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Defending against Insider Trading Claims

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Prosecutors and regulators have prioritized enforcement of insider trading laws in recent years, leading to several landmark cases. This practice note provides an overview of the current law and regulatory framework governing insider trading in the context of government investigations, criminal prosecutions, and civil enforcement proceedings. It further discusses the key legal elements, the roles and relations among enforcement bodies, and key strategies for defending against insider trading claims in the current environment.

For resources relating to drafting guidance for clients, see Insider Trading Memorandum, Insider Trading Policy and Drafting Insider Trading Policies.

Laws Governing Insider Trading Violations

Insider trading is commonly understood as trading in securities on the basis of material nonpublic information. The U.S. securities laws, however, do not expressly prohibit trading on material nonpublic information. Instead, prohibitions against insider trading have evolved as a complex mix of judge-made law arising under the securities laws' broader anti-fraud provisions.

In a speech to the New York City Bar's annual Securities Litigation Institute in early 2017, Judge Jed S. Rakoff of the U.S. District Court for the Southern District of New York lamented that the "United States, by failing to recognize, unlike most other developed countries, that a meaningful effective straightforward, simple ban on insider trading is best achieved through statute rather than judge-made law, has created unnecessary uncertainty and difficulty in dealing with the problem of insider trading." See full article here https://www.law360.com/articles/897188/rakoff-urges-securities-bar-to-write-insider-trading-law. No elegant solution appears forthcoming.

***Section 10(b) of the Securities Exchange Act of 1934 and* Rule 10b-5**

Insider trading is typically prosecuted as a violation of the broad prohibition against securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C.S. § 78j, and its implementing regulation, Rule 10b-5, 17 C.F.R. § 10b-5.

- **Section 10(b).** This prohibits "any manipulative or deceptive device or contrivance" used "in connection with the purchase or sale of any security."

- **Rule 10b5-1.** This prohibits "the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information."

Insider trading is considered a deceptive act that falls under Section 10(b)'s anti-fraud provisions on the theory that it violates the relationship of trust and confidence that exists "between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position within that corporation." United States v. O'Hagan, 521 U.S. 642, 651–52 (1997). For advising clients on Rule 10b5-1 plans, see Understanding Rule 10b5-1 Plans and Advising on Their Use.

Additional Laws and Regulations

While Section 10(b) is the most common statutory basis for insider trading claims, several other statutes and rules address insider trading in particular situations, including:

- **Section 17(a) of the Securities Act.** Section 17(a) of the Securities Act of 1933 (Securities Act) provides similar prohibitions to those found in Section 10(b) of the Exchange Act and Rule 10b-5. The primary difference is that Section 10(b) prohibits fraudulent conduct in connection with either **the purchase or sale** of a security, whereas Section 17(a) prohibits fraudulent conduct in connection with the **offer or sale** of a security. Therefore, insider traders who sell based on nonpublic information may be charged with violating both Section 10(b) and Section 17(a). However, an individual who illegally buys a security cannot be charged with a violation of Section 17(a) because that statute does not apply to the purchase of a security.

- **Section 16(b) of the Exchange Act.** Exchange Act Section 16(b) generally prohibits certain insiders of public companies from obtaining "short-swing" profits in the companies' securities. If an officer, director, or 10% shareholder of a public company buys and sells, or sells and buys, securities of that company within a six-month time period, the company may generally recover any profits of the individual that resulted from the "matching" trades that occurred within that short-swing period. There is no requirement that the insider was aware of any material nonpublic information at the time of this trading. Moreover, the statute provides for a shareholder derivative action to be brought if the company itself does not seek to recover inappropriate short-swing profits.

Section 16(b) and the rules thereunder provide various exceptions to the prohibition on short-swing profits. For example, transactions between a company and its officers and directors; bona fide gifts and inheritances; profits resulting from mergers, reclassifications, and consolidations; and transactions involving voting trusts may be exempt from the general prohibition on short-swing profits in certain circumstances. 17 C.F.R. § 240.16b, Rule 16b.

- **Rule 14e-3 of the Exchange Act.** This rule prohibits insider trading in connection with tender offers (17 C.F.R. § 240.14e-a) by any person "in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from" the offeror, issuer, or anyone acting on their behalf. See Rule 14e-3(a). Subsections (b), (c) and (d) provide exceptions designed to ensure that Rule 14e-3 regulates only the actual misuse of material nonpublic information concerning a tender offer. Unlike insider claims brought under Section 10(b), there is no personal benefit requirement in Rule 14e-3.

- **Section 20(a) of the Exchange Act.** This provision creates control person liability over any entity that has control over another person engaged in insider trading, unless the controlling person acted in good faith and did not directly or indirectly induce the acts constituting the violation or case of action. 15 U.S.C. § 78t(a).

- **Section 306(a) of the Sarbanes-Oxley Act.** This statute prohibits directors and officers of an issuer of any equity security from directly or indirectly purchasing, selling, or otherwise acquiring or transferring any equity security of the issuer during a pension plan blackout period. 15 U.S.C. § 7244(a).

- **Regulation Fair Disclosure (Reg FD).** This issuer disclosure rule prevents the selective disclosure of important nonpublic information to securities analysts or institutional investors before making full disclosures to the general public (17 C.F.R. § 243.100–243.103). Selective disclosure is akin to "tipping" or insider trading because, according to the SEC, "a privileged few gain an informational edge" over the general public (Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154).

- **FINRA Rule 2020.** This is the Financial Industry Regulatory Authority's (FINRA's) antifraud rule, which is similar to, yet broader than, Section 10(b) and Rule 10b-5. See Dep't of Enforcement v. Fillet, Complaint No. 2008011762801, 2013 FINRA Discip. LEXIS 26, at *38 & n.11 (FINRA NAC Oct. 2, 2013) (applying National Association of Securities Dealers (NASD) Rule 2120, the predecessor to Rule 2020), aff'd in relevant part, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142, at *1 (May 27, 2015).

- **The Stop Trading on Congressional Knowledge (STOCK) Act.** This statute prohibits members of Congress and other government employees from trading based on nonpublic information obtained in the course of their duties.

- **Federal criminal laws.** The federal criminal laws prohibit mail fraud, wire fraud, and securities fraud (18 U.S.C. §§ 1341, 1343, and 1348 respectively), and the Department of Justice (DOJ) may bring claims under these statutes—typically in addition to a claim under Section 10(b)—when prosecuting insider trading.

Enforcement Authorities – Investigative Techniques and Available Remedies

The primary national enforcement authorities for insider trading activity are the Securities and Exchange Commission (SEC), the DOJ, and FINRA. These authorities work together and share information, so you must assume that any information revealed to any of the regulatory authorities will be relayed to each other, and to federal prosecutors if they deem it appropriate. These materials do not cover additional state enforcement authorities that may be relevant in any particular state.

The Securities and Exchange Commission (SEC) The SEC holds primary responsibility for enforcing the securities laws, including for insider trading violations. Its investigative arsenal includes (1) market surveillance technology that allows regulators to pinpoint incidents of suspicious trading across multiple securities and identify possible relationships among traders; (2) whistleblower incentives following the passage of the Dodd-Frank Act, which allow for large rewards in exchange for reporting allegations of misconduct; and (3) cooperation agreements with admitted wrongdoers, granting them leniency in exchange for testifying and/or providing evidence against others.

When it brings an enforcement action, the SEC typically seeks civil penalties up to three times the profit gained or loss avoided, plus disgorgement of any ill-gotten gains, and injunctive relief that may include an "obey-the-law" injunction and/or the imposition of suspensions and bars from serving as an officer or director of a public company. The SEC may also seek an asset freeze shortly after bringing an enforcement action.

The SEC's request for disgorgement from a defendant may exceed the gains actually received by that defendant, as the SEC may seek to disgorge the entire benefit of an insider trading scheme from one defendant. Thus, if a fund manager trades in a fund account and not his or her own account, he or she may be personally liable to disgorge the gains received by the fund, or a defendant tipper may be liable to personally disgorge the gains made by a downstream tippee, even if that tipper did not receive any portion of the trading profits. See, e.g., SEC v. Contorinis, No. 12-1723-cv (2d Cir. February 18, 2014).

In addition, Section 21A(A) of the Exchange Act enables the SEC to seek a civil penalty on a controlling person of up to the greater of $2,011,061 (as of January 2017) or three times the profit gained or the loss avoided (15 U.S.C. § 78u-1; 12 U.S.C. § 5565). See also https://www.sec.gov/rules/final/2017/33-10276.pdf.

The Department of Justice (DOJ)

The DOJ enforces criminal securities laws and initiates grand jury investigations and criminal prosecutions. Federal prosecutors are aided by the Federal Bureau of Investigation (FBI) and also rely on their own investigative techniques. These include judicially approved wiretaps, undercover surveillance, cooperative witnesses, and search warrants.

In determining whether or not to take on a case, the DOJ will first consider whether there is evidence of fraudulent intent rising to the "beyond reasonable doubt" standard. If it opens a criminal investigation, it may issue grand jury subpoenas for documents and testimony, and rely on its additional investigative resources and techniques involving the help of federal law enforcement agents. The result could be criminal indictment on federal securities charges as well as attendant charges of aiding and abetting, conspiracy, and obstruction of justice, among others.

Successful prosecutions can result in imprisonment for up to 20 years, fines of up to $5 million for an individual or $25 million for a corporate entity, and criminal forfeiture. 15 U.S.C. § 78ff. The sentencing guidelines for insider trading are set forth in 18 U.S.C. § 2B1.4. The guideline range for insider trading sentences depends on several factors including the amount of the victim's loss or the defendant's personal gain from the insider trading, whether the offense involved an organized scheme to engage in insider trading, and the defendant's criminal history. In U.S. v. Martoma, the court held that, although the sentencing guidelines are no longer mandatory, "[i]n arriving at a sentencing decision, the District Court *must* consider the now-advisory Guidelines, for they are 'the starting point and the initial benchmark,' and are not to be treated as only a 'body of casual advice.'" U.S. v. Martoma, 48 F.Supp.3d 555, 562 (S.D.N.Y. 2014) (quoting Gall v. United States, 55 U.S. 38, 49).

The Financial Industry Regulatory Authority (FINRA)

FINRA, a not-for-profit organization authorized by Congress to regulate the securities industry, is often first to open an investigation. Every firm and broker that sells securities to the public in the United States must be licensed and registered by FINRA. FINRA's Enforcement Department is tasked with investigating potential securities violations and, when warranted, bringing formal disciplinary actions against firms and their associated persons. FINRA has the authority to fine, suspend, or bar brokers and firms from the industry.

FINRA regularly conducts inquiries into trading activity in connection with merger announcements, and may request information from public companies and their officers concerning potentially suspicious trading. The results are typically shared with the SEC if there is any evidence of a possible securities offense. The SEC may then decide to advance an investigation by issuing administrative subpoenas and taking investigative testimony. If it discovers evidence sufficient in nature and quality to sustain the higher burden of proof of a criminal prosecution, a referral to the DOJ might follow.

FINRA may also bring its own disciplinary proceedings if the suspected insider trader is registered with FINRA. Such proceedings typically go first before a hearing officer, are heard before a three-person panel made up of the hearing officer and two industry panelists, and then can be appealed to a panel known as the National Adjudicatory Council (NAC). After the NAC rules, FINRA's board of governors can then choose to take up the case or finalize the order. Once a decision becomes final within FINRA, a defendant may seek review by the SEC. Only after the SEC renders its opinion may a defendant seek review by a federal appeals court.

Elements of Insider Trading Claims

Insider trading claims broadly fall into one of two categories: (1) claims against those who trade on the basis of inside information, and (2) claims against those who "tip" inside information to others who trade on that information.

If your client is accused of trading on inside information, the government must show that your client engaged in (1) "the purchase or sale of a security of any issuer," (2) "on the basis of material nonpublic information about that security or issuer," (3) "in breach of a duty of trust or confidence . . . owed . . . to":

- "The issuer of that security" or
- "The shareholders of that issuer" –or–
- "To any other person who is the source of the material nonpublic information"

17 C.F.R. § 240.10b5-1(a).

If you are defending a client accused of providing a tip of material nonpublic information in violation of Rule 10b-5, the government must show that the tipper (1) tipped (2) material nonpublic information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or a duty of trust and confidence owed to the source of the information (misappropriation) (4) for the personal benefit to the tipper.

Rule 14e-3 provides that communicating material nonpublic information concerning a tender offer to a person without a "need to know" about the tender offer is unlawful if it is "reasonably foreseeable" that the communication is "likely to result" in illegal trading.

Use or Possession of Material, Nonpublic Information in Connection with the Purchase or Sale of Securities

An insider trading violation must include the use or possession of material nonpublic information in connection with the purchase or sale of a security.

Materiality

Material information is information that a reasonable investor would consider in making an investment decision (see Basic Inc. v. Levinson, 485 U.S. 224 (1988); TSC Industries, Inc., v. Northway, Inc., 426 U.S. 438 (1976)). Courts have found that information dealing with the following subjects is material:

- Earnings estimates
- Significant product developments
- Major changes in management
- Significant transactions such as mergers, tender offers, joint ventures, or purchases or sales of substantial assets (including preliminary discussions or negotiations concerning such transactions)
- Public offerings
- Significant litigation or government investigations

Often, materiality is recognized by a fluctuation in stock prices once the information is publicly released. The test is not whether an investor would buy or sell stock based solely on the information at issue but whether the information alters the "total mix" of information available and thus, presumably, the stock price.

Nonpublic information

Nonpublic information is the kind that is unavailable through publicly accessible sources, even if it happens to be known to a limited group of outside individuals such as analysts, brokers or institutional investors having access to undisclosed facts.

Possession versus Use

Under both the classical and misappropriation theories of insider trading, a defendant must purchase or sell securities in reliance on, or "on the basis of," material nonpublic information. O'Hagan, 521 U.S. at 651–52.

Before Rule 10b5-1 was enacted, the circuit courts were divided on whether it was sufficient to prove that a trader possessed inside information at the time of the trade (allowing one to infer that the trade was based on the inside information), or whether there needed to be proof of an actual causal connection between the possession of that information and the trading. Compare United States v. Teicher, 987 F.2d 112 (2d Cir. 1993) (knowing possession of material nonpublic information enough to sustain an insider trading claim) with United States v. Smith, 155 F.3d 1051 (9th Cir. 1998) (requiring causal relationship between the possession of material nonpublic information and trading to establish insider trading violation).

The SEC sought to resolve this split with Rule 10b5-1, which states that:

> [A] purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

17 C.F.R. § 240.10b5-1(b).

The Second Circuit adopted a low bar this requirement in United States v. Rajaratnam, No. 11-4416-CR, 2013 U.S. App. LEXIS 12885 (2d Cir. June 24, 2013). In affirming the conviction of Raj Rajaratnam for insider trading, the court held that a jury instruction that the nonpublic information obtained by Rajaratnam "was a factor, however small" in his decision to purchase stock was proper. The court rejected Rajaratnam's argument that a more "causal connection" between the inside information and the trades was required.

As discussed in Common Substantive Defenses below, Rule 10b5-1 provides certain affirmative defenses for trading while in possession of material nonpublic information, and some courts still may require more of a causal connection rather than mere awareness of the material nonpublic information at the time of the trading.

Breach of a Fiduciary Duty or Other Relationship of Trust and Confidence

The Supreme Court recognizes two theories of a breach of duty for purposes of insider trading liability under Section 10(b) of the Exchange Act: (1) the classical theory and (2) the misappropriation theory.

The classical theory of insider trading depends on the violation of a fiduciary duty by a corporate insider. Corporate insiders possessing material nonpublic information must refrain from trading on that information until it has been publicly disclosed because of their fiduciary duties owed to the entity and its shareholders. Chiarella v. United States, 445 U.S. 222 (1980).

- Tippees of corporate insiders come within the purview of this theory and must refrain from trading due to their "role as participants after the fact in the insider's breach of a fiduciary duty." 445 U.S. at 230 n.12.

- Temporary outsiders such as underwriters, lawyers, accountants, or consultants come within the classical theory if they enter into a special confidential relationship in the conduct of the business of the company and have access to information solely for corporate purposes which they would not otherwise be privy to. (See Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)).

The misappropriation theory posits that traders may be liable for insider trading if they trade on the basis of material nonpublic information that was "misappropriated" by one who owed a duty of "trust and confidence" to the source of the information. (See United States v. O'Hagan, 521 U.S. 642 (1997)).

Rule 10b5-2 includes a non-exhaustive list of circumstances giving rise to a duty of trust and confidence that, when breached, may form the basis of an insider trading claim under the misappropriation theory:

1. Whenever a person agrees to maintain information in confidence

2. Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality –or–

3. Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information

17 C.F.R. § 240.10b5-2(b).

Rule 10b5-2 has been challenged because it predicates liability on an agreement to maintain confidentiality alone, not on any promise to refrain from use of the confidential information. See *SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009)*, vacated and remanded, 620 F.3d 551 (5th Cir. 2010).

Tippers and Tippees

Under the tipper-tippee theory of liability, fiduciaries in possession of material nonpublic information may be liable for insider trading if they pass along that information and tip others to trade on the basis of that information. See Dirks v. SEC, 463 U.S. 646, 651–652 (1983). If the tippee trades on the information while knowing that the tipper's disclosure breached a duty, then the tippee also violates the federal securities laws because he or she "inherits the duty to disclose or abstain." 463 U.S. at 664. In other words, the non-insider tippee:

> [A]ssumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information . . . when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

463 U.S. at 660.

As noted above, the classical theory involves a breach of fiduciary duty by the insider. However, under the misappropriation theory, it is also possible for the tippee but not the tipper to be liable where the insider tipper lacked intent to violate the securities laws. For example, in United States v. Corbin, 729 F. Supp. 2d 607 (S.D.N.Y. 2010), an employee shared confidential business information she obtained in the course of her work with her husband, who was a broker. The husband then shared the information with various others, including the defendant who traded on it. The husband and the trader were convicted of insider trading. United States v. Devlin, no. 08-cr-01307-WHP (S.D.N.Y.) (husband pleaded guilty); United States v. Bouchareb, no. 09-cr-00463-VM, docket ## 113–114 (S.D.N.Y. Dec. 29, 2011) (Daniel Corbin sentenced to six months' imprisonment). No charges were brought against the wife, however, as the government concluded that she had shared the information with her husband under an expectation of confidentiality and had no knowledge of his intended use of the information.

Other Theories of Deceptive Conduct

In what is likely to become a more common fact pattern, the SEC has also asserted insider trading violations when computer hackers obtain material nonpublic information, on the theory that the act of hacking into a system to obtain nonpublic information is itself deceptive and thus does not require breach of any independent duty of confidentiality to satisfy the deception element of Section 10(b). See, e.g., SEC v. Dorozhko, 574 F.3d 42, 49–50 (2d Cir. 2009).

Scienter

A violation of insider trading laws requires proof that the defendant acted with scienter (i.e., "a mental state embracing intent to deceive, manipulate, or defraud").

Civil Cases

Federal courts have adopted a recklessness standard for scienter in civil cases. See, e.g., S.E.C. v. One or More Unknown Traders in Securities of Onyx Pharmaceuticals, Inc., 296 F.R.D. 241, 250 (S.D.N.Y. 2013) ("Negligence does not rise to the level of scienter, but recklessness is sufficient."). In *SEC v. McNulty*, the Second Circuit described reckless conduct as that "[w]hich is highly unreasonable and which represents an extreme departure from the standards of ordinary care." SEC v. McNulty, F.3d 732, 741 (2d Cir. 1998).

Criminal Cases

In criminal cases, 15 U.S.C. § 78ff(a) requires that the government prove "that a person '*willfully*' violated" the securities laws or that the defendant "knowingly and purposefully" disregarded or disobeyed the securities laws. In this context, conscious avoidance can be sufficient to establish scienter. In U.S. v. Gansman, the Second Circuit approved jury instructions that allowed the jury to consider whether an insider tipper "deliberately closed his eyes to what would otherwise have been obvious to him." 657 F.3d 85, 94 (2d Cir. 2011).

The burden of proof also differs between civil and criminal cases. In civil cases, scienter must be established by a preponderance of the evidence. See SEC v. Johnson, 174 F. App'x 111, 115 (3d Cir. 2006). In criminal cases, defendant's intent must be established beyond a reasonable doubt. See Gansman, 657 F.3d at 91 n.7.

Application to Tippers

For a tipper to be held liable, "the tipper must know that the information that is the subject of the tip is nonpublic and is material for securities trading purposes, or act with reckless disregard of the nature of the information"; and "the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty." The tipper cannot avoid liability simply because he did not know with absolute certainty that the tippee would trade on the information he gave him, but will have a valid defense to scienter if he can show that he believed "in good faith" that the information he disclosed would not be used for trading purposes. Obus, 693 F.3d at 286–87.

Application to Tippee Traders

The Second Circuit has held that a tippee must know (or, in the civil context, be reckless in not knowing) not only that information is nonpublic, but also that it was disclosed in breach of a duty. As a result, the government must show that the tipper knew "that the insider disclosed confidential information in exchange for personal benefit." U.S. v. Newman, 773 F.3d 438, 449 (2d Cir. 2014), cert. denied, *136 S. Ct. 242 (2015)*. That is because "the insider's disclosure of confidential information, standing alone, is not a breach." 773 F.3d at 448. While the Supreme Court's opinion in Salman v. United States, 137 S. Ct. 420, 421 (2016), clarified that a personal benefit need not be pecuniary, and tipping to a trading relative or friend may be sufficient, Salman did not alter the Second Circuit's holding in Newman that the downstream tippee must know of the tipper's personal benefit to be held liable.

Tender Offers

In the tender offer context, Rule 14e 3 provides a "reasonably foreseeable" standard to determine whether a tipper should have known that disclosing information is "likely to result" in illegal trading. While that language sounds more akin to negligence that recklessness, defense counsel might credibly argue that Congress did not provide for liability under Section 14(e) for anything less than recklessness.

The Personal Benefit Requirement

Where the insider discloses information to a tippee who trades on the information, the test for assessing whether there has been a violation of insider trading laws is whether the insider "personally will benefit, directly or indirectly, from his disclosure." Dirks v. SEC, 463 U.S. 646, 662 (1983). The Second Circuit has held that this requirement is met if the insider "disclos[es] inside information as a gift . . . with the expectation that [the recipient] would trade" on the basis of such information or otherwise exploit it for his pecuniary gain. United States v. Martoma, 869 F.3d 58, 69 (2d Cir. 2017).

This element is relatively straightforward where there is clear quid pro quo of financial compensation to the insider. The analysis becomes more difficult where the insider does not receive anything tangible in exchange for providing the tip.

In *Newman*, the Second Circuit appeared to have narrowed the scope of the personal benefit test to require a concrete pecuniary gain to the insider. See U.S. v. Newman, 773 F.3d 438, 452 (2d. Cir. 2014) ("an inference of [personal benefit] is impermissible in the absence of proof of a meaningfully close relationship that generates an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature"). However, the Supreme Court clarified in *Salman* that the personal benefit does not have to be a concrete pecuniary gain. Rather, a gift of confidential information to a trading friend or relative may constitute a personal benefit to the insider sufficient to support an insider trading conviction. Salman v. United States, 137 S. Ct. 420, 421 (2016). The *Salman* court left open questions of what constitutes a sufficiently close friendship or familial relationship, and what constitutes a personal benefit outside the context of a close friendship or family relationship.

The Second Circuit responded to *Salman* in *Martoma*, where the Second Circuit abrogated the test it had set forth in *Newman* to hold that a gift of information to anyone is a personal benefit if it is given with the expectation that the tippee will trade. Evidence of a close relationship may still be probative to support an inference that the tipper knew trading would result, but a close relationship is not required. The Second Circuit explained that:

> [T]he straightforward logic of the gift-giving analysis in *Dirks*, strongly reaffirmed in *Salman*, is that a corporate insider personally benefits whenever he "disclos[es] inside information as a gift ... with the expectation that [the recipient] would trade" on the basis of such information or otherwise exploit it for his pecuniary gain. Salman, 137 S.Ct. at 428. That is because such a disclosure is the functional equivalent of trading on the information himself and giving a cash gift to the recipient. Nothing in *Salman*'s reaffirmation of this logic supports a distinction between gifts to people with whom a tipper shares a "meaningfully close personal relationship" . . . and gifts to those with whom a tipper does not share such a relationship.

United States v. Martoma, 869 F.3d 58, 69 (2d Cir. 2017).

The Second Circuit identified two examples of disclosures that do not constitute a personal benefit—a whistleblower and an inadvertent disclosure—and noted that it is the "province of the jury" to decide what actually motivated a tipper. Martoma, 869 F.3d at 71.

There was a lengthy dissent in *Martoma* based in part on the fact that the decision seems to open the door for more civil actions by the SEC, where the intent element can be met with circumstantial evidence indicating recklessness. If you are defending a client in a circuit that has not yet interpreted *Salman*, those arguments may still have some persuasive force.

Common Substantive Defenses

When defending an insider trading case, you should first consider any bases to challenge the evidence supporting each of the substantive elements of an insider trading claim set forth above, including:

- Whether the challenged transaction involved a "security"
- Whether the trader had information that was both (1) nonpublic and (2) material at the time of the trade
- Whether there was a deceptive act, typically in the form of a breach of a duty of confidence, either to shareholders or to the source of the information:
  - For alleged tippers, whether they received a personal benefit (or had a sufficiently close relationship with the tippee to infer a benefit) in exchange for the tip
  - For alleged tippees, whether they breached a duty of confidence to the tipper by trading, or knew that an insider had breached a duty of confidence by providing the tip without any such expectation of confidence (including whether they knew the insider tipper received a personal benefit)
- Whether the government can prove the requisite level of intent

In addition, you should consider the following defenses.

Establish an Alternative Basis for the Trading

Under both the classical and misappropriation theories of insider trading, a defendant must purchase or sell securities "on the basis of" material nonpublic information. (O'Hagan, 521 U.S. at 651–52.) As noted above, the SEC has adopted an "awareness" standard identical to the "knowing possession" standard followed by the Second Circuit (17 C.F.R. § 240.10b5-1(b)), and the Second Circuit found proper a jury instruction that the nonpublic information "was a factor, however small" in the decision to purchase stock. United States v. Rajaratnam, No. 11-4416-CR, 2013 U.S. App. LEXIS 12885 (2d Cir. June 24, 2013).

While that sets a low bar for the government to establish that trades were "on the basis" of inside information, you should still consider whether the trading has some other basis in which material nonpublic information was not a factor at all.

Safe Harbor for Rule 10b5-1 Trading Plans

For those with regular access to material nonpublic information, Rule 10b5-1 plans are the most common way to facilitate trading for reasons unrelated to inside information. A Rule 10b5-1 plan is a written plan for trading securities, and such plans are widely used by directors and officers of public companies, large stockholders, and other insiders.

Under Rule 10b5-1(c), any person executing preplanned transactions pursuant to a Rule 10b5-1 plan that was established in good faith has an affirmative defense against accusations of insider trading, even for trades that are executed under the plan at a time when the individual may be aware of material nonpublic information.

Rule 10b5-1 provides an affirmative defense based on plans that are established when an insider has no material nonpublic information about the company or its securities. To conform to Rule 10b5-1, a plan must (1) be established in good faith (2) before the person becomes aware of material nonpublic information, and (3):

- Specify the amount, price, and specific dates of purchases or sales
- Include a written formula, algorithm, or program for determining amount, price, and date of trading –or–
- Grant exclusive authority for trading to someone who is not aware of any material nonpublic information at the time the trades are made

Moreover, there cannot have been any trading under the plan for a reasonable period of time after the plan was adopted and the insider must have had only one plan at a time with minimal amendments or terminations. The person also may not deviate from the plan to enter into any corresponding or hedging transactions or positions with respect to the security.

For additional guidance, see Understanding Rule 10b5-1 Plans and Advising on Their Use and 10b5-1 Plans Best Practices Checklist.

Mosaic Theory

The mosaic theory is a defense premised on the argument that a defendant obtained information legally in bits and pieces, with no single disclosure that constituted material nonpublic information. Only after such disparate pieces of information were assembled could the final mosaic lead to discovery of material nonpublic information. The SEC itself has acknowledged that an investor can "assemble pieces of nonpublic and immaterial information into a mosaic that reveals a material conclusion." Speech by SEC Staff: New Rules, Old Principles, U.S. Securities and Exchange Commission (Dec. 4, 2000) (statements by David Becker), available here http://www.sec.gov/news/speech/spch444.htm).

To succeed, the defense must demonstrate that each individual piece of information that forms a part of the "mosaic" is, by itself, immaterial information.

The SEC's adoption of Regulation FD, however, has made it more difficult for defendants to successfully assert a mosaic theory defense. The SEC has stated that, while an issuer is not prohibited from disclosing an immaterial piece of information to an analyst, Regulation FD prohibits issuers from attempting to "render material information immaterial simply by breaking it into ostensibly nonmaterial pieces" (Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154). Yet, at the same time, the SEC explicitly recognized that an issuer was not prohibited from "disclosing . . . non-material piece[s] of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a 'mosaic' of information that, taken together, is material." SEC, Comments to Reg FD, available here http://www.sec.gov/rules/final/33-7881.htm.

Thus, under Reg. FD, persons are not prohibited from using outside experts—or even "channel checking" (collecting information from distribution channels)—in order to assemble a mosaic.

Good Faith Reliance

A defendant may be able to refute an insider trading claim based on their reliance on advice of counsel in limited circumstances. To avail themselves of this defense, the defendant must have:

- Disclosed all relevant facts and circumstances to counsel
- Requested advice from counsel about the trade being contemplated

- Received advice that was legal –and–
- Relied in good faith on that advice

See SEC v. Goldfield Deep Mines Co. of Nev., 758 F.2d 459,467 (9th Cir. 1985). In those circumstances, the reliance on counsel tends to rebut any allegation of intent to violate the securities laws. However, the defense is not absolute and it requires that the defendant waive attorney-client privilege, so you should carefully consider the potential consequences of that waiver before asserting the defense.

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