INTENT TO RECONCILE: *SEC V. OBUS*, THE SECOND CIRCUIT'S EDIFICATION OF THE TIPPEE SCIENTER STANDARD

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INTRODUCTION

On September 6, 2012, the U.S. Court of Appeals for the Second Circuit resurrected a $1.3 million enforcement action initiated by the U.S. Securities Exchange Commission (SEC) against, among others,

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Wynnefield Capital, Inc. founder Nelson Obus.[1] Finding that the SEC provided sufficient evidence to create genuine issues of material fact as to whether Obus and the other defendants engaged in conduct amounting to insider trading in violation of the Securities Exchange Act of 1934[2] and Rule 10b-5[3] promulgated thereunder, the Second Circuit vacated the district court's decision to grant summary judgment in favor of the defendants.[4] However, the significance of the Second Circuit's decision is not limited to its revival of the SEC's complaint. Perhaps more importantly, the opinion offered a long-awaited resolution to the question of the degree of knowledge a tippee[5] must have in order to satisfy insider trading's scienter element.[6] The Second Circuit opined that sufficient scienter exists when the "tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly" and "the tippee intentionally or recklessly traded while in knowing possession of that information."[7]

This Note argues that by adopting both a negligence and actual knowledge standard in *SEC v. Obus*,[8] the Second Circuit failed to provide a practical resolution to the apparent tippee scienter conflict. Part I provides a brief overview of the seminal Supreme Court cases that define the ambits of insider trading regulation and outlines the theoretical inconsistency in the Supreme Court's approach to tippee scienter. Part II sets forth the facts and procedural history of *Obus* and provides the details of the Second Circuit's decision. Part III contends that by adopting the conflicting language without offering a workable application mechanism, the Second Circuit merely

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1. SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).
2. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78ee (2006 & Supp. IV 2011)).
3. 17 C.F.R. § 240.10b-5 (2012).
4. *Obus*, 693 F.3d at 279.
5. A "tippee" is an individual who trades in securities on the basis of nonpublic information obtained from a corporate insider or misappropriator. The types of individuals considered to be "insiders" include officers, directors, and majority and controlling shareholders. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). In this Note, the term "misappropriator" is used to describe an individual, such as an independent certified public accountant or outside legal counsel, who misappropriates confidential corporate information to which he or she had legitimate access. United States v. O'Hagan, 521 U.S. 642, 652 (1997); *see also infra* text accompanying notes 25–26.
6. *Obus*, 693 F.3d at 287–88. Scienter is the "degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission." BLACK'S LAW DICTIONARY 1463 (9th ed. 2009). The Supreme Court, in *Ernst & Ernst v. Hochfelder*, 463 U.S. 646 (1983), adopted scienter as an element of section 10(b) and Rule 10b-5 liability.
7. *Obus*, 693 F.3d at 288.
8. 693 F.3d 276 (2d Cir. 2012).

solidified the incongruity surrounding tippee scienter rather than providing for a remedy. Part III further argues that the Second Circuit undermined the connection between insider trading and fraud by adopting a negligence standard.

I. BACKGROUND

A. Liability for Insider Trading: An Overview of the Supreme Court's Interpretation of Section 10(b) and Rule 10b-5

Prohibition of insider trading—the "unlawful trading in securities based on material non-public information"[9]—is well vested in the American legal system.[10] However, the statutory footing on which the prohibition stands—section 10(b) of the Exchange Act with companion Rule 10b-5—is notably devoid of any express proscription.[11] Instead, section 10(b) and Rule 10b-5 state merely that it is unlawful for individuals to perpetrate a fraud or deceit upon any person in connection with the purchase or sale of securities.[12]

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9. *Id.* at 284.

10. *See Cady, Roberts*, 40 S.E.C. at 907 (noting that the need for securities regulation is so well known and the prevention of fraud so understood to be a major purpose of that regulation that "citation is unnecessary"); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 936 (5th ed., 2004) (commenting on how the extensive development of Rule 10b-5 reflects a unique conflation of legislative, administrative, and judicial law); Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1293 (1998) (observing the ongoing position insider trading has held on the pens of federal judges and legal commentators); William R. McLucas et al., *Settlement of Insider Trading Cases with the SEC*, 48 BUS. LAW. 79, 85 (1992) (describing the continual importance of insider trading as one of the SEC's primary areas of enforcement).

11. *See* 15 U.S.C. § 78j(b) (Supp. IV 2011) ("It shall be unlawful . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any . . . deceptive device . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate . . . ."); 17 C.F.R. § 240.10b-5 (2012) ("It shall be unlawful . . . [t]o employ any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security."); *cf.* Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1166–68 (1997) (discussing Congress's unsuccessful attempt to provide a legislative definition for insider trading). Although section 10(b) and Rule 10b-5 delineate certain conduct as unlawful, neither provide for a private right of action to individuals injured by a violation thereof. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 164 (2008). However, beginning in 1946 with *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), courts have consistently recognized a private right of action for 10b-5 violations. Anne T. Foley, Note, *The Clarification of Tippee Liability Under Rule 10b-5:* Dirks v. SEC, 25 B.C. L. REV. 1059, 1060 n.7 (1984) (citing RICHARD W. JENNINGS & HAROLD MARSH, JR., SECURITIES REGULATION: CASES AND MATERIALS 808 (5th ed., 1982)). Conversely, criminal liability for Rule 10b-5 violations is provided for in section 32(a) of the Exchange Act. 15 U.S.C. § 78ff(a).

12. John I. McMahon, Jr., Note, *A Statutory Definition of Insider Trading: The Need To Codify the Misappropriation Theory*, 13 DEL. J. CORP. L. 985, 986–87 (1988).

Thus, in the absence of more specific direction from Congress or the SEC, courts have been left to define the contours of the law against insider trading.[13]

Generally, the Supreme Court has interpreted "deceptive device"[14] in section 10(b) to include the use of inside information, i.e., material nonpublic information about an issuing company or the market, in connection with the buying and selling of securities.[15] However, the Court has stopped short of classifying all securities trading on the basis of inside information as a form of deception contemplated by the Act and accompanying Rule.[16] Instead, the Court has built its insider trading jurisprudence on the notion that only certain individuals have a duty to either disclose inside information or abstain from trading on it.[17] In *Chiarella v. United States*,[18] the Supreme Court articulated that the duty to disclose or abstain arises from the existence of a fiduciary relationship between a corporate insider and the corporation's shareholders.[19] The *Chiarella* Court explained that it is this duty that implicates section 10(b) and

13. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."); Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 545 (2011) ("The law of securities fraud is one of the most heavily judicially created bodies of federal law."); Dalley, *supra* note 10, at 1294 ("[F]ederal courts have been left to determine what exactly is common law fraud in the securities context."). Eventually, the SEC formally acknowledged insider trading as conduct prohibited by section 10(b), after years of uncertainty among courts, legislators, and legal and business commentators as to the scope of insider trading regulation. 17 C.F.R. § 240.10b5-1(a) (2000). For a discussion of the impetus and reaction to Rule 10b5-1, see generally Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 190–96 (2003).

14. 15 U.S.C. § 78j(b).

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

16. Dirks v. SEC, 463 U.S. 646, 658–59 (1983).

17. Chiarella v. United States, 445 U.S. 222, 226–27 (1980).

18. 445 U.S. 222 (1980). *Chiarella* involved an employee of a financial printer who was convicted of securities trading in violation of section 10(b) and Rule 10b-5. *Id.* at 224–25. By deciphering coded takeover bid announcements that were to be printed by his employer company, Chiarella learned the identity of certain corporations targeted for acquisition. *Id.* at 224. Before the potential acquisitions were announced, Chiarella purchased stock in the targeted companies. *Id.* He then sold the stock when the bids were made public. *Id.* Chiarella was indicted and subsequently convicted in district court on seventeen counts of violating 10(b) and Rule 10b-5. *Id.* at 225. The Second Circuit affirmed the convictions, which were ultimately reversed by the Supreme Court. *Id.*

19. *Id.* at 227. Under this theory, Chiarella's conviction was reversed by the Court because he did not have a fiduciary or similar relationship of trust and confidence with the targeted companies, and therefore, he did not have a duty to disclose or abstain from trading. *Id.* at 233–35. The *Chiarella* decision foreclosed on a dueling theory of liability that anyone who had access to material nonpublic information had the duty to disclose or abstain. *See id.* at 231–33 (refusing to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information").

Rule 10b-5's antifraud provisions, because consistent with misrepresentation in the common law, "one who fails to disclose material information . . . commits fraud only when he is under the duty to do so."[20]

The Court confers the duty to disclose or abstain on the basis of one of two theories: the classical theory or the misappropriation theory. Under the classical theory, corporate insiders are precluded from using material nonpublic information to trade in the securities of that corporation.[21] The classical theory is premised on the trust and confidence owed to a corporation's current and future shareholders by corporate insiders who acquire confidential information as a result of their position.[22] The shareholder is entitled to the inside information known by the insider as a consequence of the trust-evoking nature of their relationship.[23]

Under the misappropriation theory, sanctioned by the Supreme Court in *United States v. O'Hagan*,[24] it is not the corporate insider who has a duty to disclose or abstain, but rather the corporate outsider who has been entrusted with confidential information and who owes a duty to the source of that information not to use it for his or her personal benefit.[25] The misappropriation theory is premised on the notion that "[a] fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain, dupes or defrauds the principal."[26]

Under both the classical and misappropriation theories, liability for insider trading is not strictly limited to those insiders and misappropriators who personally trade on the inside information.[27] The Court feared that such a limitation would result in fiduciaries doing indirectly that which they could not do directly.[28] Thus, the Court has interpreted section 10(b) and Rule 10b-5's proscriptions to also include situations in which the insider or misappropriator relates

20. *Id.* at 228. *But see id.* at 247 (Blackmun, J., dissenting) (arguing that common law support for the majority's position is tenuous at best); Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 360–66 (1982) (criticizing the *Chiarella* Court's application of the misrepresentation doctrine to the insider trading context).
21. *Chiarella*, 445 U.S. at 230.
22. *Id.*
23. *Id.* at 228.
24. 521 U.S 642 (1997).
25. *Id.* at 652.
26. *Id.* at 653–54 (second alteration in original) (citation omitted) (internal quotation marks omitted).
27. WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 167 (3d ed. 2010).
28. Dirks v. SEC, 463 U.S. 646, 659 (1983).

inside information to another individual who uses the information to trade.[29]

B. Tippee Liability Under Section 10(b) and Rule 10b-5: The Scienter Element and the Apparent Conflict Between Dirks v. SEC *and* Ernst & Ernst v. Hochfelder

In *Dirks v. SEC*,[30] the Court held that liability for insider trading extends to instances where an insider or misappropriator tips material nonpublic information to a third party who then trades on the basis of that tip.[31] Under *Dirks*, a tippee inherits the tipper's duty to disclose or abstain when the tipper has breached his or her fiduciary duty by relating inside information to the tippee[32] and the tippee "knows or *should know* that there has been a breach."[33] It is the Court's use of "should know," language typically denoting a negligence standard,[34] which is the source of considerable confusion surrounding tippee liability, as seven years prior to its decision in *Dirks*, the Court had expressly ruled that negligent conduct would not give rise to section 10(b) liability.[35]

In *Ernst & Ernst v. Hochfelder*,[36] the Court concluded that the plain language of section 10(b) "so clearly connotes intentional

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29. *Id.* at 654–64 (accepting tippee liability for insider trading).

30. 463 U.S. 646 (1983). The *Dirks* Court reviewed the conviction of Raymond Dirks, a securities analyst who received material nonpublic information from insiders of a corporation with which he otherwise had no connection. *Id.* at 648. Dirks relayed this information to investors who used the information to trade in the corporation's shares. *Id.*

31. *See id.* at 659–60 (recognizing that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain"). Although the *Dirks* decision only addressed tipper/tippee liability under the classical theory of insider trading, circuit courts have adopted *Dirks* in the misappropriation context. *See, e.g.*, SEC v. Obus, 693 F.3d 276 (2d Cir. 2012); SEC v. Talbot, 530 F.3d 1085 (9th Cir. 2008); United States v. Evans, 486 F.3d 315 (7th Cir. 2007); SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003). *But see* WANG & STEINBERG, *supra* note 27, at 207–08, 388–89, 476–82 (discussing the practical and theoretical difficulties associated with establishing tipper/tippee liability under the misappropriation theory).

32. The test for whether the tipper breached a fiduciary duty by disclosing the information is determined by whether he or she derives "benefit, directly or indirectly, from [the] disclosure." *Dirks*, 463 U.S. at 662.

33. *Id.* at 660 (emphasis added).

34. *See, e.g.*, RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 cmt. g (2010) (stating that to establish an actor's negligence, the likelihood of harm must have been foreseeable, as determined by "what the actor 'should have known'"); RESTATEMENT (SECOND) OF TORTS § 284 cmt. a (1965) (stating that negligent conduct is the performance of an act that the actor "knows or should know[] would realize the existence of the risk and its unreasonable character").

35. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

36. 425 U.S. 185 (1976).

misconduct" that a private action could not survive merely on a showing of negligence.[37] The Court observed that nothing in section 10(b)'s legislative history indicated that Congress intended to proscribe conduct without scienter.[38] While the *Hochfelder* Court generally defined "scienter" as the "mental state embracing intent to deceive, manipulate, or defraud,"[39] the Court failed to provide a precise measure of the degree of knowledge that would satisfy the scienter requirement.[40] Instead, the Court made clear what would not: negligence.[41]

Therefore, the Court's adoption of negligence-type rhetoric in the *Dirks* opinion has generated a great deal of uncertainty as to the degree of knowledge required for tippee liability under section 10(b).[42] Notably, the *Dirks* opinion does not reject or attempt to distinguish the scienter requisite from the *Hochfelder* Court; in fact, the *Dirks* opinion reaffirms that scienter is a requirement for section 10(b) liability.[43] Even with the *Dirks* Court's clear acceptance of scienter as an element of insider trading, legal authorities are hesitant to dismiss the opinion's use of "should know" as simply

37. *Id.* at 200–01. Although the *Hochfelder* Court only addressed the question of whether intent was required in section 10(b) private civil actions, the Court in *Aaron v. SEC*, 446 U.S. 680 (1980), extended the requirement to administrative actions brought by the SEC. *Id.* at 701–02.

38. *Hochfelder*, 425 U.S. at 202.

39. *Id.* at 194 n.12.

40. *See* Buell, *supra* note 13, at 534 (explaining that the statement, "scienter is required for liability," in practice does no more than rule out strict liability, and therefore, a range of cognizance levels may be encompassed by the word). The *Hochfelder* Court specifically reserved the question of whether recklessness satisfies the scienter requirement, 425 U.S. at 194 n.12, and the Court has yet to rule on the matter, Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1322 (2011). Among the circuit courts, recklessness has widely been adopted as a sufficiently culpable mental state. *See, e.g.*, SEC v. Obus, 693 F.3d 276, 286 (2d Cir. 2012); SEC v. Shanahan, 646 F.3d 536, 543 (8th Cir. 2011); SEC v. Platforms Wireless Int'l Corp., 617 F.3d 1072, 1093 (9th Cir. 2010); SEC v. Lyttle, 538 F.3d 601, 603 (7th Cir. 2008); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982).

41. *Hochfelder*, 425 U.S. at 214–15 & n.33.

42. *See* WANG & STEINBERG, *supra* note 27, at 403 & n.487 (outlining the contrasting approaches commentators have offered to reconcile the *Dirks* Court's "knows or should know" test and the scienter requirement); William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under Federal Securities Law*, 34 HOUS. L. REV. 121, 122 (1997) ("The state of mind required to commit fraud under Section 10(b) . . . has long been a subject of uncertainty."). *But see* WANG & STEINBERG, *supra* note 27, at 168 (maintaining that the requirement that the tippee knows or should know is distinct from the scienter element).

43. Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983) ("[A] violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors . . . .'" (quoting *Hochfelder*, 425 U.S. at 199)).

careless word choice,[44] and the Court has propagated this stance by continuing to quote the *Dirks* opinion's "should know" language in its insider trading jurisprudence.[45] When the Second Circuit issued its *Obus* opinion in September 2012, almost thirty years after the *Dirks* decision, the implication of the Court's use of "should know" was still unanswered.[46]

II. *SEC v. OBUS*

A. *Facts and Procedural History*

In the spring of 2001, Allied Capital Corporation approached General Electric Capital Corporation (GE) about financing for Allied's prospective acquisition of SunSource, Inc.[47] As assistant vice president and underwriter for GE, Thomas Strickland learned about the potential acquisition when he was assigned by his employer to perform due diligence for the deal.[48] Strickland then learned that Wynnefield Capital was a large shareholder in SunSource.[49] The SEC alleged that it was at this point when Strickland contacted his old college friend and Wynnefield Capital employee, Peter Black, and tipped him to the pending acquisition.[50] Conversely, Strickland and Black maintained that their conversation pertained only to Strickland's inquiry into

44. *See, e.g.*, ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 12:132 (2012), *available at* Westlaw SECDRSL (contending that use of "should know" in the *Dirks* opinion was hardly a "slip of the pen").

45. *See, e.g.*, United States v. O'Hagan, 521 U.S 642, 675 (1997) (holding that insider trading liability was supported by the misappropriation theory when a lawyer representing a company during a merger traded on the information); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 311 n.21 (1985) (affirming a decision permitting tippees to sue for misrepresentations). Circuit courts have since parroted the *Dirks* Court's use of "should know" when addressing questions of tippee liability. *See, e.g.*, WPP Lux. Gamma Three Sarl v. Spot Runner, Inc., 655 F.3d 1039, 1056 (9th Cir. 2011), *cert. denied*, 132 S. Ct. 2713 (2012); SEC v. Rocklage, 470 F.3d 1, 5 (1st Cir. 2006); United States v. Falcone, 257 F.3d 226, 232 (2d Cir. 2001); United States v. Ruggiero, 56 F.3d 647, 655 (5th Cir. 1995); SEC v. Maio, 51 F.3d 623, 632 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1166 (10th Cir. 1992). *But see, e.g.*, SEC v. Yun, 327 F.3d 1263, 1270 (11th Cir. 2003) (failing to employ the *Dirks* Court's "should know" standard); SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) (same).

46. *See* JACOBS, *supra* note 44, § 12:119 (asserting that the anomalies between *Dirks* and *Hochfelder* "continue to plague" us today); Thomas O. Gorman, *Case Study:* SEC v. Obus, LAW 360 (Sept. 17, 2012, 12:09 PM), http://www.law360.com/white collar/articles/378428/case-study-sec-v-obus (suggesting that the significance of the *Obus* decision was its resolution of the crucial issue related to tippee scienter).

47. SEC v. Obus, 693 F.3d 276, 279 (2d Cir. 2012).

48. *Id.*

49. *Id.* at 280. This information was obtained by Strickland via public sources. *Id.*

50. *Id.*

Black's opinion of SunSource's management, which Strickland sought as part of his due diligence analysis.[51]

Soon after, Black contacted his boss at Wynnefield Capital, Nelson Obus.[52] The SEC and Black disagreed about the details of Black's conversation with Obus. Black maintained that he contacted his boss to relay his suspicion, based on Strickland's questions, that SunSource was contemplating a transition that would dilute its existing shares.[53] The SEC asserted that Black disclosed Allied's pending acquisition of SunSource, which was not yet public information.[54] Following his conversation with Black, Obus called SunSource's CEO, Maurice Andrien.[55] Andrien claimed that in the course of their conversation he learned that Obus had been tipped about the acquisition, a fact that Obus denied.[56]

On June 8, 2001, about two weeks after Black and Strickland's initial conversation, Wynnefield Capital purchased 287,200 shares of SunSource at $4.75 per share.[57] The transaction was initiated by a trader at an outside trading company who contacted Wynnefield Capital with the offer.[58] Wynnefield Capital's June 8th purchase was approximately the same size as the company's earlier purchases of SunSource stock.[59] On June 19, 2001, Allied publicly announced that it was acquiring SunSource.[60] As a result, SunSource's share price nearly doubled in value, earning Wynnefield Capital a paper profit of about $1.3 million.[61]

Subsequently, the SEC filed a complaint against Obus, Black, and Strickland for alleged violation of section 10(b) and Rule 10b-5.[62] Under the misappropriation theory,[63] the SEC asserted that as an employee of GE, Strickland had a duty to the corporation to keep confidential the information regarding the SunSource acquisition, and that he breached that duty when he disclosed the information to

51. *Id.*
52. *Id.* at 280–81.
53. *Id.*
54. *Id.* at 281.
55. *Id.*
56. *Id.* Andrien testified that Obus had told him "a little birdie told me that you guys are planning to sell the company to a financial buyer," and implied, then confirmed, that the "little birdie" was someone at GE. *Id.*
57. *Id.* at 282.
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.* at 283.
63. *See supra* text accompanying notes 25–26 (explaining that the misappropriation theory allows for liability upon breach of a fiduciary duty owed to the source of material nonpublic information).

Black.[64] The SEC sought to hold Black and Obus liable as tippees—after-the-fact participants in Strickland's breach.[65]

The U.S. District Court for the Southern District of New York granted the defendants' motion for summary judgment, determining that the SEC had failed to establish a genuine issue of material fact regarding whether Strickland breached his duty to GE.[66] The court based its decision on the fact that GE's internal investigation of Strickland's conduct found that Strickland had not breached his duty to the corporation.[67] Finding that Strickland—the alleged tipper—had not breached his duty, the court concluded that Black and Obus could not be held liable as tippees.[68] The SEC appealed the district court's order, and the Second Circuit reviewed the case de novo.[69]

B. The Second Circuit's Decision

The Second Circuit began its discussion with an overview of the misappropriation theory and the status tipping holds as a basis for insider trading liability.[70] In its discussion, the court noted the role that scienter plays as a requisite for liability, stating, "[i]n every insider trading case, at the moment of tipping or trading, . . . the unlawful actor must know or be reckless in not knowing that the conduct was deceptive."[71] Turning its attention specifically to the tippee's scienter, the court espoused the rule established by the *Dirks* Court and highlighted the nature of its conflict with the *Hochfelder* opinion.[72] The Second Circuit asserted that both standards were relevant to the question of tippee liability and that their conflict with each other is cured by distinguishing the facts or conditions to which the different standards pertain. Specifically, the court offered the following:

64. SEC v. Obus, No. 06 CIV 3150 GBD, 2010 WL 3703846, at *14 (S.D.N.Y. Sept. 20, 2010), *vacated*, 693 F.3d 276 (2d Cir. 2012). The SEC also asserted liability under the classical theory, *id.* at *10–13; however, this Note limits its discussion to misappropriation because the SEC appealed to the Second Circuit solely on that theory.
65. *Id.* at *1.
66. *Id.* at *16.
67. *Id.* at *15–16.
68. *Id.*
69. *Obus*, 693 F.3d at 284.
70. *Id.* at 284–85.
71. *Id.* at 286.
72. *Id.* at 286–88; *see supra* Part I.B (explaining the apparent conflict between the *Dirks* decision, which implies that tippee liability can be established through a negligence standard, and the *Hochfelder* decision, which rejected negligence as sufficient for liability).

> [T]he 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 . . . . *Dirks*' knows or should know standard pertains to a tippee's knowledge that the tipper breached a duty . . . to his principal . . . . *Hochfelder*'s requirement . . . pertains to the tippee's eventual use of the tip through trading or further dissemination of the information.[73]

The court explained that this framework applies to each tippee in a "tipping chain."[74] As such, each tippee must know or have reason to know that the information was procured through a breach, and each tippee must intentionally or recklessly trade on the information or further tip the information for personal benefit.[75]

Applying this framework, the court concluded that contrary to the district court's ruling, the SEC had offered sufficient evidence to withstand summary judgment.[76] The Second Circuit first determined that the SEC had provided sufficient evidence to establish a factual question as to whether Strickland breached his fiduciary duty to GE by tipping Black on the acquisition.[77] The Second Circuit determined that the findings by the GE internal investigation were not determinative, concluding that there was otherwise sufficient evidence that Strickland knew he owed GE a duty to keep the acquisition information confidential and not to use it for his personal profit.[78]

The court next turned to whether Black inherited the duty to disclose or abstain as a derivative of Strickland's breach.[79] The circuit court performed a fact-specific analysis to determine if Black knew or should have known that Strickland breached his fiduciary duty to GE when he conveyed the confidential information to Black.[80] The Second Circuit found that Black was a sophisticated financial analyst,

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73. *Obus*, 693 F.3d at 288.
74. *Id.*
75. *Id.*
76. *Id.* at 293. Summary judgment is appropriate only where "the pleadings, the discovery and disclosure materials on file, and any affidavits show that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law." FED. R. CIV. P. 56(c)(2). A genuine issue of material fact exists when the evidence is such that a reasonable jury could find in favor of the nonmoving party. Anderson v. Liberty Lobby, Inc. 477 U.S. 242, 248 (1986). Considering this high bar, which a defendant moving for summary judgment must overcome, the Second Circuit's decision is not untenable in light of evidence presented by the SEC. *See supra* notes 47–65 and accompanying text (offering the facts alleged by the SEC and the defendants as understood by the Second Circuit).
77. *Id.* at 291.
78. *Id.*
79. *Id.* at 292.
80. *Id.* at 288, 292.

Black personally knew Strickland and that Strickland worked for GE in the development of financing packages, and Black knew that information related to a pending acquisition would be both confidential and material to trading.[81] These facts, the court concluded, would allow a jury to find that Black knew or had reason to know that Strickland's tip constituted a breach of his fiduciary duty.[82]

Lastly, the Second Circuit evaluated whether Obus—the final tippee in the chain—also inherited the duty to disclose or abstain.[83] The court admitted that unlike the situation with Black, there was no evidence to indicate that Obus was aware of Strickland's precise position at GE.[84] Yet, this fact was not fatal, as the court found that Obus's financial sophistication gave him reason to know that Strickland breached his fiduciary duty, a conclusion further supported by Obus's call to Andrien.[85] The Second Circuit surmised that from the facts taken together, a jury could determine that Obus knew or had reason to know that Strickland had a duty to keep the acquisition information confidential.[86] The Second Circuit completed its analysis of Obus's liability by finding that the SEC provided sufficient evidence for a jury to also determine that Obus traded while he knowingly possessed material nonpublic information.[87]

III. APPLYING TWO DIFFERENT STANDARDS OF AWARENESS RESULTS IN A LOGICAL INCONGRUITY AND IS INCONSISTENT WITH INSIDER TRADING'S CONNECTION TO FRAUD

The Second Circuit appears to have taken a Solomon-like approach in resolving the conflict between the *Dirks* and *Hochfelder* decisions, splitting the elements of tippee liability and assigning a distinctive knowledge standard to each. The *Dirks* negligence-like standard emerges in the court's discussion of the tippee's knowledge that the tipper breached his or her fiduciary duty in communicating the information.[88] The *Hochfelder* actual (or reckless) knowledge standard emerges in the court's discussion of what the tippee does

81. *Id.* at 292.
82. *Id.*
83. *Id.* at 292–93.
84. *Id.* at 293.
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.* at 288.

with that information.[89] At first blush, the Second Circuit's approach seems to be a workable, if not obvious, resolution of the *Dirks-Hochfelder* conflict, as it preserves—at least superficially—the edicts of both opinions.[90] However, the court's resolution requires that these two elements of tippee liability can be severed and analyzed independently under differing standards of awareness,[91] a condition that this Note argues is both impractical and contrary to insider trading liability's foundation in fraud.

In what is otherwise described as a murky body of law,[92] there is little doubt that liability for insider trading under section 10(b) and Rule 10b-5 requires both the existence of a duty to disclose or abstain derived from a fiduciary relationship and the improper use of material nonpublic information as a basis for trading.[93] In effect, the Second Circuit resolved the *Dirks-Hochfelder* conflict by distinguishing the state of mind required to create the tippee's duty to disclose or abstain from the state of mind required to create liability for the tippee's failure to disclose or abstain in light of this duty.[94] The problem with such a distinction is that the tippee's knowledge of the tipper's breach cannot be strictly isolated to its function of giving rise to the tippee's duty to disclose or abstain. Understanding the flaw in the Second Circuit's dual-awareness approach requires a critical look at how these two requirements interact to create tippee liability. For a tippee to be liable under section 10(b) and Rule 10b-5, the tippee must not just knowingly trade on information; he or she must knowingly trade on *improper* information.[95] The information's

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89. *Id.*

90. *Compare id.* at 288 ("[T]ippee liability can be established if a tippee knew or had *reason to know* that confidential information was initially obtained and transmitted improperly . . . , and if the tippee intentionally or recklessly traded while in knowing possession of that information." (emphasis added)), *with* Dirks v. SEC, 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation . . . only when . . . the tippee knows or *should know* that there has been a breach." (emphasis added)), *and* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (concluding that liability under section 10(b) and Rule 10b-5 will not lie in the absence of "knowing or intentional misconduct").

91. *See Obus*, 693 F.3d at 288 ("[T]he 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 . . . .").

92. Kimberly D. Krawiec, *Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing* United States v. O'Hagan, 33 TULSA L.J. 163, 163 (1997).

93. Stuart Sinai, *Rumors, Possession v. Use, Fiduciary Duty and Other Current Insider Trading Considerations*, 55 BUS. LAW. 743, 757 (2000); Swanson, *supra* note 13, at 201–02.

94. *See Obus*, 693 F.3d at 288; *see also supra* Part I.A (describing the theories under which the duty to disclose or abstain arises and under what circumstances this duty creates liability for insider trading).

95. *See Dirks*, 463 U.S. at 659–60 (rejecting the assertion that anyone who possesses material nonpublic information is prohibited from trading on that

impropriety stems not from the fact that it is material and confidential;[96] it stems from the conditions under which the information was gained.[97] In the case of a tippee, the improper nature of the information results from the tipper's breach.[98] Therefore, the tippee's knowledge of the tipper's breach can be said to "necessitate[] tippee knowledge of each element."[99]

However, the Second Circuit maintains that the *Hochfelder* Court's knowing or reckless standard applies only to the tippee's use of material nonpublic information[100] and not to the tippee's knowledge of the information source. Thus, there is a degree of incongruity in the Second Circuit's approach, as it would seem that a tippee, who only negligently knew of the tipper's breach, could not then knowingly trade on the basis of improper information if the information is only made improper by the breach.[101] In other words, the negligence standard annuls the actual or reckless knowledge standard in that a tippee may knowingly or recklessly trade on information without knowing that the information is of the type of which the Act and accompanying Rule prohibit trading. Such an effect would be contrary to insider trading regulation's foundation in common law fraud and to its purpose of protecting the stability of the securities market.

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information and extending liability only when one "assume[s] an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*").

96. Chiarella v. United States, 445 U.S. 222, 233 (1980) (rejecting the theory that there is a "general duty between all participants in market transactions to forgo actions based on material, nonpublic information").

97. *Id.* at 230; *see also* SEC v. Falbo, 14 F. Supp. 2d 508, 524 (S.D.N.Y. 1998) (stating that for a tippee to have acted with scienter, the tippee must be in "knowing possession of material information obtained in violation of a duty of trust and confidence"); Anderson, *supra* note 20, at 360–61 (concluding that the Court's discussion of tippee liability in *Chiarella* "suggests that the wrong associated with the tippee's behavior is not deception of the other party to the trade[,] . . . [r]ather, the wrong is the use of confidential information improperly acquired").

98. Swanson, *supra* note 13, at 201–02; *see also Obus*, 693 F.3d at 288 ("[T]ippee 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)" (emphasis added)); LOSS & SELIGMAN, *supra* note 10, at 1003 (postulating that the theory of tippee liability is "simply a manifestation of the broader principle that the transactions of those who knowingly participate with the fiduciary in [his or her] breach are as forbidden as transactions [completed] on behalf of the trustee himself." (first alteration in original) (quoting *Dirks*, 463 U.S. at 659) (internal quotation marks omitted)).

99. State Teachers Ret. Bd. v. Fluor Corp., 592 F. Supp. 592, 594 (S.D.N.Y. 1984).

100. *Obus*, 693 F.3d at 286.

101. *Cf.* Buell, *supra* note 13, at 532 ("[I]f a court holds that fraud requires an intent to defraud and that an intent to defraud, in turn, requires scienter as to the falsity of the representation, then the second fault standard has displaced the first." (footnote omitted)); JACOBS, *supra* note 44, § 12:119 (explaining the anomalies that exist when one tries to apply both the *Hochfelder* and *Dirks* standards).

The decisions in *Chiarella*, *Dirks*, and *O'Hagan* can be read to create a general scheme of insider trading liability: Section 10(b) and Rule 10b-5 prohibit fraudulent deception; deception occurs where there is a knowing and unlawful failure to disclose or abstain from trading on material nonpublic information; the failure to disclose or abstain is unlawful only where there is a duty to disclose or abstain; the duty to disclose or abstain arises only where there exists a fiduciary relationship between insider/misappropriator and the shareholders/information source.[102] *Hochfelder*'s scienter requirement flows from this basis, as "deception necessarily implicates state of mind."[103]

Tippee liability for insider trading does not fit seamlessly into this arrangement because a typical tippee does not meet the last requirement—a direct fiduciary relationship.[104] The *Dirks* Court explained that absent this direct fiduciary relationship, a tippee's duty is derivative of that of the possessor of the fiduciary relationship, arising only when the fiduciary has breached the relationship and the tippee is aware of that breach.[105] The Court elucidated that "the tippee's obligation has been viewed as arising from his *role as a participant* after the fact in the insider's breach of a fiduciary duty."[106] The Court's designation of the tippee as a "participant" in the insider or misappropriator's breach implies that the tippee must engage in active conduct constituting more than just passive negligence.[107] Therefore, while the Second Circuit was technically consistent with the specific "knows or should know" language used by the *Dirks* Court when it provided the basis for the tippee's duty, its approach may be inconsistent with the *Dirks* Court's rationale for creating such a duty.

This proposition is further supported by the Court's resolve that insider trading regulation is not founded on the notion that all participants in the securities market are entitled to equal access to

102. *See supra* notes 15–26, 43 and accompanying text.
103. Swanson, *supra* note 13, at 155.
104. *See Dirks*, 463 U.S. at 655 (discussing that the duty to refrain from trading arises from the trader's relationship to the shareholders).
105. *Id.* at 659.
106. *Id.* (emphasis added) (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).
107. *See* United States v. Rajaratnam, 802 F. Supp. 2d 491, 499 (S.D.N.Y. 2011) (holding that a tippee "cannot be said to be a knowing participant in the tipper's breach" unless the tippee "knew" that the tipper breached his or her duty) (quoting State Teachers Ret. Bd. v. Fluor Corp., 592 F. Supp. 592, 594 (S.D.N.Y. 1984)); *State Teachers Ret. Bd.*, 592 F. Supp. at 594 ("It is not, then, the knowledge of possession of material, nonpublic information that creates tippee liability; rather, it is the knowledge of joint participation, *with* the tipper, in the tipper's breach of duty.").

information.[108] Setting aside moral objections, the prevailing belief is that an oscillating distribution of information actually increases market efficiency.[109] The view is that "[i]f participants believe it is worthwhile to seek out valuable market information, investing considerable time and effort to 'beat the market' with better research, those efforts enhance market efficiency."[110] The Second Circuit's decision is contrary to this theory because it puts at risk the innocent tippee who receives and uses market information without actually or recklessly knowing that his or her acquisition of the information was improper.

CONCLUSION

Following the Second Circuit's *Obus* decision, courts are still left wanting for a resolution to the *Dirks-Hochfelder* conflict because the court failed to provide a workable resolution congruent with insider trading liability's long-time marriage to fraud. Therefore, the question of what level of awareness is required of a tippee to be liable for insider trading remains on the long list of insider trading-related questions awaiting the Supreme Court's answer.

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108. *Dirks*, 463 U.S. at 657; *Chiarella*, 445 U.S. at 232–33; *Fluor Corp.*, 592 F. Supp. at 595.
109. Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV.179, 182 (1991); Swanson, *supra* note 13, at 160.
110. *Id.*