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INSIDER TRADING

# The Amorphous 'Personal Benefit' Requirement for Insider Trading Tipping Liability

BY SCOTT M. HIMES

By their terms, Section 10(b) of the Securities Exchange Act of 1934[1] and Securities and Exchange Commission Rule 10b-5,[2] which are the most common bases for a claim of unlawful insider trading in securities, do not proscribe insider trading. Yet liability for insider trading under these antifraud provisions is well-settled. The Securities and Exchange Commission first recognized it in 1961 in the landmark case *In re Cady, Roberts & Co.*,[3] and the U.S. Supreme Court established and defined it further in subsequent years in several seminal cases, principally *Chiarella v. United States*,[4] *Dirks v. S.E.C.*[5] and *United States v. O'Hagan*.[6]

Insider trading typically occurs when a corporate insider, or someone else having access to corporate information, uses material nonpublic information to buy or sell securities, or otherwise discloses — or ''tips'' — the information to someone who then trades. But trading based on material nonpublic information, standing alone, does not violate Section 10(b) and Rule 10b-5.[7] Rather, for insider trading to be actionable under these provisions, there must also be, in the language of the provisions, '' 'manipulation or deception.' ''[8] And for manipulation or deception to exist under these provisions, the would-be defendant must breach a fiduciary-like duty of trust or confidence to another in connection with trading securities.[9]

Significantly, for insider trading liability based on tipping, the breach-of-duty element looks to whether an insider who disclosed information to the tippee-trader ''personally benefited'' from the disclosure. In other words, what did *the tipper* — who does not himself trade on the confidential information — get in return for revealing the information to someone who does trade on it? Often the benefit is obvious — such as when the tippee secretly pays for the information or shares trading profits with the tipper.[10] However, based on the Supreme Court's lead, the lower courts have set the bar

[1] 15 U.S.C. § 78j(b).
[2] 17 C.F.R. § 240.10b-5 (2009).
[3] 40 S.E.C. 907 (1961).
[4] 445 U.S. 222 (1980).
[5] 463 U.S. 646 (1983).
[6] 521 U.S. 642 (1997).

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[7] *See, e.g.*,*Chiarella*, 445 U.S. at 234-35.
[8] *Dirks*, 463 U.S. at 654 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977)).
[9] *O'Hagan*, 521 U.S. at 651-53; *Dirks*, 463 U.S. at 654-55.
[10] For example, in the recent, widely-publicized case for unlawful insider trading by a partner in the accounting firm KPMG, the government asserted that the accountant received cash payments, as well as expensive jewelry and entertainment expenses, in exchange for providing information about to-be-released financial results of KPMG clients to a friend who then traded on the information. *See* Complaint, ¶¶ 31-32, *S.E.C. v. London*, No. 2:13-cv-02558-RGK-PGK (C.D. Cal. filed Apr. 11, 2013); Peter Lattman, *Ex-KPMG Partner Is Charged in Insider Case*, N.Y. TIMES, April 11, 2013 (reporting that accountant supposedly received envelopes of cash, expensive concert tickets and valuable jewelry), *available at* http://dealbook.nytimes.com/2013/04/11/former-kpmg-partner-is-charged-with-insider-trading/. In subsequently pleading guilty to criminal charges, the accountant acknowledged receiving these kinds of illicit financial payments for the information. *See* Plea Agreement for Defendant Scott London, Ex. A, at 20,

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low by holding that personal benefit to the tipper can be established on vague and uncertain circumstances. Adding even more uncertainty to the mix: murky criteria have emerged for sustaining personal benefit; the personal benefit requirement sometimes coalesces with other elements of insider trading liability; and some courts drop the personal benefit requirement for ''misappropriation'' (as opposed to ''classical'') cases of insider trading. These issues are particularly significant today, given the recent wave of insider trading cases, where wrongdoing sometimes is asserted without allegations of ''payoffs,'' profit-sharing or other quintessential financial gain.[11] As a consequence, insider trading tipping cases — both civil and criminal — are being brought and tried on an amorphous construction of ''personal benefit,'' raising unsettled issues and posing both pitfalls and opportunities for each side.

## The *Dirks* Personal Benefit Requirement

Raymond Dirks was an officer of a broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional clients. He received information from a former officer of an insurance company that its assets were overstated due to fraud. Dirks investigated the claim, interviewing company officers and employees (who denied any fraud). Dirks and his firm did not trade in the company's securities. However, Dirks discussed the information with several clients and investors, some of whom sold their holdings in the company. Dirks also contacted a *Wall Street Journal* bureau chief, but the *Journal*, concerned about the accuracy of the information, declined to write a story on the fraud allegations. During the period in which Dirks pursued his investigation and spread word of the allegations, the company's stock price dropped significantly, causing the New York Stock Exchange to halt trading. Shortly afterwards, insurance regulators impounded the company's records and discovered evidence of the fraud. The SEC then filed a complaint against the company and, at that point, the *Journal* published a front-page story based mainly on Dirks' information. The company promptly went into receivership.[12]

In an administrative proceeding, the SEC found that Dirks had aided and abetted violations of Section 10(b) and other antifraud provisions ''by repeating the allegations of fraud to members of the investment community who later sold their [company] stock.''[13] Stating the ''disclose-or-abstain'' rule from *Cady, Roberts*, the SEC concluded that ''[w]here 'tippees' — regardless of their motivation or occupation — come into possession of material 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading.''[14] Dirks received only a censure, however, because he played an important role in revealing a corporate fraud. The U.S. Court of Appeals for the District of Columbia Circuit upheld the SEC's determination, entering judgment against Dirks.[15]

The Supreme Court reversed. The Court explained that *Chiarella* accepted the two elements of *Cady, Roberts* for an insider trading violation under Section 10(b): ''(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.''[16] The Court emphasized, however, that *Chiarella* held that ''there is no general duty to disclose before trading on material nonpublic information.''[17] Instead, ''[s]uch a duty arises . . . from the existence of a fiduciary relationship.''[18]

*Dirks* then addressed the ''analytical difficulties . . . in policing tippees who trade on inside information.''[19] ''Unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. In view of this absence, it has been unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information.''[20] The Court rejected the SEC's view that a tippee inherits the disclose-or-abstain duty wherever he receives information from an insider. Indeed, it rejected the notion that the antifraud provisions require equal information among all traders. Rather, the duty to disclose or abstain ''attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws'' — which arises from ''the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.''[21]

Although the Court emphasized that recipients of inside information do not automatically acquire a duty to abstain or disclose, that ''does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear.''[22] Insiders are prohibited not only from using undisclosed corporate information to their own advantage but also may not give that information ''to an outsider for the same improper purpose of exploiting the information for their personal gain.''[23] Consequently, ''the transactions of those who knowingly participate with the fiduciary in such a breach'' are prohibited.[24]

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¶ 9(f), *United States v. London*, No. 2:13-cr-00379-GW (C.D. Cal. filed May 28, 2013).

[11] *See, e.g.*, Superseding Indictment, ¶¶ 8, 28(a), *United States v. Steinberg*, S4 12 Cr. 121 (RJS) (S.D.N.Y. filed Mar. 28, 2013) (broadly alleging violation of fiduciary and other duties of trust and confidence owed by tippers); Indictment, ¶¶ 8, 9, 11, 22, 35(a), *United States v. Rajarengan Rajaratnam*, 13 Cr. 211 (NRB) (S.D.N.Y. filed Mar. 20, 2013) (same); Amended Complaint, ¶ 33, *S.E.C. v. Lee*, 13-CV-5185 (RMB) (S.D.N.Y. filed July 30, 2013) (alleging that defendant tipped information simply ''with the expectation of receiving a benefit''). *See also United States v. Gupta*, 904 F. Supp. 2d 349, 351, 354 (S.D.N.Y. 2012) (post-trial sentencing memorandum and order in widely-publicized insider trading case, noting that defendant tipper ''did not share in any direct sense'' in tippee's monetary gain; and that defendant did ''not immediately profit[] from tipping Rajaratnam, [but] viewed it as an avenue to future benefits, opportunities, and even excitement'').

[12] *Dirks*, 463 U.S. at 648-50.

[13] *Id.* at 650-51.

[14] *Id.* at 651 (citations omitted).

[15] *See id.* at 652.

[16] *Id.* at 653-54 (quotation marks and citations omitted).

[17] *Id.* at 654 (footnote omitted).

[18] *Id.*

[19] *Id.* at 655.

[20] *Id.*

[21] *Id.* at 657-58 (quotation marks and citations omitted).

[22] *Id.* at 659.

[23] *Id.*

[24] *Id.*

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*Dirks* therefore held that tippee liability derives from the insider-tipper's breach of duty: ''the tippee's duty to disclose or abstain is derivative from that of the insider's duty. . . . [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information *only when the insider has breached his fiduciary duty to the shareholders* by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.''[25]

As a result, whether a tippee is liable depends on ''whether the insider's 'tip' constituted a breach of the insider's fiduciary duty.''[26] *Dirks* observed that sometimes a disclosure of confidential corporate information does not run afoul of an insider's duty to shareholders. ''Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.''[27] From this reasoning, *Dirks* set forth the ''personal benefit'' requirement to liability: ''[T]he test is whether *the insider personally will benefit*, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.''[28]

The Court characterized personal benefit as involving ''objective criteria . . . such as a pecuniary gain or a reputational benefit that will translate into future earnings.''[29] ''Objective facts and circumstances'' might support an inference of personal benefit — ''[f]or example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient.''[30] At the extreme, the Court endorsed the notion of personal benefit to a tipper *from gifting information*: ''The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.''[31]

In the end, the Court recognized that determining whether an insider personally benefits from disclosing particular information is a question of fact that ''will not always be easy for courts.''[32] The Court nonetheless characterized personal benefit as an essential guiding principle for enabling market participants to abide by insider trading rules.

Applying these insider trading and tipping rules, the Court held that Dirks did not violate the securities law. Dirks himself owed no duty to shareholders, and he could not be liable unless the insider-tippers who had disclosed nonpublic information to him breached their disclose-or-abstain duty by their disclosures. The Court ruled that the insiders received no monetary or personal benefit in making disclosure to Dirks, nor was their purpose to make a gift of valuable information to him. As such, they did not breach their duty to shareholders, and there then was no derivative breach by Dirks.[33]

## The Gray Areas of Personal Benefit

*Dirks* adopted the improper purpose of personal benefit for determining whether an insider breached a duty to shareholders as a *limiting* principle for insider trading tipping liability. Nonetheless, the Supreme Court's characterization of personal benefit permitted expansive — and potentially uncertain — circumstances for establishing it. In particular, the Court's statements that tipping confidential information might produce a ''reputational benefit'' or be ''a gift'' from the tipper endorsed liability based on intangible and inchoate benefits. Moreover, these notions spill over into other aspects of insider trading liability.

### ■ Relationship-Based Personal Benefit

In a recent criminal insider trading case, one district court explained that ''the [personal] benefit does not need to be financial or tangible in nature; it could include, for example, maintaining a useful networking contact, improving the reputation or power within the company, obtaining future financial benefits, or just maintaining or furthering a friendship.''[34] Simply put, very little need be shown to establish that the tipper intended to benefit personally from disclosure, and the existence of the tipper/tippee relationship itself may satisfy this element.

*S.E.C. v. Yun*[35] is illustrative. There, the SEC brought an enforcement action against a tipper who divulged nonpublic information about the financial performance of her husband's company to one of her co-workers in a real estate firm. The SEC prevailed at trial, and the issue of personal benefit arose on appeal. Citing *Dirks*, the U.S. Court of Appeals for the Eleventh Circuit noted that ''[t]he showing needed to prove an intent to benefit is not extensive.''[36] The SEC had presented evidence that the tipper and tippee ''were 'friendly,' worked together for several years, and split commissions on various real estate transactions over the years.'' The Court concluded that this evidence was ''sufficient for a jury reasonably to conclude that [the tipper] expected to benefit from her tip to [the tippee] by maintaining a good relationship between a friend and frequent partner in real estate deals.''[37]

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[25] *Id.* at 659-60 (emphasis added).
[26] *Id.* at 661.
[27] *Id.* at 662.
[28] *Id.* (emphasis added).
[29] *Id.* at 663.
[30] *Id.* at 664.
[31] *Id.*
[32] *Id.*

[33] *Id.* at 665-67. Justice Powell delivered the Court's opinion in *Dirks*. Justice Blackmun, joined by Justices Brennan and Marshall, dissented, asserting that the Court's requirement that an insider act for personal gain is not an element of breach of the insider's duty. *See id.* at 668, 671, 674. Indeed, the dissent asserted that ''[t]he Court's approach is particularly difficult to administer when the insider is not directly enriched monetarily by the trading he induces,'' noting that the benefit to the insider in *Dirks* of ''the good feeling of exposing a fraud'' is little different from the benefit of giving information ''as a gift to a friend or relative.'' *Id.* at 676 n.13.
[34] *United States v. Whitman*, 904 F. Supp. 2d 363, 371 n.7 (S.D.N.Y. 2012).
[35] 327 F.3d 1263 (11th Cir. 2003).
[36] *Id.* at 1280.
[37] *Id.* The Court cited a U.S. Court of Appeals for the First Circuit case, *S.E.C. v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000), for the proposition that personal benefit existed ''when the tipper passed on information 'to effect a reconciliation with his friend and to maintain a useful networking contact.' '' However, a threshold issue in *Yun* was whether personal benefit is

In *S.E.C. v. Rubin*,[38] the SEC brought insider trading claims against a company insider and the insider's stockbroker, alleging that the insider had tipped the broker to an upcoming transaction and a financial loss of the company. Defendants were found liable at trial, and the court denied their motion for post-trial relief. The court rejected defendants' argument that there was insufficient evidence of a ''concrete benefit,'' noting that *Dirks* does not require proof that ''the tipper anticipated or received a specific or tangible benefit'' for liability to be established.[39] Rather, emphasizing *Dirks'* observation that some relationships suggest a *quid pro quo* benefit, the court stated that, absent evidence of a proper motive for the disclosure in issue, ''[t]he relationship here of customer and broker was sufficient itself to create the inference of an intent to benefit.''[40]

Relationships such as friendship and familial ties between tipper and tippee are particularly significant in determining whether the tipper sought to benefit by ''making a gift'' of confidential information.[41] As *Dirks* observed, an insider cannot trade on material nonpublic information and then gift the profits to someone else, so an insider's disclosure in order to enable another person to realize trading profits is, functionally, a gift of valuable information — and a such a gift is more likely to be inferred where the tipper and tippee are friends or family. While the courts have sometimes noted whether the parties had a ''close'' or long friendship, or a history of helping one another,[42] the existence of a friendship or family relationship generally is a low bar for establishing a gift. Indeed, courts sometimes even seem to *presume*, rather than infer from the facts, that an insider's disclosure of material, nonpublic information is a gift.[43]

Not surprisingly, only a few cases find *lack* of personal benefit where there is a concrete tipper/tippee relationship — but those cases are important for ascertaining some limitations.

In *S.E.C. v. Anton*,[44] the SEC alleged that Anton, the chairman of an insurance company, unlawfully tipped material nonpublic information about the company's finances to Johnson, a retired former executive of the company. Anton and Johnson had known each other for about 35 years. Despite that relationship, the court found that the SEC failed to prove that Anton benefited from the alleged disclosure to Johnson, scrutinizing particulars of the relationship to reach that conclusion. Although Johnson testified that ''he considered'' Anton to be a friend, the court concluded that they were not actually friends. Both testified that they had no social relationship. Johnson had been to Anton's home only once, did not have contact information for Anton other than an office phone number, and had never received a gift from Anton. Other than a very general comment, Johnson never received financial advice from Anton. Johnson was uncertain of the name of Anton's wife. And Anton, for his part, did not recall socializing with Johnson and did not consider Johnson a friend, viewing him no differently than any other former employee-shareholder.[45] Given these circumstances, the court found that ''[t]he evidence does not show Anton expected to benefit from a tip to Johnson by maintaining a good relationship or expected any meaningful future advantage.''[46] The court therefore concluded that Anton did not provide the information as a gift to Johnson, and thus Anton received no personal benefit from the alleged disclosure.

In *S.E.C. v. Maxwell*,[47] the SEC claimed that a corporate executive (Maxwell) divulged confidential information concerning the acquisition of Maxwell's company to his longtime barber (Jehn) during a haircut. Jehn invested in the stock market and had a practice of asking his clients about the corporations for which they worked. During haircut appointments, Jehn and Maxwell would discuss family and personal matters, ''how things were going'' at Maxwell's company, and their own investments. Maxwell knew that Jehn invested in the market. Before the acquisition in issue, Jehn and

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required where the insider trading claim is based on the misappropriation theory, rather than on the classical theory. Despite finding that personal benefit was proven, the Eleventh Circuit vacated and remanded because the jury instructions erroneously adopted the SEC's position that personal benefit was not required for the misappropriation theory of insider trading liability, which was the basis for the SEC's claim. *See* text accompanying nn. 78-79 below.

[38] 1993 WL 405428 (S.D.N.Y. Oct. 8, 1993).

[39] *Id.* at *4.

[40] *Id.* at *4-*5. The court also noted that, ''[i]f more were needed,'' there was evidence that the broker previously had offered the insider confidential information about other companies; and that the insider had motive to disclose nonpublic information in gratitude for trading profits or with the hope of recouping certain losses. *Id.* at *5.

[41] *See, e.g., S.E.C. v. Obus*, 693 F.3d 276, 291 (2d Cir. 2012) (''[T]he undisputed fact that Strickland and Black were friends from college is sufficient to send to the jury the question of whether Strickland received a benefit from tipping Black.''); *S.E.C. v. Sekhri*, No. 98 Civ. 2320 (RPP), 2002 BL 893, at *2-3 (S.D.N.Y. Nov. 22, 2002) (''[W]hen Sekhri disclosed insider information to his father-in-law, Sehgal, it may be inferred that Sekhri received some personal benefit from the gift of information.''); *see also S.E.C. v. Steffes*, 805 F. Supp. 2d 601, 615 (N.D. Ill. 2011) (insider's tip to his wife's brother which ''induced [tippee] to trade and resulted in significant profits'' established personal benefit); *S.E.C. v. Blackwell*, 291 F. Supp. 2d 673, 692 (S.D. Ohio 2003) (personal benefit adequately pled based on allegations that tipper ''made a gift of confidential information to family members and close friends'').

[42] *See, e.g., S.E.C. v. Warde*, 151 F.3d 42, 48-49 (2d Cir. 1998) (sufficient showing of personal benefit to tipper where ''close friendship'' suggested that tip was intended to benefit tippee); *S.E.C. v. Maio*, 51 F.3d 623, 632 (7th Cir. 1995) (''[tipper's] tipping was just one of many favors that he has done for [tippee] through the years by reason of their friendship''); *S.E.C. v. Berrettini*, Case No. 10-cv-01614, 2012 BL 299215, at *11 (N.D. Ill. Nov. 15, 2012) (''[defendants'] friendship is rooted in a business relationship, goes back more than ten years, and is sufficiently close that they would spend time socializing in Las Vegas together''); *S.E.C. v. Carroll*, Civil Action No. 3:11-CV-165-H., 2011 BL 302712, at *9 (W.D. Ky. Nov. 23, 2011) (co-defendants described as ''close friends'').

[43] *See Blackwell*, 291 F. Supp. 2d at 692 (''A mere allegation that the insider has disclosed material non-public information is sufficient to create a legal inference that the insider intended to provide a gift to the recipient of the information, thereby establishing the personal benefit requirement.''); *S.E.C. v. Blackman*, 2000 WL 868770, at *9 (M.D. Tenn. May 26, 2000) (''the legal inference is that the mere fact of [the insider's] disclosure of this information sufficiently alleges a gift by him to the other defendants so as to satisfy the personal benefit requirement of *Dirks*'').

[44] No. 06-2274, 2009 BL 87440 (E.D. Pa. Apr. 23, 2009).

[45] *Id.* at *2 n.3, *10.

[46] *Id.* at *10.

[47] 341 F. Supp. 2d 941 (S.D. Ohio 2004).

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Maxwell had discussed Jehn's purchasing stock in Maxwell's company, and Jehn once called Maxwell at home to ask if the company was going to be sold. Maxwell and Jehn did not socialize together. They were not close friends. After learning of the acquisition from Maxwell during a haircut, Jehn purchased securities of Maxwell's company, which he subsequently sold for a profit once the deal went public. Jehn admitted that he thought Maxwell might have had nonpublic information about the acquisition and that he bought the stock because of his conversation with Maxwell.

On defendants' summary judgment motion, the court found that Maxwell had communicated material nonpublic information about the acquisition to Jehn, who then bought securities of Maxwell's company while in possession of that information. Nonetheless, the court granted summary judgment for both defendants based on lack of personal benefit. Despite the circumstances of their relationship, the court held that Maxwell ''did not stand to gain'' from disclosing the information to Jehn.[48] There was no pecuniary gain or any evidence of *quid pro quo*. Moreover, ''[g]iven the parties' relative stations in life, any reputational benefit to Defendant Maxwell in the eyes of his barber is extremely unlikely to have translated into any meaningful future advantage.'' *Dirks*, the court explained, ''requires an intended benefit of at least some consequence.''[49] The court further held that the benefit-by-gift rationale did not apply: there was ''no family relationship or close friendship'' between Maxwell and Jehn; they ''did not even socialize outside of [the] haircut appointments''; there was no ''history of substantial loans or personal favors between [them]''; and, thus, ''there was no particular reason for Defendant Maxwell suddenly to decide to bestow upon Defendant Jehn a significant gift.''[50] The court distinguished numerous personal benefit cases (as discussed above) because they involved a showing that the tipper actually expected to benefit from the relationship with the tippee, or that the tipper and tippee had more substantial ties or closer friendships/relationships than existed in *Maxwell*.[51]

Consequently, while personal benefit is a low hurdle in the breach-of-duty calculus, nevertheless very particularized scrutiny of the facts is always warranted where the personal benefit asserted is an intangible rather than a direct pecuniary gain. What is the specific relationship between tipper and tippee? Is the relationship alone — whether based on friendship, family or business — sufficient to establish benefit? How close, or ''strong,'' is the relationship? Do the tipper and tippee have a ''history'' of helping one another, and is the disclosure of information at issue more of the same? Do the tipper and tippee otherwise (outside of the tipping in issue) have business dealings with each other or shared financial interests? Does the tip indirectly advance these business dealings or interests? Do the tipper and tippee truly have a social or friendship relationship (does an allegation to this effect hold up; or was the relationship instead an arms-length professional or business one), and is the tip plausibly viewed as an intention to make a gift to the tippee due to the relationship? Was the tip given to nurture a developing relationship or further an existing one? And does the disclosure promote the relationship going forward, or somehow enhance the tipper's reputation or curry favor with the tippee, so as to lead to some meaningful future advantage for the tipper? Significantly, are there circumstances suggesting that the tipper did *not* expect the tippee to trade on the information (or not expect that profits would be earned from trading on it), thereby contradicting an intention to benefit the tippee?

In short, considering the aggregate of the relationship facts, is it plausible to infer that the tipper personally benefited, be it even an indirect or intangible gain, from the tip? Careful answers to these questions will determine whether personal benefit exists.

### ■ Overlap With Knowledge

A related issue is the tippee's knowledge of the tipper's personal gain. Under *Dirks*, as noted, tippee liability derives from the tipper's breach of duty with the tippee being a knowing participant in that breach. Thus, in *United States v. Rajaratnam*, one of the recent, widely-publicized Wall Street hedge fund prosecutions, the court stated: '' 'knowledge of tipper breach [of fiduciary duty] . . . necessitates tippee knowledge of *each element*, including the personal benefit, of the tipper's breach.' ''[52]

In *United States v. Whitman*,[53] Judge Rakoff of the U.S. District Court for the Southern District of New York differentiated, as regards the tippee's knowledge of the tipper's benefit, between classical and misappropriation cases. Under the classical theory of insider trading (as in *Dirks*), a corporate insider is prohibited from trading, or tipping so others can trade, in shares of the insider's corporation based on material nonpublic information in violation of a duty owed to the corporation's shareholders. The misappropriation theory (as in *O'Hagan*) makes it unlawful for a person who is not a corporate insider but to whom material nonpublic information has been entrusted in confidence to use the information to trade in securities of a corporation, or tip others for doing so, in breach of a fiduciary duty owed to the source of the information.[54] In *Whitman*, the court explained that in a misappropriation case, ''the tippee's knowledge that disclosure of the inside information was unauthorized is sufficient for liability.''[55] However, in a classical case (the theory of prosecution in *Whitman*), the purpose is ''to protect shareholders against self-dealing by an insider who exploits for his own gain the duty of confidentiality he owes to his company and its shareholders,'' which requires ''self-dealing, in the form of a personal benefit.'' Accordingly, ''the tippee must have knowledge that such self-dealing

[48] *Id.* at 948.
[49] *Id.*
[50] *Id.*
[51] *Id.* at 948-49. *See also S.E.C. v. Rorech*, 720 F. Supp. 2d 367, 373, 415-16 (S.D.N.Y. 2010) (bond trader-tipper had no motive to provide confidential information to portfolio manager-tippee, who was neither a personal friend nor tipper's most significant account).

[52] 802 F. Supp. 2d 491, 498-99 (S.D.N.Y. 2011) (quoting *State Teachers Ret. Bd. v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984)) (emphasis in original); *see also Obus*, 693 F.3d at 287 (''a tippee has a duty to abstain or disclose 'only when the insider has breached his fiduciary duty . . . and the tippee *knows or should know* that there has been a breach' '') (quoting *Dirks*) (emphasis in original).
[53] 904 F. Supp. 2d 363 (S.D.N.Y. 2012).
[54] *See United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997) (describing both theories).
[55] 904 F. Supp. 2d at 370.

occurred, for, without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information.''[56]

Nevertheless, *Whitman* noted that the tippee in a classical case does not need to know ''the details of the benefit provided; it is sufficient if he understands that some benefit, however modest, is being provided in return for the information.'' The tippee need have only ''a general understanding that the insider was improperly disclosing inside information for personal benefit.''[57] Thus, the court's jury instructions required that the defendant trade on inside information ''*knowing* that the information had been obtained from an insider'' in violation of the insider's duty ''and in exchange for, or in anticipation of a personal benefit.''[58]

Another recent Wall Street case suggests otherwise, however. In *United States v. Newman*,[59] Judge Richard Sullivan of the Southern District of New York rejected defendants' position that the jury instructions should expressly require the tippee to have knowledge that the tipper disclosed the information for personal benefit. Based on *Dirks*, defendants argued that acting for personal benefit is what makes the tipper's disclosure an improper breach of duty, and so the tippee must know of that benefit. Nonetheless, the court (relying on the U.S. Court of Appeals for the Second Circuit's interpretation of *Dirks* in *S.E.C. v. Obus*,[60] and without differentiating classical and misappropriation theories as in *Whitman*) accepted the government's position that liability is established on proof that the tippee knew only that the tipper had disclosed information in violation of a duty of trust or confidence.[61] In a post-trial ruling on defendant's request for bail pending appeal of his conviction, which considered whether defendant's appeal raised a substantial question likely to result in a reversal, the court adhered to its reasoning: ''*Obus* . . . makes clear that the *tipper*'s breach of fiduciary duty and receipt of a personal benefit are *separate* elements and that the *tippee* need know only of the former. . . . As the Court held at trial, *Obus* clearly applies and does not require that Defendant had knowledge that the insider obtained a personal benefit.''[62]

For cases where the tipper's personal benefit from making disclosure may be intangible or indirect, the tippee's knowledge of that benefit can be a difficult question. Personal benefit in the form of a gift or reputational gain may be elusive, and the tippee's requisite knowledge of it might be even more so. How can it be shown that the tippee knew and understood that the tipper intended to make ''a gift'' of information? How does the tippee know that the tipper is disclosing information in order to enhance a relationship, with the potential for future advantage? Personal benefit comes down to a showing of the insider's self-dealing — that the insider received *something* in return for the tip — but can a tippee show that he did not know of or participate in any such exchange under the particular circumstances? Can the tippee rebut having given anything in return? This issue could be especially pertinent where downstream tippees are involved. As *Whitman* recognized, ''one can imagine cases where a remote tippee's knowledge that the tipper was receiving some sort of benefit might be difficult to prove.''[63] Even more fundamentally, is the tippee's knowledge that the tipper personally benefited required *at all* (or, as addressed below, only in certain insider trading cases)? These remain issues for future cases and appeals.

■ **Impact on Materiality**

The personal-benefit knowledge requirement also can blur into the issue of materiality. As a prerequisite to liability, the tipped information traded upon, in addition to being nonpublic, must be ''material.''[64] Of course, scienter — ''a mental state embracing intent to deceive, manipulate, or defraud''[65] — is also a requirement for proving securities fraud. Thus, to be liable ''the tipper *must know* that the information that is the subject of the tip is non-public and *is material* for securities trading purposes or act with reckless disregard of the nature of the information.''[66]

The Second Circuit addressed this showing some time ago in *Elkind v. Liggett & Myers, Inc.*,[67] a civil securities fraud case involving a company's disclosures of performance-related financial information to analysts. One tip from a corporate officer confirmed negative sales information and revealed that a preliminary earn-

[56] *Id.* at 370-71.

[57] *Id.* at 371.

[58] *Id.* (emphasis in original). The court also held that ''willful blindness'' or ''conscious avoidance'' satisfy this knowledge requirement. *Id.* at 372 (citing *Obus*, 693 F.3d at 287).

[59] *United States v. Newman*, 12 Cr 121 (RJS) (S.D.N.Y. filed Feb. 7, 2012).

[60] 693 F.3d 276 (2d Cir. 2012).

[61] Trial Tr. at 3594-3605, *United States v. Newman*, 12 Cr 121 (RJS) (S.D.N.Y. filed Feb. 7, 2012) (ruling on instructions); *see id.* at 4037 (charge stating: not unlawful for person to trade on tips ''where he does not know that the information has been disclosed in violation of a duty or confidence'').

[62] *United States v. Newman*, 2013 WL 1943342, at *2 (S.D.N.Y. May 7, 2013) (emphasis in original). In its post-trial decision, the court also stated that there is little difference between the misappropriation and classical theories on this issue. *Id.* (''*Obus* strongly suggests that, at least with respect to tippee scienter, the difference between misappropriation and classical insider trading cases is immaterial.''). Notably as well, other recent insider trading decisions involving tippee liability have not specifically required, or even addressed, knowledge of the tipper receiving a personal benefit. *See, e.g.*, *United States v. Goffer,* WL 3830127, at *7 (2d Cir. July 25, 2013) (upholding conviction where evidence showed that tippee knew or consciously avoided that tip was based on nonpublic information ''illegally disclosed in breach of a fiduciary duty''); *Gordon v. Sonar Capital Mgmt. LLC*, No. 11 Civ. 9665 (JSR), 2013 BL 156204, *2 (S.D.N.Y. June 13, 2013) (Rakoff, J.) (insider trading claim in shareholder class action dismissed because allegations failed adequately to allege what benefit tipper received, without referring to tippee's knowledge of benefit).

[63] *Whitman*, 904 F. Supp. 2d at 372; *see also Rajaratnam*, 802 F. Supp. 2d at 499 n.2.

[64] ''[I]n order for information to be 'material' for purposes of § 10(b) and Rule 10b-5, there must be a substantial likelihood that a reasonable investor would view it as significantly altering the 'total mix' of information available.'' *United States v. Cusimano*, 123 F.3d 83, 88 (2d Cir. 1997) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), and *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

[65] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94, n.12 (1976).

[66] *Obus*, 693 F.3d at 286 (emphasis added); *see also* D. Langevoort, 18 *Insider Trading Regulation, Enforcement and Prevention* § 4:6 (''Tipping occurs when an insider deliberately passes on information which he knows is material and nonpublic to an outsider, in violation of a fiduciary duty to the issuer.'').

[67] 635 F.2d 156 (2d Cir. 1980).

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ings statement would be issued in a week or so; the analyst, knowing other information, deduced that sales would be lower than expected. A second tip, from a different officer to a different analyst, disclosed (the day before the earnings announcement) that earnings would be down. In considering the materiality of the disclosed information for the scienter analysis, the Second Circuit stated: ''One who deliberately tips information *which he knows to be material* and non-public to an outsider who may reasonably be expected to use it to his advantage has the requisite scienter.''[68] Then applying this standard, the court concluded that the first tip was given without scienter because ''[t]here is no evidence to indicate that when [the tipper] acknowledged what was commonly known by the analysts and mentioned that preliminary earnings would be released in a week, he believed that he was disclosing information that would be of significance in any analyst's or investor's assessment of [the company's] stock, much less used for any trading advantage. . . . Absent evidence from which it may be inferred that the tipper knows or should certainly appreciate that the disclosure could reasonably be expected to be used by the tippee to his advantage, the essential state of mind for 10b-5 liability is lacking.''[69] However, the Court held that there was sufficient evidence of scienter as to the second tip because ''[o]ne could reasonably infer that an official commenting on earnings shortly before their public release will know that the tip could reasonably be expected to be used by the tippee for trading advantages. It is therefore material.''[70]

In short, a defense to insider trading liability can be based on a showing that the tipper believed in good faith that the information disclosed to someone else was not material and would not be used for trading purposes.[71] While this showing typically would be made by the tipper (whose knowledge is in issue), an interesting question remains whether a tippee — whose liability often is premised derivatively as a participant in the tipper's breach of duty — could also defend on this basis.

Significantly, in some circumstances knowledge of materiality could bear upon the personal benefit requirement. The Supreme Court noted in *Dirks* that not all disclosures of confidential information by an insider violate the insider's duty: ''For example, it may not be clear — either to the corporate insider or to the recipient analyst — whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.''[72] This observation then led to the Court's conclusion that a breach of duty occurs if the insider made the disclosure for the improper purpose of seeking a personal benefit.

As a result, the insider's knowledge or belief about the materiality of the information disclosed can be said to coalesce with the personal benefit requirement — which, in turn, raises interesting issues. If the insider believes that the information he discloses is not material, and therefore likely not valuable for trading purposes, what ''personal benefit'' inures to the tipper from the disclosure? Has the tipper really intended even a ''gift'' if he believes that he is not conveying information of real trading value? How does the tipper gain a ''reputational'' benefit, or enhance a relationship, if the information is not thought to be material so as to induce trading?

Materiality of the disclosed information is often an issue in insider trading cases. Colloquially put, was the information truly important to an investment decision, and was it really new or, instead, out in the market or known to analysts? But the personal benefit requirement, by combining with materiality, scienter and knowledge, adds a wrinkle. What is the proof that the tipper *knew or believed* that the information in issue was material; if that proof is lacking, a defendant (both tipper and tippee) might be able to challenge the personal benefit requirement.[73]

### ■ Omission in Misappropriation Cases?

Another issue is whether personal benefit is unnecessary where liability is premised on the misappropriation rather than the classical theory.

For example, in *S.E.C. v. Lyon*, the court stated that ''the Second Circuit has declined to impose a 'benefit' requirement in misappropriation theory cases, finding instead that the fraud 'may simply be thought of as the misuse, by trading, of stolen information.' ''[74] The underlying reasoning, based on *O'Hagan* and Second Circuit cases, is that where an outsider misappropriates confidential information, the fraud is deemed to be consummated when the information is used to trade securities — so that the securities transaction and breach of duty itself ''coincide.'' As the Second Circuit put it in *United States v. Falcone*, ''O'Hagan legitimately possessed the information given his fiduciary relationship with the source of the information, and the 'misappropriation' occurred only when he used that information to trade securities.[75]

Indeed, *Falcone* applied this reasoning in the tipping context, even where exact coincidence of the breach of duty and trading is lacking. Thus, *Falcone* held: ''To support a conviction of the tippee defendant, the government was simply required to prove a breach by Salvage, the tipper, of a duty owed to the owner of the misappropriated information, and defendant's knowledge that the tipper had breached the duty.''[76] In essence, when the misappropriation theory applies, some courts have diverged from *Dirks*' personal benefit requirement by finding that the misuse of the information *per se* is

[68] *Id.* at 167.
[69] *Id.* at 167-68.
[70] *Id.* at 168.
[71] *See Obus*, 693 F.3d at 287 (''there is a valid defense to scienter if the tipper can show that he believed in good faith that the information disclosed to the tippee would not be used for trading purposes'').
[72] 463 U.S. at 662.
[73] *See Obus*, 693 F.3d at 286-87 (''the first and second aspects of scienter — a deliberate tip with knowledge that the information is material and non-public — can often be deduced from the same facts that establish the tipper acted for personal benefit. . . . The inference of scienter is strong because the tipper could not reasonably expect to benefit unless he deliberately tipped material non-public information that the tippee could use to an advantage in trading'') (citation omitted).
[74] 605 F. Supp. 2d 531, 548-49 (S.D.N.Y. 2009) (citations omitted).
[75] 257 F.3d 226, 233 (2d Cir. 2001) (Sotomayor, J.).
[76] *Id.* at 234.

sufficient for liability (perhaps on a presumption that the information has value).[77]

But not all courts agree. The Eleventh Circuit in *Yun* held that there must be proof in a misappropriation case that the misappropriator expected to benefit from the tip. The court analyzed insider trading and tipping law in detail, as well as the policies underlying the insider trading rules, and concluded that not requiring a personal benefit to the tipper in a misappropriation case ''constructs an arbitrary fence between insider trading liability based upon classical and misappropriation theories.''[78] The court emphasized that it is important to ''attempt to synthesize, rather than polarize, insider trading law'' and that, at least in the context of an SEC enforcement action, requiring a showing that ''the misappropriator intended to benefit from his tip will develop consistency in insider trading caselaw.''[79] As discussed, *Yun* found that personal benefit had been established based on the relationship between the tipper and tippee, but the court vacated and remanded because the jury instructions erroneously omitted personal benefit as a requirement for liability.

Whether personal benefit must be proven for insider liability under the misappropriation theory remains an unsettled question which the Supreme Court ultimately may need to decide.[80] The issue is especially important in criminal cases, because the government frequently alleges the bare-bone elements for an insider trading offense without specifying whether the prosecution is premised on a classical or misappropriation theory. As a consequence, a defendant may be left unsure whether personal benefit is an element of the case, raising serious concerns about how a defendant should prepare, defend and try his case. Indeed, *Yun* noted that ''nearly all violations under the classical theory of insider trading can be alternatively characterized as misappropriations,''[81] and so the uncertainty of whether the personal benefit is required could unfairly prejudice a defendant.

**Conclusion** Because of silence in the antifraud statutes themselves, the law governing insider trading liability has developed through judge-made concepts. The personal benefit requirement is a particularly important one. Insider trading cases often involve difficult factual issues of knowledge and intent, turning upon circumstantial proof and inferences from the evidence.

But the amorphous parameters of ''personal benefit'' compound these difficulties for defendants, prosecutors and plaintiffs alike — and, more generally, pose real uncertainties for analysts, traders and other marketplace participants. Hopefully greater clarity will come as the recent spate of insider trading cases works through the courts and (perhaps) also comes to lawmakers' attention.

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[77] *See United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993) (''The tipper's knowledge that he or she was breaching a duty to the owner of confidential information suffices to establish the tipper's expectation that the breach will lead to some kind of a misuse of the information. This is so because it may be presumed that the tippee's interest in the information is, in contemporary jargon, not for nothing.'') (followed by *Falcone*). *See also S.E.C. v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (''There is some disagreement about whether benefit to a misappropriating tipper is a required element of section 10(b) and Rule 10b–5 liability. . . . [T]he Second Circuit strongly implied [in *Libera*], also in dicta, that there was no need to make an affirmative showing of benefit in cases of misappropriation. . . . Thus, it appears . . . that the Second Circuit would probably not require a showing of benefit to the tipper for tipper (or tippee) liability, but would create a presumption of section 10(b) and Rule 10b-5 liability if there was misappropriation followed by a tip.'').

[78] 327 F.3d at 1275.

[79] *Id.* at 1276.

[80] In fact, some lower court decisions even within the Second Circuit appear to require personal benefit in misappropriation cases. *See, e.g., S.E.C. v. Rorech*, 720 F. Supp. 2d 367, 373, 415-16 (S.D.N.Y. 2010) (misappropriation case addressing lack of motive and benefit to tipper); *S.E.C. v. Ducland Gonzalez de Castilla*, 184 F. Supp. 2d 365, 374-75 (S.D.N.Y. 2002) (misappropriation case citing *Dirks*, suggesting personal benefit required). Moreover, while in *Obus* the SEC appealed only on the misappropriation theory, much of the Second Circuit's analysis addressed the requirements of *Dirks* and personal benefit; *see* 693 F.3d at 283, 285, 287-88, 291-92.

[81] 327 F.3d at 1279.

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