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Abandoning the 'Mosaic Theory': Why the 'Mosaic Theory' of Securities Analysis Constitutes Illegal Insider Trading and What to Do About It

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INTRODUCTION

In *Dirks v. SEC*[1] the United States Supreme Court appeared to recognize the legality of the *mosaic theory* of securities analysis, in which analysts obtain fragments of information from company insiders and then utilize those fragments to create a mosaic of information used to value the company's worth.[2] "It is commonplace for analysts to ferret out and analyze information," the Court stated, "and this often is done by meeting with and questioning corporate officers and others who are insiders."[3] Since *Dirks* was decided in 1983, however, much has changed in the legal landscape of insider trading.[4] As a result, the mosaic theory, once viewed by investment

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1. 463 U.S. 646 (1983).

2. *See* MORRISON & FOERSTER, *Insider Trading: 2010 Review*, 5 (2010), *available at* http://www. mofo.com/files/Uploads/Images/110223-Insider-Trading-2010-Review.pdf.

3. *Dirks*, 463 U.S. at 658 (internal citations omitted).

4. *See, e.g.*, 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/ ("Defendants convicted in an insider trading trial appear to have little hope of avoiding time in a federal correctional institution"); Bill Saporito & Massimo Calabresi, *The Street Fighter*, TIME MAG. (Feb. 13, 2012), http://www.time.com/time/ magazine/article/0,9171,2105971,00.html (highlighting the recent use of wiretaps, cooperators, and other prosecutorial investigative tactics in insider trading cases); Steve Schaefer, *Wall Street Sherriff Preet Bharara Talks Insider Trading*, FORBES (July 18, 2012), http://www. forbes.com/sites/steveschaefer/2012/07/18/wall-street-sheriff-preet-bharara-talks-insider-trading/ (identifying the multitude of recent high profile insider trading prosecutions against individuals such as Raj Rajaratnam and Rajat Gupta); James B Stewart, *In a New Era of Insider Trading*,

banks, hedge funds, expert network firms,[5] and other securities firms as a reliable method of information gathering, may now be in jeopardy.[6]

Concerns surrounding the mosaic theory have arisen as the Securities and Exchange Commission (SEC) and local and federal prosecutors continue to devote increasing resources to regulating and prosecuting illegal insider trading.[7] While the definition is occasionally thought of as "ambiguous and overinclusive,"[8] illegal insider trading occurs "when a person buys or sells a security while in possession of material nonpublic information that was obtained in

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It's Risk vs. Reward Squared, N.Y. TIMES (Dec. 7, 2012), http://www.nytimes.com/2012/12/08/business/insider-trading-persists-and-gets-stealthier.html?pagewanted=all&_r=0 (recognizing that while insider trading has long been investigated, regulated, and prosecuted, nowadays prosecutors "have exposed a vast network of insider trading" that "dwarfs that of the earlier era" in its sophistication, breadth, and profits).

5. "Expert network firms" are "research consulting firms that provide market intelligence by connecting clients—mostly institutional investors such as hedge funds—with persons with specialized expertise in the clients' areas of interest. For example, investors in the pharmaceutical field may gain valuable insights from certain doctors. These research outfits pool together vast networks of experts who can provide unique perspectives and insights to various industries." MORRISON & FOERSTER, *supra* note 2, at 5.

6. In October 2009, in the midst of the federal insider trading case against billionaire hedge fund manager Raj Rajaratnam, the U.S. Attorney for the Southern District of New York cautioned: "This case should be a wake up call for Wall Street. It should be a wake call for every hedge fund manager and every Wall Street trader and every corporate executive who is even thinking about engaging in insider trading. As the defendants in this case have now learned the hard way, they may have been privy to a lot of confidential corporate information, but there was one secret they did not know: we were listening." Press Release, Dep't of Justice, Manhattan U.S. Attorney Charges Hedge Fund Managers, Fortune 500 Executives, and Management Consulting Director in $20 Million Insider Trading Case (Oct. 16, 2009), http://newyork.fbi.gov/dojpressrel/pressrel09/nyfo101609.htm.

7. Both the Department of Justice and the SEC have "continued to generate headlines with insider trading investigations, prosecutions, and enforcement actions." MORRISON & FOERSTER, *supra* note 2, at 1. In 2010 alone, the SEC filed thirty-three insider trading actions, while the Department of Justice brought criminal insider trading charges against twenty five individuals. MORRISON & FOERSTER, *supra* note 2, at 1. "In terms of both the number of cases and the scope of the investigations . . . regulators made clear that 'insider trading continued to be a priority.'" MORRISON & FOERSTER, *supra* note 2, at 1 (quoting Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. and Exch. Comm'n, Speech to the Society of American Business Editors and Writers (SABEW) (Mar. 19, 2010)).

8. MORRISON & FOERSTER, *supra* note 2, at 1; *see also* Kathleen F. Brickey, CORPORATE AND WHITE COLLAR CRIME 162–63 (5th ed. 2011) (stating that insider trading "is a controversial subject" which opponents, including the SEC and the Justice Department, "believe . . . must be curbed if investors are to have confidence in the market," while "insider trading proponents argue that it should remain unregulated because it promotes market efficiency").

breach of a fiduciary duty or relationship of trust."[9] Indeed, courts, regulators, and prosecutors have given broad meaning to this definition,[10] particularly since the economic crisis of 2008. As a result, the prevalence of ongoing insider trading cases, such as the high profile cases against Raj Rajaratnam,[11] Rajat Gupta,[12] Doug Whitman,[13] and others[14]—and the unsuccessful outcomes for the defendants in each of those cases—indicates that the mosaic theory is eroding as a valid method of securities analysis.[15]

In this Note, I propose that the mosaic theory is an unlawful method of securities analysis constituting illegal insider trading based on the tipper/tippee theory of liability established in *Dirks*.[16] I also propose that as illegal insider trading continues to be investigated and prosecuted with increasing vigor, the mosaic theory will continue to erode, due in large part to broadening beliefs by courts about what constitutes material nonpublic information.[17] Due to these changes, securities analysts will need to reassess the methods they use to

9. MORRISON & FOERSTER, *supra* note 2, at 1; *see also Insider Trading*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/answers/insider.htm (last visited Dec. 26, 2014) ("Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security").

10. *See supra* note 7 and accompanying text.

11. United States v. Rajaratnam, No. 09-CR-1184 (RJH), 2010 WL 4867402 (S.D.N.Y. Nov. 24, 2010), *aff'd*, No. 11-4416-CR, F.3d, 6 2013 WL 3155848 (2d Cir. June 24, 2013).

12. *Gupta v. SEC*, 796 F. Supp. 2d 503 (S.D.N.Y. 2011).

13. United States v. Whitman, No. 12 CR. 125(JSR), 2012 WL 5505080 (S.D.N.Y. Nov. 14, 2012).

14. *See* MORRISON & FOERSTER, *supra* note 2, at 17–20 (listing over thirty individual- or entity-defendants involved in ongoing criminal or SEC insider trading cases as of the end of 2010).

15. Rajaratnam, Gupta, and Whitman all tried—and failed—to successfully use the mosaic theory defense in their federal jury trials. *See infra* notes 77, 78, 81.

16. *See* David T. Cohen, Note, *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, 549 (2006) (noting that Dirks tipper/tippee theory of liability held that "where a corporate insider discloses material, nonpublic information to one who then uses that information to trade in the stock of the insider's corporation, the corporate insider and the trader" are liable when the tipper personally benefits from making the tip.").

17. While insider trading statutes and SEC regulations have failed to define the scope of material nonpublic information, courts have taken up the task, giving broad meaning to the term. *See infra* notes 87, 92 and accompanying text. As such, the well-established test for materiality is whether the information would be important to a reasonable investor when considered in the "total mix" of available information. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

obtain information. Furthermore, hedge funds, investment banks, and other firms employing securities analysts will consequently need to reassess their training and compliance programs in order to institute a corporate culture in which analysts rely on investor relations officers or other legitimate sources for information, as opposed to illegitimate company insiders operating under confidentiality agreements.

Part I of this Note addresses the meaning and history of the mosaic theory as it has evolved over time. Part II discusses the history of insider trading law in the United States in an effort to understand why the mosaic theory violates those laws. Part III analyzes the confluence of insider trading law and the mosaic theory, showing why the mosaic theory indeed violates insider trading law. Finally, Part IV identifies the costs and benefits of abandoning the mosaic theory in its current form and proposes ways to move forward in the world of securities analysis without the legal risks embedded in the mosaic theory. This Note concludes that financial actors will need to abandon the mosaic theory in order to confidently guard against prosecution for insider training.

I. THE HISTORY OF THE MOSAIC THEORY

The mosaic theory is a method of research used by securities analysts to gather information about a company.[18] The theory involves collecting pieces of information about a company in order to determine the underlying value of the company's securities and to enable the analyst to make recommendations to clients based on that information.[19] As *The New York Times'* leading financial contributor, Andrew Ross Sorkin, explains,

> Every day, professional investors and research analysts work the phones to ferret out information about companies that can't be found by simply reading news releases. Some will walk through shopping malls interviewing store managers . . . to gauge how sales are going. Others might monitor sales of certain component parts in Asia to determine how many iPads

18. MORRISON & FOERSTER, *supra* note 2 and accompanying text.
19. *Id.*

> Apple might sell this quarter. . . . Investors use multiple tidbits of nonpublic information from various sources to build a "mosaic" to try to get an edge on other investors. For better or worse, that is what passes as "research" in the finance world.[20]

But the legality of the mosaic theory is being questioned as people such as Sorkin—and more importantly, prosecutors, regulators, and judges—begin to ask whether this method of information gathering captures "just tidbits, or material facts for insider trading."[21]

As early as the 1970s, various courts noted the validity of the mosaic theory process, even before the term was coined.[22] In the Second Circuit case *SEC v. Bausch & Lomb, Inc.*,[23] the court noted that, "corporate management may reveal to securities analysts or inquirers non-public information that merely fills interstices in analysis."[24] Similarly, in the 1980 case *Elkind v. Liggett & Myers, Inc.*,[25] the Second Circuit reaffirmed the validity of the theory, stating that, "a skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public

20. Andrew Ross Sorkin, *Just Tidbits, or Material Facts for Insider Trading?*, N.Y. TIMES (Nov. 29, 2010), http://dealbook.nytimes.com/2010/11/29/just-tidbits-or-material-facts-for-insider-trading/. Sorkin explains that "while it has long been considered standard practice to ask the local GAP store manager how sales are going, the store manager's answer may actually fall into a gray area" based on whether the information provided is material. *Id.* Therefore, while "knowing the sales at one GAP store isn't material" due to the large number of GAP stores across the country, "if you went store to store and managed to find out sales figures for" a significant number of stores, "you might have something closer to material information." *Id.*

21. *Id.*

22. *See* SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).

23. 565 F.2d at 8. The SEC brought this case against Bausch & Lomb and the chairman of its board of directors claiming that the board chairman had tipped off securities analysts to earnings estimates and other information that was not available to the general public. *Id.* at 10–12. The court held that injunctive relief was properly denied because the disclosure of the material, nonpublic information was an isolated incident that was unlikely to recur. *Id.* at 18–19.

24. *Id.* at 14.

25. 635 F.2d 156. A shareholder brought this securities fraud class action against the corporation based on tipped information. *Id.* at 158. The court held that the company could not be held liable for tipping certain nonpublic information to analysts because such information was not material; however, the court held that other tipped information was material since it involved earnings numbers. *Id.* at 158, 173.

information."[26] Finally, the Supreme Court appeared to recognize the legitimacy of the mosaic theory in *Dirks*,[27] the seminal 1983 case, whereby the Court accepted analysts' common practice of meeting with company insiders to "ferret out and analyze information"[28] and then using such information as "the basis for judgments as to the market worth of a corporation's securities."[29]

Questions regarding the mosaic theory's continued legality have arisen due to the SEC's implementation of Regulation Fair Disclosure ("Regulation FD"),[30] promulgated in August 2000 and effective since October of that year.[31] While Regulation FD dictates that "an issuer cannot render material information immaterial simply by breaking it into ostensibly non-material pieces,"[32] the SEC seemingly attempted to allay any fears regarding the erosion of the mosaic theory as a legal method of analysis.[33] The SEC noted that a company "is not prohibited from disclosing a nonmaterial piece of information to an analyst, even if, unbeknownst to the issuer, that

26. *Id.* at 165 (internal citations omitted).

27. 463 U.S. 646 (1983).

28. *Id.* at 658.

29. *Id.* at 658–59. According to *The New York Times'* financial contributor, Andrew Ross Sorkin, any upcoming cases that are brought challenging the mosaic theory will likely be analyzed against *Dirks*. Sorkin, *supra* note 20.

30. 17 C.F.R. § 243. Regulation FD was promulgated in order to "address concerns about the selective disclosure of material information." MORRISON & FOERSTER, *supra* note 2, at 6. Upon enacting the regulation, the SEC explained that "[m]any issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark." U.S. SEC. AND EXCH. COMM'N, *Final Rule: Selective Disclosure and Insider Trading*, http://www.sec.gov/rules/final/33-7881.htm#P22_3882 (last visited Jan. 24, 2013). As a result, Regulation FD required that when material nonpublic information was disclosed "to certain individuals or entities—generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information"—the information also be publicly disclosed. MORRISON & FOERSTER, *supra* note 2, at 6.

31. 17 C.F.R. § 243.

32. U.S. SEC. AND EXCH. COMM'N, *Final Rule: Selective Disclosure and Insider Trading*, http://www.sec.gov/rules/final/33-7881.htm#P22_3882 (last visited Jan. 24, 2013).

33. The SEC explicitly acknowledged that securities "[a]nalysts can provide valuable service in sifting through and extracting information that would not be significant to the ordinary investor to reach material conclusions . . . [and that Regulation FD was not intended to] discourage this sort of activity." U.S. SEC. AND EXCH. COMM'N, Selective Disclosure and Insider Trading, 17 C.F.R. §§ 240, 243, 249 (2000), *available at* http://www.sec.gov/rules/final/33-7881.htm#P22_3882 (last visited Jan. 24, 2013).

piece helps the analyst complete a 'mosaic' of information that, taken together, is material."[34] As a result, "Regulation FD is not violated where an issuer discloses immaterial information that is significant in completing an analyst's mosaic of information."[35] The crux of the issue, therefore, lies in scope of what constitutes "material" information.

II. THE HISTORY OF INSIDER TRADING LAW

Understanding the contours of insider trading law in the United States is essential to effectively evaluating whether the mosaic theory constitutes illegal insider trading. According to the SEC, "illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security."[36] However, insider trading laws in the United States are "rooted in the common law tradition"[37] of liability for

34. *Id.*

35. D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and It's Impact on Market Participants*, 77 IND. L.J. 551, 567 (2002).

36. *Insider Trading*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/answers/insider.htm (last visited Feb. 10, 2013). In a 2008 speech, the director of enforcement for the SEC defined insider trading as "the purchase or sale of securities, with *scienter* (or guilty knowledge), while in possession of material, non-public information in breach of a duty arising out of a fiduciary relationship or other relationship of trust and confidence." Linda Chatman Thomsen, Dir. Div. of Enforcement, U.S. SEC. AND EXCH. COMM'N, *Remarks Before the Australian Securities and Investments Commission 2008 Summer School: U.S. Experience of Insider Trading Enforcement* (Feb. 19, 2008), http://www.sec.gov/news/speech/2008/spch021908lct.htm. This is in contrast to *legal* insider trading, whereby "corporate insiders—officers, directors, and employees—buy and sell stock in their own companies" and then report their trades to the SEC, as required by regulation. *Insider Trading*, U.S. SEC. AND EXCH. COMM'N, http://www.sec.gov/answers/insider.htm.

37. Thomas C. Newkirk, Assoc. Dir. Div. of Enforcement, U.S. SEC. AND EXCH. COMM'N, *Insider Trading—A U.S. Perspective* (Sept. 19, 1998) (noting that our legal system is based on the Common Law system of England, which established the original source for prohibitions against insider trading tactics of fraud and deception), *available at* http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

deception and fraud.[38] Congress has also played an important role in shaping insider trading law.[39]

In response to the stock market crash of 1929, Congress enacted the Securities Act of 1933[40] (the "Securities Act") and the Securities Exchange Act of 1934[41] (the "Exchange Act"), statutes that were "aimed at controlling abuses believed to have contributed to the crash."[42] The Exchange Act addresses insider trading directly in Section 16(b)[43] by regulating the trading activities of corporate

38. Historically, the element of mens rea, or a "vicious will," per Blackstone, was required at common law for any criminal conviction. *See* Morissette v. United States, 342 U.S. 246, 251 (1952). Mens rea, in this context, became loosely synonymous with terms such as "criminal intent," "malice aforethought," and "scienter." *Id.* at 252. The Supreme Court, in *Ernst & Ernst v. Hochfelder*, defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. 185, 194 (1976). The rationale for this requirement was that for someone to be culpable in the criminal context, where the punishment was so severe (death for all felonies at common law) and the stain on one's record so serious, the prosecution should be required to prove beyond a reasonable doubt that the defendant in fact intended the wrongful act. *See, e.g.*, *Morissette*, 342 U.S. at 270 (holding that the defendant could not be guilty of the crime of "unlawfully, willfully, and knowingly steal[ing] and convert[ing]" property of the United States without the requisite intent or mens rea).

39. Senator Duncan Fletcher, the sponsor of the Securities Exchange Act of 1934, identified the importance of Congressional action:

> "Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America. Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors."

78 Cong. Rec. 2271 (1934) (statement of Sen. Fletcher), *quoted in Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 765 (1975).

40. Pub. L. No. 73-38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)). Also referred to as the Truth in Securities Act, the Federal Securities Act, and the '33 Act.

41. Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj (1994)). Also referred to as the Exchange Act and the '34 Act.

42. Newkirk, *supra* note 37; *see also* Christopher D. Jones, Note, *The Misappropriation Theory of Rule 10B-5: The Ultimate Deception*, 23 J. CONTEMP. L. 439, 439 (1997) (noting that the "haunting memory of the economic despair during the 1930's Great Depression was a powerful motivation for Congressional regulation of crucial aspects of American's economy," inducing Congress to enact the Securities Act of 1933 and the Securities Exchange Act of 1934).

43. 15 U.S.C. § 78p(b) (1988). Section 16(b) of the Exchange Act "prohibits short-swing profits (profits realized in any period less than six months) by corporate insiders in their own corporation's stock, except in very limited circumstance. It applies only to directors or officers of the corporation and those holding greater than 10% of the stock and is designed to prevent

insiders, such as company directors and officers. The Exchange Act also addresses insider trading indirectly through Section 10(b),[44] which broadly bans "manipulative or deceptive"[45] practices involving the sale of securities. Because Section 10(b) does not merely prohibit corporate insiders from particular trading activities, it quickly became the leading tool for regulating and prosecuting illegal insider trading.[46]

Section 10(b) of the Exchange Act states that it shall be unlawful for any person "to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe."[47] To implement Section 10(b), the SEC promulgated Rule 10b-5 in 1942, making it unlawful for any person, directly or indirectly:

> (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements . . . not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security.[48]

In sum, Rule 10b-5 establishes "broad anti-fraud provisions, mak[ing] it unlawful to engage in fraud or misrepresentation in

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insider trading by those most likely to be privy to important information." Newkirk, *supra* note 37; *see also* Marc I. Steinberg & Daryl L. Landsdale, Jr., *The Judicial and Regulatory Constriction of Section 16(B) of the Securities Exchange Act of 1934*, 68 NOTE DAME L. REV. 33, 34–36 (1992).

44. 15 U.S.C. § 78j(b) (1988).

45. *Id.*

46. This is due in large part to the fact that the anti-fraud provisions stipulated in Section 16(b) were "relatively easy to apply to the corporate insider who secretly traded in his own company's stock while in possession of inside information because such behavior fit within traditional notions of fraud." Newkirk, *supra* note 38. On the other hand, whether Section 10(b) prohibited insider trading by non-insiders was not as clear based on the plain the language of the statute. *Id.*

47. Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj (1994)).

48. 17 C.F.R. § 240.10b-5 (1996).

connection with the purchase or sale of a security."[49] However, because Section 10(b) and Rule 10b-5 are not limited to insider trading, the most important developments in insider trading law have come from the federal courts.[50]

Beginning in the 1960s, the courts in *In re Cady, Roberts & Co*.[51] and *S.E.C. v. Texas Gulf Sulphur Co.*[52] broadly construed the statutory language of Section 10(b) and Rule 10b-5, holding that anyone in possession of insider information could be liable for illegal insider trading.[53] However, the 1980 Supreme Court case of *Chiarella v. United States*[54] narrowed the scope of Section 10(b) and Rule 10b-5. The Court in *Chiarella* held that merely trading on material nonpublic information was not sufficient to trigger

49. Newkirk, *supra* note 37.

50. *Id.*

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

52. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

53. *See Cady, Roberts*, 40 S.E.C. at 912. The court in *Cady, Roberts* identified that the obligation not to engage in insider trading rested on two principal elements: (1) "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone," and (2) "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Id.* The court further noted that "[i]n considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited." *Id.*; *see also Texas Gulf*, 401 F.2d at 851–52 (reaffirming the ruling in *Cady Roberts* and stating that "[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions . . . [as] [i]t was the intent of Congress that all members of the investing public should be subject to identical market risks").

54. 445 U.S. 222 (1980). In *Chiarella*, the Supreme Court reversed the criminal conviction of a printer who had obtained nonpublic information regarding "corporate takeover bids" from documents he was hired to print. *Id.* at 224, 233. The printer subsequently purchased stock based on the information, making a profit of more than $30,000. *Id.* at 224. The case was tried on the theory that, by failing to disclose the information, the printer engaged in fraud in violation of Rule 10b-5. *Id.* at 226. In reversing the conviction, the Supreme Court refused to accept the theory advanced by the lower courts that "the use by anyone of material information not generally available is fraudulent [merely] because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers." *Id.* at 232. Instead, the Court held that a specific corporate relationship must exist before liability will be warranted. *Id.* at 232–33. In this case, the Court found that "[n]o duty could arise from [the printer's] relationship with the sellers of the target company's securities, for [he] had no prior dealings with them. [H]e was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." *Id.* at 232.

liability.[55] The Court noted that "a duty to disclose under [Section] 10(b) does not arise from the mere possession of nonpublic market information" because "there can be no fraud absent a duty to speak."[56]

The most significant aspect of the *Chiarella* decision came not from the majority's holding, however, but from Chief Justice Burger's dissent.[57] According to Burger, liability under Section 10(b) and Rule 10b-5 was proper based solely on the fact that the defendant "misappropriated" confidential information and wrongfully used it for personal gain.[58] This interpretation of the Exchange Act's provisions, known as the misappropriation theory, has become an accepted basis for insider trading liability under Section 10(b) and Rule 10b-5.[59]

Three years after *Chiarella*, the Supreme Court in *Dirks* addressed Chief Justice Burger's misappropriation theory as it related to the liability of *tippees*—those who receive information from an inside *tipper*.[60] Raymond Dirks, an officer of a New York broker-dealer firm, received material nonpublic information from an inside tipper

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55. *Chiarella*, 445 U.S. at 232.

56. *Id.* at 235.

57. *Id.* at 239–45.

58. *Id.* at 240. Justice Burger stated that a proper reading of Section 10(b) and Rule 10b-5 meant "that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading" regardless of the lack of a special relationship of trust or confidence. *Id.* Justice Burger arrived at this understanding by focusing on the plain language of the provisions, which "[b]y their terms . . . reach *any* person engaged in *any* fraudulent scheme. This broad language negates the suggestion that congressional concern was limited to trading by 'corporate insiders' or to deceptive practices related to 'corporate information.'" *Id.* As such, Justice Burger proclaimed that the "very language of [Section] 10(b) and Rule 10b-5 'by repeated use of the word 'any' [was] obviously meant to be inclusive.'" *Id.* at 241 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).

59. *See* MORRISON & FOERSTER, *supra* note 2, at 1 (stating that the misappropriation theory is one of the two "primary theories of insider trading," imposing liability on anyone "who improperly obtains material nonpublic information and then trades based on such information"); *see also* United States v. Newman, 664 F.2d 12, 16–17 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir. 1983), *cert. denied*, 464 U.S. 863 (1983) (where the Second Circuit adopted Justice Burger's misappropriation theory, holding that an individual with no fiduciary relationship to an issuer could nonetheless be liable under Rule 10b-5).

60. MORRISON & FOERSTER, *supra* note 2, at 1 (stating that insider trading law "holds liable any tippee—that is, someone with whom . . . the tipper shares the information—as long as the tippee also knows that the information was obtained in breach of a duty").

of a corporation with which he had no connection.[61] Dirks subsequently disclosed the information to investors "who relied on it in trading in the shares of the corporation."[62] Recognizing that in certain situations tippees, such as Dirks, should be liable under Rule 10b-5, the Court held that a tippee assumes 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."[63] However, the Court held that Dirks escaped liability under the circumstances since the inside tipper "disclosed the information . . . for the purpose of exposing a fraud and not for personal gain."[64]

Following *Dirks*, in the 1986 case *Carpenter v. United States*,[65] the Supreme Court again addressed the misappropriation theory and again adopted Chief Justice Burger's broader perception of liability.[66] Quoting an earlier New York state court decision, the Court stated: "It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that

61. Dirks v. SEC, 463 U.S. 646, 648 (1983).

62. *Id.*

63. *Id.* at 660; *see also* Newkirk, *supra* note 37 (stating that "*Dirks* held that tippees are liable if they knew or had reason to believe that the tipper had breached a fiduciary duty in disclosing confidential information and the tipper received a direct or indirect personal benefit from the disclosure").

64. Newkirk, *supra* note 37. Another significant aspect of the *Dirks* ruling was contained in footnote 14 of the opinion, where the Court formulated the "concept of the 'constructive insiders'—outside lawyers, consultants, investment bankers or others—who legitimately receive confidential information from a corporation in the course of providing services to the corporation." Newkirk, *supra* note 37. These constructive insiders "acquire the fiduciary duties of the true insider, provided the corporation expected the constructive insider to keep the information confidential." Newkirk, *supra* note 37.

65. 484 U.S. 19 (1987). The *Carpenter* case involved a financial columnist for the *Wall Street Journal*, whose influential columns affected stock prices of the companies discussed in the paper. *Id.* at 22. The columnist tipped information regarding his upcoming columns to others (outside of the *Wall Street Journal*) and then shared in the profits that those individuals had made by trading prior to the publication of the columns. *Id.* at 23. In upholding the conviction of the columnist for securities fraud under Rule 10b-5, the Second Circuit rejected the argument that the misappropriation theory only applies to information misappropriated by corporate or constructive insiders. *Id.* at 24. The case was appealed to the Supreme Court, which, while divided about whether the defendant engaged in securities fraud, unanimously affirmed the Second Circuit's ruling on mail and wire fraud convictions. *Id.* at 28.

66. *See id.*

knowledge or information for his own personal benefit."[67] In the wake of *Dirks* and *Carpenter*, Chief Justice Burger's misappropriation theory began to gain widespread acceptance in federal courts.[68]

Finally, in the 1997 case *United States v. O'Hagan*,[69] the Supreme Court "explicitly adopted the misappropriation theory of insider trading,"[70] creating a significant milestone in defining the scope of Rule 10b-5. The *O'Hagan* Court stated that Chief Justice Burger's misappropriation theory accurately recognized that a person "commits fraud 'in connection with' a securities transaction, and thereby violates [Section] 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[71] The Court went on to explain that "[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[72]

67. *Id.* at 27–28 (quoting *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (N.Y. 1969)).

68. *See, e.g.*, SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984); Rothberg v. Rosenbloom, 771 F.2d 818, 822–23 (3d Cir. 1985); SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1990); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990). In 1995 and 1996, however, two federal courts rejected the misappropriation theory. *See* United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995); United States v. O'Hagan, 92 F.3d 612, 618 (8th Cir. 1996). The Eight Circuit in *O'Hagan* rejected the misappropriation theory on the grounds that the theory "does not require either a material misrepresentation or nondisclosure." 92 F.3d at 618. Additionally, the court claimed that the theory was not "moored [in] [Section] 10(b)'s requirement that 'the fraud be "in connection with the purchase or sale of any security."'" United States v. O'Hagan, 521 U.S. 642, 660 (1997) (quoting the Eighth Circuit's opinion in *O'Hagan*, 92 F.3d at 618).

69. 521 U.S. 642. O'Hagan was a partner in a Minnesota law firm; the firm was hired to represent a London company, Grand Metropolitan PLC, regarding a potential tender offer for common stock of the Pillsbury Company. *Id.* at 647. O'Hagan did not work on the Grand Met representation. *Id.* When O'Hagan learned about the potential deal, he purchased options in Pillsbury stock, which he eventually sold for a profit of over $4 million. *Id.* at 647–48. O'Hagan claimed that since neither he nor his firm owed a fiduciary duty to Pillsbury, he did not commit fraud by purchasing Pillsbury stock. *Id.* The Court rejected O'Hagan's arguments, reversing the Eighth Circuit decision and reinstating O'Hagan's conviction. *Id.* at 678.

70. Newkirk, *supra* note 37.

71. 521 U.S. at 652.

72. *Id.* The Court also acknowledged two arguments for prohibiting insider trading. First, the Court stated that insider trading is "well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." *Id.* at 658.

Since *O'Hagan*, and particularly since the 2008 economic crisis, federal prosecutions premised on the misappropriation and tipper/tippee theories of insider trading liability have been on the rise.[73] For example, in 2010, Raj Rajaratnam, the former head of the multibillion dollar Galleon hedge fund group, was charged as a tippee for trading on inside information received from executives at IBM, Intel, and McKinsey & Co., resulting in more than $49 million in illicit profits or avoided losses.[74] Rajaratnam claimed that the fragments of information were not material to his trading decisions, and therefore did not constitute illegal insider trading under the mosaic theory.[75] The jury rejected this argument, and in October 2011, Rajaratnam was sentenced to eleven years in federal prison, the longest sentence ever imposed for insider trading.[76]

Similarly, in 2012, Rajat Gupta, a former Goldman Sachs director and former head of McKinsey & Co., was charged as a tipper for providing Rajaratnam with confidential inside information.[77] Gupta's defense counsel pointed to other potential sources of the inside information, arguing that the prosecution had failed to meet its burden of proof regarding the nonpublic nature of the information.[78] Again, the jury rejected this argument and in October 2012 Gupta was sentenced to two years in federal prison.[79]

Finally, in the 2012 case against Doug Whitman, a former California-based hedge fund manager, the government charged

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Second, the Court pointed to the "information as property" rationale, stating that a company's confidential information "qualifies as property to which the company has a right of exclusive use. 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." *Id.* at 654 (internal citations and quotations omitted).

73. *See supra* note 7 and accompanying text for a discussion on the increasing attention on prosecuting insider trading.

74. *See* MORRISON & FOERSTER, *supra* note 2, at 2.

75. *See* Henning, *supra* note 4.

76. *See* Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case*, N.Y. TIMES, Oct. 13, 2011, *available at* http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years/.

77. Michael Rothfeld & Dan Strumpf, *Gupta Gets Two Years for Leaking Inside Tips*, WALL ST. J., Oct. 25, 2012, *available at* http://online.wsj.com/article/SB10001424052970203897404578077050403577468.html.

78. *Id.*

79. *Id.*

Whitman with receiving confidential information about Marvell Technology, Google, and Polycom, leading to trades that generated over $900,000 in profits for his firm.[80] Whitman argued at trial that he acted in good faith in analyzing stocks, which led him to make investment decisions unrelated to any inside information.[81] In other words, Whitman claimed that the information he received was inconsequential on its own and was legitimately used to create a mosaic, which then assisted him in his trades. The jury again rejected this defense, convicting Whitman in August 2012 of two counts of conspiracy for trading on illegal tips and two counts of securities fraud.[82] On January 24, 2013, Whitman was sentenced to two years in federal prison.[83]

While the landscape of insider trading law continues to evolve, the broad anti-fraud provisions of Section 10(b) and Rule 10b-5 make clear that those who misappropriate material nonpublic information, either as tippers or tippees, will likely be liable for insider trading.

III. ANALYSIS

Notably, even as the scope of liability under Section 10(b) and Rule 10b-5 has broadened over time, none of the developments in insider trading law have explicitly banned the mosaic theory. In fact, the SEC has continued to reaffirm that company insiders are permitted to disclose nonmaterial pieces of information to analysts, who may then use such information to "complete a mosaic of information that, taken together, is material."[84] Under the tipper/tippee theory of liability set forth by *Dirks*, however, it is not clear that this mode of securities analysis is in fact permissible due to

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80. Peter Lattman, *Hedge Fund Manager Found Guilty of Insider Trading*, N.Y. TIMES (Aug. 20, 2012), *available at* http://dealbook.nytimes.com/2012/08/20/hedge-fund-manager-whitman-is-found-guilty/; Patricia Hurtado & Bob Van Voris, *Whitman Capital Founder Found Guilty of Insider Trading*, BLOOMBERG (Aug. 20, 2012), http://www.bloomberg.com/news/2012-08-20/whitman-capital-s-doug-whitman-guilty-of-insider-trading.html.

81. Lattman, *supra* note 80.

82. Hurtado, *supra* note 80.

83. Jonathan Stempel, *Whitman Capital Founder Gets Two Years for Insider Trades*, REUTERS (Jan. 24, 2013), http://www.reuters.com/article/2013/01/25/us-insidertrading-whitman-idUSBRE90N1AT20130125.

84. U.S. SEC. AND EXCH. COMM'N, *Final Rule: Selective Disclosure and Insider Trading*, http://www.sec.gov/rules/final/33-7881.htm#P22_3882 (last visited Jan. 24, 2013).

the expansive meaning that courts have given to the term 'nonpublic material information.'[85]

The Court in *Dirks* held that insider trading is established if a three-part test was met: (1) the tipper breached a fiduciary duty by disclosing material nonpublic information to the tippee, (2) the tippee knew or should have known that the tipper breached a fiduciary duty, and (3) the tipper benefited as a result of providing the information to the tippee.[86] Prior to assessing the liability of securities analysts under each of the *Dirks* prongs, it is necessary to first confirm that analysts engaging in the mosaic theory constitute tippees. Analysts engage in the mosaic theory by obtaining pieces of information from company insiders.[87] *Dirks* made clear that an individual becomes a tippee "whenever he receives inside information from an insider."[88] As a result, such analysts clearly constitute tippees under *Dirks* by receiving information from company insiders acting as tippers.[89]

Satisfied that securities analysts engaging in the mosaic theory constitute tippees, the next step in the analysis turns to the first prong of the *Dirks* test: determining whether the tipper breached a fiduciary duty by disclosing material nonpublic information to the tippee.[90] This prong has three independent subparts that must be met: (a) the breach of a fiduciary duty, (b) by disclosing nonpublic information, (c) that is material. Courts have given broad meaning to the term *fiduciary duty*, finding that violations of trust and confidence by employees constitute such a breach.[91] Therefore, an employee-tipper who discloses any confidential information to an analyst-tippee will likely be viewed as having breached a fiduciary duty by violating the trust and confidence of the employer.

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85. *See infra* note 98.

86. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983).; *see also* SEC v. Obus, 693 F.3d 276, 285 (2d. Cir. 2012) (stating that the *Dirks* Court recognized that a tippee will be liable if he [1] knows or should know that the information was received from one who breached a fiduciary duty (such as an insider or a misappropriator), [2] and the tippee trades or tips for personal benefit [3] with the requisite scienter).

87. *See* MORRISON & FOERSTER, *supra* note 2, at 5.

88. *Dirks*, 463 U.S. at 655.

89. *Id.*

90. *Id.* at 660.

91. *See* United States v. Whitman, 904 F. Supp. 2d 363, 367 (S.D.N.Y. 2012) (stating that "liability exists if the tipper breaches a fiduciary-like duty of trust and confidence owed to his employer and its shareholders to keep confidential the material nonpublic information . . . .").

Courts have similarly given broad meaning to the scope of *nonpublic information*,[92] in large part due to the pervasive use of confidentiality agreements prohibiting corporate employees from disclosing inside information.[93] Factors such as "written company policies, employee training, [and] measures the employer has taken to guard the information's secrecy. . . ." are common indications of whether information will be classified as nonpublic.[94] In the modern corporate landscape, the overwhelming majority of individuals employed by publicly traded companies operate under comprehensive agreements banning the unauthorized disclosure of any company information potentially useful to a securities analyst.[95] Noting this fact, one New York federal judge stated that "every employee of a company has a legal duty not to disclose . . . financial or other confidential information . . . that the company has not disclosed to the public."[96] Due to the prevalence and breadth of such agreements, information disclosed by an employee-tipper to an analyst-tippee will likely classify as nonpublic information.

The last subpart of the first *Dirks* prong requires that the information obtained by the analyst-tippee is *material*.[97] Here, again, courts have adopted a particularly broad view of materiality.[98] So long as "there is a substantial likelihood that a reasonable shareholder would consider [the information] important," the information will be deemed material.[99] This standard has been said to be "so vague that

92. *See id.*

93. *See* Gardner Davis, *Regulatory: Insider Trading Policies and Confidentiality Agreements Need Review*, INSIDE COUNSEL, Apr. 6, 2011, http://www.insidecounsel.com/2011/04/06/regulatory-insider-trading-policies-and-confidentiality-agreements-need-review (noting that "[b]oth public and private companies have historically adopted employee policies prohibiting the disclosure of confidential company information. . . .").

94. United States v. Whitman, 904 F. Supp. 2d 363, 367 (S.D.N.Y. Nov. 14, 2012), as corrected (Nov. 19, 2012), *aff'd*, 13-491-CR, 2014 WL 628143 (2d Cir. Feb. 19, 2014).

95. Davis, *supra* note 94.

96. United States v. Fleishman, No. 11 Cr. 32(JSR), 2012 WL 1611375 at *2 (S.D.N.Y. May 7, 2012).

97. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983).

98. *See* Peter J. Henning, *A Standard That Raises More Questions Than It Answers*, N.Y. TIMES (Apr. 7, 2011), http://dealbook.nytimes.com/2011/04/07/a-standard-that-raises-more-questions-than-answers/ (noting that "the Supreme Court has consistently resisted providing more precision to materiality" in the insider trading context).

99. TSC Indus. v. Northway, 426 U.S. 438, 449 (1976).

almost any tidbit about a company could fall within it."[100] Therefore, while analysts may claim that the mosaic theory does not constitute insider trading based on the immaterial nature of the tipped information, courts and juries have readily rejected such arguments, as indicated by the recent convictions of Rajaratnam, Gupta, and Whitman,[101] among others.[102] As such, the first prong of *Dirks* is easily met when analyst-tippees engaging in the mosaic theory obtain inside information from employee-tipppers.

The second prong of the *Dirks* test, which requires that the analyst-tippee knew or should have known that the tipper breached a fiduciary duty, is equally easy to satisfy. Securities analysts are hired to learn, study, and understand the workings of corporate enterprises.[103] Therefore, they should know that corporate employees

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100. Henning, *supra* note 4.

101. At the trials of Rajaratnam and Gupta, defense attorneys interrogated the prosecution's witnesses about whether the information provided to the defendants was publicly available, arguably making it immaterial. Moreover, prior to his arrest on October 16, 2009, Rajaratnam claimed that his Galleon analysts investing in technology companies had an "advantage over rivals because most were trained as engineers and all focused their energies exclusively on research." David Glovin, Patricia Hurtado & Bob Van Voris, *Rajaratnam Guilty in Insider Trading Case*, BLOOMBERG (May 11, 2011), http://www.bloomberg.com/news/2011-05-11/rajaratnam-is-found-guilty-of-all-counts-in-galleon-insider-trading-trial.html. However, when former Galleon analyst and trader, Adam Smith, testified at Rajaratnam's trial he admitted that the hedge fund "gained its advantage through other means." *Id.* Smith explained how "Rajaratnam emphasized 'getting the number'—or learning revenue figures before they became public—from insiders at Intel Corp., Intersil Corp. and other public traded companies." *Id.* "Research is sort of doing your homework ahead of time," said Smith, and "[g]etting the number is more like cheating on the test." *Id.* Smith testified after pleading guilty to insider trading and agreeing to cooperate with prosecutors. *Id.*

102. In the July 2012 guilty plea of John Kinnucan, for example, Kinnucan admitted to working from 2008 to 2010 to "obtain private information from employees of public companies so that he could relay the information to others, who would then make profitable trades ahead of the public announcement of the developments." *Analyst Who Taunted Authorities Pleads Guilty*, N.Y. TIMES, July 25, 2012, *available at* http://www.nytimes.com/2012/07/26/business/john-kinnucan-pleads-guilty-to-insider-trading.html?_r=0. Kinnucan's company, Broadband Research LLC, operated as an "expert network firm," providing client-investors with securities information about technology companies. Susan Pulliam, *FBI Visit Exposes Trade-Probe Tactics*, WALL ST. J., Nov. 22, 2010, *available at* http://online.wsj.com/article/SB10001424052748703567304575629061523575940.html. Following Kinnucan's plea, prosecutors and regulators continue to examine "the role of consultants and analysts who provide hedge funds and mutual funds with detailed information about the businesses and industries in which they specialize." *Id.*

103. *See Securities Analysts*, U.S. SEC. AND EXCH. COMM'N (Feb. 9, 2012), *available at* http://www.sec.gov/divisions/marketreg/securitiesanalysts.htm.

are bound by comprehensive confidentiality agreements and that violating such an agreement is a breach of the employees' fiduciary duty.[104] It is highly unlikely that a tippee, such as Rajaratnam, Whitman, or any of their firm's securities analysts, could successfully argue that he did not know and should not have known about the obligations that an inside tipper at a large public company was operating under.

Finally, the third *Dirks* prong requires that the tipper obtain a benefit from providing the information to the tippee. And while monetary benefits certainly satisfy this requirement, courts have broadly construed the scope of the benefit, holding that "it includes not only 'pecuniary gain,' such as a cut of the take or a gratuity from the tippee, but also a 'reputational benefit' or the benefit one would obtain from simply 'mak[ing] a gift of confidential information to a trading relative or friend.'"[105] Therefore, anytime an analyst-tippee receives information from an inside tipper, prosecutors can easily show that tipper received some sort of benefit, even if it's merely the benefit of "an ongoing personal relationship or enhancement to the tipper's reputation. . . ."[106]

Therefore, due to the breadth with which courts have interpreted liability under the *Dirks* tipper/tippee analysis, along with the vigor with which prosecutors and regulators have brought such claims, securities analysts should think twice before engaging in the mosaic theory. The securities analyst working today must operate under the assumption that insiders are expressly prohibited from disclosing any pertinent company information and that doing so will likely meet the requirements of nonpublic material information in violation of the insider's fiduciary duty. To assume otherwise may cause such analysts to end up in the same boat—or cell—as Rajaratnam, Gupta, Whitman, and many others.

104. Davis, *supra* note 93.

105. SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) (internal citation omitted).

106. Peter J. Henning, *White Collar Watch: Gray Area*, N.Y. TIMES (Dec. 10, 2010), http://query.nytimes.com/gst/fullpage.html?res=9B04E0DD133FF931A35751C1A9669D8B63.

IV. PROPOSAL

Due to the increasing blurriness between material and nonmaterial information,[107] as well as the increasing prevalence of comprehensive corporate confidentiality agreements broadening the scope of nonpublic information,[108] securities analysts must refrain from engaging in 'research' practices in furtherance of the mosaic theory. At the same time, however, securities analysts serve an important function in the financial marketplace and consequently should be able to engage in securities research without the constant fear of facing prosecution for insider trading. Therefore, a proper balance must be struck. This can be achieved in a variety of ways, two of which will be proposed here.

First, the problem can be addressed from within the sphere of public corporations, which employ, train, and regulate the individuals often accused of operating as inside tippers.[109] Corporations employing these potential tippers should increase the emphasis on the importance of their internal confidentiality agreements.[110] Furthermore, the agreements should clearly state that employees are prohibited from disclosing any company information to outside analysts.[111] The agreements should also explain that the employee may be liable for criminal charges if the policy is disregarded. Individuals studying the trends in insider trading law have also identified these weaknesses in current corporate policies, noting that "confidentiality agreements need to explicitly prohibit employees from ever . . . consulting with a third party or otherwise providing information about the company without the company's prior written authorization."[112]

107. *See* Henning, *supra* note 4 and accompanying text.

108. *See* Davis, *supra* note 93 and accompanying text.

109. *See id.*

110. *See id.* (emphasizing that "[t]o protect against the risk of insider trading based on nonpublic information about other companies, corporate policies and confidentiality agreements should prohibit disclosure of material non-public information about other companies obtained in the course of employment. . . .").

111. *Id.* (stating that "[t]raditional policies, standard [confidentiality agreements] and existing employee training programs may no longer be adequate and should be reviewed in light of recent developments").

112. *Id.*

In addition to presenting employees with clear confidentiality agreements, corporate employers should better train their employees on the evolving landscape of insider trading liability.[113] This includes instructing employees on the proper steps to take when contacted by an analyst who is trying to obtain inside information. Without the appropriate training and compliance measures in place, corporations will continue to find their employees liable for serving as illegal tippers.

As the same time, the problem can similarly be addressed from the sphere of the securities firms who allow their analysts to root out inside information from corporate employees. Analysts should also operate under internal policy guidelines enforced by their hedge fund or securities firm employers. Like corporate confidentiality agreements, these policies should prohibit analysts from obtaining information from corporate insiders without the explicit understanding that the insider is authorized to disclose the information.

One way to achieve this goal is to require analysts to rely solely on corporate investor relations officers for their information.[114] Investor relations officers serve the "strategic executive function" of providing "the investment community with an accurate portrayal of both a company's current performance and its future prospects."[115] Because such individuals are tasked with distributing company information, analysts and their employers can rest assured that obtaining information from them will not violate insider trading laws.

Neither of these solutions is flawless and both will likely be met with significant resistance from securities analysts and their employers. Analysts will surely argue that relying on investor relations officers defeats the value and skill of their hard work and research, which is what allows their companies to succeed. They will likely claim that they are trained to cross-reference and verify the information released by investor relations officers, as well as ferret

113. *See id.* (highlighting that "appropriate training of employees about the expanded policies and the risks of sharing nonpublic information is essential to establish the desired culture of compliance").

114. BENJAMIN MARK COLE, THE NEW INVESTOR RELATIONS: EXPERT PERSPECTIVES ON THE STATE OF THE ART 3 (2004).

115. *Id.*

out other information to aid them in evaluating the value of the companies. In the end, however, these arguments are likely to fall on deaf ears as prosecutors, regulators, and judges show no signs of relaxing their broad interpretations of insider trading. While "nothing may deter the determined rogue employee, appropriate policies, confidentiality agreements and training programs will mitigate the reputational harm and legal risk. . . ."[116] to both public corporations and the securities firms and analysts that invest in them.

CONCLUSION

There was a time not long ago when securities analysts would unhesitatingly call their contacts at large public companies for the inside scoop on that company's 'status.'[117] Maybe the analyst would be so lucky as to get upcoming revenue numbers or maybe he would merely get tidbits of manufacturing data. Maybe the analyst believed the information had already been disclosed to someone else, and therefore was already public. Or maybe he believed that the information was immaterial, since it was simply one piece that would be used in deciding whether to buy or sell the company's stock. Either way, these analysts were afforded an advantage over the average investor by obtaining such information. And it was this advantage that made the mosaic theory of securities analysis unlawful under insider trading law.

Technically, securities analysts may still legally obtain fragments of immaterial information from corporate insiders and use those fragments to create a mosaic of useful information.[118] The reality, however, is that increasingly broad interpretations of the insider trading anti-fraud provisions reveal that those who engage in the mosaic theory face grave dangers and an uphill battle when it comes to defending against insider trading claims.[119] As a result, the mosaic theory in its current form should be abandoned and replaced with

116. Davis, *supra* note 93.
117. *See* Sorkin, *supra* note 20.
118. *See* U.S. SEC. AND EXCH. COMM'N, *supra* note 34.
119. *See* Henning, *supra* note 4.

legitimate research techniques that properly give all investors fair access to information.