204. *Id.* at 442-43. With respect to James Covello, the court found strong proof of scienter based on his professional status. As a bond trader, he was deemed to be familiar with the secrecy surrounding corporate acquisitions and the duties of confidentiality imposed by law firms on their employees. *Id.* at 442. The court found the proof of Daniel Covello's scienter "somewhat more conjectural," but concluded that the circumstances surrounding his trades, his general sophistication as an investor, and other evidence indicated that he knew or should have known he was trading on improperly obtained information. *Id.*

205. *Id.* at 445.

206. *Musella II*, 678 F. Supp. at 1061.

207. *Id.* at 1062. Defendants knew Stivaletti (PT), but had "severed connections" with him before trading. *Id.* Both defendants did acknowledge that they believed John Musella's (ST/RTR1) recommendations were based upon confidential non-public information. *Id.* As indicated in the hypotheticals in the following section, such knowledge alone does not necessarily mean that the information was the result of a breach of a fiduciary duty. *Id.* O'Neill also admitted, however, that they felt John Musella could be receiving inside information. *Id.* Moreover, the defendants' actions, including spreading their trades through several accounts and insisting on payments in a sufficiently small amount to avoid bank reporting requirements, indicated "they were aware they had tapped into a pipeline of non-public information, did not wish to interrupt the flow, and did not want their source to become known. *Id.* at 1063.

208. *See supra* note 202.

209. *Musella II*, 678 F. Supp. at 1063-64.

210. *Id.*; *see also Musella III*, 748 F. Supp. 1028, 1038 n.5 (remote tippee on notice to question source of information; conscious avoidance does not defeat scienter).

211. *Id.* at 1063. The circumstantial evidence included the fact that defendants were experienced investors and knew of the ban against insider trading. *Id.* The court was also likely influenced by the fact that the tippees in *Musella I* and *II* received a number of tips, indicating that more than simple good luck or coincidence was involved. LANGEVOORT, *supra* note 24, § 4:10.

212. *Musella II*, 678 F. Supp. at 1063.

otherwise would subvert the insider trading laws.[213] Having concluded that the SEC had met its burden of proof, the court granted summary judgment against the remote tippees.[214]

The *Musella* cases demonstrate the courts' strong deference to the SEC's proof problems by allowing heavy reliance on circumstantial evidence for proof of knowledge[215] and inferences of liability from assertion of constitutional privilege. The court's refusal to require knowledge of the identity of the primary tipper in *Musella II* indicates particular deference to the SEC's inherent proof problems in remote tippee cases.[216] Moreover, the *Musella* cases indicate that remote tippees have a duty to inquire and investigate in order to determine whether information may be tainted by a breach of duty. In the interim, they must arguably abstain from trading.[217] This leads to the dilemma illustrated in Section III.A.

Before addressing that dilemma, however, one additional issue relating to remote tippees bears noting. The more remote a tippee is from the primary tipper and tippee, the more likely it becomes that the information received by the remote tippee is less specific and less accurate[218] than the information that was originally possessed or

213. *Id.*

214. *Id.* at 1064.

215. *See also* SEC v. Palermo, 2001 WL 1160612 *5-6 (S.D.N.Y. 2001) (substantial investments, failure to ascertain source of information, parallel trading with tipper, lack of credible explanation, and subsequent tips to relative and friends constitute circumstantial evidence that remote tippee knew or suspected he improperly obtained nonpublic information).

216. *See also* SEC v. Thrasher, 152 F. Supp. 2d 291, 299 n.6 & 304 (S.D.N.Y. 2001) (liability is not predicated on trader's knowledge of insider's identity; to require proof that tippee knew details of primary tipper's involvement would insulate many remote tippers from liability). *But cf.* Prime Mkts. Group v. Masters Capital Mgmt., 2003 WL 21031965 *3 (N.D. Ill. 2003) (although plaintiffs are not required to identify specific persons who tipped, evidence that alleged primary tippee's trading was atypical is not sufficient alone to prove he was tipped by someone who breached a fiduciary duty).

217. *See* LANGEVOORT, *supra* note 24, § 4:10. Professor Langevoort observes that the "real question" for remote tippees is what to do on receipt of new information that may be tainted by breach of duty. *Id.* He notes that it is difficult and probably futile to investigate sources of rumored information. *Id.* While members of the public may be in a position to abstain from trading out of prudence, investment professionals would not be able to operate if forced to abstain from trading in their rumor-filled world. *Id.* Nevertheless, an SEC commissioner and his counsel have indicated that the "safest" route is not to trade while in possession of nonpublic information. *See* Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 353-54 (1988).

218. In SEC v. Platt, 565 F. Supp. 1244, 1250, 1259 (W.D. Okla. 1983), for example, relatively specific information conveyed to the primary and secondary tippee by an insider (PTR) about a proposed liquidation of an oil and gas corporation and the retention of an investment bank to handle the transaction transmuted into more general statements about intent to buy and "something" that was "going to happen" when conveyed to a remote tippee (RT1). In SEC v. Thrasher, 152 F. Supp. 2d 291, 299 (S.D.N.Y. 2001), a remote tippee (RT1) was given false information concerning the source and details of information

conveyed by the primary tipper.[219] This process has been anecdotally compared to the children's game of "telephone,"[220] but the attenuation in accuracy and specificity of information as it passes from one person to another has also been demonstrated in academic studies involving hearsay evidence and the psychology of rumors.[221] Courts have recognized this phenomenon and have generally considered it in the context of determining whether a tippee has knowingly received material, nonpublic information.[222] Thus, the remote tippee's apparent duty to inquire is further complicated by the necessity of determining when information is sufficiently specific and accurate so as to be material and raise suspicions that it emanated from a tainted source,[223] not from general market-place rumors.[224]

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concerning a proposed merger. *See also infra* note 220.

219. Moreover, the dissemination of nonpublic information through webs of remote tippees may eventually lead to *widespread* rumors, such that the impact of the information is assimilated into the price of the securities being traded. *See generally* United States v. Libera, 989 F.2d 596 (2d Cir. 1993) (information may be public even if small number of persons possess it, provided that their trading causes the information to be fully impounded into the price of the traded stock); Wang & Steinberg, *supra* note 13, § 4.3.2 (discussing when information becomes public).

220. *See* Harvey L. Pitt & Karl A. Groskaufmanis, *Family Ties, Tippees and the Chestman Decision: Time for a Principled Definition of Insider Trading*, 4 No. 7 INSIGHTS, *7 (1990).

221. William C. Thompson and Maithilee K. Pathak, *Empirical Study of Hearsay Rules: Bridging the Gap Between Psychology and Law,* 5 PSYCHOLOGY, PUBLIC POLICY & LAW 456, 464-65 (1999) (describing key studies and concluding that "the notion that information can be degraded and distorted as it is passed from one person to the next is well established and uncontroversial").

222. Although it did not involve a remote tippee, the most frequently cited case is SEC v. Monarch Fund, 608 F.2d 938 (2d Cir. 1979), in which an investment advisor (an alleged PT) for two family investment partnerships heard rumors that a corporation was seeking private financing. After receiving general verification from several outside sources, the advisor contacted a director of the corporation, who reported that the company was working on the financing and expected it to be completed shortly. *Id.* at 939-40. Observing that the ability to find a violation of the securities laws diminishes in proportion to the degree that the disclosed information is so general that the possessor is still incurring a substantial economic risk, the Second Circuit found that the information disclosed to the investment advisor lacked basic elements of specificity in that he was told no details about the proposed financing. *Id.* at 942. The court thus held that the lower court erred when it found that the investment advisor knew or had reason know that the information received was non-public and had been obtained improperly. *Id.* at 941. *Monarch Fund* was cited with approval, but was distinguished, in *SEC v. Thrasher*, which held that although a remote tippee was given some general information and some inaccurate details about merger discussions, the "essence" of the information disclosed to him about merger negotiations was material and nonpublic. 152 F. Supp. at 299. *See supra* note 216.

223. This inquiry is further complicated in misappropriation cases by the fact that information often passes through several hands before it is misappropriated. In United States v. Chestman, 947 F.2d 551, 555 (2d Cir. 1991), for example, the president of a corporation

III. THE DILEMMA OF THE REMOTE TIPPEE

The position of the remote tippee under federal insider trading laws has long been recognized as one of the more "vexing" areas for determining appropriate treatment.[225] Among other things, remote tippees test the limits of the fiduciary-based rationale for prohibiting insider trading because the more remote a tippee is from the primary tipper who breached a duty by tipping for personal gain, the more likely that the tippee is being prosecuted for mere possession of confidential information because of the absence of the requisite knowledge of the breach of duty or because of weaknesses in the personal benefit analysis, or both.[226]

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told his sister about the pending sale of the corporation, offered to tender her shares along with his, and explained that the information about the sale was confidential and should not be discussed. The sister told her daughter, warning her not to tell anyone except her husband. The daughter told her husband, warning him that he should not tell anyone else. *Id.* The husband then called his broker, Chestman, and told him he had definite, accurate information that the corporation was about to be sold for an above-market price. Chestman, who knew that the husband was related to a corporate insider, then bought shares in the corporation for his own account. *Id.* Initially, a Second Circuit panel held that there was no evidence that Chestman had actual or constructive knowledge that the husband was breaching a confidential relationship by imparting knowledge. 903 F.2d 75, 79 (2d Cir. 1990). The court noted that it was impossible to attribute knowledge of confidentiality "in view of the attenuated passage of the information" and without evidence the information retained confidentiality in the husband's hands. *Id.* After an *en banc* hearing, the Second Circuit ultimately decided that the evidence did not support a finding that the husband owed a fiduciary duty of confidentiality or "its functional equivalent" to his wife or her family. *Id.* at 570-71. It was therefore unnecessary to reach the question of Chestman's knowledge. Because the husband did not breach a duty by disclosing this information, Chestman could not be derivatively liable as a tippee and his conviction under Rule 10b-5 was reversed. *Id.* at 571. Although commentators have referred to Chestman as a remote tippee, this characterization is potentially confusing since Chestman's liability, if there had been any, derived from the husband who was his immediate tipper. *See, e.g.*, Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 213-14 (1991) (characterizing Chestman as a remote tippee, but explaining why he could not be prosecuted under the classic theory). Under the terminology and analysis in this article, Chestman would have been a primary tippee, rather than a remote tippee.

224. *See* LANGEVOORT, *supra* note 24, § 4:10 (explaining that it is difficult and probably futile to investigate sources of rumored information); *see also* Fisch, *supra* note 223, at 248-49 (noting that it is impractical and perhaps inefficient to require tippees to analyze the source of information to determine whether "somewhere up the chain of information" a misappropriation or breach of fiduciary duty occurred); Janet E. Kerr & Tor S. Sweeney, *Look Who's Talking: Defining the Scope of the Misappropriation Theory After United States v. O'Hagan*, 51 OKLA. L. REV. 53, 79 (1998) (concluding that it is impracticable and often impossible for a remote tippee to investigate every piece of information prior to trading).

225. *See* Pitt & Groskaufmanis, *supra* note 220, at 7, 8.

226. By the time the information reaches the remote tippee, there may also be serious

On the other hand, gaps in the duty-based rationale also lead to the result that remote tippees, who are, arguably, equally culpable because they participated in "improper acts," will be treated differently because of the identity of the primary tipper. From the standpoint of the would-be trader who is several degrees removed from the source of information, this leads to the remote tippee's dilemma—whether to trade and risk the possibility that the original source, or primary tipper, breached a duty, or whether to refrain from trading and risk foregoing a profit or avoiding a loss in a transaction that would have been legal. This section first examines several hypotheticals in order to demonstrate these points. Proposed solutions to the remote tippee dilemma are then discussed.

A. *The Differing Treatment of Remote Tippees in Different Circumstances*

Four hypothetical fact patterns developed from insider trading literature to illustrate the remote tippee dilemma. First, it is widely assumed that persons who accidentally stumble across nonpublic information are not liable under either the classic or the misappropriation theory for trading on the basis of that information or for tipping others.[227] Assume, then, that Jack, an executive and a classic insider at X Corporation, gets on an elevator[228] on the eightieth floor of a large office building, accompanied by his friend and co-worker, Max. Riding along with them is Susan, who got on the elevator on the eighty-eighth floor and is standing next to Jack and Max. Susan does not work for X corporation, but knows several employees who do. She recognizes that Jack and Max entered the elevator from an X Corporation floor and recalls seeing the two men on the elevator on other occasions (though she does not know their names). During a two-minute elevator ride, Susan overhears Jack quietly tell Max that he has been working incredible hours on a "hush-hush" multi-million dollar contract with Toyota that is scheduled to be signed in Tokyo in two days, and he expects the value of his X Corporation stock options to sky-rocket when the news gets out. Jack further tells Max that he needs Max to cover for him at the office while he is away in Tokyo. Max and Susan get off the elevator on the first floor and Bob, another friend of Jack's, steps on the elevator and rides with Bob down to the parking garage. Jack tells Bob the same story he told Max.

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questions as to whether the information has the requisite accuracy and specificity to be considered material, nonpublic information in the first instance.

227. *See, e.g.*, SEC v. Switzer, 590 F. Supp. 756, 766 (W. D. Okla. 1984) ("tippee" who inadvertently overheard insider relate nonpublic information to his wife did not acquire or assume fiduciary duty to corporate issuer's shareholders); LANGEVOORT, *supra* note 24, § 1:12.

228. The basic elevator example, much embellished here, is borrowed from LANGEVOORT, *supra* note 24, § 1:12.

As they leave the building, Bob (PT/STR)[229] and Susan (PT/STR) pull out their cell phones and call their spouses to tell them what they learned from Jack (PTR). Bob's spouse (ST/RTR1) tells her dentist (RT1/RTR2), who tells a golfing buddy (RT2/RTR3), who tells his father (RT3/RTR4), who tells his friend, Marilyn (RT4), who buys X Corporation stock (as does Bob, his spouse, and the other tippees in the chain). At the same time, Susan's spouse (ST/RTR1) tells a neighbor (RT1/RTR2), who tells a close friend (RT2/RTR3), who tells a sister (RT3/RTR4), who tells a friend and co-worker, Michael (RT4), who buys X Corporation stock (as do Susan, her spouse, and all of the tippees in the chain).

In each case in which the nonpublic information was passed along, the recipient was told the information was confidential, yet he or she nevertheless proceeded to buy substantial amounts of X Corporation stock shortly after the conversation in which the information was discussed. In each case, the recipient had never before traded in X Corporation stock. When an SEC investigator contacts Michael (RT4) and Marilyn (RT4), each initially denies having bought any stock and then, when faced with proof, recants.

Assuming that Jack relayed the information to Bob about the contract as a "gift," Jack has breached a duty owed to X Corporation shareholders and is liable as a primary tipper, even if he does not trade himself.[230] Bob is liable as a primary tippee if he knows or has reason to know of the breach—knowledge that may be inferred from his friendship with Jack, the timing of his trades, the amount of money invested, and the fact that he has made an unusual first-time purchase for which he has no credible alternative explanation.[231] Using similar circumstantial evidence, each recipient of information in the chain of tippees may be inferred to have knowledge of Jack's breach of duty.[232] In Marilyn's case, the added evidence of her attempt at concealment will bolster the inference of knowledge, even though she has received the nonpublic information sixth-hand from the source.

229. For an explanation of the meaning of primary tipper, PT and similar terms and abbreviations being used in this section, see *supra* notes 95-96 and accompanying text. For purposes of these hypothetical fact patterns, the word tippee is being used in a very broad sense to mean a recipient of nonpublic information, without regard to whether the recipient's possession or use of the information is technically legal or not.

230. *See id.*

231. *See supra* notes 121-25 and accompanying text.

232. As the information moves down the chain of tippees, however, the evidence of a close relationship with the primary tipper typically attenuates and then disappears from the mix of circumstantial evidence. For example, whereas the circumstantial evidence against Bob includes his friendship with Jack, the direct and circumstantial evidence against Marilyn (RT4) and her father (RT3) may well indicate they had no knowledge of Jack's identity or position at X Corporation. Depending on what was said and whether they are part of a group of friends consisting of Jack, Bob and Bob's spouse, the dentist (RT1) and his golfing buddy (RT2) may also be unaware of Jack or his position as an insider.

Under current law, by contrast, Jack is *not* liable for tipping Susan because his disclosure to her was inadvertent.[233] Jack's arguable breach of a duty of care to X corporation through his negligent disclosure in the elevator does not appear to be a basis for imposing direct liability on Jack for tipping or for imposing derivative liability on Susan for trading and tipping others.[234] With no basis for derivative liability, none of the tippees in the chain is liable for trading or tipping. Michael, the last tippee, is not derivatively liable—even though the timing of his trades, the amount, the unusual nature of the purchase, and the attempt at concealment are as indicative of "guilty" knowledge that the source of the information is "improper" as is Marilyn's behavior and the circumstances surrounding her trade. However, under current law, Marilyn is liable for insider trading and Michael is not.[235]

If facts are added such that the SEC is unable to clearly identify the primary tipper but has circumstantial evidence that the disclosure of nonpublic information came from an insider on the eightieth floor, the odds rise that Michael will also be inferred to have knowledge that the information was disclosed in breach of a duty by an unidentified insider—even though the information actually came from Susan, an eavesdropper. In that instance, Michael risks liability for a trading decision that he had a right to make. Even if he ultimately prevails, Michael faces a stressful and expensive investigation, and may find himself under pressure to settle by disgorging any profit rather than take the risk that a jury will not find his explanation credible in light of the circumstantial evidence surrounding his trades.

In both Michael's and Marilyn's cases, there is a strong chance that they did not, in fact, know Jack's identity or that the source of the information was an insider at X Corporation. They may simply have believed and trusted the friend or relative who relayed the "hot tip."[236] Yet, the circumstantial evidence of suspicious timing, unusual trading, and attempts at concealment by both Michael and Marilyn[237] might

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233. *See* LANGEVOORT, *supra* note 24, § 1:12.

234. *See* BAINBRIDGE, *supra* note 30, at 74 (*Dirks* proscribes breach of duty of loyalty, not breach of duty of care); *see also* Langevoort, *supra* note 165, at 25-26 (basing tippee liability on awareness of breaches of duty of care would move law closer to a duty that runs with information, which is inconsistent with *Dirks*).

235. *See* BAINBRIDGE, *supra* note 30, at 73-74. It is possible that the odds of Marilyn or Michael being caught are low here because they are only involved in a single transaction and, in the overall market, the volume of their purchases may not catch the attention of government regulators. If Jack decides around the same time to make large purchases of X corporation stock, however, the odds that remote tippees will be caught up in the surrounding investigation increase substantially.

236. In a few cases, courts have accepted this explanation. *See, e.g.*, SEC v. Materia, 1983 WL 1396 at *15 (S.D.N.Y. 1983), *aff'd*, 745 F.2d 197 (2d cir. 1984) (estranged wife had reason to believe her husband was a knowledgeable stock trader, and there were no specific conversations or other evidence indicating information she received was confidential); SEC. v. Monarch Fund, 608 F.2d 938, 942 (2nd Cir. 1979) (family investment partnership manager relied on the information of insiders); U.S. v. Mylett, 97 F.3d 663, 667 (2nd Cir. 1997) (predictions made by insider cannot form basis for insider trading simply because a tippee relies on them).

237. With the parameters of insider trading law as unclear as they are, it seems plausible that

lead to an inference that they knew that the information was nonpublic and came from an insider, with a jury disregarding their denials of knowledge of the identity of the primary tipper as self-serving. Again, however, it should be emphasized that Marilyn would be liable for insider trading, but Michael would not because of the absence of an initial breach of duty when Susan overheard Jack talking. Unless Marilyn *actually* knew Jack breached a duty by making a disclosure to Bob, while Michael *actually* knew Jack did *not* breach a duty by blabbing in front of Susan, their "guilty knowledge" and ultimate moral culpability seem difficult to distinguish.

In another hypothetical setting that raises similar concerns under the misappropriation theory, a burglar who steals nonpublic information can trade and tip on the basis of the information without incurring liability under the fraud-based insider trading restrictions.[238] Similarly, a computer hacker who breaches the computer security walls of a large publicly held corporation and extracts nonpublic information may also trade and tip without running afoul of the insider trading rules.[239] The burglar and computer hacker may be liable for the conversion of nonpublic information under other laws,[240] but the insider trading laws themselves appear not to prohibit the burglar or hacker from trading or tipping on the basis of the stolen information. This is because there was no breach of a duty of loyalty to traders under the classic theory or to the source of the information under the misappropriation theory.[241]

Assume then that Jeff, a skilled computer hacker, breaks into X Corporation's computer system and obtains quarterly earnings information indicating that the corporation is about to announce that it has substantially exceeded published earnings estimates. Jeff does not work for X Corporation or serve in any other capacity that gives rise to a fiduciary or quasi-fiduciary duty to X Corporation. Jeff relays the nonpublic information about X Corporation to his friend, Melody (PT/STR), who tells a neighbor (ST/RTR1) who knows of Jeff's skills as a hacker. The neighbor tells his stock broker brother (RT1/RTR2), who tells his biggest client (RT2/RTR3), who tells his girlfriend Allison (RT3). Allison buys X Corporation stock (as do Jeff, Melody, and all of the tippees in the chain).

A week later, Jeff lawfully accesses the computer system of Y Corporation, for whom his employer is doing confidential consulting work. Jeff learns that Y

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a trader in Michael's position would be just as likely as Marilyn to panic and attempt to deny or conceal information about his trades when confronted with a government investigation—even though Marilyn should ultimately be found liable and Michael should not. Less weight should thus arguably be given to evidence of "guilty behavior" that takes place after an investigation begins than to efforts at concealment at the time of trading, which indicate forethought.

238. *See* Nagy, *supra* note 59, at 1253-54.

239. The computer hacker hypothetical, again much embellished, is borrowed from Nagy, *supra* note 59, at 1253-55.

240. *See id.* at 1253 n.156 (hacker's actions would likely constitute misappropriation of a trade secret, subject to potential civil and criminal liability).

241. *See id.* at 1233.

Corporation is reaching the final stages of document preparation before publicly announcing plans to merge into a subsidiary of a large media conglomerate. Jeff relays the nonpublic information about Y Corporation to his close friend and stock broker, Robert (PT/STR), in the hope that Robert will continue to relay rumors of "hot stocks" as he has done in the past. Robert in turn tells an important client (ST/RTR1), who tells his father (RT1/RTR2), who tells his business partner (RT2/RTR3), who tells her physician, Rachel (RT3). Rachel buys Y Corporation stock (as do Jeff, Robert, and all of the tippees in the chain).

In each case in which the nonpublic information about X Corporation and Y Corporation was passed along, the recipient was told that the information was confidential; yet he or she bought substantial amounts of corporate stock shortly after the conversation in which the information was discussed. In each case, the recipient had never before traded in that stock. When an SEC investigator contacts Allison and Rachel, each initially denies having bought any stock and then, when faced with proof, recants.

Here, Jeff is not liable for tipping Melody about the X Corporation earnings estimate because he did not owe a fiduciary duty of loyalty to X Corporation, the source of the information.[242] With no basis for derivative liability, none of the tippees in the chain is liable for trading in X Corporation stock or for tipping. Allison, the last tippee in the chain, is not derivatively liable even though the timing of her trades, the amount, the unusual nature of the purchase, and the attempt at concealment are as indicative of "guilty" knowledge that the source of the information is "improper" as are the facts surrounding Marilyn's trading in the earlier eavesdropper hypothetical and Rachel's behavior in trading in the stock of Y Corporation. In contrast, Rachel, like Marilyn in the eavesdropper hypothetical, is potentially liable because she *does* have a derivative duty to disclose or abstain from trading. This derivative duty is based on the fact that Jeff breached his duty to his employer and its client, Y Corporation, when he misappropriated nonpublic information about the merger. The timing of Rachel's trades, the large amount, the first-time investment, and the attempt at concealment allow a fact finder to infer that she knew or had reason to know of Jeff's breach. Thus, Rachel is liable for insider trading, whereas Allison and Marilyn are not.

B. *Macro-Solutions to the Remote Tippee Dilemma*

The dilemma of the remote tippee in attempting to determine whether to trade in securities based on information many steps removed from the original source could be ameliorated either by broad-based reform or by narrower changes in the existing approach. This section begins with the two basic solutions proposed over thirty years ago and then moves to an alternative broad-based reform.

242. *See* BAINBRIDGE, *supra* note 30, at 73-74.

Beginning with the early approaches, it should be noted that the anomalous treatment of Marilyn, Michael, Rachel, and Allison in the foregoing hypotheticals was implicitly anticipated by Justice Powell in *Dirks v. SEC*[243] and by the SEC in *In re Investors Management Co.*,[244] although their solutions to the problem differed. Justice Powell recognized the anomaly that some forms of trading on the basis of nonpublic information would escape sanction and accepted it as an inherent result of rejecting the fairness rationale in favor of a more limited duty-based rule.[245] Justice Powell acknowledged the broad moral and social implications of insider trading.[246] He also acknowledged that, depending on the circumstances, even legal trading on material, nonpublic information may be behavior that falls below ethical standards of conduct.[247] He essentially concluded that it was necessary to distinguish between legal obligations and ethical ideals in determining the scope of a statute of general application.[248]

Justice Powell's "solution," which is to tolerate some forms of trading on nonpublic information,[249] even if arguably unethical, reflects to some extent the current state of the law. However, the categories of insider trading that escape regulation are now narrower than Justice Powell appears to have originally intended.[250] Moreover, while Justice Powell's recognition that some forms of unethical behavior will not be illegal has the virtue of frankness, the resulting legal framework does not address the dilemma of those attempting to comply with the duty-based rules.[251] In other words, from the standpoint of those attempting to conform their behavior to the existing legal requirements, the distinction between information that is tainted by breaches of duty at the source and information that merely results from illegal, unethical, or even morally neutral behavior is very difficult to perceive without legal skills—particularly for the remote tippee.

243. 463 U.S. 646 (1983).

244. 44 S.E.C. 633 (1971).

245. *Dirks*, 463 U.S. at 657. Justice Powell quoted approvingly from a passage in the lower court's opinion in *Dirks*, in which Judge Wright described the abstain or disclose duty as "extraordinary." *Id.* (quoting Dirks v. SEC, 681 F.2d 824, 837 (2d Cir. 1982)).

246. *Id.* at 661 n.21 (quoting Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1, 55 (1980)).

247. *Id.*

248. *Id.* (citing an SEC report to Congress).

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

250. *See supra* Section II.B.

251. *See generally* Harvey L. Pitt & Karen L. Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415, 416-17 (1988) (egregious conduct may be clear, but "outer limits of permissible conduct by persons who want to conform their conduct to the requirements of the law remain uncertain.").

The SEC's solution to the inherent anomaly in treatment of remote and other tippees was an attempt to remove it.[252] Thus, under the fairness approach advanced in *Investors Management*,[253] the Commission stated that tippees would be liable if they knew or had reason to know that corporate information was non-public and had been improperly obtained "by selective revelation *or otherwise*."[254]

The Commission observed that its formulation of the test would result in liability where the recipient of nonpublic information knew or had reason to know the information was obtained by "industrial espionage, commercial bribery or the like."[255] The Commission added that there would also be potential liability where persons *innocently* obtain and then "use information which they have reason to know [was] intended to be confidential."[256] Trading on nonpublic information obtained directly or indirectly as a result of negligent disclosures, loss, or theft would be prohibited under the SEC's fairness-based test of tippee liability.[257] If this approach

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252. *Investors Management*, 44 S.E.C. at 645.

253. *Id.* Although not entirely clear, it appears that the Commission was attempting to include all "improper" disclosures of corporate information. *Id.* Selective revelation appears to refer to disclosures for a limited corporate purpose that are then used improperly for another purpose. *Id.* at 645 (concluding that investment bank tippees knew nonpublic information was conveyed to managing underwriter for valid, but limited, corporate purpose). The reference to information obtained improperly "otherwise" refers to information obtained through theft or loss. *Id.* at 641n.18. As the Commission itself recognized, the fairness approach does not completely resolve the problem of dealing with remote tippees because as information passes down a chain of tippees it will become increasingly difficult to tell whether a particular tippee had the requisite knowledge. *See* id. at 645 (recognizing that remote tippees may present more questions of factual proof of required knowledge). In addition, it will be more difficult to determine whether the information conveyed was sufficiently specific to be material and distinguishable from mere rumor. *See supra* notes 171-76 and accompanying text. The question of whether and how to reconcile the Commission's "reason to know" standard with the scienter requirement in *Hochfelder* is also still present. *See supra* notes 168-73 and accompanying text.

254. 44 S.E.C. at 64 (emphasis added).

255. *Id.* at 641 n.18. Commissioner Smith also recognized the risk of anomalies in treatment under a duty-based rule. His solution was briefly raised in a footnote in *Investors Management*. *Id.* at 650 n.2 (Smith, Comm'r, concurring). In that passage, he acknowledged the majority's concern that a narrow rule would leave a gap allowing stolen or lost corporate information to be used or passed along without risk of liability. *Id.* He suggested, however, that the requirement that the tippee know or have reason to know of a breach of duty to a corporation would in fact encompass situations where someone purloins corporate information, knowingly receives such information, or accidentally finds a lost document. *Id.* Whether Commissioner Smith's proffered solution can be integrated into the existing fraud-based rules presents an interesting question, as discussed in the following section. *See infra* notes 256-66 and accompanying text.

256. *Investors Management*, 44 S.E.C. at 641 n.18 (adding that the test would depend on an evaluation of specific facts and circumstances and would not attach responsibility as to information obtained by general observation or analysis).

257. *See id.* Several efforts at codifying the insider trading prohibitions have attempted to achieve this objective. For example, a proposed 1987 statute drafted by a committee of lawyers and incorporated into a Senate Bill provided that "information shall have been used or obtained

was applied in the preceding hypotheticals, remote tippees Marilyn, Michael, Rachel, and Allison would all be liable for insider trading violations if they knew or recklessly disregarded the fact that the information on which they traded was nonpublic.

From the standpoint of the remote tippee, the Commission's fairness test for determining liability has the advantage of greater clarity and ease of application than the duty-based rules, since it does not require actual knowledge of the source of the information or actual or constructive knowledge of the primary tipper's duties and motives for tipping.[258] Knowledge that information is nonpublic can often be ascertained from reviewing publicly available information or may be inferred from some of the same circumstantial evidence that is currently being employed to determine liability under the duty-based tests.[259] Remote tippees like Rachel and Allison or Marilyn and Michael would thus have the same risks of liability for the same behavior, unlike the current approach. Weighing against the Commission's approach, however, is the fact that the fairness test has been widely criticized, has the potential to be overly broad in discouraging the generation of socially useful information, and may not be a politically feasible solution.[260]

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wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal, or other relationship of trust and confidence." S. 1380, 100th Cong. §2 (1987). *See* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 100 (1998) (describing SEC opposition to proposed definition and later revisions that included express references to bribery and espionage).

258. *Investors Management*, 44 S.E.C. at 644. Even the broad fairness test may not catch all insider trading based on unfair informational advantages. For example, no liability attaches to an insider's decision to abstain from trading when abstention enables the insider to avoid losses or to profit by the delay in trading. An insider in possession of material, *favorable* information about the issuer is precluded from buying more stock of the issuer until the information becomes public, but is *not* prevented from abstaining from selling. Thus, insiders may delay a sale of issuer stock that would otherwise have taken place and wait until after the favorable information is disseminated to the public, leading to a higher sale price. Conversely, an insider in possession of material, *unfavorable* information about the issuer may not sell issuer stock to avoid a loss, but is not precluded from abstaining from any purchases of stock he or she might otherwise have made. Some critics of insider trading restrictions have pointed to this anomaly as one of the inconsistencies in the theoretical underpinnings of the insider trading rules. *See, e.g.*, Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention From trading: An Analysis of Gaps in the Insider trading Laws*, 68 WASH. L. REV. 307, 333-34 (1993) (abstention from trading by insiders is indistinguishable in terms of fairness). Professor Fried contends, however, that the workings of the abstention rules actually make sense in that abstentions from trading that favor the insider are in effect balanced out over time by the situations in which the abstention rule works to the insider's disadvantage by requiring the insider to forego profits he could have made or incur losses he could have avoided if he had been allowed to trade based on inside information. *See* Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 457-59 (2003).

259. *See Investors Management*, 44 S.E.C. at 646-47.

260. *See, e.g.*, Cox & Fogerty, *supra* note 217, at 367 (discussing problems raised by fairness theory).

An alternative solution to the dilemma of the remote tippee has been proposed by some commentators and adopted in some countries.[261] Under that alternative, all of the law's power of deterrence would be focused on the source of nonpublic information—the breaching insider or misappropriator who tips. Under this system, liability would flow to the breaching source and possibly to secondary and remote tippers. In other words, there would be liability for tipping, but not for receiving, nonpublic information.[262] For many of the same reasons explained in this article, Professor Fisch has argued that the *Dirks* derivative liability test is too difficult to apply in practice, both for courts and traders.[263] The result is arguably both inefficient and unfair.[264] Accordingly, Professor Fisch proposes that tippee trading be regulated only indirectly by requiring tippers to bear the responsibility for the economic consequences of tippee trading on nonpublic information.[265] Because tippers, not tippees, are in a position to control disclosure and prevent harmful manipulation of corporate actions to facilitate personal trading decisions, Professor Fisch contends

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261. *See* Fisch, *supra* note 223, at 243.

262. An even clearer reform would entail a system in which insider trading is not regulated at all, except perhaps by freely negotiated contractual restrictions on the use of nonpublic information. *See* Macey, *supra* note 160. This, of course, opens up the entire debate over the rationale for insider trading regulation. *See supra* note 30. If the SEC's concern that unfettered inside trading will undermine public confidence in the markets proves true, this choice is likely to have little appeal to the average investor.

263. *See* Fisch, *supra* note 223, at 248.

264. *Id.* at 248-49. Professor Fisch explains the difficulties of attempting to determine whether somewhere up the chain of information flow there has been a misappropriation or breach of duty from the standpoint of professional analysts and traders. *Id.* However, ordinary investors face similar difficulties. In fact, the dilemma of ordinary investors in dealing with potentially tainted nonpublic information is arguably greater than that of professional traders, although the economic consequences of their decisions may be less consequential. This is because the relatively unconstrained use of circumstantial evidence of suspiciously timed and unusually circumstanced trades tends to leave average investors without a viable defense unless they can prove to a skeptical jury that they did not possess nonpublic information or were planning to trade anyway. *See supra* note 217. By contrast, large trades, rapid investment decisions and high risk transactions by professional investors are less unusual and may allow proof that a challenged investment decision was not based on inside information. *Id.* Combined with the fact that average investors are probably less likely to have experienced legal counsel (if they have counsel at all) and more likely to have a significant portion of their personal assets at stake in any liability determination, the consequences of unclear rules are arguably higher for the average investor, who at the same time receives less guidance over how to proceed. *See infra* note 274 and accompanying text.

265. Fisch, *supra* note 223, at 247-48 & n.287. Under Professor Fisch's proposal, a tipper's motive would be irrelevant, and tipping would be simply defined as selective disclosure of nonpublic information by an insider under circumstances in which trading by the insider himself would be illegal. Liability for profits earned by tippee trading would be imposed on tippers if the tippers acted negligently or wrongfully in making selective disclosures and if tippee trading was reasonably foreseeable. *Id.* For a similar proposal based on similar reasoning, see Kerr & Sweeney, *supra* note 224, at 84-86.

that abolishing direct tippee liability will not interfere with the objective of early and complete disclosure and, through the imposition of substantial civil liability on tippers, will adequately deter tipping—irrespective of the profit motive.[266]

In enacting insider trading laws, some countries have elected to restrict the scope of tippee liability.[267] In Japan, for example, the prohibition on inside trading extends only to someone who receives nonpublic information directly from a party related to the corporation.[268] In other words, remote tippees are free to trade.[269] The U.S. Congress has, however, gone in the opposite direction by implicitly accepting the concept of remote tippee liability in the Insider Trading & Securities Enforcement Act of 1988.[270] Under that act, primary tippers are liable for remote tippee trades in actions brought by the government, but are relieved of liability to private plaintiffs for remote tippee trades.[271] As Congress seems to have been driven by concerns of undue tipper exposure to liability in enacting the latter exemption, it appears to have rejected an argument that the best deterrent impact would come from focusing on tippers, rather than tippees.[272]

There continue to be many reasons for favoring reform efforts that seek to resolve on a macro level the uncertain and inconsistent conceptual basis for the existing federal insider trading regime—not just to deal with the remote tippee dilemma, but also to rationalize and clarify the entire regulatory scheme.[273]

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266. Fisch, *supra* note 223, at 249. Professor Fisch recognizes that her proposal would prevent prosecution of many outsider tippees under the insider trading rules, but contends that those who acquire nonpublic information through improper or illegal means can be dealt with under other civil and criminal laws, such as criminal statutes, civil contract and tort provisions, and professional disciplinary rules. *Id.*

267. Other nations actually expand tippee liability. In Australia, tippee liability is encompassed within a broad fairness-based rule that prohibits *all* persons in possession of confidential information from trading on that information, subject to enumerated exceptions. *See* Donald C. Langevoort, *Defining Insider Trading: The Experience in Other Countries*, 6 No. 4 INSIGHTS at 7, 8 (April 1992); Franklin A. Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 77 (2002).

268. Gevurtz, *supra* note 267, at 83. The groups of persons considered related to a corporation under the Japanese law include directors, officers, employees, and shareholders, as well as persons associated with a corporation through a contract or a government supervisory role. *See id.*

269. *Id.* at 84.

270. Insider Trading & Securities Enforcement Act of 1988 (ITSEA), §§ 21A(a)(3), 20A(c) (1988).

271. *Id.* ITSEA also extends to controlling persons the exemption from liability for remote tippee trades and makes the exemption available in both private and governmental actions. *See* LANGEVOORT, *supra* note 24, § 4:9.

272. *See id.* One possible disadvantage to relieving remote tippees or all tippees from liability may be that it would reduce the SEC's enforcement leverage by removing an incentive to obtain tippee testimony against others as part of negotiations to reach a settlement or plea bargain in tippee insider trading actions.

273. The number of commentators inside academia and out who have called for reform is

Currently, however, there does not seem to be significant political pressure to tackle the reform of insider trading regulation by any such legislative actions.[274] An alternative approach is, therefore, to pursue reform through the existing micro-process of continued judicial development of what has been called the federal "common law" of insider trading.[275]

C. *Micro-Solutions to the Remote Tippee Dilemma*

To the extent that resolution of any anomalies in the treatment of remote tippees remains in the hands of the courts to determine on a case-by-case basis, Commissioner Smith's solution in *Investors Management* may hold some promise to resolve one aspect of the remote tippee's dilemma in the preceding hypothetical problems.[276] Commissioner Smith suggested that a duty is owed to a corporation not

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staggering. One collection of sources arguing for clearer statutory guidelines is contained in Fisch, *supra* note 223, at 179 n.5. Some commentators indicate, however, that the pressure for reform may have lessened with the *O'Hagan* decision. *See* Pritchard, *supra* note 66, at 17 (misappropriation theory is consistent with common law, fills an important gap and secures insider trading law to "firmer foundations"); Seligman, *supra* note 43, at 24 (law reaches a "mature synopsis" in *O'Hagan* and case represents "work well done").

274. In addition to the plight of remote tippees, there are many reasons for reforming the insider trading regulations. For example, the widespread criticism that the insider trading rules lack clear definition stems from conceptual, efficiency and due process concerns that impact traders, tippers and tippees alike. *See, e.g.*, Langevoort, *supra* note 39, at 1337 (pointing to existing "patchwork system" comprised of two different and "intellectually awkward" theories plus the "wholly inconsonant" tender offer rule); Fisch, *supra* note 223, at 182 (absence of clear guidelines may hamper efficient functioning of markets); and sources cited *supra* notes 29, 72 & 257).

275. *See* Bainbridge, *supra* note 30, at 1201 (federal insider trading law should be classified within genus of federal common law).

276. *See Investors Management*, 44 S.E.C. at 680 & n.2. The aspect referred to is the potentially different treatment of remote tippees who obtain nonpublic information from eavesdroppers and thieves and those who receive the information from sources who have breached a fiduciary or quasi-fiduciary duty. *Id.* Even if these disparities in treatment are "resolved" by treating lost or stolen information as "tainted," it is still hypothetically possible for the liberal use of circumstantial evidence to lead to the same dilemma for a remote tippee who may have received information from another source who did not have a fiduciary duty to abstain or disclose. For example, if one posits in the first hypothetical *supra* at notes 228-33 that Jack (PTR) is in the same position as Donald Secrist in the *Dirks* case and then follows through with the same assumptions as to how the information is relayed until it reaches Michael (RT4), it appears that Michael would be in the same position as he was in the eavesdropper hypothetical in that he would not know whether the information was tainted or not. Thus, finding a rationale for holding that eavesdroppers and thieves can create a derivative duty on the part of their tippees will perhaps reduce the instances in which remote tippees may be foregoing legal trades because of uncertainties as to the source, but it will not entirely eliminate them. A fairness-based rationale that imposes direct tippee liability for trading on nonpublic information would, however, focus the inquiry on whether the information was nonpublic, rather than deflecting attention to the source of the information and whether that source breached a duty. *See supra* note 253 and accompanying text.

to steal or knowingly receive stolen property or exercise dominion over property known to belong to others, and that such a duty exists without the presence of a special relationship.[277] He did not cite any authority in support of such a duty.[278] Although some commentators strongly contend that the existence and content of fiduciary duties in the insider trading context should be developed through reference to state law,[279] the process of judicial development since *Chiarella* has been to use state fiduciary principles as a guide, but to adapt them to the needs of the federal system of regulation.[280] Accordingly, it may be possible to develop a duty-based analysis to hold eavesdroppers liable for trading and tipping on inside information by adapting precedents and theories from other lines of cases, such as state laws relating to lost and mislaid property.[281]

For example, the eavesdropper who overhears an insider or misappropriator discuss nonpublic information is somewhat akin to the finder of mislaid or lost property.[282] Conceptually, however, the analogy is only a rough one because the law

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277. *Investors Management*, 44 S.E.C. at 650 n.2. It should be noted that the perceived duty is owed to the corporation, not its shareholders. Therefore, it appears to be rooted in property law, rather than agency or investor protection considerations. *See id.*

278. *Id.*

279. *See, e.g.,* Bainbridge, *supra* note 30. Though consistent with a property-based rationale, the incorporation of state fiduciary principles raises the possibility of the development of an even more complex body of law governing insider trading as potentially different results are reached from state to state.

280. Thus, for example, fiduciary duties of traditional insiders are deemed to run to non-shareholders under federal insider trading law, even though some states have disclaimed such a duty. *See supra* note 35. The expansive development of quasi-fiduciary duties under the guise of "relationships of trust and confidence" is another example of the federalization of state law concepts. *See supra* notes 82-86 and accompanying text.

281. Along the same lines, Commissioner Smith in the *Investors Management* decision advanced the notion that a general duty is owed to the corporation not to steal nonpublic information from it. *See supra* note 253 and accompanying text. Justice Powell also alluded to the possibility that information obtained by theft might be encompassed by the duty-based rules he proposed when he observed that Dirks, as alleged tippee, did not "misappropriate *or illegally obtain*" the nonpublic information in issue. *Dirks*, 463 U.S. at 665. It is difficult, however, to see how theft by a person who owes no pre-existing duty to the corporation fits within the agency and fraud-based statute and precedents that the Court was interpreting in *Dirks* as there is often no special relationship between the thief and the source of the information giving rise to an agency-based duty and contact between the thief and the source around which a charge of deception can be framed. *See* Geraldine Szott Moohr, *Federal Criminal Fraud and the Development of Intangible Property Rights in Information*, 2000 U. ILL. L. REV. 683, 687-89 (theft involves interference with property, while fraud involves taking property by deception); *see also* SEC v Cherif, 933 F.2d 403, 412 n.6 (7th Cir. 1991) (declining to reach the question of whether Rule 10b-5 applies to "mere" thieves).

282. The law of finders is relatively complex. At common law, there are several lines of analysis depending on the nature of the property found and its location, among other factors. None fit easily within the confines of intangible property. *See, e.g.,* M. June Harris, *Who Owns the Pot of Gold at the End of the Rainbow? A Review of the Impact of Cultural Property on Finders and*

of lost or mislaid property is derived from cases involving tangible personal property. Once tangible property is lost or mislaid by the rightful owner, he or she loses both physical possession and the accompanying ability to use the property until it is returned.[283] Information, however, can be "physically" held in the minds of both the rightful owner and the finder at the same time. Therefore, what the owner loses is the *exclusive* use of the information.[284]

A "finder" of the lost or mislaid information can also use the information and can easily pass it along to others who then use it, too. Moreover, it is virtually impossible to "return" exclusive use of information to the rightful owner, whether physically or otherwise (at least until selectively targeted "mind flushing" drugs are invented and allowed to be used).[285] Therefore, the only remedy that is functionally equivalent to the return of exclusive use of lost or mislaid information to the rightful owner is a prohibition on use of the information by the finder and those to whom he or she relayed the information.[286] Applied to eavesdroppers, this analogy could be used to develop a duty-based rationale for prohibiting use of nonpublic information.

Salvage Laws, 14 ARIZ. J. INT'L & COMP. L. 223, 228-29 (1997) (explaining differences between treasure trove, lost property, abandoned property, embedded property and other categories); R.H. Helmholz, *Equitable Division and the Law of Finders*, 52 FORDHAM L. REV. 313, 313-14 (1983) (discussing difference between lost and mislaid property and observing that finders cases puzzle and interest courts and commentators).

283. Moohr, *supra* note 281, at 693

284. *Id.* at 691-93. *See also* I. Neel Chatterjee, *Should Trade Secret Appropriation be Criminalized?*, 19 HASTINGS COMM. & ENT. L.J. 853, 866 (1997) (intangible property such as information can be used by many without exhaustion).

285. *See* Chatterjee, *supra* note 284, at 867-68 (once relayed, information cannot be returned).

286. A similar issue arises in cases in which attorneys inadvertently convey privileged client information to a party or counsel on the other side of a litigation. Under a "finders-keepers" rationale that has also been used to justify relieving eavesdroppers and other finders of nonpublic information from liability in insider trading cases, courts initially held that inadvertent disclosure of confidential, privileged client information waived the privilege and enabled the litigation opponent to use the information freely in court. *See, e.g.*, Suburban Sew 'n Sweep, Inc. V. Swiss-Bernina, Inc., 91 F.R.D. 254 (N.D. Ill. 1981) (privilege waived after counsel discovers privileged document while digging around opposing attorney's trash dumpster). In a series of decisions, ethical opinions and commentaries almost as confusing and contested as those in the insider trading area, the general trend now is to hold that the attorney-client privilege is not waived by accidentally revealing confidential information, provided that a lawyer and client take reasonable precautions to prevent inadvertent disclosure. *See* RONALD D. ROTUNDA & JOHN DZIENKOWSKI, LEGAL ETHICS—THE LAWYER'S DESKBOOK ON PROFESSIONAL RESPONSIBILITY § 4.4-3(a) (2005-2006 ed.). In jurisdictions following this approach, the inadvertently revealed information must be returned if it is contained in documentary form, although most courts have resisted efforts to disqualify the attorney who received the privileged information even though it may be impossible for the lawyer to forget what he or she read. *Id.* §§ 4.4-3(a); 4.4-3(b). Although waiver of the evidentiary privilege is distinct from the ethical obligation to return information, the general trend is also to preserve the evidentiary privilege so that inadvertently disclosed information may not be used in court. *See id.*

There are, however, significant conceptual problems with the lost or mislaid property analysis as long as insider trading regulation is tied to the existing interpretation of Rule 10b-5, which requires that liability sound in fraud and deceit. A duty to refrain from using lost or mislaid information could be analogized to the deceptive trading-in-secret analysis from *O'Hagan*,[287] but the entire edifice of steps to reach that point is contrived and riddled with weaknesses. There are also conceptual problems arising from the determination as to whom a duty not to use lost or mislaid information would run when the owner of the information is a corporate issuer. In that instance, the information is "owned" by the corporation, and the accompanying duty would presumably be owed to the corporation, rather than to its shareholders. Prohibited use of the information by eavesdroppers and other "finders" in classic insider cases would fall within the property-based rationale of insider trading regulation, rather than the investor protection rationale.[288] That, in turn, raises conceptual problems with the "in connection" requirement when nonpublic information is in the hands of the tippee rather than the eavesdropper/finder (who is akin to the misappropriator under this analysis).[289]

Other possible avenues for partial judicial amelioration of the remote tippee dilemma involve "tinkering around" the edges of the problem. A more skeptical look at the inferences drawn from circumstantial evidence relating to the knowledge of remote tippees is one possibility. As pointed out earlier, the behavior of remote tippees may well not vary in situations in which the nonpublic information is tainted by a primary tipper's breach of duty and in situations in which it is not.[290] For example, evidence of concealment by a remote tippee may not in fact be particularly probative evidence of knowledge that information was derived from a breach of fiduciary duty by the remote tippee; it may only reflect panic and uncertainty when faced with government interrogators. Similarly, the courts should give more rigorous scrutiny to the use of circumstantial evidence to rebut remote tippee denials that they received specific nonpublic information. As discussed earlier, the common lore of the children's telephone game, as well as studies of the accuracy of hearsay, indicate that information becomes less accurate and less clear as it passes from one person to another.[291] Therefore, testimony that a tip was just a generalized recommendation, though seemingly self-serving, may in fact be true.

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287. *See supra* notes 74-77 and accompanying text.

288. *See supra* notes 72 & 79 and accompanying text.

289. *See supra* notes 180-81. Those conceptual problems already exist where lost or mislaid information belongs to an outside (rather than inside) source and is improperly relayed to a tippee. *See id.*

290. *See supra* note 217.

291. *See, e.g.*, Thompson and Pathak, *supra* note 221, at 464-65 (describing key studies and concluding that "the notion that information can be degraded and distorted as it is passed from one person to the next is well established and uncontroversial"). Under the misappropriation theory, the potential problem of attenuated specificity is complicated by the fact that the breaching source may be several steps away from the true original source of the information. For example, information

A final, and again only partial, resolution of the remote tippee dilemma is to improve investor education. If the onus is in fact on the remote tippee to investigate the source of nonpublic information before trading, then that obligation should be made clear.[292] One problem in this regard is that most of the current investor education initiatives are undertaken by corporate employers, broker-dealers, law firms, and other entities that regularly handle nonpublic information.[293]

This approach makes general sense from an efficiency standpoint since the greatest access to and temptations to use nonpublic information for unearned informational advantage presumably exist in those institutions. If the premise of this article proves true, and more Joe Q. and Josephine Publics join the ownership society by investing in publicly held stocks,[294] the need for education of average investors about the risks of insider trading[295] will accompany the need for education about the risks of investing in general. Hence, the avenues and costs of providing the necessary education to the general investor public should be factored into regulatory enforcement mechanisms.

As information is increasingly conveyed via the internet, one prominent and relatively inexpensive avenue for investor education is the SEC's website.[296] Unfortunately, a prospective remote tippee/trader reviewing that site for guidance today is likely to come away more confused than when he started. Assume, for

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may have been legitimately relayed from employee to employee within the ranks of the corporate issuer and then relayed through several channels of an investment bank before it reaches a misappropriator who "steals" the information for personal gain.

292. *See supra* notes 215-19 and accompanying text.

293. For a brief history and discussion of the elements of training and compliance programs for professional firms, financial intermediaries, and publicly held corporations, see Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 S.M.U. L. REV. 1783 (1984). *Cf.* SEC v. Musella, 578 F. Supp. 425, 439 (S.D.N.Y. 1984) (taking judicial notice that law firms that routinely handle confidential matters convey to incoming employees the expectation that they will not discuss client matters in public).

294. *See supra* note 7 and accompanying text.

295. Although some may contend that average investors are unlikely to be privy to nonpublic information sufficiently frequently to merit an educational campaign, the rapid growth of investor "chat rooms" and e-mail contacts between investors casts doubt on that assumption.

296. Currently, a "Google" search leads directly to the SEC website as the first, and most frequently accessed site relating to insider trading. http://www.google.com/search?hl=en&q=%22insider+trading%22&b... (last visited April 26, 2006). The other sites listed in the top ten results from the Google search include press accounts of recent insider trading cases and investment services that access public filings reporting insider purchases and sales of issuer securities. *See, e.g.*, *Insider Trading: What did Martha Do?*, http://www.economics.about.com/cs/finance/a/insider_trading.htm; *MSN Money—Insider trading transactions, insider planned sales*, http://www.moneycentral.msn.com/investor/invsub/insider/trans.asp. Also listed is an article by Professor Haddock that discusses the history and economic arguments for and against insider trading regulation, but does not address when trading on nonpublic information is and is not allowed. David D. Haddock. *Insider Trading*, http://www.econlib.org/library/Enc/InsiderTrading.html.

example, that Josephine Public faces difficulties in deciding whether she may or may not trade based on information overheard in an elevator or received as a "hot tip" from a co-worker who has heard the information third or fourth-hand from "friends of friends." The first impediment is finding out whether trading based on the information or tip would lead to criminal or civil charges for illegal inside trading. Josephine could, of course, consult an attorney, but the cost disadvantages of lost time and legal fees make resort to this option unlikely. Should Josephine turn to the SEC's Investor Information link on the Internet for guidance, however, she would find extremely general and often confusing information.[297]

For example, the insider trading description on the SEC's Investor website begins with the observation that, although most investors usually associate the phrase with illegal conduct, "insider trading" actually includes *legal*, as well as illegal, conduct.[298] Cross-linking to information about insider reports on Forms 3, 4 and 5, the SEC states that "[t]he legal version is when corporate insiders—officers, directors, and employees—buy and sell stock in their own companies."[299] The implicit intent of this organizational choice seems to be to emphasize assistance to investors who are tracking patterns of legal insider trading in order to guide their own investments.[300] The priority placed on an explanation of legal trading in the web site discussion nevertheless seems odd if a primary enforcement goal of the SEC is to deter illegal insider trading.

Two paragraphs later in the website discussion, the SEC lists examples of cases of illegal insider trading.[301] First on that list are "[c]orporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments."[302] Although the differences between the legal insider trading just described and this brief description of illegal trading may be

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297. *See* U.S. Securities & Exchange Commission, *Insider Trading* (April 19, 2001), *available at* http://www.sec.gov/answers/insider.htm. An investor looking for information from the SEC home page (http://www.sec.gov), would link to *Investor Information*; then to *Questions: Get Fast Answers*; and then to *Insider Trading* and other entries on the index to topics. Cross links within the insider trading description lead to a speech by a staff member and to a detailed rule proposal. *Id.* Neither give succinct and clear advice to average investors as to what is allowed and what is not.

298. *Id.*

299. *Id.* The site does not list examples of legal trading by potential tippees. *See id.*

300. *See* U.S. Securities & Exchange Commission, *Insider Trading*, http://www.sec.gov/answers/insiders.htm.

301. *Id.*

302. *Id.* Other primary violators cited as examples are (1) employees of law, banking, brokerage and printing firms who receive inside information to enable them to perform services, (2) government employees who receive inside information through their employment, and (3) other persons who misappropriate and take advantage of their employers' confidential information. *Id.* The site does not indicate, except indirectly in its general definition, that investors who receive and trade on information directly or indirectly from these primary violators may themselves be illegal tippees.

discerned if the two passages are read and compared carefully, the overall explanation is not "reader-friendly" and is not very clear, especially if the targeted audience includes the general public.

As a general definition to guide the investor, the SEC website states that illegal insider trading refers to purchases or sales of securities "in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security."[303] However, the site fails to explain any of the terms in the definition, unless one reads between the lines and looks to examples and supplements by cross-linking to SEC Rules 10b5-1 and 10b5-2.[304]

The site also points out that insider trading violations may include "tipping" material, nonpublic information, as well as securities trading by persons who are tipped.[305] But, even though securities trading by persons who misappropriate inside information is described as illegal conduct, the site does not clearly explain that tippees of persons who misappropriate may also violate the restrictions on illegal insider trading.[306] Furthermore, the site does not clearly explain when someone is liable as a "tippee." In fact, the reader may be left with the impression that most insider trading is legal, when in fact it is not, if the trading is based on material, nonpublic information.

This is not to suggest that a long, technical explanation of the insider trading rules is necessary. But, the over-emphasis on legal trading and the brief list of examples of illegal trading are not very helpful to the average person trying to determine whether proposed conduct is lawful.[307] A more complete explanation of the scope and purpose of the insider trading restrictions and a description of more common examples of unlawful trading—all in "plain English"—is in order. As long as the risk of trading on tainted information is on the investor, the web site—along with other materials for investor education—should also make clear that investors receiving nonpublic information from inside sources *as well as from sources that are not known* have the obligation to investigate before trading.

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303. *Id.*

304. *See* U.S. Securities & Exchange Commission, *Insider Trading*, http://www.sec.gov/answers/insider.htm.

305. *Id.*

306. *Id.* Similarly, in the SEC's examples of illegal insider trading, the website lists trading by "[f]riends, business associates, family members, and other "tippees" of [corporate] officers, directors, and employees," but does not list tippees of other types of primary violators or tippees of tippees. *Id.*

307. *Id.*

IV. CONCLUSION

Due process concerns have been raised about the scope and manner of development of the insider trading restrictions under Rule 10b-5 for over 40 years.[308] At virtually every juncture, formal due process challenges have been rejected by the courts.[309] Regardless of whether the lack of clarity in the insider trading rules is sufficient at this point to justify overturning on constitutional grounds a set of tests that have been in place for decades, it remains troubling from a policy standpoint that increasing civil and criminal penalties are being imposed where the laws remain so expansive, complicated, inconsistent, and unclear.[310] Traditional insiders, professional traders and investors, employees of law firms and accounting firms, and others who serve corporate issuers, or other players in the securities markets at least tend to have the benefit of educational programs and access to legal advice that make it easier to comply with the law. But, ordinary citizens usually lack such advantages, and to the extent that more of them become direct investors to amass retirement savings, the need to either clarify the rules or educate investors as to their scope and limitations is likely to become more pressing.

Admittedly, resolution of the remote tippee dilemma and other problems associated with the complexity and uncertainty of the insider trading rules is not a simple task—analytically or politically. Viewed simply from the standpoint of formulating an easily understandable rule, however, a legal standard based on the SEC's early fairness test has the advantage of simplicity and underlying appeal to the

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308. In *TGS*, for example, Chief Judge Moore, in dissent, contended that the resolution of the question whether and when insiders should be prohibited from trading on nonpublic information "should be by rule, as definite as possible, formulated in the light of reality and not retroactive in effect . . . ." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 877 (2d Cir. 1968) (Moore, C.J., dissenting). *See supra* notes 109-12 and accompanying text; *see also* Bainbridge, *supra* note 30, at 1198 (failure to define scope and conduct of fiduciary duty element of insider trading prohibitions raises important due process and fairness concerns); Brodsky & Kramer, *supra* note 72, at 80 (misappropriation theory fails to provide clear or rational standard as to when trading with an informational advantage leads to liability, thereby raising significant due process concerns). Frustration with unclear rules is not limited to academic observers. *See, e.g.*, Pitt & Groskaufmanis, *supra* note 220, at n.48 (citing articles by critics in the financial press).

309. *See, e.g.*, United States v. Newman, 664 F.2d 12, 19 (2d Cir. 1981) (rejecting due process challenge); SEC v. Willis, 777 F. Supp. 1165, 1173-74 (S.D.N.Y. 1165) (tippee's conduct sufficiently deceptive to convince court that Rule 10b-5's general anti-fraud proscription provided adequate notice). *But see* United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1990) (en banc) ("elastic and expedient" equitable concepts that find confidential relationships on "suitable occasions" would offend due process if applied in criminal fraud cases).

310. *See, e.g.*, Pitt & Shapiro, *supra* note 251, at 417 (finding it "deeply troubling" that prosecution and increasingly severe penalties can be based on crime that Congress has never defined). *But see* Daniel L. Goelzer & Max Berueffy, *Insider Trading: The Search for a Definition*, 39 ALA. L. REV. 491, 496 (1988) (clear statutory definition may be desirable as matter of principle, but same is true of antitrust and civil rights statutes).

public's sense of equity. In other words, average investors would likely understand that using significant, nonpublic information that the investor has done nothing to amass or produce, but has simply been given or accidentally come across, is forbidden because it confers an unfair advantage over other persons trading in the market. A series of regulatory safe harbors could then be enacted to cover situations in which protections for socially useful information-gathering are deemed necessary. In a sense, the law has been moving steadily toward an approximation of just such a system, as illustrated by the expansive lower court interpretations of Supreme Court cases and the adoption of Rule 14e-3, Regulation FD, and Rules 10b5-1 and 10b5-2 by the SEC.[311] But, much of the literal language of the law of insider trading remains built around a "jerry-rigged" and confusing system of common law duty rules, twisted fraud doctrines, and unprincipled exceptions.[312]

Even though judicial, regulatory, or legislative clarification has been advocated many times before,[313] this author joins the choir in recommending substantial changes in approach to this entire area of law. Perhaps there is no perceived urgency now, but the potential of an onslaught of ordinary investors, all of whom are nearing or planning for retirement and are facing a confusing, intimidating and risk-filled investment world, may ultimately add the voices of the voting public to those in the financial and academic communities who are already urging reform.

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311. *See supra* notes 23, 56, 78 & 85. Under Regulation FD, 17 C.F.R. §§ 243.100-103, publicly held corporations that disclose material nonpublic information to broker-dealers, investment advisors, investment companies, or other investors who may be expected to trade on the basis of the information, must make public discourse of that information. Regulation FD exempts some communications from the public disclosure requirements, including communications to parties who agree to keep this information confidential or who have a duty of trust or confidence to parties who agree to keep the information confidential or who have a duty of trust or confidence to the corporation. 17 C.F.R. §§ 243.100(b)(2)(i) & (ii). For a discussion and critique of Regulation FD, see Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533 (2002).

312. *See* Pitt & Shapiro, *supra* note 251, at 417.

313. *See* Fisch, *supra* note 223.