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(Re)Conceptualizing Insider Trading: *United States v. Newman* and the Intent to Defraud

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(Re)Conceptualizing Insider Trading

UNITED STATES V. NEWMAN AND THE INTENT TO DEFRAUD

J. Kelly Strader†

INTRODUCTION

Recent insider trading enforcement efforts have been unparalleled in their scope and impact,[1] producing the lengthiest insider trading sentences in history[2] and pushing the boundaries of existing law.[3] Largely because of these efforts, insider trading

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[1] For example, the insider trading cases arising from the investigation of hedge fund giant SAC Capital Investors LP ("SAC") are some of the largest and most complex ever prosecuted. *See* Patricia Hurtado et al., *SAC Record $1.8 Billion Plea Caps Seven-Year Insider Trading Probe*, 9 White Collar Crime Rep. (BNA) No. 242, at 1 (Apr. 18, 2014); Bob Van Voris, *Portfolio Manager Martoma Found Guilty in Massive Insider Trading Scheme at Hedge Funds*, 9 White Collar Crime Rep. (BNA) No. 4, at 106 (Feb. 10, 2014). The prosecutor leading the efforts had an extraordinary success record until recent events. *See* Matthew Goldstein et al., *A Winning Streak on Insider Cases Ends*, N.Y. TIMES, July 9, 2014, at B1, *available at* http://dealbook.nytimes.com/2014/07/08/jury-clears-rengan-rajaratnam-in-insider-trading-case.

[2] Raj Rajaratnam, a former hedge fund manager, was convicted of 14 counts of conspiracy and securities fraud based upon an insider trading scheme. He was sentenced to 11 years in prison, the longest insider trading prison sentence in history, and assessed over $150 million in criminal and civil penalties. Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case*, N.Y. TIMES (Oct. 13, 2011, 11:18 AM), http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years; Peter Lattman, *Rajaratnam Ordered to Pay $92.8 Million Penalty*, N.Y. TIMES (Nov. 8, 2011, 6:44 PM), http://dealbook.nytimes.com/2011/11/08/rajaratnam-ordered-to-pay-92-8-million-penalty/#main; *see* United States v. Rajaratnam, 719 F.3d 139 (2d. Cir. 2013), *cert. denied*, 134 S. Ct. 2820 (2014). Although sentences vary widely under the discretionary federal sentencing guidelines, the statutory maximum for insider trading is 20 years for each count and fines of up to $5 million for individuals and $25 million for organizations. 15 U.S.C. §§ 78j(b), 77ff, 78ff (2012). In white collar cases, the sentences are often driven up dramatically by the amount of loss. *See* U.S. SENTENCING GUIDELINES MANUAL § 2B1.1 (2014).

[3] *See infra* Parts I & II.

law and policy could well be on the brink of substantial transformation. In what is potentially a landmark decision, the Second Circuit in *United States v. Newman*[4] sought to clarify insider trading law. In particular, the decision takes a major step in returning insider trading doctrine to its core concept: because insider trading liability is grounded in the specific intent crime of common law fraud, such liability requires both a breach of duty and intentional behavior with respect to that breach.

The *Newman* decision arose within the context of a series of Second Circuit insider trading decisions that applied conflicting mens rea standards governing core culpability elements of the offense, particularly with respect to tipper/tippee liability.[5] These cases raise issues that have the potential to reshape insider trading law and that ultimately must be decided by the United States Supreme Court.[6] It is within this context that this article re-conceptualizes and systematizes insider trading law as grounded within and defined by the common law theft crime of fraud.

To understand the expansiveness of current law, consider the case against Anthony Chiasson, Todd Newman's co-defendant. Both were hedge fund portfolio managers.[7] Each was convicted of multiple counts in an alleged insider trading scheme; Chiasson was sentenced to six and a half years and Newman to four and a half years in prison.[8]

In the case against Chiasson, the alleged original tipper worked in Dell Inc.'s investor relations department, and leaked advance information about a Dell financial performance report. Chiasson received the information as a fourth-level tippee after

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4 United States v. Newman, 773 F. 3d 438 (2d Cir. 2014), *reh'g en banc denied*, 2015 WL 1954058 (2d Cir. Apr. 3, 2015). The government moved for rehearing, which the Second Circuit denied. *Id. See* Phyllis Diamond, *U.S. Focuses on Personal Benefit in Bid for Rehearing of Insider Ruling*, 10 White Collar Crime Rep. (BNA) No. 3, at 75. (Feb. 6, 2015) [hereinafter Diamond, *Personal Benefit*]; Matthew Goldstein & Ben Protess, *Court Rejects Bharara's Plea to Reconsider Insider Trading Ruling*, N.Y. TIMES DEALBOOK (Apr. 3, 2015), http://www.nytimes.com/2015/04/04/business/dealbook/appeals-court-rejects-request-to-rehear-landmark-insider-trading-case.html. As this Article goes to press, the government is considering whether to seek review by the United States Supreme Court. *See id.*

5 *See* Robert J. Anello & Richard F. Albert, *Second Circuit to Resolve Split on Insider Trading*, 250 N.Y.L.J. No. 107 (Dec. 3, 2013) [hereinafter Anello & Albert, *Resolve*] (noting conflicting standards for tippee liability).

6 *See* Yin Wilczek, *Insider Trader's Second Circuit Appeal Could Lead to Evolution of Law, Lawyers Say*, 8 White Collar Crime Rep. (BNA) No. 19, at 666 (Sept. 17, 2013). The government's 133-page brief in one of these cases shows that the government recognizes the high stakes in the case's potential for defining insider trading law—particularly with respect to a tippee's mens rea. *See* Brief for United States of America, United States v. Horvath, 2013 WL 6163307, at *41 (2d Cir. Nov. 14, 2013) (Nos. 13-1837, 13-1917).

7 *Newman*, 773 F.3d at 442.

8 *Id.* at 444.

it had been passed through intermediaries. At trial, the government did not show that Chiasson knew the identity of the person who tipped him or that he knew whether the tipper had obtained the information improperly.[9] In such circumstances, can a tippee be held criminally liable for trading on the information? The trial court in Chiasson's case said yes, while other courts have said no.[10]

In reversing Newman's and Chiasson's insider trading convictions, the Second Circuit attempted to clarify the inconsistent Second Circuit precedent. Most importantly, the court held that the trial court had used improper jury instructions that omitted core mens rea elements for tippee liability.[11] The court also took the extraordinary step of finding the evidence against the defendants insufficient as a matter of law, thus foreclosing the possibility of a retrial.[12]

As one commentator aptly noted, the *Newman* case "addresses 'very directly' and 'very starkly' the eroding legal distinction between the permissible sharing of information, and the illegal use of material nonpublic information."[13] In its opinion, the Second Circuit made this very point, criticizing the "doctrinal novelty" of the prosecution and noting that it could locate no other criminal convictions of such remote tippees.[14] In this light, *Newman* is "a potentially game-changing decision"[15] that signals long-overdue resistance to the government's boundary-pushing insider trading prosecutions.[16]

And *Newman* may be part of a broader pushback.[17] In another high profile case, the trial judge dismissed the principal

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[9] *Id.* at 443. Under *Dirks v. SEC*, 463 U.S. 646, 665 (1983), a tipper acts improperly only when the tipper acts for personal gain. In *Chiasson*, the trial court did not require that the jury find that Chiasson, the tipper, knew that the tipper was acting improperly, *i.e.*, for personal gain.

[10] *See* Anello & Albert, *Resolve*, *supra* note 5.

[11] *Newman*, 773 F.3d at 450-51.

[12] *Id.* at 12-14 (dismissing the case with prejudice).

[13] Wilczek, *supra* note 6, quoting securities law expert Martin Klotz.

[14] *Newman*, 773 F.3d at 448.

[15] Phyllis Diamond & Hugh B. Kaplan, *Second Circuit Makes Insider Trading Hard to Prove When Trader Is Steps Removed from Insider*, 96 Criminal Law Rep. (BNA) No. 12 at 292 (Dec. 17, 2014) (quoting former SEC attorney Michael MacPhail).

[16] *See* Peter J. Henning, *What an Appeals Court Insider Trading Decision Does, and Doesn't, Do*, N.Y. TIMES DEALBOOK (Dec. 10, 2014), http://dealbook.nytimes.com/2014/12/10/what-an-appeals-court-insider-trading-decision-does-and-doesnt-do/ ("The ruling represents the first significant appellate decision in a number of years that curtails the scope of insider trading laws."); *see also* Patricia Hurtado, *Bharara Fenced in by Ruling Undercutting Insider Trading Convictions*, 9 White Collar Crime Rep. (BNA) No. 26, at 906 (Dec. 16, 2014) (describing the praise and criticism that the decision has earned).

[17] *See* Patricia Hurtado & Robert Wilhelm, *Second Circuit Questions Insider Trading Jury Instructions*, 9 White Collar Crime Rep. (BNA) No. 9, at 278 (May 2,

insider trading charges and the jury acquitted the defendant on the remaining charge.[18] As the *New York Times* noted, this case "underscored a broader whiff of skepticism about the crackdown on insider trading."[19] And in the high profile civil case that the SEC brought against Nelson Obus, the jury found Obus and his co-defendants not liable.[20] A number of other insider trading prosecutions and convictions may also be in jeopardy.[21]

In this highly charged regulatory environment, insider trading law is in dire need of reform. Because insider trading is a form of securities fraud that is primarily judicially-defined,[22] the crime requires proof of elements that are often vague and ill-defined, particularly with respect to the mens rea element(s).[23] This vagueness raises two basic due process concerns: denying potential defendants fair notice and emboldening prosecutors to push the law beyond established boundaries.[24]

2014); Leah McGrath Goodman, *Why Rengan Rajaratnam Got Off on Insider Trading Charges*, NEWSWEEK, July 9, 2014, http://www.newsweek.com/why-rengan-rajaratnam-got-insider-trading-charges-258005.

[18] The acquittal was of Rengan Rajaratnam, the brother of Raj Rajaratnam. Goodman, *supra* note 17.

[19] Goldstein et al., *supra* note 1, at B1.

[20] Rachel Abrams, *After Fighting Insider Trading Charges for 10 Years, a Fund Manager Is Cleared*, N.Y. TIMES DEALBOOK (May 30, 2014), http://dealbook.nytimes.com/2014/05/30/fund-manager-found-not-liable-in-insider-trading-case/.

[21] *See* Phyllis Diamond, *Second Circuit's Ruling Clarified Bright-Line Rule, Chiasson Lawyer Says*, 10 White Collar Crime Rep. (BNA) No. 1, at 23 (Jan. 9, 2015).

[22] Robert J. Anello & Richard F. Albert, *Revisiting Criminal Insider Trading Liability*, N.Y. L.J. June 3, 2014, at 2 [hereinafter Anello & Albert, *Revisiting*] ("Illegal insider trading is not defined by statute, but by an amalgamation of judicial opinions.").

[23] *See* Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 556 (2011) [hereinafter Buell, *Securities Fraud*] ("The Supreme Court has never identified the scienter required for a criminal conviction for securities fraud. The lower federal courts have issued dozens of opinions making a mess of the matter."); Michael L. Seigel, *Bringing Coherence to Mens Rea Analysis For Securities-Related Offenses*, 2006 WIS. L. REV 1563, 1624 (2006) ("[T]he failure of commentators and courts to tackle mens rea analysis head-on has resulted in lasting incoherence in the law" of securities fraud.); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 150 (2003) ("The scienter concept . . . appears to be slipping away" from insider trading law.). For an analysis of the vague boundaries of securities fraud in general, see generally Peter J. Henning, *Testing The Limits of Investigating and Prosecuting White Collar Crime: How Far Will the Courts Allow Prosecutors To Go?*, 54 U. PITT. L. REV. 405 (1993) and Ellen S. Podgor, *Jose Padilla and Martha Stewart: Who Should Be Charged with Criminal Conduct?*, 109 PENN ST. L. REV. 1059 (2005); J. Kelly Strader, *White Collar Crime and Punishment: Reflections on Michael, Martha, and Milberg Weiss*, 15 GEO. MASON L. REV. 45, 49 (2007) [hereinafter Strader, *White Collar Crime*].

[24] Because most insider trading cases, like other categories of federal criminal cases, settle without any trial, the boundary-pushing theories are rarely tested in court or otherwise subject to review. *See* Lucian E. Dervan, *White Collar Overcriminalization: Deterrence, Plea Bargaining, and the Loss of Innocence*, 101 KY. L.J. 723, 744 (2013) (almost 97 percent of federal criminal cases are resolved by plea bargain). As a result, "[n]ovel legal theories and overly-broad statutes [are] tools merely for posturing during charge and sentence bargaining," and are rarely "defended

The expanding scope of insider trading law is also emblematic of two widely-criticized phenomena in federal criminal law, eroding mens rea standards and the over-criminalization of activities more appropriately left to civil and regulatory enforcement.[25] By seeking to define the mens rea of insider trading liability more carefully, the approach that this article proposes meets many of the concerns arising from overcriminalization. Insider trading exists in what the United States Supreme Court termed "the gray zone" between socially desirable and undesirable business conduct.[26] As the Court has noted in the particular context of tipper/tippee liability, it is the job of market analysts aggressively to seek out generally unavailable market information.[27]

For that reason, insider trading as a form of securities fraud provides a particularly fertile context for examining laws and regulations that purport to define the "gray zone." As Second Circuit Judge Barrington Parker commented during the oral argument in *Newman*, "We sit in the financial capital of the world . . . . [The government's approach] gives precious little guidance to all the institutions, all the hedge funds, that are trying to come up with some bright line rule of what they can and can't do."[28]

By infusing insider trading doctrine with the law and policy of common law fraud, we can more clearly define the crime and conform it to its core policy goals. The United States Supreme Court has provided the groundwork for this framing in 30 years of insider trading precedent. This theoretical underpinning has been subject to substantial criticism, and is not always applied

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and affirmed both morally and legally at trial." *Id*. S*ee also* Strader, *White Collar Crime*, *supra* note 23, at 53. Further, cases that settle, whether through consent decrees, plea bargains, or deferred—or non-prosecution agreements, themselves become a sort of internal precedent that then may lead to ever broader application of the insider trading laws. *See, e.g*., Harry Litman, *Pretextual Prosecution*, 92 GEO. L.J. 1135 (2004); Erik Luna, *Principled Enforcement of Penal Codes*, 4 BUFF. CRIM. L. REV. 515 (2000); Gerard E. Lynch, *Our Administrative System of Criminal Justice*, 66 FORDHAM L. REV. 2117 (1998).

[25] *See* Geraldine Szott Moohr, *Playing with the Rules: An Effort to Strengthen the Mens Rea Standards of Federal Criminal Laws*, 7 J.L. ECON. & POL'Y 685, 685 (2011) [hereinafter Moohr, *Playing*] ("Mens rea standards have eroded over time, making people subject to punishment who would not otherwise be blameworthy in the classic criminal law sense. In this way, the diminished significance of the *mens rea* element is part of the trend to overcriminalize."); Sara Sun Beale, *The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization*, 54 AM. U. L. REV. 747, 748 (2005); Erik Luna, *The Overcriminalization Phenomenon*, 54 AM. U. L. REV. 703, 743-44 (2005).

[26] United States v. U. S. Gypsum Co., 438 U.S. 422, 441 (1978).

[27] Dirks v. SEC, 463 U.S. 646, 658 (1983).

[28] Hurtado & Wilhelm, *supra* note 17 (quoting Judge Barrington D. Parker Jr.).

consistently.[29] Nonetheless, until Congress decides to define insider trading, or until the Supreme Court decides to overturn over three decades of its own precedent, the common law of fraud will continue to provide the governing doctrinal framework. The *Newman* decision is one important step in re-conceptualizing insider trading as a form of common law fraud.

When a party who owes a fiduciary duty or its equivalent to the information's owner takes and trades on the information without disclosing the theft to the owner, that party breaches a duty to the owner and commits illegal insider trading.[30] As the Supreme Court has consistently emphasized, it is the duty element that serves to cabin the scope of potential insider trading liability.[31] Absent this limitation, a person who innocently possessed and traded on the information could nonetheless be convicted of a crime.

All the elements of insider trading, then, should be re-conceptualized in accordance with these foundational principles. In mens rea terms, fraud is a common law offense that requires proof of "specific intent"; fraud cannot be committed by recklessness or other forms of non-intentional behavior.[32] To commit insider trading—a form of securities *fraud*—the defendant must act

[29] For insightful critiques of current insider trading doctrine, and proposals for new theories of insider trading, *see generally* Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1369-78 (2009) [hereinafter Nagy, *Principles*]; *see also* Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881 (2010) (identifying the inconsistent ways in which insider trading law is applied).

[30] This article operates under the premise that, as I have argued elsewhere, it is the harm from criminal activity that is the guiding principle for establishing the scope of criminal liability. *See* J. Kelly Strader, Lawrence's *Criminal Law*, 16 BERKELEY J. CRIM. L. 41, 47 (2011); J. Kelly Strader, *The Judicial Politics of White Collar Crime*, 50 HASTINGS L.J. 1199, 1270 (1999); Strader, *White Collar Crime*, *supra* note 23, at 55. Others have focused on the moral wrongfulness of insider trading rather than upon the harm that it causes. *See, e.g.*, Stuart P. Green, *Cheating*, 23 LAW & PHIL. 137, 177-78 (2004); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 382 (1999). Whether viewed as harmful, immoral, or both, it is the breach of duty that lies at the core of insider trading liability. *See infra* Part I.A.

[31] This point, in fact, underlies the *Chiarella* opinion, which held that common law fraud principles inform federal securities fraud. Chiarella v. United States, 445 U.S. 222, 227-28 (1980).

[32] *See* Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1985 (2006) [hereinafter Buell, *Novel Criminal Fraud*] (citing United States v. Harm, 442 F.3d 367, 372 (5th Cir. 2006) ("[T]he mens rea for fraud is 'specific intent to defraud.'"). As discussed *infra* Part II.A, "specific intent" is not easily defined. As Prof. Buell points out, intent to deceive or mislead alone cannot be sufficient, for such a definition does not clearly separate out merely aggressive business activities from fraudulent ones. Buell, *Securities Fraud*, *supra* note 23, at 539. For analogous reasoning in the mail fraud context, see *United States v. Regent Office Supply Co.*, 421 F.2d 1174, 1180 (2d Cir. 1970). The Supreme Court addressed the intent component of insider trading in *United States v. O'Hagan*, 521 U.S. 642, 653-54 (1997) discussed *infra* Part II.C.

intentionally with respect to the breach of duty. This applies to principals as well as to tippers and tippees. Criminal law exists to punish the culpable, and culpability is tied to the defendant's mens rea; a defendant who did not act culpably should not be criminally sanctioned.[33]

Sending someone to jail for up to 20 years for non-intentionally using inside information runs counter to basic fraud principles, which require that the defendant intentionally set out with a plan to harm the victim of the fraud. The Supreme Court has made the distinction between intentional and non-intentional offenses in a number of significant cases, from a high profile criminal antitrust case[34] to a recent case assessing the concept of "willful blindness." The latter case, *Global-Tech Appliances, Inc. v. SEB S.A.*,[35] is particularly significant, for it distinguishes willful blindness from the concept of "recklessness," a mens rea denoting accidental conduct that courts sometimes incorrectly apply to insider trading law. In *Global-Tech*, the Court adopted a rigorous test for willful blindness, a form of criminal "intent" that is particularly apt for certain elements of insider trading.[36]

Building on both *Newman* and *Global-Tech*, this article proposes that courts adopt jury instructions that more accurately reflect culpability principles than the instructions that federal courts currently employ in insider trading cases—such as the flawed jury instructions in *Newman*. Absent a statutory definition of insider trading, fuller and more accurate jury instructions are central to rationalizing insider trading law.[37]

Using *Newman* and other recent Second Circuit insider trading cases as focal points,[38] this article examines the errors that courts typically make when articulating the mens rea of insider trading in general and tipper/tippee liability in particular. The article then proposes that courts carefully delineate insider trading elements and attach appropriate mens rea levels to each element.

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[33] *Cf.* Darryl K. Brown, *Federal Mens Rea Interpretation and the Limits of Culpability's Relevance*, 75 L. & CONT. PROB. 109, 116 (2012) ("Instrumental goals of maximizing harm prevention by more easily imposing punishment simply reject the value of culpability.").

[34] United States v. U.S. Gypsum Co., 438 U.S. 422, 435 (1978).

[35] Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2070 (2011). Although a civil case, the decision has broad applicability to criminal cases as well.

[36] *See infra* Part II.A.

[37] *See* Goodman, *supra* note 17.

[38] United States v. Newman, 773 F.3d 438 (2d Cir. 2014); United States v. Goffer, 721 F.3d 113 (2d Cir. 2013); SEC v. Obus, 693 F.3d 276 (2d Cir. 2012); United States v. Whitman, 904 F. Supp. 2d 363 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014) (Summary Order) (unpublished opinion), *cert. denied*, 135 S. Ct. 352 (Nov. 10, 2014).

Part I of this article provides an overview of insider trading doctrine, including the traditional and misappropriation theories and tipper/tippee liability, with a focus on the *Newman* decision. This Part sets the context, based upon decades of precedent, of insider trading as a form of the common law crime of fraud. Part II then re-conceptualizes this law by carefully employing common law fraud as the foundational doctrinal principle and by tailoring the crime's elements to the core harms attendant to the fraudulent theft of property. This article posits that, under the law of fraud, the core wrong of insider trading is the theft of the intangible property interests that are embodied in material nonpublic information.[39] Each of the insider trading elements, with respect to the attendant mens rea required, should reflect this doctrinal grounding. Part III then provides the framework for a systematic restatement of the mens rea elements of insider trading in a set of proposed jury instructions that matches culpability principles with each of the actus reus elements. These instructions take the *Newman* case as their starting point, but expand upon that holding to make the jury instructions more systematic and coherent. In this way, the article seeks to provide much-needed consistency and clarity to insider trading law.

I. INSIDER TRADING DOCTRINE AND THE *NEWMAN* DECISION[40]

Insider trading is a subspecies of securities fraud.[41] This section traces the development of the principal insider trading theories—the traditional and misappropriation theories—as

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[39] *See* Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 158 (1998) (noting that "the courts are implicitly . . . creat[ing] a federal property right in information for certain persons" when applying the misappropriation theory of insider trading).

[40] "Insider trading" is a misnomer; one can be liable for trading on material nonpublic information even if one is an "outsider"—that is, even when one has no relationship with the issuer of the securities. *See infra* Part I.A. But the term "insider trading" is ubiquitous in our culture and in the law, and so I use it here.

[41] For present purposes I accept the proposition that insider trading should be regulated and criminalized. This proposition has been subject to substantial debate, with many arguing that the harm from insider trading is hard to prove and/or that insider trading actually promotes market efficiency. *See* Kim, *supra* note 29, at 945-47; Strader, *White Collar Crime*, *supra* note 23, at 68. For a discussion of the normative underpinnings of insider trading prohibitions, see Stuart P. Green & Matthew B. Kugler, *When is it Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L. J. 445, 450-52 (2011). While I share others' skepticism over the criminalization of insider trading, I assume for purposes of this article that such criminalization is justified. For an earlier analysis of this issue, see Strader, *White Collar Crime*, *supra* note 23, at 49.

forms of securities fraud.[42] The section also evaluates the theory used in the recent high profile insider trading prosecutions—tipper/tippee liability. The principal focus is on criminal insider trading liability, though much of the analysis will also be applicable to civil insider trading liability.[43] Throughout this analysis, the goal is to make sense of current insider trading doctrine, with a focus on the *Newman* decision.[44] In this way, we can lay the groundwork for providing a systematic restatement of the mens rea elements of insider trading.

A. The Traditional and Misappropriation Theories

Because no statute explicitly defines "insider trading," the law has generally developed through SEC and judicial decisions reaching back more than 50 years.[45] In broad terms, the securities laws forbid buying or selling securities based upon

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[42] The many forms of civil and criminal securities fraud arise under a myriad of statutes, regulations, and judicial decisions. *See* WHITE COLLAR CRIME: BUSINESS AND REGULATORY OFFENSES §§ 12.01-03 (Otto G. Obermaier et al., eds., 2014).

[43] Courts, including the Supreme Court, consistently cite and rely upon civil and criminal cases fairly indiscriminately. In fact, it is difficult to discern a clear distinction between the standards for civil and criminal cases. This article focuses on the mental element necessary for criminal insider trading liability. Some overlap between civil and criminal liability is unavoidable, however. *See* Geraldine Szott Moohr, Essay, *What the Martha Stewart Case Tells Us About White Collar Criminal Law*, 43 HOUS. L. REV. 591, 601 (2006) [hereinafter Moohr, *Stewart*] ("The merger of civil and criminal standards means that the only distinction between civil and criminal liability is the standard of proof in a criminal case, beyond a reasonable doubt."). In insider trading cases brought under Section 10b, the only statutory distinction is the requirement that the government prove that a defendant in a criminal case acted "willfully." 15 U.S.C. § 78ff(a) (2012). *See* Brian J. Carr, *Culpable Intent Required for All Criminal Insider Trading Convictions after* United States v. O'Hagan, 40 B.C. L. REV. 1187, 1188 (1999). As discussed more fully below, *infra* Part II.A, the statutes do not define this term, and courts struggle with what this requirement actually adds to the government's burden.

[44] I accept the United States Supreme Court's definition of insider trading as a form of the common law theft crime of fraud; as a form of theft, this crime deprives its victims of their property interest in confidential information. In this sense, I do not undertake a reformulation of insider trading theory. For examples of such reformulations, see Kim, *supra* note 29; Nagy, *Principles*, *supra* note 29. Instead, my goal is to flesh out the underlying fraud theory upon which insider trading law is already grounded.

[45] The most important early decisions are *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1969).

material,[46] nonpublic[47] information obtained in breach of a duty owed to the source of the information.[48]

Insider trading cases initially were brought under the "traditional," also termed the "classical," theory.[49] Under the traditional theory, a corporate insider breaches a duty to the corporation's shareholders if the insider trades on material, nonpublic information without first disclosing the information to the shareholders. Those cases also asserted that it was unfair for a person to trade on information that was not generally available to the investing public.[50] The latter rationale is sometimes termed the "parity of information" approach.[51]

The United States Supreme Court rejected the parity of information rationale in its 1980 decision in *Chiarella v. United States*,[52] the foundational case for modern insider trading law. Chiarella worked for a printing company that represented corporate clients seeking to acquire target companies.[53] The defendant was able to profit because he bought the target companies' stock before the offers were made public and sold at a significant profit after the information went public. The government charged Chiarella with securities fraud based upon

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[46] Materiality is an element of the offense. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). According to the Supreme Court, information is material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

[47] The nonpublic nature of the information is also an element of the offense. *See* SEC v. Svoboda, 409 F. Supp. 2d 331, 340 (S.D.N.Y. 2006).

[48] The SEC can bring an administrative action or a civil insider trading case seeking disgorgement, injunctive relief, and other remedies. Private parties may also bring civil cases in certain instances. In addition or instead, the Department of Justice can bring a criminal case. Many forms of securities fraud may also give rise to private civil lawsuits. This article does not focus on the scienter required for such suits. For an overview of criminal and civil enforcement paths, see Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459 (2009).

[49] *See, e.g.*, *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[50] *See, e.g.*, *Tex. Gulf Sulphur*, 401 F.2d at 848 ("[T]he Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.").

[51] As Prof. Coffee has noted, "most securities law scholars and practitioners have resisted a parity-of-information approach to defining the scope of the insider trading prohibition because it would dull market efficiency by chilling the incentive to search for new information." John C. Coffee, Jr., *Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 312-13 (2013).

[52] Chiarella v. United States, 445 U.S. 222, 233 (1980).

[53] A tender offer is an announcement by an offering company that it intends to acquire the stock of another (the "target") company at a specified price above the then-prevailing market price for the stock. After the tender offer is made public, the price of the target company's stock generally rises. *See* J. KELLY STRADER, UNDERSTANDING WHITE COLLAR CRIME 106-07 & n.62 (3d ed. 2011) [hereinafter STRADER, UNDERSTANDING].

the theory that he defrauded the target companies' shareholders from whom he purchased his stock.

The Court reversed Chiarella's conviction, essentially holding that securities fraud is just that—a form of fraud. The Court noted that Chiarella was not charged based upon any affirmative misrepresentation to the targets' shareholders. Instead, the theory was that he committed fraud based upon an omission, that is, that he failed to disclose the confidential information—the pending acquisitions—that he possessed but that the sellers of the target companies' stock did not.[54]

On these facts, the Court held that the nondisclosure theory was fatally flawed. As the Court explained, "[a]t common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[55] Because Chiarella owed no duty to the alleged victims (the persons with whom he traded), he could not be liable based upon omissions.

The Court expressly rejected an alternate theory—a "duty to the market" theory—that both the lower courts and the government had relied upon.[56] Under this theory, anyone who possesses material nonpublic information is a "market insider" and must disclose the information "to the investing public" or refrain from trading.[57] The Court held that there is no duty to the market as a whole; rather, duties derive from common law principles of fraud.[58]

The Court also declined to consider the validity of a third theory—the "misappropriation theory"—because it had not been raised at trial.[59] In the years following *Chiarella*, most federal

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[54] *See Chiarella*, 445 U.S. at 226 ("[T]his case concerns the legal effect of the petitioner's silence.").

[55] *See id*. at 227-28.

[56] The Second Circuit had held that "[*a*]*nyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir.1978), *rev'd*, 445 U.S. 222 (1980).

[57] *Id*. at 1364 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc)). In rejecting the duty to the market theory, the Supreme Court in *Chiarella* did not explicitly state to whom the disclosure must be made, but at minimum disclosure is required to the person(s) with whom the insider is trading. *Chiarella*, 445 U.S. at 227 ("'[I]nsiders must disclose material facts which are known to them by virtue of their position but *which are not known to persons with whom they deal* and which, if known, would affect their investment judgment.'") (quoting Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (emphasis added)).

[58] *Chiarella*, 445 U.S. at 232 ("[N]ot every instance of financial unfairness constitutes fraudulent activity under Section 10(b).").

[59] Under this theory, Chiarella breached a duty to his employer, the printing company, and perhaps also a duty owed to his employer's clients, see *Dirks v. SEC*, 463

circuit courts approved the misappropriation theory.[60] Courts applied the theory in a wide array of contexts.

One of the most notable cases was *Carpenter v. United States*,[61] in which the defendants were charged with insider trading and with mail fraud based upon that trading. The case hinged on the activities of a *Wall Street Journal* reporter who wrote a widely read financial column that had the capacity to affect stock prices. The reporter and his tippees traded the stock of companies discussed in the column, netting substantial profits. Because none of the defendants were insiders of the companies at issue, they could not be charged under the traditional theory. Instead, the government alleged that the reporter had breached his duty of confidentiality to the *Journal* by using its secret information to his advantage.

The defendants were convicted of securities fraud and mail fraud, and appealed to the Supreme Court. The Court affirmed the mail fraud convictions, but split four-to-four on whether the misappropriation theory is a valid basis for insider trading liability.[62] As the Court noted, however, "[i]t was this appropriation of confidential information that underlay both the securities laws and mail and wire fraud counts."[63] As will be seen below,[64] the decision's doctrinal underpinning in the mail fraud context applies to the Court's insider trading jurisprudence.

The Supreme Court finally approved the misappropriation theory in *United States v. O'Hagan*.[65] O'Hagan was an attorney whose law firm represented a potential bidder for a target company. As in *Chiarella*, O'Hagan used that information to

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U.S. 646, 655 n.14 (1983), to whom he owed a common law fiduciary duty, by using confidential business information belonging to the employer—in effect, by stealing or "misappropriating" this information. By not disclosing that use, the theory goes, Chiarella defrauded the printing company. The Court did not address this argument because the government had not charged or tried Chiarella based on that theory. *Chiarella*, 445 U.S. at 236. The Court later accepted this theory in *United States v. O'Hagan*, 521 U.S. 642, 650 (1997), discussed below.

[60] *See, e.g.*, United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991); SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990).

[61] 484 U.S. 19, 19 (1987).

[62] In an important holding for our purposes, the Court did affirm the defendants' mail fraud convictions. The Court held that the government had proven that the defendants had used the mails to deprive the *Journal* of its property interest in its confidential business information, that is, in the contents of the reporter's column. *See infra* Part II.C. This holding was not without controversy. *See* John C. Coffee, Jr., *Hush!: The Criminal Status of Confidential Information After* McNally *and* Carpenter *and The Enduring Problem of Overcriminalization*, 26 AM. CRIM. L. REV. 121, 121 (1988-1989) [hereinafter Coffee, *Hush*].

[63] *Carpenter*, 484 U.S. at 24.

[64] *See infra* Part I.B.2.

[65] 521 U.S. 642, 650 (1997).

profit from trading in the target's stock. This time, however, the government alleged that the victims of the fraud were the law firm and its client, rather than the persons with whom the defendant traded.[66]

The Court affirmed O'Hagan's conviction on the theory that he misappropriated confidential information from the law firm and its client without disclosing that theft.[67] Relying heavily on *Carpenter*, the Court focused on the defendant's breach of duty to the law firm and its client.[68] Consistent with its *Chiarella* holding, the Court stated that "[d]eception through nondisclosure is central to the theory of liability for which the government seeks recognition."[69] Thus, if the alleged thief discloses the possession and use of the information to its source, then there is no breach of duty and no liability.[70]

The Court provided a core policy rationale for extending insider trading liability to misappropriators. The misappropriation theory, according to the Court, is "well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."[71]

It is worth emphasizing that the market integrity rationale in *O'Hagan* has its distinct limits. As the Court explained, if an employee sought and gained permission to use the confidential information, then there would be no breach of duty and no liability under Section 10b.[72] This is true even though the threat

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[66] *Id.* at 648.

[67] *Id.* at 665-66.

[68] *See infra* Part I.B.2.

[69] *O'Hagan*, 521 U.S. at 654. *See* David T. Cohen, *Old Rule, New Theory: Revising the Personal Benefit Requirement for Tipper/Tippee Liability Under the Misappropriation Theory of Insider Trading*, 47 B.C. L. REV. 547, 557 (2006) (concluding that the Court adopted common law agency principles in "deriving the scope of the misappropriation theory"); *see* Kim, *supra* note 29, at 943-45 (same). As discussed in detail below, the Court set forth this doctrinal underpinning in *Carpenter v. United States*, 484 U.S. 19, 28 (1987), which affirmed an insider trading conviction under the mail fraud statute. *See infra* Part II.B.2.

[70] "[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no Section 10(b) violation . . . . " *O'Hagan*, 521 U.S. at 655. For a discussion of the sort of disclosure required under the traditional theory, see Kim, *supra* note 29, at 978.

[71] *O'Hagan*, 521 U.S. at 658 ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").

[72] Although *O'Hagan* implied that disclosure alone could be sufficient, this seems implausible; otherwise, the thief could simply say, "look, I'm stealing from you," and thus avoid responsibility. *See, e.g.*, Kim, *supra* note 29, at 944 (discussing SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006)). In addition to the disclosure, permission to use the information should also be required. As the Court noted in *Carpenter*, the theft of

to market integrity is the same as if the employee had been acting without permission.[73]

The Court in *O'Hagan* thus affirmed *Chiarella*'s essential holding: insider trading liability is rooted in common law fraud.[74] Fraud requires a breach of duty, and it is the harm to the information's owner that is the core wrong.[75] Although the Court emphasized risks to "market integrity," it did not call into question *Chiarella*'s holding that a market participant does not owe a duty to the market in general, or to market participants in particular.[76]

In sum, in any insider trading case under Section 10b and Rule 10b-5, liability rests upon theft of material nonpublic information in breach of a duty. The person can be a corporate insider who buys or sells corporate securities, or can be a corporate outsider who has misappropriated the information. (In this sense, the term "insider trading" is too narrow; a person can be liable without being an insider.) When that insider or

confidential information is akin to the crime of embezzlement. *Carpenter*, 484 U.S. 19, 27 (1987). Embezzlement requires proof that one entrusted with property converted the property to that person's own use, accompanied by a specific intent to defraud the owner of the property. *See* WAYNE R. LAFAVE, CRIMINAL LAW § 19.6(f) (5th ed. 2009).

[73] Critics have noted that the boundaries of fiduciary duties or their "equivalent" are imprecise and subject to a void-for-vagueness challenge. *See* Painter et al., *supra* note 39, at 177. The SEC has attempted to clarify the scope of the applicable duties in Rule 10b5-2(b)(1), 17 C.F.R. § 240.10b5-2(b)(1). Whether that attempt has been successful is the subject of substantial debate. *See, e.g.*, Ryan M. Davis, *Trimming the "Judicial Oak:" Rule 10b5-2(B)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469 (2010); Hazen, *supra* note 29, at 896. One principal source of confusion is whether state law, federal common law, or some other source defines the duties. *See, e.g.*, United States v. Whitman, 904 F. Supp. 2d 363, 370 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014) (Summary Order) (unpublished opinion), *cert. denied*, 135 S. Ct. 352 (Nov. 10, 2014) (holding that Rule 10b-5 is based on federal common law rather than on state law conceptions of fiduciary duties). In *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010), the Fifth Circuit seemed to assume that § 10b5-2 expands the notion of common law duties. For an analysis of this aspect of the *Cuban* decision, see Kim, *supra* note 29, at 1000-03. This article does not undertake a detailed analysis of the types of duties that trigger securities fraud liability, nor does it undertake an analysis of the validity of § 10b5-2.

[74] *See* Allison M. Vissichelli, *Intent to Reconcile*: SEC v. Obus, *the Second Circuit's Edification of the Tippee Scienter Standard*, 62 AM. U. L. REV. 763, 776 (2013) (noting "insider trading regulation's foundation in common law fraud").

[75] *See* Painter et al., *supra* note 39, at 226 ("'[T]he only conceivable justification for banning insider trading is that such trading involves the theft of valuable corporate property from its rightful owner.'") (quoting JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 67 (1991)).

[76] Insider trading can be prosecuted under laws other than Section 10b and Rule 10b-5. Section 14 of the Exchange Act and Rule 14e-3(a) thereunder, for example, forbid trading while in possession of material nonpublic information relating to a tender offer. Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a). Rule 14e-3 provides that trading on such information violates the rule irrespective of whether the information was obtained in breach of a duty. *Id.* In *O'Hagan*, the Court upheld the regulation as applied to the facts of the case. *O'Hagan*, 521 U.S. at 689-90.

misappropriator, or another person (a "tippee"), buys or sells securities armed with the material, nonpublic information, then insider trading has potentially occurred.

Finally, it is important to note that all insiders who trade on material nonpublic information are also misappropriators; they have taken—misappropriated—confidential information and used it without disclosing that use to the shareholders. The reverse is not true, however; some misappropriators—such as the reporter in *Carpenter* and the attorney in *O'Hagan*—are not liable as insiders, but only as misappropriators.

B. Tipper/Tippee Liability

In a straightforward case, when an insider has traded on confidential information, or when a misappropriator has stolen information from an employer, the breach of duty is usually easy to identify and the assessment of the alleged wrongdoer's culpability is relatively straightforward. In either case, there has been a direct breach of trust by the insider or misappropriator. When tippers and tippees are involved, however, assessing liability becomes much more complex. This is particularly true in cases involving multiple tippers and tippees. At each step in the chain, the elements of insider trading liability apply.

1. The *Dirks* Decision

The Supreme Court established the outline for tipper/tippee liability in *Dirks v. SEC*.[77] In that case, insiders of Equity Funding Inc. were concerned about ongoing fraud at the company. They revealed the fraud to Dirks, an investment advisor, with the intent that Dirks investigate and expose the fraud. Dirks passed the information to his clients, who sold Equity Funding stock and avoided the losses that they would have incurred had they held the stock until the fraud was made public. The SEC imposed sanctions on Dirks based upon the theory that he aided and abetted his clients' "inside" trading.[78]

The Supreme Court reversed, holding that Dirks was not liable. In the key part of the opinion, the Court reaffirmed *Chiarella*'s fundamental holding that securities fraud based upon non-disclosure must be based upon a breach of duty.[79]

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[77] Dirks v. SEC, 463 U.S. 646, 662-65 (1983).
[78] *Id.* at 646.
[79] *Id.* at 664.

Dirks himself did not have a duty to Equity Funding.[80] He could, however, be liable as a tippee based upon a "derivative breach" of duty flowing from an original breach by the inside tippers.[81] As the Court stated,

> a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when (1) the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and (2) the tippee knows or should know that there has been a breach.[82]

Leaving the second part of the rule aside for now,[83] the critical holding is the definition of the breach of duty. An insider's simple disclosure of material nonpublic information does not, standing alone, constitute a breach. Rather, the disclosure constitutes a breach only when the tipper passes the information to a tippee for the tipper's personal gain. The Court defined personal gain as a monetary or career benefit to the tipper, or the tipper's gift of valuable information to the tippee.[84] Because, as the SEC did not dispute, the insider tippers acted solely to expose the fraud, they did not act for personal gain. Because the tippers did not act for personal gain, they did not breach their duty to Equity Funding by tipping Dirks. And because the tippers did not breach a duty, Dirks did not engage in a derivative breach of duty; there was no initial breach from which his breach could derive. Again, the Court articulated the core insider trading harm as the breach of duty owed to the source of the information.[85]

Finally, it is important to note that, in 2000, the SEC adopted Regulation FD.[86] This rule forbids issuers from selectively disclosing material nonpublic information to market professionals, but instead requires disclosure to the public at large. This rule, however, does not supplant preexisting laws and regulations

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[80] *Id.* at 665.

[81] *Id.* at 662.

[82] *Id.* at 660 (internal numbering added).

[83] The requirement that the tippee "knows or should know that there has been a breach," *id.* at 660, is discussed *infra* Part III.A.3

[84] *Dirks*, 463 U.S. at 667. Prof. Kim argues that *Dirks* conflated "the insider's duty of disclosure owed to the shareholders" with the "duty of loyalty and confidentiality, which is owed to the corporation." Kim, *supra* note 29, at 941. In either event, it is the breach of duty that underlies the tipper's liability and the tippee's derivative liability. Further, after the Supreme Court's decision in *United States v. O'Hagan*, 521 U.S. 642, 650 (1997), all insiders who steal information are liable under both the traditional theory (which formed the basis of the *Dirks* decision) *and* under *O'Hagan*'s misappropriation theory. *See supra* Part I.A.

[85] *Dirks*, 463 U.S. at 667.

[86] 17 C.F.R. § 243.100(a).

concerning insider trading, including the *Dirks* test for tipper/tippee liability.[87] Indeed, in its brief in the *Newman* appeal, the government appeared to concede this point.[88]

2. Applying *Dirks* to Misappropriation Cases

Although the case law now sets the parameters of insider trading law in general terms, there is one substantial open question that the United States Supreme Court has not resolved. *Dirks* arose under the traditional theory; the tippers were insiders of Equity Funding. Lower courts have struggled to ascertain (1) whether *Dirks* tippee liability applies where the tipper is a misappropriator, rather than an insider, and, (2) if so, whether each element of the *Dirks* rule applies under the misappropriation theory.[89] For present purposes, let us again focus on the harm from insider trading: to the corporation and its shareholders under the traditional theory, and to the source of the information under the misappropriation theory. It is the breach of trust, under the traditional and misappropriation theories, that gives rise to liability. It makes no sense, in this light, to limit the *Dirks* rule and each of its elements to the traditional theory; the harm that flows from tippee trading occurs whether the tipper was an insider or misappropriator. As the Second Circuit noted in *SEC v. Obus*, although *Dirks* was decided in a traditional insider trading case, "the same analysis governs in a misappropriation case."[90] The Second Circuit explained that the misappropriator engages in deception "by pretending 'loyalty to the principal while secretly converting the principal's information for personal gain.'"[91]

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87 *See* Joan MacLeod Heminway, *Willful Blindness, Plausible Deniability and Tippee Liability: SAC, Steven Cohen, and the Court's Opinion in* Dirks, 15 TRANSACTIONS: TENN. J. BUS. L. 47, 59 (2013) (citing 17 C.F.R. § 243.102 (2013)).

88 *See* Anello & Albert, *Resolve*, *supra* note 5.

89 Two of the cases upon which this article focuses appear to disagree on this vital issue. The district court in *United States v. Whitman*, 904 F. Supp. 363, 371 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014) (Summary Order) (unpublished opinion), *cert. denied*, 135 S. Ct. 352 (Nov. 10, 2014) stated that the intent to benefit element does not apply to misappropriation cases, and dismissed the Second Circuit's contrary view in *SEC v. Obus*, 693 F.3d 276, 289 (2d Cir. 2012). In a footnote, the court in *Whitman* acknowledged that other courts have either directly held or have implied that an intent to benefit is a required element in a tipper/tippee case brought under the misappropriation theory. *Whitman*, 904 F. Supp. at 371 n.6 (citing SEC v. Yun, 327 F.3d 1263, 1282 (11th Cir. 2003)); *see also* SEC. v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000). For a list of cases applying both approaches see Nelson S. Ebaugh, *Insider Trading Liability for Tippers and Tippees: A Call for the Consistent Application of the Personal Benefit Test*, 39 TEX. J. BUS. L. 265, 281 (2003).

90 *Obus*, 693 F.3d at 285-86 (citing United States v. Falcone, 257 F.3d 226, 233 (2d Cir. 2001)).

91 *Id.* at 284-85 (internal citations omitted) (quoting *O'Hagan*, 521 U.S. at 653).

The court further noted that, if the alleged misappropriator discloses the information to its source, then there is no breach of duty and no insider trading liability.[92]

A number of cases have affirmed tippee liability where the tipper is a misappropriator, applying each of the *Dirks* elements.[93] The SEC famously charged Martha Stewart under precisely this theory, and a number of high profile criminal cases have also been brought under this theory.[94] Importantly, all culpable inside tippers are also misappropriators—they have breached a duty of confidentiality to the corporation and its shareholders. Because both theories apply to insiders, requiring different elements for the two theories is doctrinally inconsistent.[95]

Assuming that *Dirks* applies where the tipper is a misappropriator, courts have further struggled as to whether the "intent to benefit" element—which requires that the tipper provide the tip to the tippee for personal benefit—must be proven in a misappropriation case or is only necessary in a traditional theory case.[96] Given the animating purpose of tipper/tippee liability, the element must apply under both theories.

Where the tipper does not breach a duty to the source of the information, there is no culpability under the *Chiarella*/*Dirks*/*O'Hagan* line of cases; *Dirks* says that absent an intent to benefit, the tipper does not breach a duty.

Some have argued that courts are moving away from fiduciary duties as insider trading's animating principle, citing as an example a "hacking and trading" case, *SEC v. Dorozhko*.[97] The

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[92] *Id.* at 285.

[93] *See, e.g.*, United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993); SEC v. Rorech, 720 F. Supp. 2d 367, 416 (S.D.N.Y. 2010); *see also Falcone*, 257 F.3d at 227 (upholding tippee liability under the misappropriation theory where the tipper owed a duty to the owner of the misappropriated information and the tippee knew that the tipper breached that duty).

[94] *See, e.g.*, Carpenter v. United States, 484 U.S. 19, 28 (1987); *Falcone*, 257 F.3d at 227. For an analysis of the *Stewart* case, see Moohr, *Stewart, supra* note 43, at 619*;* Strader, *White Collar Crime*, *supra* note 23, at 70-80.

[95] *Obus*, 693 F.3d at 285-86 ("The Supreme Court's tipping liability doctrine was developed in a classical case, *Dirks*, but the same analysis governs in a misappropriation case."); SEC v. Yun, 327 F.3d 1263, 1279 (11th Cir. 2003) ("[T]he need for an identical approach to determining tipper and tippee liability under the two theories becomes evident when one realizes that nearly all violations under the classical theory of insider trading can be alternatively characterized as misappropriations.").

[96] *Compare Yun*, 327 F.3d at 1282 (holding that the intent to benefit test under *Dirks* requires more than proof that the tippee was "severely reckless"), *with Libera*, 989 F.2d at 600 (rejecting intent to benefit test and holding that tipper's knowledge of breach suffices under a tippee misappropriation theory).

[97] SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009). *See*, *e.g.*, Kim, *supra* note 29, at 998-1000; Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. REV. 1105, 1113 n.40 (2011). Prof. Kim notes that "a majority

defendant in that case hacked into the computer of a company, stole information, and traded on it. The district court dismissed the case, but the Second Circuit reversed and remanded.[98]

The Second Circuit's opinion does not, however, support the proposition that courts are retreating from the fiduciary duty requirement. A fiduciary duty or its equivalent is required in all *omissions* cases, in accordance with common law fraud principles, per *Chiarella*. The Second Circuit in *Dorozhko* did not hold that the hacker could be liable based on an omission.[99] Instead, the court held that an affirmative act of deception was required because the hacker owed no duty to the source of the information; the court remanded for a determination of whether the hacking entailed an affirmative misrepresentation.[100] The Supreme Court has never retreated from its requirement that a breach of duty is required in all *omissions* cases.[101]

3. The *Newman* Decision

In *Newman*,[102] the Second Circuit issued one of the most highly anticipated insider trading decisions in years,[103] and in the process, reaffirmed the core *Dirks* doctrine outlined above. As discussed more fully in the sections below, *Newman*

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of commentators believe that current insider trading law does not cover hacker trader cases, but that most believe that it should be." Kim, *supra* note 29, at 998.

98 *Dorozhko*, 574 F.3d at 43.

99 The more complex issue may be whether the fraud—the hacking—was "in connection with" the trading. *See* Stephen Bainbridge, *The Second Circuit's Egregious Decision in* SEC v. Dorozhko, PROFESSORBAINBRIDGE.COM (July 29, 2009), http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html. It seems likely that *O'Hagan*'s broad reading of the "in connection with" requirement would bring "hacking and trading" within the ambit of Section 10b. *See* United States v. O'Hagan, 521 U.S. 642, 667 (1997).

100 *Dorozhko*, 574 F.3d at 49-51. It is unclear why the government insisted on bringing an insider trading allegation in this case, when the action seemed to clearly violate the computer fraud statute and probably the wire fraud statute, as the district judge noted in the case. *Id.* at 45. In any event, a hacker may engage in an affirmative misrepresentation, as the Second Circuit noted. *Id.* at 51. This is what distinguishes a hacker from, say, a person who finds a prospectus that has fallen off of a truck and trades on the material nonpublic information contained in that prospectus.

101 Dorozhko did not oppose the SEC's motion for summary judgment on remand. *See* SEC Litigation Release No. 21465 (Mar. 29, 2010),http://www.sec.gov/litigation/litreleases/2010/lr21465.htm. The substantive issue in the case—whether the hacking involved an affirmative misrepresentation—was thus never litigated. Despite all the commentary that it generated, *Dorozhko* has had minimal impact as precedent; I located no insider trading case that has cited *Dorozhko* for the proposition that a breach of duty is no longer required in omission cases.

102 United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

103 *See generally* Anello & Albert, *supra* note 5.

attempted to resolve conflicting standards that the Second Circuit had applied to tippee liability over the years.

To recap the facts outlined above, *Newman* involved a complex, multi-level alleged insider trading scheme. The government charged that a group of hedge fund and investment firm analysts received tips from insiders of technology companies, shared the information concerning the companies' financial projections, and later passed the tips to the portfolio managers—including defendants Newman and Chiasson—at the analysts' firms.[104] Both defendants were convicted as tippees.

The Second Circuit's decision reversing the convictions contains four major holdings. In its opinion, the court (1) clarified the nature of a tipper's breach of duty, (2) defined the level of proof required for the tipper's breach of duty, (3) clarified the standard for the tippee's mens rea as to the tipper's breach, and (4) defined the level of proof required for the tippee's mens rea as to the tipper's breach. Each of these holdings merits close attention.

On the first issue, the court affirmed *Dirks*' basic holding:

> *Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b–5. For purposes of insider trading liability, *the insider's disclosure of confidential information, standing alone, is not a breach*.[105]

Thus, for there to be a breach by the tipper, the tipper must be acting for personal benefit; without the intent to obtain a personal benefit from the tip, there is no breach by the tipper, and neither the tipper nor the tippee can be liable. Significantly, the court also acknowledged the Supreme Court's previous rejection of a parity-of-information rule: "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."[106]

Second, the court defined the type and degree of benefit that the tipper must anticipate for the disclosure of the information to amount to a breach under *Dirks*. Initially, the court stated that "personal benefit" includes not only direct financial benefits but also any "'reputational benefit that will translate into future earnings and the benefit one would obtain from simply making a gift of confidential information to a trading

[104] *Newman*, 773 F.3d at 443-44.

[105] *Id.* at 447-48 (second emphasis added).

[106] *Id.* at 448-49.

relative or friend.'"[107] The court explained that this element requires "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[108] A mere casual friendship or acquaintance will not suffice in the absence of this additional level of proof.[109]

Third, in addition to defining the meaning of "breach" under *Dirks*, the court explained the corresponding proof of mens rea that the government must prove as to tippees. If a tippee believes that the tip was legal—that the information was not passed in breach of a duty, defined as the personal benefit to the tipper—then the tippee is not liable. "[W]ithout establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach."[110]

Finally, the court expounded upon the level of proof required on the element of the tippee's knowledge of the tipper's breach. In a surprising and non-appealable holding, the court held that the government had adduced insufficient evidence on this element as a matter of law.[111] The court stated,

> no reasonable jury could have found beyond a reasonable doubt that [the defendant-tippees] knew, or deliberately avoided knowing, that the information originated with corporate insiders. In general, information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source. But in this case, where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.[112]

This is perhaps *Newman*'s core holding and one that should not be surprising to anyone. The Supreme Court in

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[107] *Id.* at 452 (quoting United States v. Jiau, 734 F.3d 147, 153 (2d Cir. 2013)).

[108] *Id.* ("[T]his requires evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'") (quoting *Jiau*, 734 F.3d at 153) (alteration in original).

[109] *Id.* (otherwise the government could "meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity.") In its motion for rehearing, the government focused solely on this aspect of the *Newman* decision. *See* Diamond, *Personal Benefit*, *supra* note 4.

[110] *Id.* at 448. Significantly, in its motion for rehearing, the government did not contest this portion of the *Newman* holding. *See* Diamond, *Personal Benefit*, *supra* note 4.

[111] *Id.* at 454-55.

[112] *Id.* at 455.

Dirks held that the tippee must have some awareness of the tipper's breach, and defined the tipper's breach as acting for personal gain. If the tippee was not aware that the tipper was acting for personal gain, then as a matter of simple logic this element of tippee liability is not met.

Significantly, however, and as discussed in more detail below, the court in *Newman* failed to clarify the meaning of the *Dirks*' "should have known" language. Initially, in the language quoted above, the court in *Newman* required proof that the tippee had actual or constructive knowledge of the tipper's breach of duty. Two sentences later, however, the opinion references *Dirks*' "should have known" standard, thus conflating the subjective mens rea standard of knowledge and the objective mens rea standard of simple negligence.[113]

The *Newman* decision goes a long way towards clarifying the mens rea of insider trading with respect to tippers and tippees. Nonetheless, the court left some gaps as to the precise levels of mens rea that must be proven. The next section explores the appropriate levels of mens rea that attach to insider trading as a form of fraud.

II. CONCEPTUALIZING INSIDER TRADING AS FRAUD

This article places insider trading, as defined in the preceding section, in the context of criminal law offenses in general and securities fraud in particular. And as the Supreme Court has repeatedly held, securities fraud is itself grounded in the common law of fraud. That lower courts have misinterpreted and misapplied the law of fraud does not mean that fraud is an unworkable basis for insider trading law. One of the principal contributions of the *Newman* decision is to clarify (with some gaps) how the intentionality of common law fraud applies to tippers and tippees.

In (re)conceptualizing insider trading as a form of the crime of fraud, I do not attempt to construct a new insider trading model.[114] It is highly unlikely, in my view, that courts will adopt a comprehensive reworking of insider trading law, and it is unclear whether Congress is willing or able to take that step.[115] Instead,

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[113] *See id.*

[114] *See* Kim, *supra* note 29, at 932; Nagy, *Principles*, *supra* note 29, at 1369.

[115] Insider trading is just one of the many areas in which Congress has failed to carefully delineate and define the mens rea elements of crimes. *See* Moohr, *Playing*, *supra* note 25, at 685 ("Congress can . . . be faulted for its focus on conduct and its lack of attention to mens rea terms."). In the wake of the *Newman* decision, bills have been

courts should focus on insider trading as a subspecies of common law fraud, and should define the elements of the offense accordingly. Insider trading as a form of fraud is the most well-articulated substantive policy framework that we now have for cabining the scope of insider trading liability. It also has the advantage of drawing upon the well-developed history and theory of common law fraud. The more that insider trading law is untethered from the law of fraud, the greater the risk that the boundaries of insider trading law become indistinct.

With one exception, the actus reus elements of insider trading are generally well-established.[116] As *Newman* demonstrates,[117] however, courts are in disarray as to the mens rea of insider trading. By assessing the appropriate mens rea levels that should attach to the actus reus elements, we can draw the line between conduct that warrants criminal punishment and conduct that does not.

This Part first defines the basic mens rea concepts that apply to fraud crimes. It then places insider trading within the context of fraud in general and business and regulatory offenses in particular. Finally, this section examines recent case law to examine whether, and to what degree, courts have defined the mens rea of insider trading in accordance with common law fraud.

A. Distinguishing Intentional from Non-Intentional Offenses

Before turning to the elements of insider trading, this section provides a brief but essential overview of current mens rea[118] concepts and terminology applicable to insider trading.[119]

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introduced to define insider trading. *See* Rob Tricchinelli, *House Bill, the Third Since* Newman *Case, Would Supersede Ruling on Tippee Liability*, 10 White Collar Crime Rep. (BNA) No. 7, at 257 (Mar. 26, 2015). These bills appear to apply a negligence standard. *See id.* As argued throughout this article, negligence is an inappropriate mens rea standard in the fraud context.

116 See *infra* note 261 for a discussion of the "possession" vs. "use" debate in insider trading law.

117 *See* Anello & Albert, *Resolve*, *supra* note 5.

118 Courts sometimes use the term "scienter" as a synonym for criminal mens rea. *See, e.g.*, United States v. X-Citement Video, Inc., 513 U.S. 64, 72 (1994). To further complicate matters, "scienter" is commonly used to describe the mental state required in civil securities fraud cases. *See* Moohr, *Stewart*, *supra* note 43, at 601. To avoid confusion, this article uses the term "mens rea" throughout.

119 A mens rea, or criminal mind, is a fundamental element in criminal law. *See, e.g.*, *X-Citement Video*, 513 U.S. at 72; United States v. U.S. Gypsum Co., 438 U.S. 422, 446 (1978); Morisette v. United States, 342 U.S. 246, 251-52 (1952). The Supreme Court has approved of dispensing with the men rea requirement, that is, imposing strict liability, only when (1) Congress clearly intended to impose strict liability and (2) the crime is a "public welfare" offense that threatens substantial harm to the public.

Proof of a culpable mental state is a requirement of both civil and criminal insider trading liability. Courts (and legislatures) are notoriously imprecise, however, when identifying and defining mens rea levels.[120] This is particularly apparent in securities fraud cases in general and in insider trading cases in particular. Given that insider trading is largely a court-created offense, the current state of affairs is highly problematic.

In terms of defining and applying insider trading elements, this article proposes that courts adopt Model Penal Code (MPC) principles when interpreting insider trading law. Adopted after decades of reform efforts undertaken by the American Law Institute and others, the MPC attempted nothing less than a comprehensive restructuring of the criminal law.[121] Some 34 states have revised their penal codes according to MPC principles, to greater and lesser degrees.[122] Even in jurisdictions that have not adopted the MPC, most notably the federal government and California,[123] courts frequently cite the MPC as persuasive authority.[124]

See United States v. Park, 421 U.S. 658, 672-73 (1975). These circumstances do not apply to securities fraud in general or to insider trading in particular.

[120] For an overview, see Brown, *supra* note 33. Legislators compound the problem by drafting imprecise criminal codes. The federal criminal code is perhaps the key offender. *See, e.g.*, Sara Sun Beale, *Is Corporate Criminal Liability Unique?*, 44 AM. CRIM. L. REV. 1503, 1507 (2007) ("The federal criminal code is a bloated and disorganized hodgepodge."); Julie R O'Sullivan, *The Federal Criminal "Code" is a Disgrace: Obstruction Statutes as Case Study*, 96 J. CRIM. L. & CRIMINOLOGY 643, 643-64 (2006).

[121] The precision and structure of the code distinguish it from the hodge-podge of common law-based codes that existed before the MPC was promulgated and that still exists in many jurisdictions including the federal system. *See* Seigel, *supra* note 23, at 1565 (describing the MPC's birth as "a rare moment of collective genius").

[122] Paul H. Robinson & Markus D. Dubber, *The American Model Penal Code: A Brief Overview*, 10 NEW CRIM. L. REV. 319, 326 (2007); *see generally* MARKUS DUBBER, CRIMINAL LAW: MODEL PENAL CODE (2002) [hereinafter, DUBBER, MPC].

[123] The federal criminal code does not provide consistent, clearly defined mens rea elements, nor does it set forth general interpretive principles. *See* Moohr, *Playing*, *supra* note 25, at 692. Largely for this reason, the United States Supreme Court has relied heavily on the MPC when interpreting the mens rea elements of criminal offenses. *See Gypsum*, 438 U.S. at 444 ("The . . . [MPC] is one source of guidance upon which the Court has relied to illuminate questions [concerning required levels of mens rea]."). Others have proposed importing MPC principles into securities fraud in general, *see* Seigel, *supra* note 23, but those proposals do not delve into the particulars of insider trading liability.

[124] *See* Robinson & Dubber, *supra* note 122, at 327 ("Thousands of court opinions have cited the Model Penal Code as persuasive authority for the interpretation of an existing statute or in the exercise of a court's occasional power to formulate a criminal law doctrine."). The United States Supreme Court has cited the MPC well over 100 times. *See* DUBBER, MPC, *supra* note 122, at 7. Even when the Court does not explicitly cite the MPC, it applies MPC-type analysis when interpreting criminal statutes. *See* Leonid Traps, *"Knowingly" Ignorant: Mens Rea Distribution in Federal Criminal Law After* Flores-Figueroa, Note, 112 COLUM. L. REV. 628, 643 (2012) ("The Court's interpretive choice and rhetoric evoked the language and spirit of the Model Penal Code's approach.").

Among its most notable reforms, the MPC adopts a precise structure for parsing and interpreting criminal statutes.[125] First, the MPC separates the actus reus from the mens rea components. An actus reus element may take one of three forms: conduct (for example, driving under the influence), a result (for example, causing injury while driving under the influence), or a circumstance (the driver actually being under the influence).[126] Although the distinctions among conduct, result, and circumstance are often confusing in the abstract, the distinctions generally are easy to apply to particular crimes.[127] Second, the MPC identifies four possible levels of mens rea that might apply to the actus reus element or elements. Third, the MPC provides us with methods for ascertaining which level of mens rea applies to each of the actus reus elements.[128]

By clarifying the imprecise, overlapping, and confusing common law mens rea definitions, MPC section 2.02's mens rea definitions—purpose, knowledge, recklessness, and negligence—have been enormously influential.[129] The MPC's overriding structural goal is to align culpability with punishment.[130] Accordingly, the MPC's ranking of mens rea levels reflects our understanding of the relative culpability of offenders under basic punishment principles.[131] The higher the level of culpability—as defined by the level of mens rea that the government has

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[125] Although precise and influential, the MPC has not eliminated all ambiguity in defining and applying mens rea concepts. In both MPC and common law jurisdictions, for example, the term "intent" is used in different ways in criminal cases. First, "intent" is often employed as a synonym for mens rea in general: a court might, for example address the type of "intent" required for a particular crime. Second, the term "intent" may be used to signify a particular level of mens rea. *See Gypsum*, 438 U.S. at 435 ("[A] defendant's state of mind or intent is an element of a criminal antitrust offense."). The common law often speaks in terms of criminal "intent" as a form of mens rea in the latter sense. *See* Morissette v. United States, 342 U.S. 246, 248 (1952).

[126] *See* DUBBER, MPC, *supra* note 122, at 32.

[127] In any event, categorizing among the three actus reus components is rarely key to the outcome when applying MPC principles. *See id.* at 45.

[128] If no mens rea is stated, then it is assumed to be recklessness. MODEL PENAL CODE § 2.02(3). With some exceptions, if the statute specifies one level of mens rea, that level applies to all the elements. *See* JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW § 10.07(C) (6th ed. 2012).

[129] *See* Robinson & Dubber, *supra* note 122, at 335 ("[T]he Model Penal Code's definitions of these four mental states may be the code's most important contribution to American criminal law reform."). The MPC defines the different levels of mens rea depending on the corresponding form of actus reus. *See* DUBBER, MPC, *supra* note 122, at 61.

[130] *See generally* DUBBER, MPC *supra* note 122. A culpable mental state is a fundamental requirement for culpability under Anglo-American criminal law, though courts are highly inconsistent when applying that requirement. *See* Brown, *supra* note 33, at 109.

[131] Despite the MPC's largely successful effort to modernize and systematize the criminal law, the Code has had remarkably little influence on the development of the law of securities fraud in general or insider trading in particular. *See* Seigel, *supra* note 23, at 1566-67.

proven—the greater the punishment. In utilitarian terms, for example, negligence is least subject to deterrence and corresponds to the lowest level of culpability; deterrence is more difficult when one is not actually aware of a risk. In retributive terms, one who acts with a purpose to cause harm is more culpable than one who caused harm by accident.[132]

Generally, at common law, "intentional" crimes are committed when the defendant acts with the equivalent of what the MPC terms "purpose" or "knowledge."[133] On the other hand, crimes committed recklessly or negligently are considered to be unintentional.[134] As discussed more fully below, securities fraud is an intentional crime.[135] That is, one does not commit fraud by accident.

Another frequently used common law term is "specific intent," a concept that the MPC does not employ.[136] Fraud is generally termed a specific intent, as opposed to a general intent, crime.[137] Courts seem to define "specific intent" temporally; the fact finder evaluates the actor's mental state at the time of the alleged criminal act and queries whether, at that moment, the actor had the goal of engaging in particular conduct or producing a particular result in the future.[138] This concept is roughly

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[132] *See* Moohr, *Playing*, *supra* note 25, at 690 (citing Morissette v. United States, 342 U.S. 246, 250 (1952)).

[133] *See* CYNTHIA LEE & ANGELA HARRIS, CRIMINAL LAW CASES AND MATERIALS 215 (3d. ed. 2014). As the Court explained in *Gypsum*, "'[I]t is now generally accepted that a person who acts (or omits to act) *intends* a result of his act (or omission) under two quite different circumstances: (1) when he consciously desires that result, whatever the likelihood of that result happening from his conduct; and (2) when he knows that the result is practically certain to follow from his conduct, whatever his desire may be as to that result.'" United States v. U.S. Gypsum Co., 438 U.S. 422, 445 (1978) (quoting LAFAVE & A. SCOTT, CRIMINAL LAW 196 (1972)) (alteration in original). An equivalent distinction applies to torts. *See* RESTATEMENT (SECOND) OF TORTS § 8A (1977).

[134] Recklessness and negligence are forms of mens rea that connote risk-taking, as opposed to purpose and knowledge, which connote intentional activity. *See* DRESSLER, *supra* note 128, at § 10.07(B)(1). Again, tort law follows suit. *See* RESTATEMENT (SECOND) OF TORTS § 8A (1965).

[135] *See infra* Part II.B.1; Heminway, *supra* note 87, at 55 ("Although insider trading liability may be civil or criminal in nature, the scienter requirement, which exists in both civil and criminal claims, relies on intentional behavior.").

[136] The concept of specific intent had a tortuous birth. Courts developed the concept in the 19th century to avoid what seemed to be draconian results in cases involving voluntary intoxication. Courts began to develop a category of "specific intent" crimes for which voluntary intoxication would be a defense. *See* Gideon Yaffe, *Intoxication, Recklessness, and Negligence*, 9 OHIO ST. J. CRIM. L. 545 (2012). The distinction between specific and general intent has never been defined clearly or consistently defined. *See* Seigel, *supra* note 23, at 1564-65 (describing the "massive confusion surrounding" the concepts of specific and general intent).

[137] *See infra* Part II.B.2.

[138] *See* LEE & HARRIS, *supra* note 133, at 215. The classic example is common law burglary: The fact finder must determine whether, at the moment the actor committed the

equivalent to the MPC concepts of "purpose" and "knowledge." In either case, the fact finder must determine whether, at the time of the act/omission, the actor had the "conscious object" of engaging in the conduct or producing the result or knew that such conduct or result were practically certain.[139]

At this point we also need to consider the concept of willfulness. Under the principal securities fraud statutes, willfulness is the sole element that distinguishes criminal from civil liability.[140] Many commentators have attempted to define the meaning of the term "willfully," with mixed success at best.[141]

It is arguable that "willfully" adds virtually nothing to the government's burden in a criminal securities fraud case.[142] As noted above, in many instances the only real difference between a civil and criminal securities fraud case is the burden of proof.[143] And as discussed below, all fraud requires intentional behavior.[144]

In an attempt to give meaning to the term, some courts and commentators have argued that "willfully" in the criminal securities fraud context means acting with a conscious awareness that one is acting wrongfully.[145] Words in statutes should be given meaning, and if willfulness adds nothing to the burden in a criminal case then the word is basically written out of the statute. As Professors Buell and Griffin have argued, requiring some consciousness of wrongdoing—one reading of the willfulness requirement for criminal securities fraud liability—helps meet this basic requirement of statutory construction.[146]

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actus reus (breaking and entering the dwelling at night), the actor intended thereafter to commit a felony once inside the dwelling.

139 *See* Robert Batey, *Judicial Exploitation of Mens Rea Confusion, at Common Law and Under the Model Penal Code*, 18 GA. ST. U. L. REV. 341, 402 (2001).

140 *See* Moohr, *Playing*, *supra* note 25, at 693.

141 *See* Norwood P. Beveridge, *Is* Mens Rea *Required for a Criminal Violation of the Federal Securities Laws*? 52 BUS. LAW. 35, 37-39 (1996-1997) (describing the efforts of Professor Louis Loss, the "leading American commentator on the federal securities laws," to give meaning to the term "willfully").

142 *See* Seigel, *supra* note 23 at 1604-05 ("Both courts and commentators disagree as to whether, in [securities] fraud cases, [the willfulness] requirement adds anything to the analysis.").

143 *See* Moohr, *Stewart*, *supra* note 43, at 600.

144 *See infra* Part II.B.2.

145 *See* Buell, *Novel Criminal Fraud*, *supra* note 32, at 1985; Samuel W. Buell & Lisa Kern Griffin, *On the Mental State of Consciousness of Wrongdoing*, 75 LAW & CONTEMP. PROBS. 133, 145 (2012) ("To act with consciousness of wrongdoing would simply be to act knowing that one is engaged in any sort of moral transgression."). Such consciousness helps distinguish aggressive business activities from fraud, *see* Buell, *Novel Criminal Fraud*, *supra* note 32, at 2032, and ordinary document retention policies from obstruction of justice, *see* Arthur Andersen LLP v. United States, 544 U.S. 696, 706 (2005).

146 Buell & Griffin, *supra* note 145, at 150 ("The actor who is aware of her own wrongdoing 'received' some notice, at least in the sense that she had occasion to consider the normative significance of her conduct and refrain from it had she wished.").

Using the plain language of the statute as the principal guide,[147] Webster's defines willful as "done deliberately: intentional."[148] In white collar cases, proving such consciousness often will not be as straightforward an exercise as it is in cases involving tangible harm to persons or property. This is one reason why proof of an intent to harm—as opposed to proof of the impact of the defendant's actions—is so important in such cases.[149] A mere intent to mislead or deceive cannot be sufficient because many business practices not amounting to fraud are based on exaggerated and even misleading practices.[150] The difference between puffing and fraud, then, must go to the intent to injure the victim.[151]

In the securities fraud context, proof of willfulness would require an intent to defraud the victim, knowing that such fraud is wrongful.[152] Put another way, the government should be required to prove that the defendant engaged in a scheme that was designed to produce profit at the expense of the victim—the person who or entity that suffered the breach of duty.[153] Ultimately, the fact finder must choose between competing narratives to attempt to discern, after the fact, what the actor was thinking at the time, an imperfect but necessary process in such adjudications.[154]

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[147] *See* Brown, *supra* note 33, at 113 (citing United States v. Fisher, 289 F.2d 1329, 1338 (11th Cir. 2005)).

[148] WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2617 (1986). *See* Brown, *supra* note 33, at n.19 (describing courts' use of dictionary definitions to establish mens rea requirements).

[149] *See* United States v. U.S. Gypsum Co., 438 U.S. 422, 435 (1978) ("[A] defendant's state of mind or intent is an element of a criminal antitrust offense which must be established by evidence and inferences drawn therefrom and cannot be taken from the trier of fact through reliance on a legal presumption of wrongful intent from proof of an effect on prices.").

[150] *See infra* Part II.B.1.

[151] *See* United States v. Regent Office Supply Co., 421 F.2d 1174, 1182 (2d Cir. 1970) ("[T]he intent of the schemer is to injure another to his own advantage by withholding or misrepresenting material facts.").

[152] *See, e.g.*, United States v. Newman, 773 F.3d 438, 447 (2d Cir. 2014) ("We have defined willfulness in this context 'as a realization on the defendant's part that he was doing a wrongful act under the securities laws.'") (quoting United States v. Cassese, 428 F.3d 92, 98 (2d Cir. 2006)); United States v. Tarallo, 380 F.3d 1174, 1188 (9th Cir. 2004), *amended by* 413 F.3d 928 (9th Cir. 2005); United States v. Tucker, 345 F.3d 320, 334 (5th Cir. 2003).

[153] In MPC terms, this means acting with the purpose—the conscious objective—to defraud. *Cf.* Buell, *Securities Fraud*, *supra* note 23, at 527 ("Purpose is therefore necessary to give the concept of deception the moral content it ought to have. If fraud requires deception and deception requires purpose, then fraud requires purpose."). As discussed below, at a minimum, the jury should be required to find that the defendant acted with either purpose or knowledge. *See infra* Part III.

[154] *See* Buell & Griffin, *supra* note 145, at 158.

Another mens rea level is particularly important for present purposes: willful blindness, sometimes also termed conscious avoidance.[155] The MPC and common law both provide that, when proof of knowledge is an element of a crime, proof that the defendant was willfully blind will suffice.[156]

In *Global-Tech*,[157] the Supreme Court affirmed both the viability of willful blindness as a substantive criminal (and civil) law doctrine and the MPC's central role in the Court's criminal law jurisprudence. The Court held that knowledge is an element of a cause of action for inducement of patent infringement.[158] The Court also held that the knowledge requirement can be satisfied by proof of willful blindness. According to the Court, this approach comports with traditional principles of punishment, under which "defendants who behave [with willful blindness] are just as culpable as those who have actual knowledge."[159]

In its decision, the Court noted that it has relied upon MPC mens rea definitions in a number of contexts.[160] The MPC provides that willful blindness meets the requirement of "knowledge" in criminal statutes, and the vast majority of federal circuits have agreed.[161] Relying upon cases from a number of circuits, the Court held that to act with willful blindness "(1) the defendant must subjectively believe that there is a high

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[155] The concepts are essentially the same. *See* United States v. Svoboda, 347 F.3d 471, 477-78 (2d Cir. 2003); United States v. Reyes, 302 F.3d 48, 54 (2d Cir. 2002); *see also* Lorelei D. Ritchie, *Is "Willful Blindness" the New "Recklessness" After* Global-Tech*?*, 21 FED. CIR. B.J. 165, 186 (2011).

[156] MPC § 2.02(7) provides that "[w]hen knowledge of the existence of a particular fact is an element of an offense, such knowledge is established if a person is aware of a high probability of its existence, unless he actually believes that it does not exist." Arguably, *Global-Tech* establishes a more onerous, and more appropriate, test for willful blindness. *See infra* Part II.C.

[157] Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060 (2011). Although a civil case, the Court imported criminal law mens rea concepts in its decision. As Justice Kennedy noted in his dissent, "[t]he Court appears to endorse the willful blindness doctrine here for all federal criminal cases involving knowledge." *Id.* at 2072 (Kennedy, J., dissenting). Courts have recognized that the *Global-Tech* decision has important implications for criminal cases. *See, e.g.*, United States v. Goffer, 721 F.3d 113, 128 (2d Cir. 2013); United States v. Denson, 689 F.3d 21, 25 (1st Cir. 2012), *cert. denied*, 133 S. Ct. 996 (2013); United States v. Marsh, 820 F. Supp. 2d 320, 335 (E.D.N.Y. 2011).

[158] *Global-Tech*, 131 S. Ct. at 2065.

[159] *Id.* at 2069 (citing Edwards, *The Criminal Degrees of Knowledge*, 17 MOD. L. REV. 294, 302 (1954)).

[160] *Id.*

[161] *Id.* (citing MODEL PENAL CODE § 2.02(7)). The Court noted that "every Court of Appeals—with the possible exception of the District of Columbia Circuit—has fully embraced willful blindness, applying the doctrine to a wide range of criminal statutes." *Id.* at 2069-70 n.9 (listing cases).

probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact."[162]

For our purposes, the *Global-Tech* decision is foundational, for several reasons. First, the Court clearly articulated a willful blindness test that should now apply in all civil and criminal federal cases.[163] Second, the Court carefully articulated the distinction between willful blindness and recklessness—a distinction that, as will be seen below, is often lost on courts in insider trading cases. Third, the Court set forth a rigorous willful blindness test—requiring that the defendant take affirmative steps to avoid learning the truth—that avoids many of the risks of a weaker willful blindness definition that often seems like just another version of recklessness.[164] This sort of willful blindness "with teeth" helps allay the concerns that some have articulated over allowing anything short of actual knowledge to suffice when proving securities fraud.[165]

To return to the concept of "intentional" crimes—those committed with purpose or knowledge—willful blindness puts us at the lowest level of the proof required for criminal "intent." This concept will be key to our discussion of the mens rea required for white collar crime in general and for insider trading in particular.[166]

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[162] The Court did not define what sort of "deliberate steps" would suffice, and on its face this requirement appears to add a sub-element that is not present in the tests that many, perhaps most, circuits have adopted. A number of decisions nonetheless have opined that *Global-Tech* did not change the conscious avoidance standard, but merely adopted the approach used by a majority of circuit courts. *See*, *e.g.*, *Goffer*, 721 F.3d at 127-28; United States v. Jinwright, 683 F.3d 471, 480 (4th Cir. 2012), *cert. denied*, Jinwright v. United States, 133 S. Ct. 843 (2013). Under this reading, making a deliberate decision to turn a blind eye—the pre-*Global-Tech* standard—is still sufficient. *See* United States v. Brooks, 681 F.3d 678, 702 (5th Cir. 2012). It is difficult to believe that the Court would have used such strong language—requiring "deliberate steps"—without meaning what it said, and a "deliberate step" does not seem to be the same as a "deliberate decision" to take no action. *See* Jeremy Adler, *See No Evil: How the Supreme Court's Decision in* Global-Tech Appliances, Inc. v. SEB S.A.: *Further Muddles the Intent Element of Induced Infringement*, 11 NW. J. TECH. & INTELL. PROP. 559, 561 (2013) (arguing that *Global-Tech* changed the definition and application of willful blindness); Dane C. Ball, *Improving 'Willful Blindness' Jury Instructions in Criminal Cases After High Court's Decision in* Global-Tech, 6 CRIM. L. REP. (BNA) No. 18, at 762 (June 15, 2011); James G. Dilmore, *Actual Knowledge of Direct Patent Infringement Is Required for Induced Infringement:* Global-Tech Appliances, Inc. v. SEB S.A., 50 DUQ. L. REV. 659, 676 (2012).

[163] *See Global-Tech*, 131 S. Ct. at 2070. Again, courts and commentators disagree as to whether or in what way the *Global-Tech* decision may have changed the federal definition of willful blindness. *See supra* note 162. For an overview of the federal courts' conflicting approaches to willful blindness, see United States v. Alston-Graves, 435 F.3d 331, 337-41 (D.C. Cir. 2006).

[164] *See* Adler, *supra* note 162, at 566-67; Dilmore, *supra* note 162, at 665-66.

[165] *See, e.g.*, Moohr, *Playing*, *supra* note 25, at 696.

[166] *See infra* Part III.A.

Allowing proof of willful blindness to meet the knowledge element is based upon the normative assumption that a willfully blind person is as culpable as a person who had actual knowledge.[167] This doctrine also provides prosecutors with an important tool in cases in which proof of actual knowledge may present an unfair and insurmountable obstacle to conviction. In many cases, a defendant can simply deny knowledge, and direct evidence of actual knowledge may not exist.[168] Willful blindness has played an important role in insider trading cases, in which defendants often argue that they did not know that the relevant information was nonpublic information stolen from its source.[169]

An underlying problem with willful blindness is that, as a definitional matter, it is often difficult to distinguish from recklessness, which the MPC defines as awareness of a high probability that a fact exists.[170] Under *Global-Tech*, to prove willful blindness the government must show that "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact."[171] Read superficially, these concepts seem almost indistinguishable. As explained below,[172] however, the question is one of the defendant's degree of awareness; the jury must determine, as with any mens rea assessment, the defendant's mental state at the time of the act.

The Second Circuit's high profile *Obus* decision elucidates the confusion both between intentional and non-intentional behavior[173] and between the concepts of recklessness and willful

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167 *See Global-Tech*, 131 S. Ct. at 2068-69. The doctrine has its critics, include Justice Kennedy. *Id.* at 2072 (Kennedy, J., dissenting) ("Willful blindness is not knowledge; and judges should not broaden a legislative proscription by analogy.").

168 The willful blindness standard provides prosecutors with a means of proving knowledge in, for example, drug possession and trafficking cases where defendants frequently claim the ignorance defense. *See, e.g.*, United States. v. Jewell, 532 F.2d 697, 699 (9th Cir. 1976).

169 *See, e.g.*, United States. v. Goffer, 721 F.3d 113 (2d Cir. 2013); United States v. Svoboda, 347 F.3d 471 (2d Cir. 2003). Although the Second Circuit uses the term "conscious avoidance" rather than willful blindness, the concepts are essentially the same. *See Global-Tech*, 131 S. Ct. at 2070 n.9.

170 As Prof. Langevoort points out, courts in securities fraud cases often define "recklessness" "to capture the situation akin to conscious avoidance or indifference: the speaker knows that he does not know the truth, but speaks as if he did." Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 436-37 (2013).

171 *Global-Tech*, 131 S. Ct. at 2070.

172 *See infra* Part III.A.

173 One commenter has noted that "*Obus* is required reading for anyone working in the white collar and securities fraud fields," because of the attempted reconciliation of the "supposed conflict between *Dirks* and *Hochfelder*." Ellen Podgor, *Second Circuit Releases Magnum OBUS On Insider Trading*, WHITE COLLAR CRIME

blindness.[174] The fundamental error in the *Obus* decision is its failure to recognize this basic criminal law distinction. Had the court paid attention to the Supreme Court's decision in *Global-Tech* distinguishing the two mens rea levels, it would have avoided this error.

In *Obus*, the original tipper, Strickland, worked for GE Capital.[175] Allied approached GE Capital about financing Allied's potential acquisition of SunSource. GE Capital assigned Strickland the task of performing due diligence on the deal. Strickland had a conversation with Black, a college friend who worked as a securities analyst at Wynnefield Capital, about the potential acquisition.[176] Shortly after that conversation, Black spoke with Obus, Wynnefield's principal and Black's boss.[177] Two weeks later, Wynnefield bought a substantial additional amount of SunSource stock.[178]

The SEC filed an insider trading complaint against Strickland, Black, and Obus. Under the misappropriation theory, the SEC alleged that Strickland breached his duty to his employer by relaying his employer's confidential information to Black.[179] The district court granted the defendant's summary judgment motion,[180] but the Second Circuit vacated and remanded.

In its opinion, the Second Circuit began by noting that the mens rea for securities fraud requires proof of "'intent to

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PROF BLOG (Sept. 6, 2012), http://lawprofessors.typepad.com/whitecollarcrime_blog/2012/09/second-circuit-releases-magnum-obus-on-insider trading.html.

[174] *See* United States v. Alston-Graves, 435 F.3d 331, 342 (D.C. Cir. 2006) (observing that the district court confused the concepts of willful blindness and recklessness). *Cf.* United States v. Precision Medical Labs., Inc., 593 F.2d 434, 446 (2d Cir. 1978) ("The phrases 'reckless disregard of whether the statements made were true' and 'conscious purpose to avoid learning the truth' mean essentially the same thing."); *see also* United States v. Kaiser, 609 F.3d 556, 566 (2d Cir. 2010) (stating that the lower court's conscious avoidance instruction was misstated and there was risk that a jury could have convicted defendant if he was merely negligent.); Moohr, *Playing*, *supra* note 25, at 696 (describing courts' "shading of knowing conduct into reckless conduct.").

[175] SEC v. Obus, 693 F.3d 275, 279 (2d. Cir. 2012).

[176] Strickland's "tasks included analyzing SunSource's financial performance, but the parties dispute whether Strickland was authorized to gather information about SunSource's management." *Id.* at 279. The defendants asserted that the conversation was part of Strickland's due diligence work, a characterization that the SEC contested. *Id.* at 290. It may be that the lack of clear proof as to the contents of this conversation was one reason why the government chose not to bring criminal charges.

[177] After Allied's acquisition of SunSource was announced, Wynnefield netted a paper profit of over $1.3 million. *Id.* at 282.

[178] *Id.*

[179] *Id.* at 283. The SEC also alleged a traditional theory case, which it later dropped on appeal. *Id.* at 283.

[180] *Id.* at 284 (citing SEC v. Obus, No. 06 Civ. 3150, 2010 WL 3703846, at *16 (S.D.N.Y. Sept. 20, 2010)). The trial court also found that, because GE Capital's own internal investigation had concluded that Strickland had not breached a duty to his employer, there was no breach. *Id.* at 291.

deceive, manipulate, or defraud.'"[181] The court then noted that, although the *Dirks* "should know" language sounds like negligence, such a standard is inappropriate in a securities fraud case under *Hochfelder*.[182] The court observed that a number of circuits, including the Second Circuit, have held that recklessness may suffice:

> [W]e have held that scienter "may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care" . . . . In every insider trading case, at the moment of tipping or trading, just as in securities fraud cases across the board, the unlawful actor *must know or be reckless in not knowing* that the conduct was deceptive.[183]

The language "must know or be reckless in not knowing" ignores the three distinct mental states that the Court recognized in *Global-Tech*: actual knowledge, willful blindness equating to actual knowledge, and recklessness.[184]

As discussed above,[185] the concepts of willful blindness and recklessness are indeed difficult to distinguish. But in terms of culpability, the distinction is crucial. A willfully blind defendant is acting with the equivalent of knowledge, and therefore is acting "intentionally" in common law terms.[186] A reckless defendant is only acting with an awareness of a risk, and therefore is acting unintentionally in common law terms.[187]

The distinction between actual awareness of a fact, and awareness of the mere possibility that a fact exists, is critical.

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[181] *Id.* at 286 (quoting *Hochfelder*, 425 U.S. at 193 & n.12.).

[182] *Id.* (quoting SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998)) (emphasis added) (internal citations omitted).

[183] *Id.*

[184] Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2068-71 (2011).

[185] *See supra* Part II.A.

[186] In MPC terms, "[a] person acts knowingly with respect to a material element of an offense when: (i) if the element involves the nature of his conduct or the attendant circumstances, he is aware that his conduct is of that nature or that such circumstances exist; and (ii) if the element involves a result of his conduct, he is aware that it is practically certain that his conduct will cause such a result." MODEL PENAL CODE § 2.02(2)(b) (1985).

[187] In MPC terms, on the other hand,

> a person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves a gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

Id. at § 2.02(2)(c).

The Supreme Court made this very point in *Global-Tech*,[188] articulating a willful blindness standard that is more easily distinguishable from mere recklessness than the standard that courts typically apply. Drawing such distinctions is not an easy task, but it is a task that juries must undertake all the time.

The *Obus* decision's omission of willful blindness simply muddies the water. Had the court stated that the unlawful actor must know or be actually aware of the high likelihood that the act is deceptive, but turn a blind eye to that fact, then we would have a precisely drawn description of the mental state that would comport with the nature of securities fraud as just that—a form of fraud. As discussed in the previous section, *Newman* similarly conflated mens rea concepts—in that case, the concepts of willful blindness and negligence.

As the leading federal appeals court on securities law, the Second Circuit sets standards followed by federal courts around the country.[189] The decision's use of such imprecise and misleading mens rea standards shows exactly why we need a new, systematic articulation of the mens rea of insider trading.

B. *Insider Trading as an Intentional Offense*

As a matter of both law and policy, courts should recognize that insider trading is a crime that requires intentional behavior. Insider trading prohibitions seek to regulate business activities. It is therefore essential to define the crime as carefully as possible, both to provide fair warning of illegality and to avoid regulatory creep at the bounds of permissible conduct. The Supreme Court has determined, consistently, that the best way to accomplish this goal is by situating insider trading within the boundaries of fraud.[190]

1. Insider Trading as a Business and Regulatory Offense

When defining the mens rea elements of business and regulatory offenses, the essential nature of these crimes helps ascertain the appropriate level of mens rea. Unlike crimes involving readily ascertainable harm to persons or property, these

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[188] *Global-Tech*, 131 S. Ct. 2060, 2070-71 (2011).

[189] *See* Roberta S. Karmel, *The Second Circuit's Role in Expanding the SEC's Jurisdiction Abroad*, 65 ST. JOHN'S L. REV. 743, 743 (1991).

[190] *See* Chiarella v. United States, 445 U.S. 222, 227-28 (1980) ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.").

offenses often seek to draw the difficult line between acceptable and unacceptable business behavior. In such contexts, as the courts have recognized in areas including antitrust and mail fraud, requiring that the defendant acted intentionally is one principal way of drawing this line. Most white collar offenses fall within the category of specific intent crimes.[191] By definition, these crimes—under either the common law or MPC definitions—are intentional rather than accidental crimes.[192]

For example, in *United States v. U.S. Gypsum Co.*, the Court addressed the mens rea requirements of the Sherman Act's criminal provisions. Initially, the Supreme Court focused on the fundamental due process concerns that underlie much of white collar criminalization: a criminal law must (1) provide fair notice to potential defendants and (2) serve to limit prosecutorial abuses.[193] The Court emphasized the "indeterminacy of the Sherman Act's standards" when assessing whether criminal intent should be required for conviction.[194] In language at least equally applicable to insider trading laws, the Court stated: "'The Sherman Act, inevitably perhaps, is couched in language broad and general . . . . Thus, it may be difficult for today's businessman to tell in advance whether projected actions will run afoul of the Sherman Act's criminal strictures.'"[195]

In an oft-quoted passage, the Court remarked that "the behavior proscribed by the [Sherman] Act is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct."[196] The same observation applies to insider trading law. Compare this passage with the following passage from *Dirks*:

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[191] For example, bribery requires offering or giving something of value to a federal public official with the specific intent that the official engage in a federal official act in exchange. *See* STRADER, UNDERSTANDING, *supra* note 53, at 172. Mail fraud requires that the defendant use the federal mails with the specific intent that a victim be deprived of money, property, or honest services. *Id.* at 78.

[192] To take bribery as just one example, one cannot accidentally give money *with the expectation* that an official will do something in return, *see id.* at 182, or accidentally *scheme with the goal* so that a victim will be deprived of money, property, or honest services, see *id.* at 68.

[193] United States v. U.S. Gypsum Co, 438 U.S. 422, 446 n.22 (1978).

[194] *Id.* at 439.

[195] *Id.* (quoting Report of the Attorney General's National Committee to Study the Antitrust Laws 439 (1955)).

[196] *Id.* at 440-41. In another important passage directly applicable to insider trading, the Court stated that interpreting the law too broadly "holds out the distinct possibility of overdeterrence; salutary and procompetitive conduct lying close to the borderline of impermissible conduct might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty regarding possible exposure to criminal punishment for even a good-faith error of judgment." *Id.* at 441.

> Imposing a duty to disclose or abstain [from trading] solely because a person knowingly receives material nonpublic information from an insider and trades on it 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.[197]

Relying heavily on the MPC, the Court in *Gypsum* then addressed two specific issues: whether some level of criminal intent is necessary for a criminal antitrust violation and, if so, what specific level of mens rea is required. The relevant statute did not on its face require any proof of mens rea, and the Court—as is so often true when interpreting white collar offenses—essentially had to fill in the statutory gaps.[198]

The Court initially rejected the trial court's instruction to the jury that it could presume that the defendants intended to engage in anticompetitive behavior if their actions had an anticompetitive effect—in essence, a strict liability instruction.[199] The Court then turned to the specific MPC definitions: "the Code enumerates four possible levels of intent—purpose, knowledge, recklessness, and negligence."[200] Significantly, for present purposes, the Court concluded that, "[i]n dealing with the kinds of business decisions upon which the antitrust laws focus, the concepts of recklessness and negligence have no place."[201] In other words, when trying to distinguish between illegal and legal business activities, where the line between the two is often murky, it is illogical and even potentially dangerous to impose criminal liability based upon mens rea levels that equate with unintentional activity.[202] To be deemed criminal, anti-competitive activity must be intentional, not accidental.[203]

Here, there are interesting parallels between anticompetitive practices and insider trading. Laws governing each activity have the broader goals of ensuring that the

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[197] Dirks v. SEC, 463 U.S. 646, 658 (1983).

[198] *Gypsum*, 438 U.S. 422 at 443 ("As we have noted, the language of the Act provides minimal assistance in determining what standard of intent is appropriate.").

[199] 438 U.S. at 436 ("We are unwilling to construe the Sherman Act as mandating a regime of strict-liability criminal offenses.").

[200] *Id.* at 444.

[201] *Id.*

[202] This aspect of the *Gypsum* decision is discussed more fully below, *infra* Part II.B.2.

[203] The Court then decided whether the level of intent required should be purpose or knowledge. First, the Court concluded that "action undertaken with *knowledge* of its probable consequences and *having the requisite anticompetitive effects* can be a sufficient predicate for a finding of criminal liability under the antitrust laws." *Id.* (emphasis added). Second, the Court also decided that, in cases where anticompetitive effects have *not* been proven, the government must show that the defendant acted with the *purpose* of causing such effects. *Id.* at 477 n.21. In both cases, then, the Court required proof of intentional behavior.

markets function fairly. Such market-focused policy goals necessarily risk ensnaring activity that is not obviously criminal and that might actually be desirable. As one commentator noted, the securities laws, "like the antitrust laws, cover a great body of legitimate business activity, through which the line between accepted and proscribed behavior frequently is hard to draw."[204]

2. Insider Trading as Fraud

Building upon the Court's reasoning in *Gypsum*, in the context of fraud in general or insider trading in particular, it makes little sense in terms of law or policy to employ mens rea concepts that connote accidental crimes. Fraud is defined in terms of intentionality—scheming to obtain something of value from a victim.[205] Black's Law Dictionary's principal definition of fraud is "[a] knowing misrepresentation or knowing concealment of a material fact *made to induce* another to act to his or her detriment."[206] In this sense, fraud is a form of theft, a classic "specific intent" crime.[207] And the intentional nature of fraud applies to both civil and criminal fraud.[208]

The crimes of mail and wire fraud have strong parallels to securities fraud; the securities laws' principal antifraud provision, Section 10b, was modeled on the federal mail fraud statute,[209] and the Supreme Court has held that mail fraud is grounded in common law fraud.[210] An inchoate offense, the mail or wire fraud scheme must be designed to deprive the victim of money, property, or honest services, but need not succeed for the defendant to be liable.[211] Under these statutes, money and property interests include intangible interests such as confidential business

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[204] Beveridge, *supra* note 141, at 64.

[205] This is true in both the civil and criminal context. *See infra* Part II.C.

[206] *Fraud*, BLACK'S LAW DICTIONARY (10th ed. 2014) (emphasis added).

[207] *See* DRESSLER, *supra* note 128, § 10.06.

[208] *See* Buell, *Securities Fraud*, *supra* note 23, at 538-39.

[209] *See* United States v. Tarallo, 380 F.3d 1174, 1181 (9th Cir. 2004)) ("[L]ike[ ][mail fraud], a defendant may be convicted of committing securities fraud only if the government proves specific intent to defraud, mislead, or deceive."), *amended by* 413 F.3d 928 (9th Cir. 2005); United States v. Whitman, 904 F. Supp. 2d 363, 372 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014) (Summary Order) (unpublished opinion), *cert. denied*, 135 S. Ct. 352 (Nov. 10, 2014).

[210] *See* McNally v. United States, 483 U.S. 350, 359-60 (1987).

[211] STRADER, UNDERSTANDING, *supra* note 53, at 66.

information.[212] The duty to provide honest services derives from a fiduciary duty or its equivalent, as under Section 10b.[213]

The mail and wire fraud statutes often work in tandem with the securities fraud statutes; insider trading indictments often contain parallel mail/wire fraud charges under the deprivation of property theory and/or the honest services theory.[214] And as one commentator has noted, "statutory crimes based in common-law offenses are presumed to carry common-law culpability requirements even when the statute includes no such term."[215] As an inchoate offense, mail/wire fraud "is similar to an attempt, and requires a similar level of culpability: knowing conduct (deception) undertaken with the purpose of defrauding or harming the victim."[216] Absent such proof, a defendant cannot be liable.[217]

One well-known wire fraud case, *United States v. Czubinski*, illustrates this point.[218] The defendant was an IRS employee who used interstate computer connections (hence, the use of the wires) to view confidential taxpayer information in violation of IRS policies. The government charged him with defrauding the IRS of both its intangible property interest in the confidential taxpayer information and the honest services that the defendant owed the IRS as its employee.

The First Circuit reversed, holding that merely gaining access to confidential information does not amount to fraud; the defendant must plan to use the information in a way that would somehow benefit the defendant or harm the IRS.[219] The government did not offer any such proof. Therefore, the defendant

[212] Carpenter v. United States, 484 U.S. 19, 28 (1987) ("We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes.").

[213] *See* Skilling v. United States, 130 S. Ct. 2896, 2930 (2010) (stating that the "solid core" of the honest-service doctrine is a "violation of a fiduciary duty").

[214] *See, e.g.*, *id.* at 2908; United States v. Goffer, 721 F.3d 113 (2d Cir. 2013); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

[215] *See* Brown, *supra* note 33, at 113.

[216] Moohr, *Playing*, *supra* note 25, at 695 (noting that courts sometimes do not articulate the mens rea correctly, conflating the intent to deceive with the intent to defraud, that is, with the intent to use the deception to harm the victim); *see also* Geraldine Szott Moohr, *Mail Fraud Meets Criminal Theory*, 67 U. CIN. L. REV. 1, 5-7 (1998).

[217] *See* United States v. Stavroulakis, 952 F.2d 686, 694 (2d Cir. 1992) ("Essential to a conviction under the 'scheme to defraud' clause of the mail fraud statute is a showing of fraudulent intent: *i.e.*, intent to deceive and intent to cause actual harm.").

[218] United States v. Czubinski, 106 F.3d 1069, 1077 (1st Cir. 1997).

[219] *Id.* at 1075 ("[W]ithout evidence that Czubinski used or intended to use the taxpayer information (beyond mere browsing), an intent to deprive [the IRS of property] cannot be proven, and, *a fortiori*, a scheme to defraud is not shown.").

did not violate his duty of honest services to his employer and did not deprive his employer of its property.[220]

Citing *Carpenter*, the court also stated that "confidential information may constitute intangible 'property' and . . . its unauthorized dissemination or other use may deprive the owner of its property rights."[221] The citation to *Carpenter* is telling, for certainly there would have been no insider trading case on the *Carpenter* facts if the reporter had engaged in "unauthorized dissemination" by simply discussing the contents of his *Wall Street Journal* column with others instead of actually profiting from the disclosure. And as argued below, since both mail fraud and securities fraud are specific intent crimes, the reporter should only be liable if he intended that the persons to whom he disclosed would use the information. Disclosure without intent to use cannot constitute the required intent to harm the source of the information.[222] As the Court held in *Dirks*, fiduciary duties forbid agents from "*using* undisclosed corporate information to their advantage."[223] Although perhaps the reporter would violate workplace rules by such a casual conversation, the appropriate remedy would be to punish, fire, or sue the reporter, but not send him to jail.[224]

Securities fraud law, like mail and wire fraud law, is replete with proof that such intentionality is required for liability. For example, in securities fraud cases, as in mail and wire fraud cases, the general rule is that a good faith defense, such as reliance on professional advice, negates proof of mens rea.[225] Why should this be so? If a defendant knowingly traded on material nonpublic information, why should reliance on counsel be a defense? The answer is that the defendant, in addition to possessing the information, must believe that the information was

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[220] *Id.* at 1077 ("[T]he government has failed to prove that Czubinski intended to use the IRS files he browsed for any private purposes, and hence his actions, however reprehensible, do not rise to the level of a scheme to defraud his employer of his honest services.").

[221] *Id.* at 1074 (citing Carpenter v. United States, 484 U.S. 19, 26 (1987)).

[222] *See id.* at 1074-75.

[223] Dirks v. SEC, 463 U.S. 646, 659 (1983) (emphasis added); *see* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1195 (1995) ("[T]he mere fact of a tip is not sufficient to result in liability. What is proscribed is . . . a breach of the duty of loyalty imposed on all fiduciaries to avoid personally profiting from information entrusted to them.").

[224] *See* Coffee, *Hush*, *supra* note 62, at 123.

[225] *See, e.g.*, United States v. Walters, 913 F.2d 388, 391 (7th Cir. 1990) (reversing defendant's mail fraud conviction in part because of the lack of a good faith defense instruction); *see also* Buell & Griffin, *supra* note 145, at 137 ("[G]ood faith reliance on advice of counsel negates a mens rea element if that element is one of 'specific intent.'").

wrongfully obtained. If a lawyer told the defendant that the trade would be legal, then this element is missing.[226]

When affirming criminal insider trading liability based upon misappropriation in *O'Hagan*, the Supreme Court implicitly and explicitly recognized much of the foregoing analysis.[227] That is, the Court both emphasized that mens rea is an important component in limiting the scope of the crime and incorporated common law fraud principles in its analysis.[228] The Court stated that "[v]ital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter."[229] First, the Court noted that, "[t]o establish a criminal violation of Rule 10b–5, the government must prove that a person 'willfully' violated the provision."[230] Unfortunately, the Court did not expound upon its understanding of this notoriously vague term. But by emphasizing the substantial burden of proving willfulness as a way of limiting the scope of the misappropriation theory, the Court at least implied that the government must show that the defendant acted intentionally. The Court in fact stated that "'the presence of culpable intent as a necessary element of the offense'" provides an important limitation on the scope of the offense.[231]

Significantly, the Court tied the mens rea element to the breach of duty element. Responding to criticism over the potential breadth of the misappropriation theory, the Court emphasized that "the theory is limited to those who breach a recognized duty."[232] Given that the Court linked the culpability requirement with the breach of duty requirement, it is reasonable to infer that the government must show that the defendant acted intentionally with respect to the breach.[233]

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[226] *See*, *e.g.*, United States v. Wenger, 427 F.3d 840, 853 (10th Cir. 2005); United States v. Gross, 961 F.2d 1097, 1100 (3d Cir. 1992). Reliance on professional advice requires that the defendant have fully disclosed all relevant information and have acted in good faith. *See* STRADER, UNDERSTANDING, *supra* note 53, at 104.

[227] In this portion of the opinion, the Court responds to Justice Thomas's dissent, which criticized the misappropriation rule as lacking a "coherent and consistent" underlying theory and as "open-ended." United States v. O'Hagan, 521 U.S. 642, 680-92 (1997) (Thomas J., dissenting).

[228] *O'Hagan*, 521 U.S. at 665-66.

[229] *Id.* at 665.

[230] *Id.*

[231] *Id.* at 666 (quoting Boyce Motor Lines, Inc. v. United States, 342 U.S. 337, 342 (1952)).

[232] *Id.*

[233] *See* United States v. U.S. Gypsum Co., 438 U.S. 422, 444 (1978) ("[T]he concepts of recklessness and negligence have no place" when discussing liability based upon complex business regulations).

Because fraud requires some intentional act or omission on the actor's part, with insider trading in particular we need to identify the intended injury precisely in order to define the crime: what is the harm that the actor intends to cause? It is not difficult to articulate harms attached to breaches of duty. Under the traditional theory, shareholders expect that corporate officers and directors will act in the shareholders' interests and not in their own self-interests.[234] Presumably, self-dealing actually harms shareholders by giving an unjustifiably larger slice of the corporation's economic pie to the self-dealer.[235]

The injury is perhaps more articulable in misappropriation cases. This is true in every major reported case; the breach of trust by an attorney or employee, for instance, usually produces at least a theoretical tangible harm. In *O'Hagan*, for example, clients would certainly hesitate before hiring a law firm whose partners knowingly use confidential client information to their benefit. The client may suffer a direct financial harm: if a misappropriator buys stock in the target, the price of the deal may rise, making the transaction more expensive for the acquiring company.[236] The firm's reputation and business will also likely be harmed once the misappropriation becomes public. In *Carpenter*, the *Wall Street Journal*'s reputation for neutral financial information would be undermined if its readers knew that reporters were trading on their columns in advance; readers would likely conclude, correctly or not, that information in the columns is not reliable.[237]

C. *Defining the "Intent" of Insider Trading*

Insider trading is a form of fraud. Under the common law, fraud is generally considered a specific intent crime: in the classic formulation, the defendant's goal is to make a misrepresentation (or material omission if there is a duty) that the victim will rely upon to the victim's detriment.[238] In a straightforward securities

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[234] *See* Chiarella v. United States, 445 U.S. 222, 228 (1980) ("[A] relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.").

[235] *See* Laura Nyantung Beny, *Do Investors in Controlled Firms Value Insider Trading Laws - International Evidence*, 4 J.L. ECON. & POL'Y 267, 267 (2007-2008) ("[S]tringent insider trading laws and enforcement are associated with greater corporate valuation.").

[236] *See O'Hagan*, 521 U.S. at 653; *see also* SEC v. Bauer, 723 F.3d 758, 769 (7th Cir. 2013).

[237] As the Second Circuit noted, the misappropriation scheme "threatened to harm the *Journal*'s reputation for professionalism and integrity." United States v. Carpenter, 791 F.2d 1024, 1035 (2d Cir. 1986).

[238] *Chiarella*, 445 U.S. at 227-28.

fraud case, for example, a seller lies about the financial condition of the company in order to bolster the stock price with the intent that the buyer pay more for the stock than it is worth.

With insider trading, however, the harm is not always to the person with whom the defendant is trading. Rather, the harm may instead result from the breach of duty owed the owner of the information. The nature of the fiduciary duties and "their equivalent"[239] that fall within the ambit of securities fraud has been the subject of a great deal of discussion and debate. Whatever the outer boundaries of those duties, and the conduct that constitutes breaches of those duties, the Supreme Court has repeatedly held that such breaches are required for insider trading liability, under both the misappropriation and traditional theories.

Simply put, the putative thief—whether an insider and/or misappropriator—must act with the intent of taking the information from its owner and using it to benefit the thief. Because the nature of the property interest may be intangible, it is often more difficult to conceptualize the specific intent here than when the fraudster schemes to obtain the victim's money. But the property owner's right to the exclusive use of the intangible property interest is an interest that underlies much of the federal law of fraud.

The key case is *Carpenter*. There, the Supreme Court held that the defendants "cannot successfully contend . . . that a scheme to defraud requires a monetary loss, such as giving the information to a competitor; it is sufficient that the [*Wall Street Journal*] has been deprived of its right to exclusive use of the information, for exclusivity is an important aspect of confidential business information and most private property for that matter."[240] Courts have repeatedly used *Carpenter*'s holding to elucidate the interests at stake in insider trading cases.[241]

The Supreme Court made this point explicitly in *O'Hagan*. The Court began by citing *Carpenter* for the principle that "an employee's undertaking not to reveal his employer's confidential information 'became a sham' when the employee provided the information to his co-conspirators in a scheme to obtain trading

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[239] United States v. Chestman, 947 F.2d 551, 567-68 (2d Cir. 1991).

[240] *Carpenter*, 484 U.S. 19, 26-27 (1987). This holding was controversial at the time because of its potential for a vast expansion of the scope of the federal mail and wire fraud statutes. *See* Coffee, *Hush*, *supra* note 62, at 121-24. But it is now settled law. *See, e.g.*, United States v. Adler, 186 F.3d 574, 576-77 (4th Cir. 1999).

[241] *See, e.g.*, United States v. Falcone, 257 F.3d 226, 233-34 (2d Cir. 2001) (citing *Carpenter*, 791 F.2d at 1033).

profits."[242] As discussed above, *Carpenter* held that confidential business information is a form of property the deprivation of which may damage its owner.[243] And here is the core *O'Hagan* holding, which derives directly from *Carpenter*: "The undisclosed misappropriation of such information, in violation of a fiduciary duty . . . constitutes fraud akin to embezzlement—'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'"[244]

Finally, the Court in *O'Hagan* confirmed that the theft is not complete until the thief uses the information without disclosing that use: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure."[245] The core harm, then, is the use plus the omission to disclose.[246] Of course, the abstain-or-disclose rule also applies to the traditional theory under *Cady Roberts* and its progeny.[247]

If we import MPC language, as the Court has frequently done in various contexts,[248] then the government must show that an insider or misappropriator acted either purposely or knowingly. That is, that the insider or misappropriator acted with either (1) the conscious goal of breaching a duty to the company and its shareholders or to the owner of the information, respectively, or (2) an awareness that the theft of the information almost certainly constituted such a breach.

Under this formulation, willful blindness would also be sufficient. This would meet the essential goal of insider trading law: to protect principals from the nefarious acts of their agents and their agents' cohorts. It is appropriate to cast this net to include those who are almost certain that (1) the information they possess is secret information that belongs to the principal and (2) that using the information would violate the agent's duty to the principal. Although we could make a strong argument that willful

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242 United States v. O'Hagan, 521 U.S. 642, 654 (1997).

243 *Carpenter*, 484 U.S. at 26.

244 *O'Hagan*, 521 U.S. at 654 (citing *Carpenter*, 484 U.S. at 27).

245 *Id.* at 654 (quoting Oral Argument transcript) (alterations in original).

246 *Id.* at 655 ("[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.").

247 *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

248 *See Global-Tech* discussion, *supra* Part II.A.

blindness should not suffice for a specific intent crime,[249] the pragmatic considerations running in favor of a willful blindness standard are deeply rooted in the law—and may well explain courts' mistaken and misleading tendency to employ a recklessness standard in insider trading cases.[250]

In this framework, recklessness is not an appropriate level of mens rea for any element of insider trading. As should be apparent from the above discussion, and as others have argued,[251] recklessness is a non-intentional level of mens rea that is fundamentally at odds with an intentional offense such as insider trading.[252] Harm caused by reckless behavior is, by definition, non-intentional under generally accepted concepts of criminal mens rea. The common law defines intentional behavior as acting with the goal of causing the harm or knowing that the harm will almost certainly happen; acting with knowledge of a mere risk is non-intentional.[253] Unfortunately, in the securities fraud context, the Court's earlier decision in *Ernst & Ernst v. Hochfelder* failed to use the precise distinctions that the Court employed in *Gypsum* and thus added to the confusion over the mens rea of securities fraud.[254] In *Ernst & Ernst*, the Court held that negligence is not the appropriate mental state in a private civil securities fraud case for damages. Rather, the Court held, the defendant must have acted with "an intent to deceive, manipulate, or defraud."[255] But the Court contributed to the

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[249] *See* Moohr, *Playing*, *supra* note 25, at 696 ("The lack of uniformity and the shading of knowing conduct into reckless conduct makes willful blindness a poor substitute for a knowing *mens rea*."). As argued above, *supra* Part II.A, the *Global-Tech* definition of willful blindness should alleviate many of these concerns.

[250] Others have recognized that courts often confuse the two concepts. *See* Moohr, *Playing*, *supra* note 25, at 696 (describing "the shading of knowing conduct into reckless conduct").

[251] *See, e.g.*, Buell, *Securities Fraud*, *supra* note 23, at 564 ("[I]f [an actor] is merely reckless as to whether she has an illegitimate informational advantage, then she is perhaps misleading her counterparty, but she is not defrauding her counterparty in the core sense of fraud.").

[252] *Cf. id.* at 515 ("If one believes that fraud is a morally charged concept that requires that an actor seek to deceive another . . . no such thing as no-fault fraud, negligent fraud, or arguably even reckless fraud can exist.").

[253] *See* DRESSLER, *supra* note 128, at § 10.04(A)(1) (explaining that intentional crimes are committed purposely or knowingly). In terms of homicide law, for example, at common law criminal negligence or ordinary recklessness will typically produce manslaughter liability. Extreme recklessness may give rise to second degree "depraved heart" murder. But these are all forms of non-intentional killings, which the law distinguishes from intentional killings, that is, those done with a subjective awareness that the act will almost certainly produce death or with the conscious goal that it will do so. *See* MODEL PENAL CODE §§ 210.1-4; DRESSLER, *supra* note 128, at § 31.02(A).

[254] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n.12 (1976) (conflating intentional and reckless conduct).

[255] *Id.* at 193.

mens rea confusion by referring to "recklessness" as a form of "intentional conduct," a fundamentally illogical equation, and then stating that it was not deciding whether recklessness might suffice in the kind of case before the Court.[256] Later in the opinion, however, the Court evidenced a more accurate understanding of scienter's meaning by focusing on the text of Rule 10b(5). The Court noted that statutory or regulatory "words such as 'manipulative,' 'devise,' and 'contrivance,' proscribe a type of conduct quite different from negligence."[257] The Court went on to examine these terms, concluding that they connote a sort of intentionality inapposite to negligence[258] and—we might say, by way of natural inference—to recklessness as another mental state connoting non-intentional conduct. Indeed, the Court noted that Section 10(b) speaks "specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of *intentional wrongdoing*."[259]

For example, a tippee who did not act intentionally with respect to the core harm—the tipper's theft of information from one to whom the tipper owed a duty—should not be sanctioned. Consider the analogous case of a child who, after a parent's admonition to slow down, runs through a house, bumps into a table, and knocks over and breaks a valuable vase. The child is aware of the risk, but proceeds nonetheless; in criminal mens rea terms, this is an accident committed recklessly—with awareness of risk but without the intent that the vase break.[260] Now take the case of a child who angrily picks up the vase and smashes it to the floor; this child intended to break the vase. Instinctively, we feel that the second child is more culpable.

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256 *See id.* at 193 n.12. The opinion thus left the door open for lower courts to adopt a recklessness standard for securities fraud. Twelve circuits have upheld some form of recklessness as a basis for securities fraud liability; the majority of courts cite a Seventh Circuit decision, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977). Although most courts do apply a recklessness standard, they vary on how they define the term. *See* Moohr, *Playing*, *supra* note 25, at 696.

257 *Hochfelder*, 425 U.S. at 199 ("Use of the word 'manipulative' is especially significant . . . . It connotes *intentional or willful* conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.") (emphasis added) (footnotes omitted).

258 *Id.* The Court found support for this conclusion in the legislative history: Section 10(b) "was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices,'" language that does not connote negligence. *Id.* at 202.

259 *Id.* at 214 (emphasis added). *See* Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

260 *See supra* note 134 (discussing recklessness).

Drawing from Supreme Court precedent in the context of business and regulatory offenses in general and fraud in particular, all elements of insider trading should require intentional behavior. Unfortunately, largely because of the confusion that *Hochfelder* created, lower federal courts have employed inaccurate and misleading mens rea standards in insider trading cases. Even the *Newman* opinion, which did much to clarify the mens rea elements of tipper and tippee liability, confused constructive knowledge and negligence.

To recap, insider trading requires proof of intentionality. Insider trading is a classic "gray-area" white collar crime, the boundaries of which are uncertain. The indefinite nature of the crime supports the conclusion that no mens rea equated with non-intentionality (recklessness and negligence) should ever suffice for an insider trading conviction. This comports with insider trading's grounding in common law fraud, a theoretical construct from which the United States Supreme Court has never wavered in all its insider trading decisions.

III. SYSTEMATIZING INSIDER TRADING

Based upon a conception of insider trading as grounded in common law fraud, this article next identifies the precise levels of mens rea that attach to each of the actus reus elements of insider trading. This task is most complex when dealing with tippers and tippees, particularly when there are remote (second and third level) tippees.

A. Matching the Mens Rea and Actus Reus Elements of Insider Trading

Based upon the case law, it should be clear that insider trading liability requires three basic actus reus components: (1) the possession of material nonpublic information; (2) the purchase or sale of a security; and (3) the breach of duty. Each requires a unique analysis to determine the requisite level of mens rea that should attach to give rise to criminal liability.

1. Possession of Material Nonpublic Information

To be guilty of insider trading an actor must possess material nonpublic information.[261] To ensure that the actor is culpable, the government should be required to prove that the actor knowingly possessed the information and knew that the information was material and nonpublic. Otherwise, the defendant's act could have been purely innocent; if the actor does not know that the information is material and nonpublic, then the actor does not know that trading on the information is harmful. This rule should apply both to misappropriators and insiders acting as principals who trade, and to tippers and tippees.

The knowledge requirement is based on core culpability principles. One of the Supreme Court's leading mens rea decisions, *Morissette v. United States*, illustrates the importance of requiring knowledge as to a core element.[262] In that case, the defendant found and took some abandoned shell casings while hunting. He was convicted under a statute that provided, "'whoever embezzles, steals, purloins, or knowingly converts' government property is punishable by fine and imprisonment."[263]

In a "canonical" decision,[264] the Court applied the mens rea term "knowingly" to the circumstance element of the crime (that the property actually be "property of the United States") as well as to the active conduct element (the conversion).[265] The Court reasoned that, if the defendant knowingly converted the property believing it to have been abandoned, then he did not act culpably.[266] And in a series of other cases, the Court has held that mens rea requirements should apply to all of the actus reus elements of criminal statutes.[267]

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[261] These basic actus reus elements are non-controversial, with one exception. Courts have disagreed as to whether mere possession of material nonpublic information when trading is sufficient, or whether the government must prove that the defendant actually used the information. In 2000, the SEC enacted Rule 10b5-1, which adopts the "knowing possession" standard; however, some courts apparently have continued to require proof of use. *See* Anello & Albert, *Revisiting*, *supra* note 5; Langevoort, *supra* note 170, at 439. Because the Second Circuit has consistently applied the knowing possession standard, I assume for purposes of this article that this is the correct standard.

[262] Morisette v. United States, 342 U.S. 246, 275 (1952).

[263] *Id.* at 248 (quoting 18 U.S.C. § 641).

[264] Brown, *supra* note 33, at 110 n.6.

[265] *Morissette*, 342 U.S. at 270-72 (requiring "knowing conversion").

[266] *Id.* at 250 ("The contention that an injury can amount to a crime only when inflicted by intention is no provincial or transient notion. It is as universal and persistent in mature systems of law as belief in freedom of the human will and a consequent ability and duty of the normal individual to choose between good and evil.").

[267] *See* Traps, *supra* note 124, at 631-35.

This conclusion is particularly compelling when the circumstance is a core culpability element. In *Morissette*, the defendant was not culpable if he was unaware that the property belonged to another.[268] In insider trading, by way of analogy, the defendant is not culpable if the defendant honestly believes that the information is public.[269]

To illustrate this point, let us consider the following scenario. If two friends are having a conversation, and work-related matters happen to arise, then it is easy to see how one person might casually share secret business information with the other person. If the other person trades on that information believing that it is not secret, then that person has not acted with the sort of fraudulent intent underlying the crime. Similarly, if the other person believes that the information is unimportant and therefore immaterial, then that person lacks the necessary culpability.[270] Of course, the jury must find both circumstance elements—that the information was indeed both material and nonpublic—beyond a reasonable doubt, but the question is the mens rea that attaches to each element. To draw an analogy, the crime of selling stolen property that you have obtained from another is akin to the crime of trading on material nonpublic information that you received from another. If you do not know that the property is stolen, then you lack culpability;[271] if you do not know that the information was obtained in breach of a duty, then you lack culpability.

Under both general common law and MPC principles relating to intentional crime, if the jury were to find that the tippee was merely aware of some possibility that the information was secret—that the tippee was reckless—then the tippee should not be liable. If the jury were to find that the defendant knew that the information almost certainly was secret, but

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[268] *Morissette*, 342 U.S. at 270-72.

[269] Traps, *supra* note 124, at 636 (citing Liparota v. United States, 471 U.S. 419 (1985) (noting that in *Liparota* the Court held that in prosecution for unlawful use of food stamps, the government must prove that the defendant knew that his possession of food stamps was not authorized by law or regulation));*see also* Flores-Figueroa v. United States, 556 U.S. 646, 657 (2009) (holding that in a prosecution for possessing means of identification of another person, the government must prove that the defendant knew the means of identification belonged to another person); United States v. X-Citement Video, Inc., 513 U.S. 64, 68 (1994) (holding that in a prosecution for transportation of child pornography, the government must prove that the defendant had knowledge that the pornography involved underage participants). For another analysis of *Flores-Figueroa*, see Brown, *supra* note 33, at 120.

[270] The materiality element is usually easy to meet; if the defendant traded on the information, it will be hard for the defense to convince a jury that the defendant believed that a reasonable investor would not want to know the information.

[271] *Morissette*, 342 U.S. at 272 n.32.

deliberately decided not to ascertain the nature of the information, then the defendant knowingly possessed the information and acted with intentionality.

Courts seldom seem to be able to articulate this insider trading element—the mens rea with respect to possession of material nonpublic information—with any precision. Again consider *Obus*,[272] which offers a muddled mens rea definition on the possession element for both tippers and tippees.

On the possession element of tippee liability, the court described the mental state that the SEC was required to show as to the ultimate tippee, Obus. The court held that the jury should be required to find that the "tippee intentionally or *recklessly traded* while in knowing possession of that information."[273] On its face, the sentence does not make sense; one cannot "recklessly" trade securities, that is, one cannot merely be aware of the possibility that one is trading.

Presumably, the court meant to require that the tippee must know or be reckless as to the *possession* of material, nonpublic information. Attaching recklessness—a mens rea level denoting unintentional behavior—to the possession element makes no sense in the context of possession of nonpublic information. Knowing that you are trading on secret information is the essence of insider trading. If you merely suspect that you might be trading on secret information, or merely suspect that the information is material, then you are not behaving intentionally. Mere suspicion—and a "suspicion" is a subjective belief—does not equate with fraud.

The use of the term "recklessly" raises a recurring problem: the court failed to define the term to distinguish it clearly from willful blindness. If we replace "recklessly" with "acted with willful blindness," then we have an appropriate

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[272] SEC v. Obus, 693 F.3d 276 (2d Cir. 2013). *Obus* was a civil case brought by the SEC. *Id.* at 279. Presumably, the government did not seek criminal charges because of the somewhat vague proof on the mens rea elements. As noted above, this case is important for our discussion because the elements of civil and criminal securities fraud so often overlap. *See* Moohr, *Stewart*, *supra* note 43, at 601. The case took on a symbolic life of its own. As the *New York Times* reported, "For more than 10 years, Mr. Obus has refused to settle the lawsuit as a matter of principle, according to his lawyer. His battle with the S.E.C. is a rare one. Most insider trading defendants settle lawsuits brought by regulators, agreeing to forfeit ill-gotten gains and pay a fine, without admitting or denying wrongdoing." Peter Lattman, *Appeals Court Revives Insider Trading Case Against Obus*, N.Y. TIMES (Sept. 6, 2012), http://dealbook.nytimes.com/2012/09/06/appeals-court-revives-insider-trading-case-against-obus/. This has come a great cost to Mr. Obus: "'This has turned into a nightmare,' Mr. Obus, 64, says. He has run up $6 million in legal bills." Susanne Craig, *The Curious Case of Nelson Obus*, N.Y. TIMES (June 4, 2011), http://dealbook.nytimes.com/2011/06/04/the-curious-case-of-nelson-obus/.

[273] *Obus*, 693 F.3d at 288 (emphasis added).

standard on this element.[274] Willful blindness equals knowledge; knowledge equals intent.

In discussing *tipper* liability, the court in *Obus* was again imprecise. Here, the court stated, "the tipper must know that the information . . . is non-public and is material . . . or act with reckless disregard of the nature of the information."[275] Here, the court again dropped from knowledge to recklessness without ever discussing willful blindness.

The confusion between willful blindness and recklessness underlies much of the insider trading mens rea mess. The United State Supreme Court recognized this significant distinction when describing these mental states in *Global-Tech*.[276] Acting with mere recklessness should not be sufficient for fraud. Acting with the purpose to defraud, or acting with actual knowledge or willful blindness, is sufficient.

2. Purchase or Sale of a Security

The second element of insider trading is the purchase or sale of a security. According to the analysis above, courts should require proof that the defendant was aware that the scheme involved a purchase or sale of a security. With a trading party, this is of course a non-issue.

With a non-trading tipper, however, the knowledge that the tip will likely lead to trading goes to the core *Dirks* requirement that the tipper act for personal gain. Without knowledge that the tippee plans to use the tip to the tippee's benefit, then the tipper has no gain either. There is no financial or reputational benefit to the tipper, and no benefit that comes from the giving of a valuable gift—the gift having no value unless it leads to potential profit for the tippee.

So the question for non-trading tipper liability boils down to this: assuming that the tippee trades on the tip, and acts with knowledge that the information is material and nonpublic and obtained in breach of a duty, in what circumstances can the tipper be liable for that trade? Because the tipper has not traded, the tipper's liability must be for aiding and abetting the tippee's trade; this was the theory under which Dirks himself was charged.

Basic aiding and abetting principles require that, at a minimum, the government prove that the aider/abettor had (1)

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[274] *See supra* Part II.A.
[275] *Obus*, 693 F.3d at 286.
[276] *See supra* Part II.A.

the intent to aid and abet the principal actor;[277] and (2) the intent that the principal actor (here, the trading tippee) commit the crime.[278] So, on the first level, the tipper must intend that the tippee trade on the information. This is common sense; the very term "tipper" connotes the giving of information for the purpose (or, at a minimum, with the knowledge) that the tippee will use that information.[279] And on the second level, the tipper must know that the information is material and nonpublic and know that it was obtained in breach of a duty; otherwise, the tipper would not be aware that trading by the tippee would be illegal.

Courts, however, simply do not engage in careful analysis of these mens rea elements. In *United States v. Whitman*,[280] the trial court's decision on the insider trading jury instructions is emblematic of courts' confusion surrounding the mens rea of tipper liability.[281] Whitman was the principal of two securities firms who was charged as a second-level tippee. Corporate insiders tipped intermediaries (the first level tippees), who themselves tipped Whitman.[282] The government brought *Whitman* under the traditional theory, based upon the original tips from corporate insiders. After the jury convicted Whitman, the trial judge, Jed Rakoff,[283] issued an unusually detailed post-trial opinion explaining his jury instruction on tipper-tippee liability.[284]

On tipper liability, the court in *Whitman* ignored basic mens rea principles. On the elements of tipper liability as

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277 *See* DRESSLER, *supra* note 128, § 30.05[A].

278 *See id.* Most courts seem to require that the aider/abettor have the purpose to aid, though some allow conviction based upon proof of knowledge. *Id.* at § 30.05(B)(2).

279 *See* Langevoort, *supra* note 170, at 448 ("*Dirks* is describing the essence of a tip as a communication *deliberately intended* to benefit both tipper and tippee by enabling the latter's trading. It is thus a form of conscious fiduciary disloyalty.").

280 United States v. Whitman, 904 F. Supp.2d 363 (S.D.N.Y. 2012), *aff'd*, 555 F. App'x. 98 (2d Cir. 2014) (Summary Order) (unpublished opinion), *cert. denied*, 135 S. Ct. 352 (Nov. 10, 2014).

281 *Id.* at 372-73. *See* Chad Bray, *Former Hedge-Fund Manager is Sentenced*, WALL ST. J. (Jan. 25, 2013), http://www.wsj.com/articles/SB10001424127887323539804578262273492132016; Peter J. Henning, *The Winning Record of Prosecutors on Insider Trading*, N.Y. TIMES (Aug. 21, 2012), http://dealbook.nytimes.com/2012/08/21/the-winning-record-of-prosecutors-of-insider-trading/.

282 *Whitman*, 904 F. Supp. 2d at 365.

283 Judge Rakoff is a highly respected former federal prosecutor and criminal defense attorney with substantial experience litigating complex white collar cases. *See* Michael Rothfeld, *No Mr. Nice Guy—Just Ask Wall Street*, WALL ST. J. (Nov. 9, 2011), http://www.wsj.com/articles/SB10001424052970203733504577026422455885502. For an analysis of Judge Rakoff's prominence in the field of securities law, see Ben Protess & Matthew Goldstein, *Overruled, Judge Still Left a Mark on SEC Agenda*, N.Y. TIMES (June 5, 2014), http://dealbook.nytimes.com/2014/06/04/appeals-court-overturns-decision-to-reject-s-e-c-citigroup-settlement/. Nonetheless, even such an expert judge does not always get the law exactly right, as the discussion below will show.

284 Such post-trial decisions are rare, and decisions of this depth even rarer.

aiding and abetting the tippee's trading, the court stated that it is sufficient if the tipper knows that the tippee "*may trade* on the information."[285] These words indicate that it is sufficient if the tipper knew that there *was a risk* that the tippee would trade; this is classic recklessness language—knowing of a risk that a social harm might come to pass. This is not an appropriate level of mens rea for criminal tipper liability; one cannot accidentally, under basic common law principles, have the intent to assist another to commit a crime.[286]

The Second Circuit in *Obus* made the same error with respect to the tipper's mens rea. First, the court stated that the tipper must "deliberately or recklessly" give the information to the tippee. This language is problematic on several levels. The term "deliberate" equates with the MPC term "purpose," defined as acting with the "conscious object" to engage in the proscribed conduct or to cause the proscribed result.[287] But from this high level of mens rea, the court skipped over knowledge and dropped down to recklessness.

Then, the court conflated basic mens rea concepts. The *Obus* court noted that "[b]ecause a defendant cannot be held liable for negligently tipping information, difficult questions may arise when a tip is not apparently deliberate or when the alleged tipper's knowledge is uncertain." True enough. But then the court stated, "a tipper cannot avoid liability merely by demonstrating that he did not know to a certainty that the person to whom he gave the information would trade on it."[288] Here, the court misstated the definition of "knowledge," which does not require "certainty." Rather, "knowledge" requires proof that the actor was "aware of a high probability" of the existence of a particular fact.[289] Building upon this misstatement of the law, the court then concluded that the difficulty of proving "certainty" justifies a recklessness standard, which the court applied earlier in its opinion. Finally, to add to the confusion, the court stated that "conscious avoidance can be sufficient to establish tipper scienter,"[290] either jettisoning the recklessness standard that the court had earlier endorsed or conflating the concepts of recklessness and willful blindness.

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[285] *Whitman*, 904 F. Supp. 2d at 367 (emphasis added).

[286] *See* DRESSLER, *supra* note 128, § 30.05[A].

[287] MODEL PENAL CODE § 2.02(2)(a); *see also* DUBBER, MPC, *supra* note 122, at 63.

[288] SEC v. Obus, 693 F.3d 276, 287 (2d Cir. 2012).

[289] MODEL PENAL CODE § 2.02(7).

[290] *Obus*, 693 F.3d at 287.

For a tipper to breach a duty under *Dirks*, the tipper must intend to benefit from the tip by receiving a monetary or professional benefit or by giving a gift of valuable information. It is nonsensical to say that one can "recklessly" expect to receive a professional or financial benefit or can "recklessly" give a gift. To expect to receive a benefit is consciously to expect that the reward will occur. The very act of gift giving requires intentionality.[291] To consider a reckless or otherwise unintentional transfer as a gift is contrary to basic legal conceptions of gift giving.[292] As the Court explained in *Dirks*, a gift of valuable information by an insider to a trading recipient resembles an inside trader transferring the profits to the recipient.[293] As later cases have noted, a gift of information might be based upon the expectation of a future quid pro quo.[294] Or, the giving of the gift might provide emotional or other benefits to the tipper, as in the common scenario when tippers provide information to family members.[295]

It makes little sense, then, to attach recklessness to the trading element of insider trading. A non-trading tipper who acts for personal benefit will, in most cases, be acting with the specific intent or purpose to give a valuable gift to the tippee. Perhaps, in some cases, knowledge should be sufficient. But that tip must be intentional, under any plausible reading of the *Dirks* rule.

3. Breach of Duty

The third actus reus element of any insider trading case is the breach of duty. In the context of tipper/tippee liability, recent

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[291] In an article challenging the lack of enforceability of donative promises from the perspective of law and emotions, Professor Hila Keren demonstrates that altruistic behavior can be explained by a person consciously seeking a self-interested reward and/or emotional benefits. Hila Keren, *A Considering Affective Consideration*, 40 GOLDEN GATE U. L. REV. 165, 192-93 (2010).

[292] The *Restatement (Third) of Property* defines a gift as a transfer that requires donative intent, labeling this intent as a gift's essence and critical to distinguishing a gift from an involuntary transfer. RESTATEMENT (THIRD) OF PROP. § 6.1 cmt. b (2003); *see also* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 348 (1979) (arguing that selective giving of information is the equivalent of selling the information to the recipient for cash resulting in personal gains to tipper).

[293] Dirks v. SEC, 463 U.S. 646, 664 ("The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."). *Cf.* United States v. Maxwell, 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004) ("Given the parties' relative stations in life, any reputational benefit to [the tipper] is extremely unlikely to have translated into any meaningful future advantage.").

[294] *Dirks*, 463 U.S. at 664 ("[T]here may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient.").

[295] *See* SEC v. Warde, 151 F.3d 42, 49 (2d Cir. 1998).

cases from the Second Circuit illustrate the courts' fundamental confusion over the mens rea that attaches to this element. Of course, a tipper must intentionally breach a duty to the source of the information, as required by *Chiarella*, *Dirks*, and *O'Hagan*. The lack of clarity arises with respect to the tippee's mens rea.

The cases raise two issues with respect to tippees that the appeals court and, ultimately, the Supreme Court, will need to resolve. First, in a case against a tippee, must the government prove any mens rea with respect to the tipper's breach of duty? Second, assuming that some proof of the tippee's mens rea is required as to the tipper's breach of duty, what is the appropriate level of mens rea? Should recklessness, or even negligence, suffice? Some trial courts have held that the government need prove no mens rea on the tippee's part with respect to the tipper's breach of duty, effectively imposing strict liability on this prong of tippee liability.[296] This holding rests on a plain misunderstanding of insider trading law.

Insider trading is, according to the Supreme Court, a form of common law fraud.[297] Fraud requires intent; the fraud in insider trading is upon the source of the information.[298] Under *Dirks*, the tippee cannot be liable unless the tipper breached a duty; a tipper breaches a duty by disclosing confidential information without authorization in a manner designed to benefit the tipper. Although courts sometimes dispense with mens rea requirements as to certain elements of crimes, they generally do not do so when the element goes to a core culpability requirement.[299] That is true here, where a tippee who is not aware that the tipper obtained the information wrongfully—and *Dirks* defines wrongfulness as acting for personal gain—is not aware of the breach of duty element that is at the core of the offense.

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[296] *See* Anello & Albert, *Resolve*, *supra* note 5, and cases discussed therein. Although courts do sometimes fail to require proof of a mens rea for all elements of crimes, such failure is usually limited to elements that do not go to the core culpability of the offense. *See* Brown, *supra* note 33, at 114 ("[W]hether mens rea attaches to [an element of a crime] is a question of culpability's relation to the gravity of punishment".).

[297] *See* Chiarella v. United States, 445 U.S. 222, 227-30 (1980).

[298] *See* Brown, *supra* note 33, at 113 ("[S]tatutory crimes based in common-law offenses are presumed to carry common-law culpability requirements even when the statute includes no such term.").

[299] *See id.* at 110-11 (describing courts' approaches to assigning mens rea elements as either "proportionate culpability" or "threshold culpability.") Under either approach, a tippee should not be liable if the tippee had no culpability with respect to the breach of duty—the core harm from the offense. *See id.*; Stephen F. Smith, Essay, *Proportional Mens Rea*, 46 AM. CRIM. L. REV. 127, 127-28 (2009) (Mens rea doctrine should "ensure that the acts which lead to criminal liability will be *sufficiently blameworthy* to deserve the sanctions imposed by the substantive offense.").

Therefore, some level of mens rea on the tippee's part is required. But what level? Confusion on this question arises largely because of the Supreme Court's sloppy mens rea language in *Dirks*. In its holding, the Court set forth two prongs of tippee mens rea. First, in a straightforward holding, the Court stated that the tippee must know that the tipped information was material and nonpublic.[300] Second, in the vexing part of the opinion, the Court stated that there must also be proof that "the tippee knows or should know that there has been a breach [by the tipper]."[301]

The Court cannot have meant that "should know" would be sufficient. "Should know" is an objective standard that requires that a reasonable person in the defendant's shoes would have known of the breach. This is classic negligence language,[302] and the Court had previously held in *Hochfelder* that negligence is not sufficient for securities fraud.[303]

Given the common understanding of securities fraud as an intentional crime, the only rational explanation of the Court's use of this language was that it was being sloppy. As the Court made abundantly clear in *Chiarella*, *Dirks*, and *O'Hagan*, the core harm in insider trading is the breach of duty. To say that the tippee could be liable because the tippee was merely negligent as to the tipper's breach of duty flies in the face of (1) the Court's holding that concepts of recklessness and negligence have no place in complex business crimes such as price-fixing (and, we can infer, a similarly complex and ill-defined crime such as insider trading),[304] (2) the Court's holding that negligence is not an appropriate standard even in a civil securities fraud case,[305] and (3) the willfulness requirement in criminal securities fraud cases.

It is easy to imagine a negligent tippee who is not sufficiently culpable to incur fraud liability. Take a barber who has a long-time client.[306] That client works for a publicly traded company, and regularly discusses his work while having his hair cut. One day the client mentions that the company may soon be taken over. Based on this information, the barber trades and nets a profit. Let us assume for a moment that the client intended this

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300 *Dirks*, 463 U.S. at 658 ("knowingly receiv[ing] material nonpublic information" is only the first prong required for proving liability).

301 *Id.* at 660.

302 *See* MODEL PENAL CODE § 2.02(2)(d); DUBBER, MPC, *supra* note 122.

303 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214.

304 *See* United States v. U.S. Gypsum Co., 438 U.S. 422, 444 (1978).

305 *See Hochfelder*, 425 U.S. at 198-99.

306 This discussion is loosely based on *SEC v. Maxwell*, 341 F. Supp. 2d 941 (S.D. Ohio 2004).

information to be a gift to the barber, and therefore breached a duty. But should the barber go to jail for this trade? Did the barber have actual knowledge of the breach, or was the barber actually aware of this possibility but decided to turn a blind eye? These would be subjective tests that would more accurately match culpability with liability; the barber's mental state would evidence some intentionality. Suppose that, instead, we ask the jury to inquire whether the barber, if he had been a reasonable person, would have been aware of the breach; not "was he aware" but "should he have been aware?" It would be far easier to impose liability under the latter standard. And this barber's mental state does not seem sufficiently culpable to conclude that he is a criminal fraudster.[307]

Courts seldom get this right, as the *Whitman* decision shows. The court initially described the personal benefit element for tippee liability quite clearly and accurately:

> [I]f the only way to know whether the tipper is violating the law is to know whether the tipper is anticipating something in return for the unauthorized disclosure, then *the tippee must have knowledge that such self-dealing occurred*, for, without such a knowledge requirement, the tippee does not know if there has been an 'improper' disclosure of inside information.[308]

The court continued, "On the other hand, there is no reason to require that the tippee know the details of the benefit provided; it is sufficient if he understands that some benefit, however modest, is being provided in return for the information."[309] By using the subjective term "understands," the court effectively held that the tippee must know that the tipper intended to benefit by transferring the information.

So far, so good. The court continued, however, to so water down the knowledge requirement as to render it almost meaningless. The court instructed the jury that "[a]s to the defendant's knowledge that the insider has breached the insider's duty of trust and confidentiality in return for some actual or anticipated benefit, . . . it is sufficient that the defendant *had a general understanding* that the insider was improperly disclosing inside information for personal benefit."[310] What does "a general

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[307] *Cf.* United States v. Kaiser, 609 F.3d 556, 569 (2d Cir. 2010) ("[I]nsider trading does not necessarily involve deception, and it is easy to imagine an insider trader who receives a tip and is unaware that his conduct was illegal and therefore wrongful.").

[308] United States v. Whitman, 904 F. Supp. 2d 363, 371 (S.D.N.Y. 2012) (emphasis added).

[309] *Id.*

[310] *Id.* (emphasis added).

understanding" mean? This sounds perilously close to recklessness, under which a defendant need only be aware of a risk that the tipper was acting for personal benefit. That is the mens rea of accidental behavior, and is not fraud.

Take, for example, two long-time friends who often meet over drinks and discuss their work and personal lives. One tells the other, "You know, the latest financials scare me. My company's not doing so well, and I'm afraid I might lose my job." There is no evidence that the insider expected, or even suspected, that the friend would trade on the information. The friend promptly sells shares in the company's stock and avoids substantial losses. Would the "tippee" have a "general understanding" that the "tipper" was acting for personal benefit? Is it not a personal benefit to be able to share sorrows and concerns with a friend? Perhaps, but that is not the sort of benefit that *Dirks* described: a financial or reputational benefit to the tipper, or the giving of a valuable gift.

If, instead, the government could show that (1) the tipper knew that the tippee held stock in his company, (2) the tipper intended or expected that the tippee use the information, and (3) the tippee was aware of the tipper's motive, then both parties are culpable. Absent such proof, they are not. Yet, they could be liable under the *Whitman* standard, under which "very little in the way of 'benefit' needed to be shown."[311]

Rather, as *Newman* held, proof of a precise benefit should be required. Either a clear financial benefit or, at a minimum, "proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[312] A higher level of proof would not handicap the government, because in the vast majority of tipper-tippee cases the intent to benefit is apparent.

On the issue of the tippee's mental state as to the breach, the court in *Obus* erred even more egregiously than the court in *Whitman*. Initially, the court in *Obus* correctly noted that *Dirks*' "should know" language "sounds somewhat similar to a negligence standard" and therefore conflicts with *Hochfelder*'s holding that negligence is not an appropriate level of scienter for securities fraud.[313] Somewhat nonsensically, the court attempted to explain

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[311] *Id.*

[312] United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014); *see supra* note 107, and accompanying text.

[313] SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012). Actually, the *Dirks* standard is not "somewhat similar" to a negligence standard; it *is* a negligence standard. *See id.* (citing

why the *Dirks* "should know" language is nonetheless appropriate by noting that this language only goes to the tippee's state of mind concerning the tipper's breach of duty.[314] Purporting simply to restate the negligence standard that the Supreme Court (mis)articulated in *Dirks*, the court in *Obus* concluded, "[t]hus, tippee liability can be established if a tippee knew or *had reason to know* that confidential information was initially obtained and transmitted improperly (and thus through deception) . . . ."[315]

Again, the court conflated mens rea concepts. The court said that it was applying negligence—an objective, reasonable person standard—but then required that the tippee subjectively "had reason to know" of the breach. If the tippee actually "had reason to know" that the tipper was breaching a duty, then in all likelihood the tippee was acting either with actual knowledge or willful blindness.

The *Obus* court also plainly misstated the law with respect to the *tipper's* mens rea on the breach of duty element. The court stated that the tipper "must know [*read: have actual knowledge*] or be reckless in not knowing [*read: act with recklessness*] that to disseminate the information would violate a fiduciary duty."[316] It is the breach of duty that forms the essence of the offense, and it is nonsensical to talk of a reckless breach of duty in the context of insider trading. Indeed, the very next sentence in the court's opinion contradicts the language above: "While the tipper need

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RESTATEMENT (THIRD) OF TORTS § 3, cmt. g (2010)) ("Negligence requires foreseeability, which 'concerns what the actor "should have known."'").

[314] The court's analysis is so convoluted that it cannot really even be paraphrased in a way that makes sense. Here is the entire excerpt:

> We think the best way to reconcile *Dirks* and *Hochfelder* in a tipping situation is to recognize that the two cases were not discussing the same knowledge requirement when they announced apparently conflicting scienter standards. *Dirks*' knows or should know standard pertains to a tippee's knowledge that the tipper breached a duty, either to his corporation's shareholders (under the classical theory) or to his principal (under the misappropriation theory), by relaying confidential information. This is a fact-specific inquiry turning on the tippee's own knowledge and sophistication and on whether the tipper's conduct raised red flags that confidential information was being transmitted improperly.

Obus, 693 F.3d at 288. In the second sentence, the court did not even attempt to explain why negligence should suffice on the second level of scienter. *See* Heminway, *supra* note 87, at 52 ("If the *Ernst & Ernst* opinion is to retain its original meaning, *Obus* cannot be right [in employing a negligence standard]."); Vissichelli, *supra* note 74, at 776 (noting that *Obus*'s application of a negligence standard is "contrary to insider trading liability's foundation in common law fraud.").

[315] *Obus*, 693 F.3d at 288 (emphasis added).

[316] *Id.* at 286.

not have specific knowledge of the legal nature of a breach of fiduciary duty, *he must understand that tipping the information would be violating a confidence*."[317] An actual understanding—knowledge—that the tipper is violating a duty of confidentiality is precisely the correct standard. This standard cannot be met if the tipper is reckless—simply aware of some risk—that the tip constitutes a breach of the confidentiality duty.[318]

In its 2013 decision in *Goffer*,[319] the Second Circuit continued to employ sloppy mens rea language, but at least got the substance on the tipper's knowledge of the breach of duty right. In its decision, the Second Circuit affirmed the defendants' convictions in a wide-ranging and complex criminal insider trading conspiracy. The material nonpublic information came from two junior attorneys at a New York law firm who tipped others who in turn tipped additional co-conspirators.[320]

On appeal, a tippee challenged the sufficiency of the evidence as to his mental state concerning the breach of duty. In affirming the conviction, the court first quoted the *Dirks* "should know" language.[321] Shortly thereafter, though, the court stated that "we find ample support for the jury to conclude that [the tippee] was tipped by [the tipper] and *knew or consciously avoided* knowing that [tipper's] tip . . . was based on nonpublic information illegally disclosed in breach of a fiduciary duty."[322] Although the court regrettably did not point out the inconsistency between *Dirks* and the standard it applied, the court ultimately got the substance of the rule exactly right.

In sum, the *Whitman, Obus*, and *Goffer* decisions suffer from a fundamental lack of clarity and precision; *Newman* mostly got it right, but with some muddled mens rea language along the way. In *Whitman*, the court seemed to apply a recklessness standard for tippee liability, and misconstrued the *Dirks* breach of duty element. In *Obus*, the court repeatedly confused and conflated mens rea concepts. It used the terms "recklessness" and "negligence" at various points to mean that the defendant "had reason to know" the facts constituting a particular element. And the court threw in willful blindness

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317 *Id.*

318 *Id.* at 287 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12); *see also* SEC v. Yun, 327 F.3d 1263, 1277-78 (holding that violation of § 10(b) requires tipper act with expectation and goal of benefitting personally and reckless disclosure "itself is insufficient to constitute a breach" for insider trading liability).

319 United States v. Goffer, 721 F.3d 113 (2d Cir. 2013).

320 *Id.* at 119.

321 *Id.* at 124 (quoting *Obus*, 693 F.3d at 124).

322 *Id.* at 125.

(termed "conscious avoidance") seemingly as a lower level of mens rea compared to recklessness. In *Goffer*, the court stated that it was applying negligence, but then defined negligence to require knowledge.[323] And even the *Newman* decision, which made such great strides in clarifying mens rea standards for tippees, conflated constructive knowledge and negligence.[324] All this imprecision is enough to give a law professor a headache, much like reading a bad exam answer.[325]

Employing such confused and confusing mens rea standards has the potential to inflict significant damage. Potential defendants will have difficulty drawing the line between "socially acceptable and economically justifiable business conduct"[326] and conduct that may give rise to securities fraud liability. And prosecutors will be tempted to push the boundaries of "gray zone" cases so as to expand the scope of criminal behavior into unchartered territory.

Because of this state of affairs, courts should, at a minimum, adopt clearer mens rea standards in insider trading cases in particular and in securities fraud cases in general. And an even better result would be for Congress to address the problem by enacting a far more precise—and carefully graded—insider trading statute.[327] In the absence of Congressional action,

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[323] *See supra* notes 319-20 and accompanying text.

[324] *See supra* notes 111-12 and accompanying text.

[325] At the end of the day, though, it is difficult to know whether the errors affected the outcomes. In *Whitman* and *Goffer*, there did seem to be substantial evidence from which a jury could find tipper/tippee liability under the appropriate standards of intentional crimes. The court in *Obus* found sufficient allegations on summary judgment for the case to go to trial. It does seem as though a jury could find that Strickland intended to benefit by giving the information to his friend, Black, and that Black intended to benefit professionally by tipping his boss. The only problematic part of the court's concluding analysis is its rejection of GE Capital's internal finding that Strickland had not breached a duty; it was this internal finding that led the district court to dismiss the insider trading theory based upon misappropriation. SEC v. Obus, No. 06 CIV 3150 GBD, 2010 WL 3703846, at *16 (S.D.N.Y. Sept. 20, 2010). The Second Circuit reasoned that "the GE investigation was motivated by corporate interests that may or may not coincide with the public interest in unearthing wrongdoing and affording a remedy." *Obus*, 693 F.3d at 291. This is a somewhat glib conclusion, given the policy that underlies the misappropriation theory. This theory is based upon a breach of duty to the owner of the information. If GE Capital had told Strickland that it would be fine for him to give the information to his friend Black, and that it would be fine for Black to give the information to Obus, then there would have been no breach of duty and no tipper misappropriation. If GE Capital concluded after the fact that Strickland did not breach, then surely that finding merits more discussion than the Second Circuit gave it.

[326] United States v. U. S. Gypsum Co., 438 U.S. 422, 441 (1978).

[327] It is unlikely that Congress would amend the securities fraud statutes so as to narrow the scope of liability. *See* Moohr, *Playing*, *supra* note 25, at 689 ("Although Congress usually has constitutional authority to enact corrective legislation, legislators seem more likely to do so when judicial interpretation has narrowed, rather than broadened, the scope of a criminal law."). Indeed, bills introduced in the wake of *Newman* would substantially

a newly systemized set of jury instructions is the best solution to the problem.

B. Proposed Jury Instructions

What can we glean from the preceding discussion? First, that insider trading cannot be based upon levels of mens rea that equate with accidents; rather, this is an intentional offense. Second, based upon MPC methodology, we should carefully parse the elements and be precise about the level of mens rea that attaches to each. Each actus reus component should require proof of intentional behavior, defined in MPC terms as acting with purpose or knowledge.

Insider/Misappropriator Liability

With respect to a principal actor who takes material nonpublic information as an insider or misappropriator and then trades on the information, the intentionality requirement is straightforward. The actor knowingly possesses the information, and trades on it without disclosing the theft to the party to whom the actor owes a duty. The intent to harm is inherent, per the *Carpenter* decision; the actor is breaching a duty by engaging in self-dealing without disclosure, and intends to benefit from that breach.

Based upon the analysis in *Chiarella*, *Dirks*, and *O'Hagan*, and employing MPC definitions, courts should instruct juries that the government must prove the following elements in an insider trading case against an alleged insider or misappropriator who has traded securities:

Actus Reus	**Mens Rea**
1) Conduct: The defendant possessed the information.	Knowledge: The defendant was aware of the information.[328]

broaden insider trading liability. *See* Tricchinelli, *supra* note 115. In other contexts, Congress has enacted statutes that grade culpability by the defendant's level of mens rea. The computer fraud statute does this in some detail. *See* STRADER, UNDERSTANDING, *supra* note 53, at 130-31. The proposed insider trading legislation does not engage in a careful application of mens rea standards. *See supra* note 115.

[328] For a discussion of the "use" vs. "possession" standards, see *supra* note 261.

2) Circumstance A: The information was material and nonpublic.	Knowledge: The defendant was aware that the information was material and nonpublic.[329]
3) Circumstance B: The defendant's act of obtaining and trading on the information breached a fiduciary duty.	Knowledge: The defendant was aware that obtaining and trading on the information constituted a breach of a duty of confidentiality.[330]
4) Conduct: The defendant bought or sold securities.	Purpose: The defendant's conscious objective was to trade on the information. Willfulness (in a criminal case): The defendant acted with knowledge that the trading was wrongful.[331]

This instruction builds upon existing law for principals—insiders and misappropriators—who allegedly traded on inside information by themselves breaching a fiduciary duty. It clarifies the law by making explicit that knowledge (including constructive knowledge in a case where such an instruction is warranted) is required for each of the circumstance elements: (1) the material, non-public nature of the information; and (2) the breach of duty.

Tipper/Tippee Liability

The elements are more complex in a tipper-tippee case. Again, it is critical to focus on the nature of the wrongdoing. As shown above, under the traditional and misappropriation theories, the tipper's culpability is based upon the breach of duty. And under *Dirks*, the tipper only breaches a duty if the tipper is acting for personal benefit. As *Newman* held, for a breach of duty to arise from theft of information, whether from the corporation under the traditional theory or from another owner of the information under the misappropriation theory, the tipper must somehow intend to gain from use of the information.[332] Just as the *Dirks* insiders were whistleblowers who did not intend to benefit

[329] *See supra* Part III.A.

[330] The defendant must be generally aware of the breach of duty. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024, 1033 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

[331] *See supra* Part II.B.2.

[332] United States v. Newman, 773 F.3d 438, 451-52 (2d Cir. 2014).

from the tip, so could an outside party reveal information without intending to benefit.[333] For example, a stock broker who believes that the broker's firm is trading on inside information and reveals the information to a third party in order to blow the whistle is no different from Dirks.

Based upon these principles, in a case against a tipper, the government must prove that the tipper knowingly gave material, nonpublic information to the tippee, and acted with the requisite levels of mens rea:

Tipper Liability

Actus reus	**Mens rea**
1) Conduct: The defendant possessed the information.	Knowledge: The defendant was aware of the information.
2) Circumstance A: The information was material and nonpublic.	Knowledge: The defendant was aware that the information was material and nonpublic.
3) Conduct: The defendant transmitted the information for use by the tippee.	Knowledge: The defendant was aware that the tippee would likely trade on the information.
4) Circumstance B: Transmitting the information would violate a duty owed to the source.	Knowledge: The defendant knew that transmitting the information to the tippee would produce a personal benefit to the tipper and thereby violate the duty that the defendant owed to the information's source. Willfulness (in a criminal case): The defendant acted with knowledge that the trading was wrongful.[334]

[333] *See, e.g.*, United States v. Chestman, 947 F.2d 551, 555 (2d Cir. 1991) (holding that there was no breach of duty where husband disclosed sale of company to wife so that she could prepare to sell her share); SEC v. Switzer, 590 F. Supp. 756, 761 (W.D. Okla. 1984) (holding that there was no breach of duty where husband disclosed inside information to wife in connection with family travel).

[334] *See supra* Part II.A.

For tippee liability, the government must show that the tippee knowingly possessed material nonpublic information, traded on that information, and knew that the information was obtained illegally. The last element requires knowledge of a breach of fiduciary duty as defined by *Dirks*—knowledge that the tipper took the information from the source without permission and acted for an improper purpose, that is, for personal gain:

Tippee Liability

Actus reus	**Mens rea**
1) Conduct: The defendant possessed the information.	Knowledge: The defendant was aware of the information.
2) Circumstance A: The information was material and nonpublic.	Knowledge: The defendant was aware that the information was material and nonpublic.
3) Circumstance B: The tipper's transmission of the information violated a duty owed to the source.	Knowledge: The defendant was aware that the tipper intended to benefit by transmitting the tip and thereby violated a duty to the source.
4) Circumstance C: The tipper transmitted the information for use by the tippee.	Knowledge: The defendant was aware that the tipper transmitted the information for likely use by the tippee.
5) Conduct: The defendant bought or sold securities.	Purpose: The defendant's conscious object was to trade on the information. Willfulness (in a criminal case): The defendant acted with knowledge that the trading was wrongful.[335]

As the Second Circuit noted during oral argument in the *Newman* case, it is critical that the law provide market participants with clear guidance on the scope of insider trading

[335] *See supra* Part II.A.

liability.[336] The possible scenarios run the gamut from the clearly illegal to the clearly innocent: from the tippee paying off the tipper to receive information to the friend who learns during a casual conversation that a friend's employer has financial problems and then trades on the information without knowing that the information is nonpublic or that the friend provided this information as a gift. Only by establishing clear standards on the mens rea required for tippers and tippees can we provide fair notice to those thousands of people who trade securities based upon a vast array of information as to when that trading crosses the line.

To return to the *Newman* decision, the Second Circuit seemed well aware of the policy implications of its decision. The court was concerned with providing notice of the boundaries of the law.[337] The court was also highly aware of the mechanics of the stock market, which operates effectively only if material information is made available to market participants.[338] Thus, the court reiterated the essential insights of *Dirks* and *Chiarella*: that it is the job of market analysts to ferret out hard-to-obtain information,[339] and that, as a result of this reality, equality of information among all market participants is neither required nor realistic.[340]

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[336] *See* Hurtado & Wilhelm, *supra* note 17, and accompanying text (quoting Judge Barrington D. Parker Jr.).

[337] *Id.*

[338] United States v. Newman, 773 F.3d 438, 451-52 (2d Cir. 2014) ("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 . . . ."(quoting United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring)) (internal quotation marks omitted) (alteration in original)).

[339] As the Court stated in *Dirks v. SEC*,

> [i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it 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. It is commonplace for analysts to 'ferret out and analyze information,' and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

Dirks v. SEC, 463 U.S. 646, 658-59 (1983) (internal citation omitted).

[340] As the Court stated in *Chiarella*, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." Chiarella v. United States, 445 U.S. 222,

The *Newman* defendants, the court seemed to say, were convicted and sentenced to lengthy jail terms for doing their jobs. Under the jury instructions outlined above, they lacked the knowledge that the original tippers breached a duty by acting for personal gain: the essential *Dirks* requirement. In *Obus*, on the other hand, the facts alleged by the SEC could theoretically have led a jury to believe that (1) the original tipper, Strickland, and the original tippee, Black, had a "meaningfully close personal relationship" to support a conclusion that Strickland was operating for personal gain when tipping Black, (2) Black was acting for personal (professional) gain when tipping Obus, and (3) Obus, the trading tippee, was aware of Strickland's breach. Obus, unlike Newman and Chiasson, knew both the identity of the original tipper and the relationship between the tipper and the intermediary.[341]

In any insider trading case, and especially in a tipper/tippee case, coherent and systematic jury instructions are essential to conceptualizing the offense in a way that conforms to principles of the underlying doctrine. Such instructions would require that prosecutors be more careful when charging insider trading. The instructions would also provide much-needed clarity to market participants who must distinguish between legal and illegal behavior.

CONCLUSION

Insider trading law raises concerns endemic to white collar criminalization: due process vagueness and the concurrent risk of overcriminalization. The decisions in *Whitman* and *Obus* cast a harsh light on courts' tendency to misdefine and conflate mens rea terms. By emphasizing that insider trading is a form of fraud, and that fraud is a form of intentional behavior, courts can begin to remedy the problem.

This reform requires, as a first principle, a focus on the breach of duty that is the core wrong of insider trading cases. The *Newman* decision takes a substantial step in that direction by

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232 (1980). "[N]either the Congress nor the Commission ever has adopted a parity-of-information rule." *Id.* at 233.

[341] However, the jury found Obus and his co-defendants not liable, apparently because the jury did not believe that the insider passed material nonpublic information to the tippees. *See* Max Stendahl, *SEC Loses Latest Trial to Hedge Fund Boss*, LAW360 (May 30, 2014, 4:58 PM), http://www.law360.com/articles/543114/sec-loses-latest-trial-to-hedge-fund-boss-obus ("[T]he jury ruled that Strickland did not pass material, inside information to Black; that Black did not pass an illegal tip to Obus; and that Obus did not violate the law by purchasing SunSource stock.").

requiring clear intentionality on the part of both tippers and tippees. In a perfect world, Congress would undertake the task as a matter of legislation rather than court-created criminalization. Whatever the solution, the current state of the law is, quite frankly, an embarrassment that should not be allowed to endure.