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

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THE MOSAIC THEORY OF MATERIALITY – DOES THE ILLUSION HAVE A FUTURE?

by Allan Horwich*

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

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

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While the pronouncements of the demise of the mosaic theory are very much exaggerated, the practical ability to employ the theory in any given case is limited. Securities professionals, for example, who intend to rely on the theory as they assemble information from multiple sources, including insiders, act at their peril.

I. MATERIALITY UNDER THE SECURITIES LAWS

In an action under Rule 10b-5\(^1\) of the Securities and Exchange Commission (SEC or Commission) a fact is material if “there is a substantial likelihood that a reasonable shareholder

\[\text{17 C.F.R. } \text{§ 240.10b-5 (2013). The rule provides:}\]

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

This rule is the basis for most private securities litigation and a substantial portion of SEC enforcement activity. DONNA M. NAGY, ET AL., SECURITIES LITIGATION AND ENFORCEMENT 6-7, 23-24 (3d ed. 2012).

In a typical § 10(b) private action a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

would consider it important” in making his investment decision. An omitted fact is material if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”

Judgments ex ante about which facts are material under the securities laws are often complex and difficult.

II. THE CLASSICAL THEORY OF INSIDER TRADING

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

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

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


Potential liability extends beyond the insider who learns the information in the course of his relationship with the company. The insider who discloses nonpublic information to an outsider may be a tipper and the recipient of the information is a tippee, each violating Rule 10b-5.

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach. . . .

. . . .

In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider’s “tip” constituted a breach of the insider’s fiduciary duty [to keep the information confidential]. All

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

The “misappropriation theory” holds that a person commits fraud “in connection with” a securities transaction, and thereby violates § 10(b) and Rule 10b–5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. . . . In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.

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

There is a third approach, which depends on a direct act of affirmative deception. See SEC v. Dorozhko, 547 F.3d 42 (2d Cir. 2009) (sustaining theory of Rule 10b-5 liability where, even absent any fiduciary duty to the source of the information, the defendant engages in deception in order to obtain material nonpublic information, after which the defendant trades).

For an in-depth analysis of the theories of insider trading, see 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION passim, especially chs. 3 & 6 (2013); WILLIAM K. S. WANG & MARC I. STEINBERG, INSIDER TRADING passim, especially ch. 5 (3d ed. 2010).
disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. . . . Whether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure. . . . [T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.6

The Second Circuit Court of Appeals recently addressed the necessary element of scienter—intent to deceive—in determining whether a tipper has violated Rule 10b-5:

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


Personal benefit to the tipper is broadly defined: it includes not only “pecuniary gain,” such as a cut of the take or a gratuity from the tippee, but also a “reputational benefit” or the benefit one would obtain from simply “mak[ing] a gift of confidential information to a trading relative or friend.”


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

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

Id. at 286-87 (citations omitted).
Most important for present purposes is that the tipper must know that the information he tipped was material.

An essential element of tippee liability is that the tippee also know that the tipped information is material and nonpublic. In addition, an element of the violation is that the tippee knew or should have known that confidential information was initially obtained and transmitted improperly by a tipper. This is a fact-specific inquiry turning on the tippee’s own knowledge and sophistication, and on whether the tipper’s conduct raised red flags that confidential information was being transmitted improperly.

In actions against tippees based on the classical theory of insider trading, there is sometimes a dispute about whether the defendant was aware of material nonpublic information.

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8 Obus, 693 F.3d at 287-88.

9 Id. at 288. While the court in Obus finds this to be consistent with Dirks (id., citing 463 U.S. at 660), commentators have criticized the absence of a scienter requirement here. See Joan MacLeod Heminway, Willful Blindness, Plausible Deniability and Tippee Liability: SAC, Steven Cohen, and the Court’s Opinion in Dirks, 15 TRANSACTIONS: TENN. J. OF BUS. L. 47, 52-53 (2013) (stating that it is appropriate to question whether it is tenable in application to separate the knew or should have known test from the test for intentional trading by the tippee while in knowing possession of material nonpublic information); Allison M. Vissichelli, Note, Intent to Reconcile: SEC v. Obus, The Second Circuit’s Edification of the Tippee Scienter Standard, 62 AM. U. L. REV. 763, 776 (2013) (“the negligence standard annuls the actual or reckless knowledge standard in that a tippee may knowingly or recklessly trade on information without knowing that the information is of the type of which the Act and accompanying Rule prohibit trading”); see also Donald C. Langevoort, “Fine Distinctions” in the Contemporary Law of Insider Trading, 2013 COLUM. BUS. L. REV. 429, 456 (observing that Obus may change the tippee scienter standard).

10 Obus, 693 F.3d at 288.

11 See SEC Rule 10b5-1(b), 17 C.F.R. § 240.10b5-1(b) (2013) (“a purchase or sale of a security of an issuer is ‘on the basis of’ material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale”) (emphasis added). Rule 10b5-1(c) affords specific
A defendant may argue, for example, that he did not know anything material that was not public at the time he traded\textsuperscript{12} or that what he knew that was not public was not material.\textsuperscript{13} This latter contention implicates the mosaic theory.

affirmative defenses to a charge of trading on the basis of material nonpublic information where the person on whose behalf the trade was made was aware of the information at that time.

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

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

Further consideration of that issue is not pertinent to the question addressed in this article, where it is assumed that the tippee-trader consciously relied on all information known to him when he engaged in the challenged trade.

\textsuperscript{12} See, e.g., United States v. Contorinis, 692 F.3d 136, 144 (2d Cir. 2012) (affirming judgment on jury verdict of unlawful insider trading, holding that court’s instructions adequately conveyed the concept of nonpublic information); United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993) (affirming judgment on jury verdict of unlawful insider trading, holding that evidence was sufficient for jury to find that information in question was nonpublic).

\textsuperscript{13} See, e.g., *Contorinis*, 692 F.3d at 144 (affirming judgment on jury verdict of unlawful insider trading, holding that court’s instructions adequately conveyed the concept of material information); United States v. Cusimano, 123 F.3d 83, 99 (2d Cir. 1997) (affirming judgment on jury verdict of unlawful insider trading, holding that evidence was sufficient for jury to find that information in question was material).
III. THE MOSAIC THEORY OF MATERIALITY

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

The SEC addressed the mosaic theory when it adopted Regulation FD. In essence, that regulation prohibits some selective disclosure of material nonpublic information by public

14 For ease of discussion, the terms “tipper” and “tippee” will sometimes be used here both where the disclosure violates Rule 10b-5 and where it does not.

This mosaic theory of materiality is not the same as the mosaic theory of misrepresentation under the securities laws. Under the latter, where the defendants are alleged to have made material misrepresentations to the public

[the allegedly misleading] public statements must be viewed as part of a “mosaic” to see if those statements, in the aggregate, created a misleading impression. Contrary to defendants’ contention, the proper test is not the literal truth or the materiality of each positive statement, but the overall misleading impression that it combines to create.


reporting companies.\textsuperscript{16} “[W]hen an issuer, or person acting on its behalf, discloses material nonpublic information to certain categories of persons (in general, securities market professionals and holders of the issuer’s securities who may well trade on the basis of the information), it must make public disclosure of that information.”\textsuperscript{17} If there is intentional disclosure of material nonpublic information to someone among the specified categories of persons, the company must make simultaneous public disclosure; if there is a “non-intentional” covered selective material disclosure there must then be “prompt” public disclosure.\textsuperscript{18}

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

an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a “mosaic” of information that, taken together, is material. Similarly, since materiality is an objective test keyed to the reasonable investor, Regulation FD will not be implicated where an issuer discloses immaterial information whose significance is discerned by the analyst.\textsuperscript{19}

There are several potential limitations on the implications of this commentary for Rule 10b-5. First, Regulation FD addresses only when an issuer is obligated to make a public disclosure of previously undisclosed material information. The regulation says nothing explicitly about what use, if any, the recipient of a disclosure that does not comply with Regulation FD may lawfully make of the information. In this regard it may be important that the statutory

\textsuperscript{16} For this purpose the SEC applies the test of materiality set forth \textit{supra} text accompanying notes 2-3. \textit{Id.} 65 F.R. at 51721.

\textsuperscript{17} \textit{Adopting Release}, \textit{supra} note 15, 65 F.R. at 51727.


\textsuperscript{19} \textit{Adopting Release}, \textit{supra} note 15, 65 F.R. at 51722.
authority for imposing obligations under Regulation FD is sections 13 and 15 of the Exchange Act,\(^{20}\) which require that companies that are listed on a stock exchange, have a specified minimum number of shareholders of record or have had a registered public offering of their securities file certain reports with the SEC. Indeed, Regulation FD provides, “No failure to make a public disclosure required solely by [Rule 100] shall be deemed to be a violation of Rule 10b-5.”\(^{21}\) Thus, the SEC did not directly address insider trading issues under Rule 10b-5 in discussing a mosaic of information, and the closing sentence of the statement quoted above states only that “Regulation FD will not be implicated” when there is a disclosure of the type described.\(^{22}\) Nevertheless, the absence of any statement that these concepts, which are so intertwined with the subject of insider trading, do not apply to Rule 10b-5 suggests that they do apply, in the view of the SEC.

The SEC’s statement that whether a fact is material is determined under an “objective test” keyed to the reasonable investor is consistent with the Supreme Court’s explanation of what facts are material under the securities laws.\(^{23}\) The language quoted above from the Adopting Release also recognizes that something that is not, when standing alone, material to the

\(^{20}\) 15 U.S.C. §§ 78m, 78o (2006 & Supp. 2010). See Adopting Release, supra note 15, 65 F.R. at 51726 (“Regulation FD is an issuer disclosure rule that is designed to create duties only under Sections 13(a) and 15(d) of the Exchange Act and Section 30 of the Investment Company Act. It is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.”) (footnote omitted).

\(^{21}\) Regulation FD, Rule 102, 17 C.F.R. § 243.102 (2013). See also Adopting Release, supra note 15, 65 F.R. at 51718 (“we have revised Regulation FD [from the form in which it was proposed] to make absolutely clear that it does not establish a duty for purposes of Rule 10b-5”).

\(^{22}\) Supra text accompanying note 19.

\(^{23}\) TSC, 426 U.S. at 445 (“The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.”).
“reasonable investor”—and therefore not material generally for purposes of the securities laws—may nevertheless be quite important to a particular investor or analyst.24

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

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

Answer: Yes. It depends on whether, in so doing, the issuer communicates material nonpublic information. For example, an issuer ordinarily would not be conveying material nonpublic information if it corrected historical facts that were a matter of public record. *An issuer also would not be conveying such information if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic information.* It would not violate Regulation FD to reveal this type of data even if, when added to the analyst’s own fund of knowledge, it is used to construct his or her ultimate judgments about the issuer. An issuer may not, however, use the discussion of an analyst’s model as a vehicle for selectively communicating—either expressly or in code—material nonpublic information.25

24 While many of the materials cited in this article focus on disclosures by an insider to a securities analyst, there is nothing in the principles that underlie the mosaic theory that limits its application to investment professionals in the securities industry. For example, Regulation FD applies to communications by an issuer not only to investment professionals but also to current holders of the company’s securities. Regulation FD, Rule 100(b)(1), 17 C.F.R. § 243.100(b)(1) (2013). The law of insider trading should be the same for the analyst and for any resourceful investor who ferrets out information and combines it with other information he knows to discern something material that is not publicly known.

25 SEC Division of Corporation Finance, *Compliance and Disclosure Interpretations* 101.03 (Aug. 14, 2009), http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm (last modified June 4, 2010) (emphasis added). Note that this formulation does not include the phrase “unbeknownst to the issuer” that is in the *Adopting Release*. See *supra* text accompanying note 19. For the significance of this phrase, see *infra* text accompanying notes 98-104.

The securities analyst profession relies upon this guidance. See Cert. Fin. Analyst Institute, *STANDARDS OF PRACTICE HANDBOOK* 51 (2010):

*Mosaic Theory.* A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the
As with the statement in the *Adopting Release*, the C&DI refers only to Regulation FD. Nevertheless, the italicized language in the preceding quotation has unmistakable relevance to Rule 10b-5—there is no unlawful tipping if there is no communication of material information.

SEC administrative decisions applying Rule 10b-5 that predated Regulation FD are consistent with the Commission statement in the *Adopting Release*. In dictum in the Commission’s decision in *Dirks*, where the Commission found that a securities analyst violated Rule 10b-5 by misusing material nonpublic information, a ruling later reversed by the Supreme Court on other grounds, the Commission noted that

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

The judicial decision cited by the SEC in its opinion in *Dirks* was an appellate decision that affirmed a judgment adverse to the Commission. In that opinion the court summarized the SEC’s position as a litigant there:

> basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the “mosaic theory,” financial analysts are free to act on this collection, or mosaic, of information without risking violation.

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The SEC, of course, does not maintain that the securities laws prohibit all disclosures of internal corporate information. The Commission itself has recognized that corporate management may reveal to securities analysts or other inquirers non-public information that merely fills “interstices in analysis,” or tests “the meaning of public information.” Only when the inside information so “leaked” is essentially “extraordinary in nature” and “reasonably certain to have a substantial effect on the market price of the security” if it is publicly disclosed does a duty arise to make the information generally available.27

Of course, facts may be material even when they are not “extraordinary in nature” or “reasonably certain to have a substantial effect on the market price of the security.”28

All of this suggests that the SEC’s discussion on a mosaic of material and immaterial bits of information in the Adopting Release29 applies as much to the scope of Rule 10b-5 as it does to Regulation FD. This was confirmed in 2011 when a senior SEC staff member stated that recent prosecutions for insider trading do not represent some inherent hostility by the Commission toward expert networks, nor do they indicate that the Commission is seeking to undermine the mosaic theory, under which analysts and investors are free to develop market insights through assembly of information from different public and private sources, so long as that information is not material nonpublic information obtained in breach of or by virtue of a duty or relationship of trust and confidence.30

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28 See supra text accompanying notes 3-4 (stating the meaning of “material” under the securities laws).
29 See supra text accompanying note 19.
In 2013 the SEC settled an enforcement action that some suggest reflects that the SEC is retrenching on its recognition of the mosaic theory.\textsuperscript{31} Moore was an investment banker for Canadian Imperial Bank of Commerce (CIBC).\textsuperscript{32} His responsibilities included pitching possible transactions to CIBC’s clients, one of which was the Canada Pension Plan Investment Board (CPPIB).\textsuperscript{33} In early 2010 the CPPIB Managing Director was working on a possible acquisition of Tomkins plc, based in London, whose ADRs were traded on the New York Stock Exchange.\textsuperscript{34} The Managing Director told Moore that he was working on something interesting and active; he rebuffed Moore’s offer of help and did not disclose the parties to the proposed transaction.\textsuperscript{35}

Moore learned that the Managing Director was travelling to London.\textsuperscript{36} The SEC alleged that during a charity event in June 2010 Moore observed a chance encounter between the CPPIB Managing Director and the Chief Executive Officer (“CEO”) of Tomkins. However, the CPPIB Managing Director declined to introduce Moore to the CEO or to reveal his identity. Later that day another CIBC employee attending the event volunteered the CEO’s identity to Moore. Those events, coupled with other information that he had learned in the course of his efforts to get CIBC a role in the CPPIB Managing


\textsuperscript{32} Complaint, supra note 31, ¶ 6.

\textsuperscript{33} Id. at ¶ 10-11.

\textsuperscript{34} Id. at ¶ 7, 15-16

\textsuperscript{35} Id. at ¶ 17.

\textsuperscript{36} Id. at ¶ 7, 19.
Director’s deal, led Moore to conclude that the CPPIB Managing Director was likely working on a transaction involving Tomkins.\textsuperscript{37}

Several months later another banker at CIBC told Moore that he had spoken to someone at CPPIB; thereafter Moore observed that CPPIB had a “[b]ig deal in the works in europe/usa.”\textsuperscript{38}

Several days later, after confirming that the Managing Director was still working on the unidentified deal, Moore purchased Tomkins ADRs in the US, as well as common stock offshore, with further purchases several weeks later, ultimately investing one-third of his net worth in Tomkins securities.\textsuperscript{39} Several days later Tomkins announced it had received an offer to be acquired by CPPIB and a private equity firm. Moore realized a substantial profit on his Tomkins securities.\textsuperscript{40}

The SEC alleged that Moore had “knowingly or recklessly misappropriated from his employer” information that “he knew, or was reckless in not knowing, was material, non-public, and had been acquired in the course of his employment.”\textsuperscript{41} Because the case was settled when it

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\textsuperscript{37} Id. at ¶ 20.

\textsuperscript{38} Id. at ¶ 24. Nothing in the complaint identifies the source of this updated information about the CPPIB deal, as it was Moore who stated a big deal was in the works; this information is not explicitly attributed to Moore’s CIBC colleague. Presumably had the case been tried the SEC would have argued that the jury could infer from the sequence of events that Moore obtained the information from a CIBC colleague who had in turn obtained the information from CPPIB and thus misappropriated confidential information provided to CIBC in connection with its off-and-on relationship with CPPIB.

\textsuperscript{39} Id. at ¶¶ 25-28.

\textsuperscript{40} Id. at ¶ 29.

\textsuperscript{41} Id. at ¶ 31.
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was filed, the defendant did not challenge the sufficiency of the claim. The complaint does not, however, allege that any specific fact learned or observed by Moore was material in and of itself; the first use of the word “material” appears in the concluding paragraphs of the complaint, which state that Moore misappropriated material nonpublic information.

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

- The Managing Director of CPPIB was working on a significant transaction. This fact arguably was disclosed to Moore in Moore’s role as a CIBC banker. (Notably, however, though CIBC sought to work on the deal in question it never did.) This information was, it appears, nonpublic.

- The Managing Director had travelled to London. Presumably this information was public, or at least no effort was made to conceal this activity.

- Moore saw the Managing Director socially, in public, with the CEO of Tomkins; the Managing Director declined to introduce Moore to him or to identify him—perhaps signaling a concern about being tied to him in Moore’s eyes given what the Managing Director knew that Moore knew about the Managing Director’s current pre-occupation—and then Moore independently learned the companion’s identity.

None of these facts appear to have been material standing alone; Canadian authorities agree. All three facts noted above are essentially unremarkable, though combining the public fact of a

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

43 In settled proceedings against Moore before the Ontario Securities Commission arising out of the same conduct, the staff of that commission stated, “In no specific instance did [the Managing Director of CPPIB] ever provide Moore with any material, generally undisclosed information.” Statement of Allegations of Staff of the Ontario Securities Commission, In the Matter of Richard Bruce Moore ¶ 11 (Apr. 11, 2013), http://osc.gov.on.ca/en/Proceedings_soa_20130411_moorerb.htm. Moore was alleged to have “deduced” CPPIB’s impending takeover of Tomkins.

Moore [having] reached this conclusion as a result of his previous knowledge of Tomkins obtained from public sources including rumours that it would be the...
reticence to identify someone—whose identity was a matter of public record—with the awareness that CPPIB had something big in the works did produce an arguably marginal material mosaic to the effect that the something big at CPPIB might involve Tomkins, publicly rumored to be a takeover target.

Some commentators have written that the SEC’s case against Moore reflects the abandonment of the mosaic theory. As discussed in this article, and by the SEC from time to

subject of a takeover, his observations of a friend and senior representative of CPPIB (“Mr. A.”) and comments of a general nature made by Mr. A. about work that he was involved in for CPPIB. These interactions with Mr. A. occurred over the course of several months, including on social occasions.

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

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

Id. at ¶ 23.

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

The Moore case illustrates the limits of the “mosaic theory.” Under the mosaic theory investors can assemble many different pieces of information, which may include both publically available information and immaterial non-public information that may be confidential, into a mosaic that provides the investor with a material insight into a security that is not known to the market in general. The Moore case suggests that if all of the immaterial, non-public information in a mosaic was obtained as a result of a breach of duty, then the “mosaic theory” may not be available as a defense to insider trading.
time, the mosaic theory addresses when a tipper violates Rule 10b-5 by revealing a separate item of immaterial information that then forms the tipper’s mosaic; the theory informs the analysis of when the tipper violates Rule 10b-5 and when the tippee’s use of the information violates Rule 10b-5. As discussed further below, in Moore the charge was not that the Managing Director of CPPIB unlawfully tipped Moore; it was that Moore misappropriated information from his employer, CIBC, that was, apparently lawfully, provided by CPPIB to CIBC (i.e., Moore and perhaps one of his colleagues). This includes the information Moore was provided directly by the CPPIB Managing Director. It is legitimate to ask whether the SEC has pushed the envelope in alleging that certain facts were material, but this claim is not one that lends itself to application of the mosaic theory properly understood.

Greg Kramer & Stephen M. Schultz, Case Against a Canadian Investment Banker Highlights The SEC’s Expansive View of Insider Trading, BLOOMBERG LAW (undated), http://about.bloomberglaw.com/practitioner-contributions/the-secs-expansive-view-of-insider-trading/. See also Michael Rosensaat, First Half 2013 Insider Trading Review, FINANCIAL FRAUD LAW REPORT 606, 609-10 (Jul.-Aug. 2013), http://www.kattenlaw.com/files/46826_FFLR%20Rosensaat%20Final.pdf (“This complaint seems to invite a mosaic theory defense—that even if the information gleaned through Moore’s employer were insider information, it was only pairing it with the public information at the charity event that made it material. However, the SEC seems unconcerned.”); Linklaters, Financial Crime Update 4 (May 2013), http://www.linklaters.com/pdfs/mkt/london/Financial_Crime_Update_May_2013.pdf (stating that the Moore complaint “highlights . . . the expanding definition of materiality and the decline of the mosaic theory safe haven”).

45 See infra text accompanying notes 108-110.

46 See supra note 5 (describing misappropriation theory).

47 See supra text accompanying note 35.
IV. THE MOSAIC THEORY IN THE COURTS

Very few cases have addressed the mosaic concept in so many words.\textsuperscript{48} \textit{Elkind v. Liggett & Myers, Inc.} addressed the extent to which disclosure of nonpublic information provided by the chief financial officer of the company to a security analyst was an unlawful tip of material nonpublic information.\textsuperscript{49} The court introduced the concept of a mosaic:

A skilled analyst with knowledge of the company and the industry may piece seemingly inconsequential data together with public information into a mosaic which reveals material non-public information. Whenever managers and analysts meet elsewhere than in public, there is a risk that the analysts will emerge with knowledge of material information which is not publicly available.\textsuperscript{50}

The court emphasized that in order for there to have been a Rule 10b-5 violation “the tipped information must be material.”\textsuperscript{51}

The court then addressed two instances of disclosure by the issuer to a securities analyst. The first disclosures—that sales in some operations were slipping and that the company was going to make a preliminary announcement of quarterly earnings—were found not to be material.\textsuperscript{52} Though not discussing the mosaic concept in this context, the court found that the

\textsuperscript{48} The research for this article sought to identify cases expressly referring to a “mosaic” or “matrix” in the context of a securities law materiality analysis.

\textsuperscript{49} 635 F.2d 156 (2d Cir. 1980).

\textsuperscript{50} \textit{Id.} at 165 (footnote omitted).

\textsuperscript{51} \textit{Id.} at 166. The court also stated that “a relevant question in determining materiality in a case of alleged tipping to analysts is whether the tipped information, if divulged to the public, would have been likely to affect the decision of potential buyers and sellers.” \textit{Id.} This may suggest, though the meaning of the statement is not entirely free from doubt, that “inconsequential” information may itself become material if it is the fact that completes a material mosaic, at least when the other facts are public. \textit{See infra} note 60 and text accompanying notes 78-79, where this conclusion is further addressed.

\textsuperscript{52} \textit{Id.} at 166.
information the analyst conveyed to clients after receiving this information was also not material.\textsuperscript{53}

The court affirmed the lower court’s determination that the second revelation by the insider—a “grudging” affirmative response to an inquiry whether the recent quarter’s earnings would be down—was material in and of itself, especially where the officer told the analyst that the information was confidential.\textsuperscript{54}

The actual rulings in \textit{Elkind} did not apply any version of a mosaic theory either to exonerate or to condemn the disclosure of specific nonpublic information, because the first disclosure, as well as the conclusion reached by the analyst, was not material and the second disclosure was material standing alone.

In \textit{State Teachers Retirement Board v. Fluor Corporation} the court of appeals reversed a summary judgment in favor of the defendants to an insider trading claim.\textsuperscript{55} The plaintiff’s evidence reflected that Fluor representatives disclosed to representatives of a firm that later bought Fluor stock that Fluor was under consideration for a major contract, a fact the court held “would [likely] be significant information for the reasonable investor,” especially because Fluor did not routinely disclose projects on which it had submitted a bid.\textsuperscript{56} While the court quoted the passage in \textit{Elkind} that referred to an analyst creating a mosaic of information,\textsuperscript{57} the court ruled

\begin{itemize}
\item \textsuperscript{53} \textit{Id.} at 166-67.
\item \textsuperscript{54} \textit{Id.} at 161, 167.
\item \textsuperscript{55} 654 F.2d 843 (2d Cir. 1981).
\item \textsuperscript{56} \textit{Id.} at 854.
\item \textsuperscript{57} \textit{Id.}, quoting \textit{Elkind}, 635 F.2d at 165, quoted \textit{supra} text accompanying note 50.
\end{itemize}
for the plaintiff because the tipped information itself appeared to be material wholly apart from any other information that was independently known to the recipient of the nonpublic information.\textsuperscript{58}

On remand in \textit{Fluor}, the district court was faced with another defense motion for summary judgment, this time attempting to rebut anything supporting liability in a “laundry list” of twenty-one items gleaned by an analyst from conversations with Fluor personnel that were alleged to support the claim of unlawful insider trading.\textsuperscript{59} The court first stated that the mosaic approach, as it read \textit{Elkind}, may result in a determination that some fact “seemingly insignificant” may be material if it “completes the mosaic, or ‘the matrix’. . . .”\textsuperscript{60} In other words, an immaterial fact that completes a matrix thereby becomes a material fact itself, so that the disclosure by the insider may become wrongful. The court did not address in detail what the speaker needs to know about the other elements of the mosaic in order to appreciate that his otherwise inconsequential disclosure, in the particular circumstance, is of a material fact. In

\textsuperscript{58} 654 F.2d at 854. The court also disagreed with the district court that the substance of the information in question was already public. \textit{Id.} In addition, on the issue of scienter the court stated that there was evidence that the speaker knew the tipped information was material, without any reference to whether he knew that the information would complete a material mosaic. \textit{Id.}


\textsuperscript{60} \textit{Id.} at 949. This is the court’s complete statement:

\begin{quote}

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

\textit{Id.}, quoting \textit{TSC}, 426 U.S. at 439, 449.
assessing materiality in *Fluor*, the court noted that even if there was no market movement associated with the later public disclosure of discrete tipped items, it was necessary to consider whether an item “may or not be a coordinate in the ‘matrix.’” 61

The court then addressed one by one, the allegedly material items that were disclosed, finding that some presented an issue for the jury on the question of materiality, some were not the basis for a claim because they were already public when they were discussed by Fluor with the analyst, and some were not material to the defendant’s purchase of Fluor stock (e.g., because the information was unfavorable to Fluor). 62 In some cases the court held that the tipped information may have been material because, even though it was consistent with public estimates


62 *Id.* at 949-54.
made by others, the fact that the company had made a similar estimate could be material.\textsuperscript{63} In the end, the jury found for the defendants, and there was no further appeal.\textsuperscript{64}

_Elkind_ did not present a robust application of a mosaic approach comparable to that expressed later by the SEC.\textsuperscript{65} _Fluor_ is more illuminating, but did not entail a direct application of the mosaic theory. This is essentially the end of the trail with respect to judicial decisions addressing materiality with _express reference_ to a mosaic or matrix concept.\textsuperscript{66}

\textsuperscript{63} *Id.* at 950-51. The question in those situations was thus whether the fact that the company made the projection was sufficient additional information to make the disclosure material. For example, as to some projections the court observed, “Although these projections [by outsiders] may have made the [tipped] information less material, particularly in the light of Fluor’s limited [financial] interest [in the projects], still the projection as a company figure and its materiality remain properly an issue of fact.” *Id.* at 951.

On this dimension, more recently see _Contorinis_, 692 F.3d at 144 (citing SEC v. Mayhew, 121 F.3d 44, 52 (2d Cir. 1997)):

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

\textsuperscript{64} See No. 76 Civ. 2135 (RWS), 1985 WL 183 (S.D.N.Y. Jan. 10, 1985) (addressing awarding of costs after jury verdict for defendants). There is no further case history reported on Westlaw.

\textsuperscript{65} See _supra_ text accompanying note 19.

\textsuperscript{66} Some expected that there would be a meaningful analysis of the mosaic theory in connection with Raj Rajaratnam’s defense of charges of insider trading. See, e.g., _The Mosaic Defense_, _THE ECONOMIST_ Apr. 14, 2011, http://www.economist.com/node/18561025/print (“[Rajaratnam’s] lawyers insist that much of Galleon’s trading was based on publicly available information. Traders patched together data from equity analysts’ reports, company announcements and newspaper articles, a practice known as the ‘mosaic theory’ of investing.”)

Rajaratnam was convicted of multiple counts of securities fraud. United States v. Rajaratnam, 802 F. Supp. 2d 491, 495 (S.D.N.Y. 2011). In denying Rajaratnam’s post-trial
One recent case is worth addressing for what it does not say about the mosaic theory and for misinterpretations of the decision in that respect. The SEC brought insider trading charges against, among others, employees of a corporation who pieced together information that allegedly led them to conclude that the parent company of their employer was about to be sold. In denying defendants’ motion to dismiss, the court stated:

[One of the defendant employees] is alleged to have pieced together for himself what was occurring based on information that was available to him as an [employee of a subsidiary of the public company that was later acquired]. This is a cognizable theory: it is well established that a defendant can be held liable for motion for acquittal, the court held that there was sufficient evidence that the nonpublic disclosures Rajaratnam received were in and of themselves material. 802 F. Supp. 2d at 512-19. The mosaic theory was given only cursory treatment in the briefs on Rajaratnam’s appeal. Brief on Behalf of Appellant, at 59-60, United States v. Rajaratnam, No. 11-4416 (2d Cir. Jan. 25, 2012) (quoting Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980), to the effect that an analyst “‘may piece seemingly inconsequential data together with public information into a mosaic’ that the analyst is free to exploit” and arguing that an instruction prevented the jury from “distinguishing between trades caused by legal sources of information and those that were alleged to be the product of inside information’); Brief on Behalf of Appellee, at 68-70, No. 11-4416 (2d Cir. Apr. 25, 2012) (arguing in support of the contested jury instruction because it required only that the jury find that the material non-public information in some way informed the investment decision and that in any event any error was harmless in light of the “overwhelming” evidence of securities fraud).

In affirming Rajaratnam’s conviction, the Second Circuit Court of Appeals did not address the mosaic theory. 719 F.3d 139, 160 (2d Cir. 2013) (upholding instruction that permitted the jury to convict if “material non-public information given to the defendant was a factor, however small, in the defendant’s decision to purchase or sell stock”). One commentator characterized this ruling as “confirm[ation]” of the “death knell’s sound on the mosaic defense. Michael M. Rosensaft, A Look Back at Insider Trading in 2013, SECURITIES LAW360 (Jan. 13, 2014), http://www.law360.com/securities/articles/500198?nl_pk=356c60bb-0ccd-459d-af43-a2f24c364474&utm_source=newsletter&utm_medium=email&utm_campaign=sec (on file with author). This is an overstatement of what the court of appeals held, as the court’s analysis did not address any immaterial information garnered by the defendant and all of the material information was tipped to the defendant in breach of a duty owed by the tipper. 719 F.3d at 158. The mosaic theory, by contrast, applies where the information tipped was not material standing alone. See supra text accompanying note 23 and infra text accompanying note 76.

insider trading when he or she obtains and acts on pieces of information, which, “piece[d] together,” constitute material nonpublic information. [Citations omitted]

. . . .

. . . [T]he SEC does not contend that each of these underlying facts on its own is a material nonpublic fact. Rather, the SEC alleges that Defendants’ trades were based on the ultimate conclusion—deduced from the totality of the information available to [the two employees]—that [the public company] was in the process of being sold before the sale was announced.69

In addition to criticism that the SEC was pushing the boundaries of insider trading law with the complaint in Steffes,70 one commentator observed, after the decision in Steffes, that “U.S. courts often do not recognize the mosaic theory as a defense at all.”71 This seems to be an unjustifiably pessimistic assessment that fails to appreciate the nature of the case. Steffes was not

68 The cited cases are discussed infra note 73.


a case where some outsider, such as an analyst, pried one or two seemingly insignificant nuggets of information from an insider. On the contrary, the principal defendants were themselves corporate employees and every item of information they allegedly used to form their mosaic—a term the court did not use—was gleaned either from their own involvement in matters that were related to the proposed sale or activities they observed on company premises. Most of the cited support for the court’s analysis was cases presenting similar fact patterns, where insiders aggregated nonpublic information obtained solely from their own company, thus not addressing the mosaic theory where an insider provided only one component of a mosaic to an outsider. In Steffes the SEC alleged that the defendants knew this information was confidential. Finally, the court observed in giving the plaintiff the benefit of the doubt on a motion to dismiss, that “the allegations are by no means overwhelming.”

72 805 F. Supp. 2d at 605, 610-13. The court also relied on internal rumors about a possible sale of the company. See infra note 75. In this respect the case resembles the SEC’s suit against Moore, which has also been incorrectly criticized as reflecting the SEC’s rejection of the mosaic theory. See supra text accompanying note 41 (noting that the claim against Moore was for misappropriating his employer’s nonpublic information that was, in the aggregate, material).

73 One case relied on by the court in Steffes, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), also involved an employee piecing together information he learned entirely in his employee capacity. In another, United States v. Mylett, 97 F.3d 663 (2d Cir. 1996), the conviction of a tippee was upheld where the tipper had pieced together information as a corporate employee. This was also substantially the situation presented in the third case cited in Steffes, SEC v. Binette, 679 F. Supp. 2d 153 (D. Mass. 2010). The fourth and final case cited by Steffes on this point was the opinion of the court of appeals in Fluor, the only case cited allegedly involving an insider tipping an outsider. See supra text accompanying notes 55-58.

74 Id. at 616.

75 Id. at 613. The SEC argued that the facts that (1) other persons, who apparently had no more information than the defendants, were asking the principal defendants if the company was for sale, and (2) there were rumors about a possible sale both factored into the defendants’ decision to trade. Id. at 605, 611, 613, 616. The court does not explain how such rumors, when they did
An insider using only internal company-generated information to reach a material conclusion bears no resemblance, from a legal analytical perspective, to the situation where an outsider obtains only an item or two of internal information that complete a picture when combined with information from external sources, some or all of which may be public. The parallel to the insider-outsider situation would be the insider giving a complete package of information to the outsider that the outsider uses, with nothing else, in deciding to trade. Thus, whatever one may think of the merits of Steffes in holding to account insiders who, without any tip from someone else within the company, assemble a mosaic of information from within, which they allegedly know to be nonpublic and confidential, Steffes fails to illuminate the law on when it is wrongful for an insider incidentally to provide an outsider with immaterial information that may, as it were, fill out the outsider’s straight flush, especially where the insider does not know what cards the outsider already holds.

V. COMMENTATORS ON THE MOSAIC THEORY

The cases lack clarity in treating a mosaic; the views of commentators are also disparate in their understanding of a mosaic theory. In his treatise on insider trading, Professor Langevoort presents his conception of the law:

A case can arise where a person receives nonpublic information—for example, the planned introduction of a new product—that by itself would not be terribly important to the investment community generally. But because of the person’s unique expertise and research, that information leads him to conclude that the company’s earnings will increase substantially. In that case, he should not be precluded from trading, for though the information was material to him, it was not material to the “reasonable” investor in the marketplace. For this reason, investment analysts can properly elicit bits of information from company insiders and piece them together in a mosaic that can lead to an investment decision, so

not emanate from persons in the know, can be deemed material information, or even part of a mosaic in this context.
long as the pieces of information are not, standing alone, material. In that case, it is principally the skill of the analyst that leads to the profit, not simply his access to an insider. These “mosaic theory” cases pose some of the most difficult enforcement challenges in the law of insider trading.\textsuperscript{76}

Professor Langevoort elaborates later in his text, “The question [of unlawful tipping] becomes closer if the insider knows or suspects that the investor very much wants and needs a bit of information, perhaps wanting to be the first among all the analysts to be able to complete the mosaic that they are all competing to finish.”\textsuperscript{77}

Professors Wang and Steinberg interpret \textit{Elkind} to mean that “even if information is not by itself important, this information may still be material if the defendant [tippee] already knows other items of information (public or nonpublic, material or immaterial) that, when combined with the new information, creates a significant ‘mosaic.’”\textsuperscript{78} This parallels the observation in \textit{Fluor}.\textsuperscript{79} This may identify when a disclosure is material; the next step is to assess whether the disclosure is wrongful. These authors comment that the \textit{Adopting Release} “surprisingly

\textsuperscript{76} \textsc{Langevoort}, \textit{supra} note 5, § 5:3, at 5-18 to -19 (footnote omitted). This section of this treatise does not include any reference to the SEC’s expression of the mosaic theory in the \textit{Adopting Release}, \textit{supra} text accompanying note 19, though it essentially restates the SEC’s position.

\textsuperscript{77} \textit{Id.} at § 11:5, at 11-18 (footnote omitted, including citation to the \textit{Adopting Release}, \textit{supra} note 15). In proposing new rules to clarify and expand the prohibition on insider trading, Professor Coffee also notes the difficulty of grappling with the mosaic concept. John C. Coffee, Jr., \textit{Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies}, 2013 \textsc{Colum. Bus. L. Rev.} 281, 314 (“Some uncertainty would likely surround the loose edges of [his proposed] rule, including in cases where analysts have arguably pieced together a ‘mosaic’ of information from multiple sources. To say the least, such a rule would be resisted by analysts and others within the financial services industry.”).

\textsuperscript{78} \textsc{Wang & Steinberg}, \textit{supra} note 5, at § 4.2.3[D], at 136.

\textsuperscript{79} \textit{See supra} text accompanying note 60.
interpret[s]” Elkind as “permitting, rather than forbidding, analysts from trading on a mosaic that reveals material nonpublic information.” Wang and Steinberg focus on the phrase in the Adopting Release—“unbeknownst to the issuer”—as “suggest[ing] that the SEC does not endorse the Elkind mosaic approach [which does not prohibit tippee-trading where the insider reveals only immaterial information], at least where the issuer is unaware of the contents of the analyst’s mosaic.” That is, they interpret the SEC as saying that an insider does not violate Rule 10b-5 if the insider did not know that the information he revealed would complete the analyst’s material mosaic. It is difficult to interpret the SEC comment any other way. They express surprise at the SEC’s approach, but after noting that the mosaic theory “generates considerable uncertainty,” they do not take a clear stand on what the law should be.

A leading text on securities fraud concludes that “the SEC has endorsed first implicitly, then explicitly, the propriety of analysts obtaining and using nonmaterial information to develop material information.” These authors read Elkind to mean, however, that “[a] piece of information that is separately immaterial may have aggregate or ‘mosaic’ materiality when considered with other separate pieces of information.” As explained earlier, however, Elkind

80 WANG & STEINBERG, supra note 5, at 136 n. 189 (emphasis in original).
81 See supra text accompanying note 19.
82 WANG & STEINBERG, supra note 5, § 4.2.3[D], at 139.
85 5 id. § 7:32, at 7-116. These authors’ text on this topic has not been updated since 2003.
does not directly condemn disclosure of immaterial information, even if it provides the recipient of the disclosure with a material mosaic. These authors decline to endorse a specific formulation of the mosaic theory in the insider trading context.

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

Another commentator expressed the most narrow interpretation of the reach of Rule 10b-5 in this context:

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

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

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86 *See supra* text accompanying notes 49-54.

87 Another text on insider trading only briefly discusses *Bausch & Lomb* and the *Adopting Release* in describing the mosaic theory, without further analysis. RALPH C. FERRARA ET AL., *FERRERA ON INSIDER TRADING AND THE WALL §2.02[3], at 2-18 to -19 (2012).*


Another author expressed a contrary view, that whether the insider knows that his disclosure completes a material mosaic does matter. It is “intentionally selective disclosure of material, nonpublic information” for an issuer to disclose “information [that] completes the mosaic and the issuer knows that providing such specific information to the analyst would influence an investment decision.”90 No authority was offered for this conclusion.

Another author interprets the SEC’s mosaic theory—at least as a Regulation FD issue, whether or not also for purposes of Rule 10b-5—as entirely dependent upon whether the insider conveying the information knows that what he disclosed completed a material mosaic, in effect reading “even if” as used in the Adopting Release91 to mean “only where”:

When an issuer is unaware of either an analyst’s research or the conclusions gleaned therefrom, the issuer may freely communicate nonmaterial information to the analyst in reliance of [sic] the “reasonable investor” standard. Nevertheless, a problem arises when an issuer becomes aware of the contents of an analyst’s mosaic, which often contains information “not generally known” to the investing public. Under this scenario, the issuer may not communicate information the issuer knows will provide important missing pieces to the mosaic, regardless of whether the information, by itself, would satisfy the “reasonable investor” standard. Consequently, if an issuer knows that otherwise nonmaterial information will play a vital role in assisting the analyst to complete the mosaic, the issuer may not provide the information on a selective basis.92


91 Supra text accompanying note 19.

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

VI. THE APPLICATION OF THE MOSAIC THEORY IN THE CONTEXT OF THE CLASSICAL THEORY OF INSIDER TRADING

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

Consider this scenario. Company X, the only company of significance based in Remote City, California, has publicly announced that it hopes to employ some of its large horde of idle cash to make strategic acquisitions in the computer software industry. A securities analyst with a registered broker-dealer (Alex) is friends with the chief financial officer of Company Y (Bill), a publicly held software development company. They have made plans to play golf next weekend. Bill calls Alex, explaining that he must cancel their golf date, bemoaning that he has been called away to spend an uncertain period of time in “godforsaken” Remote City, California. The fact of the financial executive’s trip is surely not material fact in and of itself about Company Y, but when this fact is combined with what Alex knows about Company X’s publicly stated intentions Alex formulates a (likely material\textsuperscript{93}) mosaic that Company Y is involved in friendly acquisition

\textsuperscript{93} When applying the Supreme Court’s definition of materiality to a contingent event, materiality depends on the magnitude of the event, should it occur, and the probability that it will occur
negotiations with Company X.\textsuperscript{94} That is, Alex concludes Bill must be going to meet with Company X because why else would anyone be going to Remote City for an extended period, and takes into account that is a financial (rather than, say, marketing) executive meeting with Company X.\textsuperscript{95}

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

\textit{Dirks} in the Supreme Court provides that in analyzing whether an insider who discloses nonpublic information has breached a duty, the critical inquiry is whether the insider made the

\begin{center}
assessed at the time of the relevant materiality determination, e.g., when the trading occurred. \\
\textit{Basic}, 485 U.S. at 238.
\end{center}

\textsuperscript{94} For a case where the disclosure of travel plans was one factor in the analysis of misappropriated material information, see SEC v. Falbo, 14 F. Supp. 2d 508, 521-23 (S.D.N.Y. 1998) (granting summary judgment for the SEC as to insider trading liability under Rule 10b-5, based in small part on disclosure of an executive’s travel plans in connection with negotiation of an acquisition, where the defendant also had specific information from insiders about active work on a negotiation and the likely target).

\textsuperscript{95} A more complex, and perhaps more realistic, scenario in terms of analysts culling information from a variety of sources, would include the additional fact that the analyst had learned from a different source the (immaterial) fact that members of senior management of Company X have canceled long-standing vacation plans. This fact buttresses the conclusion—the probability component of the materiality assessment—that Company X is on the brink of some significant development, and, coupled with the information about Bill’s plans, that that development is the acquisition of Company Y.
disclosure for an improper purpose. It may be doubtful that Bill, in discussing why he is canceling his golf date, was motivated by any improper purpose, even taking into account that providing his explanation for the cancelation may have been unnecessary and his expression of dismay that he was dispatched to a specific location was gratuitous. On the other hand, Bill should have perceived that this information would be revelatory to the analyst in light of the publicly stated intention of Company X, the only enterprise of note in Remote City, to make acquisitions in the software industry and thus could be seen as providing a gift, in the nature of trading profits, to Alex (or Alex’s clients).

Under Obus, a tipper violates Rule 10b-5 only if, among other factors, he knows that what he disclosed was material. This requirement of knowledge of materiality suggests that the

96 See supra text accompanying note 6.

97 Dirks, 463 U.S. at 664 (“The 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. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”) On the breadth of the gift concept in this context, see Coffee, supra note 77, 2013 COLUM. BUS. L. REV. at 292 & n. 24 (“any passage of [material nonpublic] information to a friend, after Obus, may be viewed by regulators as a ‘gift’ that satisfies the Dirks standard”). One author concludes that the benefit/gift concept has been so watered down that little may remain of the requirement.

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

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

Steven J. Crimmins, Insider Trading: Where is the Line?, 2013 COLUM. BUS. L. REV. 330, 347-48 (footnotes omitted). This issue is beyond the scope of this article.

98 See supra text accompanying note 7.
tipper is liable in the mosaic context if he knows that the immaterial information he provided completes a material mosaic for the recipient, here Alex the analyst.\textsuperscript{99} This fits with the SEC’s expression of the theory (“unbeknownst” to the insider), where tipper culpability depends on whether the insider knows he is completing a material mosaic—if, as argued above, the SEC’s statement explaining Regulation FD reflects the SEC’s understanding of Rule 10b-5.\textsuperscript{100} This is also what the court stated in dictum in \textit{Fluor}\textsuperscript{101} and what most, though not all, of the commentary summarized in Part V of this article state. This approach is also supported by the conclusion of this author’s earlier analysis that the scienter of an insider-trader or tipper may be dependent

\begin{footnotesize}
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\item \textsuperscript{99} This raises the question whether the tipper’s reckless disregard of the public facts in this situation, and thus that the immaterial disclosure will complete the matrix, will satisfy the scienter requirement that the tipper knows that the information disclosed was material. \textit{Obus} stated that one of the elements of tipping is that “the tipper must know that the information that is the subject of the tip is non-public and is material for securities trading purposes or act with reckless disregard of the nature of the information.” 693 F.3d at 286. As discussed in the text, where the only other facts known to the tippee are public, then actual knowledge of the remaining components of the mosaic, or its functional equivalent, may be easy to demonstrate. As discussed later in this section, however, this element may be more difficult to establish where the tippee’s mosaic includes other \textit{non}public information. \textit{See infra} text accompanying note 104.

\item \textsuperscript{100} \textit{See supra} text accompanying notes 20-25. As a quibble, the SEC’s statement would be clearer if the SEC had written “if unbeknownst to the issuer” or “only if unbeknownst to the issuer,” but the statement is clear enough. The use of “even” in the phrase “even if, unbeknownst to the issuer” seems intended to provide emphasis that the issuer has not violated Regulation FD \textit{notwithstanding} that the disclosure completes a mosaic, \textit{so long as} the issuer does not know that it does. There is nothing in the \textit{Adopting Release} that even implies that Regulation FD would not be triggered (and Rule 10b-5 arguably violated) if the speaker \textit{did} know that the information he provided would complete a material mosaic. This parts company with one author whose analysis is quoted above. \textit{See supra} text accompanying note 89.

\item \textsuperscript{101} \textit{See supra} text accompanying note 60.
\end{itemize}
\end{footnotesize}
upon his conscious appreciation of, or perhaps reckless failure to appreciate, the materiality of
the information in question.\textsuperscript{102}

If the analyst-tippee had only public information before learning something nonpublic
from the insider, as in the hypothetical at the beginning of the section, the case against the tipper
may be easy to make. For these purposes a senior officer should be presumed to know what
information is public about both his company and the firm with which he is dealing directly.\textsuperscript{103}
In any event, if need be it should be easy to prove that Bill actually knew the public information
about Company X that is relevant to the impending transaction and thus to Alex’s mosaic. It also
should not be too difficult to persuade the trier of fact that Bill would expect an astute analyst to
be able to complete a material mosaic upon learning that he was going to Remote City.

If some of the other components of the mosaic are nonpublic and are not in and of
themselves material, then the plaintiff, such as the SEC, must establish by direct evidence that

\begin{flushright}
\textsuperscript{102} Allan Horwich, An Inquiry into the Perception of Materiality as an Element of Sciente r under SEC Rule 10b-5, 67 BUS. LAW. 1, passim (2011). Professor Langevoort concludes that the
Commission’s discussion of the “unbeknownst” situation “would suggest, more consistently with
the case law, that the question is [the tippee’s] awareness (sciente r) rather than materiality in and
of itself.” LANGEVOORT, supra note 5, § 11:4, at 11-13 n.5. In fact, the breach and materiality
analyses merge at this point, converging on sciente r. See supra note 7 (Obus on the intertwining
of the elements) and infra text accompanying note 116 (applying these concepts to a
hypothetical).

\textsuperscript{103} See Michael J. Kaufman & John M. Wunderlich, Messy Mental Markers: Inferring Sciente r
from Core Operations in Securities Fraud Litigation, 73 OHIO ST. L. J. 507, 519-23 (2012)
(arguing that “[p]resuming senior management’s knowledge of core operations—or facts that are
material to the company—is consistent with common sense, the common law, and the securities
laws”). Though this concept may be limited to the most important information regarding the
company (see Horwich, supra note 102, 67 BUS. LAW. at 8), its application to a scenario of the
type discussed here, where the speaker is directly involved in the matter at hand, seems
appropriate. The application of this concept to an insider-tipper who is not directly involved in
the matter and who is conveying second-hand or more remote information may be less
compelling.

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the insider knew what the tippee already knew, for example, information the analyst learned privately from Company X about the kind of software companies it might pursue for an acquisition. The SEC could not otherwise establish that the insider “knew” that his disclosure completed a material mosaic.\textsuperscript{104}

One wrinkle is introduced by Professor Langevoort, who suggests that it would be inappropriate for Bill to tell only Alex, and not other analysts, of his travel plans, that is, where an insider could favor one analyst over another, both of whom already know the same information.

Normally, other analysts have access to the same (or at least similar) base of “nonpublic” information and expertise; saying that one analyst can profit from information that other analysts (if not the general public) would find significant would allow for unequal treatment of shareholder groups, depending on the whim or other motivation of the insider conveying the information.\textsuperscript{105}

\textit{If} Bill knows that details about his personal travel would complete a material mosaic for other analysts, then his selective disclosure to Alex would at the very least violate Regulation FD.\textsuperscript{106}

Similar to the disclose or abstain mantra that applies in insider trading generally,\textsuperscript{107} someone in

\begin{footnotes}
\item[104] In this connection, it should be noted the SEC sometimes fails to establish insider trading claims that are based on circumstantial evidence. \textit{See, e.g.}, SEC v. Schvacho, No. 12-cv-02557, 2014 WL 54801, at *13 (N.D.Ga. Jan. 7, 2014) (granting judgment for insider trading defendant after bench trial where circumstantial evidence was insufficient to prove certain elements of the claim); SEC v. Garcia, 10 CV 5268, 2011 WL 6812680, at *14-15 (N.D. Ill. Dec. 28, 2011) (granting summary judgment for defendant in insider trading case where circumstantial evidence was found to be insufficient).
\item[105] \textsc{Langevoort}, \textit{supra} note 5, §11:4, at 11-13.
\item[106] Bill is a senior official of Company Y (Regulation FD, Rule 101(c)), whose statement to Alex was a statement by someone acting on behalf of Company Y (Rule 100(a)) made to someone in a Regulation FD-covered category (Rule 100(b)(1)(ii)).
\item[107] \textsc{Obus}, 693 F.3d at 285:
\end{footnotes}
Bill’s position would, of course, simply refrain from revealing anything to Alex rather than have the company issue a press release about his travel plans! This reinforces the conclusion that the private disclosure would be unlawful tipping where, as Professor Langevoort indicates, the insider knows what else the analyst knows. Professor Langevoort does not address, however, how it is that someone in Bill’s position knows the “base of ‘nonpublic’ information” known to analysts. His analysis is more compelling where that base of information public.

As noted earlier, the SEC’s case against Moore does not implicate the mosaic theory—that was not a tipper-tippee case at all.\textsuperscript{108} As a case study, however, it is instructive to evaluate that claim as if it had been brought against Moore as a tippee of CPIBB. The Managing Director of CPIBB took steps to avoid revealing the identity of the person he was speaking with at the social engagement and the Managing Director did not know that Moore independently learned that person’s identity. This appears to have been the only fact that tied what the Managing Director was working on to Tomkins. Moreover, the Managing Director disclosed that he was working on a significant matter \textit{before} he was openly observed at the social engagement with the Thomson CEO.\textsuperscript{109} The Managing Director provided the first piece of the mosaic, not the piece that completed the material mosaic. At the time of his only disclosure to Moore he could not

\begin{quote}
One who has a fiduciary duty of trust and confidence to shareholders (classical theory) or to a source of confidential information (misappropriation theory) and is in receipt of material non-public information has a duty to abstain from trading or to disclose the information publicly. The “abstain or disclose” rule was developed under the classical theory to prevent insiders from using their position of trust and confidence to gain a trading advantage over shareholders.
\end{quote}

\textsuperscript{108} \textit{See supra} text accompanying notes 44-47.

\textsuperscript{109} \textit{See supra} text accompanying note 35.
have *known* he was completing a mosaic. Timing is everything. Apart from other considerations, such as that the Managing Director did not reveal information to Moore for an improper purpose, this suggests why the SEC did not charge the Managing Director with tipping and instead charged Moore under the misappropriation theory for using information he obtained *from CIBC* in confidence.\(^{110}\)

**VII. CONCLUSION**

This article establishes that an insider who discloses information that standing alone is nonpublic but not material does not violate Rule 10b-5 unless he knows, at that time, that the information he is conveying will complete a material mosaic of information for the recipient of the disclosure. If the tipper-insider *does* know, then he is vulnerable to a charge of unlawful tipping where the other elements, such as disclosing for an improper purpose, can be established.

How does this analysis guide an insider’s communications with an outsider, the arguable tippee? One can, of course, choose never to say anything that is not already public. Even if the insider scrupulously follows the admonition to document contemporaneously what is said to any outsider, that will not be a sufficient prophylactic means to demonstrate the absence of a wrongful disclosure, because documenting an (otherwise) immaterial disclosure does not address what the speaker knew about what the tippee already knew. If that other information is public, it is, as noted, easy to prove the tipper knew it and there may even be a presumption that the speaker knew the tippee was aware of this information.\(^ {111}\) Where the tippee pieced together an as yet immaterial picture from other *non*public sources, the speaker’s liability then likely depends

\(^{110}\) *See supra* text accompanying note 41.

\(^{111}\) *See supra* text accompanying note 103.
on what the speaker in fact already knew about what the tippee knew. If this is the law, then it surely behooves the analyst not to reveal to the insider what the analyst already knows, lest this provide the underpinning for an argument that any subsequent disclosure by the insider becomes a knowing disclosure of mosaic-completing information, making the insider an unlawful tipper and the analyst culpable if he trades or advises clients to do so.

The plaintiff in an insider trading case, such as the SEC, has the burden of proof that material nonpublic information was tipped. In many situations, the SEC’s opening case is a circumstantial one so that absent a dismissal at the close of the SEC’s case the defendant will need to put in rebuttal evidence, unless he intends only to argue that the SEC’s evidence does not prove wrongdoing by a preponderance of the evidence. The principal evidence from the alleged tipper-defendant in a mosaic case might be his assertion that he did not know what the tippee already knew, that is, that he did not know enough to appreciate that his immaterial disclosure completed the tippee’s material mosaic. This defendant must essentially prove a negative.


113 See, e.g., SEC v. Horn, No. 10–cv–955, 2010 WL 5370988, at * 4 (N.D.Ill. Dec. 16, 2010) (“Although it admits a lack of direct evidence, the SEC contends it can present enough circumstantial evidence to persuade a reasonable jury that [defendant] possessed nonpublic information. Direct evidence of insider trading is, indeed, rare; and the SEC is entitled to prove its case through circumstantial evidence.”). See also Crimmins, supra note 97, 2013 COLUM. BUS. L. REV. at 363 (“Insider trading cases are virtually the only cases that the SEC frequently litigates based simply on circumstantial evidence.”). See also supra note 104 (citing cases the SEC lost where its case was dependent on circumstantial evidence).

114 No claim should lie when the outsider obtains additional information, after the insider discloses immaterial information that turns out, in the end, to be crucial to completing the mosaic. In that event the insider cannot know that what he has provided will, only in the future, be crucial to completing a mosaic based on information not yet known to the outsider. See supra text accompanying notes 109-110 (analyzing this issue in a variant of Moore).
Similarly, the tippee will be liable if it is proven that he knew, or was reckless in not knowing, that the disclosure of the mosaic-completing information breached the tipper’s duty to the source of the information.\footnote{115} Whether the tipper breached a duty is likely to depend in part on whether the tipper knew, or was reckless in not knowing, that his disclosure completed the tippee’s mosaic. The tippee here will know whether the tipper knew what the tippee already knew where that information is entirely public or was provided by the tippee to the tipper. In this respect, two components of scienter, knowledge of materiality and knowing (or should have known) of the tippee’s breach, are interrelated.\footnote{116} If, however, some of the tippee’s information is nonpublic from other sources and the tippee himself did not tell the tipper what he, the tippee, already knew, the tippee would not, at the time, be able to assess whether the tipper knows that the inconsequential information the tipper is providing in fact is material because it completes the tippee’s mosaic.

In the end, the advice to the insider must be more than “do not disclose material nonpublic information.” It must also be “do not disclose immaterial nonpublic information, don’t reveal anything that is relevant to the company or its securities that is not already public.”\footnote{117} An

\footnote{115} \textit{Obus}, 693 F.3d at 287.

\footnote{116} \textit{See supra} text accompanying notes 7-13 (discussing the \textit{Obus} analysis of tipper and tippee scienter.)

\footnote{117} Similarly, after surveying the uncertainties in the law and the aggressive posture taken by the SEC and the Department of Justice in pursuing insider trading cases, one experienced securities litigator recently observed:

[A] rational retail investor without access to experienced securities enforcement counsel faces a dilemma. An incorrect guess on what an appellate court may determine on a duty or materiality question years after the fact may land the investor in jail or subject to crushing civil fines and career ruin.
insider cannot know with certainty what is already known to the person to whom he discloses nonpublic information and someday he may have to prove that he did not know what the tippee knew. Likewise, the tippee is taking a big risk in acting on the tipper’s information when the tippee cannot assess how much of his mosaic the tipper already knows.

The mosaic theory is not an illusion. The theory that underlies it is conceptually sound. It is, however, very much in doubt that a defendant-tipper can rely on it in defending a case under the classical theory of insider trading. Because the insider’s ability to use the mosaic theory as a shield is in question, the supposed tippee, whose liability is derived from that of his tipper, is in a precarious position as well.

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

Crimmins, supra note 97, 2013 COLUM. BUS. L. REV. at 355-56.

One can of course ask what the other person knows. It is not clear if he lies and the insider believes him that the insider could thus rebut that he breached a duty in making disclosure. Plausible deniability may not carry the day here. Compare Heminway, supra note 9, 15 TRANSACTIONS: TENN. J. OF BUS. L. at 58 (questioning whether it is “right to allow [certain] securities trading firm principals . . . to avoid liability because they can plausibly deny the origins of material nonpublic information that underlies securities trading undertaken at their behest or for their financial benefit” by interposing other firm employees between them and sources of material nonpublic information).