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The Mosaic Theory of Materiality— Does the Illusion Have a Future?

*By Allan Horwich**

Deception lies at the heart of any claim under the federal securities laws for unlawful insider trading; materiality is an essential element of that deception. This article addresses one dimension of materiality in the context of insider trading—the extent to which it is lawful for an insider to privately disclose a nonpublic fact that is not material in and of itself, when that fact is to be combined with other facts known to the recipient of the disclosure to complete a material mosaic. The mosaic theory, an approach under which a disclosure may be lawful, has often been written about, as the citations in this article demonstrate, but has never been applied in a reported case and the contours are uncertain. This presents the question whether the theory is an illusion, a construct of academic interest alone, or whether the theory offers meaningful protection for the analyst or investor who aggressively probes here and there for nuggets of information that ultimately create a significant aggregate.

This article begins with a summary of the concept of materiality, followed by an overview of the classical theory of insider trading, including tipper and tippee liability. After stating the SEC's expression of the mosaic theory of materiality, the article then turns to a discussion of the limited case law and the scholarly and practitioner commentary. The article then analyzes how the mosaic theory should be applied in the context of a claim that the person who provided the last piece of the puzzle has violated the law and that the person who received the information and assembled that mosaic then engaged in unlawful insider trading.

Though the usefulness of the theory as a defense has proven to be limited because the facts that emerge at trial do not fit the contours of the theory, pronouncements of the demise of the mosaic theory are very much exaggerated. Recent developments in the scienter requirement as applied to insider trading may raise the bar considerably for proving liability of the tipper and tippee across the board, including in a mosaic situation. Never-

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theless, securities professionals and others who intend to rely on the theory as they assemble information from multiple sources, including from insiders, should be mindful of the possible application of the theory to protect their actions, at the same time recognizing that defendants advancing the theory at trial may face significant problems of proof.

I. Materiality Under the Securities Laws

In an action under Securities and Exchange Commission (SEC or Commission) Rule 10b-5¹ a fact is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making his investment decision.² An omitted fact is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”³ Judgments *ex ante* about which facts are material under the securities laws are often complex and difficult.⁴

II. The Classical Theory of Insider Trading as Applied to Tipping

The inquiry here into the mosaic theory focuses on the classical theory of insider trading, one of several applications of Rule 10b-5 that prohibit buying or selling securities based on material nonpublic information.

Under the “traditional” or “classical theory” of insider trading liability, § 10(b) [of the Securities Exchange Act] and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a “deceptive device” under § 10(b) . . . because “a relationship of trust and confidence [exists] between the shareholders of the corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”⁵

Even if he does not trade, the insider who discloses nonpublic information to an outsider may be a tipper and the recipient of the information a tippee, each violating Rule 10b-5:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only 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 . . .

. . .

In determining whether a tippee is under an obligation to disclose or abstain [from trading based on the tip], it thus is necessary to determine whether the insider’s “tip” constituted a breach of the insider’s fiduciary duty [to keep the information confidential]. All disclosures of confidential corporate information are not inconsis-

tent with the duty insiders owe to shareholders . . . Whether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure . . . [T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.⁶

The Second Circuit Court of Appeals has twice in recent years addressed in detail the necessary element of scienter—intent to deceive—in determining whether a tipper and tippee have violated Rule 10b-5, applying *Dirks*:

First, the tipper must tip deliberately or recklessly, not through negligence. Second, the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes, or act with reckless disregard of the nature of the information. Third, the tipper must know (or be reckless in not knowing) that to disseminate the information would violate a fiduciary duty. While the tipper need not have specific knowledge of the legal nature of a breach of fiduciary duty, he must understand that tipping the information would be violating a confidence.⁷

Most important for present purposes is that the tipper must know that the information he tipped was material.

An essential element of tippee liability is that the tippee also know that the tipped information is material and nonpublic.⁸ Moreover, an element of the violation is that the tippee knew or should have known that confidential information was initially obtained and transmitted improperly by a tipper.⁹ More recently, in *Newman* the court held that the tippee's knowledge of the tipper's breach, including that the tipper received a personal benefit, is an essential element of the violation; the government must prove "that the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit . . ."¹⁰ *Newman*, of course, is not the final word on these issues. It is binding only in the Second Circuit. Both the Department of Justice and the SEC may choose to pursue cases in other circuits, in an effort to achieve a more favorable ruling.¹¹ The SEC's current Director of the Division of Enforcement has been reported as observing that the SEC still has the option to bring cases in other circuits and in its own administrative courts.¹² This article will return to the scienter components of the violation.¹³

There is sometimes a dispute about whether the tippee-defendant was aware of material nonpublic information.¹⁴ A defendant may argue, for example, that he did not know anything material that he knew was nonpublic at the time he traded¹⁵ or that what he knew that was not public was not material.¹⁶ This latter contention is where the mosaic theory may apply.

III. The Mosaic Theory of Materiality¹⁷

The mosaic theory of materiality addresses the situation where a tipper tells a tippee some nonpublic information that is not material in and of itself but which, when combined with public information, or with nonpublic information lawfully obtained by the tippee from another source, forms a mosaic of information that gives the tippee a material informational advantage in trading.¹⁸ The insider trading questions that arise are whether the person who provided that immaterial item of nonpublic information and the recipient who traded based on the mosaic have violated Rule 10b-5.

The SEC addressed the mosaic theory when it adopted Regulation FD, in the same release in which it adopted Rule 10b5-1.¹⁹ That regulation effectively prohibits some selective disclosure of material nonpublic information by public reporting companies and their senior officials.²⁰ “[W]hen an issuer, or person acting on its behalf, discloses material nonpublic information to certain categories of persons (in general, securities market professionals and holders of the issuer’s securities who may well trade on the basis of the information), it must make public disclosure of that information.”²¹ If there is intentional disclosure of material nonpublic information to someone among the specified categories of persons, the company must make simultaneous public disclosure; if there is a “non-intentional” covered selective material disclosure there must then be “prompt” public disclosure.²²

In explaining the scope of the public disclosure requirement imposed by Regulation FD, the SEC stated that

[A]n issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a “mosaic” of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst.²³

There are several potential limitations on the implications of this commentary for Rule 10b-5, the subject of this article. First, Regulation FD addresses only when an *issuer* is *obligated* to make a public disclosure of previously undisclosed material information. The regulation says nothing explicitly about what use, if any, the recipient of a disclosure may lawfully make of the information where the issuer does not comply with Regulation FD. The statutory authority for imposing obligations under Regulation FD is sections 13 and 15 of the Exchange Act,²⁴ which require that companies whose securities are listed on a stock exchange, that have a specified minimum number of shareholders of record, or that have had a registered public offering of their

securities file certain reports with the SEC. The regulation was not adopted to implement Section 10(b),²⁵ and Regulation FD provides, “No failure to make a public disclosure required solely by [Rule 100] shall be deemed to be a violation of Rule 10b-5.”²⁶ Thus, the SEC did not address insider trading issues under Rule 10b-5 in discussing a mosaic of information, and the closing sentence of the statement quoted above states only that “Regulation FD will not be implicated” when there is a non-material disclosure of the type described.²⁷ Nevertheless, the absence of any statement that these concepts, which are so intertwined with the subject of insider trading, do *not* apply to Rule 10b-5 at least suggests that they do apply, in the view of the SEC, and at least one senior SEC Staff member’s later statement reflects that the mosaic theory has application to claims of insider trading.²⁸

The SEC’s statement that whether a fact is material is determined under an “objective test” keyed to the reasonable investor is consistent with the Supreme Court’s explanation of what facts are material under the securities laws.²⁹ The language quoted above from the *Adopting Release* also recognizes that something that is not, when standing alone, material to the “reasonable investor”—and therefore not material generally for purposes of the securities laws—may nevertheless be quite important to a particular investor or analyst.³⁰

The SEC staff has adhered to the interpretation of Regulation FD expressed in the *Adopting Release* in 2000:

Question: Can an issuer ever review and comment on an analyst’s model privately without triggering Regulation FD’s disclosure requirements?

Answer: Yes. It depends on whether, in so doing, the issuer communicates material nonpublic information. For example, an issuer ordinarily would not be conveying material nonpublic information if it corrected historical facts that were a matter of public record. *An issuer also would not be conveying such information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information.* It would not violate Regulation FD to reveal this type of data even if, when added to the analyst’s own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer. An issuer may not, however, use the discussion of an analyst’s model as a vehicle for selectively communicating—either expressly or in code—material nonpublic information.³¹

Like the statement in the *Adopting Release*, the C&DI refers only to Regulation FD.

SEC administrative decisions applying Rule 10b-5 in insider trading cases that predated Regulation FD are consistent with the Commission statement in the *Adopting Release*. In dictum in

the Commission's decision in *Dirks*, where the Commission found that a securities analyst violated Rule 10b-5 by misusing material nonpublic information, a ruling later overturned by the Supreme Court on other grounds, the Commission noted that

this is not a case in which a skilled analyst weaves together a series of publicly available facts and non-material inside disclosures to form a "mosaic" which is only material after the bits and pieces are assembled into one picture. We have long recognized that an analyst may utilize non-public, inside information which in itself is immaterial in order to fill in "interstices in analysis." [citing *Investors Management Co., Inc.*, 44 S.E.C. 633, 646 (1971)] That process is legitimate even though such "tidbits" of inside information "may assume heightened significance when woven by the skilled analyst into the matrix of knowledge obtained elsewhere," thereby creating material information. [citing *S.E.C. v. Bausch & Lomb, Inc.*, 565 F.2d 8, 9, 14 (2d Cir. 1977)]³²

Bausch & Lomb was an appellate decision that affirmed a judgment adverse to the Commission. In that opinion the court summarized the SEC's position as a litigant there:

The SEC, of course, does not maintain that the securities laws prohibit all disclosures of internal corporate information. The Commission itself has recognized that corporate management may reveal to securities analysts or other inquirers non-public information that merely fills "interstices in analysis," or tests "the meaning of public information." Only when the inside information so "leaked" is essentially "extraordinary in nature" and "reasonably certain to have a substantial effect on the market price of the security" if it is publicly disclosed does a duty arise to make the information generally available.³³

Under current law facts may be material even when they are not "extraordinary in nature" or "reasonably certain to have a substantial effect on the market price of the security."³⁴

These earlier references suggest that the SEC's discussion about a mosaic of information in the *Adopting Release*³⁵ applies as much to the scope of Rule 10b-5 as it does to Regulation FD. This was confirmed in 2011 when a senior SEC staff member stated that recent enforcement actions for insider trading:

[D]o not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory, under which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is not material nonpublic information obtained in breach of or by virtue of a duty or relationship of trust and confidence.³⁶

In 2013 the SEC brought an enforcement action that some suggest reflects that the SEC is retrenching from its recognition of the mosaic theory.³⁷ Moore was an investment banker for Cana-

dian Imperial Bank of Commerce (CIBC).³⁸ His responsibilities included pitching possible transactions to CIBC's clients, including the Canada Pension Plan Investment Board (CPPIB).³⁹ In early 2010 the CPPIB Managing Director was working on a possible acquisition of Tomkins plc, based in London, whose ADRs were traded on the New York Stock Exchange.⁴⁰ The Managing Director told Moore that he was working on something interesting and active; he rebuffed Moore's offer of help from CIBC and did not disclose the parties to the proposed transaction.⁴¹

Moore learned that the Managing Director was travelling to London.⁴² The SEC also alleged that during a charity event in June 2010:

Moore observed a chance encounter between the CPPIB Managing Director and the Chief Executive Officer ("CEO") of Tomkins. However, the CPPIB Managing Director declined to introduce Moore to the CEO or to reveal his identity. Later that day another CIBC employee attending the event volunteered the CEO's identity to Moore. Those events, coupled with other information that he had learned in the course of his efforts to get CIBC a role in the CPPIB Managing Director's deal, led Moore to conclude that the CPPIB Managing Director was likely working on a transaction involving Tomkins.⁴³

Several months later another banker at CIBC told Moore that he had spoken to someone at CPPIB; thereafter Moore observed that CPPIB had a "[b]ig deal in the works in europe/usa."⁴⁴

After confirming that the Managing Director was still working on the unidentified deal, Moore purchased Tomkins ADRs in the US, as well as common stock offshore, with further purchases several weeks later, ultimately investing one-third of his net worth in Tomkins securities.⁴⁵ Several days later Tomkins announced it had received an offer to be acquired by CPPIB and a private equity firm. Moore realized a substantial profit on his Tomkins securities.⁴⁶

The SEC alleged that Moore had "knowingly or recklessly misappropriated from his employer" information that "he knew, or was reckless in not knowing, was material, non-public, and had been acquired in the course of his employment."⁴⁷ Because the case was settled when it was filed, the defendant did not formally challenge the sufficiency of the claim.⁴⁸ The complaint does not, however, allege that any specific fact learned or observed by Moore was material in and of itself; the first use of the word "material" in the complaint appears in the concluding paragraphs, which allege that Moore misappropriated material nonpublic information.

This is a summary of what the SEC alleged that Moore knew:

- The Managing Director of CPPIB was working on a signifi-

cant transaction. This fact arguably was disclosed to Moore in Moore's role as a CIBC banker. (Though CIBC sought to work on the deal in question it never did.) This information was, it appears, nonpublic.

- The Managing Director had travelled to London. Presumably this information was public, or at least no effort was made to conceal this activity.
- Moore saw the Managing Director socially, in public, with the CEO of Tomkins; the Managing Director declined to introduce Moore to him or to identify him, perhaps signaling a concern about being tied to him in Moore's eyes given what the Managing Director knew that Moore knew about the Managing Director's current pre-occupation. Then Moore independently learned the companion's identity, a public fact.

None of these facts appears to have been material standing alone and some were public; Canadian authorities agree.⁴⁹ All three facts highlighted above are essentially unremarkable, though combining the *public* fact of a reticence to identify someone—whose identity was a matter of public record—with the awareness that CPPIB had something big in the works did produce an arguably *material* mosaic to the effect that the something big at CPPIB might involve Tomkins, which was publicly rumored to be a takeover target.

Some commentators have written that the SEC's case against Moore reflects its abandonment of the mosaic theory.⁵⁰ As discussed in this article, and by the SEC from time to time, the mosaic theory addresses when a *tipper* violates Rule 10b-5 by revealing a discrete item of immaterial information that completes the *tippee's* mosaic. As discussed further below,⁵¹ in *Moore* the SEC's charge was not that the Managing Director of CPPIB unlawfully *tipped* Moore; it was that Moore misappropriated information from his employer, CIBC, that was, apparently lawfully, provided by CPPIB to CIBC, to Moore and at least one of his colleagues.⁵² This includes the information Moore was provided directly by the CPPIB Managing Director.⁵³ It is legitimate to ask whether the SEC has pushed the envelope in alleging that this cluster of facts was material. The SEC's claim in this case, however, is not one that might have involved application of the mosaic theory of tipper-tippee liability properly understood.

IV. The Mosaic Theory in the Courts

Very few cases have addressed the mosaic concept, fewer still by name.⁵⁴ *Elkind v. Liggett & Myers, Inc.* addressed the extent to which disclosure of nonpublic information provided by the chief financial officer of the company to a securities analyst was an unlawful tip of material nonpublic information.⁵⁵ The court

introduced the concept of a mosaic:

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 information. Whenever managers and analysts meet elsewhere than in public, there is a risk that the analysts will emerge with knowledge of material information which is not publicly available.⁵⁶

The court emphasized that in order for there to have been a Rule 10b-5 violation “the tipped information must be material.”⁵⁷

The court then addressed two instances of disclosure by the issuer to a securities analyst. The first disclosures—that sales in some operations were slipping and that the company was going to make a preliminary announcement of quarterly earnings—were found not to be material.⁵⁸ Though not discussing the mosaic concept in this context, the court found that the information the analyst conveyed to clients after receiving this information was also not material.⁵⁹ The court affirmed the lower court’s determination that the second revelation by the insider—a “grudging” affirmative response to an inquiry whether the recent quarter’s earnings would be down—was material in and of itself, especially where the officer told the analyst that the information was confidential.⁶⁰ Thus, the actual rulings in *Elkind* did not apply any version of a mosaic theory either to exonerate or to condemn the disclosure of specific nonpublic information—the first disclosure, as well as the conclusion reached by the analyst, was not material and the second disclosure was material standing alone.

In *State Teachers Retirement Board v. Fluor Corporation* the court of appeals reversed a summary judgment in favor of the defendants to an insider trading claim.⁶¹ The plaintiff’s evidence reflected that Fluor representatives disclosed to representatives of a firm that later bought Fluor stock that Fluor was under consideration for a major contract, a fact the court held “would [likely] be significant information for the reasonable investor,” especially because Fluor did not routinely disclose projects on which it had submitted a bid.⁶² While the court quoted the passage in *Elkind* that referred to an analyst creating a mosaic of information,⁶³ the court ruled for the plaintiff because the tipped information *itself* appeared to be material wholly apart from any other information that was independently known to the recipient of the nonpublic information.⁶⁴

On remand in *Fluor*, the district court was faced with another defense motion for summary judgment, this time attempting to rebut anything supporting liability in a “laundry list” of twenty-one items gleaned by an analyst from conversations with Fluor personnel that were alleged to support the claim of unlawful

insider trading.⁶⁵ The court first stated that the mosaic approach, as it read *Elkind*, may result in a determination that some fact “seemingly insignificant” may be material if it “completes the mosaic, or ‘the matrix’ . . .”⁶⁶ In other words, an immaterial fact that completes a matrix *thereby becomes a material fact itself*, so that the disclosure by the insider may have been wrongful. The court did not address in detail what the speaker needs to know about the other elements of the mosaic in order to appreciate—here is where the tipper’s scienter may be relevant—that his otherwise inconsequential disclosure, in the particular circumstance, becomes a *material* fact. In assessing materiality in *Fluor*, the court noted that even if there was no market movement associated with the later public disclosure of discrete tipped items, it was necessary to consider whether an item “may or not be a coordinate in the ‘matrix.’”⁶⁷

The court then addressed one by one, the allegedly material items that were disclosed, finding that some presented an issue for the jury on the question of materiality, some were not the basis for a claim because they were already public when they were discussed by Fluor with the analyst, and some were not material to the defendant’s purchase of Fluor stock (e.g., because the information was unfavorable to Fluor).⁶⁸ In some cases the court held that the tipped information may have been material because, even though it was consistent with public estimates made by others, the fact that the *company* had made a similar estimate could be material.⁶⁹ In the end, the jury found for the defendants, and there was no further appeal.⁷⁰

Elkind did not present a robust application of a mosaic approach comparable to that expressed later by the SEC because the facts did not, in the end, present a mosaic question.⁷¹ *Fluor* is more illuminating, but it did not entail a direct application of the mosaic theory. This is essentially the end of the trail with respect to judicial decisions addressing materiality with *express reference* to a mosaic or matrix concept.⁷²

One more recent litigated case is worth addressing for what it does not say about the mosaic theory and for misinterpretations of the decision in that respect.⁷³ The SEC brought insider trading charges against, among others, employees of a corporation who combined items of company information that allegedly led them to conclude that the parent company of their employer was about to be sold. In denying defendants’ motion to dismiss, the court stated:

[One of the defendant employees] is alleged to have pieced together for himself what was occurring based on information that was available to him as an [employee of a subsidiary of the public company that was later acquired]. This is a cognizable theory: it is well

established that a defendant can be held liable for insider trading when he or she obtains and acts on pieces of information, which, “piece[d] together,” constitute material nonpublic information. [Citations omitted⁷⁴]

. . . [T]he SEC does not contend that each of these underlying facts on its own is a material nonpublic fact. Rather, the SEC alleges that Defendants’ trades were based on the ultimate conclusion—deduced from the totality of the information available to [the two employees]—that [the public company] was in the process of being sold before the sale was announced.⁷⁵

In addition to criticism that the SEC was pushing the boundaries of insider trading law with the complaint in *Steffes*,⁷⁶ one commentator observed that, after the decision in *Steffes*, “U.S. courts often do not recognize the mosaic theory as a defense at all.”⁷⁷ This is an unjustifiably pessimistic assessment that fails to appreciate the nature of the case. *Steffes* was not a case where some *outsider*, such as an analyst, pried one or two seemingly insignificant nuggets of information *from an insider*. On the contrary, the defendants were themselves corporate employees and their tippees and all of the information the employees allegedly used to form their mosaic—a term the court did not use—was gleaned either from their own involvement in matters that were related to the proposed sale or activities they observed on company premises.⁷⁸ Most of the cited support for the court’s analysis was cases presenting similar fact patterns, where insiders aggregated nonpublic information obtained *solely* from their own company, thus not addressing the mosaic theory where an insider provided an outsider with information that completed a mosaic.⁷⁹ The SEC alleged that the defendants knew this information was confidential.⁸⁰ The court observed, in giving the SEC the benefit of the doubt on a motion to dismiss, that “the allegations are by no means overwhelming.”⁸¹

An insider using *only* information internal to the company to reach a material conclusion bears no analytical resemblance to the situation where an outsider obtains only an item or two of immaterial internal information that complete a picture when combined with information from the outsider’s *external* sources, some or all of which information may be public. The parallel to the insider-outsider situation would be the insider giving a complete package of information to the outsider that the outsider uses, with nothing else, in deciding to trade. Holding to account insiders who, without any breach of the duty of corporate confidentiality by someone else within the company, assemble a mosaic of information from within, which they allegedly know to be nonpublic and confidential, fails to illuminate the law on when it is wrongful for an insider to provide an outsider with immate-

rial information that may, as it were, fill out the outsider's straight flush, especially where the insider does not know what cards the outsider already holds.

In contrast to the gloomy assessment based on the complaints in *Moore* and *Steffes*, a few commentators have taken comfort from some language in *Newman* that they read as support for the mosaic theory.⁸² This view appears to be based on the court's observation that the insiders' tips were consistent with the financial modeling done in-house at the hedge funds that allegedly made use of the tipped information, where the "analysts routinely solicited information from companies in order to check assumptions in their models in advance of earnings announcements."⁸³ The court relied on the melding of in-house analyses based on these "routine" disclosures and related facts to conclude that:

[n]o reasonable jury could have found beyond a reasonable doubt that [defendants] knew, or deliberately avoided knowing, that the information [on which the defendants based their trade] originated with corporate insiders. In general, information about a firm's finances could certainly be sufficiently detailed and proprietary to permit the inference that the tippee knew that the information came from an inside source. But in this case, where the financial information is of a nature regularly and accurately predicted by analyst modeling, and the tippees are several levels removed from the source, the inference that defendants knew, or should have known, that the information originated with a corporate insider is unwarranted.⁸⁴

In other words, the court relied on the facts that possibly tainted information and untainted information was mixed *before* the resulting mosaic reached the defendant-tippees when the court assessed the prosecution's argument that the defendants must have known the ultimate source of information was an insider-tipster who acted unlawfully.

It is a stretch to conclude that this analysis conceded the immateriality of the tipped information itself on a mosaic approach.⁸⁵ On the contrary, the essence of the prosecution's case was that the tipped information was material, and nothing in the appellate reversal took issue with that. The point made in the language quoted was simply that when the mix of information reached the defendants they could not necessarily have discerned what information came from what sources—what information was tainted because it was tipped for a personal benefit (if any) and what information was developed in-house at the funds from permissible sources. If the mosaic theory was on its death bed, *Newman* did not resuscitate it.

V. Commentators on the Mosaic Theory

In the absence of definitive case law, the views of commenta-

tors are widely disparate in their understanding of a mosaic theory of materiality. In his treatise on insider trading, Professor Langevoort presents his conception of the law:

A case can arise where a person receives nonpublic information—for example, the planned introduction of a new product—that by itself would not be terribly important to the investment community generally. But because of the person’s unique expertise and research, that information leads him to conclude that the company’s earnings will increase substantially. In that case, he should not be precluded from trading, for though the information was material to him, it was not material to the “reasonable” investor in the marketplace. For this reason, investment analysts can properly elicit bits of information from company insiders and piece them together in a mosaic that can lead to an investment decision, so long as the pieces of information are not, standing alone, material. In that case, it is principally the skill of the analyst that leads to the profit, not simply his access to an insider. These “mosaic theory” cases pose some of the most difficult enforcement challenges in the law of insider trading.⁸⁶

Professor Langevoort elaborates later in his text, “The question [of unlawful tipping] becomes closer if the insider knows or suspects that the investor very much wants and needs a bit of information, perhaps wanting to be the first among all the analysts to be able to complete the mosaic that they are all competing to finish.”⁸⁷

Professors Wang and Steinberg interpret *Elkind* to mean that “even if information is not by itself important, this information may still be material if the defendant [tippee] already knows other items of information (public or nonpublic, material or immaterial) that, when combined with the new information, creates a significant ‘mosaic.’”⁸⁸ This is not what *Elkind* itself says;⁸⁹ this comment does, however, square with the same court’s later observation in *Fluor*.⁹⁰ Wang and Steinberg comment that the *Adopting Release* “surprisingly interpret[s]” *Elkind* as “permitting, rather than forbidding, analysts from trading on a mosaic that reveals material nonpublic information.”⁹¹ They focus on the phrase in the *Adopting Release*—“unbeknownst to the issuer”⁹²—as “suggest[ing] that the SEC does not endorse the *Elkind* mosaic approach [which does not prohibit tippee-trading where the insider reveals only immaterial information], at least where the issuer is unaware of the contents of the analyst’s mosaic.”⁹³ That is, they interpret the SEC as saying that an insider does not violate Rule 10b-5 if the insider did not know that the information he revealed would complete the analyst’s material mosaic. It is difficult to interpret the SEC comment any other way. Even after expressing surprise at the SEC’s approach and noting that the mosaic theory “generates considerable uncertainty,”⁹⁴ however, they do not take a clear stand on how Rule 10b-5 should

be applied in that situation.

A leading (though in this respect dated) text on securities fraud concludes that “the SEC has endorsed first implicitly, then explicitly, the propriety of analysts obtaining and using nonmaterial information to develop material information.”⁹⁵ These commentators read *Elkind* to mean, however, that “[a] piece of information that is separately immaterial may have aggregate or ‘mosaic’ materiality when considered with other separate pieces of information.”⁹⁶ As explained earlier, however, *Elkind* does not directly condemn disclosure of immaterial information, even if it provides the recipient of the disclosure with a material mosaic.⁹⁷ These authors also decline to endorse a specific formulation of the mosaic theory in the insider trading context.⁹⁸

In a comprehensive article on insider trading, two practitioners stated that “an investor that assembles multiple pieces of [nonpublic] non-material information to reach a material conclusion has not violated insider trading laws.”⁹⁹ These authors did not address, however, whether it matters whether the tipper knows what the tippee already knows from other sources.

The most lenient interpretation of the reach of Rule 10b-5 in this context was stated soon after Regulation FD was adopted:

The phrase “unbeknownst to the issuer” (as stated in the adopting release) is a new addition to the mosaic theory and does not appear in *Elkind*. It is unclear and unlikely that an issuer’s lack of awareness is a necessary condition of the mosaic theory . . . [A]n officer of the issuer can knowingly convey an immaterial fact to an analyst.¹⁰⁰

Under this approach an insider of the issuer could lawfully convey information that is not material in and of itself, even if he knows that it will complete a significant mosaic for the analyst.

Another author expressed a contrary view, that whether the insider knows that his disclosure completes another’s material mosaic *does* matter. It is “intentionally selective disclosure of *material*, nonpublic information” for an issuer to disclose “information [that] completes the mosaic and the issuer knows that providing such specific information to the analyst would influence an investment decision.”¹⁰¹ No authority was offered for this conclusion, however.

Another author also interpreted the SEC’s mosaic theory—at least as a Regulation FD issue, whether or not also for purposes of Rule 10b-5—as entirely dependent upon whether the insider conveying the information knows that what he disclosed completed a material mosaic, in effect reading “even if” as used in the *Adopting Release*¹⁰² to mean “only where”:

When an issuer is unaware of either an analyst’s research or the conclusions gleaned therefrom, the issuer may freely communicate

nonmaterial information to the analyst in reliance of [sic] the “reasonable investor” standard. Nevertheless, *a problem arises when an issuer becomes aware of the contents of an analyst’s mosaic*, which often contains information “not generally known” to the investing public. Under this scenario, the issuer may not communicate information the issuer knows will provide important missing pieces to the mosaic, regardless of whether the information, by itself, would satisfy the “reasonable investor” standard. Consequently, if an issuer knows that otherwise nonmaterial information will play a vital role in assisting the analyst to complete the mosaic, the issuer may not provide the information on a selective basis.¹⁰³

The most recent commentary, a student note, takes an extremely cautious approach.¹⁰⁴ While noting that the mosaic theory has not been “banned” and that “the SEC has continued to reaffirm that company insiders are permitted to disclose nonmaterial pieces of information to analysts,” the author concludes, with minimal analysis, that “it is not clear that this mode of securities analysis is in fact permissible due to the expansive meaning that courts have given to the term ‘nonpublic material information.’”¹⁰⁵ The author then counsels restraint: “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.”¹⁰⁶ He recommends that prophylactic measures be taken so that “securities analysts must refrain from engaging in ‘research’ practices in furtherance of the mosaic theory.”¹⁰⁷ This will be underscored by prohibiting “employees . . . from disclosing any company information to outside analysts.”¹⁰⁸ This recent contribution does not add to the analysis of the theory itself, though in the end the measures it counsels may be what the prudent analyst will do.¹⁰⁹

Part IV showed that the case law lacks analytical rigor and clarity, if only because so much of it is dicta. Part V reflected that the commentators also differ in their views, albeit many of the articles cited in that section are dated. The next section of this article presents a proposed statement of the legal principles that should apply.

VI. The Application of the Mosaic Theory in the Context of the Classical Theory of Insider Trading

The following analysis addresses the situation where an insider discloses to an outsider information that is not material standing alone and the recipient of the information uses it to complete a material mosaic, a complete picture that is not known to the public, and then trades in the securities of the issuer.

Consider this scenario. Company X, the only business of signif-

icance based in Remote City, California, has publicly announced that it hopes to employ some of its large horde of idle cash to make strategic acquisitions in the computer software industry. Alex, a securities analyst employed by a registered broker-dealer, is friends with Bill, the chief financial officer of Company Y, a publicly held software development company. They had made plans to play golf next weekend. Bill calls Alex to cancel their golf date, bemoaning that he has been called away to spend an uncertain period of time on business in “godforsaken” Remote City, California. The fact of the financial executive’s trip is surely not a material fact in and of itself about Company Y, though Bill’s plans are confidential, at least until he begins his travel.

Alex combines this seemingly insignificant fact of Bill’s trip with Company X’s *publicly* stated intention to buy software companies to formulate a (likely *material*¹¹⁰) mosaic that Company Y is involved in friendly acquisition negotiations with Company X.¹¹¹ That is, Alex concludes that Bill must be going to meet with Company X, because there is no other reason for him to go to Remote City for an extended period on business, and factors in that Bill is a *financial* (rather than, say, sales) executive, inferring that this meeting with Company X is not likely about products or marketing.¹¹²

Postulating that the acquisition discussions are friendly, that the parties have reached a critical, positive stage because Bill is headed to personal meetings, and that any acquisition of Company Y will be at a price in excess of the current market price, Alex’s firm privately recommends to some clients that they purchase stock of Company Y. The questions, then, are whether Bill has unlawfully tipped Alex by disclosing his destination and whether Alex is a tippee who has also violated Rule 10b-5 by tipping his clients.

Dirks provides that in analyzing whether an insider who discloses nonpublic information has breached a duty, one critical inquiry is whether the insider made the disclosure for an improper purpose.¹¹³ As recently explained in *Newman*, the crux of this component is whether confidential information was disclosed in exchange for a personal benefit.¹¹⁴ Two years before *Newman* the same court’s decision in *Obus* suggested that the personal benefit test was easily satisfied in many cases.¹¹⁵ *Newman*, however, raised the bar considerably, at least in the Second Circuit.¹¹⁶

Under the stringent *Newman* test it might be doubtful that Bill, in disclosing why he is canceling his golf date, was motivated by anticipating a personal benefit in exchange from Alex. On the other hand, one might be suspicious of his gratuitous disclosure of a *specific, identified* location to a close personal friend who is a

securities analyst. Moreover, Bill should have perceived, or was reckless in not appreciating, that this information would be revelatory to Bill, an analyst, in light of the publicly stated intention of Company X, the only enterprise of note in Remote City, to make acquisitions in Company Y's industry. This could be seen as subtly providing a gift, in the nature of potential trading profits, to Alex (or Alex's clients), even sufficient to satisfy the *Newman* test of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."¹¹⁷ Here one would want to know if Bill and Alex are in the habit of exchanging items of value from time to time.¹¹⁸ In any event, a court outside the Second Circuit that followed the more easily satisfied personal benefit formulation in *Obus* might have no problem interpreting Bill's behavior as improperly gifting to Alex the profits Bill himself could have gained by buying stock of Company Y.¹¹⁹ Under *Newman* the SEC would have to prove that the first tier tippee, Alex, *knew* that Bill had potential trading profits gifted to him. This ought not to be difficult, as Alex, being the direct tippee, knew that Bill had given him information that was not public.¹²⁰

Let us now return to the materiality/mosaic analysis itself. Under *Obus*, a tipper violates Rule 10b-5 only if, among other factors, he knows that what *he* disclosed was material.¹²¹ This facet of the scienter requirement, knowledge of materiality, means that the tipper is liable in the mosaic context if and only if he knows that the immaterial information he provided completes a material mosaic for the recipient, here Alex the analyst.¹²² This comports with the SEC's expression of the theory ("unbeknownst" to the insider), where tipper culpability depends on whether the insider knows he is completing a material mosaic—if, as argued above, the SEC's statement explaining Regulation FD reflects the SEC's understanding of Rule 10b-5.¹²³ This is also what the court stated in dictum in *Fluor*¹²⁴ and what some, though not all, of the commentary cited in Part V of this article states. This approach is also supported by the conclusion of this author's analysis elsewhere that the scienter of an insider-trader or tipper may be dependent upon his conscious appreciation of, or perhaps reckless failure to appreciate, the materiality of the tipped information.¹²⁵

This raises the question whether scienter in this respect can be established by the tipper's reckless disregard of the significance of the *public* facts, which provide everything but that last piece of the mosaic in this scenario. *Obus* stated that one of the elements of tipping is that "the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes or act with reckless disregard of the nature

of the information.”¹²⁶ Where the only other facts known to the tippee are public, then the tipper’s actual knowledge of the remaining components of the mosaic, or its functional equivalent, may be easy to demonstrate. As discussed later in this section, however, this element may be more difficult to satisfy where the tippee’s mosaic includes other nonpublic information.¹²⁷

If the analyst-tippee had only public information before learning something nonpublic from the insider, as in the scenario at the beginning of this section, the case against the tipper may be easy to make, save for the heightened proof required to satisfy the benefit requirement, and knowledge of the benefit, to the extent imposed by *Newman*.¹²⁸ For these purposes a senior officer should be presumed to know what information is public about both his company (here Bill the CFO of Company Y) and the other firm with which he is dealing directly (here Company X, the acquiring company).¹²⁹ In any event, if need be it should be easy to prove that Bill actually knew the public information about Company X that is relevant to the impending transaction and thus to Alex’s mosaic. It also should not be difficult to persuade the trier of fact that Bill would expect an astute analyst to be able to complete a material mosaic upon learning that he, the CFO of Company Y, was going to Remote City on business.

If some of the other components of the mosaic are nonpublic, for example, more specific information Alex the analyst learned privately from Company X about the nature of its acquisition targets in the software business, then the SEC must establish by direct evidence that Bill, the Company Y insider, knew what Alex the tippee already knew to the extent that information was what Alex combined with the travel disclosure to complete a material mosaic.¹³⁰ The SEC could not otherwise establish that the insider at Company Y, Bill, “knew” that his disclosure to Alex completed a material mosaic.

As noted earlier, the SEC’s case against Moore does not implicate the mosaic theory—that was not a tipper-tippee case at all.¹³¹ As a case study, however, it is instructive to evaluate that claim as if it had been brought against Moore as a tippee of CPIBB. The Managing Director of CPIBB took steps to avoid revealing the identity of the person he was speaking with at the social engagement and the Managing Director did not know that Moore independently learned that person’s identity. This appears to have been the only fact that tied what the Managing Director was working on to Tomkins, the company to be acquired (though this was confirmed to some extent by the knowledge of travel to London). Moreover, the Managing Director disclosed that he was working on a significant matter *before* he was openly observed at the social engagement with the Tomkins CEO.¹³² The Managing

Director had provided the first piece of the mosaic, not the piece that completed the material mosaic. At the time of his earlier sole verbal disclosure to Moore he did not complete a mosaic.¹³³ Timing is everything. Apart from other considerations, such as that the Managing Director did not reveal information to Moore for an improper purpose, this likely explains why the SEC did not charge the Managing Director with tipping and instead charged Moore under the misappropriation theory for using information he obtained *from CIBC*, his employer, in confidence.¹³⁴

VII. Conclusion

This article establishes that an insider who discloses information that standing alone is nonpublic but not material does not violate Rule 10b-5 unless he knows or is reckless in disregarding that the item of information that he is conveying will complete a material mosaic of information for the recipient of the disclosure. If the tipper-insider *does* know, then he is vulnerable to a charge of unlawful tipping where the other elements can be established, such as the tipper's disclosing for an improper purpose of obtaining a benefit and, at least under *Newman*, the tippee's knowledge of that personal benefit.

What guidance does this provide for an insider's communications with an outsider, the arguable tippee? One can, of course, choose never to say anything that is not already public. That, however, seems impractical, especially where there is a pre-existing social or other personal relationship.

An insider could scrupulously contemporaneously document, even record (with permission where required by law), what is said to and by any outsider. That measure, however, will not be sufficient to demonstrate the absence of a wrongful disclosure, because documenting an (otherwise only) immaterial disclosure may not include everything the speaker knew about what the tippee already knew, such as what he might have said in another conversation. That is, it does not provide a record of the entire context of the insider's disclosure, and that makes all the difference in applying the mosaic theory. If that context, that other information, is public, it is easy to prove the tipper knew it and there may even be a presumption, at least in a civil case,¹³⁵ that the speaker/tipper knew the tippee was aware of this information.¹³⁶ If some of the contextual information is nonpublic, it surely behooves the inquiring analyst or investor not to reveal to the insider what the analyst already knows, lest this provide the underpinning for an argument that the subsequent disclosure by the insider was a knowing disclosure of mosaic-completing information, making the insider an unlawful tipper and the analyst culpable if he trades or advises clients to do so (Again, the benefit and knowledge of benefit elements also have to be addressed.).

In an insider trading case the SEC, as a plaintiff in a civil action, has the burden of proof that material nonpublic information was tipped.¹³⁷ In many situations, the SEC's opening case is a circumstantial one.¹³⁸ Absent a judgment for the defendant at the close of the SEC's case the defendant will need to present evidence on what the tipper knew, or more to the point did not know, of the tippee's knowledge that completed the mosaic.¹³⁹ The principal evidence from the alleged tipper-defendant in a mosaic case might be his assertion that he did not know what the tippee already knew, that is, that he did not know enough to appreciate that his immaterial disclosure completed the tippee's material mosaic. This defendant must essentially prove a negative. Corroboration from the tippee may help, though if the tippee himself is a defendant or has settled with the SEC (even if he neither admitted nor denied liability), his testimony in favor of the tipper may not carry much weight.

No claim should lie when the outsider obtains nonmaterial information from the insider that *does not* complete a material mosaic until the outsider *later* obtains additional information *elsewhere* that completes the mosaic, even if the insider's earlier disclosure became an essential element of the mosaic. In that situation the insider cannot know *at the time of his disclosure* that what he has provided will, in the future, be crucial to completing a mosaic based on information not yet known to the outsider.¹⁴⁰ It is a stretch to impose liability on the basis that the insider was, say, reckless in not appreciating that there was a likelihood that, sometime in the future, before the insider's disclosure became public, the recipient of the information would discover additional information from another source that would then complete a mosaic, even if that other information already exists though it is not yet known to the tippee.

If the tipper violated the law, then the tippee is exposed to a claim that he violated Rule 10b-5 himself if he traded or tipped someone else. Of course, in the world of trials, this is not a two-step process where there is first a final determination of the tipper's liability before the tippee must defend himself. The tippee will be liable if it is proven, at least as required by *Newman*, that he knew that the disclosure of the mosaic-completing information breached the tipper's duty of confidentiality to the source of the information and that the tipper benefitted from the tip.¹⁴¹ Whether the tipper breached a duty is thus likely to depend in part on whether the tipper knew, or was reckless in not knowing, that his disclosure completed the tippee's mosaic. That is, a disclosure that is not known to be valuable to the tippee is not likely to generate expectation on the tipper's part of receipt of a *quid pro quo* from the tippee. The tippee here will know whether

the tipper knew what the tippee already knew only where that information (1) is entirely public or (2) was disclosed by the tippee himself to the tipper. In this respect, two components of scienter, knowledge of materiality and the tippee's knowledge of the tipper's breach, are interrelated.¹⁴² If, however, some of the tippee's information is nonpublic from sources other than this tipper and the tippee himself did not tell the tipper what he, the tippee, already knew, the tippee would not, at the time, be able to assess whether the tipper knows that the inconsequential information the tipper is providing in fact is useful because it completes the tippee's mosaic.

Consider the situation, however, where the tipper has learned from a source *other than* the tippee what the tippee already knows. In order to bestow a gift of profits on the tipper (say a very close personal friend, in order to provide the necessary underpinning for an "objective, consequential" exchange under *Newman*¹⁴³), the tipper provides something that fills out the tippee's mosaic. It is difficult to conclude that the tippee could be held liable, however, unless he had knowledge, or a strong basis to believe so that disregarding the facts was reckless, that the tipper *knew* that the tipper was completing the tippee's mosaic.

In the end, the advice to the insider must be more than "do not disclose material nonpublic information." It must also be "do not disclose immaterial nonpublic information, don't reveal *anything* that is relevant to the company or its securities that is not already public."¹⁴⁴ An insider cannot know with certainty what is already known to the person to whom he discloses nonpublic information¹⁴⁵ and someday *he* may have to prove that *he did not know* what the tippee already knew. Likewise, the tippee is taking a big risk in acting on the tipper's information when the tippee cannot assess how much of his mosaic the tipper already knows.

The mosaic theory is not an illusion. The theory that underlies it is conceptually sound and consistent with the general case law of insider trading. In a case where the result is dependent upon the application of the theory, however, the outcome may depend on the tipper's ability to convince the trier of fact that he did not know what the tippee already knew, that he did not know that his revelation was completing a material mosaic. This may be a difficult burden to satisfy.

NOTES:

¹⁷ C.F.R. § 240.10b-5. The rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

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

This rule is the basis for a substantial portion of SEC enforcement activity. Donna M. Nagy, et al., *Securities Litigation and Enforcement* 6–7, 23–24 (3d ed. 2012). The Supreme Court has explained that [i]n a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 157, 128 S. Ct. 761, 169 L. Ed. 2d 627, Fed. Sec. L. Rep. (CCH) P 94556 (2008). Reliance, economic loss, and loss causation need not be established in an SEC enforcement proceeding or criminal prosecution for a violation of Rule 10b-5. Nagy, *id.* at 149.

²*Basic Inc. v. Levinson*, 485 U.S. 224, 231, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S. Ct. 2126, 48 L. Ed. 2d 757, Fed. Sec. L. Rep. (CCH) P 95615 (1976) (action under the SEC proxy anti-deception rule, Rule 14a-9, 17 C.F.R. § 240.14a-9 (2015))). The Court recently reaffirmed *Basic*'s explanation of what facts are material. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318, 179 L. Ed. 2d 398, Fed. Sec. L. Rep. (CCH) P 96249, 62 A.L.R. Fed. 2d 737 (2011).

³*Basic*, 485 U.S. at 231–32 (quoting *TSC*, 426 U.S. at 449).

⁴*See* Horwich, *An Inquiry into the Perception of Materiality as an Element of Scienter under SEC Rule 10b-5*, 67 Bus. Law. 1, 14–15 (2011) (discussing the difficulty of determining materiality and collecting authorities). *See also* Oesterle, *The Overused and Under-Defined Notion of “Material” in Securities Law*, 14 U. Pa. J. Bus. L. 167, 167 (2011) (“the case-law [of materiality under the federal securities laws] is quixotic at best, and fickle at worst”).

⁵*U.S. v. O’Hagan*, 521 U.S. 642, 651–52, 117 S. Ct. 2199, 138 L. Ed. 2d 724, Fed. Sec. L. Rep. (CCH) P 99482, 191 A.L.R. Fed. 747 (1997) (quoting *Chiarella v. U. S.*, 445 U.S. 222, 228, 100 S. Ct. 1108, 63 L. Ed. 2d 348 (1980)).

The misappropriation theory is the other principal theory of insider trading.

The “misappropriation theory” holds that a person commits fraud “in connection with” a securities transaction, and thereby violates § 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 . . . In 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.

O’Hagan, 521 U.S. at 652 (citation omitted).

There is a third approach, which depends on a direct act of affirmative deception. *See S.E.C. v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (sustaining theory of Rule 10b-5 liability where, even absent any fiduciary duty to the source of the information, the defendant engages in deception in order to obtain material nonpublic information, after which the defendant trades).

For an in-depth analysis of the theories of insider trading, see 18 Donald C. Langevoort, *Insider Trading: Regulation, Enforcement & Prevention* *passim*, especially chs. 3 & 6 (2015); William K. S. Wang & Marc I. Steinberg, *Insider Trading* *passim*, especially ch. 5 (3d ed. 2010).

⁶*Dirks v. S.E.C.*, 463 U.S. 646, 660–62, 103 S. Ct. 3255, 77 L. Ed. 2d 911, Fed. Sec. L. Rep. (CCH) P 99255 (1983). One court recently summarized the concept of benefit.

Personal benefit to the tipper is broadly defined: 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.”

S.E.C. v. Obus, 693 F.3d 276 (2d Cir. 2012) (quoting *Dirks*, 463 U.S. at 663–64). In a later case that court provided a further gloss on this concept raising the bar for satisfying the benefit element in some situations:

To the extent *Dirks* suggests that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee’s trades “resemble trading by the insider himself followed by a gift of the profits to the recipient,” [quoting *Dirks*, 463 U.S. at 664], we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature . . . [T]his requires evidence of “a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the [latter].”

U.S. v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (quoting *U.S. v. Jiau*, 734 F.3d 147, 152–53 (2d Cir. 2013), for additional opinion, see, 545 Fed. Appx. 34 (2d Cir. 2013), cert. denied, 135 S. Ct. 311, 190 L. Ed. 2d 226 (2014) and cert. denied, 135 S. Ct. 311, 190 L. Ed. 2d 226 (2014)). Any petition to the Supreme Court for a writ of certiorari is due July 2, 2015. Sup. Ct. R. 13.1.

⁷*Obus*, 693 F.2d at 286. The court elaborated on the multiple elements of scienter for the tipper:

[T]he first and second aspects of scienter—a deliberate tip with knowledge that the information is material and non-public—can often be deduced from the same facts that establish the tipper acted for personal benefit. The inference of scienter is strong because the tipper could not reasonably expect to benefit unless he deliberately tipped material non-public information that the tippee could use to an advantage in trading. The third aspect of scienter, that the tipper acted with knowledge that he was violating a confidence, will often be established through circumstantial evidence.

Id. at 286–87 (citations omitted). The Supreme Court has never decided whether scienter encompasses reckless conduct; it has repeatedly expressly reserved the question under Rule 10b-5 for thirty-five 35 years. Most recently see *Matrixx*, 131 S. Ct. at 1323–24. The courts of appeals uniformly have held that scienter includes reckless conduct in civil actions. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 n.3, 127 S. Ct. 2499, 168 L. Ed. 2d 179, Fed. Sec. L. Rep. (CCH) P 94335 (2007) (“Court for a writ of certiorari is due August 1, 2015. Docket No. 14A1264.”).

⁸*Obus*, 693 F.3d at 287–88.

⁹*Id.* at 288. After the court in *Obus* found the alternative “should have known” to be consistent with *Dirks* (*id.*, citing *Dirks*, 463 U.S. at 660), commentators criticized the absence of a scienter requirement here. See Heminway, *Willful Blindness, Plausible Deniability and Tippee Liability: SAC, Steven Cohen, and the Court’s Opinion in Dirks*, 15 *Transactions: Tenn. J. of Bus. L.* 47, 52–53 (2013) (stating that it is appropriate to question whether it is tenable

in application to separate the knew or should have known test from the test for intentional trading by the tippee while in knowing possession of material nonpublic information); Vissichelli, Note: Intent to Reconcile: SEC v. Obus, The Second Circuit's Edification of the Tippee Scier Standard, 62 Am. U. L. Rev. 763, 776 (2013) ("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"); see also Langevoort, "Fine Distinctions" in the Contemporary Law of Insider Trading, 2013 Colum. Bus. L. Rev. 429, 456 (observing that *Obus* may change the tippee scier standard). The subsequent development of this issue in *Newman* should satisfy these critics. See *infra* text accompanying note 10.

¹⁰*Newman*, 773 F.3d at 449–50. While the court took into account the necessity of proving a wilful violation of Rule 10b-5, *mens rea*, in order to obtain a criminal conviction (*id.* at 447, 450), the overall tenor of the decision may support a knowledge-of-the-benefit requirement for tippees in civil insider trading cases. In light of the scier requirement that applies to all actions under Rule 10b-5, *Newman*'s citation of civil enforcement cases, including *Dirks* (*id.* at 446–47, 450 n.5), strongly suggests that civil actions require proof of the defendant's knowledge of the tipper's personal benefit. A former Director of Enforcement observed, "Because the scier element also applies in an SEC case, there is no reason to think that the knowledge of personal benefit requirement would not also apply in a civil case brought by the SEC." William R. McLucas, Jr., et al., Recent Insider Trading Decision (Dec. 23, 2014), <https://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=17179875784>.

At the same time, it is difficult to reconcile that conclusion with *Obus*, decided by the same court, which did not include knowledge-of-the-benefit in its purportedly exhaustive list stating when scier must be proven in a civil enforcement action, a ruling which *Newman* did not distinguish. *Obus*, 693 F.2d at 288 ("tippee liability can be established if a tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly"). After *Newman*, one court has noted that the scier element may be satisfied in a civil case by a showing that the tippee recklessly disregarded that the tippee received a benefit. *S.E.C. v. Payton*, Fed. Sec. L. Rep. (CCH) P 98442, 2015 WL 1538454, *5–6 (S.D. N.Y. 2015).

¹¹See, e.g., McLucas, *supra* note 10 ("there is a risk that either the DOJ or, more likely, the SEC will pursue cases in other circuits on the theory that the knowledge requirement announced in *Newman* is an incorrect interpretation of *Dirks*"). See, e.g., *U.S. v. Salman*, 2015 WL 4068903, at *6 (9th Cir. July 6, 2015) (refusing to follow *Newman* to the extent that doing so "would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an 'insider makes a gift of confidential information to a trading relative or friend,'" quoting *Dirks*, 463 U.S. at 664).

¹²Stephanie Russell, SEC's Ceresney Isn't Sweating 2nd Circ.'s *Newman* Ruling, Law360 (Feb. 10, 2015), <http://www.law360.com/articles/620472/sec-s-ce-resney-isn-t-sweating-2nd-circ-s-newman-ruling>.

¹³See *infra* text accompanying notes 119–130.

¹⁴See SEC Rule 10b5-1(b), 17 C.F.R. § 240.10b5-1(b) (2015) ("a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale") (emphasis added). Rule 10b5-1(c) affords specific, purportedly exclusive, affirmative defenses to a charge of trading "on the basis of" material nonpublic information where the person on whose behalf the trade was made

was aware of the information at that time. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, 65 F.R. 51716, 51727 (Aug. 24, 2000) [hereinafter *Adopting Release*].

This author has contended, both before and after the adoption of Rule 10b5-1, that one who trades while aware of material nonpublic information has violated Rule 10b-5 *only* if that person relied on, that is, made conscious use of, material nonpublic information in deciding to trade. Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 *Bus. Law.* 913, 943–49 (2007); Horwich, *Possession v. Use: Is There a Causation Element in the Prohibition on Insider Trading*, 52 *Bus. Law.* 1235 *passim* (1997). Notwithstanding the SEC’s interpretation expressed in Rule 10b5-1(b), some courts still recognize proof of nonuse of the nonpublic information as a defense. *See* Jury Instructions Given, SEC v. Steffes, Case. No. 1:10 cv 6266 (N.D. Ill. Jan. 24, 2014), ECF No. 290, Instruction No. 29:

[E]ven if you believe that a defendant was in possession of material nonpublic information, if you also believe the defendant would have made the exact same trade whether or not he possessed material nonpublic information, then you may infer that the defendant did not trade on the basis of material nonpublic information.

The validity of Rule 10b5-1 was recently challenged, albeit not head-on, in a petition for certiorari. *Petition for Writ of Certiorari at 18 n.2, Whitman v. United States*, No. 14-29 (July 8, 2014). Although the petition was denied without a noted dissent, Justice Scalia, joined by Justice Thomas, questioned whether courts should defer to agency interpretations of criminal prohibitions, such as what Rule 10b5-1 provides for Rule 10b-5.

With deference to agency interpretations of statutory provisions to which criminal prohibitions are attached, federal administrators can in effect create (and uncreate) new crimes at will, so long as they do not roam beyond ambiguities that the laws contain. Undoubtedly Congress may make it a crime to violate a regulation [citation omitted], but it is quite a different matter for Congress to give agencies—let alone for us to presume that Congress gave agencies—power to resolve ambiguities in criminal legislation [citation omitted].

Whitman v. U.S., 135 S. Ct. 352, 190 L. Ed. 2d 381 (2014) (statement of Scalia, J., joined by Thomas, J., respecting the denial of certiorari). Further consideration of that issue is not pertinent to the question addressed in this article, where it is assumed that when he engaged in the challenged trade the tippee-trader consciously relied on all information known to him.

¹⁵*See, e.g., U.S. v. Contorinis*, 692 F.3d 136, 144 (2d Cir. 2012) (affirming judgment on jury verdict of unlawful insider trading, holding that court’s instructions adequately conveyed the concept of nonpublic information); *U.S. v. Libera*, 989 F.2d 596, 601, Fed. Sec. L. Rep. (CCH) P 97383 (2d Cir. 1993) (affirming judgment on jury verdict of unlawful insider trading, holding that evidence was sufficient for jury to find that information in question was nonpublic).

¹⁶*See, e.g., Contorinis*, 692 F.3d at 144 (affirming judgment on jury verdict of unlawful insider trading, holding that court’s instructions adequately conveyed the concept of material information); *U.S. v. Cusimano*, 123 F.3d 83, 99 (2d Cir. 1997) (affirming judgment on jury verdict of unlawful insider trading, holding that evidence was sufficient for jury to find that information was material).

¹⁷The mosaic theory of materiality is not the same as the mosaic theory of misrepresentation under the securities laws. Under the latter, where the defendants are alleged to have made material misrepresentations to the public [the allegedly misleading] public statements must be viewed as part of a “mosaic” to see if those statements, in the aggregate, created a misleading

impression. Contrary to defendants' contention, the proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create.

In re Genetech, Inc., Securities Litigation, Fed. Sec. L. Rep. (CCH) P 94544, 1989 WL 106834, *3 (N.D. Cal. 1989), clarified on denial of reconsideration, Fed. Sec. L. Rep. (CCH) P 94813, 1989 WL 137189 (N.D. Cal. 1989). The mosaic theory of materiality is also not to be confused with the mosaic theory of the Fourth Amendment. See Kerr, *The Mosaic Theory of the Fourth Amendment*, 111 Mich. L. Rev. 311, 313 (2012) ("Under the mosaic theory, searches can be analyzed as a collective sequence of steps rather than as individual steps.").

¹⁸For ease of expression, the terms "tipper" and "tippee" will sometimes be used here both where the disclosure and trading violates Rule 10b-5 and where it does not.

¹⁹See *Adopting Release*, *supra* note 14; Regulation FD, 17 C.F.R. Part 243 (2015).

²⁰For this purpose the SEC applies the test of materiality set forth *supra* text accompanying notes 2–3. *Id.* 65 F.R. at 51721.

²¹*Adopting Release*, *supra* note 14, 65 F.R. at 51727.

²²Regulation FD, Rules 100-101, 17 C.F.R. §§ 243.100 & 101 (2015).

²³*Adopting Release*, *supra* note 1419, 65 F.R. at 51722.

²⁴15 U.S.C.A. §§ 78m, 78o (2006 & Supp. 2010). See *Adopting Release*, *supra* note 14, 65 F.R. at 51726 ("Regulation FD is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act.").

²⁵See *Adopting Release*, *supra* note 14, 65 F.R. at 51726 ("Regulation FD . . . is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.") (footnote omitted).

²⁶Regulation FD, Rule 102, 17 C.F.R. § 243.102 (2015). See also *Adopting Release*, *supra* note 14, 65 F.R. at 51718 ("we have revised Regulation FD [from the form in which it was proposed] to make absolutely clear that it does not establish a duty for purposes of Rule 10b-5").

²⁷*Supra* text accompanying note 23.

²⁸See *infra* text accompanying note 36.

²⁹*TSC*, 426 U.S. at 445 ("The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.").

³⁰While many of the materials cited in this article focus on disclosures by an insider to a securities analyst, there is nothing in the principles that underlie the mosaic theory that limits its application to investment professionals. For example, Regulation FD applies to communications by an issuer to current holders of the company's securities. Regulation FD, Rule 100(b)(1), 17 C.F.R. § 243.100(b)(1) (2015). The law of insider trading should be the same for the analyst and for any resourceful investor who ferrets out information and combines it with other information he knows to discern something material that is not publicly known.

³¹SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations* 101.03 (Aug. 14, 2009), <http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm> (last updated June 4, 2010) (emphasis added). This formulation

does not include the phrase “unbeknownst to the issuer” that is in the *Adopting Release*. See *supra* text accompanying note 23. For the significance of this phrase, see *infra* text accompanying notes 121–130.

The securities analyst profession relies upon this guidance. See Cert. Fin. Analyst Institute, Standards of Practice Handbook 62 (11th ed. 2014):

Mosaic Theory. A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the “mosaic theory,” financial analysts are free to act on this collection, or mosaic, of information without risking violation.

³²*In the Matter of RAYMOND L. DIRKS*, Release No. 34, 17480, Release No. 17480, 21 S.E.C. Docket 1401, 1981 WL 36329 (S.E.C. Release No. 1981), *aff’d sub nom. Dirks v. SEC*, 681 F.2d 824 (D.C.Cir. 1982), *rev’d on other grounds*, 463 U.S. 646 (1983).

³³*Securities and Exchange Commission v. Bausch & Lomb Inc.*, 565 F.2d 8, 14–15, Fed. Sec. L. Rep. (CCH) P 96186 (2d Cir. 1977) (footnote and citation omitted).

³⁴See *supra* text accompanying notes 3–4 (stating the meaning of “material” under the securities laws).

³⁵See *supra* text accompanying note 23.

³⁶Carlo V. di Florio, Director of the SEC Office of Compliance Inspections and Examinations, at the IA Watch Annual IA Compliance Best Practices Seminar (Mar. 21, 2011), available at <http://www.sec.gov/news/speech/2011/spch032111cvd.htm>.

³⁷Complaint, *SEC v. Moore*, No. 14 Civ. 2514 (S.D.N.Y. April 16, 2013), ECF No. 1, available at <http://www.sec.gov/litigation/complaints/2013/comp22674.pdf>. The settlement of the case upon filing is reported in SEC Charges Former Investment Banker with Insider Trading, Litigation Release No. 22,674 (Apr. 16, 2013), available at <http://www.sec.gov/litigation/litreleases/2013/lr22674.htm>.

³⁸Complaint, *supra* note 37, ¶ 6.

³⁹*Id.* At ¶¶ 10–11.

⁴⁰*Id.* at ¶¶ 7, 15–16.

⁴¹*Id.* at ¶ 17.

⁴²*Id.* at ¶¶ 7, 19.

⁴³*Id.* at ¶ 20.

⁴⁴*Id.* at ¶ 24. Nothing in the complaint identifies the original source of this updated information about the CPPIB deal, as it was Moore himself who allegedly observed that a big deal was in the works; in the SEC’s complaint this information is not explicitly attributed to Moore’s CIBC colleague. Presumably had the case been tried the SEC would have argued that the jury could infer from the sequence of events that Moore obtained the information from a CIBC colleague who had in turn obtained the information from CPPIB and thus misappropriated confidential information provided to CIBC in connection with its off-and-on relationship with CPPIB.

⁴⁵*Id.* at ¶¶ 25–28.

⁴⁶*Id.* at ¶ 29.

⁴⁷*Id.* at ¶ 31.

⁴⁸Speculation why a particular case is settled at this stage tends to be uninformed. Moore may have been concerned, however, that his alleged efforts to hide his trading (*see id.* at ¶ 26) may have compromised his ability to argue that he did not use information improperly obtained.

⁴⁹In settled proceedings against Moore before the Ontario Securities Commission arising out of the same conduct, the staff of that commission stated, “In no specific instance did [the Managing Director of CPPIB] ever provide Moore with any material, generally undisclosed information.” Statement of Allegations of Staff of the Ontario Securities Commission, In the Matter of Richard Bruce Moore ¶ 11 (Apr. 11, 2013), http://osc.gov.on.ca/en/Proceedings_soa_20130411_moorerb.htm. Moore was alleged to have “deduced” CPPIB’s impending takeover of Tomkins, Moore [having] reached this conclusion as a result of his previous knowledge of Tomkins obtained from public sources including rumours that it would be the subject of a takeover, his observations of a friend and senior representative of CPPIB (“Mr. A.”) and comments of a general nature made by Mr. A. about work that he was involved in for CPPIB. These interactions with Mr. A. occurred over the course of several months, including on social occasions.

Id. at ¶¶ 7–8. The Ontario Commission staff concluded:

Moore’s conduct involving the purchase of securities of Tomkins as outlined above fell below the standard of behaviour expected from someone in Moore’s position and given his extensive experience in the capital markets industry. In particular, he ought not to have made use of information obtained in part by virtue of his position as an employee of a registrant prior to its general disclosure to the public.

Id. at ¶ 23.

⁵⁰As one commentary expressed it, “[T]he SEC’s aggressive stance against Moore suggests that, if disparate pieces of information—even if nonpublic and immaterial—are gathered in breach of a duty, then the mosaic theory may not be available as an affirmative defense to insider trading.” Morrison & Foerster, Insider Trading Annual Review 2013, at 8 (Jan. 2014), available at <http://www.mofo.com/files/Uploads/Images/140108-Insider-Trading-Annual-Review.pdf>. Two other commentators stated:

The Moore case illustrates the limits of the “mosaic theory.” Under the mosaic theory investors can assemble many different pieces of information, which may include both publically available information and immaterial non-public information that may be confidential, into a mosaic that provides the investor with a material insight into a security that is not known to the market in general. The Moore case suggests that if all of the immaterial, non-public information in a mosaic was obtained as a result of a breach of duty, then the “mosaic theory” may not be available as a defense to insider trading.

Greg Kramer & Stephen M. Schultz, *Case Against a Canadian Investment Banker Highlights The SEC’s Expansive View of Insider Trading*, Bloomberg Law (undated), <http://about.bloomberglaw.com/practitioner-contributions/the-secs-expansive-view-of-insider-trading/>. *See also* Ralph C. Ferrara et al., Ferrera on Insider Trading and the Wall § 2.01[3], at 2–22 (2014) (commenting that the complaint in *Moore* “could be read to erode certain protections previously thought to be available under the mosaic theory”); Michael Rosenhaft, First Half 2013 Insider Trading Review, Financial Fraud Law Report 606, 609–10 (Jul.-Aug. 2013), http://www.kattenlaw.com/files/46826_FFLR%208-2013%20Rosenhaft%20Final.pdf (“This complaint seems to invite a mosaic theory defense—that even if the information gleaned through Moore’s employer

were insider information, it was only pairing it with the public information at the charity event that made it material. However, the SEC seems unconcerned.”); Linklaters, Financial Crime Update 4 (May 2013), http://www.linklaters.com/pdfs/mkt/london/Financial_Crime_Update_May_2013.pdf (stating that the Moore complaint “highlights . . . the expanding definition of materiality and the decline of the mosaic theory safe haven”).

⁵¹See *infra* text accompanying notes 131–134.

⁵²See *supra* note 5 (describing misappropriation theory).

⁵³See *supra* text accompanying note 41.

⁵⁴The research for this article included seeking to identify cases expressly referring to a “mosaic” or “matrix” in the context of a securities law materiality analysis.

⁵⁵*Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, Fed. Sec. L. Rep. (CCH) P 97716 (2d Cir. 1980) (deciding appeal and cross-appeal from judgment after bench trial).

⁵⁶*Id.* at 165 (footnote omitted).

⁵⁷*Id.* at 166. The court also stated that “a relevant question in determining materiality in a case of alleged tipping to analysts is whether the tipped information, if divulged to the public, would have been likely to affect the decision of potential buyers and sellers.” *Id.* This may suggest, though the meaning of the statement is not entirely free from doubt, that independently “inconsequential” information may itself *become* material if provides *the* facts that complete a material mosaic, at least when the other facts are public. See *infra* note 66 and text accompanying notes 88–90, where this conclusion is further addressed.

⁵⁸*Id.* at 166.

⁵⁹*Id.* at 166–67.

⁶⁰*Id.* at 161, 167.

⁶¹*State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, Fed. Sec. L. Rep. (CCH) P 98005 (2d Cir. 1981).

⁶²*Id.* at 854.

⁶³*Id.*, quoting *Elkind*, 635 F.2d at 165, quoted *supra* text accompanying note 56.

⁶⁴654 F.2d at 854. The court also disagreed with the district court that the substance of the information in question was already public. *Id.*

⁶⁵*State Teachers Retirement Bd. v. Fluor Corp.*, 566 F. Supp. 945, 947–48, Fed. Sec. L. Rep. (CCH) P 99264 (S.D. N.Y. 1983).

⁶⁶*Id.* at 949. This is the court’s complete statement:

Although the information may be seemingly insignificant and in some instances speculative, if it completes the mosaic, or “the matrix,” and it is non-public, it may be material if “there [is] a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

Id., quoting *TSC*, 426 U.S. at 439, 449.

⁶⁷566 F. Supp. at 949–50.

⁶⁸*Id.* at 949–54.

⁶⁹*Id.* at 950–51. The question in those situations was thus whether the fact that the *company* made the projection was sufficient additional information to

make the disclosure material. “Although these projections [by outsiders] may have made the [tipped] information less material, particularly in the light of Fluor’s limited [financial] interest [in the projects], still the projection as a company figure and its materiality remain properly an issue of fact.” *Id.* at 951.

On this dimension, more recently see *Contorinis*, 692 F.3d at 144 (citing *S.E.C. v. Mayhew*, 121 F.3d 44, 52, Fed. Sec. L. Rep. (CCH) P 99496 (2d Cir. 1997)):

Insiders often have special access to information about a transaction. Rumors or press reports about the transaction may be circulating but are difficult to evaluate because their source may be unknown. A trier of fact may find that information obtained from a particular insider, even if it mirrors rumors or press reports, is sufficiently more reliable, and, therefore, is material and nonpublic, because the insider tip alters the mix by confirming the rumor or reports.

Thus, an insider’s confirmation of a rumor or of other facts known to the tippee may be material in and of itself, and thus something much more than completing a mosaic as that concept is used in this article. It bears emphasis that the focus of this article is disclosure by the insider of information that is not material in and of itself.

⁷⁰See No. 76 Civ. 2135 (RWS), 1985 WL 183 (S.D.N.Y. Jan. 10, 1985) (addressing awarding of costs after jury verdict for defendants). There is no further case history reported on Westlaw.

⁷¹See *supra* text accompanying note 23.

⁷²Some—including the defendant—expected that there would be a meaningful analysis of the mosaic theory in connection with Raj Rajaratnam’s defense of charges of insider trading. See, e.g., Laura Nyantung Beny & H. Negat Seyhun, Has Illegal Insider Trading Become More Rampant in the United States? Empirical Evidence from Takeovers, in *Research Handbook on Insider Trading* 211, 218 (Stephen M. Bainbridge ed., 2013) (“The heart of the defense’s legal theory was the mosaic theory.”); *The Mosaic Defense*, *The Economist* Apr. 14, 2011, <http://www.economist.com/node/18561025/print> (“[Rajaratnam’s] lawyers insist that much of Galleon’s trading was based on publicly available information. Traders patched together data from equity analysts’ reports, company announcements and newspaper articles, a practice known as the ‘mosaic theory’ of investing.”).

Rajaratnam was convicted of multiple counts of securities fraud. *U.S. v. Rajaratnam*, 802 F. Supp. 2d 491, 495 (S.D. N.Y. 2011). In denying Rajaratnam’s post-trial motion for acquittal, the court held that there was sufficient evidence that the nonpublic disclosures Rajaratnam received were in and of themselves material. *Id.* at 512–19. The mosaic theory was given only cursory treatment in the briefs on Rajaratnam’s appeal. Brief on Behalf of Appellant, at 59–60, *United States v. Rajaratnam*, No. 11-4416 (2d Cir. Jan. 25, 2012) (quoting *Elkind*, 635 F.2d at 165, to the effect that an analyst “‘may piece seemingly inconsequential data together with public information into a mosaic’ that the analyst is free to exploit” and arguing that an instruction prevented the jury from “distinguishing between trades caused by legal sources of information and those that were alleged to be the product of inside information”); Brief on Behalf of Appellee, at 68–70, No. 11-4416 (2d Cir. Apr. 25, 2012) (arguing in support of the contested jury instruction because it required only that the jury find that the material non-public information in some way informed the investment decision and that in any event any error was harmless in light of the “overwhelming” evidence of securities fraud).

In affirming Rajaratnam’s conviction, the Second Circuit Court of Appeals did not address the mosaic theory. *U.S. v. Rajaratnam*, 719 F.3d 139, 160, Fed.

Sec. L. Rep. (CCH) P 97534 (2d Cir. 2013), cert. denied, 134 S. Ct. 2820, 189 L. Ed. 2d 785 (2014) (upholding instruction that permitted the jury to convict if “material non-public information given to the defendant was a factor, however small, in the defendant’s decision to purchase or sell stock”). One commentator characterized this ruling as “confirm[ation]” of the “death knell’s sound on the mosaic defense.” Michael M. Rosensaft, A Look Back at Insider Trading in 2013, *Securities Law360* (Jan. 13, 2014), <http://www.law360.com/articles/500198/a-look-back-at-insider-trading-in-2013>. This is an overstatement of what the court of appeals held, as the court’s analysis did not address any immaterial information garnered by the defendant. 719 F.3d at 158. The mosaic theory, by contrast, applies where the information tipped was not material standing alone. *See supra* text accompanying note 29 and *infra* text accompanying note 86.

⁷³*S.E.C. v. Steffes*, 805 F. Supp. 2d 601, Fed. Sec. L. Rep. (CCH) P 96509 (N.D. Ill. 2011).

⁷⁴The cited cases are discussed *infra* note 79.

⁷⁵*Steffes*, 805 F. Supp.2d at 610–13 (footnote omitted). The non-settling defendants in that case, including one of the alleged tippers, prevailed in a jury trial. Jury Finds Defendants Not Liable for Insider Trading, Litigation Release No. 22,917 (Feb. 4, 2014), available at <http://www.sec.gov/litigation/litreleases/2014/lr22917.htm>. The jury instructions repeated the concept expressed in the first sentence of the quotation in the text. *SEC v. Steffes*, Jury Instructions Given, Case No. 1:10-cv-06266 (N.D. Ill. Jan. 24, 2014), ECF No. 290, p. 29 (“A defendant may be held liable for insider trading when he obtains and acts on pieces of information which, pieced together, constitute material nonpublic information.”).

⁷⁶*See, e.g.*, Stephen Bainbridge, *SEC Stretches Definition of Inside Information and Materiality Past Breaking Point*, <http://www.professorbainbridge.com/professorbainbridge.com/2011/02/sec-stretches-definition-of-inside-information-and-materiality-past-breaking-point.html> (Feb. 8, 2011) (“First, there is no inside information here . . . What you have here are educated guesses derived from observations of events. There’s nothing to suggest secrecy nor is there anything to suggest a communication conveying knowledge.”); Gibson Dunn, 2010 Year-End Securities Enforcement Update 14–15, <http://www.gibsondunn.com/publications/Pages/2010Year-EndSecuritiesEnforcementUpdate.aspx> (Jan. 10, 2011) (describing the SEC’s complaint as testing the limits of inside information).

⁷⁷Greene and Schmid, *Duty-Free Insider Trading?*, 2013 Colum. Bus. L. Rev. 369, 415 (2013).

⁷⁸805 F. Supp.2d at 605, 610–13. The court also relied on internal rumors about a possible sale of the company. *See infra* note 81. In this respect the case resembles *Moore*, which has also been incorrectly criticized as reflecting the SEC’s rejection of the mosaic theory. *See supra* text accompanying note 47 (noting that the claim against Moore was for misappropriating his employer’s nonpublic information that was, in the aggregate, allegedly material).

⁷⁹One case relied on by the court in *Steffes*, *S.E.C. v. Materia*, 745 F.2d 197, Fed. Sec. L. Rep. (CCH) P 91681 (2d Cir. 1984), also involved an employee piecing together information he learned entirely in his employee capacity. In another, *U.S. v. Mylett*, 97 F.3d 663, Fed. Sec. L. Rep. (CCH) P 99326 (2d Cir. 1996), the conviction of a tippee was upheld where the tipper had pieced together information as a corporate employee. This was also substantially the situation presented in the third case cited in *Steffes*, *S.E.C. v. Binette*, 679 F. Supp. 2d 153, Fed. Sec. L. Rep. (CCH) P 95583 (D. Mass. 2010). The fourth and final case cited by *Steffes* on this point was the opinion of the court of appeals in *Fluor*, the only case the court cited that allegedly involved an insider tipping an

outsider. *See supra* text accompanying notes 61–64.

⁸⁰*Id.* at 616.

⁸¹*Id.* at 613. The SEC argued that the facts that (1) *other persons*, who apparently had no more information than the defendants, were asking the tipper defendants if the company was for sale, and (2) there were rumors about a possible sale both factored into the defendants' decision to trade. *Id.* at 605, 611, 613, 616. The court does not explain how such rumors, when they did not emanate from persons in the know, can be deemed material information, or even part of a mosaic in this context.

⁸²*See* Akin Gump, *Court of Appeals Reins in Prosecutors in Insider Trading Cases* (Dec. 15, 2014) (concluding that *Newman* “provides fertile ground on which traders . . . can show that their trades were based on a mosaic of available public information, rather than impermissibly obtained material nonpublic information”), <http://www.akingump.com/en/news-insights/court-of-appeals-reins-in-prosecutors-in-insider-trading-cases.html>. Surely, however, no one contends that basing a trade on “a mosaic of public information” ever violates Rule 10b-5. *See also* Samuel Buell, *Inside Trading Law in Deeper Waters*, The CLS Blue Sky Blog (Jan. 27, 2015) (stating, without further explanation, “The court’s opinion explicitly carries water for the ‘mosaic of information’ theory”), <http://cls.bluesky.law.columbia.edu/2015/01/27/insider-trading-law-in-deeper-waters-3/>.

⁸³*Newman*, 773 F.3d at 454.

⁸⁴*Id.* at 455.

⁸⁵Knowing that an insider is the source of the confirmation of a rumor factors into the analysis of the materiality of that confirmation. *Supra* note 69. In *Newman* there was no evidence that the tippee-defendants knew that the source that confirmed the analysts' earnings models was an insider. 753 F.3d at 455.

⁸⁶Langevoort, *supra* note 5, § 5:3, at 5-19 to -20 (footnotes omitted). This section of his treatise does not include any reference to the SEC’s expression of the mosaic theory in the *Adopting Release*, *supra* text accompanying note 23, though it essentially states the SEC’s position.

⁸⁷*Id.* at § 11:5, at 11–18 (footnote omitted, including citation to the *Adopting Release*, *supra* note 14).

Professor Langevoort also offers an analysis that would essentially vitiate the mosaic theory, however, at least in the context of the misappropriation theory, though he recognizes that the cases have not yet gone in this direction. Under the misappropriation theory, where the focus is on deception of the source of the information (*see supra* note 5), the test of materiality might not be the importance of the information to an investor but rather its significance to the source, such as the employer of the person making the disclosure. Professor Langevoort posits that it would be disloyal in violation of Rule 10b-5 even to disclose “submaterial” information (as measured from the investor perspective) without first disclosing to the source that the employee is going to reveal this information. “Corporate information, quite simply, is not an employee’s to sell, whether or not it is obviously market-moving.” *Id.* at § 11:5, at 11–19.

⁸⁸Wang & Steinberg, *supra* note 5, at § 4.2.3[D], at 136. They presumably mean something akin to Langevoort’s “material to him,” i.e., the analyst. *See supra* text accompanying note 86.

⁸⁹*See supra* text accompanying notes 55–60.

⁹⁰*See supra* text accompanying note 66.

⁹¹Wang & Steinberg, *supra* note 5, at 136 n. 189 (emphasis in original).

⁹²*See supra* text accompanying note 23.

⁹³Wang & Steinberg, *supra* note 5, § 4.2.3[D], at 139.

⁹⁴*Id.* at 138, quoting Dennis, Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix, 25 Wm. & Mary L. Rev. 373, 415 n. 205 (1984).

⁹⁵Alan R. Bromberg et al., Securities Fraud and Commodities Fraud § 6:155, at 6-461 to -62 (2d ed. 2013) (relying on *Investors Management* and the Commission's decision in *Dirks*, without reference to the *Adopting Release*, *supra* note 14). These authors' discussion of this specific topic has not been updated since 2003.

⁹⁶*Id.* § 7:32, at 7-116.

⁹⁷*See supra* text accompanying notes 55–60.

⁹⁸Another text on insider trading discusses the mosaic theory in the context of what facts have been found or alleged to have been material, addressing *Elkind*, *Bausch & Lomb*, the *Adopting Release* and some of the recent cases discussed here, as well as an earlier version of this article. The authors do not, however, present a critique of the mosaic theory and how it should be applied. Ralph C. Ferrara et al., Ferrara on Insider Trading and the Wall § 2.01[3], at 2-19 to -23 (2014).

⁹⁹Bondi and Lofchie, Practitioner Note: The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance, 8 N.Y.U. J. L. & Bus. 151, 154–55 (2011) (footnotes omitted, citing *Fluor*, 654 F.2d at 854).

¹⁰⁰D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and Its Impact on Market Participants*, 77 Ind. L. J. 551, 566 (2002) (footnotes omitted).

¹⁰¹Barry, The Securities and Exchange Commission's Regulation Fair Disclosure: Parity of Information or Parody of Information?, 56 U. Miami L. Rev. 645, 659 (2002) (emphasis added). While this statement focuses on the scope of Regulation FD, branding something an "intentionally selective disclosure" may express an implicit Rule 10b-5 analysis as well.

¹⁰²*Supra* text accompanying note 23.

¹⁰³Jennings, Recent Development, Regulation FD: SEC Establishes Enforcement Capabilities over Selective Disclosure, 32 St. Mary's L.J. 543, 579 (2001) (footnote, citing *Adopting Release*, *supra* note 14, omitted).

¹⁰⁴Davidowitz, Note: Abandoning The "Mosaic Theory": Why the "Mosaic Theory" of Securities Analysis Constitutes Illegal Insider Trading and What to do about it, 46 Wash. U. J.L. & Pol'y 281 (2014).

¹⁰⁵*Id.* at 295–96.

¹⁰⁶*Id.* a 296.

¹⁰⁷*Id.* at 300.

¹⁰⁸*Id.*

¹⁰⁹*See infra* text accompanying note 144.

¹¹⁰When determining the materiality of a contingent event, materiality depends on the magnitude of the event, should it occur, and the probability that it will occur assessed at the time of the relevant materiality determination, when the trading occurred. *Basic*, 485 U.S. at 238.

¹¹¹For a case where the disclosure of travel plans was one factor in the analysis of misappropriated material information, see *S.E.C. v. Falbo*, 14 F.

Supp. 2d 508, 521–23, Fed. Sec. L. Rep. (CCH) P 90273 (S.D. N.Y. 1998) (granting summary judgment for the SEC on a claim of insider trading in violation of Rule 10b-5, based in small part on disclosure of an executive’s travel plans in connection with negotiation of an acquisition, where the defendant also had specific information from insiders about active work on a negotiation and the likely target). This was also a factor in *Moore*. See *supra* text accompanying note 42.

¹¹²A more complex, and perhaps more realistic, scenario in terms of analysts culling information from a variety of sources would include the additional nonpublic fact that the analyst had learned from a *different* source the (separately immaterial) fact that members of senior management of Company X have canceled long-standing vacation plans. This fact would buttress the conclusion—the probability component of the materiality assessment—that Company X is on the brink of some significant development, and, coupled with the information about Bill’s plans, that that development is the acquisition of Company Y.

¹¹³See *supra* text accompanying note 6.

¹¹⁴*Dirks*, 463 U.S. at 663–64; *Newman*, 773 F.3d at 450.

¹¹⁵For example, after *Obus* Professor Coffee observed that “any passage of [material nonpublic] information to a friend, after *Obus*, may be viewed by regulators as a ‘gift’ that satisfies the *Dirks* standard.” Coffee, Jr., Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies, 2013 Colum. Bus. L. Rev. 281, 292 & n. 24 (2013). One author concluded that the benefit/gift concept had been so watered down that little may remain of the requirement.

In *Obus*, the Second Circuit found the benefit requirement could be satisfied based on evidence that the underwriter with the information and the hedge fund analyst with whom he spoke were “friends from college . . .

. . . If the *Obus* approach is the trend, little, if anything, will remain of the benefit requirement, which *Dirks* called “the test” for tipper liability.”

Crimmins, *Insider Trading: Where is the Line?*, 2013 Colum. Bus. L. Rev. 330, 347–48 (2013) (footnotes omitted).

¹¹⁶*Supra* note 6. Moreover, *Newman* requires proof that the tippee knew that the insider received a personal benefit; it is uncertain if this applies with such rigor in SEC enforcement actions. See *supra* note 10.

¹¹⁷773 F.3d at 452.

¹¹⁸See, e.g., *Payton*, 2015 WL 1538454, at *5 (detailing the SEC’s allegations of the intertwined financial relationship of an alleged tipper and tippee).

¹¹⁹See, e.g., *S.E.C. v. Carroll*, 9 F. Supp. 3d 761, 770, Fed. Sec. L. Rep. (CCH) P 97869 (W.D. Ky. 2014) (holding that friendship between tipper and tippee satisfies the *Dirks* personal benefit requirement, relying on an earlier decision in the case, where the court stated (*S.E.C. v. Carroll*, Fed. Sec. L. Rep. (CCH) P 96608, 2011 WL 5880875, *8 (W.D. Ky. 2011), subsequent determination, 835 F. Supp. 2d 281, Fed. Sec. L. Rep. (CCH) P 96609 (W.D. Ky. 2011), citing *Dirks*, “the case law is clear that a gift of confidential information between friends satisfies the personal benefit requirement”).

¹²⁰As in *Newman*, this knowledge requirement becomes more difficult to establish when the tippee is remote from the source.

¹²¹See *supra* text accompanying note 7. In formulating the elements of the violation, *Newman* does not expressly include as an element the tipper’s or the tippee’s knowledge of the materiality of the disclosed information, though this

may fairly be implied from the entirety of the analysis. *See, e.g.*, 773 F.3d at 450 (stating that “*mens rea* . . . which requires that the defendant know the facts that make his conduct illegal, is a necessary element in every crime” though not listing knowledge of materiality, only knowledge of breach of confidentiality, when setting out each of the elements the government must prove).

¹²²*See infra* text accompanying note 130.

¹²³*See supra* text accompanying notes 24–31. The SEC’s statement would be clearer if the SEC had written “only if unbeknownst to the issuer,” but the statement is clear enough. The use of “even” in the phrase “even if, unbeknownst to the issuer” seems intended to provide emphasis that the issuer has not violated Regulation FD *notwithstanding* that the disclosure completes a mosaic, *so long as* the issuer does not know that it does. There is nothing in the *Adopting Release* (*supra* note 14) that even implies that Regulation FD would not be triggered (and Rule 10b-5 arguably violated) if the speaker *did* know that the information he provided would complete a material mosaic. This parts company with one author whose analysis is quoted above. *See supra* text accompanying note 100.

¹²⁴*See supra* text accompanying note 66.

¹²⁵Allan Horwich, *supra* note 4, 67 Bus. Law. *passim*. Professor Langevoort concludes that the Commission’s discussion of the “unbeknownst” situation “would suggest, more consistently with the case law, that the question is [the tippee’s] awareness (scienter) rather than materiality in and of itself.” Langevoort, *supra* note 5, § 11:4, at 11–14 n.5. In fact, the breach and materiality analyses merge at this point, converging on scienter. *See supra* note 7 (noting the intertwining of the elements in *Obus*) and *infra* text accompanying note 142 (applying these concepts to a hypothetical).

¹²⁶693 F.3d at 286.

¹²⁷*See infra* text accompanying note 130.

¹²⁸*Supra* text accompanying note 10.

¹²⁹*See, e.g.*, Kaufman and Wunderlich, Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation, 73 Ohio St. L.J. 507, 519–23 (2012) (arguing that “[p]resuming senior management’s knowledge of core operations—or facts that are material to the company—is consistent with common sense, the common law, and the securities laws”). Though this concept may be limited to the most important information regarding the company (*see* Horwich, *supra* note 125, 67 Bus. Law. at 8), its application to a scenario of the type discussed here, where the speaker is directly involved in the matter at hand, seems appropriate.

¹³⁰The SEC sometimes fails to establish insider trading claims that are based on circumstantial evidence. *See, e.g.*, *S.E.C. v. Schvacho*, 991 F. Supp. 2d 1284, 1298–99, Fed. Sec. L. Rep. (CCH) P 97788 (N.D. Ga. 2014) (granting judgment for insider trading defendant after bench trial where circumstantial evidence was insufficient to prove certain elements of the claim); *S.E.C. v. Garcia*, Fed. Sec. L. Rep. (CCH) P 96703, 2011 WL 6812680, *14–15 (N.D. Ill. 2011) (granting summary judgment for defendant Sanchez in insider trading case where circumstantial evidence was found to be insufficient). After a bench trial, judgment was entered for Schvacho (Judgment, No. 12-cv-2557-WSD (Jan. 7, 2014), ECF No. 63.) and the SEC did not appeal the grant of summary judgment in favor of defendant Sanchez in *Garcia*.

¹³¹*See supra* text accompanying notes 50–53.

¹³²*See supra* text accompanying note 41.

¹³³Non-verbal disclosures may trigger not only the application of Regulation FD (see *S.E.C. v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 708 n.14, Fed. Sec. L. Rep. (CCH) P 93343 (S.D. N.Y. 2005) (“Tacit communications, such as a wink, nod, or a thumbs up or down gesture, may give rise to a Regulation FD violation.”)) but also the application of Rule 10b-5 (see *Stoneridge*, 552 U.S. at 158 (“[c]onduct itself can be deceptive”)).

¹³⁴See *supra* text accompanying note 47. In any event, nothing in the complaint suggests that the Managing Director *qua* tipper received a personal benefit for making any disclosure to Moore.

¹³⁵See, e.g., *Sandstrom v. Montana*, 442 U.S. 510, 524, 99 S. Ct. 2450, 61 L. Ed. 2d 39 (1979) (“A presumption which, although not conclusive, had the effect of shifting the burden of persuasion to the defendant, would have suffered from [constitutional] infirmities.”).

¹³⁶See *supra* text accompanying note 129.

¹³⁷See, e.g., *S.E.C. v. Willis*, 825 F. Supp. 617, 622, Fed. Sec. L. Rep. (CCH) P 97819 (S.D. N.Y. 1993).

¹³⁸See, e.g., *S.E.C. v. Carroll*, 9 F. Supp. 3d 761, Fed. Sec. L. Rep. (CCH) P 97869 (W.D. Ky. 2014) (“Direct evidence is rarely available in insider trading cases, since the tipper and tippee are usually the only witnesses to the exchange. The SEC is entitled to prove its case through circumstantial evidence.”); *S.E.C. v. Horn*, 2010 WL 5370988, *4 (N.D. Ill. 2010) (“Although it admits a lack of direct evidence, the SEC contends it can present enough circumstantial evidence to persuade a reasonable jury that [defendant] possessed nonpublic information. Direct evidence of insider trading is, indeed, rare; and the SEC is entitled to prove its case through circumstantial evidence.”). See also Crimmins, *supra* note 115, 2013 Colum. Bus. L. Rev. at 363 (“Insider trading cases are virtually the only cases that the SEC frequently litigates based simply on circumstantial evidence.”); and *supra* note 130 (citing cases where the SEC lost because its claim was dependent on circumstantial evidence).

¹³⁹If the court denies a motion for judgment as a matter of law at the close of the SEC’s case, then the defendant knows that if he puts in no evidence the jury will be free to find in favor of the SEC. Fed. R. Civ. P. 50(a)(2).

¹⁴⁰See *supra* text accompanying notes 132–134 (analyzing this issue in a variant of Moore).

¹⁴¹*Newman*, 773 F.3d at 450.

¹⁴²See *supra* text accompanying notes 7–10 (discussing the *Obus* and *Newman* analyses of tipper and tippee scienter).

¹⁴³773 F.3d at 452.

¹⁴⁴Similarly, after surveying the uncertainties in the law and the aggressive posture taken by the SEC and the Department of Justice in pursuing insider trading cases, one experienced securities litigator recently observed:

[A] rational retail investor without access to experienced securities enforcement counsel faces a dilemma. An incorrect guess on what an appellate court may determine on a duty or materiality question years after the fact may land the investor in jail or subject to crushing civil fines and career ruin.

The only way to manage such risk would seem to be for the retail investor in possession of nonpublic information to simply refrain from trading on the information. This effectively forces the retail investor into what has been called a “parity-of-information” regime—a regime that prohibits trading on significant information unless it is broadly shared across the markets. The retail investor is then subject to a *de facto* restriction on trading on any particular development or piece of information, no matter how speculative or general in nature.

Crimmins, *supra* note 115, 2013 Colum. Bus. L. Rev. at 355–56.

¹⁴⁵An insider could, of course, ask the analyst what he already knows, even ask why he wants this additional information. It is not clear if the analyst lies and the insider believes him that the insider could successfully rebut that he breached a duty in making disclosure, that he fell in the *unbeknownst* category. See *supra* text accompanying notes 23, 92, & 123. Plausible deniability may not carry the day here. Compare Heminway, *supra* note 9, 15 Transactions: Tenn. J. of Bus. L. at 58 (questioning whether it is “right to allow [certain] securities trading firm principals . . . to avoid liability because they can plausibly deny the origins of material nonpublic information that underlies securities trading undertaken at their behest or for their financial benefit” by interposing other firm employees between them and sources of material nonpublic information). In *Newman* the defendants were many steps removed from the original sources of nonpublic information, so that by the time the information came to them it was inextricably combined with other, untainted information and analysis. 773 F.3d at 455.

