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Regulating Channel Checks: Clarifying the Legality of Supply-Chain Research

Marron C. Doherty

NOTES

REGULATING CHANNEL CHECKS: CLARIFYING THE LEGALITY OF SUPPLY-CHAIN RESEARCH

INTRODUCTION

In 2010, the U.S. Securities and Exchange Commission (the SEC) began investigating an investment research practice known as "channel checking" to determine whether, in the SEC's view, the practice violated the laws prohibiting trading illegally on the basis of material, non-public information, known informally as illegal insider trading.[1] In a channel check, an investment analyst communicates with suppliers and clients, as well as current and former employees of a company to obtain clues about the company's performance.[2] The practice is most common among technology analysts, who often attempt to estimate how many product units a company like Apple expects to ship in the next quarter.[3] Analysts also use channel checks to estimate the future performance and profitability of companies in other sectors, especially large retail and restaurant chains.[4] Channel checks help keep issuers honest, as it is not uncommon for a company to paint a rosy picture of its performance in the news, only to eventually reveal that sales are down, cash flow has dried up, and senior managers are using the company jet to ship their wives to Paris for fashion week.

Channel checking has long been an industry-accepted practice, but the SEC's investigation has caused concern among buy-side and third-party investment analysts for whom it is an important tool.[5] Many professional investors, including hedge funds and investment advisers, are pulling back from the use of supply-chain research, channel checks, and expert networking firms.[6]

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1. Susan Pulliam, *Supply Data Now a Focus of Probe*, WALL ST. J. (Nov. 24, 2010, 12:01 AM), http://online.wsj.com/article/SB10001424052748703730304575633173086330184.html.
2. Bruce Carton, *Who's Checking Your Channel?*, SEC. DOCKET (Dec. 8, 2010, 7:15 AM), http://www.securitiesdocket.com/2010/12/08/who%E2%80%99s-checking-your-channel/.
3. Alexis C. Madrigal, *What's a 'Channel Check,' Anyway?*, ATLANTIC (Nov. 24, 2010, 11:55 AM), http://www.theatlantic.com/technology/archive/2010/11/whats-a-channel-check-anyway/67017/.
4. *See* Todd Wallack, *Keeping Track on Black Friday; Analysts Visit Stores, Count Cars to Find Trends*, BOS. GLOBE, Nov. 25, 2011, at A1.
5. *See Is "Channel Checking" Illegal Insider Trading?*, FRAUD FILES BLOG (Dec. 10, 2010), http://www.sequenceinc.com/fraudfiles/2010/12/is-channel-checking-illegal-insider-trading/.
6. Evelyn M. Rusli, *Scrutiny of Expert Networks Loosens Links; Window on Wall Street*, INT'L HERALD TRIB., May 13, 2011, at 24.

This Note seeks to examine the investment research practice known as channel checking within the context of insider trading law and proposes an appropriate regulatory framework. It will also touch on and analyze the proper role of expert networking firms in channel checks to provide a clearer picture of how to prevent such firms from facilitating trading on illegally obtained insider information. The analysis will examine and critique the policy goals of current insider trading law and explain where channel checks and expert networks fit in. Finally, the proposed solutions will attempt to balance the competing interests of market fairness and market efficiency.

Part I of this Note will provide a discussion of the current insider trading regime, with a truncated explanation of the judicial recognition of the insider's duty to disclose or abstain, the development and expansion of tipper/tippee liability, and an introduction to the misappropriation theory of insider trading. Part II will comment on the current cases dealing with the use of supply-chain information in trading. Part III will explore the current legal status of supply-chain research, expert networks, and the mosaic theory of investment analysis. Part IV will identify and comment on some of the problems with the current enforcement regime. Part V will propose a solution based on principles of market efficiency and the constitutional authority of the SEC.

I. THE CURRENT INSIDER TRADING REGIME

Perhaps no form of white-collar crime has captured the public imagination as fully as illegal insider trading: "Insider trading is one of the few issues in securities regulation that has become a matter of cultural symbolism as well as legal controversy."[7] The very phrase "insider trading" conjures up images of wealthy executives sitting in glass-walled towers, lining their pockets at the expense of ordinary investors. In fact, much of the modern era of enforcement can be attributed to a legislative desire to punish the perceived greed of the already-rich using inside information to further build their wealth.[8]

The phrase "insider trading" may refer to two separate types of trading, one of which is perfectly legal.[9] On one hand, it is perfectly legal for corporate insiders to sell their company's stock, as long as they file reports with the SEC and comply with regulations designed to prevent the misuse of nonpublic information.[10] On the other hand, illegal insider trading as governed by section 10(b) of the Securities Exchange Act of 1934 (the

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7. DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT, AND PREVENTION § 1.1 (2012).

8. *Id.*

9. *See Insider Trading*, SEC, http://www.sec.gov/answers/insider.htm (last visited Apr. 11, 2014).

10. *Id.*

Exchange Act) occurs when a corporate insider or temporary insider, in connection with a purchase or sale of securities, knowingly omits or fails to disclose material facts to his counterparty.[11] In a modern securities transaction, this means that an insider must disclose any material facts he possesses to the market before trading in securities of his own company, or he must abstain from trading altogether.[12]

The government has a number of statutes it can use to prosecute suspected insider traders, including section 16 of the Exchange Act,[13] the Insider Trading Sanctions Act of 1984 (ITSA),[14] various mail and wire fraud statutes, and, less frequently, the Racketeer Influenced and Corrupt Organization Act (RICO).[15] The most important statute in modern cases, and the one most relevant to this Note, is section 10(b) of the Exchange Act,[16] and SEC rule 10b-5 thereunder, prohibiting the use of manipulative and deceptive devices in connection with any purchase or sale of a security.[17] The Exchange Act, from which the SEC derives its constitutional authority to prosecute insider trading and other forms of securities fraud, does not specifically prohibit insider trading.[18] The SEC added rules 10b5-1[19] and 10b5-2[20] in order to clarify its position on misappropriation of

11. ELIZABETH SZOCKYJ, THE LAW AND INSIDER TRADING: IN SEARCH OF A LEVEL PLAYING FIELD 108–09 (1993).

12. Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907, 910 (Nov. 8, 1961) [hereinafter Cady, Roberts & Co. Release].

13. NASSER ARSHADI & THOMAS H. EYSELL, THE LAW AND FINANCE OF CORPORATE INSIDER TRADING: THEORY AND EVIDENCE 43 (1993).

14. *Id.* at 49. The ITSA allows the SEC to seek a civil penalty of up to three times profit or loss avoided for those found guilty of insider trading. 15 U.S.C. § 78u-1(a)(2) (2012).

15. ARSHADI & EYSELL, *supra* note 13, at 54.

16. 15 U.S.C. § 78j.

17. 15 U.S.C. § 78j 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—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

18. SZOCKYJ, *supra* note 11, at 3.

19. 17 C.F.R. § 240.10b5-1(b) (2014) defines trading "on the basis of" material nonpublic information as follows:

> Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, 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.

20. 17 C.F.R. § 240.10b5-2(b)(1) ("For purposes of this section, a 'duty of trust or confidence' exists in the following circumstances, among others: (1) Whenever a person agrees to maintain information in confidence . . . .").

insider trading and make enforcement against such activity easier.[21] The modern constitutional contours of section 10(b) and rule 10b-5 are wholly defined by *Chiarella v. United States*, *Dirks v. SEC*, and *United States v. O'Hagan*, the only three insider trading cases heard by the Supreme Court in the modern era.[22]

In the first case, Vincent Chiarella, a mark-up man in the employ of a financial printer, was assigned to review a number of takeover proposals.[23] Chiarella was able to deduce the takeover targets from the content of the proposals, despite the fact that the names of the target companies were obscured or altered.[24] He then purchased shares in the target companies and sold them after the takeovers were made public, netting about $30,000.[25] In this decision handed down by the Supreme Court in 1980, the Court sharply limited the "disclose-or-abstain" rule proposed by the SEC.[26] The Court held that a person trading on material, non-public information commits illegal insider trading only if he had a duty to his counterparty to disclose the information beforehand.[27] Such a duty arises from a corporate insider's fiduciary duty to the corporation's shareholders.[28] Under the *Chiarella* standard, non-insiders who learn of material, non-public information have no duty to disclose before trading on that information.[29] This had the effect of doing away with the "parity of information" standard, in which any investor with material information has a duty to disclose that information before trading on the basis of that information.[30] In striking down the parity standard, the Court denied the existence of a general duty between market participants to abstain from trading on material, non-public information and

21. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51716 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249) [hereinafter Selective Disclosure Release].

22. United States v. O'Hagan, 521 U.S. 642 (1997); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); ARSHADI & EYSELL, *supra* note 13, at 46–47.

23. *Chiarella*, 445 U.S. at 224.

24. *Id.*

25. *Id.*

26. In the Cady, Roberts & Co. Release, *supra* note 12, the SEC argued:

> Insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

27. *Chiarella*, 445 U.S. at 228.

28. *Id.*

29. *Id.*

30. SEC v. Tex. Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968); *see also* SZOCKYJ, *supra* note 11, at 44.

noted that "neither Congress nor the [SEC] ever has adopted a parity-of-information rule."[31]

Dirks v. SEC expanded the definition of an insider but also placed an important restriction on the transmission of a duty to disclose or abstain from an inside "tipper" to an outside "tippee."[32] In that case, Raymond Dirks, a prominent insurance industry investment analyst, received a tip from a former officer of Equity Funding of America.[33] The officer, Ronald Secrist, stated that the value of Equity Funding's assets had been significantly overstated due to a massive and ongoing fraud at his former employer.[34] Secrist also told Dirks that securities regulators had been informed and had taken no action, and he asked Dirks to verify his allegations independently.[35] Dirks did so and passed on his findings to a number of his clients.[36] Dirks also went to the *Wall Street Journal* with the information he uncovered about the fraud, but the reporter declined to publish the story, apparently fearing a libel lawsuit.[37] Subsequently, several of the clients Dirks tipped off sold their interests in Equity Funding, thereby avoiding massive losses.[38] The SEC found that Dirks had engaged in illegal insider trading as a tipper, but, in recognition of his role in bringing the Equity Funding scandal to light, only censured him.[39] Dirks appealed, perhaps recognizing the grave damage that even the relatively light sanction would do to his reputation as an investment analyst, and ultimately the Supreme Court overturned his conviction.[40] In deciding that Dirks could not be held liable for insider trading, the Court held that tippees only inherit the *Cady, Roberts*[41] duty to disclose when they receive material nonpublic information improperly, that is, from a person who breaches his or her fiduciary duty by passing along the information.[42] Secrist had not violated any duty to his employer because he neither expected to nor actually received any benefit by disclosing his company's fraud to Dirks.[43]

In 1997, the Supreme Court expanded the law of insider trading when it upheld the securities fraud conviction of James H. O'Hagan.[44] O'Hagan had

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31. *Chiarella*, 445 U.S. at 233. The parity of information standard had been formulated and adopted by the appellate court in *Texas Gulf Sulphur*, 401 F.2d at 848.
32. Dirks v. SEC, 463 U.S. 646, 661–62 (1983).
33. *Id.* at 649–50.
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.* at 650.
38. *Id.* at 670 (Blackmun, J., dissenting).
39. *Id.* at 650–52 (majority opinion).
40. *Id.* at 652.
41. *See supra* note 26; *see also* SEC v. Tex. Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968); SZOCKYJ, *supra* note 11, at 40–43.
42. *Dirks*, 463 U.S. at 655–56.
43. *Id.* at 662.
44. United States v. O'Hagan, 521 U.S. 642 (1997). The Supreme Court had previously heard a case involving the misappropriation theory in 1987, *Carpenter v. United States*, 484 U.S. 19

been a partner at Dorsey & Whitney LLP and obtained information about a pending tender offer that his firm was working on.[45] Although O'Hagan did no work on the representation, and as such was not a temporary insider,[46] he was convicted of insider trading.[47] In upholding the conviction, the Court noted that a fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain . . . dupes or defrauds the principal,"[48] and further that "[a] company's confidential information, we recognized in *Carpenter*, qualifies as property to which the company has a right of exclusive use."[49] These Supreme Court decisions indicate that the Court views insider trading as a crime consisting of fraud and involving breach of fiduciary duty and conversion, that is, the theft of information and the transformation of that information into profit or avoidance of loss.[50]

II. POLICY JUSTIFICATIONS FOR INSIDER TRADING LAWS

Several policy concerns have been advanced as an explanation for the current insider trading regime.[51] Chief among these are fairness, the promotion of investor confidence in the marketplace, and the right of corporations to have exclusive use of their intellectual property.[52] The fairness justification is premised on the idea that insider trading harms shareholders and is fundamentally unfair to investors without the same access to information that insiders possess.[53] As noted above, the Supreme Court rejected the fairness justification when it refused to recognize a general duty between market participants in *Chiarella.*[54] The Court returned to this theme again when it decided *Dirks v. SEC*:

(1987), in which R. Foster Winans' conviction for insider trading was upheld. The Court deadlocked 4–4 on the issue of whether Winans could be held liable for misappropriation but voted to uphold his wire fraud conviction.

45. *O'Hagan*, 521 U.S. at 647.

46. A temporary insider is an outsider like an investment banker, accountant, outside attorney, or broker who comes to possess a corporate client's confidential information in the course of his duties to the client. *Dirks*, 463 U.S. at 655 n.14. Such individuals are prohibited from trading on this information on the same theory as "traditional" insiders. *See id.*

47. *O'Hagan*, 521 U.S. 642.

48. *Id.* at 653.

49. *Id.* at 654 (citing *Carpenter*, 484 U.S. 19).

50. Not all insider trading cases involve a breach of duty or conversion. The SEC has promulgated rule 14e-3, which provides for the prosecution of persons who trade ahead of a tender offer, no matter where the information comes from and whether or not the trader is affiliated with either the offeror or the target. 17 C.F.R. § 240.14e-3 (2014). The constitutionality of this rule has been challenged, but the *O'Hagan* Court held that, at least with respect to that particular case, the SEC did not exceed its constitutional rulemaking authority. *O'Hagan*, 521 U.S. at 644.

51. *See, e.g.*, JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 21–26 (1991); *see also* ARSHADI & EYSELL, *supra* note 13, at 130–34.

52. *See* MACEY, *supra* note 51, at 23–24.

53. *Id.*

54. Chiarella v. United States, 445 U.S. 222, 224 (1980).

> [O]ur opinion in *Chiarella* [repudiated] any notion that traders must enjoy equal access to information before trading: "[The] 'information' theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws." We reaffirm today that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[55]

Why then does the fairness theory of enforcement retain such significant popularity with the SEC and Congress? One reason is that the public perceives insider trading as "cheating,"[56] a method of trading and making money not available to the general public; this is combined with a historic lack of organized industry opposition.[57] Another more cynical interpretation of the fairness theory's survival and continued popularity is that it plays well in the media and allows the SEC to maintain its power, influence, and moral high ground within the federal government and the financial industry.[58] Insider trading cases, focused as they generally are on one or a group of individuals as opposed to a monolithic firm, have the advantage of character and personal drama to pique the public's interest and keep the regulator and U.S. Attorney in the spotlight.[59] Finally, there is the notion that insider trading results in identifiable harm to investors and shareholders. The Supreme Court commented on this in the *Dirks* case:

> [I]n many cases there may be no clear causal connection between inside trading and outsiders' losses. In one sense, as market values fluctuate and investors act on inevitably incomplete or incorrect information, there are always winners and losers; but those who have "lost" have not necessarily been defrauded. On the other hand, inside trading for personal gain is fraudulent, and is a violation of the federal securities laws.[60]

The lack of demonstrable harm to any one investor is dealt with by the "property right" theory of insider trading.[61] The right of a corporation to have exclusive use of its proprietary information, in the nature of a property right, is the theoretical basis for the illegality of the misappropriation theory.[62] The theory can also be applied to classical insider trading; such an adaptation goes something like this: "[F]irms often incur great expense to develop [their] information. To deny these firms the ability to exploit this information fully for profit diminishes the wealth of the shareholders who

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55. Dirks v. SEC, 463 U.S. 646, 657–58 (1983) (internal citations omitted).
56. SZOCKYJ, *supra* note 11, at 2.
57. *Id.* at 24–26.
58. *See id.* at 28–31; *see also* MACEY, *supra* note 51, at 52.
59. MACEY, *supra* note 51, at 67–68.
60. *Dirks*, 463 U.S. at 666 n.27.
61. ARSHADI & EYSELL, *supra* note 13, at 129; *see also* MACEY, *supra* note 51, at 44–45.
62. MACEY, *supra* note 51, at 44–45.

have paid for the creation of the information."[63] A property right conception of insider trading means that any executive, director, or other insider violates his fiduciary duty to his company by using corporate assets for his own benefit, instead of for that of the company.[64] On the flip side, an outsider owing a duty of trust and confidence to the company would be liable for simple conversion of corporate intellectual property for his own benefit.[65]

Another plausible theoretical justification for insider trading regulation is the notion that insider trading undermines the integrity of the securities markets by reducing investor confidence in the fairness and equity of those markets.[66] Investors will avoid the markets, the theory goes, if they feel that they have little chance of competing with the inside knowledge of insiders and the select few with whom they share their information; potential market participants want a level playing field before they will engage in securities trading.[67] This argument has been criticized by some as a disguised retread of the fairness argument, replacing the value proposition that equality of information is the only fair context for trading in securities with the assertion that unless all parties believe they have equal access to information, they will not trade.[68] Investment analysts and other securities market professionals constantly strive for an informational advantage over their counterparties by collecting and analyzing all of the publicly available information about a company in order to take advantage of pricing inefficiencies in the company's securities.[69] This group of market professionals will always have an advantage over less-informed investors by virtue of their superior research and analysis capabilities.[70]

One of the ways that market professionals maintain an informational advantage is by using their superior resources to poke around in the guts of companies in which they wish to invest.[71] Many employ channel checkers to track supply-chain information that could provide a window into a company's inner workings, or they engage in supply-chain channel checks themselves.[72] However, recent commentary suggests that the SEC takes a dim view of this practice, at least in situations where it leads to an analyst learning confidential information about a company.[73]

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63. *Id.* at 52.
64. ARSHADI & EYSELL, *supra* note 13, at 129.
65. *See* MACEY, *supra* note 51, at 44–45.
66. *Id.* at 41.
67. *Id.* at 23–24.
68. *See id.* at 43.
69. ARSHADI & EYSELL, *supra* note 13, at 131.
70. MACEY, *supra* note 51, at 41–42.
71. *See* Wallack, *supra* note 4, at A1.
72. *Id.*
73. Pradheep Sampath, *"How's Business?" Could be a Federal Offence*, SUPPLY CHAIN EUR., Jan./Feb. 2011, at 50.

III. THE LEGAL STATUS OF CHANNEL CHECKS AND SUPPLY-CHAIN RESEARCH

A. DEFINITION OF A CHANNEL CHECK AND COMMON USES IN INVESTMENT RESEARCH

Channel checks take a number of forms, including conversations between analysts and supply-side sources, independent surveys of franchise outlets, aggregation of shipping or trucking data, and simply counting the cars in the parking lot outside of Best Buy.[74] The checks under scrutiny are those conducted between an investment analyst and a current or former employee of a company engaged in supplying parts, expertise, or other significant "building blocks" to a larger company.[75] The channel check is an especially crucial tool for investment analysts because of the increasing prevalence of production outsourcing; its importance is ably summed up by Pradheep Sampath:

> It's a sign of the times that most companies don't do most of their own manufacturing; they use contract manufacturers, subcontractors and so on. So, anyone wanting to find out how a company is performing has to go beyond that company to get a quasi-decent picture of performance. Financial analysts have 'got' this; so, particularly for the more secretive and sensitive supply chains, they are delving ever deeper into the manufacturers, distribution partners, and warehouse operations, looking at production levels and raw material flows to piece together a picture from which they can advise investors and other clients. They may not have got all or any of this information from the 'channel master,' but such 'channel checkers' have a leg up in the investment game.[76]

Channel checks are not limited to technology companies. The method is also useful to analysts who follow retailers, restaurant chains, and other service-industry companies.[77] These analysts often visit stores and restaurants to see how much traffic they get, what their prices look like compared to the previous week or month, and any other information they can glean.[78] In some cases, expert networking firms or third-party research firms facilitate these conversations by connecting the analyst to an industry expert or employee with relevant information; in other cases, these third parties perform the research themselves and sell it to buy-side analysts.[79] Channel checks are part of the investment research that many financial

74. Wallack, *supra* note 4, at A1.
75. Madrigal, *supra* note 3.
76. Sampath, *supra* note 73, at 50.
77. Serena Ng, *Channel Checkers Sniff Around for Trends*, WALL ST. J. ASIA FELLOWSHIP NYU (Aug. 8, 2005), http://wsjfellowship.com/2009/01/channel-checkers/.
78. Wallack, *supra* note 4, at A1.
79. *See* Jenny Anderson, *Wall Street 'Matchmakers' Under New York Scrutiny*, N.Y. TIMES, Jan. 7, 2007, at C5; *see also* Wallack, *supra* note 4, at A1.

analysts perform on public companies, either to identify potential investment targets or evaluate a current position.[80] It is not uncommon for analysts and officers of financial firms that perform analysis to rely at least in part on their channel checks when making a recommendation.[81]

B. THE MOSAIC THEORY

One of the ways that some analysts use information obtained by channel checks is commonly referred to as "mosaic theory."[82] Mosaic theory is the practice of seeking out and combining all public and material information, as well as non-public, non-material information, to paint a larger picture of the company being targeted for investment.[83] Also called the "scuttlebutt method,"[84] an analyst employing a mosaic theory strategy may seek out non-public information from within the target company.[85] As long as the information does not rise to the level of material information, such research is legal because the law only prohibits trading on information if it is both material *and* non-public.[86]

As a defense to insider trading allegations, mosaic theory is risky. Most recently, Raj Rajaratnam claimed that his activities were the product of a mosaic theory strategy.[87] One of the biggest risks is the loose term "materiality," which is sometimes defined as a fact that a reasonable investor would view as having actual significance in deciding whether to invest.[88] In general, things like top-line earnings, confidential company performance numbers, and pending acquisitions or mergers are deemed material as a matter of law.[89] Other facts that may or may not be deemed material include possible credit events, changes in management, or changes in regulatory expenses or structure.[90] In *United States v. Rajaratnam*, much of the information Rajaratnam was accused of obtaining illegally was clearly material, including a tip about Berkshire Hathaway's September 2008 agreement to make a $5 billion investment in Goldman Sachs.[91]

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80. *See* Wallack, *supra* note 4, at A1.
81. *See* Ng, *supra* note 77.
82. Peter J. Henning, *Why Insider Trading Is Wrong*, N.Y. TIMES DEALBOOK (Apr. 11, 2011, 3:51 PM), http://dealbook.nytimes.com/2011/04/11/why-is-insider-trading-wrong/.
83. *See* Pradheep Sampath, *Where Supply Chains Meet Insider Trading*, ALL ABOUT B2B (Nov. 29, 2010), http://www.gxsblogs.com/sampathp/2010/11/channel-check-where-supply-chains-meet-insider-trading.html.
84. PHILIP A. FISHER, COMMON STOCKS AND UNCOMMON PROFITS 44–45 (1958).
85. Henning, *supra* note 82.
86. *Id.*
87. *Id.*; *see also* Michael Rothfeld & Chad Bray, *The Galleon Case: Loss Raises Questions over Defense Strategy*, WALL ST. J., May 13, 2011, at C1.
88. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (articulating the test for "materiality" in the context of cases under section 14(a) of the Exchange Act).
89. SCHULTE ROTH & ZABEL LLP, INSIDER TRADING LAW AND COMPLIANCE ANSWER BOOK 2011–2012, § 1.1.3 (Harry S. Davis ed., 2011).
90. *Id.* § 6.9.
91. United States v. Rajaratnam, 802 F. Supp. 2d 491, 500 (2011).

Rajaratnam's attorneys, however, argued that the information was not "economically" material, that is, it was already reflected in the stock prices of the companies in which he traded.[92] Whether or not this argument is plausible, it is becoming increasingly clear that the definition of materiality is more or less whatever the government retroactively decides it should be.[93] On numerous occasions, the Supreme Court and SEC have rejected suggestions that they formulate a more concrete definition of materiality.[94] Though the practice is nominally legal, channel checkers who subscribe to the mosaic theory put themselves in harm's way because of the government's refusal to clarify its position.[95]

C. EXPERT NETWORKS

Expert networks are consulting firms that specialize in connecting buy-side investment analysts with industry experts or high-level employees from industries and sectors in which they might wish to invest.[96] For example, Integrity Research Associates performed a study on expert networking and shared its findings:

> Over two-thirds of all investors use expert networks primarily to obtain market and company background pertaining to the various investment theses they are researching. Following this, European users are most likely to be interested in forecasts and macro/economic issues, while North American users are most likely to be interested in current trends. Accounting and legal issues are significantly more likely to be of interest to North American users than their European counterparts.[97]

The recent insider trading cases are not, however, focused on the use of expert networks as background. They concern consultants and employees of the expert networks who passed material, non-public information to hedge funds and other investors.[98]

The expert networking industry arose as an unintended consequence of one of the SEC's own regulations intended to even the playing field for smaller investors—Regulation FD.[99] In the wake of *Dirks v. SEC*, the SEC

92. Peter J. Henning, *A Standard That Raises More Questions than It Answers*, N.Y. TIMES DEALBOOK (Apr. 7, 2011, 12:04 AM), http://dealbook.nytimes.com/2011/04/07/a-standard-that-raises-more-questions-than-answers/.

93. *See id.*

94. *Id.*

95. *See* Carton, *supra* note 2.

96. Anderson, *supra* note 79; *see also* Rusli, *supra* note 6, at 24.

97. Michael W. Mayhew, *2009 Expert Network Trends*, INTEGRITY RES. ASSOCIATES (Nov. 16, 2009, 6:30 PM), http://www.integrity-research.com/cms/2009/11/16/2009-expert-network-trends/.

98. Michael W. Mayhew, *Feds Agree: Expert Networks Are Okay*, BUS. INSIDER (Feb. 28, 2011, 5:22 PM), http://www.businessinsider.com/feds-agree-expert-networks-okay-2011-2.

99. Selective Disclosure Release, *supra* note 21; Evelyn M. Rusli, *Hardball Tactics Against Insider Trading: Next Up: A Crackdown on Outside Expert Firms*, N.Y. TIMES, May 12, 2011, at B1.

was concerned that investment professionals regularly obtained material information about issuers prior to disclosure to the general marketplace, giving such professionals an unfair competitive advantage.[100] Regulation FD was designed to prevent selective disclosure to certain analysts, disclosure that the SEC believed gave those analysts and their employers an unfair trading advantage.[101] Regulation FD cut off the flow of information that analysts had come to rely on from top corporate executives by forbidding selective disclosure to certain classes of persons, including anyone associated with a broker-dealer.[102] In response, companies began using channel checks, often with the help of third-party research firms, to find out crucial supply data about their investment targets.[103] Many companies are now pulling back from these expert networks out of fear of being implicated in one of the current insider trading scandals.[104] In fact, some analysts predict that, without more clarity from the SEC on the limits of an expert network's uses, the entire industry could go belly-up.[105]

1. SEC Commentary on the Use of Expert Networks

On February 3, 2011, the SEC announced that it would bring insider trading charges against several consultants and employees of Primary Global Research LLC, an expert networking firm.[106] In the announcement, the SEC acknowledged that there was nothing inherently illegal about the primary function of expert networks: providing expert advice and analysis.[107] On February 8, the U.S. Attorney for the Southern District of New York, Preet Bharara, stated that the government is only pursuing systematic, brazen violations of the insider trading laws in the context of the expert networking industry.[108] He also tacitly endorsed the practice of channel checking by stating that there was "nothing inherently wrong with or bad about hedge funds or expert networking firms or aggressive market research for that matter. Nothing at all."[109] When pressed, Bharara refused to answer substantively a question about where the line was drawn between experts and analysts' "legitimate" conversations and the illegal sharing of inside information.[110]

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100. Selective Disclosure Release, *supra* note 21.
101. *Id.*
102. 17 C.F.R. § 243.100(b)(1)(i) (2014).
103. Rusli, *supra* note 6, at 24.
104. *Id.*
105. *Id.*
106. Mayhew, *supra* note 98.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id.*

Since Bharara and SEC Enforcement Director Robert Khuzami refuse to provide any more information about what will be considered material[111] or who will be pursued next, the way forward for analysts who use expert networks is unclear. Khuzami urged companies who use expert networks to increase compliance, without addressing the core issue of what constitutes an illegal tip.[112] More troubling for the expert networking industry are comments made in February 2012 by David Rosenfeld, Associate Regional Director of the New York Regional Office of the SEC.[113] Rosenfeld stated that no corporate executive should ever work with an expert network and implied that such activity could violate Reg FD and the laws against insider trading.[114]

IV. PROBLEMS WITH THE CURRENT ENFORCEMENT REGIME

A. LACK OF CLARITY ABOUT THE LEGALITY OF CHANNEL CHECKS REDUCES THE AMOUNT AND QUALITY OF INFORMATION AVAILABLE TO THE MARKET

Banning or disincentivizing aggressive research may limit the amount of public information firms use in their analyses as they take precautionary steps back. The costs of compliance and the amount of human capital needed to ensure that expert networks and channel checkers are on the right side of the insider trading laws are already enormous and growing rapidly in the wake of the Primary Global Research cases.[115] Because it is still unclear exactly where the line is drawn between research and improper access to and use of inside information, large investors must sift through the facts of each case and try not to engage in such behavior.[116] It is likely that their analysis will lead them to create a "buffer" zone of legal investment research left undone to insulate themselves from even the appearance of impropriety, or firms may even eschew the services of research firms altogether.[117] For example, it is perfectly legal for an employee at a given company to discuss non-material, public information with an investor, as long as his or her employer does not forbid that kind of contact.[118] Such conversations have historically played an important role in channel checks.[119] Without a clear definition of what qualifies as material

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111. *Id.*
112. *Id.*
113. Charlie Gasparino & Sital Patel, *Exclusive: Regulators May Expand Definition of Insider Trading*, FOX BUS. (Feb. 15, 2012), http://www.foxbusiness.com/industries/2012/02/15/regulators-may-expand-definition-insider-trading/.
114. *Id.*
115. Rusli, *supra* note 6, at 24.
116. *See id.*
117. *Id.*
118. Anderson, *supra* note 79, at C5.
119. *See id.*

information, however, the investor may not call, and the employee may not pick up. The legal definition of materiality is so vague that almost any information passed from an insider carries risks both for the insider and the analyst.[120] The SEC has also resisted providing a clearer definition of materiality, apparently in order to broaden the types of conduct against which it can bring enforcement actions.[121] Summed up in a few words, the risk of unclear regulation is that it will be difficult for either party to tell "which bits of information are 'material' and which are just 'really awesome,'"[122] since "[t]he gray area is vast."[123]

The effect of this lack of clarity will be to reduce the market's efficiency at pricing investment securities.[124] If information is excluded from an analyst's report or is never uncovered to begin with, the price of the relevant security may not accurately reflect its true value in light of all the public, material facts available.[125] Efficient pricing is desirable because it contributes to market liquidity and low-cost access to the securities markets, allowing investors to buy securities safe in the knowledge that the price is accurate.[126]

The market efficiency argument, by its nature, ignores the "fairness" justification for insider trading regulation, focusing only on the efficiency benefits of allowing trading on inside information.[127] However, the broader perception, shared by many at the SEC, is that unequal access to information may be unfair to the small investor.[128] What justifies this unequal access to information? The short answer, of course, is that such large investors pay for it, either by paying their own analysts or a third-party research group.[129] Here there is another gray area between paying for legitimate research and offering a bribe for inside information, the latter of which was alleged in several of the Primary Global Research cases.[130] Some of the information allegedly passed from the consultants in those cases, like quarterly revenue and gross profits, can be fairly classified as material under almost any test.[131] Some consultants, however, passed along

120. Henning, *supra* note 92.
121. *Id.*
122. Madrigal, *supra* note 3.
123. *Id.*
124. MACEY, *supra* note 51, at 11.
125. *Id.*
126. *Id.*
127. *See id.*
128. *See* Sampath, *supra* note 73, at 50; *see also* ARSHADI & EYSELL, *supra* note 13, at 131 (discussing former SEC enforcement chief Stanley Sporkin's belief that anyone with a strong informational advantage with respect to a company should be forbidden from trading in that company's stock).
129. *See* Wallack, *supra* note 4, at A1.
130. *E.g.*, Complaint at 13, 15, 20, 22, SEC v. Longoria, No. 11-CV-0753 (S.D.N.Y. Feb. 3, 2011), 2011 WL 324641 [hereinafter *Longoria* Complaint].
131. *Id.* at 20.

information that was less clearly material, such as what orders a supplier expected from a large client.[132] More importantly, the hedge fund clients often declined to invest in the company whose information was communicated but did invest in companies either up or down the supply chain.[133] If the parity of information standard is applied, all of the conduct just described appears illegal because it is unfair to investors who cannot afford to purchase such information. This is a plausible argument, but it does not comport with the current Supreme Court view of the grounds for a misappropriation charge; a party must have, and violate, a fiduciary duty to another by passing along or trading on information that is both material and nonpublic.[134]

The Supreme Court has also recognized that independent, aggressive research is important to the efficiency and honesty of the securities markets.[135] Indeed, the Court acknowledged that such analysis plays a crucial role in keeping markets healthy and companies honest:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities . . . . [I]t is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.[136]

This analysis reaffirms the general principle that insider trading liability is premised on a breach of fiduciary duty and not mere possession of material, non-public information. Firms who engage in channel checking and other aggressive research put money and time into developing and synthesizing that research into a cohesive picture of an issuer's structure, performance, and attractiveness as an investment.[137] Must firms, in the interest of fairness, disclose the product of such research to the public before using it to avoid liability? Alternatively, must they expend even more time and money to discover and quarantine inside information passed

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132. *Id.* at 15.
133. *See, e.g.*, *id.* at 16–18 (describing one consultant who confirmed that Apple's new line of iPhones would have two cameras and provided the confidential information to a recipient who bought shares in Omnivision—a company that supplied cameras to Apple at that time).
134. United States v. O'Hagan, 521 U.S. 642 (1997).
135. Dirks v. SEC, 463 U.S. 646, 658 (1983) (internal citations omitted).
136. *Id.* at 658–59.
137. MACEY, *supra* note 51, at 52.

on inadvertently?[138] The first solution is problematic because it would result in free-riding[139] and remove the incentive for firms to spend money on analysts and research in order to gain a competitive advantage. Since "information cannot be enjoyed in limitless quantities by everyone, individuals and firms will not find it sensible to invest in producing information if they cannot profit from it."[140] The second may similarly reduce the incentive to engage in aggressive research because it would require firms to spend more money on compliance and legal analysis, leaving less of a margin for profit.[141]

The current regime may also result in prosecution of analysts performing research in good faith and makes it significantly more difficult for those analysts to effectively perform their research.[142] Analysts take steps to protect themselves from liability but may come to possess inside information accidentally.[143] Preet Bharara of the U.S. Attorney's Office has stated that the authorities are not pursuing those who do not intentionally seek out inside information,[144] but neither he nor the SEC has articulated an intelligible standard about what constitutes intent. The SEC has also cast a wide net with respect to what qualifies as material, non-public information and has seemingly expanded the definition of a duty of trust and confidence to include non-disclosure agreements with suppliers or customers.[145] As early as 1993, scholars noted that the vagueness of the insider trading statutes incented the SEC to expand its reach,[146] and the SEC has done so—except in cases where it is halted by the Supreme Court.[147] The SEC continues to insist that its definition of insider trading is clear enough, that its rules provide a "bright line," and that analysts should know when they cross that line.[148]

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138. *Id.*

139. The term "free rider" refers to a person or entity who obtains a benefit from group membership but does not share in the costs paid by the group to obtain such benefit. Robert Albanese & David D. Van Fleet, *Rational Behavior in Groups: The Free-Riding Tendency*, 10 ACAD. MGMT. REV. 244, 244 (1985). In the context of this Note, the term refers to a hypothetical situation in which a firm that spends money to develop information, later determined to be confidential and material, would be forced to disclose such information to the wider market, giving other investors the benefit of its research without those other investors being forced to share in the costs.

140. MACEY, *supra* note 51, at 10.

141. *See* Henning, *supra* note 92.

142. *See id.*

143. *See id.*

144. Mayhew, *supra* note 98.

145. *See, e.g.*, *Longoria* Complaint, *supra* note 130, at 62.

146. *See* SZOCKYJ, *supra* note 11.

147. *Id.*

148. Ashby Jones, *Again, Expert-Networking Firm Is at Heart of Insider-Trading Case*, WALL ST. J.L. BLOG (Nov. 20, 2012, 12:36 PM), http://blogs.wsj.com/law/2012/11/20/once-again-expert-networking-firms-at-heart-of-insider-trading-allegations/.

B. THE SEC LACKS CONSTITUTIONAL AUTHORITY TO EXPAND THE DEFINITION OF INSIDER TRADING

Following the Second Circuit's decision in *SEC v. Texas Gulf Sulphur*, the government has sought to expand the definition of insider trading to include possession and use of material, nonpublic information by any person, sometimes known as the "fairness" standard.[149] The *Texas Gulf Sulphur* court reasoned that section 10(b) of the Exchange Act could be read to require that

> anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[150]

Three Supreme Court cases since *Texas Gulf Sulphur* have limited insider trading liability to those who have some species of fiduciary duty requiring them to disclose or abstain.[151]

The basic limitations are these: to be liable for insider trading, an individual must have, and breach, a fiduciary duty to the shareholders of the company in whose securities he proposes to trade,[152] or a fiduciary-like duty of trust and confidence to the source of the inside information.[153] An individual who would otherwise meet neither standard inherits the duty to disclose or abstain only if he received the inside information from a person he knew had a duty not to share such information and the person sharing the information in breach of his duty received a benefit from doing so.[154] The equality of information standard urged by the SEC "differs little from the view that [the Supreme Court] rejected as inconsistent with Congressional intent in *Chiarella*."[155] In the absence of the fiduciary duty requirement, the SEC rule would have no limiting factor, exposing analysts to unrestrained litigation risk; "without legal limitations, market participants are forced to

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149. *See* SZOCKYJ, *supra* note 11, at 107–08 (discussing the Supreme Court's rejection of the "financial fairness" theory of insider trading).

150. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

151. *See* United States v. O'Hagan, 521 U.S. 642 (1997); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980). For a more in-depth discussion of these three cases, see *supra* Part I.

152. *Chiarella*, 445 U.S. at 222.

153. *O'Hagan*, 521 U.S. at 642; *see also* MACEY, *supra* note 51, at 54. ("A rational, straightforward definition of insider trading is available from the Supreme Court, should regulators and bureaucrats find the political will to make use of it. Those who abscond with corporate information in breach of a preexisting fiduciary relationship should be punished. Those, however, who expend the resources necessary to develop valuable information about a firm should be allowed to profit from it.").

154. *Dirks*, 463 U.S. at 646.

155. *Id.* at 656.

rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous."[156]

The SEC's investigation of channel checking is premised largely on the notion that employees of supply companies who share information with analysts do so in breach of an express or implied duty of confidentiality to the customer.[157] This is analogous to the *O'Hagan* standard,[158] but it goes too far. A finding of liability under *O'Hagan* requires that the accused have misappropriated confidential, material, non-public information, in breach of a fiduciary duty owed to the source of the information, for the purposes of securities trading.[159] A fiduciary duty is defined as

> [a] duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another).[160]

In the absence of a confidentiality agreement falling under rule 10b5-2, this definition does not describe the nature of the relationship between an employee of a given supplier and that supplier's customer. An argument could be made that, regardless of his duty to the customer, an employee always owes such a duty to his employer as the employer's agent; this is accurate, but if the information in question is classified as the property of the customer, passing it on does not breach a duty to the employer since it is the customer, not the employer, who enjoys exclusive use under *O'Hagan.*[161]

One possible criticism of this line of reasoning is that the SEC has historically been given broad authority by the courts to shape its regulatory regime, especially in the context of insider trading.[162] The Supreme Court held that the SEC did not exceed its authority in promulgating rule 14e-3, which prohibits trading on inside information concerning a tender offer, whether or not the trader had a duty to either the offeror or the offerees.[163] The rulemaking authority there specified that the SEC could make any rules needed to prevent fraudulent conduct in connection with a tender offer.[164] However, in granting that authority through the passage of the Williams

156. *Id.* at 656 n.24.
157. Kit Eaton, *Apple Analyst "Channel Checks" Now Under SEC Spotlight as Insider Trading*, FAST COMPANY (Nov. 24, 2010), http://www.fastcompany.com/1705110/apple-analyst-channel-checks-now-under-sec-spotlight-inside-trading.
158. *O'Hagan*, 463 U.S. at 666.
159. *Id.* at 652.
160. BLACK'S LAW DICTIONARY 581 (9th ed. 2009).
161. *O'Hagan*, 463 U.S. at 652.
162. *See id.* at 668.
163. *Id.*
164. *Id.*

Act,[165] Congress also noted that its preferred method of market regulation was through disclosure rather than "court-imposed principles of 'fairness.'"[166] The difference between the wording of section 10(b) and Congress's express intent to limit regulation on the grounds of fairness suggests by counterfactual inference that rule 10b-5 still requires a nexus of duty between an alleged insider trader/tipper and the owner of the information.[167]

V. PROPOSED SOLUTIONS

A. THE SEC SHOULD FORMULATE GUIDELINES FOR CHANNEL CHECKERS

To reduce the instances of insider trading, investors need guidance in order to police themselves more effectively. Such guidelines should not completely preclude aggressive, independent research. As noted earlier, channel checks and other forms of independent research are an important check on companies, preventing them from fooling the investment public with vague or even inaccurate disclosure.[168] It is well known that "[c]ompanies routinely claim to be doing well and do not like being contradicted, but that is the task of investors, analysts and the media."[169] Limiting such research must be done in a way that does not give companies the ability to lie to the public and get away with it—independent research can allow hedge funds and other market-moving investors to move the price of an entity in a way that signals its overall financial health. Crippling the research capabilities of large investors would render efforts to predict a company's future performance or current fair value "mere guesswork."[170] Companies who wish to prevent channel checking may take steps to protect their information by imposing non-disclosure agreements on their suppliers.[171] In such a situation, SEC rule 10b5-2 would allow enforcement actions against both the tipper and the tippee, provided the information is material and non-public.[172] Otherwise, the SEC becomes a tool for companies hiding damaging information.[173]

The SEC has taken the position that a non-disclosure agreement creates a relationship of trust and confidence sufficient to warrant a misappropriation charge if breached.[174] However, at least one court has

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165. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968).
166. *O'Hagan*, 463 U.S. at 668.
167. *See id.* at 666; *see also* Mayhew, *supra* note 97.
168. John Gapper, *The Feds Must Cast Their Net Wisely*, FIN. TIMES, Nov. 25, 2010, at 15.
169. *Id.*
170. Eaton, *supra* note 157.
171. *See* Anderson, *supra* note 79.
172. 17 C.F.R. § 240.10b5-2 (2014).
173. *See* Eaton, *supra* note 157.
174. 17 C.F.R. § 240.10b5-2.

questioned rule 10b5-2, noting that it conflates a confidentiality agreement with a fiduciary-like relationship.[175] The court went on to note that in some cases, a confidentiality agreement could give rise to a fiduciary-like duty, but only one including terms that bore the hallmarks of such a duty.[176] Several of the charges against former Primary Global Research consultants contained the phrase, "non-disclosure agreements between [company *x*] and [company *y*] governed all of this type of information,"[177] implying that any non-disclosure agreement creates a fiduciary-like duty of trust and confidence between the employee of the supplier and the customer.

The most recent cases of insider trading brought by the SEC have focused more on the confidential nature of the information being passed to analysts and less on the materiality of that information.[178] However, the question of materiality is crucial since insider trading liability only ensues if the misappropriated information is material.[179] Whether channel checking remains a valid method of research will depend in large part on whether the SEC expands the definition of materiality to include practically any confidential information about a company.

1. Congress or the SEC Must Clarify the Definition of Materiality

The lack of clarity over the definition of materiality has led to confusion among large investors and accusations that the SEC intentionally keeps the definition broad so it can decide what kinds of conduct to attack without coming under attack for ex post lawmaking.[180] Some in the financial industry reject this idea, claiming in essence that materiality is so obvious that, as Justice Potter Stewart famously said,[181] one should "know it when they see it."[182] Stephen Taub claims that there is a wide gulf between inside information and channel-checking activity, restricting the term "channel check" to activities like visiting retail outlets and counting cars in store parking lots.[183] This is an artificial limitation as the industry often uses the term to refer to activities like calls to employees at supply or customer companies.[184] The risk of the "know it when they see it"

175. United States v. Kim, 184 F. Supp. 2d 1006, 1013 (N.D. Cal. 2002).
176. *Id.* at 1015.
177. *E.g.*, *Longoria* Complaint, *supra* note 130, at 62.
178. Pulliam, *supra* note 1.
179. Henning, *supra* note 92.
180. *Id.*
181. Justice Potter Stewart famously noted that hard-core pornography was hard to define but that he knew it when he saw it. Jacobellis v. Ohio, 378 U.S. 184 (1964) (Stewart, J., concurring).
182. Stephen Taub, *Memo to Managed Funds Association: Don't Trade on Insider Information*, INSTITUTIONAL INVESTOR (Feb. 2, 2011), http://www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2760679.
183. *Id.*
184. *See* Sampath, *supra* note 83.

definition of materiality is that it leaves open the possibility of judicial or regulatory expansion. Even a good-faith effort to implement compliance policies to prevent transmission of material information may not be enough to avoid receiving such information and as such being subject to insider trading liability.[185] For example, when a piece of information is just one part of an investment thesis or analyst report but forms an important part of the mosaic,[186] is it material?[187] After all, it does add to the total mix of information, and it may be difficult to determine whether it adds "significantly" or simply to some unspecified extent.

The SEC should provide a definition of what constitutes "material information" for the purposes of insider trading liability, marking certain types of information as clearly material and strictly off-limits for discussion. A definition would not have to preclude the SEC from pursuing actions for the sharing of non-listed items, but rather could provide a good guide to investors and analysts to keep them out of trouble. Off-limits information should include pre-release earnings numbers, cash flow figures, and other important financial data. This may be done in conjunction with a determination of materiality of at least some types of information. The cases brought against experts and channel checkers at this point have primarily involved clearly material information like pre-publication earnings numbers.[188] There may come a time, though, when the materiality of the information obtained by an analyst is not so clear. Channel checks by their nature involve development of information that most investors do not have, and a more even-handed approach would be for the SEC to develop materiality guidelines to supplement the Court's general definition of materiality.

The Supreme Court has previously refused to adopt a bright-line test of materiality in connection with alleged false and misleading statements made in contravention of rule 10b-5.[189] In *Matrixx Initiatives, Inc. v. Siracusano*, a pharmaceutical company failed to disclose certain adverse events relating to its cold remedy product and defended on the ground that the events were statistically insignificant.[190] The Court did not agree that an adverse event must be statistically significant, holding that, since investors may act on a non-statistically significant event, such an event, if disclosed, may be deemed to have significantly altered the total mix of information available

185. *See* Evelyn M. Rusli, *Amid Insider Trading Inquiries, Experts Get a Cold Shoulder*, N.Y. TIMES, Dec. 28, 2010, at B4.
186. *See supra* Part III.B.
187. Henning, *supra* note 92.
188. *See, e.g.*, Peter J. Henning, *The Impact of the Latest Insider Trading Convictions*, N.Y. TIMES DEALBOOK (Dec. 18, 2012, 3:42 PM), http://dealbook.nytimes.com/2012/12/18/the-impact-of-the-latest-insider-trading-convictions/.
189. Matrixx Initiatives, Inc. v. Siracusano, 131 S. Ct. 1309, 1313–14 (2011).
190. *Id.* at 1310.

to an investor.[191] This is a signal that the Court wishes to reserve for itself broad discretion in determining what information is material.

Not everyone in the SEC thought it wise to leave the definition of materiality open to interpretation.[192] Former SEC chairman John Shad attempted to draft a definition of materiality ahead of the passage of the Insider Trading Sanctions Act but was unable to do so before the legislation was passed in 1983.[193] Senator Donald Riegel, Chair of the Subcommittee on Securities, spoke out in favor of such a definition, noting that the courts have interpreted the current test inconsistently:

> Unfortunately, the courts have not interpreted fraud as it relates to insider trading with any degree of consistency or clarity. As a result, not even lawyers, let alone members of the public, can be sure from one court case to another what the state of the law actually is in this area . . . . I think that's really an unacceptable situation and has to be changed.[194]

The last attempt to impose a definition on the question of materiality was defeated by the fear that a savvy trader or defense lawyer would find a way around it.[195] This Note argues that such a fear is unjustified, as long as the SEC is willing to limit itself to situations in which illegal insider trading has actually occurred and refrains from pursuing traders who either lack a duty to any issuer or have simply collected enough information to attain an advantage not shared by the general public. To keep the current definition is to have a rule without limit, which the Supreme Court disapproved in *Dirks v. SEC*.[196]

B. SAFE HARBOR WHEN SCIENTER CANNOT BE SHOWN

The most glaring problem with aggressively prosecuting analysts for channel-checking-related insider trading is that it may cast too wide a net and include those who unintentionally obtain misappropriated information. Liability for insider trading under the misappropriation theory, the only conceivable grounds for a prosecution flowing from channel-checking activities, requires willful breach of a recognized duty.[197] In the case of a channel check, the original duty would necessarily lie with the insider passing along information to the analyst.[198] In order for liability to pass to the analyst as a tippee, that analyst would have to receive the information knowing that the insider violated a duty not to disclose it.[199] This creates a

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191. *Id.* at 1314.
192. SZOCKYJ, *supra* note 11, at 109–10.
193. *Id.*
194. *Id.*
195. *Id.*
196. Dirks v. SEC, 463 U.S. 646, 664 (1983).
197. United States v. O'Hagan, 521 U.S. 642, 665–66 (1997).
198. *See Dirks*, 463 U.S. at 665.
199. *See O'Hagan*, 521 U.S. at 666.

catch-22 for the analyst since confidentiality agreements are often themselves subject to confidentiality, preventing the insider from disclosing whether he has a duty to keep certain information secret.[200]

Expert networks are also a problem since high compensation for providing information about a company may incentivize consultants to provide information covered by a confidentiality agreement without disclosing such an agreement.[201] Some former expert network consultants charge that their former employers would intentionally neglect to ask about any confidentiality agreements in order to try to avoid the scienter element of insider trading liability.[202]

In order to avoid the prosecution of innocent analysts, the SEC should carve out an exemption for those who legitimately were not aware that their source was speaking in violation of a duty of trust and confidence to the customer of the source's company. This could be accomplished by working with industry compliance experts to formulate the appropriate questions and disclosures that analysts may ask sources to determine what sorts of information they are permitted to share. Investment professionals have already begun beefing up compliance programs and examining their communications with supply-chain personnel to avoid liability for insider trading.[203]

In the past, the SEC has worked with regulated entities on thorny issues like channel checking. When high-frequency trading firms became controversial because of the 2010 "flash crash" attributed to their trading style, the SEC solicited input from such firms to better understand how to tailor regulations that would be effective and fair.[204] Recently, high-frequency trading has come under fire from some Wall Street traders, who accuse firms of using the strategy to front-run other investors without providing any useful capital to corporate participants in the equity markets.[205] By contrast, channel checks are used to evaluate the long-term financial health and growth potential of a particular company—a slow and analytical process designed to evaluate the most efficient allocation of investment capital. A discussion of the relative merits of high frequency trading and long-term investment is beyond the scope of this Note, but if the SEC is willing to collaborate with high-frequency trading firms, it should be willing to work with investors who use channel checks.

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200. Sampath, *supra* note 72, at 50.
201. Rusli, *supra* note 185, at B4.
202. *Id.*
203. *Id.*
204. Nathaniel Popper & Ben Protess, *To Regulate Rapid Traders, SEC Turns to One of Them*, N.Y. TIMES, Oct. 8, 2012, at B1.
205. *See* MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT 79–80 (2014).

CONCLUSION

The debate over whether channel checking and the use of expert networks should be legal involves a policy-based and technical analysis of the insider trading laws. It forces us to look at the tension between a purely fairness-based system, where the government ensures that all market participants have access to exactly the same information at the same time, and a purely efficiency-based system, where information about a given security is impounded in its price the moment it is created or becomes known.[206] The answer, I think, lies somewhere between these two extremes.

It does no good to enforce a pure fairness standard because to do so damages the efficiency of the markets, exposes market participants to nearly unlimited risk at the discretion of the SEC, and allows companies with adverse events to hide them from the public, if not forever, at least for some time. Such a standard is also contrary to established law at the Supreme Court level. At the same time, it is against our social conscience to allow some in-the-know individuals to profit at the expense of those who have limited access to inside information.

The incentive to make large amounts of money will always induce some to violate the law.[207] However, it undermines our market system when, in search of those bad actors, we punish those who work to develop and disseminate independent research. Instead, the government and the securities industry should work towards a more tailored approach that allows the government to police bad actors and gives securities professionals an idea of where the "line" is that separates legal from illegal conduct. Perfect efficiency and perfect fairness are difficult, if not impossible, to achieve; however, there is much to be said for an attempt to balance both. The key is to find a solution that does not shut down securities markets by over-regulation of legitimate, in-depth research, but leaves tools for the SEC and U.S. Department of Justice to discipline those who have actually misappropriated material, non-public information.

Marron C. Doherty[*]

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206. *See* ARSHADI & EYSELL, *supra* note 13, at 36.

207. Tamar Frankel, *Self-Regulation of Insider-Trading in Mutual Funds and Advisers*, 8 BROOK. J. CORP. FIN. & COM. L. 80 (2013) ("People who deal with money are usually hungry for more money. For such people there is never enough. For people who are envious of richer people, there are always those who have more.").

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