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Salman v. United States: Insider Trading's Tipping Point?

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The Supreme Court's 2016 term officially begins on the first Monday in October. But corporate insiders, securities analysts, and professional traders (as well as securities lawyers and scholars) are focusing their attention on Wednesday, October 5, when the Court, for the first time in nearly two decades, will hear argument in an insider trading case. It has been even longer still since the Court—in its 1983 decision in *Dirks v. SEC*[1]—last grappled with the circumstances under which tipping and trading on stock tips constitute violations of the antifraud provisions of the federal securities laws.

I am honored to contribute to this important Symposium by setting the stage for the four Essays that follow. Jill Fisch (Pennsylvania), Donald Langevoort (Georgetown), Jonathan Macey (Yale), Adam Pritchard (Michigan), and I (Indiana University-Bloomington) have each been writing about insider trading law for two or three decades, and our views, expressed in both this Symposium and prior work, provide contrasting perspectives.

We agree on several matters. First and foremost, each of us expects the Court in *Salman v. United States*[2] to affirm the lower court's decision upholding the petitioner's securities fraud and conspiracy convictions for trading on the basis of stock tips. The tipper in *Salman* was an investment banker employed at Citigroup who, on multiple occasions, disclosed to his brother confidential information about upcoming mergers and acquisitions, knowing that his brother was using the information to profit in the securities market.[3] The brother also passed the lucrative information to the petitioner, Bassam Salman, a family member by marriage, who traded on the tips knowing that the

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

2. United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), *cert. granted*, 136 S. Ct. 899 (2016).

3. *Id.* at 1088-89.

information had been misappropriated from Citigroup and its clients.[4] In his appeal to the Ninth Circuit, Salman argued that his guilty verdict and three-year prison sentence were not supported by legally sufficient evidence because the investment banker had neither sought nor received a tangible benefit in exchange for gratuitously tipping his brother.[5] The Ninth Circuit rejected that argument and held, correctly in our opinion, that proof of a tangible benefit is not required for joint tipper-tippee liability under *Dirks*, provided there is sufficient evidence of an intention on the part of the tipper to give entrusted information as a gift to a trading relative or friend.[6] The Ninth Circuit thus created what is, at least arguably, a split with the Second Circuit's controversial ruling in *United States v. Newman*.[7]

The five of us also agree that the Court's classical and misappropriation theories of insider trading fit awkwardly into a rubric of securities fraud under Section 10(b) of the Securities Exchange Act[8] and Rule 10b-5 thereunder.[9] These complementary theories of insider trading are predicated on the Court's adaptation of fiduciary principles to Section 10(b)'s prohibition of deceptive devices and contrivances "in connection with the purchase and sale of a security."[10] The classical approach from *Dirks* and *Chiarella v. United States*[11] is directed at a corporate insider's deceptive silence in transactions with shareholders of the securities issuer. And the misappropriation approach from *United States v. O'Hagan*[12] is premised on an outsider's deception of the source of the entrusted information. Both theories encompass a host of doctrinal "anomalies,"[13] including (and perhaps particularly) *Dirks*'s notion that a tipper's breach of fiduciary duty can somehow impute to the tip's recipient a disclosure

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4. *Id.* at 1089.
5. *Id.* at 1093.
6. *Id.* at 1093-94.
7. The Court granted a Writ of Certiorari on the first question presented in the Petition:

   > Does the personal benefit to the insider that is necessary to establish insider trading under *Dirks v. SEC* require proof of "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature," as the Second Circuit held in *United States v. Newman*, or is it enough that the insider and the tippee shared a close family relationship, as the Ninth Circuit held in this case?

   Petition for Writ of Certiorari at i, *Salman*, No. 15-628 (U.S. Nov. 10, 2015), 2015 WL 7180648, at *i (citations omitted).
8. 15 U.S.C. § 78j(b) (2015)).
9. 17 C.F.R. 240.10b-5 (2015).
10. 15 U.S.C. § 78j(b).
11. 445 U.S. 222 (1980).
12. 521 U.S. 642 (1997).
13. *See* Donald C. Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 ALA. L. REV. 399, 403 (1988) (describing the "fiction of insider trading as fraud").

obligation of "trust and confidence," provided the tippee "knows or should know that there has been a breach."[14] But in the absence of explicit statutory prohibitions against insider trading and tipping, and because silence absent a duty to disclose is not fraudulent,[15] we recognize the value of the Court's legal fictions.

The tipper-tippee liability issue in *Dirks* presented a particularly nettlesome problem because tippees—such as the family members in *Salman* or the two hedge fund managers whose convictions were vacated in *Newman*[16]—are typically strangers to both the securities issuer's shareholders and the source of the entrusted information. They are thus fiduciaries to neither shareholders nor sources in any real sense. *Dirks* created the "personal benefit" test to determine whether an insider's disclosure of entrusted information breaches a fiduciary duty, which then renders a tippee with awareness of that breach a "participant" in the fiduciary's fraud.[17] The test, according to the Court, must focus on "objective criteria, *i.e., whether the insider receives a direct or indirect personal benefit from the disclosure*, such as a pecuniary gain or a reputational benefit that will translate into future earnings."[18] But *Dirks* likewise observed that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist *when an insider makes a gift of confidential information to a trading relative or friend*."[19] Thus, under *Dirks*'s personal benefit test, tippees assume a disclosure duty of trust and confidence to transacting shareholders (under the classical theory) or to the source of entrusted information (under the misappropriation theory) only when material nonpublic information "has been made available to them *improperly*."[20] At issue in *Dirks* were nonpublic disclosures made to a securities analyst by corporate insiders, who did not act improperly because they "were motivated by a desire to expose" a massive ongoing fraud at the corporation.[21]

The Court in *Dirks* eschewed the SEC's broader reading of Section 10(b) and Rule 10b-5, fearing that it would have "an inhibiting influence on the role of market analysts."[22]As Pritchard observes from his review of initial drafts of the *Dirks* opinion, Justice Lewis Powell "wanted to leave space for securities professionals to uncover non-public information, even if it came from corporate

14. Dirks v. SEC, 463 U.S. 646, 660 (1983).

15. *Chiarella*, 445 U.S. at 228 (emphasizing the common law principle that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so").

16. *See infra* text accompanying notes 47-48.

17. *Dirks*, 463 U.S. at 659.

18. *Id.* at 663 (emphasis other than *i.e.* added).

19. *Id.* at 664 (emphasis added).

20. *Id.* at 660.

21. *Id.* at 667.

22. *Id.* at 656-58.

insiders."[23] Justice Powell had been confident that trading on the basis of selectively disclosed information would contribute to stock market pricing efficiency, which the Court concluded "redounds to the benefit of all investors."[24]

This Symposium's consensus diverges when it comes to our opinions about how the *Salman* Court should evaluate its insider trading law precedents. Fisch, Macey, and Pritchard would like to see the Court strictly adhere to *Dirks*'s personal benefit test. I agree that the Court should reaffirm *Dirks* insofar as it held that only improper disclosures trigger joint tipper-tippee liability.[25] But in my view, the *Salman* Court should instead employ the interpretive methodology Justice Ruth Bader Ginsburg used in *O'Hagan*, construing Rule 10b-5 broadly to effectuate the congressional objectives of "insur[ing] honest securities markets and thereby promot[ing] investor confidence."[26] The *Salman* Court should likewise evaluate the investment banker's gratuitous tips to his brother with a view to *O'Hagan*'s misappropriation doctrine. That is, regardless whether a fiduciary stands as an insider or outsider to the securities issuer, loyalty duties are breached—and frauds are perpetrated—whenever fiduciaries secretly make third-party disclosures that deprive principals of the "exclusive use" of entrusted information.[27] Thus, *O'Hagan* supports a joint tipper-tippee liability test that turns on evidence of disclosures that violate a fiduciary's duty of loyalty, whether or not the tipper acted self-servingly and sought or received a personal benefit in exchange for the information.[28] Langevoort likewise questions why personal benefit should continue to play such an outsized role in Rule 10b-5 liability determinations.[29]

This Symposium also provides conflicting assessments of actions (and inactions) by Congress, the Court, and the SEC in the development of insider trading law. Pritchard, for instance, criticizes both the SEC, for pursuing a largely litigation-oriented "campaign against insider trading," and Congress, for failing to "take responsibility for enacting criminal prohibitions" on insider

23. A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 861 (2015).

24. *Dirks*, 463 U.S. at 658 n.17 (observing that "market efficiency in pricing is significantly enhanced by [analyst] initiatives to ferret out and analyze information").

25. *See* Donna M. Nagy, *Beyond* Dirks*: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1 (forthcoming 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2665820.

26. United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.").

27. *Id.* at 652.

28. Nagy, *supra* note 25, at 61-66.

29. *See* Donald C. Langevoort, *Informational Cronyism*, 69 STAN. L. REV. ONLINE 37, 39 (2016) (contending that "there should be liability when an insider plays a corrupted Santa Claus with corporate secrets").

trading.[30] Yet, as I see it, Congress's multiple determinations to forego a legislative definition evidence not abdication, but rather concerted judgments that fraud-based insider trading and tipping proscriptions—and the interstitial lawmaking inherent in such proscriptions—put securities traders on appropriate notice that transactions based on misappropriated information will be subject to stiff civil sanctions and harsh criminal penalties.[31] Fisch similarly holds a favorable view of what she has elsewhere termed an insider trading "lawmaking partnership" among Congress, the Court, and the SEC.[32]

Our differing opinions about the judiciary's and the SEC's respective responsibilities for policy choices under the federal securities laws prompt particularly stark disagreements over the interplay between Rule 10b-5's scope and Regulation FD,[33] which effectively bans what the SEC regards as "unfair selective disclosure."[34] The SEC promulgated Regulation FD in 2000 as an "issuer disclosure rule" pursuant to its rulemaking power under Section 13(a) of the Exchange Act.[35] The regulation, which seeks to create a more "level playing field" for all investors,[36] prohibits issuer officials from selectively sharing unreleased earnings announcements and other material nonpublic information with securities analysts and other industry professionals.[37]

Although it is clear that the SEC adopted Regulation FD to put an end to the privileged status analysts and their clients enjoyed in the wake of *Dirks*,[38] the

30. A.C. Pritchard, *The SEC, Administrative Usurpation, and Insider Trading*, 69 STAN. L. REV. ONLINE 55, 57, 63 (2016).

31. *See* Nagy, *supra* note 25, at 34-44 (discussing the Insider Trading Sanctions Act of 1984, the Insider Trading and Securities Fraud Enforcement Act of 1988, and the Stop Trading on Congressional Knowledge Act of 2012); *id.* at 32 & n.182 (differentiating the property-based Rule 10b-5 fraud theory endorsed in *O'Hagan* from the due process concerns that prompted the honest-services fraud holding in *Skilling v. United States,* 561 U.S. 358 (2010)).

32. *See* Jill E. Fisch, *Federal Securities Fraud Litigation as a Lawmaking Partnership*, 93 WASH. U. L. REV. 453, 469-70 (2015) (contending that insider trading "demonstrates the advantages of the lawmaking partnership as a tool to develop financial regulation," *id.* at 483).

33. 17 C.F.R. § 243.100-243.103 (2015).

34. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319 at 83,680 (Aug. 15, 2000) [hereinafter *Selective Disclosure Release*].

35. *Id.* at 83,666.

36. *Id.* at 83,677.

37. 17 C.F.R. § 243.101.

38. *See* Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1024 (1990) (observing that insiders' disclosures to analysts typically were not unlawful after *Dirks* because they served a variety of corporate ends "such as to enhance the company's standing with the investor community or to strengthen pre-existing lines of communication").

authors of this Symposium hold decidedly different views as to which policy preferences—the SEC's or the *Dirks* majority's—should be accorded greater weight in deciding when tipping selectively disclosed information and trading on the basis of those tips constitute securities fraud.[39] *Dirks*'s policy rationale is predicated on an empirical claim that some selective disclosures by insiders to analysts are overall a positive force in securities markets.[40] It is hardly surprising that our views differ not only on how to weigh the SEC's contrary claim (reflected in its adoption of Regulation FD after notice and comment),[41] but also on how to regard post-Regulation FD evidence that supports the SEC's contentions.[42] We likewise disagree as to whether insiders who cause issuers to violate Regulation FD and/or flagrantly contravene issuers' compliance procedures pertaining to market-sensitive information can ever be regarded under Rule 10b-5 as acting "benignly" for legitimate corporate purposes.[43] As I have argued, insiders who deliberately leak information in violation of Regulation FD have failed to act in good faith and thereby breach their duty of

39. *Compare* Jonathan R. Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE 64, 69 (2016) (arguing that in Rule 10b-5 insider trading cases, courts should continue to defer to *Dirks*'s view of salutary selective disclosure but acknowledging that *Dirks* "explicitly condoned" the selective disclosure practices that "the SEC made illegal" seventeen years later in Regulation FD), *with* Langevoort, *supra* note 29, at 43 (explaining that Regulation FD "took direct aim at the kind of selective disclosure to analysts that Justice Powell (naively, I think) had treated as an unqualified good"). *See also* Nagy, *supra* note 25, at 53 n.307 (raising, but leaving unresolved, the application of administrative law principles in decisions including *Chevron U.S.A., Inc. v. Nat. Res. Def. Council*, 467 U.S. 837 (1984)).

40. *See supra* text accompanying notes 22, 24 (quoting *Dirks*); *see also* Macey, *supra* note 39, at 70 (contending that *Dirks* recognized that "selective disclosure can benefit investors and capital markets by ferreting out fraud . . . or by encouraging investor monitoring and moving capital market prices to reflect more accurately underlying corporate values").

41. *See Selective Disclosure Release*, supra note 34, at 83,677 (stating that "the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets"); Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,849 & n. 19 (Dec. 20, 1999) (discussing ways in which selective disclosure impairs market efficiency).

42. *Cf.* Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 112, 125 (Stephen M. Bainbridge ed., 2013) (concluding that the "mixed results" from extensive empirical studies make it difficult "to draw definitive conclusions about the effects of the Regulation").

43. *Compare* Macey, *supra* note 39, at 70 (contending that insiders often tip for "benign" reasons that do not benefit the insiders but rather further the interests of the company whose confidential information is disclosed), *with* Nagy, *supra* note 25, at 55-58 (emphasizing state court decisions that construe breaches of the duty of loyalty to encompass not only self-dealing but also other conduct evidencing a failure of act in good faith, such as "where the fiduciary acts with the intent to violate applicable positive law" (quoting Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006) (citation omitted)).

loyalty "by causing the corporation to violate the positive laws that it is obligated to obey."[44]

To be sure, because the investment banker/tipper at Citigroup was not an official acting on behalf of a securities issuer, Regulation FD relates only indirectly to the *Salman* petitioner's claim that gratuitous tipping does not support a conviction for securities fraud under *Dirks*. But because the Second Circuit in *Newman* sought to facilitate efforts by securities analysts and other market professionals to gather and use informational advantages in their securities trading,[45] our respective views concerning selective disclosure inform our opinions about what (if anything) the Court should say regarding the Second Circuit's determination in *Newman* to heighten the standard for proving a personal benefit under *Dirks*.

The two initial tippers in *Newman* were insiders at Dell and NVIDIA, who each, on multiple occasions, shared unreleased quarterly earnings information with a casual friend.[46] For well over a year, the confidential information traveled down two multilevel chains of securities analysts that ended with the two hedge fund manager defendants.[47] *Newman* held that even if evidence establishes that an insider and tippee are friends, the disclosures do not implicate joint liability under Rule 10b-5 "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."[48]

To varying degrees, Fisch, Pritchard, and Macey would each be satisfied with a ruling by the *Salman* Court that does not disturb *Newman*'s formulation of the personal benefit test and simply reiterates *Dirks*'s very clear "gift" language—which fits to a T the informational tips from the investment banker to his family members. But they highlight different reasons for championing *Newman*. Pritchard argues that Rule 10b-5's proscription against insider trading and tipping, as unwritten prohibitions, should be interpreted narrowly because they carry criminal consequences and were developed principally through adjudication rather than rulemaking or (ideally) legislation.[49] Macey lauds the

44. Nagy, *supra* note 25, at 57-58 (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)). *See* Desimone v. Barrows, 924 A.2d 908, 934-35 (Del. Ch. 2007) ("The knowing use of illegal means to pursue profit for the corporation is director misconduct.").

45. *See* United States v. Newman, 773 F.3d 438, 449 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) ("Efficient capital markets . . . require that persons who acquire and act on information about companies be able to profit from the information they generate." (quoting United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring))).

46. *Id.* at 442-43.

47. *Id.*

48. *Id.* at 452.

49. *See generally* Pritchard, *supra* note 30.

Newman opinion for recognizing what he regards as selective disclosure's "curative" effects.[50] In contrast, Fisch emphasizes the chilling effect that "an ambiguous liability standard" has on efforts by analysts and traders to gather and use legitimate research.[51] She therefore argues that the SEC's concerns about unfair selective disclosure are much better addressed through enforcement actions against the issuers and their officials who "give professional traders advantages over other investors" in violation of Regulation FD.[52]

Langevoort and I, however, would be pleased if the *Salman* Court issues an opinion that disavows *Newman*'s heightened standard for proving a personal benefit. *Newman*'s focus on tangible benefits has impeded the government's ability to prosecute cases involving corrupt and arrogant disclosures of entrusted information to casual friends and business cronies.[53] And, by invoking *Newman*, a host of defendants have successfully sought court orders to vacate their criminal convictions, guilty pleas, or civil liability judgments.[54]

But our preference would be for the *Salman* Court to reconceptualize insider trading law more generally, by establishing a synthesized doctrine of insider trading and tipping that better aligns with the jurisprudence that has evolved in the nearly twenty years since *O'Hagan*.[55] The approach I have advanced on other occasions,[56] and that Langevoort considers "the best way to make sense of insider trading law,"[57] was espoused by Chief Justice Warren Burger in his *Chiarella* dissent, which deemed trading on wrongfully obtained information a fraud on contemporaneous traders.[58]

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50. *See* Macey, *supra* note 39, at 68.

51. *See* Jill E. Fisch, *Family Ties: Salman and the Scope of Insider Trading*, 69 STAN. L. REV. ONLINE 46, 48 (2016).

52. *Id.* at 54.

53. *See* Langevoort, *supra* note 29, at 39 (contending that *Newman*'s "objective, consequential" exchange language "is pernicious in a wide variety of professional settings that involve fiduciary disloyalty without any visible return promise").

54. *See* Patricia Hurtado, *Inside Traders Who May Find Hope in Supreme Court Move: List* 47 SEC. REG & L. REP. 1930, 1930 (Oct. 5, 2015).

55. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1340-64 (2009) (charting the diminishing importance of fiduciary principles in insider trading decisions by lower courts and settled enforcement proceedings).

56. *See id.* at 1373-78; Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1296-1304 (1998); *see also* Nagy, supra note 25, at 70 (contending that a new approach is warranted now because insider trading jurisprudence has become "unnecessarily complex").

57. *See* Langevoort, *supra* note 29, at 44.

58. Chiarella v. United States, 445 U.S. 222, 240-45 (1980) (Burger, C.J., dissenting) (agreeing with the majority's observation that silence about material facts in business transactions is generally permissible absent a fiduciary relationship between the parties, but arguing that this general rule "should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means").

Interpreting Rule 10b-5 as the Chief Justice suggested would consolidate the Court's prior classical and misappropriation approaches into a unified framework under which the investors who are "harm[ed]"[59] and "victim[ized]"[60] by the wrongful use of material nonpublic information are also the parties deceived and defrauded. This new theory would thus parallel Section 20A of the Exchange Act, which grants an express private right of action to those investors trading contemporaneously with an insider-trader.[61] A "fraud on contemporaneous traders" theory would also prohibit a broader range of securities transactions based on material nonpublic information because the disclosure obligation would turn not on a relationship of trust and confidence but rather on the illicit nature of the informational advantage. The theory, therefore, would support liability when information thieves (such as computer hackers) trade securities based on market-moving information stolen from its rightful owner,[62] and, as I have contended, in instances where the recipients of repeated selective disclosures trade securities while aware of an insider's deliberate and disloyal violations of Regulation FD.[63] Finally, because securities trading based on wrongfully obtained information has an "inhibiting impact on market participation"[64] irrespective of a fiduciary connection, the new theory would better advance what *O'Hagan* identified as the important policy objectives of promoting the integrity of and investor confidence in the securities markets,[65] which in turn enhances market efficiency.[66]

If the Court were to endorse this unified and expanded framework, the opinion in *Salman* would mark a monumental development in the law of insider trading. But no matter how the Court resolves the issue of gratuitous tipping, the spirited debate reflected in this Symposium is bound to continue for a long time to come.

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59. United States v. O'Hagan, 521 U.S. 642, 656 (1997) (observing that a misappropriator "deceives the source of the information and simultaneously harms members of the investing public").

60. Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1067 (2014) (observing that an insider trader's "victims [are] 'members of the investing public' harmed by the defendant's gaining of an 'advantageous market position' through insider trading" (quoting *O'Hagan*, 521 U.S. at 644, 655)).

61. 15 U.S.C. § 78t-1 (2015).

62. *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (questioning whether the defendant's computer hacking constituted active deception or "mere[ly] theft").

63. *See* Nagy, supra note 25, at 58-60, 65 n.366 (discussing the interplay between state fiduciary law and Rule 10b-5, and suggesting revisions to Regulation FD clarifying its overlap with Rule 10b-5's prohibitions of insider trading and tipping).

64. *See O'Hagan*, 451 U.S. at 659.

65. *See supra* text accompanying note 26 (quoting *O'Hagan*, 451 U.S. at 658).

66. *See supra* note 41 (citing SEC Release proposing Regulation FD).