A SAFE HARBOR FOR COMMUNICATING OR TRADING ON MATERIAL NONPUBLIC INFORMATION OBTAINED THROUGH "REPLICABLE" METHODS OR STRATEGIES: PROPOSED SEC RULE 10B5-SH

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INTRODUCTION

Despite decades of development by the Supreme Court, the circuit courts, and the Securities and Exchange Commission (SEC),[1] "insider trading laws are among the most amorphous and vague in the entire criminal code."[2] The SEC has exacerbated this legal uncertainty in recent years by developing and pursuing novel theories of insider trading liability that have not been previously recognized by the courts.[3] It has also compounded those efforts with an increasing number of enforcement actions and a newly aggressive litigation posture.[4] As a result, the current insider trading enforcement regime conspicuously lacks the type of reliable guidelines that could clearly and effectively inform innovative researchers and investors about the legal boundaries

1 *See* discussion *infra* Part I.

2 Frank C. Razzano, *Insider Trading: Ambiguous Statute as Warning*, 5 BLOOMBERG L. REP., No. 25 (June 20, 2011), http://www.pepperlaw.com/uploads/files/razzano_insidertrading_bloomberg0711.pdf. Worse yet, "the current reach of the insider trading prohibition is both arbitrary and incomplete. Egregious cases of informational misuse are not covered, while less culpable instances of abuse are criminalized." John C. Coffee, Jr., *Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 285 (2013). Some scholars have also argued that these characteristics raise questions about the constitutionality of some insider trading laws. *See, e.g.*, Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading, and Problems of Proof*, 79 CAL. L. REV. 1421 (1991); Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960 (1985). However, while acknowledging its importance, constitutional analysis is beyond the scope of this Note.

3 *See* discussion *infra* Part II.B–D.

4 *See* discussion *infra* Part II.A.

that they must operate within when gathering, communicating, or trading on material nonpublic information.[5]

The SEC has also recently targeted securities analysts[6] despite the fact that their efforts in compiling, analyzing, and disseminating information, as well as in discovering and preventing corporate fraud, are essential to the efficient functioning of the markets.[7] The Supreme Court and Congress have long recognized the essential nature of analysts' work, and have expressly emphasized the importance of protecting analysts in the context of insider trading liability.[8] Congress has also overtly supported the ability of analysts to profit from the information that they generate, with the logical understanding that—without the potential for pecuniary gain—analysts would have little incentive to undertake their efforts in the first place.[9] The SEC itself has recognized that analysts' efforts increase market efficiency and thus benefit the markets as a whole.[10] That impact directly comports with the portion of the SEC's mission that seeks to *enhance* the flow of information to the markets.[11] Nevertheless, the unintended consequences of the SEC's so-called "war on insider trading,"[12] and the legal uncertainties that have resulted, are instead likely to harm the SEC's primary stated objectives by *inhibiting* the development and flow of information from analysts and other market participants.[13]

Rather than stifling the flow of information by engendering fear of substantial insider trading penalties (financial, reputational, criminal, or other penalties), the SEC should recognize and embrace the policy that has long supported Intellectual Property law—the right to benefit from

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5 *See* discussion *infra* Part II.E. Trading on the basis of "material" and "nonpublic" information are two of the elements of insider trading liability. *See* discussion *infra* Part I.A–C.

6 The terms "analysts," "information gatherers," and "researchers" are used interchangeably throughout this Note. A securities analyst is "[a] financial professional who studies various industries and companies, providing research and valuation reports, and making buy, sell, and hold recommendations." *Definition of 'Security Analyst'*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/s/securityanalyst.asp (last visited Feb. 7, 2015).

7 *See* discussion *infra* Part III.A.

8 *See* discussion *infra* Part III.A.

9 *See* discussion *infra* Part III.B.

10 *See* Dirks v. SEC, 463 U.S. 646, 658 & n.17 (1983) (quoting the SEC while explaining that the "disclose or abstain from trading" rule that the SEC is proposing "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market").

11 *See The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml#.VBJc-NDD9Ms (last visited Feb. 7, 2014) [hereinafter SEC: *The Investor's Advocate*]. The SEC seeks "to protect investors, maintain fair, orderly, and efficient markets, and [to] facilitate capital formation" by enforcing laws and promulgating rules that *enhance information flow* for the purposes of increasing efficiency, transparency, and preventing fraud. *Id.*

12 *See* discussion *infra* Part II.A.

13 *See* discussion *infra* Part II.E.

one's own intellectual efforts should be deliberately protected by the government in order to *reward* and *induce* individuals to "bring forth new knowledge."[14] To effectuate this policy in the context of insider trading law, this Note recommends that the SEC adopt a new safe harbor rule, and proposes the draft text of Rule 10b5-SH,[15] which expressly protects and incentivizes the use of research methods and strategies that are "replicable."[16] An express safe harbor would provide reliable guidelines and clear boundaries for insider trading liability, would reduce uncertainty within the current insider trading enforcement regime, and would likely provide the necessary incentives for information gatherers and analysts to develop innovative research methods and strategies that could benefit the market as a whole. Otherwise, as the Supreme Court has warned, the only protection that market participants may have to rely on is the reasonableness of the SEC's enforcement regime, "but that can be hazardous."[17]

Part I of this Note reviews the various definitions of insider trading, the history and development of the applicable statutes and SEC Rules, the history and development of insider trading case law (including seminal Supreme Court and circuit court cases), and the three primary theories of insider trading liability. Part II analyzes and critiques a number of recent cases and SEC enforcement actions that have marked a major expansion in the scope of insider trading enforcement and liability, and provides support for the conclusion that such expansion has created significant uncertainty for analysts and investors. Part III presents support for the thesis that information gathering should be affirmatively incentivized and that analysts should be deliberately protected. Part IV provides legal and practical support for promulgating a new SEC safe harbor rule, argues the merits of proposed Rule 10b5-SH in particular, presents the text of the proposed rule, and offers a detailed analysis of the rule's provisions.

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14 *See* discussion *infra* Part III.B.

15 *See infra* Part IV.C (setting forth the proposed text of a new safe harbor Rule 10b5-SH).

16 *See infra* Part IV.A–C. Proposed Rule 10b5-SH would provide a safe harbor for the purchase or sale of securities on the basis of, or the communication of, material nonpublic information originally obtained in whole or otherwise aggregated through methods or strategies that are "replicable," provided however, that certain conditions are met and that certain confidential disclosures are made to the SEC. In order to be "replicable," the methods or strategies must lead to material nonpublic information that could have been obtained or aggregated through efforts or expenditures by any individual or entity that possessed or employed equivalent intellectual capabilities, technologies, intellectual property, financial resources, labor resources, and/or other similar resources.

17 *See* Dirks v. SEC, 463 U.S. 646, 664 n.24 (1983) ("Without legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous . . . .").

I. THE HISTORY AND CURRENT STATUS OF INSIDER TRADING LAW

A. *What Is Insider Trading?*

The Securities Exchange Act of 1934 does not itself define the term "insider trading."[18] The average American tends to view insider trading as buying or selling stock based on information an individual possesses that is not available to the general public.[19] However, this description is too simplistic and does not capture the complexity of the concept.[20] The SEC has historically refused to provide a specific definition of insider trading, and in order to maintain flexibility in its enforcement efforts, has even successfully persuaded Congress against defining the term in relevant legislation.[21] The SEC ultimately provided a partial clarification when it incorporated a non-exclusive definition into Rule 10b5-1, which was promulgated in August of 2000.[22] The new rule expressly prohibits trading securities on the basis of material nonpublic information in breach of a duty of trust or confidence owed to the source of the information.[23] The Supreme Court has held that insider trading also includes "tipping" (providing) material nonpublic information to others, trading by a "tippee" on information received from a "tipper" in

18 *See* Sec. and Exch. Act of 1934, 15 U.S.C. § 78c (2012) (Definitions and application); *see also* BUS. LAWS, INC., CORPORATE COUNSEL'S GUIDE TO INSIDER TRADING AND REPORTING § 1:2 (2014) ("The phrase 'insider trading' is not defined under the 1933 Act or 1934 Act."). Insider trading is "a term subject to many definitions and connotations and it encompasses both legal and prohibited activity." Thomas C. Newkirk, Assoc. Dir., and Melissa A. Robertson, Senior Counsel, Div. of Enf't, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff at the 16th International Symposium on Economic Crime: Insider Trading—A U.S. Perspective (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm [hereinafter Speech by SEC Staff].

19 Razzano, *supra* note 2.

20 *Id.*

21 *See, e.g.*, Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153 (1998).

22 Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-01 (Aug. 24, 2000).

23 The Preliminary Note to Rule 10b5-1 states:

> This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information *in insider trading cases* . . . .
>
> (a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the [Exchange] Act [and Rule 10b-5] thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

17 C.F.R. § 240.10b5-1 (2014) (emphasis added). However, except as expressly written into the new rule, "[t]he law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and [the new rule] does not modify the scope of insider trading law in any other respect." *Id.*

certain limited circumstances,[24] and trading on information if it has been misappropriated from the source.[25] Overall, the concept of insider trading is difficult to circumscribe, not only because a static and conclusive definition is elusive, but also because the SEC continues to pursue novel theories of liability in the courts and continues to expand the scope of insider trading liability in its civil enforcement actions.[26]

B. *The Statutory and Regulatory Framework*

On October 29, 1929, the U.S. stock market crashed and the resulting fallout led to the Great Depression.[27] In an attempt to counteract some of the perceived causes of the crash and to prevent future market crashes, Congress enacted the Securities Act of 1933 (Securities Act)[28] and the Securities Exchange Act of 1934 (Exchange Act).[29] The Exchange Act targeted insider trading directly through Section 16(b), which provides for strict liability for certain corporate insiders (e.g., directors, officers, and large shareholders) by permitting shareholders to seek the return of profits if those insiders buy and sell (or vice versa) their company's stock within a six-month period.[30] Possession of inside information is not an element of the statute, however.[31] Section 10(b) of the Exchange Act, by contrast, prohibits "manipulative or deceptive device[s] or contrivance[s]" from being used "in connection with the purchase or sale of any security."[32] Rule 10b-5

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24 *See* Dirks v. SEC, 463 U.S. 646 (1983); *see also* discussion *infra* Part I.C.3.

25 *See* United States v. O'Hagan, 521 U.S. 642 (1997); 17 C.F.R. § 240.10b5-2(a) (2014) ("This section shall apply to any violation of Section 10(b) of the [Exchange] Act and [Rule 10b-5] thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence."); *see also* discussion *infra* Part I.C.2.

26 Stephen J. Crimmins, *Insider Trading: Where is the Line?*, 2013 COLUM. BUS. L. REV. 330 (2013). Similar commentary can be directed at the Department of Justice (DOJ) in light of its recent efforts to expand the scope of insider trading liability in the criminal context. *See, e.g.*, United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) [hereinafter *Newman II*], *reh'g denied en banc*, Nos. 13-1837(L), 13-1917(Con), 2015 WL 1954058 (Apr. 3, 2015), *petition for cert. filed*, No. 15-137 (July 30, 2015). However, analysis of criminal insider trading liability is beyond the scope of this Note.

27 *Stock Market Crash of 1929*, HISTORY.COM, http://www.history.com/topics/1929-stock-market-crash (last visited Sept. 15, 2014).

28 Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2012); *see* Speech by SEC Staff, *supra* note 18.

29 Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2012); *see* Speech by SEC Staff, *supra* note 18.

30 § 78p(b); Gollust v. Mendell, 501 U.S. 115, 116–17 (1991).

31 Razzano, *supra* note 2. Although the statute notes that it has "the *purpose* of preventing the unfair use of information" by corporate insiders, the prohibitive language uses terms such as "any sale and purchase" and "irrespective of any intention on the part of such beneficial owner." § 78p(b) (emphasis added).

32 § 78j.

was adopted by the SEC under the authority granted to it in the Exchange Act in order to implement Section 10(b).[33] However, it is doubtful that at the time of its adoption anyone thought Section 10(b) was intended to specifically effectuate a prohibition on insider trading, especially considering that insider trading was already directly addressed by Section 16(b).[34] The SEC itself has noted that insider trading prohibitions only fall within the "catch-all" anti-fraud language of Section 10(b) because of the exercise of judicial authority over the last several decades.[35] Additionally, the SEC has adopted Rule 14e-3, which prohibits trading on "material, nonpublic information in the context of tender offers."[36] Nevertheless, excluding the tender offer context, which

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[33] Aaron v. SEC, 446 U.S. 680, 687–88 (1980); *see also* Speech by SEC Staff, *supra* note 18. Rule 10b-5 states that:

> 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 (2014).

[34] *See Newman II*, *supra* note 26, at 445 ("Although Section 10(b) was designed as a catch-all clause to prevent fraudulent practices, neither the statute nor the regulations issued pursuant to it, including Rule 10b-5, expressly prohibit insider trading." (citation omitted)); Eads, *supra* note 2, at 1457 (citing Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55–69 (1980) (examining the legislative history of the 1934 Act and concluding that Congress was not very concerned with insider trading)); Razzano, *supra* note 2.

[35] "While [Section 10(b) and Rule 10b-5] do not speak expressly to insider trading, here is where the courts have exercised the authority that has led to the most important developments in insider trading law in the United States." Speech by SEC Staff, *supra* note 18. "Section 10(b) was intended to serve as an 'omnibus provision' to curtail all fraudulent schemes used in connection with securities transactions." Brief for the United States at 27, Chiarella v. United States, 445 U.S. 222 (1980) (No. 78-1202) (Joint Brief by the DOJ and the SEC).

[36] SEC Rule 14e-3 specifies that, in the context of a tender offer:

> (a) 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 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

is beyond the scope of this Note, Section 10(b) and the rules promulgated thereunder are the primary statutory and regulatory sources of insider trading liability under current securities laws.[37]

C. *The Development of the Common Law of Insider Trading*

The SEC contends that insider trading case law originated as far back as 1909 in *Strong v. Repide*, in which a corporate director committed fraud by buying stock from a counterparty that did not possess the same information about an imminent event that would cause the stock to significantly appreciate.[38] However, it was another fifty years before the foundational decision by the SEC, *In re Cady, Roberts & Co.*, presented the principles on which the SEC would pursue its enforcement efforts over the next several decades.[39] Under *Cady*, insiders had a duty to disclose material nonpublic information before trading their company's stock because the information was meant for corporate purposes and not for personal gain.[40] Additionally, it was fundamentally unfair to trade with a counterparty that did not possess the same information.[41] The Second Circuit then expanded on the *Cady* principle in *Texas Gulf Sulphur Co.* by applying it to *all* market participants, holding that *anyone* who possessed material nonpublic information was required to either disclose the information to the general public or abstain from trading on the basis of that information.[42] "In other words, there must be equality of information" for all market participants, and individuals trading with an informational advantage could be held liable for securities fraud.[43] Although the Supreme Court expressly and repeatedly rejected that policy,[44] its insider trading

> 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.

§ 240.14e-3.

37 *See* United States v. O'Hagan, 521 U.S. 642, 650–53 (1997); *see also, e.g.*, Preliminary Note to § 240.10b5-1 ("The law of insider trading is . . . defined by judicial opinions construing Rule 10b-5 . . . .").

38 Strong v. Repide, 213 U.S. 419, 421 (1909); *see also* Speech by SEC Staff, *supra* note 18.

39 *In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 S.E.C. 907 (Nov. 8, 1961); *see also* Speech by SEC Staff, *supra* note 18.

40 *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting) ("[T]he Commission relied upon two factors to impose a duty to disclose on corporate insiders: (1) ' . . . access . . . to information intended to be available only for a corporate purpose *and not for the personal benefit of anyone*' (emphasis added); and (2) the unfairness inherent in trading on such information when it is inaccessible to those with whom one is dealing." (alteration in original)).

41 *Id.*

42 SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

43 Razzano, *supra* note 2.

44 *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 657–59 (1983); *see also* discussion *infra* Part III.A.

decisions have been few and far between.[45] As a result, a pattern emerged in which the SEC had the latitude to pursue novel and expanding theories of insider trading liability without Supreme Court review—sometimes for at least a decade—and the Second Circuit would enable those efforts in the interim by regularly affirming the SEC's theories.[46]

1. The Classical Theory of Insider Trading

Twelve years after *Texas Gulf Sulphur*,[47] in *Chiarella v. United States*, the Supreme Court first rejected the notion that "parity-of-information" must exist in the marketplace.[48] The Court insisted that Section 10(b) only prohibits actual fraud and that omissions can only be fraudulent if there is a duty to speak, thus holding that absent a defined duty to disclose under Section 10(b), "mere possession of nonpublic market information" does not alone create liability under Rule 10b-5.[49] The *Chiarella* Court thus developed the "classical theory" of insider trading, which holds that it is the relationship between shareholders of the issuer of the securities being traded and corporate insiders of that issuer that creates a duty to "disclose or refrain from trading."[50] Absent such a relationship, there is no duty to disclose material nonpublic information before trading.[51] In its brief, the SEC re-argued its position from *Texas Gulf Sulphur*—that "disclose or refrain from trading" should apply to *all* market participants.[52] The Court rejected that position, however, and thus solidified the foundational "duty" element of insider trading law.[53]

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45 *See* discussion *infra* Part I.C.1–3.

46 *See* discussion *infra* Parts I.C.1–3, II.B–D. The pattern was finally broken in December of 2014 when the Second Circuit, in a highly anticipated opinion, emphatically rebuked the government's recent efforts to expand the boundaries of insider trading liability. *See Newman II*, *supra* note 26, at 447–49 ("[T]he Government relies on dicta in a number of our decisions . . . . By selectively parsing this dictum, the Government seeks to revive the absolute bar on tippee trading that the Supreme Court explicitly rejected . . . . The Government's overreliance on our prior dicta merely highlights the doctrinal novelty of its recent insider trading prosecutions . . . . Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities market."). *See generally* Ben Protess & Matthew Goldstein, *Appeals Court Deals Setback to Crackdown on Insider Trading*, N.Y. TIMES DEALBOOK (Dec. 10, 2014, 10:19 AM), http://dealbook.nytimes.com/2014/12/10/appeals-court-overturns-2-insider-trading-convictions/?_r=0.

47 *Tex. Gulf Sulphur*, 401 F.2d 833.

48 Chiarella v. United States, 445 U.S. 222, 232–35 (1980).

49 *Id.*

50 *See* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

51 *Chiarella*, 445 U.S. at 232–35.

52 Brief for the United States, *supra* note 35 at 38–49.

53 *See O'Hagan*, 521 U.S. at 651–52.

2. Misappropriation Theory of Insider Trading

In *Chiarella*, the SEC argued in the alternative that insider trading liability could be predicated on the tort of "misappropriation,"[54] i.e., that if material nonpublic information was obtained "wrongfully"—even without a corresponding duty to the issuer of the securities being traded—a defendant should be held liable for violating Rule 10b-5.[55] Although the *Chiarella* Court declined to address the "misappropriation" theory in 1980,[56] the SEC continued to pursue its then-novel theory for nearly two decades, empowered by the support it received from Chief Justice Burger's dissent,[57] as well as by the Second Circuit's wholesale adoption of the theory in 1981.[58]

The Supreme Court did ultimately adopt the "misappropriation" theory in *United States v. O'Hagan*,[59] holding that a lawyer was liable for misappropriating material nonpublic information from his firm—in violation of a duty of confidence—when he bought stock in a company that his firm's client was seeking to acquire.[60] The Court held that a fiduciary duty was not essential for liability under the "misappropriation" theory;[61] other breaches of duty, such as a violation "of a duty of loyalty or confidentiality" to the source of the information (as opposed to a duty to the investing public in general), could arguably be sufficient for insider trading liability.[62] To codify the *O'Hagan* holding and to clarify the applicability of the theory to relationships outside of the business context,[63] the SEC adopted Rule 10b5-2.[64]

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54 *See* Brief for the United States, *supra* note 35, at 38–49.

55 *See id.*

56 The Court stated that the theory was not properly submitted to the jury. *See Chiarella*, 445 U.S. at 237 n.21.

57 *See id.* at 240 (Burger, C.J., dissenting) ("I would read § 10(b) and Rule 10b-5 to . . . mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."); Brief for the United States, *supra* note 35, at 38–49. The SEC's persistent effort was also consistent with its long held view that "under the broad language of the anti-fraud provisions [the SEC is] not to be circumscribed by fine distinctions and rigid classifications." *In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 S.E.C. 907 (Nov. 8, 1961).

58 United States v. Newman (*Newman I*), 664 F.2d 12, 19 (2d Cir. 1981).

59 United States v. O'Hagan, 521 U.S. 642, 650 (1997) ("[L]iability under § 10(b) may be predicated on the misappropriation theory."). Although the Supreme Court had an earlier opportunity to rule on the misappropriation theory, the Court was unable to reach a majority opinion on that issue. Carpenter v. United States, 484 U.S. 19, 24 (1987) (affirming the lower court's convictions related to securities fraud as a result of an even split of the Court).

60 *O'Hagan*, 521 U.S. at 647–50.

61 *See id.* at 652.

62 *See id.*

63 *Insider Trading*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/insider.htm (last modified Jan. 15, 2013).

64 "Preliminary Note to § 240.10b5-2: This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the

3. Tipper/Tippee Theory of Insider Trading

Insider trading liability is not limited to classical insiders, or to those who misappropriate and trade on material nonpublic information for their own benefit, but has been expanded by the Supreme Court to include transferring such information to outsiders who trade themselves.[65] In *Dirks v. SEC*, the Court held that a "tippee" (the recipient of material nonpublic information) would risk liability if the source of the information (the "tipper") violated his fiduciary duty by disclosing the information *and* the tippee knew or had reason to know that the tipper had violated that duty in exchange for a personal benefit.[66] In other words, the tippee would absorb the tipper's duty because the information was "improperly" transferred.[67] In *United States v. Newman (Newman II)*, the Second Circuit further clarified that for liability to attach, the tippee must also have had specific knowledge of the benefit that the tipper received.[68]

Dirks was an analyst who uncovered corporate fraud at an insurance company that he investigated, and the SEC alleged that he aided and abetted the violation of federal securities laws by sharing the information he learned with clients and investors.[69] The Court rejected the SEC's arguments, again emphasizing that a duty to disclose or abstain from trading could not "arise from the *mere possession* of nonpublic market information."[70] Dirks could not have inherited a fiduciary duty because the former employee who alerted him to the fraud did not have a fiduciary duty to refrain from exposing the employer's fraud, nor did the former employee—as a whistleblower—have the requisite intent to receive a personal benefit.[71] Dirks could not have acquired such a duty simply because he was able to obtain the information as a byproduct of his "position in the market."[72]

The *Dirks* Court developed the foundation of traditional insider tipper/tippee liability, but the Court's opinion left an open question as to whether individuals who obtain such information from corporate *outsiders* could nevertheless face liability for insider trading.[73] The

'misappropriation' theory of insider trading under Section 10(b) of the [Exchange] Act and Rule 10b-5." 17 C.F.R. § 240.10b5-2 (2014).

65 *Newman II*, *supra* note 26, at 446.

66 Dirks v. SEC, 463 U.S. 646, 660 (1983).

67 Razzano, *supra* note 2.

68 *Newman II*, *supra* note 26, at 450.

69 *Dirks*, 463 U.S. at 648–52.

70 *Id.* at 654 (emphasis added).

71 *Id.* at 657–59.

72 *Id.*

73 Razzano, *supra* note 2. That issue emerged in September of 2014 when the SEC filed an action against a tippee who allegedly received information that was misappropriated from an *outsider* (a hedge fund named Pershing Square Capital) and then traded on the basis of such

Court's opinion also failed to sufficiently clarify other issues, such as the level of knowledge that the tippee must have about the benefit received by the tipper, or the type of alleged benefit that would be significant enough to meet that element of liability, the resolution of which was vital to the Second Circuit's opinion in *Newman II*.[74] These open questions created significant uncertainty for analysts and investors because, as the SEC's actions have demonstrated since *Chiarella*, *Dirks*, and *O'Hagan*,[75] any ambiguities left in the law tend to embolden the SEC to continue expanding the scope of its insider trading enforcement regime and to continue pursuing novel theories of liability to support those efforts.[76]

II. Recent Notable Cases and SEC Actions: A Significant Expansion in the Scope of Insider Trading Enforcement and Tactics[77]

A. *The SEC's "War on Insider Trading"*

The SEC has stated that "[t]he breadth of the anti-fraud provisions leaves much room for interpretation and the flexibility to meet new schemes and contrivances head on."[78] It has historically used that philosophy to expand the scope of insider trading enforcement,[79] and

information. *In re* Peixoto, Exchange Act Release No. 34-73263, 2014 WL 4826820 (Sept. 30, 2014) [hereinafter Peixoto] (Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 and Notice of Hearing); *see also infra* Part II.D.

74 *See Newman II*, *supra* note 26, at 446–55.

75 *See* discussion *infra* Part II.

76 Crimmins, *supra* note 26.

77 Many of the defendants' alleged actions within the cases in this Part are arguably immoral or unethical, and in some cases, independently criminal outside the purview of insider trading law. *See, e.g.*, SEC v. Dorozhko, 574 F.3d 42, 45 (2d Cir. 2009) (discussing the fact that computer hacking itself might violate various state and federal criminal laws). However, this Note does not argue that such defendants should be fully exonerated of all crimes, or should not otherwise be subject to civil liability, or that the SEC should somehow incentivize behavior that is independently immoral, unethical, or illegal. Instead, this Note emphasizes that the *means* used by the SEC in its enforcement efforts creates substantial uncertainty about the legal boundaries that analysts must operate within, and creates a significant risk of stifling information gathering—especially among those with completely legitimate intentions. As a familiar analogous argument, one should not be viewed as advocating for the release of alleged murderers simply because one advocates for the elimination of torture-based confessions as a *means* of securing their convictions. This Note thus argues that the *means* of insider trading enforcement should be analyzed in relation to their broader impact on market actors in aggregate and on the financial markets as a whole, not analyzed in isolation based on any individual case or set of facts.

78 *See* Speech by SEC Staff, *supra* note 18.

79 *See* discussion *supra* Part I.C.1–3 (reviewing the liability-expanding arguments made by the SEC in various Second Circuit and Supreme Court cases over the last thirty years).

has compounded those efforts in recent years by adding an element of aggressiveness to its litigation posture—"pushing the boundary of what is deemed illegal."[80] As a result, the SEC has been pursuing suspected insider trading violations at a dramatically increased rate compared to statistical trends over the preceding several decades.[81] In the three-year period ending in its fiscal year 2013, the SEC brought more enforcement actions than during any comparable period.[82]

The SEC has argued that it is attempting to ensure that markets are fair for ordinary investors, and that markets are protected against unscrupulous trading, because "[w]ho's going to trade if they think the game is rigged?"[83] Granted, noticeable and respected enforcement efforts are of course an important deterrent. However, the SEC's efforts in recent years are arguably "changing the law," not simply enforcing it.[84] Additionally, when the SEC's Director of Enforcement testifies before Congress that anyone who outperforms benchmark market indexes by as little as three percent on a regular basis could be subject to an SEC investigation,[85] that is likely to create substantial fear among market professionals who are inherently seeking to achieve maximum investment returns for themselves and their clients.[86] Overtly threatening investment professionals with enforcement action based on suspicions that stem from merely performing their roles too successfully can only increase the uncertainty already underlying insider trading law.

B. SEC v. Dorozhko*: The "Affirmative Misrepresentation" Theory of Insider Trading*

Reminiscent of its development of the "misappropriation" theory in the early 1980s, the SEC has successfully persuaded the Second

80 Roger Lowenstein, *The War on Insider Trading: Market-Beaters Beware*, N.Y. TIMES MAG. (Sept. 22, 2011), http://www.nytimes.com/2011/09/25/magazine/in-the-insider-trading-war-market-beaters-beware.html?%20pagewanted=all&_r=0 (discussing the actions of Robert Khuzami, the SEC's former Director of Enforcement).

81 *See Insider Trading Developments*, SCHULTE ROTH & ZABEL, Summer 2014, http://digital.srz.com/i/356225/0.

82 The SEC brought over 160 enforcement actions during that timeframe. Crimmins, *supra* note 26, at 349–50.

83 Lowenstein, *supra* note 80 (quoting the former SEC Director of Enforcement, Robert Khuzami).

84 *Id.* (quoting Tom Gorman, a lawyer at Dorsey & Whitney).

85 *See id.* (citing Khuzami's congressional testimony in December of 2011).

86 Alpha is "[a] measure of performance on a risk-adjusted basis [of t]he excess return of [a] fund relative to the return of the benchmark index . . . . Simply stated, alpha is often considered to represent the value that a portfolio manager adds to or subtracts from a fund's return" relative to an unmanaged passive investment in a market index. *See Definition of Alpha*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/a/alpha.asp (last visited Feb. 12, 2015).

Circuit to adopt a new theory of insider trading liability predicated on "affirmative misrepresentations."[87] According to the theory advocated by the SEC, not only is the breach of a fiduciary duty no longer essential for liability under Rule 10b-5,[88] but the violation of a "duty of trust and confidence," or of any other duty, is no longer necessary for insider trading liability.[89] All that is required is that a party transfer or trade on the basis of information that was obtained through an affirmative misrepresentation or through the use of "deception."[90]

To test its novel theory, the SEC brought an action in *Dorozhko* against a Ukrainian national who the SEC alleged had "affirmatively misrepresented" himself by hacking into a computer system.[91] The connection to insider trading was that the computer system belonged to Thomson Financial (Thomson), a company that provides information dissemination services to public companies that, among other things, plan to release their quarterly earnings information to the entire market.[92] Minutes after Thomson received the earnings information from IMS Health (IMS), Dorozhko successfully hacked into Thomson's computer system and gained access to the information.[93] He then bought put options[94] for IMS stock, which he sold for a large profit after the information was publically disseminated and IMS's stock fell sharply.[95]

The SEC's Brief argued that in various types of securities law cases, the Supreme Court had already held that the violation of a duty was not essential because liability for any type of fraud can be predicated on *either* a failure to disclose information in breach of a duty *or* on a fraudulent misrepresentation.[96] The Second Circuit thus held that insider trading liability can be predicated on fraudulent misrepresentations, accepting the SEC's argument that Dorozhko could be liable if he affirmatively misrepresented himself in his hacking

87 SEC v. Dorozhko, 574 F.3d 42, 48–49 (2d Cir. 2009).

88 *See* United States v. O'Hagan, 521 U.S. 642 (1997) (holding that a breach of a fiduciary duty was not required for insider trading liability).

89 *Id.* at 653 (holding that a breach of some duty of trust and confidence was still essential for insider trading liability).

90 *See Dorozhko*, 574 F.3d at 48–50 (stating the elements of the theory and defining the key terminology).

91 *See id.*

92 *See id.* at 44.

93 *See id.*

94 A put option "gives the owner the right to sell stock at [a specific] price for a limited time." *Put Options Explained*, TRADEKINGS.COM, https://www.tradeking.com/education/options/put-options-explained (last visited Sept. 11, 2014). Put options can be bought in order to bet that a stock's price will decline. If the price of the underlying stock declines, the value of the put option itself would rise. The option can then be sold for a profit. *Id.*

95 *See Dorozhko*, 574 F.3d at 44.

96 Opening Brief for the Securities and Exchange Commission, Appellant at 44–49, *Dorozhko*, 574 F.3d 42 (2008) (No. 08-0201-CV).

technique in order to gain access to material nonpublic information in the computer system.[97] However, the court stated that on remand, if Dorozhko is found to have simply exploited a weakness in the code, then that may just be simple theft.[98] Perhaps a broader impact on insider trading liability will be mitigated by the fact that the Second Circuit appeared to define "deception" quite narrowly—simply using *one* of the definitions in Webster's dictionary:[99] "to cause to believe the false, or to disbelieve the true."[100] However, market participants may reasonably expect that the SEC and the courts will likely be more creative in the future in identifying actions that are allegedly deceptive.[101]

The potential implications of the Second Circuit's ruling reveal how broad and potentially limitless the concepts of affirmative misrepresentation and deception can be when applied to insider trading actions. For example, one of the basic elements of an affirmative misrepresentation in the broader context of a 10b-5 claim is that the relevant statement must induce detrimental reliance on the part of the party to whom the statement was made.[102] In the context of insider trading liability, market actors may have logically assumed that the relevant action that the relying party is required to take in order trigger liability must be the purchase or sale of a security (or to refrain from selling a security)—as required by Rule 10b-5.[103] However, that was not the case in *Dorozhko*, where Thomson—to whom the affirmative misrepresentations were allegedly made—did not purchase or sell securities, and where Dorozhko was not alleged to have made any affirmative misrepresentations to the counterparties with whom he actually traded.[104]

Therefore, the logical extension of the SEC's arguments in *Dorozhko* must be that—although reliance on such affirmative misrepresentations merely caused the relying party to *disclose information*—such reliance is sufficient for liability. However, that logic is already attenuated in relation to the types of purchase or sale of security-inducing affirmative misrepresentations, or even fraud-on-the-market-type affirmative misrepresentations, that have been analyzed by the Supreme Court in the securities cases that the SEC itself cited in order to support its novel theory in *Dorozhko*.[105] Although such an

97 *Dorozhko*, 574 F.3d at 49–50.

98 *Id.* at 50–51 (remanding the case for further determination of the relevant facts).

99 Coffee, *supra* note 2, at 308 (citing *Dorozhko*, 574 F.3d at 50).

100 *Dorozhko*, 574 F.3d at 50.

101 *See* Coffee, *supra* note 2, at 308–09. The *Dorozhko* Court itself briefly mentioned another definition: "to impose upon; to deal treacherously with; cheat." *Dorozhko*, 574 F.3d at 50.

102 *See, e.g.*, Titan Group, Inc. v. Faggen, 513 F.2d 234, 238–39 (2d Cir. 1975).

103 17 C.F.R. § 240.10b-5 (2014).

104 *See Dorozhko*, 574 F.3d at 44.

105 Opening Brief for the Securities and Exchange Commission, Appellant at 44–49, *Dorozhko*, 574 F.3d 42 (No. 08-0201-CV) (citing Stoneridge Inv. Partners, LLC v. Sci.-Atlanta,

attenuated connection may plausibly fulfill the independent "in connection with the purchase or sale of any security" element of a securities fraud action,[106] it is important to note that reliance is a completely separate element of affirmative misrepresentation, which itself is a completely separate element of a securities fraud action. Therefore, the fact that the SEC has attempted to make such an attenuated connection by transposing the analysis from the "in connection with the purchase or sale of any security" element onto the "affirmative misrepresentation" element will further increase the level of uncertainty created by this novel theory.

Furthermore, that logic creates several additional layers of uncertainty. First, it is not clear whether the SEC would find it relevant that the party to whom an affirmative misrepresentation was made was neither an insider nor received the information in confidence from an insider—as was the case in *Dorozhko*. Perhaps the SEC will only require that an affirmative misrepresentation is made at any point in the information gathering process, to any source, as long as the obtained information is subsequently used in connection with the purchase or sale of a security. Second, there is uncertainty as to whether the information obtained through an affirmative misrepresentation must itself be material and nonpublic, or whether the SEC will find liability where, for example, a market actor obtains less significant information through an affirmative misrepresentation, but when that information is subsequently pieced together with other "legitimately" obtained information, the *resulting* information being material and nonpublic.

Third, it is unclear whether the SEC believes that liability can be triggered where information is *not even* the item obtained through an affirmative misrepresentation. For example, consider an individual who affirmatively misrepresents her work experience and qualifications in order to obtain employment with a hedge fund. At some subsequent point in time, the employment position enables the individual to gather and trade on the basis of material nonpublic information that she develops by piecing together and analyzing public sources of information using methods and strategies that any other professional analyst or investor would use. It is unclear whether the SEC would find liability under those circumstances even though the individual did not obtain the *information* by making an affirmative misrepresentation, but merely obtained an *employment* position that enabled her to otherwise "legitimately" obtain the information. That issue also triggers a fourth level of uncertainty. Would the SEC attempt to argue that the individual's actions in obtaining her employment were "in connection

Inc., 552 U.S. 148 (2008); Basic Inc. v. Levinson, 485 U.S. 224 (1988); Chiarella v. United States, 445 U.S. 222 (1980)).

106 *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71 (2006).

with the purchase or sale of a[] security"—a concept that the Supreme Court has historically interpreted very broadly?[107] One could reasonably believe that there is a substantial risk of the SEC making such an argument.

Although the Supreme Court has yet to address the "affirmative misrepresentation" theory in the context of insider trading liability, the absence of Supreme Court review did not deter the SEC from aggressively pursuing and enforcing its then novel "misappropriation" theory in the nearly twenty years before *O'Hagan*.[108] It is therefore unlikely that the SEC will abstain from aggressively pursuing this new theory in the interim as well.

C. SEC v. Steffes*: "Piecing Together" Information Is Successfully Argued as Prohibited*

In an attempt to further expand the scope of activities encompassed by insider trading prohibitions, the SEC has successfully argued that a defendant can violate insider trading laws by obtaining and trading on "pieces of information" that only become material once the information is "piece[d] together."[109] In other words, insider trading liability can be predicated on simply compiling fragments of information to "piece together" the whole "puzzle," whether or not the fragments themselves constitute material nonpublic information.[110] Even on the surface, those arguments seem to simply describe the fundamental work of every analyst or researcher, and expressly undercut the SEC's own historical support for the mosaic theory.[111]

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107 *See id.* at 85 ("Under our precedents, it is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else. *See* [United States v. O'Hagan, 521 U.S. 642, 651 (1997)]. The requisite showing, in other words, is 'deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller.'").

108 *See, e.g.*, Carpenter v. United States, 484 U.S. 19 (1987) (failing to reach a majority opinion on the misappropriation theory issue); United States v. O'Hagan, 92 F.3d 612, 617–18 (8th Cir. 1996) (holding that, in the Eighth Circuit, liability cannot be based on the misappropriation theory); United States v. Newman (*Newman I*), 664 F.2d 12, 19 (2d Cir. 1981) (expressly adopting the SEC's misappropriation theory in the Second Circuit).

109 Plaintiff's Response to Defendants' Motion for Summary Judgment at 19, SEC v. Steffes, 805 F. Supp. 2d 601 (N.D. Ill. 2011) (No. 10-cv-6266) (citing the court's previous ruling in an earlier part of the same case).

110 *See id.* (citing United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996) ("[U]pholding a criminal conviction for insider trading under circumstances where the defendant 'was never told about the acquisition and did no more than piece together evidence obtained while working for' the acquirer.")).

111 An SEC official has previously stated that

> the Commission is [not] seeking to undermine the mosaic theory, under which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is

In *Steffes*, the primary defendants (Steffes Defendants) were employees of a railroad company that was confidentially exploring a sale of the company to a number of potential acquirers.[112] The SEC did not allege that the Steffes Defendants had direct knowledge of the potential acquisition, but instead argued that certain tasks that they were assigned to and observations that they made in the course of their employment led them to independently conclude that an acquisition was likely.[113] The Steffes Defendants witnessed tours of the rail yards by men in suits who one defendant "believed" were investment bankers,[114] but the Steffes Defendants had no direct or indirect knowledge of the identities or affiliations of those taking the tours.[115] The SEC even emphasized that the Steffes Defendants were asked by other lower level employees whether the tours signified that the company was being sold.[116] However, that final point seems to imply that less informed employees were equally able to draw the same conclusions, thus challenging the SEC's primary arguments. Nevertheless, a federal court held, at least in a ruling against summary judgment, that "[a] defendant is liable when he 'connects the dots'"[117]—without more.

Supporters may defend the SEC's theory of liability by emphasizing that *Steffes* involved *employees* who obtained information as a result of their position within their company, and that the SEC's arguments would not necessarily apply to *outsiders* who gather such information.[118] However, that analysis mistakenly conflates three essential elements of insider trading liability. As a threshold issue, one must determine

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> not material nonpublic information obtained in breach of or by virtue of a duty or relationship of trust and confidence.

Carlo V. di Florio, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Remarks at the IA Watch Annual IA Compliance Best Practices Seminar (Mar. 21, 2011), http://www.sec.gov/news/speech/2011/spch032111cvd.htm.

112 Complaint ¶¶ 11–20, *Steffes*, 805 F. Supp. 2d 601 (No. 10-CV-6266).

113 *Id.* ¶¶ 34–38.

114 *Id.*

115 Statement of Undisputed Material Facts Accompanying the Memorandum of Law in Support of the Defendants' Motion for Summary Judgment ¶¶ 23–24, *Steffes*, 805 F. Supp. 2d 601 (No. 10-CV-6266).

116 Complaint, *supra* note 112, ¶ 34(c).

117 Plaintiff's Response to Defendants' Motion for Summary Judgment at 19, *Steffes*, 805 F. Supp. 2d 601 (No. 10-CV-6266).

118 In fact, the cases cited by the SEC for the "piece together" argument all involved employees who arguably violated a duty to their employers. SEC v. Materia, 745 F.2d 197, 199 & n.2 (2d Cir. 1984) (involving a defendant who was able to "divine the identities" of the target companies); SEC v. Berrettini, No. 10-CV-01614, 2012 WL 5557993, at *13 (N.D. Ill. Nov. 15, 2012); SEC v. Binette, 679 F. Supp. 2d 153, 159 (D. Mass. 2010); SEC v. Soroosh, No. C-96-3933-VRW, 1997 WL 487434, at *6 (N.D. Cal. Aug. 5, 1997); Plaintiff's Response to Defendants' Motion for Summary Judgment at 19, *Steffes*, 805 F. Supp. 2d 601 (No. 10-CV-6266) (citing United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996) ("[U]pholding a criminal conviction for insider trading when the defendant 'was never told about the acquisition and did no more than piece together evidence obtained while working for' the acquirer.")).

whether the information was material *and* nonpublic by analyzing, *inter alia*, the type of information gathered, its relative significance, and the conclusions ultimately drawn.[119] Crucially, one must also analyze whether a defendant at least misappropriated the information and traded in violation of a duty of trust or confidence.[120] That violation of a duty is the relevant element that implicates the employee-employer relationship at issue in *Steffes*. Yet, the SEC's novel "piece together" theory was only relevant to the element of *materiality*, not to the duty element.[121] As such, the result of the SEC's theory is that—if the information can be deemed material for the purposes of insider trading liability simply because an individual was able to "connect the dots"—such information can be deemed material for the purposes of insider trading liability for all potential defendants, including *outsiders*.[122]

One could argue that such a result is both obvious and unproblematic because analysts who piece together information under the mosaic theory, for example, *are in fact* trading on the basis of material nonpublic information, but they are not engaging in unlawful trading because analysts do not have a duty to the shareholders of the issuer or to the source of the information. However, if that argument were dispositive, the SEC would have had no logical reason to put forth its "piece together" theory in *Steffes* in the first place. Instead, the SEC could have merely pled the fact that the *conclusions* reached by the Steffes Defendants—that the company was likely in the process of being acquired—were clearly material and nonpublic, and therefore their duty to their employer prohibited them from trading on the basis of that information. The only logical inference to be drawn from the SEC's decision to introduce the "piece together" theory in *Steffes* is its implicit acknowledgment that there must be a further link between the actual pieces of information gathered and the materiality element—as opposed to merely requiring a link between the conclusions themselves and the materiality element.

The implications of the SEC's reasoning in *Steffes*, therefore, when analyzed in conjunction with the uncertainties created by the SEC's application of the "affirmative misrepresentation" theory in *Dorozhko*,[123] is that there are few barriers preventing the SEC from pursuing *outsiders* who "piece together" information and draw material conclusions, as long as the SEC can also plausibly allege that at least one vaguely defined misrepresentation or act of deceit was used to gather the

119 *See* United States v. O'Hagan, 521 U.S. 642 (1997).

120 *See id.*

121 *See* Plaintiff's Response to Defendants' Motion for Summary Judgment at 19, *Steffes*, 805 F. Supp. 2d 601 (No. 10-CV-6266).

122 *See id.*

123 *See supra* text accompanying notes 105–07.

information,[124] or that an affirmative misrepresentation was used for some other purpose that is—in some attenuated way—"in connection with the purchase or sale of any security."[125]

D. *Outsider Analysts Can Now Also Create Nonpublic Information?*

The SEC has also pursued insider trading enforcement action against analysts who allegedly disclose the content or existence of their research reports to select individuals, before the reports are released to a firm's clients, for the primary benefit of the analyst or the "tipped" individuals.[126] The SEC has supported such claims under the "misappropriation" theory[127] by alleging that analysts violate a duty of trust or confidence to their firms by misappropriating material nonpublic information for their own benefit.[128] The SEC has successfully argued that the content—or even the existence—of such

124 As the *Dorozhko* opinion and subsequent scholarly commentary have revealed, the definitions of deceit and "affirmative misrepresentation" are hardly circumscribed. *See* SEC v. Dorozhko, 574 F.3d 42, 48–49 (2d Cir. 2009); *see also* Coffee, *supra* note 2, at 308–09 ("[A]s the panel noted but did not discuss, this same edition of Webster's also defined the term to mean 'to impose upon; to deal treacherously with; cheat.' Reading another's mail, opening their desk drawers, or hacking their computer (by any means) is cheating and amounts to 'treacherous' behavior. Or, at least, the SEC could safely so rule.").

125 *See supra* note 107 and accompanying text.

126 *See, e.g.*, *In re* Bolan, Securities Act Release No. 33-9659, Exchange Act Release No. 34-73244, 2014 WL 4803778 (Sept. 29, 2014) (Order Instituting Administrative and Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934). In 2008, the Financial Industry Regulatory Authority (FINRA) proposed adopting NASD Rule 2711 (Research Analysts and Research Reports). FINRA Regulatory Notice 08-55, 2008 WL 4612508, at *7 (Oct. 14, 2008). The proposed rule was not originally adopted, but it was presented again for public comment in 2014, and was subsequently adopted on July 16, 2015. Exchange Act Release No. 34-75471, 2015 WL 4336133, at *9 (July 16, 2015). The rule is a business conduct rule for FINRA member firms for the benefit of each firm's customers in that it prohibits the selective—or tiered—dissemination of analysts' research reports to some "customers in advance of other customers." *Id.* The proposed rule does not itself speak to insider trading, but the SEC's enforcement action in *Bolan* is predicated on the same general concept, namely, that the potential "market-moving" impact of the existence or content of these reports makes is improper to "tip" this information to specific individuals for the benefit of the analyst or those individual(s), rather than simply for the benefit of one customer over another. *See Bolan*, 2014 WL 4803778. Bolan eventually entered into a settlement with the SEC in which—without admitting or denying the allegations—he consented to the entry of an "Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933." *In re* Bolan, Securities Act Release No. 33-9795, Exchange Act Release 34-75066, 2015 WL 3413279 (May 28, 2015).

127 *See supra* Part I.C.2 (explaining the "misappropriation" theory).

128 *See, e.g.*, Memorandum of Law in Opposition to Defendants' Pretrial Motions at I.A., United States v. Guttenberg, No. 07 Cr. 141(DAB), 2007 WL 4115810 (S.D.N.Y. Nov. 14, 2007) (No. 07 Cr. 141 (DAB)) ("Insider trading based on material, nonpublic information that has been misappropriated in violation of a duty of trust or confidence constitutes securities fraud within the meaning of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5. United States v. O'Hagan, 521 U.S. 642, 653 (1997) . . . .").

reports is itself material nonpublic information by analogizing the reports to pre-release copies of news articles.[129] The Second Circuit has held that some news articles are material nonpublic information because they are known to directly impact the stock prices of the subject companies.[130] The Supreme Court, however, has never decided whether trading on the basis of information misappropriated from the publisher of news articles or research reports can be deemed fraud "in connection with the purchase or sale of a[] security."[131] However, the *O'Hagan* Court did cite approvingly to a law review article that discussed *Carpenter v. United States* as unusual because the misappropriated information belonged to the Wall Street Journal rather than to an issuer.[132] Nevertheless, the Court again left the question unresolved.[133] The Second Circuit has continued to follow its own holding from *Carpenter*—that trading on the basis of such information can trigger liability for insider trading—and courts within its jurisdiction have typically upheld related SEC actions.[134]

The SEC recently took this theory of liability a step further by pursuing an enforcement action in which the facts lacked the dispositive elements of even its most aggressive cases from recent years.[135] The information at issue in the *Peixoto* action was developed by hedge fund analysts who gathered the information from publicly available sources, who did not have an affiliation with a FINRA member firm,[136] and who

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129 *See Guttenberg*, 2007 WL 4115810.

130 *See* United States v. Falcone, 257 F.3d 226, 234 (2d Cir. 2001) (holding that misappropriated pre-release copies of a Business Week column could form the basis of insider trading liability because such articles have "a known effect on the prices of securities of the companies it discusses").

131 The Supreme Court had an opportunity to rule on this exact issue in *Carpenter*, which involved the alleged misappropriation of pre-release copies of Wall Street Journal articles, but the Court failed to reach a majority opinion on the securities fraud issue. Carpenter v. United States, 484 U.S. 19, 22–24 (1987). When the Court later had an opportunity to revisit the misappropriation theory, the case involved an attorney who misappropriated information from his law firm (or arguably, directly from the firm's client) regarding the existence and terms of a tender offer that the client was making for the shares of another company—a very different set of circumstances involving more traditional insiders and their agents. United States v. O'Hagan, 521 U.S. 642 (1997).

132 *O'Hagan*, 521 U.S. at 650 n.4 (citing Barbara B. Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373, 375 (1988)). The Second Circuit itself noted this obscure footnote, *Falcone*, 257 F.3d at 234 n.5, but the court's analysis was instead focused on the argument that, since the news articles had no value outside of their use for securities trading, their misappropriation must be "in connection with" the purchase or sale of a security, as required in any violation of Rule 10b-5. *Id.* However, the Second Circuit did not discuss the element of whether the information was nonpublic in that part of its analysis. *See id.*

133 *See O'Hagan*, 521 U.S. at 650 n.4.

134 *See, e.g.*, *Falcone*, 257 F.3d 226; *Guttenberg*, 2007 WL 4115810.

135 *See* Peixoto, *supra* note 73. *See generally* discussion *supra* Part II.A–C.

136 *See* discussion *supra* note 126 (discussing the relevance of FINRA membership).

were not "sell side" analysts.[137] Notably, a major difference between "sell side" analysts, who work for investment banks and other research houses in the service of outside clients, like those targeted by the SEC in *Bolan*,[138] and "buy side" analysts, like those involved in *Peixoto*, is that the latter conduct their work for the direct benefit of their employers.[139] As such, the buy side firms themselves—as opposed to exterior clients or investors—are expected to trade on the valuable material information that is generated by their analysts.[140]

Nevertheless, in September of 2014, the SEC alleged in an Administrative Proceeding[141] that Jordan Peixoto traded on the basis of material nonpublic information that originated from an analyst working for Pershing Square Capital (Pershing), a prominent hedge fund headed by activist investor William Ackman.[142] Ackman developed a theory that Herbalife, a publicly traded company, was actually operating as an illegal pyramid scheme, and his firm subsequently accumulated a $1 billion dollar short position in the stock.[143] Ackman then made a highly publicized presentation disclosing his theory and his short position at an investor conference in December of 2012.[144] Within days of Ackman's

137 *See infra* text accompanying notes 142–48. Sell side analysts are typically employed by firms that conduct research in order to "sell" the resulting analysis to clients, either directly through fees, or indirectly through commissions that are generated when customers trade through such firms. Buy side analysts typically work for investment firms and their role is distinguishable in that the product of their research is primarily intended to only benefit the firms that employ them. *See* Stephen D. Simpson, *Buy Side vs. Sell Side Analysts*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/financialcareers/11/sell-side-buy-side-analysts.asp (last visited Feb. 14, 2015).

138 *See* discussion *supra* note 126.

139 *See* Simpson, *supra* note 137.

140 *See id.*

141 The SEC has suffered a number of highly publicized defeats in jury trials in recent years, even under theories of liability that were upheld by circuit courts in earlier stages of the same cases. *See, e.g.*, cases cited *infra* note 173. However, rather than change course and abandon some of its novel theories, the SEC seems to be expanding the scope of its enforcement efforts to new and more controversial theories by taking the fight "in-house" to Administrative Proceedings before SEC Administrative Law Judges, in which the forum and procedures are more advantageous to the SEC. *See generally* Thomas C. Frongillo & Caroline Simons, *The SEC's Gambit in Peixoto Backfires: The Commission is Forced to Dismiss its Administrative Case Against Peixoto Following* Newman *Decision*, FISH & RICHARDSON LITIG. BLOG (Dec. 22, 2014), http://www.lexology.com/library/detail.aspx?g=9b609b14-84e1-42d5-a484-0c34092cb3d4; Stewart Bishop, *SEC Again Sued Over 'Unconstitutional' Administrative Cases*, LAW360 (Oct. 20, 2014, 8:20 PM), http://www.law360.com/articles/588683/sec-again-sued-over-unconstitutional-adminstrative-cases ("SEC Enforcement Director Andrew Ceresney made waves in June [2014] when he told a gathering . . . that the agency likely would bring insider cases within its in-house court. At the time, the agency's trial unit had suffered a series of trial losses over insider trading at federal court."). Defendants are also beginning to challenge the constitutionality of these Administrative Proceedings in insider trading cases targeted at individuals. *See id.* However, such constitutional questions are beyond the scope of this Note.

142 *See* Peixoto, *supra* note 73, ¶¶ 1–5.

143 *Id.* ¶¶ 13, 26.

144 *Id.* ¶¶ 13, 25.

presentation, Herbalife's stock had plummeted.[145] Peixoto learned about the presentation in advance from his friend, Filip Szymik,[146] the roommate of a Pershing analyst who told Szymik about the presentation in confidence.[147] Peixoto then bought put options in Herbalife and subsequently earned a significant profit when the stock price fell sharply.[148]

The SEC alleged that Szymik breached his duty of trust or confidence to his analyst roommate by sharing the information with Peixoto, which prohibited Peixoto from trading on the misappropriated information.[149] However, as a threshold issue, the SEC failed to state the legal or theoretical basis for regarding information originating from a buy side hedge fund as *nonpublic* information for the purposes of insider trading liability.[150] The SEC seemed to have transposed the Second Circuit's holdings from the newspaper cases,[151] and from its own

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145 *Id.* ¶¶ 25–28.

146 The SEC brought a separate enforcement action against Filip Szymik as well. *In re* Szymik, Exchange Act Release No. 34-73262, 2014 WL 4826819 (Sept. 30, 2014) (Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order).

147 Peixoto, *supra* note 73, ¶¶ 2–3.

148 *Id.* ¶ 4.

149 *See id.* ¶¶ 3, 5. The violation of a duty of trust or confidence was just one of the elements that the SEC was required to prove. *See* United States v. O'Hagan, 521 U.S. 642, 652–53 (1997). Additionally, the "materiality" element was likely to be satisfied by the fact that Herbalife's stock price dropped dramatically after Ackman's presentation. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (holding that for information to be material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"); Basic Inc. v. Levinson, 485 U.S. 224 (1988) (holding that the Court "expressly adopt[s] the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context"); *see also* SEC v. Seibald, No. 95 CIV.2081(LLS), 1997 WL 605114, at *4–5 (S.D.N.Y. Sept. 30, 1997) (analyzing the materiality of a sell side analyst report). *Peixoto* presents two additional interesting issues. First, the duty allegedly violated in this case was a duty owed between two roommates, merely as a result of that relationship, and otherwise stemmed from the fact that, on some undisclosed date prior to the relevant communication, the analyst told his roommate not to disclose "any" of their work discussions. *See* Peixoto, *supra* note 73, ¶ 3. Additionally, the case involves the far more complicated issue of "remote tippee" liability, which the Second Circuit recently addressed again in a highly anticipated opinion released on December 10, 2014. *See Newman II*, *supra* note 26 (holding, *inter alia*, that the government went too far in attempting to hold tippees liable who were three or four steps removed from the original source of the information). Here, Peixoto received the information from his friend (Szymik), who received it from his roommate (the Pershing analyst), who received it from Pershing, who received it from publicly available sources. *See* Peixoto, *supra* note 73; *see also* Pershing Square Capital Management, *Who Wants to be a Millionaire?*, FACTSABOUTHERBALIFE.COM, http://www.factsaboutherbalife.com/media/2013/01/Who-wants-to-be-a-Millionaire.pdf (last visited Nov. 27, 2014) [hereinafter Pershing, *Who Wants to be a Millionaire?*]. Peixoto was thus at least three steps removed from the original source of the information. Nevertheless, a more in-depth discussion of "remote tippee" liability is beyond the scope of this Note.

150 *See* Peixoto, *supra* note 73.

151 The theory states that influential newspaper articles are nonpublic information because they are known to directly impact the stock prices of the companies they discuss. *See supra* text accompanying notes 126–33.

extension to the sell side analyst cases,[152] and without explanation, directly applied those theories to deem the existence and intended publication of a buy side analyst's thesis as nonpublic information.[153] However, as previously noted, the scope and purpose of buy side analysts' work is significantly different from that of sell side analysts.[154] Moreover, the SEC's theory directly contradicts the Second Circuit's own view, which holds that information is considered public even though it may only be known by a few analysts or investors because the information will be directly incorporated into a stock's price by the investors' trading activity.[155] Notably, prior to Peixoto's purchase of Herbalife put options, Pershing had already accumulated a $1 billion short position in Herbalife stock, which naturally required substantial quantities of trading.[156]

The implications of the SEC's theory are likely to create significant uncertainty among analysts and investors because—once taken to their logical conclusion—they effectively return the law to the "parity-of-information" regime expressly rejected by the Supreme Court.[157] If information that is gathered and analyzed by outsiders from publicly available sources can be deemed nonpublic for the purposes of insider trading liability, then possession of almost any material information could create a prohibition on trading—even for the analysts that compiled and analyzed the information in the first place. Although analysts cannot violate a duty of trust or confidence to themselves, the SEC has already successfully persuaded the Second Circuit to adopt its novel version of the "affirmative misrepresentation" theory.[158] As such, once the SEC has established as a matter of law that material information generated by outsiders from publicly available sources can be deemed nonpublic, the SEC would only need to prove that at least one vaguely defined misrepresentation or act of deceit was used to gather any piece of the information,[159] or that an affirmative misrepresentation was used for some other purpose that is—in some

152 *See supra* note 126 and accompanying text.

153 *See* Peixoto, *supra* note 73, ¶¶ 3, 5.

154 *See supra* text accompanying notes 139–40.

155 The Second Circuit has stated that

> [o]f course, information is public if it is available to the public through SEC filings, the media, or other sources. *See* SEC v. Mayhew, 121 F.3d 44, 50–51 (2d Cir. 1997). . . . [I]nformation is also deemed public if it is known only by a few securities analysts or professional investors. This is so because their trading will set a share price incorporating such information.

United States v. Contorinis, 692 F.3d 136, 143 (2d Cir. 2012) (discussing the separate elements of "material" and "nonpublic" information in an insider trading case).

156 *See* Peixoto, *supra* note 73, ¶¶ 13, 26.

157 *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 232–35 (1980).

158 *See* SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009).

159 *See* discussion *supra* Part II.B.

attenuated way—"in connection with the purchase or sale of any security."[160] Notably, as one example, the public investor presentation at issue in *Peixoto* openly described Pershing's use of undercover operatives that secretly attended Herbalife's sales and recruiting presentations.[161] Under its reasoning in *Peixoto*, there are few barriers preventing the SEC from also arguing that Ackman and his investigators violated insider trading law by causing Herbalife "to believe the false" while "deceptively" gathering information from its sales and recruiting presentations.[162] More importantly, it is difficult to predict which other activities could fall within the same reasoning, likely creating significant uncertainty for analysts and investors about the scope of the SEC's new theory of liability.

In the aftermath of the highly anticipated "remote tippee" opinion in *Newman II*, in which the Second Circuit emphatically rebuked the government's recent efforts to expand the boundaries of insider trading liability,[163] the SEC abruptly dismissed the *Peixoto* proceeding.[164] However, the SEC did not retract its allegations, nor did it disavow the theories admonished by the Second Circuit; instead, the SEC stated that its two key witnesses were no longer available to testify because they were in Poland and had no intention of returning to the United States. In fact, the SEC reasserted its allegations against Peixoto in its Order.[165] As a result of the continuing and unpredictable fallout from the *Newman II* opinion, as well as from the litigation posture subsequently adopted by the SEC, the uncertainty underlying insider trading enforcement is likely to substantially increase—at least in the near term.[166]

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160 *See supra* note 107 and accompanying text.

161 Pershing, *Who Wants to be a Millionaire?*, *supra* note 149.

162 *See Dorozhko*, 574 F.3d at 50 (describing just a few examples of the definition of deception).

163 *See Newman II*, *supra* note 26, at 447–49.

164 *In re* Peixoto, Exchange Act Release No. 34-74176, 2015 WL 366001 (Jan. 29, 2015) (Order Dismissing Proceeding). The SEC first sought dismissal only five days after *Newman II*. *In re* Peixoto, Administrative Proceedings Rulings Release No. 2133 (Dec. 15, 2014) (Order Cancelling Hearing and Prehearing Schedule), http://www.sec.gov/alj/aljorders/2014/ap-2133.pdf.

165 *Peixoto*, 2015 WL 366001 (Order Dismissing Proceeding).

166 In the first two months following *Newman II*, the SEC adopted a number of positions that are likely to be indicative of its future intent. The SEC dismissed *Peixoto* without linking its decision to the holdings in *Newman II*. *See id.* The SEC also issued an unwavering defense of its prior theories within its Amicus Brief to the DOJ's appeal of *Newman II*. *See* Brief for the Securities and Exchange Commission as Amicus Curiae Supporting the Petition of the United States for Rehearing or Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837-(L)), http://www.law.du.edu/documents/corporate-governance/criminal/newman/sec-amicus-brief-in-us-v-newman.pdf. The petition for rehearing was ultimately denied. *See Newman II*, *supra* note 26. Finally, a federal district court vacated several defendants' guilty pleas as a direct result of the *Newman II* opinion; the SEC unsuccessfully opposed the motions by arguing that the elements of tippee liability emphasized in *Newman II*

E. *There Are Real and Substantial Consequences to the Lack of Clear Legal Boundaries*

In his treatise, Donald Langevoort states that "the law is quite clear" about its desire to encourage research that generates significant insights into issuers, and therefore the exploitation of "one's own skill, diligence or expertise" is not deemed unlawful.[167] However, after analyzing the recent enforcement efforts by the SEC, those contemplating expenditures toward the research and development of innovative information gathering strategies and technologies, or those preparing to trade on information gathered through such tools, are unlikely to be so confident.

The consequences of the SEC's enforcement efforts are not hypothetical, but have a real and significant impact on those that are targeted. For example, when the SEC initiates an enforcement action in a *suspected* insider trading case, it also seeks to obtain a court-ordered asset freeze[168] in order to ensure that funds are available to cover any potential civil penalties.[169] The SEC may even be able to obtain an asset freeze despite failing to satisfy its pleading requirements.[170] Such freezes can remain in effect for months or years before disposition of a case,[171] and can encompass up to three times the alleged proceeds from an "insider" trade.[172] If the frozen assets consist of most of a defendant's available funds, or the relevant accounts are used to generate most of his

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did not apply to cases brought under the "misappropriation" theory, even though *Newman II* was itself brought under that theory and the Second Circuit expressly held the exact opposite of the position the SEC was arguing. *See* United States v. Conradt, No. 12 cr 00887 (ALC) (S.D.N.Y. Jan. 22, 2015), http://blogs.reuters.com/alison-frankel/files/2015/01/usvcarter-vacateguiltypleas.pdf.

167 Langevoort further emphasized that

> the law is *quite clear* that a person can properly profit from his own private information. Someone doing extensive research into issuers or their securities may well generate insights that are significant, and upon discovery would cause other traders to buy or sell. Since the law wants to encourage such research—the product of one's own skill, diligence or expertise—*it does not make its exploitation illegal*.

DONALD C. LANGEVOORT, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 1:12 (Apr. 2014) (emphases added).

168 Asset freezes prevent defendants from accessing or moving funds from accounts suspected of containing the proceeds of any alleged insider trading. *See generally* SEC v. Unifund SAL, 910 F.2d 1028, 1041 (2d Cir. 1990).

169 *See id.*

170 *See, e.g.*, SEC v. One or More Unknown Traders in the Sec. of Onyx Pharm., Inc., No. 13-CV-4645 (JPO), 2014 WL 5026153 (S.D.N.Y. Sept. 29, 2014).

171 *See id.*

172 *See Unifund SAL*, 910 F.2d at 1041 (explaining—in the context of its asset freeze ruling—that the SEC can recover "civil penalty, equal to three times the profits, . . . under section 21A of the Exchange Act upon proof of a violation[,]" as authorized in the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3(a)(2), 102 Stat. 4677 (1988) (codified at 15 U.S.C. § 78u-1 (2012))).

income, waiting for months or years is likely to cause significant financial consequences. Additionally, many defendants are not vindicated until proceeding through an entire jury trial or through an extended appeals process,[173] and are often forced to spend extraordinary sums—sometimes millions of dollars—in defense of their innocence.[174]

Such severe consequences are not limited to individuals, but can affect large financial institutions as well. For example, although the two analysts, Newman and Chiasson, had their convictions vacated in *Newman II*,[175] the allegations of insider trading alone had devastating consequences for their firms.[176] Neither the firms themselves nor their principles were ever implicated, yet the mere announcement of an investigation ultimately led to billions of dollars in client redemption requests, and caused Chiasson's $4 billion fund to close permanently.[177]

While clear and effective regulations can have a useful deterrent effect on would-be violators, the lack of reliable guidelines and clear legal boundaries can also deter legitimate activities that are beneficial to the efficient functioning of the markets.[178] Individuals and firms may plausibly conclude that the risks to their enterprises are unjustified, and the prudent and risk-averse course of action is to self-sensor and discontinue even previously uncontroversial research activities.[179]

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173 *See, e.g.*, *Newman II*, *supra* note 26; Jury Verdict Form, SEC v. Obus, 693 F.3d 276 (2d Cir. 2012) (No. 06-CV-3150 (GBD)); Judgment, SEC v. Cuban, 798 F. Supp. 2d 783 (N.D. Tex. 2011) (No. 3:08-CV-2050-D).

174 *See, e.g.*, Nelson Obus, Opinion, *Refusing to Buckle to SEC Intimidation*, WALL ST. J. (June 24, 2014, 7:37 PM), http://online.wsj.com/articles/nelson-obus-refusing-to-buckle-to-sec-intimidation-1403651178 (discussing the $12 million in legal and trial expenses Obus and his co-defendants incurred while successfully fighting the SEC's allegations in multiple courts over twelve years); Natalie Posgate & Mark Curriden, *Jury Finds No Proof Mark Cuban Engaged in Insider Trading*, DALL. MORNING NEWS (Oct. 16, 2013, 10:47 PM), http://www.dallasnews.com/business/headlines/20131016-mark-cuban-cleared-of-insider-trading-charges.ece (citing lawyers familiar with the case who estimate that "Cuban spent more than $8 million fighting the SEC" over the course of nine years).

175 *See Newman II*, *supra* note 26, at 455.

176 *See* Christine Williamson, *Insider-Trading Scandal Costs 3 Hedge Funds a Combined $9 Billion*, PENSION & INV. (Feb. 21, 2011), http://www.pionline.com/article/20110221/PRINT/302219942/insider-trading-scandal-costs-3-hedge-funds-a-combined-9-billion (discussing the closing of Level Global Investors, the $4 billion hedge fund for which Chiasson worked as an analyst, as well as the additional billions in client redemption requests in Diamondback Capital by early 2011, for which Newman worked as an analyst, after the government merely announced an investigation in November of 2010 into alleged insider trading by certain individuals at the funds).

177 *See id.*

178 *See* Crimmins, *supra* note 26, at 362 ("[L]ess sophisticated traders—and even lawyers and compliance advisers assisting sophisticated traders—can legitimately have difficulty anticipating whether certain potentially lucrative trading opportunities will cross the line.").

179 *See id.* at 330–31.

> A wrong guess on any duty, materiality, or scienter element—finally resolved years later on appeal—can lead to imprisonment, or at least heavy civil fines, and a ruined career. Yet such a determination not to trade on significant nonpublic information

Although it is too early to conclude whether the tide has turned against the SEC's theories of liability in the courts,[180] or perhaps even in the agency's own administrative proceedings,[181] the SEC still retains the discretion to initiate investigations and enforcement actions, which can inflict significant harm on the accused. The SEC has already chosen to stay the course after a slew of recent prominent defeats[182] in rulings which otherwise could have provided greater legal certainty to market participants. Under the circumstances, an express regulatory safe harbor may be the only realistic alternative to a self-imposed reversal by the SEC.

III. Analysts Should Be Deliberately Protected and Affirmatively Incentivized

A. *Rejecting a Parity-of-Information Rule*

The SEC had persuaded the Second Circuit to move toward a parity-of-information rule in several of its early insider trading cases, but the Supreme Court expressly reversed those holdings[183] and has

> effectively pushes these prudent traders into a so-called "parity-of-information" regime . . . .

Id. at 330.

180 *See, e.g.*, *Newman II*, *supra* note 26; United States v. Conradt, No. 12 Cr. 00887 (ALC) (S.D.N.Y. Jan. 22, 2015), http://blogs.reuters.com/alison-frankel/files/2015/01/usvcarter-vacateguiltypleas.pdf. *But see, e.g.*, United States v. Salman, 792 F.3d 1087 (9th Cir. 2015) (declining to extend the holding in *Newman II*).

181 *See, e.g.*, *In re* Peixoto, Exchange Act Release No. 34-74176, 2015 WL 366001 (Jan. 29, 2015) (Order Dismissing Proceeding). *But see, e.g.*, SEC v. Sabrdaran, No. 14-cv-04825-JSC, 2015 WL 901352 (N.D. Cal. Mar. 2, 2015) (declining to extend the holding in *Newman II*).

182 *See, e.g.*, Brief for the Securities and Exchange Commission as Amicus Curiae Supporting the Petition of the United States for Rehearing or Rehearing En Banc, United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837 (L)), http://www.law.du.edu/documents/corporate-governance/criminal/newman/sec-amicus-brief-in-us-v-newman.pdf (putting forth an unwavering defense of its prior theories within its Amicus Brief to the DOJ's appeal of *Newman II*); United States v. Conradt, No. 12 Cr. 00887 (ALC) (S.D.N.Y. Jan. 22, 2015), http://blogs.reuters.com/alison-frankel/files/2015/01/usvcarter-vacateguiltypleas.pdf (rearguing the exact positions emphatically rejected by the Second Circuit).

183 *See, e.g.*, United States v. Chiarella, 588 F.2d 1358, 1358 (2d Cir. 1978) ("The draftsmen of our nation's securities laws, rejecting the philosophy of Caveat emptor, Created a system providing equal access to the information necessary for reasoned and intelligent investment decisions."), *rev'd*, 445 U.S. 222, 232 (1980) ("This reasoning suffers from [a] defect[] . . . . [because] not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."); *see also* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 851–52 (2d Cir. 1968) ("The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. . . . [I]nequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life . . . ."), *cert. denied*, 404 U.S. 1005 (1971).

since consistently rejected the parity-of-information principle.[184] The Second Circuit ultimately also rejected a policy that requires equality of information in securities transactions, calling it a "critical limitation on insider trading liability."[185] The SEC had advocated for the rule because it viewed the unequal possession of information as fraudulent since it created an unfair advantage for some parties over others.[186] Such a characterization of insider trading principles stems from the SEC's original ruling in *Cady*,[187] and goes far in explaining the SEC's efforts over the last several decades. The Supreme Court has emphasized that "neither the Congress nor the [SEC] ever has adopted a parity-of-information rule,"[188] but that conclusion may have been premature. The Acting Chairman of the SEC proclaimed the return of the parity-of-information theory in her analysis of Regulation FD in 2001, emphasizing that it was necessary to circumvent the duty requirement established by the Supreme Court in *Dirks*.[189] However, Regulation FD only imposed equality on the inputs received by analysts *from* issuers—requiring issuers that release information to any one individual to also simultaneously make the information available to the entire market—not equality on inputs from *outsiders*, and certainly not equality on inputs from public sources of information.[190]

Rejecting a parity-of-information rule is also in line with congressional intent.[191] Congress has sought to protect analysts and

184 *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 657–58 nn.16–17 (1983).

185 *See, e.g.*, *Newman II*, *supra* note 26 ("Although the Government might like the law to be different, nothing in the law requires a symmetry of information in the nation's securities markets. . . . *See also* United States v. Chestman, 947 F.2d 551, 578 (2d Cir.1991) (Winter, J., concurring) ('[The policy rationale [for prohibiting insider trading] stops well short of prohibiting all trading on material nonpublic information. Efficient capital markets depend on the protection of property rights in information. However, they also require that persons who acquire and act on information about companies be able to profit from the information they generate . . . .')]. [sic] . . . [T]he Supreme Court affirmatively established that insider trading liability is based on breaches of fiduciary duty, not on informational asymmetries. This is a critical limitation on insider trading liability that protects a corporation's interests in confidentiality while promoting efficiency in the nation's securities markets.").

186 *Chiarella*, 445 U.S. at 232 (explaining that the SEC views "[t]he use by anyone of material information not generally available [a]s fraudulent . . . because [it] gives certain buyers or sellers an unfair advantage [over others]").

187 *In re* Cady, Roberts & Co., 40 SEC 907 (1961) (holding that it is inherently unfair when "a party takes advantage of . . . information knowing it is unavailable to those with whom he is dealing").

188 *Chiarella*, 445 U.S. at 233.

189 "Acknowledging the limits of *Dirks* on our ability to pursue insider trading by analysts, Regulation FD attempted to tackle the problem from another angle. Rather than reading a duty into the analyst/issuer relationship, Regulation FD returns to the '*parity of information*' theory . . . ." Laura S. Unger, Acting Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Acting Chairman: How Can Analysts Maintain Their Independence? (Apr. 19, 2001) (emphasis added), https://www.sec.gov/news/speech/spch477.htm.

190 *See* SEC Regulation FD, 17 C.F.R. § 243.100 (2014).

191 *See* Dirks v. SEC, 463 U.S. 646, 657 n.16 (1983).

other market professionals, expressly declaring that courts should seek to protect analysts and "avoid unduly inhibiting traders from generating and *acting upon* valid research information,"[192] because analysts are essential to the efficient functioning of the markets.[193] The SEC has historically agreed that the efforts of analysts are essential, and has recognized that the resulting increase in market efficiency ultimately benefits all investors.[194] Nevertheless, neither the congressional declarations nor the SEC statements serve as a "complete" safe harbor for analysts from insider trading liability.[195] More is needed.

In *O'Hagan*, the Court's most recent insider trading case, the Court reiterated the fact that unequal information is "inevitable" in the markets, but emphasized that it was acceptable as long as the disadvantage could be "overcome with research [and] skill."[196] Although Victor Brudney, who the Court cited for that proposition, sought to significantly *expand* the scope of insider trading liability pre-*Chiarella* by seeking to preclude the exploitation of all "unerodable"[197] informational advantages by all market participants, even Brudney understood the importance of permitting investors to trade on informational advantages that *could* be "overcome with research [and]

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192 LANGEVOORT, *supra* note 167, § 11:2. As Donald Langevoort has explained,

> during the passage of the Insider Trading Sanctions Act in 1984, the drafters were explicit in endorsing the socially valuable role played by analysts, stating at one point that "[w]e anticipate that the courts . . . will be mindful of the necessity . . . to avoid unduly inhibiting traders from generating and acting upon valid research information of the sort upon which efficient markets necessarily depend." Similarly, in the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988, the drafters again indicated that . . . . "[t]he Committee recognizes that market analysts play a crucial role in facilitating the dissemination of information to the marketplace, and thereby promoting smoothly functioning markets. This legislation is not intended to interfere with these critical functions."

Id.

193 "Congress' recognition that [market professionals] contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of [nonpublic information]." *Dirks*, 463 U.S. at 657 n.16 (quoting *Chiarella*, 445 U.S. at 233 n.16).

194 *Id.* at 658 & n.17 (quoting the SEC while explaining that the "disclose or abstain" from trading rule that the SEC is proposing "could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market").

195 "While these statements need not necessarily be read as a direction to give analysts a complete 'safe harbor' from insider trading liability . . . some effort to clarify, if not reduce, their exposure is appropriate." LANGEVOORT, *supra* note 167, § 11:2.

196 *See* United States v. O'Hagan, 521 U.S. 642, 658–59 (1997) (citing Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979)).

197 *See* Brudney, *supra* note 196, at 354–56 ("[U]nerodable" information advantages are those that cannot "lawfully" be overcome by the public "no matter how great may be their diligence or large their resources").

skill."[198] While Brudney's *implicit* exclusion of "erodible" informational advantages as a basis for liability may have been sufficient at the time, a safe harbor that provides *express* protection and offers precise and reliable guidelines is necessary within the current state of insider trading law.[199]

B. *Incentivizing the Essential Work of Analysts by Protecting the Exploitation of Their Efforts*

Congress and the courts have a fundamental understanding that analysts could not be expected to perform their essential function unless they had the opportunity to profit from the product of their efforts.[200] The disconnect between the SEC's apparent agreement that analysts are essential to the efficient functioning of the markets, and the SEC's simultaneous support for a parity-of-information rule,[201] seems to be a failure to acknowledge the *ex ante* impact that such a rule would have on the incentives for analysts to gather and analyze information in the first place.[202] In order to bridge that philosophical gap, the SEC should

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198 *See id.* at 353–67 ("[T]he logic of the disclose-or-refrain rule precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset. And while historically the antifraud provisions may be a response only to unerodable informational advantages held by corporate insiders or market professionals (or regulars) even when dealing at arms length, the principle it embodies extends to protecting public investors against transactions by all who possess such informational advantages. It does not detract from this conclusion that there may nevertheless be systematic inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence. The values of efficiency in pricing and resource allocation served by encouraging pursuit of information about the worth of securities are diluted, if not destroyed, by a rule purporting to offset those disparities by requiring universal sharing of information. On the other hand, realization of those values is not impeded if persons with an unerodable information advantage, generally acquired for nontrading purposes, are forbidden from exploiting it in trading.").

199 *See infra* Part IV. Imprecise rules "prevent[] parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed." *Dirks*, 463 U.S. at 658 n.17 (citing Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959) (Burger, J., sitting by designation)).

200 *See, e.g.*, *Dirks*, 463 U.S. at 657 n.16 (quoting *Chiarella*, 445 U.S. at 233 n.16, which stated that "Congress' recognition that [market professionals] contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of [nonpublic information]"); Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 435 (7th Cir. 1987) ("The ability to make profits from the possession of information is the principal spur to create the information, which the parties and the market as a whole may find valuable.").

201 *See supra* text accompanying notes 183–90.

202 Although not directing their analysis specifically at the SEC, several scholars have emphasized this disconnect among proponents of a parity-of-information rule. *See, e.g.*, Brudney, *supra* note 197, at 341 ("[F]or those who are not connected with a corporation to pursue or acquire such information requires expenditure of effort, time and money in research, and talent and training in analysis. To meet the costs of thus pursuing and analyzing information, a return must be offered. One such return is the opportunity to capitalize on the

look to the rationale that has long supported intellectual property law in the United States—the right to benefit from one's intellectual efforts is deliberately protected by the government in order to *induce* and *reward* individuals to "bring forth new knowledge."[203] In other words, expressly protecting the intellectual efforts of analysts against insider trading liability would induce them to undertake those efforts because they could rely on the expected reward from lawfully transferring or trading on the information. As Thomas Jefferson once wrote, "ingenuity should receive a liberal encouragement."[204] Indeed, in the financial markets, liberal encouragement need only take the form of a protected *opportunity* to earn profits within an enforcement regime that provides clear and reliable guidelines and reduces any substantial legal uncertainty about the risk of liability for insider trading. The rewards do not need to be guaranteed—only the protected opportunity needs to be guaranteed.

IV. Proposed SEC Rule 10b5-SH: A Safe Harbor for Communicating or Trading on Material Nonpublic Information

A. *The Proposal*

In addition to the steady erosion of the duty element over the last two decades,[205] the SEC has continued to pursue novel theories of insider trading liability,[206] and has even advocated a return to a parity-

value of being the discoverer of the information—the advantage obtained from having the first vision. Hence, market efficiency will be enhanced if persons are encouraged (by receiving the rewards of the bargain resulting from informational advantages thus obtained) to seek such advantages, for purposes of either buying or selling particular securities."); Coffee, *supra* note 2, at 313 n.71 ("[A]lthough [proponents] argue for parity of information, they never address the impact that their approach would have on the incentive to search for new information. Would Ray Dirks have still boarded his plane, flown to Los Angeles, and uncovered the Equity Funding fraud if he would have been barred from passing this information to his clients? If he had not uncovered the fraud at Equity Funding, how many more innocent victims would have invested their retirement savings in worthless life insurance? . . . [P]roponents of parity of information need to face the ex ante impact of their propos[al].").

203 *See, e.g.*, Graham v. John Deere Co. of Kan. City, 383 U.S. 1, 8–9 (1966) (citing a fundamental philosophy of American society expounded and advocated by Thomas Jefferson, who "rejected a natural-rights theory in intellectual property rights and clearly recognized the social and economic rationale of the patent system. The patent monopoly was *not* designed to secure to the inventor his natural right in his discoveries. *Rather, it was a reward, an inducement, to bring forth new knowledge*." (emphasis added)).

204 Diamond v. Chakrabarty, 447 U.S. 303, 308–09 (1980) (quoting 5 Writings of Thomas Jefferson 75–76 (H. Wash. ed. 1871)).

205 *See, e.g.*, United States v. O'Hagan, 521 U.S. 642 (1997); SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009); *see also supra* Part II.B.

206 *See* discussion *supra* Part II.B–D.

of-information rule.[207] The SEC has also compounded those efforts with an increasing number of enforcement actions and a newly aggressive litigation posture.[208] As a result, the current insider trading enforcement regime lacks the type of reliable guidelines that could clearly and effectively inform analysts and investors about the legal boundaries that they must operate within. In order to significantly reduce the resulting legal uncertainty, this Note takes a leap forward, beyond the hazards of implicit protections that are subject to the SEC's evolving litigation strategy,[209] and proposes an express regulatory safe harbor that protects the gathering and exploitation of information obtained through "replicable" methods or strategies.[210]

B. *Legal and Practical Support for Promulgating a New SEC Safe Harbor Rule*

Section 10(b) of the Exchange Act is an enabling statute that expressly delegates broad rulemaking authority to the SEC.[211] The Supreme Court has consistently upheld Rule 10b-5, and more importantly, upheld the SEC's authority to promulgate such rules pursuant to Section 10(b).[212] In August of 2000, the SEC promulgated new Rules 10b5-1 and 10b5-2 pursuant to the same authority.[213] The Third Circuit has upheld the SEC's power to promulgate Rule 10b5-2.[214] Therefore, promulgating a new insider trading rule would be within the SEC's powers. Additionally, the purposes of Rule 10b5-SH[215] are directly in line with the stated goals of Rule 10b5-1—to provide greater clarity in

207 *See supra* text accompanying notes 183–90.

208 *See* discussion *supra* Part II.A.

209 *See* Dirks v. SEC, 463 U.S. 646, 664 n.24 (1983) ("[W]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous . . . .").

210 *See infra* Part IV.C (defining "replicable" and setting forth the text of the proposed rule).

211 United States v. McGee, 763 F.3d 304, 310 (3d Cir. 2014). The statute prohibits manipulative or deceptive devices in connection with the purchase or sale of any security "in contravention of *such rules and regulations as the [SEC] may prescribe* . . . ." 15 U.S.C. § 78j(b) (2012) (emphasis added).

212 *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 651 (1997). The SEC has "the power to adopt regulations to carry [§ 10(b)] into effect." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976).

213 The new rules addressed two aspects of insider trading liability: the meaning of "on the basis of" material nonpublic information and the definition of a "duty of trust or confidence" for the purposes of misappropriation theory. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-01 (Aug. 24, 2000).

214 *McGee*, 763 F.3d at 312, 316 ("Rule 10b5-2(b)(2) is a valid exercise of the SEC's rulemaking authority.").

215 *See supra* Part IV.A.

order to "enable insiders and issuers to conduct themselves in accordance with the law."[216]

Additionally, certain considerations that were examined during the drafting process of Rule 10b5-1 provide helpful guidance for structuring Rule 10b5-SH. For example, Rule 10b5-1 starts with a broad statement of the prohibition, followed by a clarifying definition of the updated "on the basis of" standard, and concludes with a number of "carefully enumerated affirmative defenses."[217] Rule 10b5-SH contains a similar structure, although naturally inverse—the rule starts with a broad statement of the safe harbor, followed by a clarifying definition of the term "replicable," and concludes with a number of carefully enumerated exclusions.[218] The enumerated exclusions provide the SEC with an opportunity to identify specific activities that should continue to be prohibited, thus clarifying and defining how far the scope of liability is actually narrowed, which is analogous to the enumerated affirmative defenses in Rule 10b5-1.[219]

The SEC has also frequently adopted safe harbors in other related areas of securities law. For example, the SEC promulgated Rule 144A in 1990 as a safe harbor from the registration and prospectus delivery requirements of Section 5 of the Securities Act.[220] The SEC has also promulgated a rule that provides a safe harbor against liability for certain forward-looking information contained in documents filed with the SEC.[221] The SEC has promulgated new rules for a variety of reasons, including to implement changes to existing rules based on newly enacted congressional legislation,[222] as well as to provide greater certainty regarding applicable requirements under the law[223]—a central goal of Rule 10b5-SH.[224] Therefore, the scope, structure, purpose, and language of proposed Rule 10b5-SH would all reasonably fit within existing standard practices that are regularly employed by the SEC.

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216 Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-01, III.A.1 (Aug. 24, 2000) (providing greater clarity "enable[s] insiders and issuers to conduct themselves in accordance with the law").

217 *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-01 (Aug. 24, 2000).

218 *See infra* Part IV.C.

219 *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716-01 (Aug. 24, 2000).

220 *See* Resale of Restricted Securities, 55 Fed. Reg. 17933-01 (Apr. 30, 1990).

221 SEC Rule 175, 17 C.F.R. § 230.175 (2014) (providing a safe harbor against certain public statements "by or on behalf of an issuer" during the public offering process); *see also* Roots P'ship v. Lands' End, Inc., 965 F.2d 1411 (7th Cir. 1992) (discussing the safe-harbor that Rule 175 provides against Section 10(b) liability).

222 "To implement Section 201(a) of the JOBS Act, we proposed amending Rule 506 to add new paragraph (c), under which the prohibition against general solicitation contained in Rule 502(c) would not apply . . . ." Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771-01 (July 24, 2013) (codified at 17 C.F.R. § 230.506(c) (2014).

223 *See* Resale of Restricted Securities, 55 Fed. Reg. 17933-01 (Apr. 30, 1990).

224 *See supra* Part IV.A.

C. *The Draft Text of Proposed Rule 10b5-SH*

Preliminary Notes to Rule 10b5-SH:

1. This provision provides a non-exclusive safe harbor for the purchase or sale of securities on the basis of, or the communication of, material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, 10b5-1, and 10b5-2, and Rule 10b5-SH does not modify the scope of insider trading law in any other respect.[225]
2. This section is not available for any purchase or sale of securities on the basis of, or the communication of, material nonpublic information that, although in technical compliance with this section, is part of a plan or scheme to evade liability under Section 10(b) of the Act.[226]
3. Attempted compliance with this section, or reliance on this section, does not act as an exclusive election, and an individual or entity may also claim the availability of any other applicable safe harbor or affirmative defense from liability under Section 10(b).[227]
4. The availability of this section as a safe harbor from liability under Section 10(b) will not be affected by a separate purchase or sale of securities on the basis of, or the communication of, material nonpublic information that is not in compliance with this section.[228]

(a) General. The "manipulative or deceptive devices or contrivance[s]" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder do not include, among other things, the purchase or sale of securities on the basis of, or the communication of, material nonpublic information[229] that was

225 This introductory language seeks to provide a general framework for the application of the Rule, and it tracks the text in the Preliminary Note to Rule 10b5-1, combined with relevant language about trading and communicating information from Rule 10b5-2(a). *See* 17 C.F.R. § 240.10b5-1 (2014); 17 C.F.R. § 240.10b5-2(a) (2014).

226 This language mirrors a number of SEC safe harbor rules. *See, e.g.*, SEC Rule 169, 17 C.F.R. § 230.169 (2014). Its purpose is to ensure that activities that fall within the safe harbor based solely on a technicality, but which are part of a broader scheme to evade insider trading laws, are not ultimately protected under this safe harbor.

227 Similarly, this language mirrors a number of other SEC safe harbor rules. *See, e.g.*, SEC Rule 168, 17 C.F.R. § 230.168 (2014). Its purpose is to ensure that those attempting to rely on this safe harbor are not precluded from also putting forth defenses based on any existing affirmative defense or based on any possible future safe harbor.

228 This language mirrors a number of other SEC safe harbor rules. *See, e.g.*, *id.* Its purpose is to ensure that liability for any one trade or communication that is not in compliance with this safe harbor does not preclude the availability of this safe harbor for a separate trade or communication that is in compliance with this safe harbor.

229 This initial language mirrors the text of Rule 10b5-1. 17 C.F.R. § 240.10b5-1 (2014).

obtained in whole or otherwise aggregated[230] through methods or strategies that are replicable.

(b) Definition of "replicable."[231] Subject to the exclusions in paragraph (c) of this section, methods or strategies[232] are replicable if, acting solely outside the purview of the issuer,[233] they lead to material or nonpublic information[234] that could have been obtained in whole or otherwise aggregated through efforts or expenditures[235] by any other individual or entity that possessed or employed[236] equivalent intellectual capabilities, technologies, intellectual property, financial resources, labor resources, and/or other similar resources.[237]

(c) Exclusions. Methods or strategies are *not* replicable if:
(i) the only individuals or entities capable of replicating the methods or strategies also participated in the activities or circumstances for which safe harbor is sought under this

230 The terms "obtained in whole or otherwise aggregated" are designed to ensure that—as long the methods or strategies used are "replicable"—the safe harbor is still available if any piece of information itself is deemed material and nonpublic ("obtained in whole"), and otherwise still available if the resulting conclusions are material or nonpublic—after the individual bits are "pieced together" ("otherwise aggregated").

231 This clarifying definition serves to narrow and define the scope of activities encompassed by the safe harbor.

232 The terms "methods" or "strategies" are included to ensure that the safe harbor protects both individual methods of gathering information and broader (and perhaps complex) plans or strategies.

233 The phrase "acting solely outside the purview of the issuer" is intended to emphasize that the safe harbor should not be available if any material or nonpublic information is obtained from insiders. The proposed safe harbor does not intend to provide safety to activities that are already encompassed within the "classical theory" or the "tipper/tippee theory" of insider trading liability. However, the phrase is not intended to preclude the gathering and use of immaterial or public information from insiders that would otherwise be permitted under current law.

234 The term "lead to" material or nonpublic information is intended to ensure that the safe harbor protects *both* those who obtain immaterial or public bits of information and then "piece them together," *as well as* those whose methods or strategies lead directly to material nonpublic information that is otherwise in compliance with this Rule.

235 The terms "efforts or expenditures" are intended to encompass both personal efforts as well as payments for the efforts of others, which may be relevant in both the employer/employee and in the entity/contractor context.

236 "Possessed or employed" intends to encompass both owned resources and the use of the resources of others.

237 The enumerated terms intend to provide a non-exclusive list of examples of the types of resources that an individual or entity may employ to "obtain or aggregate" information, and if equally available, would be sufficient for "any other individual or entity" to succeed in obtaining or aggregating the same information. Consistent with this safe harbor's underlying purpose of incentivizing research and analysis, this clause is intended to differentiate between the activities that the safe harbor seeks to induce and reward, and activities which lead to information through tips from insiders (at one extreme) and finding information by pure luck (at the other extreme).

section or for which safe harbor is sought under any other applicable section;[238]

(ii) the information has not been obtained in whole or otherwise aggregated through the intellectual efforts or through the expenditure of resources by the individual or entity seeking safe harbor under this section, or the information has been bought, found, gifted, inadvertently observed, or overheard;[239] except that the exclusion under this paragraph (c)(ii) shall not apply if such information was communicated, directly or indirectly, by an individual or entity that would be in compliance with this section if they were to purchase or sell securities on the basis of, or communicate, the same information themselves;[240]

(iii) they are found to violate any law or regulation of any jurisdiction in which the individual or entity resides or of any jurisdiction from which the individual or entity obtained in whole or otherwise aggregated any information on the basis of which the individual or entity purchased or sold securities or communicated such information;[241] except that Section 10(b) and the Rules promulgated thereunder shall not apply to this paragraph (c)(iii);[242]

(iv) any individual or entity that purchases or sells securities on the basis of, or communicates, material nonpublic information in compliance with this section, also knowingly possessed,[243] prior to any such purchase or sale, or

238 While perhaps a bit obvious, this exclusion seeks to clarify that methods or strategies that are replicable must be replicable by an individual or entity other than that which is seeking protection under this safe harbor. The definition of "replicable" is not intended to apply to the ability of the same individual or entity to simply do it again.

239 *See supra* note 237 (second sentence). Rule 10b5-SH is not intended to newly and overtly protect obtaining information through chance or luck, and leaves those determinations to existing insider trading law.

240 The exception in this exclusion is intended to affirmatively protect and support the *transfer* of information obtained in whole or aggregated in compliance with this safe harbor. In order for research and analysis to be properly incentivized, the work product of those efforts should also be transferrable (by gift or sale)—as opposed to limiting the safe harbor to trading activities as the sole means of profiting from such investment of time and effort.

241 Although individuals or entities that break laws unrelated to insider trading should arguably not be prosecuted under the securities laws, but should simply be prosecuted under the other laws that were broken, the same philosophy seems inapplicable to one's ability to seek *protection* under a safe harbor Rule. This exclusion ensures that the methods and strategies used to obtain or otherwise aggregate information are not otherwise illegal.

242 Section 10(b) and Rules 10b-5, 10b5-1, and 10b5-2 are excepted in order to avoid the risk that the SEC or some future court might make a circular argument and interpret the safe harbor inapplicable under circumstances where one of the other insider trading Rules are allegedly violated, which would essentially nullify the safe harbor.

243 The term "knowingly possessed" is an acknowledgement of Rule 10b5-1. *See supra* note 213.

communication, material nonpublic information about any security materially impacted by such information, that was not also obtained in whole or otherwise aggregate in compliance with this section.[244]

(d) Conditions.

(i) The following disclosures shall be filed with the Commission within three (3) business days of the first purchase or sale, or communication, conducted on the basis of material nonpublic information for which any individual or entity may seek a safe harbor under this section,[245] or within three (3) business days of completing a formal pre-written and time-stamped plan for multiple purchases or sales on the basis of such information, but under no circumstances more than thirty (30) days after the first purchase or sale, or communication, on the basis of such information:[246] (A) the conclusions derived from the information obtained in whole or otherwise aggregated,[247]

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244 This clause excludes from the safe harbor circumstances where an individual or entity possesses information through methods or strategies that are in compliance with this safe harbor, but also possesses other material nonpublic information that was not obtained in compliance this safe harbor. Under those circumstances, the other information should negate the covered information, and the safe harbor should not be available. This clause is intended to ensure that—once in knowing possession of material nonpublic information—individuals or entities do not reverse engineer the information using methods or strategies that enable them to seek protection under this safe harbor, thus circumventing insider trading laws. The policy underlying this clause is in line with judicial precedent, which holds that individuals and entities can still be liable for violating insider trading laws if they traded on the basis of traditional inside information, but later sought to claim that the information (or similar information) was already publicly available. *See, e.g.*, United States v. Contorinis, 692 F.3d 136, 143–44 (2d Cir. 2012).

245 Such disclosures establish good faith at the outset because the individual or entity is not hiding either its information gathering efforts or its attempts to profit from the information. Additionally, the disclosures enable the SEC to investigate the circumstances surrounding the information gathering and trading in order to ensure compliance with insider trading laws, as well as to investigate the issuer in the event that the disclosed information identifies any fraud or wrongdoing. Moreover, a record of all communication of the information will help the SEC trace the subsequent flow of information and trading, as well as avoid wasting time by pursuing enforcement actions against individuals or entities that received the information through protected communications. Also, disclosure comports with the SEC's goal of increasing information flow to the markets by ensuring that the information will be disclosed to the public after the SEC completes its internal processes. *See infra* note 249. Finally, disclosures provide a more efficient process for granting the safe harbor as compared to a process within which the SEC must first file an enforcement action and a defendant must then seek protection from the safe harbor after-the-fact.

246 The alternative written plan provision enables individuals and entities to execute trades or communicate the information over a thirty-day period before making any disclosures. That should provide sufficient flexibility for individuals and entities to accumulate potentially large positions in securities over time, which may not otherwise be feasible within the initial three (3) day disclosure period. *See supra* note 245 and accompanying text.

247 It is important to note that this subsection, (d)(i)(A), only calls for disclosure of the

(B) a full record of all external communications of such conclusions or material nonpublic information, and (C) a full record of all purchases or sales conducted.
(ii) The disclosures filed with the Commission in compliance with paragraph (d)(i) must be filed in strict confidence and will be maintained as such by the Commission;[248] except that the Commission may publicly release the information disclosed under paragraph (d)(i), and may release the results of the Commission's own investigations of the relevant circumstances, as appropriate in the public interest or for the protection of investors.[249]

CONCLUSION

The SEC has exacerbated the legal uncertainty that pervades insider trading law by continuing to pursue novel theories of liability, by targeting analysts despite their importance to the efficient functioning of the markets, and by compounding those efforts with a newly aggressive litigation posture. As a result, there are few reliable guidelines to effectively inform market participants about the legal boundaries that they must operate within when communicating or trading on material nonpublic information. Rather than risk stifling the flow of information by continuing to pursue its current enforcement strategy, the SEC should help facilitate an increase in the flow of information by recognizing that information gathering should be protected and incentivized. To that end, the SEC should adopt an express safe harbor for communicating or trading on information obtained through "replicable" methods or strategies.

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conclusions derived from the information, not for disclosure of the methods or strategies used to reach such conclusions. Otherwise, institutional and other sophisticated investors may be unlikely to seek the protection of a safe harbor rule that requires disclosure of highly valuable propriety information. That, in turn, would destroy the purpose and effect of the safe harbor.

248 Confidentiality of the disclosures, of the information disclosed, and of the trading or communication of the information, enables the SEC to conduct its investigation of the underlying circumstances and complete the process without alerting the issuer and without harming the issuer or the disclosing party before the investigation is complete. Additionally, if the results of an investigation determine, for example, that the issuer is perpetrating a fraud, the SEC may seek to take steps to mitigate the impact on the markets and on ordinary investors. Finally, confidentiality permits the disclosing party to continue any pre-written plan or trading strategy to profit from their efforts ahead of any public disclosure by the SEC. Such a system of confidential disclosure is already offered by the SEC in other contexts. *See, e.g.*, 15 U.S.C. § 77f(e) (2012) (permitting emerging growth companies to submit confidential registration statements to the SEC in order to, *inter alia*, protect such private companies from competitors).

249 Once the SEC has completed its investigation, it may determine that public disclosure or other actions are in the best interest of investors and of the markets as a whole. Therefore, the SEC should have the flexibility at that time to at least release the conclusions drawn by the disclosing party, or release the results of its own investigation.