The Law and Economics of Insider Trading: A Comprehensive Primer

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Abstract

Insider trading likely is one of the most common forms of securities fraud, yet it remains one of the most controversial aspects of securities regulation among legal (and economic) scholars. This paper provides a comprehensive overview of both the law of insider trading and the contested economic analysis thereof. The uses a historical approach to the doctrinal aspects of insider trading, beginning with turn of the 20th Century state common law, and tracing the prohibition's evolution up to the most recent U.S. Supreme Court decisions under Rule 10b-5.

The paper also reviews the debate between those scholars favoring deregulation of insider trading, allowing corporations to set their own insider trading policies by contract, and those who contends that the property right to inside information should be assigned to the corporation without the right of contractual reassignment. Deregulatory arguments are typically premised on claims that insider trading promotes market efficiency or that assigning the property right to inside information to managers is an efficient compensation scheme. The paper also reviews the public choice analysis of isnider trading to show that the prohibition benefits market professionals and corporate managers rather than investors.

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I. Introduction

Generally speaking, insider trading is trading in securities while in possession of material nonpublic information. Since the 1960s insider trading has been regarded mainly as a problem of federal securities laws. A principal thesis of this paper, however, is that insider trading is more closely akin to problems of fiduciary duty than it is to securities fraud.

Someone violates the federal insider trading prohibition only if his trading activity breached a fiduciary duty owed either to the investor with whom he trades or to the source of the information.[1] From a securities law perspective, the federal prohibition thus is an empty shell. It has no force or substance until it has been filled with fiduciary duty concepts. Despite the centrality of the fiduciary duty element to the federal prohibition, however, that element has received relatively little attention. On close examination, however, requiring a breach of fiduciary duty as a prerequisite for insider trading liability raises two interesting questions: What is the precise fiduciary duty at issue? Is the source of that duty federal or state law? The failure to resolve these issues has robbed the federal insider trading prohibition of coherence and predictability.

This paper argues that insider trading liability is premised not on the mere existence of a fiduciary relationship, but rather on the breach of a specific fiduciary duty—namely, the duty to refrain from self dealing in confidential information owned by another party. Put another way, the law of insider trading is one of the vehicles used by society to allocate the property rights to information produced by a firm. If true, the argument suggests that insider trading differs but little from other duty of loyalty problems, such as usurpation of corporate opportunities, in which the officer or director used proprietary information or other corporate assets for personal gain. In turn, the argument thus raises the interesting question of why insider trading is a matter of federal concern.

II. Origins of the insider trading prohibition

Although we now take it for granted that regulating insider trading is a job for the SEC under federal law, it was not always so. Until quite recently, insider trading was handled as a matter of state corporate law. To be sure, the federal prohibition has largely eclipsed state law in this area, but the older state rules are still worth studying. The historical evolution of the insider trading prohibition is not only relevant to understanding current doctrine, but also is highly relevant to understanding the on-going policy debate over the merits of insider trading regulation.

A. State common law

Prior to 1900 it was treatise law that "[t]he doctrine that officers and directors [of corporations] are trustees of the stockholders . . . does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their official position."[2] Under this so-called "majority" or "no duty" rule, liability was based solely on actual fraud, such as misrepresentation or fraudulent concealment of a material fact. As one court explained, liability arose only where the defendant said or did something "to divert or prevent, and which did divert or prevent,

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[1] This is true insofar as the core federal prohibition under Securities and Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5, is concerned. Breach of fiduciary duty is not required for liability to arise under the narrower provisions of SEC Rule 14e-3, 17 C.F.R. § 240.14e-3. See U.S. v. O'Hagan, 521 U.S. 642 (1997). There is a voluminous academic literature on insider trading. For a comprehensive bibliography, see Stephen M. Bainbridge, Insider Trading, in III Encyc. of L. & Econ. 772, 798-811 (2000).

[2] H. L. Wilgus, Purchase of Shares of a Corporation by a Director from a Shareholder, 8 Mich. L. Rev. 267, 267 (1910).

the plaintiff from looking into, or making inquiry, or further inquiries, as to the affairs or condition of the company and its prospects for dividends . . . ."[3]

1. Face to face transactions

The modern prohibition arguably began taking shape in *Oliver v. Oliver,*[4] a 1903 decision in which the Georgia Supreme Court announced the so-called "minority" or "duty to disclose" rule. After 1900 most courts had continued to reject any fiduciary duty on the part of corporate officers and directors in their private dealings with shareholders.[5] In *Oliver,* however, the court held that the shareholder had a right to disclosure, stating that "[w]here the director obtains the information giving added value to the stock by virtue of his official position, he holds the information in trust for the benefit of [the shareholders]."[6] Other courts soon followed suit.[7] Under *Oliver* and its progeny, directors

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[3] Carpenter v. Danforth, 52 Barb. 581, 589 (N.Y. Sup. Ct. 1868). See also Grant v. Attrill, 11 F. 469 (S.D.N.Y. 1882) (holding that a sale of stock induced by the levy of an assessment was not so tainted with fraud as to render it void); Board of Comm'rs v. Reynolds, 44 Ind. 509 (1873) (holding over a strong dissent that there was no trustee relationship because directors did not have control, power, or dominion over the shares); Crowell v. Jackson, 23 A. 426 (N.J. 1891) (liability only for active misrepresentation, no general duty of disclosure); Krumbhaar v. Griffiths, 25 A. 64 (Pa. 1892) (shareholder cannot rescind sale of stock to secretary of corporation who discloses all information he has and conceals neither the condition of the corporation nor the value of the stock); Fisher v. Budlong, 10 R.I. 525 (1873) (liability solely because director was acting as an agent for the shareholder in the sale of the stock and abused that relationship to obtain the shares for himself at a price lower than their actual value); Deaderick v. Wilson, 67 Tenn. 108 (1874) (directors are free to purchase stock from a shareholder in the corporation on the same terms as others unless prohibited by legislative action); Hume v. Steele, 59 S.W. 812 (Tex. Civ. App. 1900) (liability based only on actual fraud); Haarstick v. Fox, 33 P. 251 (Utah 1893) (no duty of disclosure absent active misrepresentation).

For contemporary academic commentary on the state common law of insider trading, see A.A. Berle, Jr., Publicity of Accounts and Directors' Purchases of Stock, 25 Mich. L. Rev. 827 (1927); I. Beverly Lake, The Use for Personal Profit of Knowledge Gained While a Director, 9 Miss. L.J. 427 (1937); Clarence D. Layline, The Duty of a Director Purchasing Shares of Stock, 27 Yale L.J. 731 (1918); Harold R. Smith, Purchase of Shares of a Corporation by a Director from a Shareholder, 19 Mich. L. Rev. 698 (1921); Roberts Walker, The Duty of Disclosure by a Director Purchasing Stock from his Stockholders, 32 Yale L.J. 637 (1923).

[4] 45 S.E. 232 (Ga. 1903).

[5] See, e.g., Hooker v. Midland Steel Co., 74 N.E. 445 (Ill. 1905); Walsh v. Goulden, 90 N.W. 406 (Mich. 1902).

[6] *Oliver*, 45 S.E. at 234.

[7] See, e.g., Stewart v. Harris, 77 P. 277, 279 (Kan. 1904); cf. Von Au v. Magenheimer, 110 N.Y.S. 629 (N.Y. App. Div. 1908) (stockholder in nonpublic corporation who was induced to sell shares by misrepresentation on the part of management has action for damages). In Steinfeld v. Nielsen, 100 P. 1094 (Ariz. 1909), rev'd, 224 U.S. 534 (1912), the lower court followed Oliver and Stewart but found no liability because the plaintiff had equal access to the information. On remand, the court appeared to follow Strong v. Repide, 213 U.S. 419 (1909), discussed below, but

therefore had a quite modern fiduciary obligation to disclose material nonpublic information to shareholders before trading with them.

In *Strong v. Repide*,[8] the U.S. Supreme Court offered a third approach to the insider trading problem. The court acknowledged the majority rule, but declined to follow it. Instead, the court held that, under the particular factual circumstances of the case at bar, "the law would indeed be impotent if the sale could not be set aside or the defendant cast in damages for his fraud."[9] Thus was born the so-called "special facts" or "special circumstances" rule, which holds that although directors generally owe no duty to disclose material facts when trading with shareholders, such a duty can arise in (duh) "special circumstances." What facts were sufficiently "special" for a court to invoke the rule? *Strong v. Repide* identified the two most important fact patterns: Concealment of identity by the defendant and failure to disclose significant facts having a dramatic impact on the stock price.

As state law evolved in the early 1900s, both the special circumstances and minority rules rapidly gained adherents.[10] Every court faced with the issue during this period felt obliged to discuss all three rules. While many courts adhered to the majority rule, they typically went out of their way to demonstrate that the case at bar in fact did not involve any special facts. Even more strikingly, during this period no court deciding the issue as a matter of first impression adopted the old majority rule. As a result, by the late 1930s, a headcount of cases indicated that the special circumstances rule prevailed in a plurality of states, the older no duty rule no longer commanded a majority, and the duty to disclose rule had been adopted in a substantial number—albeit, still a minority—of states.[11]

2. Do selling directors owe a fiduciary duty to their nonshareholder purchasers?

Given that both the special circumstances and minority rules were based on the director or officer's fiduciary duties, a problem arose: What happened when a director sold shares, rather than buying them? A director who buys shares is trading with someone who is already a shareholder of the corporation and, as such, someone to whom the director has fiduciary obligations. A director who sells shares, however, likely is dealing

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found no special circumstances justifying a duty of disclosure. Steinfeld v. Nielsen, 139 P. 879 (Ariz. 1914).

[8] 213 U.S. 419 (1909).

[9] Id. at 433.

[10] A 1921 article identified 13 cases dealing with the duty to disclose inside information. Eight of these cases imposed liability for failure to disclose. Six cases, following the Strong special circumstances rule, found special facts justifying liability. The other two cases followed Oliver's fiduciary duty approach. Of the five cases finding no liability, three cases said they would follow the older no duty rule, but went out of their way to demonstrate that there were no special circumstances on the facts of the case. The other two cases refused to adopt the older rule, but found no special circumstances justifying imposing a duty of disclosure. Smith, supra note 3, at 712-13.

[11] Lake, supra note 3, at 448-49.

with a stranger, someone not yet a shareholder and, as such, not yet someone to whom the director owes any duties. Assuming *arguendo* that the director's fiduciary duties to shareholders proscribe buying shares from them on the basis of undisclosed material information, the logic of that rule does not necessarily extend to cases in which the director sells to an outsider. As with most questions of state law in this area, the issue is not solely of historical or academic interest. As we shall see, the modern federal insider trading prohibition is also premised on a violation of fiduciary duty, Unfortunately, while the federal prohibition indisputably applies both to insiders who buy and those who sell,[12] state law remains uncertain.

3. Stock market transactions

Both the special circumstances and minority rules were more limited in scope than may appear at first blush.[13] Most of the cases in which plaintiffs succeeded involved some form of active fraud, not just a failure to disclose. More important, all of these cases involved face-to-face transactions. The vast majority of stock transactions, both then and now, take place on impersonal stock exchanges. In order to be economically significant, an insider trading prohibition must apply to such transactions as well as face-to-face ones.

The leading state case in this area remains *Goodwin v. Aggassiz*.[14] Defendants were directors and senior officers of a mining corporation. A geologist working for the company advanced a theory suggesting there might be substantial copper deposits in northern Michigan. The company thought the theory had merit and began securing mineral rights on the relevant tracts of land. Meanwhile, the defendants began buying shares on the market. Plaintiff was a former stockholder who had sold his shares on the stock market. The defendants apparently had bought the shares, although neither side knew the identity of the other party to the transaction until much later. When the true facts became known, plaintiff sued the directors, arguing that he would not have sold if the geologist's theory had been disclosed. The court rejected plaintiff's claim, concluding that defendants had no duty to disclose the theory before trading.

Goodwin is commonly read as standing for the proposition that directors and officers trading on an impersonal stock exchange owe no duty of disclosure to the persons with whom they trade. Although that reading is correct as a bottom line matter, it ignores some potentially important doctrinal complications. The Massachusetts Supreme Judicial Court's analysis begins with a nod to the old majority rule, opining that directors generally do not "occupy the position of trustee toward individual stockholders in the corporation."[15] The court went on, however, to note that "circumstances may exist …

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[12] See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (where insiders purchased stock on inside information); SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (where defendant sold shares of stock based on his possession of material nonpublic information).

[13] See generally Michael Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 Cornell L.Q. 53 (1960).

[14] 186 N.E. 659 (Mass. 1933).

[15] Id. at 660.

[such] that an equitable responsibility arises to communicate facts,"[16] which sounds like the special circumstances rule. Indeed, the court made clear that Massachusetts would apply the special circumstances rule to face-to-face transactions: "where a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances."[17] Was the court likewise applying the special circumstances rule to stock market transactions? Perhaps. The court took pains to carefully analyze the nature of the information in question, concluding that it was "at most a hope," and was careful to say that there was no affirmative duty to disclose under the circumstances at bar. [18] At the same time, however, the dispositive special circumstance clearly was the stock market context. As to transactions effected on an impersonal exchange, no duty to disclose would be imposed.

Given that federal law later imposed just such a duty, it is instructive to carefully examine the court's explanation for its holding:

> Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud.[19]

Defenders of the insider trading prohibition find much that is contestable in the court's rationale. Two observations suffice for present purposes: First, notice the strongly normative (and strongly laissez faire) tone of the quoted passage. Why can't the law undertake to ensure that all parties to stock market transaction have at least roughly equal access to information? This question turns out to be one of insider trading jurisprudence's recurring issues. Second, consider the "difficult situation" the court claims an insider trading prohibition would create for "honest directors." Even at its most expansive, the federal insider trading prohibition never required directors to individually seek out those with whom they trade and personally make disclosure of "everything" they know about the company. A workable insider trading prohibition simply requires directors to publicly

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[16] Id. at 661.

[17] Id.

[18] Id.

[19] Id.

disclose all material facts in their possession before trading or, if they are not able to do so, to refrain from trading. Corporate policies could be developed to limit director and officer trading to windows of time in which there is unlikely to be significant undisclosed information, such as those following dissemination of periodic corporate disclosures. An inconvenience for all concerned, to be sure, but hardly enough to keep able people from serving as directors of publicly traded corporations. Not surprisingly, this aspect of the court's rationale has gotten short shrift from later courts.

B. Origins of the federal prohibition

The modern federal insider trading prohibition has its statutory basis in the federal securities laws—principally the Securities Exchange Act of 1934. As with the other New Deal-era securities laws, the Exchange Act was a response to the 1929 stock market crash and the subsequent depression. Like its fellow securities laws, the Exchange Act had two basic purposes: protecting investors engaged in securities transactions and assuring public confidence in the integrity of the securities markets. As the Supreme Court has put it, the fundamental aim was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[20] Towards that end, prohibitions of fraud and manipulation in connection with the purchase or sale of securities buttressed the Exchange Act's disclosure requirements.

Is insider trading a breach of the disclosure obligations created by the Exchange Act? If not, is it otherwise captured by the Exchange Act's prohibition of fraud and manipulation? The United States Supreme Court, among others, thinks so: "A significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office."[21] Careful examination of the relevant legislative history, however, suggests that regulating insider trading was not one of the Exchange Act's original purposes.[22]

1. The statutory background and its legislative history

The core of the modern federal insider trading prohibition derives its statutory authority from § 10(b) of the Exchange Act, which provides in pertinent part that:

> 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 –
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any

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[20] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

[21] Dirks v. SEC, 463 U.S. 646, 653 n.10 (1983).

[22] See generally Stephen M. Bainbridge, Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition, 52 Wash & Lee L. Rev. 1189, 1228-1237 (1995); Michael P. Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 55-69 (1980); Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 317-20.

> manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[23]

Notice two things about this text. First, it is not self executing. § 10(b) gives the SEC authority to prohibit "any manipulative or deceptive device or contrivance" and then makes the use of such proscribed devices illegal. Until the SEC exercises its rulemaking authority, however, the statute is unavailing.

The second point to be noticed is the absence of the word "insider." Nothing in § 10(b) explicitly proscribes insider trading. To be sure, § 10(b) often is described as a catchall intended to capture various types of securities fraud not expressly covered by more specific provisions of the Exchange Act.[24] What the SEC catches under § 10(b), however, must not only be fraud, but also within the scope of the authority delegated to it by Congress.[25] Section 10(b) received little attention during the hearings on the Exchange Act and apparently was seen simply as a grant of authority to the SEC to prohibit manipulative devices not covered by § 9. As Thomas Corcoran, a prominent member of President Roosevelt's administration and leader of the Exchange Act's supporters, put it: § 10(b) was intended to prohibit the invention of "any other cunning devices" besides those prohibited by other sections.[26] Only a single passage, albeit an oft-cited one, in the Exchange Act's voluminous legislative history directly indicates insider trading was one of those cunning devices: "Among the most vicious practices unearthed at the hearings. . .was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities."[27] In context, however, this passage does not deal with insider trading as we understand the term today, but rather with manipulation of stock prices by pools of insiders and speculators through cross sales, wash sales, and similar "cunning" methods.[28] Nothing else in the legislative history suggests that Congress intended § 10(b) to create a sweeping prohibition of insider trading.

To the extent the 1934 Congress addressed insider trading, it did so not through § 10(b), but rather through § 16(b), which permits the issuer of affected securities to recover

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[23] 15 U.S.C. § 78j(b).

[24] Chiarella v. United States, 445 U.S. 222, 234-35 (1980).

[25] See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213-14 (1976) ("The rulemaking power granted to an administrative agency . . . is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'"); cf. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC Rule 19c-4 as exceeding scope of SEC's authority under Exchange Act §§ 14(a) and 19(c)).

[26] Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

[27] S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

[28] Dooley, supra note 22, at 56 n.235.

insider short-swing profits.[29] Section 16(b) imposes quite limited restrictions on insider trading, however. It does not reach transactions occurring more than six months apart, nor does it apply to persons other than those named in the statute or to transactions in securities not registered under § 12. Indeed, some have argued that § 16(b) was not even intended to deal with insider trading, but rather with manipulation.[30] In any event, given that Congress could have struck at insider trading both more directly and forcefully, and given that Congress chose not to do so,[31] § 16(b) offers no statutory justification for the more sweeping prohibition under § 10(b).

If Congress had intended in 1934 that the SEC use § 10(b) to craft a sweeping prohibition on insider trading, moreover, the SEC was quite dilatory in doing so. Rule 10b-5, the foundation on which the modern insider trading prohibition rests, was not promulgated until 1942, eight years after Congress passed the Exchange Act. 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,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.[32]

Note that, as with § 10(b) itself, the rule on its face does not prohibit (or even speak to) insider trading. Nor was Rule 10b-5 initially used against insider trading on public secondary trading markets. Instead, like state common law, the initial Rule 10b-5 cases were limited to face-to-face and/or control transactions.[33] Not until 1961 did the SEC

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[29] 15 U.S.C. § 78p(b).

[30] Dooley, supra note 22, at 56-58.

[31] The first version of § 16 (§ 15 in draft) permitted corporate recovery of both insider and tippee short-swing profits and prohibited the tipping of confidential information by insiders. Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 9-10 (1934). The House deleted both provisions, but the restriction on insider short-swing profits was restored in conference. S. Doc. No. 185, 73d Cong., 2d Sess. 16-17 (1934).

[32] 17 CFR § 240.10b-5.

[33] See, e.g., Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) (omissions in connection with what amounted to tender offer); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (sale of control negotiated face to face); In re Ward La France Truck Corp., 13 S.E.C. 373 (1943) (same). Interestingly, in a pre-TGS case arising under Rule 10b-5, the Seventh Circuit applied the special circumstances rule to a face-to-face transaction, which

finally conclude that insider trading on an impersonal stock exchange violated Rule 10b-5.[34] Only then did the modern federal insider trading prohibition at last begin to take shape.

In sum, the modern prohibition is a creature of SEC administrative actions and judicial opinions, only loosely tied to the statutory language and its legislative history. U.S. Supreme Court Chief Justice William Rehnquist famously observed that Rule 10b-5 is "a judicial oak which has grown from little more than a legislative acorn."[35] Nowhere in Rule 10b-5 jurisprudence is this truer than where the insider trading prohibition is concerned, given the tiny (even nonexistent) legislative acorn on which it rests.

2. *Cady, Roberts*

The modern federal insider trading prohibition fairly can be said to have begun with *In re Cady, Roberts & Co.,*[36] an SEC enforcement action. Curtiss-Wright Corporation's board of directors decided to reduce the company's quarterly dividend. One of the directors, J. Cheever Cowdin, was also a partner in Cady, Roberts & Co., a stock brokerage firm. Before the news was announced, Cowdin informed one of his partners, Robert M. Gintel, of the impending dividend cut. Gintel then sold several thousand shares of Curtiss-Wright stock held in customer accounts over which he had discretionary trading authority. When the dividend cut was announced, Curtiss-Wright's stock price fell several dollars per share. Gintel's customers thus avoided substantial losses.

Cady, Roberts involved what is now known as tipping: an insider (the tipper) who knows confidential information does not himself trade, but rather informs (tips) someone else (the tippee) who does trade. It also involved trading on an impersonal stock exchange, instead of a face-to-face transaction. As the SEC acknowledged, this made *Cady, Roberts* a case of first impression. Prior 10b-5 cases in which inside information was used for personal gain had involved issues of tortious fraudulent concealment little different from the sorts of cases with which the state common law had dealt. Notwithstanding that limitation, the SEC held that Gintel had violated Rule 10b-5. In so doing, it articulated what became known as the "disclose or abstain" rule: An insider in possession of material nonpublic information must disclose such information before trading or, if disclosure is impossible or improper, abstain from trading.

3. Texas Gulf Sulphur

It was not immediately clear what precedential value *Cady, Roberts* would have. It was an administrative ruling by the SEC, not a judicial opinion. It involved a regulated industry closely supervised by the SEC. There was the long line of precedent, represented

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confirms that there was no general bar on insider trading prior to TGS. Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

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

[35] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

[36] 40 S.E.C. 907 (1961).

by *Goodwin v. Aggasiz*, to the contrary. In short order, however, the basic *Cady, Roberts* principles became the law of the land.

In March of 1959, agents of Texas Gulf Sulphur Co. (TGS) found evidence of an ore deposit near Timmins, Ontario.[37] In October 1963, Texas Gulf Sulphur began ground surveys of the area. In early November, a drilling rig took core samples from depths of several hundred feet. Visual examination of the samples suggested commercially significant deposits of copper and zinc. TGS's president ordered the exploration group to maintain strict confidentiality, even to the point of withholding the news from other TGS directors and employees. In early December, a chemical assay confirmed the presence of copper, zinc, and silver. At the subsequent trial, several expert witnesses testified that they had never heard of any other initial exploratory drill hole showing comparable results. Over the next several months, TGS acquired the rights to the land under which this remarkable ore deposit lay. In March and early April 1964, further drilling confirmed that TGS had made a significant ore discovery. After denying several rumors about the find, TGS finally announced its discovery in a press conference on April 16, 1964.

Throughout the fall of 1963 and spring of 1964, a number of TGS insiders bought stock and/or options on company stock. Others tipped off outsiders. Still others accepted stock options authorized by the company's board of directors without informing the directors of the discovery. Between November 1963 and March 1964, the insiders were able to buy at prices that were slowly rising, albeit with fluctuations, from just under \$18 per share to \$25 per share. As rumors began circulating in late March and early April, the price jumped to about \$30 per share. On April 16th, the stock opened at \$31, but quickly jumped to \$37 per share. By May 15, 1964, TGS's stock was trading at over \$58 per share—a 222% rise over the previous November's price. Any joy the insiders may taken from their profits was short-lived, however, as the SEC sued them for violating Rule 10b-5.

Texas Gulf Sulphur is the first of the truly seminal insider trading cases. It is still widely taught, in large part because it presents such a stark and classic fact pattern. In examining *Texas Gulf Sulphur*, however, it is critical to distinguish between what the law *was* and what the law *is*—although much of what was said in that opinion is still valid, the core insider trading holding is no longer good law.

The Second Circuit Court of Appeals held that when an insider has material nonpublic information the insider must either disclose such information before trading or abstain from trading until the information has been disclosed.[38] Thus was born what is now known as the "disclose or abstain" rule. The name is something of a misnomer, of course. The court presumably phrased the rule in terms of disclosure because this was an omissions case under Rule 10b-5. In such cases, the defendant must owe a duty of

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[37] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[38] Id. at 848.

disclosure to some investor in order for liability to be imposed.[39] As a practical matter, however, disclosure will rarely be an option.

During the relevant time period, TGS had no affirmative duty to disclose the ore strike. As the Second Circuit correctly noted, the timing of disclosure is a matter for the business judgment of corporate managers, subject to any affirmative disclosure requirements imposed by the stock exchanges or the SEC.[40] In this case, moreover, a valuable corporate purpose was served by delaying disclosure: confidentiality prevented competitors from buying up the mineral rights and kept down the price landowners would charge for them. The company therefore had no duty to disclose the discovery, at least up until the time that the land acquisition program was completed.

Given that the corporation had no duty to disclose, and had decided not to disclose the information, the insiders' fiduciary duties to the corporation would preclude them disclosing it for personal gain. In this case, the company's president had specifically instructed insiders in the know to keep the information confidential, but such an instruction was not technically necessary. Agency law precludes a firm's agents from disclosing confidential information that belongs to their corporate principal, as all information relating to the ore strike clearly did.[41]

Disclosure by an insider who wishes to trade thus is only feasible if there is no legitimate corporate purpose for maintaining secrecy. These situations, however, presumably will be relatively rare—it is hard to imagine many business developments that can be disclosed immediately without working some harm to the corporation. In most cases, the disclose or abstain rule really does not provide the insider with a disclosure option: generally the duty will be one of complete abstention.

The policy foundation on which the Second Circuit erected the disclose or abstain rule was equality of access to information. The court contended that the federal insider trading prohibition was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material information."[42] Put another way, the majority thought Congress intended "that all members of the investing public should be subject to identical market risks."[43]

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[39] See e.g., Chiarella v. United States, 445 U.S. 222, 230 (1980) (stating that liability for nondisclosure "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"); Dirks v. SEC, 463 U.S. 646, 654 (1983) (stating that there is no general duty to disclose and the duty to disclose must arise from a fiduciary relationship); SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (holding that overhearing inadvertently revealed inside information does not create a duty to disclose before trading because for a fiduciary duty to run to a tippee, the inside information must be disclosed for an improper purpose).

[40] Texas Gulf Sulphur Co., 401 F.2d at 350-51 & n.12.

[41] Restatement (Second) of Agency § 395 (1958).

[42] Texas Gulf Sulphur Co., 401 F.2d at 848.

[43] Id. at 852. For a defense of the equal access standard, see Victor Brudney, Insiders, Outsiders, and Information Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322 (1979). To

The equality of access principle admittedly has some intuitive appeal. As we shall see, the SEC consistently has tried to maintain it as the basis of insider trading liability. Many commentators still endorse it, typically on fairness grounds.[44] The implications of the equal access principle, however, become troubling when we start dealing with attenuated circumstances, especially with respect to market information. Suppose a representative of TGS had approached a landowner in the Timmins area to negotiate purchasing the mineral rights to the land. TGS' agent does not disclose the ore strike, but the landowner turns out to be pretty smart. She knows TGS has been drilling in the area and has heard rumors that it has been buying up a lot of mineral rights. She puts two and two together, reaches the obvious conclusion, and buys some TGS stock. Under a literal reading of *Texas Gulf Sulphur*, has our landowner committed illegal insider trading?

The surprising answer is "probably." The *Texas Gulf Sulphur* court stated that the insider trading prohibition applies to "anyone in possession of material inside information," because § 10(b) was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material information."[45] The court further stated that the prohibition applies to anyone who has "access, directly or *indirectly*" to confidential information (here is the sticking point) if he or she knows that the information is unavailable to the investing public.[46] The only issue thus perhaps would be a factual one turning on the landowner's state of mind: Did she know she was dealing with confidential information? If so, the equal access policy would seem to justify imposing a duty on her. Query whether the insider trading prohibition should stretch quite that far? Ultimately, the Supreme Court concluded that it should not.

III. The modern federal insider trading prohibition emerges: The disclose or abstain rule and the Supreme Court

Texas Gulf Sulphur sent the insider trading prohibition down a path on which insider trading was deemed a form of securities fraud and, accordingly, within the SEC's regulatory jurisdiction. There was nothing inevitable about that choice, however. State corporate law had been regulating insider trading for decades before *Texas Gulf Sulphur* was decided. Well-established state precedents treated the problem as one implicating not concepts of deceit or manipulation, but rather the fiduciary duties of corporate officers and directors. To be sure, many states held that insider trading did not violate those duties, especially with respect to stock market transactions, but so what? In light of those precedents, the Second Circuit could have held that insider trading was not within Rule

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be clear, Brudney does not claim that investors may not take advantage of inequalities arising out of superior intelligence or diligence. His claim is only that investors who have monopolistic access to material nonpublic information should not be allowed to use it for profit. Id.

[44] See, e.g., Donald C. Langevoort, Words From on High About Rule 10b-5: Chiarella's History, Central Bank's Future, 20 Del. J. Corp. L. 865, 883 (1995) (expressing a preference for an insider trading prohibition grounded on a duty to disclose to the market).

[45] Texas Gulf Sulphur Co., 401 F.2d at 848.

[46] Id. at 848 (emphasis added) (quoting Cady, Roberts & Co., 40 S.E.C. at 912)

10b-5's regulatory purview. If it had done so, the prohibition would have evolved along a far different path than the one it actually followed.

A. Chiarella

1. The facts

Vincent Chiarella was an employee of Pandick Press, a financial printer that prepared tender offer disclosure materials, among other documents.[47] In preparing those materials Pandick used codes to conceal the names of the companies involved, but Chiarella broke the codes. He purchased target company shares before the bid was announced, then sold the shares for considerable profits after announcement of the bid. He got caught and was indicted for illegal insider trading. He was thereafter convicted of violating Rule 10b-5 by trading on the basis of material nonpublic information. The Second Circuit affirmed his conviction, applying the same equality of access to information-based disclose or abstain rule it had created in Texas Gulf Sulphur.

Chiarella was one of the first of a series of high profile takeover-related insider trading cases during the 1980s. Obviously, one can significantly increase takeover profits if one knows in advance that a takeover will be forthcoming. If you know of an impending bid prior to its announcement, you can buy up stock at the low pre-announcement price and sell or tender at the higher post-announcement price. The earlier one knows of the bid, of course, the greater the spread between your purchase and sale prices and the greater the resulting profit. By using options, rather than actually buying target stock, you can further increase your profits, because options permit one to control larger blocks of stock for the same investment.[48] During the 1980s, a number of Wall Street takeover players—among whom Dennis Levine, Ivan Boesky, and Michael Milken are the best-known—allegedly added millions of illegally gained insider trading dollars to the already vast fortunes they realized from more legitimate takeover activity.[49]

Note that Nonpublic information, for purposes of Rule 10b-5, takes two principal forms: "inside information" and "market information." Inside information typically comes from internal corporate sources and involves events or developments affecting the issuer's assets or earnings. Market information typically originates from sources other than the issuer and involves events or circumstances concerning or affecting the price or market for the issuer's securities and does not concern the issuer's assets or earning power. The

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[47] Chiarella v. United States, 445 U.S. 222 (1980).

[48] See William K. S. Wang, A Cause of Action for Option Traders Against Insider Option Traders, 101 Harv. L. Rev. 1056 (1988).

[49] See generally Robert D. Rosenbaum and Stephen M. Bainbridge, The Corporate Takeover Game and Recent Legislative Attempts to Define Insider Trading, 26 Am. Crim. L. Rev. 229 (1988). The volatile mix of takeovers and insider trading is entertainingly depicted in Oliver Stone's movie Wall Street (1987). For a fascinating popular history of the 1980s insider trading scandals, see James B. Stewart, Den of Thieves (1991). For a spirited defense of Milken and his ilk, see Daniel R. Fischel, Payback : The Conspiracy to Destroy Michael Milken and His Financial Revolution (1995).

information at issue in *Chiarella* thus was a type of market information. This distinction is unimportant for our purposes because insider trading liability can be imposed on those who trade while in possession of either type.[50]

2. The holding

Relative to some of those who followed him into federal court, Vincent Chiarella was small fry. But his case produced the first landmark Supreme Court insider trading ruling since *Strong v. Repide*.[51] As noted, in affirming Chiarella's conviction the Second Circuit had invoked *Texas Gulf Sulphur*'s equality of access to information-based disclose or abstain rule. Under the equal access-based standard, Chiarella clearly loses: he had greater access to information than those with whom he traded. But notice: Chiarella was not an employee, officer, or director of any of the companies in whose stock he traded. He worked solely for Pandick Press, which in turn was not an agent of any of those companies. Pandick worked for acquiring companies—not the takeover targets in whose stock Chiarella traded.

Chiarella's conviction demonstrated how far the federal insider trading prohibition had departed from its state common law predecessors. Recall that state common law had required, where it imposed liability at all, a fiduciary relationship between buyer and seller. The mere fact that one party had more information than the other was not grounds for setting aside the transaction or imposing damages. Yet, it was for that reason alone that the Second Circuit upheld Chiarella's conviction.

The Supreme Court reversed.[52] In doing so, the court squarely rejected the notion that § 10(b) was intended to assure all investors equal access to information. The Court said it could not affirm Chiarella's conviction without recognizing a general duty between all participants in market transactions to forego trades based on material, nonpublic information, and it refused to impose such a duty.[53]

Chiarella thus made clear that the disclose or abstain rule is not triggered merely because the trader possesses material nonpublic information. When a 10b-5 action is based upon nondisclosure, "there can be no fraud absent a duty to speak," and no such duty arises from the mere possession of nonpublic information.[54] Instead, the disclose or abstain theory of liability for insider trading was now premised on the inside trader being subject to a duty to disclose to the party on the other side of the transaction that arose from a relationship of trust and confidence between the parties thereto.[55]

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[50] Stephen M. Bainbridge, Note, A Critique of the Insider Trading Sanctions Act of 1984, 71 Va. L. Rev. 455, 477 n.177 (1985).

[51] 213 U.S. 419 (1909).

[52] Chiarella v. United States, 445 U.S. 222 (1980).

[53] Id. at 233.

[54] Id. at 235.

[55] Id. at 230.

Chiarella radically limited the scope of the insider trading prohibition as it had been defined in *Texas Gulf Sulphur*. Consider the landowner hypothetical discussed above: Under an equal access to information-based standard, she is liable for insider trading because she had material information unavailable to those with whom she traded. Under *Chiarella*, however, she cannot be held liable. She is (by hypothesis) not the agent or fiduciary of TGS shareholders and, presumably, has no other special relationship of trust and confidence with them. Accordingly, she is free to trade on the basis of what she knows without fear of liability. The policy conundrum is now flipped, of course: after *Texas Gulf Sulphur*, the question was how large a net should the prohibition cast; after *Chiarella*, the question was how broad should be the scope of immunity created by the new fiduciary relationship requirement.

B. *Dirks*

The Supreme Court tackled that question three years later in *Dirks v. SEC*.[56] Raymond Dirks was a securities analyst who uncovered the massive Equity Funding of America fraud. Dirks first began investigating Equity Funding after receiving allegations from Ronald Secrist, a former officer of Equity Funding, that the corporation was engaged in widespread fraudulent corporate practices. Dirks passed the results of his investigation to the SEC and the Wall Street Journal, but also discussed his findings with various clients. A number of those clients sold their holdings of Equity Funding securities before any public disclosure of the fraud, thereby avoiding substantial losses. After the fraud was made public and Equity Funding went into receivership, the SEC began an investigation of Dirk's role in exposing the fraud. One might think Dirks deserved a medal (certainly Mr. Dirks seems to have felt that way), but one would be wrong. The SEC censured Dirks for violating the federal insider trading prohibition by repeating the allegations of fraud to his clients.

Under the *Texas Gulf Sulphur* equal access to information standard, tipping of the sort at issue in *Dirks* presented no conceptual problems. The tippee had access to information unavailable to those with whom he traded and, as such, is liable. After *Chiarella*, however, the tipping problem was more complex. Neither Dirks nor any of his customers were agents, officers, or directors of Equity Funding. Nor did they have any other form of special relationship of trust and confidence with those with whom they traded.

In reversing Dirk's censure, the Supreme Court expressly reaffirmed its rejection of the equal access standard and its requirement of a breach of fiduciary duty in order for liability to be imposed:

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "[depart] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants

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[56] 463 U.S. 646 (1983).

> in market transactions to forgo actions based on material, nonpublic information."[57]

Recognizing that this formulation posed problems for tipping cases, the court held that a tippee's liability is derivative of that of the tipper, "arising from [the tippee's] role as a participant after the fact in the insider's breach of a fiduciary duty."[58] A tippee therefore can be held liable only when the tipper breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.[59]

On the *Dirks* facts, this formulation precluded imposition of liability. To be sure, Secrist was an employee and, hence, a fiduciary of Equity Funding. But the mere fact that an insider tips nonpublic information is not enough under *Dirks*. What *Dirks* proscribes is not merely a breach of confidentiality by the insider, but rather the breach of a fiduciary duty of loyalty to refrain from profiting on information entrusted to the tipper. Looking at objective criteria, courts must determine whether the insider-tipper personally benefited, directly or indirectly, from his disclosure.[60] Secrist tipped off Dirks in order to bring Equity Funding's misconduct to light, not for any personal gain. Absent the requisite personal benefit, liability could not be imposed.

In *Dirks*, the Supreme Court identified several situations in which the requisite personal benefit could be found. The most obvious is the quid pro quo setting, in which the tipper gets some form of pecuniary gain. Nonpecuniary gain can also qualify, however. Suppose a corporate CEO discloses information to a wealthy investor not for any legitimate corporate purpose, but solely to enhance his own reputation. *Dirks* would find a personal benefit on those facts. Finally, *Dirks* indicated that liability could be imposed where the tip is a gift. A gift satisfies the breach element because it is analogous to the situation in which the tipper trades on the basis of the information and then gives the tippee the profits.

1. Selective disclosure and Regulation FD

The SEC long has been concerned that selective disclosure to analysts undermines public confidence in the integrity of the stock markets:

> [M]any issuers are disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand were able to make a profit or avoid a loss at the expense of those kept in the dark.

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[57] Id. 654-55.

[58] Id. at 659 (quoting *Chiarella*, 445 U.S. at 230 n.12).

[59] See id. at 660.

[60] See id. at 662.

> We believe that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market insiders.[61]

Unfortunately for the SEC, the *Dirks'* tipping regime was an inadequate constraint on the selective disclosure practice because, *inter alia*, it can be difficult to prove that the tipper received a personal benefit in connection with a disclosure. In 2000, the SEC adopted Regulation FD to create a noninsider trading-based mechanism for restricting selective disclosure.[62] If someone acting on behalf of a public corporation discloses material nonpublic information to securities market professionals or “holders of the issuer’s securities who may well trade on the basis of the information,” the issuer must also disclose that information to the public. Where the issuer intentionally provides such disclosure, it must simultaneously disclose the information in a manner designed to convey it to the general public. Hence, for example, if the issuer holds a briefing for selected analysts, it must simultaneously announce the same information through, say, a press release to “a widely disseminated news or wire service.” The SEC encouraged issuers to make use of the Internet and other new information technologies, such as by webcasting conference calls with analysts. Where the disclosure was not intentional, as where a corporate officer “let something slip,” the issuer must make public disclosure “promptly” after a senior officer learns of the disclosure.

2. Tipping chains

At least in theory, it is possible for a tipper to be liable even if the tippee is not liable. The breach of duty is enough to render the tipper liable, but the tippee must know of the breach in order to be held liable. Notice also that it is possible to have chains of tipping liability: Tipper tells Tippee #1 who tells Tippee #2 who trades. Tippee #2 can be held liable, so long as she knew or had reason to know that the ultimate source of the information had breached his fiduciary duties by disclosing it.

IV. The prohibition evolves: the misappropriation theory and rule 14e-3 emerge as post-*Chiarella* gap-fillers

Chiarella created a variety of significant gaps in the insider trading prohibition’s coverage. Consider this standard law school hypothetical: A law firm is hired by Raider Corporation to represent it in connection with a planned takeover bid for Target Company. Ann Associate is one of the lawyers assigned to the project. Before Raider publicly discloses its intentions, Associate purchases a substantial block of Target stock. Under the disclose or abstain rule, she has not violated the insider trading prohibition.

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[61] Exchange Act Rel. No. 43,154 (Aug. 15, 2000). On the relationship between investment analysis and insider trading, see Daniel R. Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. SEC, 13 Hofstra L. Rev. 127 (1984); Donald C. Langevoort, Investment Analysts and the Law of Insider Trading, 76 Va. L. Rev. 1023 (1990).

[62] Id.

Whatever the scope of the duties she owed Raider, she owed no duty to the shareholders of Target. Accordingly, the requisite breach of fiduciary duty is not present in her transaction. Rule 14e-3 and the misappropriation theory were created to fill this gap.

A. Rule 14e-3

Rule 14e-3 was the SEC's immediate response to *Chiarella*.[63] The Rule was specifically intended to reach the wave of insider trading activity associated with the increase in merger and acquisition activity during the 1980s. The rule prohibits insiders of the bidder and target from divulging confidential information about a tender offer to persons that are likely to violate the rule by trading on the basis of that information. This provision (Rule 14e-3(d)(1)) does not prohibit the bidder from buying target shares or from telling its legal and financial advisers about its plans. What the rule prohibits is tipping of information to persons who are likely to buy target shares for their own account. In particular, the rule was intended to strike at the practice known as warehousing. Anecdotal evidence suggests that before Rule 14e-3 was on the books bidders frequently tipped their intentions to friendly parties. Warehousing increased the odds a hostile takeover bid would succeed by increasing the number of shares likely to support the bidder's proposal.

Rule 14e-3 also, with certain narrow and well-defined exceptions, prohibits any person that possesses material information relating to a tender offer by another person from trading in target company securities if the bidder has commenced or has taken substantial steps towards commencement of the bid. The requisite "substantial step" can be found even if formal announcement of a tender offer has not yet occurred and, perhaps, even if a tender offer never takes place. Substantial steps include such things as voting on a resolution by the offering person's board of directors relating to the tender offer; the formulation of a plan or proposal to make a tender offer by the offering person; activities which substantially facilitate the tender offer, such as arranging financing for a tender offer, or preparing or directing or authorizing the preparation of tender offer materials.[64] The trader must know or have reason to know that the information is nonpublic. The trader also must know or have reason to know the information was acquired from the bidder or the target company or agents of either.

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[63] 17 C.F.R. § 240.14e-3. In fact, Rule 14e-3 was pending at the time *Chiarella* was decided, see Chiarella v. United States, 445 U.S. 222, 234 n.18 (1980), almost as though the Commission knew that its attempts to reach warehousing of takeover securities under Rule 10b-5 were of questionable validity.

[64] SEC Release No. 34-17,120 (1980). See, e.g., SEC v. Maio, 51 F.3d 623 (7th Cir. 1995) (signing a confidentiality agreement constituted a substantial step where one of the corporate parties had earlier solicited a tender offer); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (retaining law firm to advise on an impending offer constituted a substantial step); Camelot Indus. Corp. v. Vista Resources, Inc., 535 F. Supp. 1174 (S.D.N.Y. 1982) (meeting between target managers, prospective acquiror, and an investment banker deemed a substantial step); O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981) (Rule 14e-3 can be violated even if offer never becomes effective).

Unlike both the disclose or abstain rule and the misappropriation theory under Rule 10b-5, Rule 14e-3 liability is not premised on breach of a fiduciary duty. There is no need for a showing that the trading party or tipper was subject to any duty of confidentiality, and no need to show that a tipper personally benefited from the tip. In light of the well-established fiduciary duty requirement under Rule 10b-5, however, the rule arguably ran afoul of *Schreiber v. Burlington Northern, Inc.*,[65] in which the Supreme Court held that §14(e) was modeled on § 10(b) and, like that section, requires a showing of misrepresentation or nondisclosure. If the two sections are to be interpreted in pari materia, as *Shreiber* indicated, and § 10(b) requires a showing of a breach of a duty in order for liability to arise, the SEC appeared to have exceeded its statutory authority by adopting a rule that makes illegal a variety of trading practices that do not involve any breach of duty. In *United States v. O'Hagan*,[66] however, the Supreme Court upheld Rule 14e-3 as a valid exercise of the SEC's rulemaking authority despite the absence of a fiduciary duty element.

Although most lawsuits under 14e-3 have been brought by the SEC, it seems likely that a private right of action exists under the rule and is available to investors trading in the target's securities at the same time as the persons who violated the rule.[67]

While Rule 14e-3 thus escapes the fiduciary-duty based restrictions of the *Chiarella/Dirks* regime, the Rule nevertheless is quite limited in scope. One prong of the rule (the prohibition on trading while in possession of material nonpublic information) does not apply until the offeror has taken substantial steps towards making the offer. More important, both prongs of the rule are limited to information relating to a tender offer. As a result, most types of inside information remain subject to the duty-based analysis of *Chiarella* and its progeny.

B. Misappropriation

In response to the set-backs it suffered in *Chiarella* and *Dirks*, the SEC began advocating a new theory of insider trading liability: the misappropriation theory. Unlike Rule 14e-3, the SEC did not intend for the misappropriation theory to be limited to tender offer cases (although many misappropriation decisions have in fact involved takeovers). Accordingly, the Commission posited misappropriation as a new theory of liability under Rule 10b-5. Which meant, in turn, that the SEC had to find a way of finessing the fiduciary duty requirement imposed by *Chiarella* and *Dirks*.

1. Origins

The misappropriation theory is commonly (but incorrectly) traced to Chief Justice Burger's *Chiarella* dissent. Burger contended that the way in which the inside trader acquires the nonpublic information on which he trades could itself be a material

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[65] 472 U.S. 1 (1985).

[66] 521 U.S. 642, 666-76 (1997).

[67] See, e.g., O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981).

circumstance that must be disclosed to the market before trading. Accordingly, Burger argued, "a person who has misappropriated nonpublic information has an absolute duty [to the persons with whom he trades] to disclose that information or to refrain from trading."[68] The majority did not address the merits of this theory; instead rejecting it solely on the ground that the theory had not been presented to the jury and thus could not sustain a criminal conviction.[69]

Consequently, the way was left open for the SEC to urge, and the lower courts to adopt, the misappropriation theory as an alternative basis of insider trading liability.[70] The Second Circuit swiftly moved to take advantage of that opportunity. In *United States v. Newman*,[71] employees of an investment bank misappropriated confidential information concerning proposed mergers involving clients of the firm. As was true of Vincent Chiarella, the Newman defendants' employer worked for prospective acquiring companies, while the trading took place in target company securities. As such, the Newman defendants owed no fiduciary duties to the investors with whom they traded. Moreover, neither the investment bank nor its clients traded in the target companies' shares contemporaneously with the defendants.

Unlike Chief Justice Burger's *Chiarella* dissent, the Second Circuit did not assert that the Newman defendants owed any duty of disclosure to the investors with whom they traded or had defrauded. Instead, the court held that by misappropriating confidential information for personal gain, the defendants had defrauded their employer and its clients, and this fraud sufficed to impose insider trading liability on the defendants with whom they traded.[72] As eventually refined, the (pre-*O'Hagan*) misappropriation theory thus imposed liability on anyone who: (1) misappropriated material nonpublic information; (2) thereby breaching a fiduciary duty or a duty arising out of a similar

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[68] Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

[69] See id. at 236.

[70] On the post-*Chiarella* definition of insider trading, see generally Douglas Branson, Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading, 30 Emory L.J. 263 (1981); James D. Cox, Choices: Paving the Road Toward a Definition of Insider Trading, 39 Ala. L. Rev. 381 (1988); Jill E. Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, 26 Ga. L. Rev. 179 (1991); Donald C. Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 California Law Review 1 (1982); Jonathan R. Macey, From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading, 39 Ala. L. Rev. 355 (1988); Lawrence E. Mitchell, The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back, 52 Albany L. Rev. 775 (1988); William K. S. Wang, Post-Chiarella Developments in Rule 10b-5, 15 Rev. Sec. Reg. 956 (1982); William K. S. Wang, Recent Developments in the Federal Law Regulating Stock Market Inside Trading, 6 Corp. L. Rev. 291 (1983).

[71] 664 F.2d 12 (2d Cir. 1981).

[72] See id. at 17; see also United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985).

relationship of trust and confidence; and (3) used that information in a securities transaction, regardless of whether he owed any duties to the shareholders of the company in whose stock he traded.[73]

Like the traditional disclose or abstain rule, the misappropriation theory thus required a breach of fiduciary duty before trading on inside information became unlawful.[74] The fiduciary relationship in question, however, was a quite different one. Under the misappropriation theory, the defendant did not need to owe a fiduciary duty to the investor with whom he traded, nor did he need to owe a fiduciary duty to the issuer of the securities that were traded. Instead, the misappropriation theory applied when the inside trader violated a fiduciary duty owed to the source of the information.[75] Had the misappropriation theory been available against Chiarella, for example, his conviction could have been upheld even though he owed no duties to those with whom he had traded. Instead, the breach of the duty he owed to Pandick Press would have sufficed.

The misappropriation theory should be seen as the vehicle by which the SEC sought to recapture as much as possible the ground it had lost in *Chiarella* and *Dirks*. In the years following those decisions, the SEC (and the lower courts) seemed to view the fiduciary duty element as a mere inconvenience that should not stand in the way of expansive insider trading liability. They consistently sought to evade the spirit of the fiduciary duty requirement, while complying with its letter. Even a former SEC Commissioner admitted as much, acknowledging that the misappropriation theory was "merely a pretext for enforcing equal opportunity in information."[76] Put another way, the SEC used the misappropriation theory as a means of redirecting the prohibition back towards the direction in which *Texas Gulf Sulphur* had initially set it.[77]

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[73] See United States v. Bryan, 58 F.3d 933, 945 (4th Cir. 1995).

[74] See SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (stating that it is not unlawful to trade on the basis of inadvertently overheard information).

[75] See, e.g., United States v. Carpenter, 791 F.2d 1024, 1028-29 (2d Cir. 1986) (applying misappropriation theory to a journalist who breaches his duty of confidentiality to his employer).

[76] Charles C. Cox & Kevin S. Fogarty, Bases of Insider Trading Law, 49 Ohio St. L.J. 353, 366 (1988).

[77] One of the more puzzling features of the federal insider trading prohibition is the willingness of courts to aid and abet the Commission's efforts. Although the SEC's incentive to erect a broad insider trading prohibition seems easily explainable as a matter of political economy, see infra, it is far less clear why courts would be willing to go along. Yet they have consistently done so. The *Cady, Roberts* power grab was validated by *Texas Gulf Sulphur Co.*. The reversal suffered in *Chiarella* was followed by *Newman*. The SEC's most recent reversals in *O'Hagan* and *Bryan* were swept aside by the Supreme Court. At every turn, judges have aided and abetted the SEC. For an attempt to explain this course of judicial conduct, see Stephen M. Bainbridge, Insider Trading Regulation: The Path Dependent Choice between Property Rights and Securities Fraud, 52 SMU L. Rev. 1589, 1635-40 (1999).

2. *O'Hagan* and *Bryan*: the misappropriation theory is called into question

The Supreme Court first took up the misappropriation theory in *Carpenter v. United States*,[78] in which a Wall Street Journal reporter and his confederates misappropriated information belonging to the Journal. The Supreme Court upheld the resulting convictions under the mail and wire fraud statutes, holding that confidential business information is property protected by those statutes from being taken by trick, deceit, or chicanery.[79] As to the defendants' securities fraud convictions, however, the court split 4-4. Following the long-standing tradition governing evenly divided Supreme Court decisions, the lower court ruling was affirmed without opinion, but that ruling had no precedential or stare decisis value.

The way was thus left open for lower courts to reject the misappropriation theory, which the Fourth and Eighth Circuits subsequently did in, respectively, *United States v. Bryan*[80] and *United States v. O'Hagan.*[81] These courts held that Rule 10b-5 imposed liability only where there has been deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction. Because the misappropriation theory involves no such deception, but rather simply a breach of fiduciary duty owed to the source of the information, the theory could not stand. The Supreme Court took cert in *United States v. O'Hagan* to resolve the resulting split between these circuits and the prior Second Circuit holdings validating the misappropriation theory.

3. O'Hagan: facts

James O'Hagan was a partner in the Minneapolis law firm of Dorsey & Whitney. In July 1988, Grand Metropolitan PLC (Grand Met), retained Dorsey & Whitney in connection with its planned takeover of Pillsbury Company. Although O'Hagan was not one of the lawyers on the Grand Met project, he learned of their intentions and began buying Pillsbury stock and call options on Pillsbury stock. When Grand Met announced its tender offer in October, the price of Pillsbury stock nearly doubled, allowing O'Hagan to reap a profit of more than $4.3 million.

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[78] 484 U.S. 19 (1987).

[79] The federal mail and wire fraud statutes, 18 U.S.C. §§ 1341 and 1343, respectively prohibit the use of the mails and "wire, radio, or television communication" for the purpose of executing any "scheme or artifice to defraud." The mail and wire fraud statutes protect only property rights, McNally v. United States, 483, U.S. 350 (1987), but confidential business information is deemed to be property for purposes of those statutes. Carpenter v. United States, 484 U.S. 19, 25 (1987). Hence, the Supreme Court held, the Wall Street Journal owned the information used by Winans and his co-conspirators and, moreover, that their use of the mails and wire communications to trade on the basis of that information constituted the requisite scheme to defraud. Arguably, after *Carpenter* and *O'Hagan*, if there is a Rule 10b-5 violation there will also be a mail and wire fraud violation and vice-versa.

[80] 58 F.3d 933 (4th Cir. 1995).

[81] 92 F.3d 612 (8th Cir. 1996), rev'd, 521 U.S. 642 (1997).

O'Hagan was charged with violating 1934 Act § 10(b) and Rule 10b-5 by trading on misappropriated nonpublic information. As with Chiarella and the *Newman* defendants, O'Hagan could not be held liable under the disclose or abstain rule because he worked for the bidder but traded in target company stock. He was neither a classic insider nor a constructive insider of the issuer of the securities in which he traded.[82]

4. *O'Hagan*: issues

Both § 10(b) and Rule 10b-5 sweep broadly, capturing "any" fraudulent or manipulative conduct "in connection with" the purchase or sale of "any" security. Despite the almost breathtaking expanse of regulatory authority Congress thereby delegated to the Commission, the Supreme Court has warned against expanding the concept of securities fraud beyond that which the words of the statute will reasonably bear.[83] The validity of the misappropriation theory thus depends upon whether (1) the deceit, if any, worked by the misappropriator on the source of the information constitutes deception as the term is used in § 10(b) and Rule 10b-5 and (2) any such deceit is deemed to have occurred "in connection with" the purchase or sale of a security.

Deceit on the source of the information; herein of *Santa Fe*. In *Bryan*, the Fourth Circuit defined fraud—as the term is used in § 10(b) and Rule 10b-5—"as the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose."[84] So defined, fraud is present in a misappropriation case only in a technical and highly formalistic sense. Although a misappropriator arguably deceives the source of the information, any such deception is quite inconsequential. The source of the information presumably is injured, if at all, not by the deception, but by the conversion of the information by the misappropriator for his own profit. Hence, it is theft—and any concomitant breach of fiduciary duty—by the misappropriator that is truly objectionable. Any deception on the source of the information is purely incidental to the theft. Accordingly, the Fourth Circuit held, the misappropriation theory runs afoul of the Supreme Court's holding in *Santa Fe* that a mere breach of duty cannot give rise to Rule 10b-5 liability.[85]

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[82] O'Hagan was also indicted for violations of Rule 14e-3, which proscribes insider trading in connection with tender offers, and the federal mail fraud and money laundering statutes. The Eighth Circuit overturned O'Hagan's convictions under those provisions. As to Rule 14e-3, the court held that the SEC lacked authority to adopt a prohibition of insider trading that does not require a breach of fiduciary duty. *O'Hagan*, 92 F.3d at 622-27. As to O'Hagan's mail fraud and money laundering convictions, the Eighth Circuit also reversed them on grounds that the indictment was structured so as to premise the charges under those provisions on the primary securities fraud violations. Id. at 627-28. Accordingly, in view of the court's reversal of the securities fraud convictions, the latter counts could not stand either. The Supreme Court reversed on all points, reinstating O'Hagan's convictions under all of the statutory violations charged in the indictment. United States v. O'Hagan, 521 U.S. 642 (1997).

[83] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164, 174 (1994).

[84] 58 F.3d at 946.

[85] See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476 (1977). See generally Bainbridge, supra note 22, at 1258-61 (discussing the federalism implications of insider trading regulations);

Santa Fe had attempted to freeze out minority shareholders of one of its subsidiaries by means of a statutory short-form merger. While plaintiff-shareholders had a state law remedy available in the statutory appraisal rights provision, they sought redress under Rule 10b-5 instead. They claimed that the merger violated Rule 10b-5 because the deal was effected without prior notice to the minority shareholders and was done without any legitimate business purpose. They also claimed that their shares had been fraudulently under-valued. In holding that plaintiffs had failed to state a cause of action under Rule 10b-5, the Supreme Court opined that § 10(b) and Rule 10b-5 were only intended to reach deception and manipulation—neither of which was present in the case at bar.[86]

Santa Fe's requirement that conduct involve deception in order to fall within Rule 10b-5's scope featured prominently in the reasoning of those circuit courts that rejected the misappropriation theory. In *Bryan*, for example, the Fourth Circuit opined that "the misappropriation theory does not even require deception, but rather allows the imposition of liability upon the mere breach of fiduciary relationship or similar relationship of trust and confidence."[87] And, as such, ran afoul of *Santa Fe*.

Of even greater potential relevance to the problem at hand, however, is the *Santa Fe* Court's concern that a decision in favor of the plaintiffs would result in federalizing much of state corporate law.[88] *Santa Fe* is part of a long line of securities law cases in which the Supreme Court came down on the states side of federalism disputes. For example, the Court has emphasized that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law,"[89] from which the Court extrapolated the proposition that "it . . . is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."[90] In keeping with that principle, the Court emphasized that state law governs the rights and duties of corporate directors: "As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. . . . 'Corporations

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Richard W. Painter et al., Don't Ask, Just Tell: Insider Trading after United States v. O'Hagan, 84 Va. L. Rev. 153, 174-86 (1998) (same); Larry E. Ribstein, Federalism and Insider Trading, 6 Sup. Ct. Econ. Rev. 123, 149-54 (1998) (same).

86 See *Santa Fe*, 430 U.S. at 472.

87 *Bryan*, 58 F.3d at 949. This interpretation of the misappropriation theory is clearly incorrect post-*O'Hagan*, in light of the Supreme Court's clear requirement that the source of the information be deceived, and arguably misreads the pre-*O'Hagan* circuit court decisions endorsing the theory. Although courts adopting the misappropriation theory recognized that Rule 10b-5 only encompasses fraud and manipulation, they held that the deception the misappropriator works on the source of the information suffices to impose liability on him. See, e.g., United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991).

88 See *Santa Fe*, 430 U.S. at 478-79.

89 CTS Corp. v. Dynamics Corp., 481 U.S. 69, 89 (1987).

90 Id. at 91. See also id. at 89 ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations....").

are creatures of state law' . . . and it is state law which is the font of corporate directors' powers."[91]

The insider trading prohibition co-exists uneasily with these principles, at best. In *Santa Fe*, for example, the Court held that Rule 10b-5 did not reach claims "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary."[92] Yet, this is the very essence of the complaint made in insider trading cases. The Court also held that extension of Rule 10b-5 to breaches of fiduciary duty was unjustified in light of the state law remedies available to plaintiffs. Likewise, insider trading plaintiffs have available state law remedies. Granted, these remedies vary from state to state and are likely to prove unavailing in many cases. The same was true, however, of the state law remedy at issue in *Santa Fe*. Finally, the Court expressed reluctance "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[93] But this is precisely what the federal insider trading prohibition did.

Santa Fe thus loomed as a substantial obstacle for proponents of an insider trading prohibition grounded in securities fraud. As the Fourth Circuit put it: "the misappropriation theory transforms § 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships."[94] It thus amounts to "the effective federalization of [fiduciary] relationships historically regulated by the states,"[95] which is precisely what *Santa Fe* was intended to prevent.

The "in connection with" requirement; herein of *Central Bank*. According to the Eighth Circuit's *O'Hagan* opinion, "the misappropriation theory does not require 'deception,' and, even assuming that it does, it renders nugatory the requirement that the 'deception' be 'in connection with the purchase or sale of any security,'" as required by the text of § 10(b).[96] As such, the Eighth Circuit held that the theory ran afoul of the Supreme Court's *Central Bank*[97] decision.

Central Bank held the text of § 10(b) to be dispositive with respect to the scope of conduct regulated by that section. The Eighth Circuit interpreted the statutory prohibition of fraud created by § 10(b) narrowly to exclude conduct constituting a "mere breach of a fiduciary duty," but rather to capture only conduct constituting a material misrepresentation or the nondisclosure of material information in violation of the duty to

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[91] Burks v. Lasker, 441 U.S. 471, 478 (1979) (citations omitted).

[92] *Santa Fe*, 430 U.S. at 477.

[93] Id. at 479.

[94] See *Bryan*, 58 F.3d at 950.

[95] Id. at 951.

[96] *O'Hagan*, 92 F.3d at 617.

[97] Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994).

disclose.[98] Insofar as the misappropriation theory permits the imposition of § 10(b) liability based upon a breach of fiduciary duty without any such deception, the Eighth Circuit held that the theory was inconsistent with the plain statutory text of § 10(b) and, accordingly, invalid as per *Central Bank*.

The Eighth Circuit's principal rationale for rejecting the misappropriation theory, however, was based on the statutory limitation that the fraud be committed "in connection with" a securities transaction. Again relying upon the Supreme Court's *Central Bank* decision, the *O'Hagan* court gave this provision a narrow interpretation. Specifically, the court held that § 10(b) reaches "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors."[99] Absent such a limitation, the court opined, § 10(b) would be transformed "into an expansive 'general fraud-on-the-source theory' which seemingly would apply infinite number of trust relationships."[100] Such an expansive theory of liability, the court further opined, could not be justified by the text of statute.

In the typical misappropriation case, of course, the source of the information is not the affected purchaser or seller. Often the source is not even a contemporaneous purchaser or seller and frequently has no stake in any affected securities transaction. In *Carpenter*, for example, the Wall Street Journal was neither a purchaser nor seller of the affected securities, nor did it have any financial stake in any of the affected transactions. Similarly, in *Bryan*, the state of West Virginia was not a purchaser or seller, and had no direct stake in Bryan's securities transactions. In neither case did the defendant fail to disclose material information to a market participant to whom he owed a duty of disclosure. One thus must stretch the phrase "in connection with" pretty far in order to bring a misappropriator's alleged fraud within the statute's ambit, even assuming the misappropriator has deceived the source of the information . As the Fourth Circuit put it: "The misappropriation of information from an individual who is in no way connected to, or even interested in, securities is simply not the kind of conduct with which the securities laws, as presently written, are concerned."[101]

The Eighth and Fourth Circuits' interpretation of § 10(b) has much to commend it. The courts carefully considered the Supreme Court's relevant precedents, especially *Santa Fe* and *Central Bank*. Insofar as the misappropriation theory imposes liability solely on the basis of a breach of fiduciary duty to the source of the information, without any requirement that the alleged perpetrator have deceived the persons with whom he traded or other market participants, it arguably ran afoul of those precedents. As the Eighth Circuit opined, the lower court decisions endorsing the misappropriation theory had generally failed to conduct a rigorous analysis of § 10(b)'s text or the pertinent Supreme

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98 *O'Hagan*, 92 F.3d at 617-18.

99 Id. at 618. In *Bryan*, the Fourth Circuit similarly opined § 10(b) is primarily concerned with deception of purchasers and sellers of securities, and at most extends to fraud committed against other persons closely linked to, and with a stake in, a securities transaction. 58 F.3d at 946.

100 *O'Hagan*, 92 F.3d at 619 (quoting *Bryan*, 58 F.3d at 950).

101 *Bryan*, 58 F.3d at 950.

Court decisions. Indeed, in a telling passage of his partial dissent to a leading Second Circuit opinion endorsing and fleshing out the misappropriation theory, Judge Winter (a former corporate law professor at Yale) stated the misappropriation theory lacked "any obvious relationship" to the statutory text of § 10(b) because "theft rather than fraud or deceit" had become "the gravamen of the prohibition."[102] In light of these considerations, reconciling the insider trading prohibition with *Central Bank* loomed as one of the major doctrinal problems facing the Supreme Court in *O'Hagan*.[103]

5. *O'Hagan*: holding

In *O'Hagan*, a majority of the Supreme Court upheld the misappropriation theory as a valid basis on which to impose insider trading liability. A fiduciary's undisclosed use of information belonging to his principal, without disclosure of such use to the principal, for personal gain constitutes fraud in connection with the purchase or sale of a security, the majority (per Justice Ginsburg) opined, and thus violates Rule 10b-5.[104]

The court acknowledged that misappropriators such as O'Hagan have no disclosure obligation running to the persons with whom they trade. Instead, it grounded liability under the misappropriation theory on deception of the source of the information. As the majority interpreted the theory, it addresses the use of "confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[105] Under this theory, the majority explained, "a fiduciary's undisclosed, self serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[106] So defined, the majority held, the misappropriation theory satisfies § 10(b)'s requirement that there be a "deceptive device or contrivance" used "in connection with" a securities transaction.[107]

Status of *Central Bank*: As we have just seen, the tension between *Central Bank* and the insider trading prohibition was a major doctrinal issue facing the court in *O'Hagan*.

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[102] United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part).

[103] See generally Bainbridge, supra note 77, at 1613-18 (discussing doctrinal and policy questions implicated by the circuit courts' effort to extend *Central Bank* to the insider trading context).

[104] United States v. O'Hagan, 521 U.S. 642 (1997). See generally Donna Nagy, Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan* Suggestion, 59 Ohio St. L.J. 1223 (1998).

[105] Id. at 652.

[106] Id.

[107] The Supreme Court thus rejected Chief Justice Burger's argument in *Chiarella* that the misappropriation theory created disclosure obligation running to those with whom the misappropriator trades. *O'Hagan*, 521 U.S. at 655 n.6. Instead, it is the failure to disclose one's intentions to the source of the information that constitutes the requisite disclosure violation under the *O'Hagan* version of the misappropriation theory. Id. at 653-55.

Surprisingly, however, the majority essentially punted on this issue. The majority ignored both the statutory text, except for some rather glib assertions about the meaning of the phrases “deception” and “in connection with,” and the cogent arguments advanced by both the Eighth and Fourth Circuits with respect to the implications of *Central Bank* for the misappropriation theory. To the extent the majority discussed *Central Bank*’s implications for the problem at hand, it focused solely on the Eighth Circuit’s argument that *Central Bank* limited Rule 10b-5’s regulatory purview to purchasers and sellers. The interpretive methodology expounded in *Central Bank* was essentially ignored. One is therefore left to wonder whether the strict textualist approach taken by *Central Bank* was a one time aberration.

The majority’s failure to more carefully evaluate *Central Bank*’s implications for the phrase “in connection with,” as used in § 10(b), is especially troubling. By virtue of the majority’s holding that deception on the source of the information satisfies the “in connection with” requirement, fraudulent conduct having only tenuous connections to a securities transaction is brought within Rule 10b-5’s scope. There has long been a risk that Rule 10b-5 will become a universal solvent, encompassing not only virtually the entire universe of securities fraud, but also much of state corporate law. The minimal contacts *O’Hagan* requires between the fraudulent act and a securities transaction substantially exacerbate that risk. In addition to the risk that much of state corporate law may be preempted by federal developments under Rule 10b-5, the uncertainty created as to Rule 10b-5’s parameters fairly raises vagueness and related due process issues,[108] despite the majority’s rather glib dismissal of such concerns.

Status of *Santa Fe*: The majority opinion treated *Santa Fe* as a mere disclosure case, asserting: “in *Santa Fe Industries*, all pertinent facts were disclosed by the persons charged with violating § 10(b) and Rule 10b-5; therefore, there was no deception through nondisclosure to which liability under those provisions could attach.”[109] The court thus wholly ignored the important federalism concerns upon which *Santa Fe* rested and which are implicated by the misappropriation theory (indeed, by the insider trading prohibition as a whole).

6. Open questions

In many respects, *O’Hagan* posed more new questions than it answered old ones. Here are some of the more interesting and important issues it left open:

Liability for brazen misappropriators? The *O’Hagan* majority made clear that disclosure to the source of the information is all that is required under Rule 10b-5. If a brazen misappropriator discloses his trading plans to the source, and then trades on that information, Rule 10b-5 is not violated, even if the source of the information refused

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[108] See Painter et al., supra note 85, at 196-200.

[109] *O’Hagan*, 521 U.S. at 655.

permission to trade and objected vigorously.[110] If this rule seems odd, so did the majority's justification for it.

According to the majority, "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law," because they suffer from "a disadvantage that cannot be overcome with research or skill."[111] As such, the majority claimed, the misappropriation theory advances "an animating purpose of the Exchange Act: to ensure honest securities markets and thereby promote investor confidence."[112]

The difficulties with this argument should be readily apparent. Investors who trade with a brazen misappropriator presumably will not feel any greater confidence in the integrity of the securities market if they later find out that the misappropriator had disclosed his intentions to the source of the information. Worse yet, both the phraseology and the substance of the majority's argument plausibly could be interpreted as resurrecting the long-discredited equal access test.[113] If the goal of insider trading law in fact is to insulate investors from information asymmetries that cannot be overcome by research or skill, the equal access test is far better suited to doing so than the current test.

Merely requiring the prospective misappropriator to disclose his intentions before trading also provides only weak protection of the source of the information's property rights therein. To be sure, because of the disclosure requirement concerns about detecting improper trading are alleviated. As the majority pointed out, moreover, the source may have state law claims against the misappropriator. In particular, the agency law prohibition on the use of confidential information for personal gain will often provide a remedy to the source. In some jurisdictions, however, it is far from clear whether inside trading by a fiduciary violates state law. Even where state law proscribes such trading, the Supreme Court's approach means that in brazen misappropriator cases we lose the comparative advantage the SEC has in litigating insider trading cases and, moreover, also lose the comparative advantage provided by the well-developed and relatively liberal remedy under Rule 10b-5.

Liability for authorized trading? Suppose a takeover bidder authorized an arbitrageur to trade in a target company's stock on the basis of material nonpublic information about the prospective bidder's intentions. Warehousing of this sort is proscribed by Rule 14e-3, but only insofar as the information relates to a prospective tender offer. Whether such trading in a nontender offer context violated Rule 10b-5 was unclear before *O'Hagan*.

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110 *O'Hagan*, 521 U.S. at 655 ("full disclosure forecloses liability under the misappropriation theory . . . if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation").

111 Id. at 658-59.

112 Id. at 658.

113 For an argument that *O'Hagan* is premised on equal access-related concerns, see Elliott J. Weiss, United States v. O'Hagan: Pragmatism returns to the Law of Insider Trading, 23 J. Corp. L. 395 (1998).

The *O'Hagan* majority at least implicitly validated authorized trading. It approvingly quoted, for example, the statement of the government's counsel that "to satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent."[114] On the facts of *O'Hagan*, as the majority indicated, insiders would need approval from both Dorsey & Whitney and Grand Met in order to escape Rule 10b-5 liability. Is it plausible that Grand Met would have given such approval? Maybe. Warehousing of takeover stocks and tipping acquisition plans to friendly parties were once common—hence the need for Rule 14e-3—and probably still occurs.

Notice the interesting question presented by the requirement that O'Hagan disclose his intentions to Dorsey & Whitney. Given that O'Hagan was a partner in Dorsey & Whitney, query whether his knowledge of his intentions would be imputed to the firm. As a practical matter, of course, O'Hagan should have informed the lawyer with the principal responsibility for the Grand Met transaction and/or the firm's managing partner.

The authorized trading dictum has significant, but as yet little-noticed, implications. Query, for example, whether it applies to all insider trading cases or just to misappropriation cases. Suppose that in a classic disclose or abstain case, such as *Texas Gulf Sulphur*, the issuer's board of directors adopted a policy of allowing insider trading by managers. If they did so, the corporation has consented to any such inside trading, which under Justice Ginsburg's analysis appears to vitiate any deception. The corporate policy itself presumably would have to be disclosed, just as broad disclosure respecting executive compensation is already required, but the implication is that authorized trading should not result in 10b-5 liability under either misappropriation or disclose or abstain theory of liability.

On the other hand, the two theories can be distinguished in ways that undermine application of the authorized trading dictum to disclose or abstain cases. In a misappropriation case, such as *Carpenter*, liability is premised on fraud on the source of the information. In *Carpenter*, acting through appropriate decision making processes, the Journal could authorize inside trading by its agents. By contrast, however, *Chiarella* focused the classic disclose or abstain rule on fraud perpetrated on the specific investors with whom the insiders trade. Authorization of inside trading by the issuer's board of directors, or even a majority of the shareholders, does not constitute consent by the specific investors with whom the insider trades. Nothing in *O'Hagan* explicitly suggests an intent to undermine the *Chiarella* interpretation of the traditional disclose or abstain rule. To the contrary, Justice Ginsburg expressly states that the two theories are "complementary." Because the disclose or abstain rule thus remains conceptually distinct from the misappropriation theory, the authorized trading dictum can be plausibly limited to the latter context.

The fiduciary relationship requirement. Does a duty to disclose to the source of the information arise before trading in all fiduciary relationships? Consider ABA Model Rule of Professional Conduct 1.8(b), which states: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents

[114] *O'Hagan*, 521 U.S. at 654.

after consultation . . ..” Does a lawyer’s use of confidential client information for insider trading purposes always operate to the client’s disadvantage? If not, and assuming the Model Rule accurately states the lawyer’s fiduciary obligation, O’Hagan did not violate § 10(b).

The *O’Hagan* majority, however, failed to inquire into the nature of O’Hagan’s duties, if any, to Grand Met. Instead, the majority assumed that lawyers are fiduciaries, all fiduciaries are subject to a duty to refrain from self dealing in confidential information, and, accordingly, that the misappropriation theory applies to lawyers and all other fiduciaries. The majority’s approach, of course, begs the question—how do we know O’Hagan is a fiduciary?

Criminal or civil? In rejecting the Eighth Circuit’s argument that Rule 10b-5 is primarily concerned with deception of market participants, the majority noted that the discussion in *Central Bank* upon which the Eighth Circuit relied dealt only with private civil litigation under § 10(b). The court then went on to discuss its holding in *Blue Chip Stamps*[115] that only actual purchasers or sellers of securities have standing to bring private causes of action under Rule 10b-5. The court concluded: “Criminal prosecutions do not present the dangers the Court addressed in *Blue Chip Stamps*, so that decision is ‘inapplicable’ to indictments for violations of § 10(b) and Rule 10b-5.”[116]

This passage opens the door for misappropriators to argue that *O’Hagan* should be limited to criminal prosecutions, because the majority acknowledged the limitations imposed by *Central Bank* and *Blue Chip Stamps* on private party litigation. Such a limitation on private party litigation, however, seems unlikely. Although the majority declined to address the significance of the 1988 statute and its legislative history for the validity of the misappropriation theory, interpreting *O’Hagan* as validating the misappropriation theory only as to criminal actions would render the private party cause of action created by Exchange Act §20A nugatory.

V. Elements of the modern prohibition

A. Material nonpublic information

1. Materiality

In cases arising under § 10(b) and Rule 10b-5, liability arises only with respect to the misuse of material information. Materiality is defined for this purpose as whether there is a substantial likelihood that a reasonable investor would consider the omitted fact important in deciding whether to buy or sell securities.[117] Where a fact is contingent or speculative, such as was the case in *Texas Gulf Sulphur*, materiality is determined by

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[115] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[116] *O’Hagan*, 521 U.S. at 665.

[117] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

balancing the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company's activity.[118]

In a case like *Texas Gulf Sulphur*, it is just as important to determine when the information in question became material as it is to determine whether the information was material. Consider how the materiality standard would apply at two critical dates: November 12, when the visual assay indicated a potentially significant ore strike, and April 7, when the results of additional test holes confirmed that mining would be commercially viable.

Under these standards, the ore discovery was certainly material as of April 7. The additional test holes had confirmed that the initial core sample was not an aberration—TGS really had a major find on its hands. After April 7, the critical issue is not whether the strike will pay off, but when. The balancing test thus is not at issue, because we are no longer dealing with a contingent fact. Given the size of the discovery, this was certainly information any reasonable investor would consider significant.

It is less clear that the information known on November 12th would be regarded as material as of that date. Before April there was only one core sample. While that sample was remarkable, only a highly trained geologist would be able to draw conclusions from it. Since it would take a highly sophisticated investor with considerable expertise in mining operations to understand the relevance of the find, perhaps the hypothetical reasonable investor would not consider it important. On the other hand, however, there was testimony from a stock broker that one good test hole was a signal to buy mining stock.[119]

One might also consider the response of the company and the insiders. The firm's decision to acquire options on the surrounding land tends to point towards a finding of materiality. According to the court, so did the insiders' own trading conduct, although this is a somewhat dubious proposition in view of the resulting bootstrapping effect.[120]

2. Nonpublic Information: When can insiders trade?

When can insiders start trading in their company's securities, if ever? The simple answer is that insiders who do not possess (or, perhaps, use) material nonpublic information may trade freely. Timing questions arise, however, when an insider trades contemporaneously with public disclosure of the material nonpublic information in his or her possession. In such cases, the insider may only trade after the information in question has been made public. The difficulty, of course, is knowing whether or not the information in question has entered the public domain. Because insiders with access to confidential information trade at their own risk, this timing issue is a critical question.

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[118] Id. at 238-39.

[119] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850-51 (2d. Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[120] Id. at 851.

Texas Gulf Sulphur again is instructive.[121] The ore strike was first announced by a press release to the Canadian news media disseminated at 9:40 a.m. on April 16, 1964. A news conference with the American media followed at 10 a.m. on the same day. The news appeared on the Dow Jones ticker tape at 10:54 a.m. that day. Defendant Crawford had telephoned his stockbroker at midnight on the 15th with instructions to buy TGS stock when the Midwest Stock Exchange opened the next morning. Defendant Coates left the April 16th news conference to call his stockbroker shortly before 10:20 a.m. In addition to executing Coates' order, the broker ordered an additional 1500 TGS shares for himself and other customers. Crawford and Coates conceded that they traded while in possession of material information, but claimed that the information had been effectively disseminated to the public (and thus had lost its nonpublic character) before their trades were executed.

The court disagreed, holding that before insiders may act upon material information, the information must have been disclosed in a manner that ensures its availability to the investing public.[122] Merely waiting until a press release has been read to reporters, as Coates did, is not enough. The information must have been widely disseminated and public investors must have an opportunity to act on it. At a minimum, the court opined, insiders therefore must wait until the news could reasonably be expected to appear over the Dow Jones ticker tape—the news service that transmits investment news to brokers and investment professionals.[123]

Unlike other aspects of *Texas Gulf Sulphur*, this rule is still good law today. It also makes good policy sense. The efficient capital markets hypothesis tells us that all currently available public information about a corporation is reflected in the market price of its securities. However, the hypothesis depends on the ability of investment professionals to adjust their selling and offering prices to reflect that information. By requiring that insiders wait until the news has gone out over the Dow Jones wire, the court assured that brokers would have the information before trading; in other words, the price should have already started rising (or falling, as the case may be) to reflect the new information.

While the *Texas Gulf Sulphur* standard works well for the sort of dramatic, one-time event news at issue there, it works less well for the more mundane sorts of nonpublic information to which insiders routinely have access. A corporation always has undisclosed information about numerous different aspects of its business. By the time all of that information has been disseminated publicly, moreover, new undisclosed information doubtless will have been developed. In response to this concern, many firms have developed policies pursuant to which insiders may only trade during a specified window of time after the corporation has issued its quarterly and annual reports. Per SEC regulations, public corporations must send an annual report to the shareholders and also file a Form 10-Q after each of the first three quarters of their fiscal year and a Form 10-K

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[121] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[122] Id. at 854.

[123] Id.

after year's end. Because of the substantial and wide-ranging disclosures required in these reports, which are publicly available, there is a relatively low probability that an insider who trades during the time immediately following their dissemination will be deemed to have traded on material nonpublic information. As *Texas Gulf Sulphur* suggests, however, the insider may not trade the moment the report goes in the mail. Instead, the insider must wait until the market has had time to digest the report. In any event, of course, an insider who knows that he or she possesses material information that was not disclosed in the report must refrain from trading at all times—whether or not the corporation has released a periodic disclosure report.

B. The requisite fiduciary relationship

After *Chiarella*, liability for insider trading could be imposed only on persons who owe fiduciary duties to those with whom they trade: agents, fiduciaries, persons in whom the investors had placed their trust and confidence.[124] Unfortunately, the Supreme Court has failed to do a very good job of fleshing out this requirement. Is it enough that a fiduciary relationship exist, without any breach of the duties arising out of it? If a breach is required, which duty must be breached? What law determines whether the requisite fiduciary relationship and/or breach of duty is present in a particular fact pattern? Under state law, for example, corporate officers and directors generally owe no fiduciary duty to bondholders. Can insiders therefore inside trade in debt securities with impunity? Although corporate officers and directors owe fiduciary duties to their shareholders, we've seen that in many states insider trading does not breach those duties. Can insiders of firms incorporated in those states inside trade with impunity?

1. Defining the fiduciary duty requirement

In both *Chiarella* and *Dirks*, the Supreme Court frequently spoke of the need to show the existence of a "fiduciary relationship" as a predicate to liability.[125] Yet, surely that is not enough. As Justice Frankfurter put it, albeit in a different context, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations?"[126] In other words, it should not be enough to establish the existence of a fiduciary relationship. Before liability can be imposed one must also

[124] "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," and no such duty arises "from the mere possession of nonpublic market information." Chiarella v. United States, 445 U.S. 222, 235 (1980). Thus, there can be no duty to disclose where the person who has traded on or tipped inside information "was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Id. at 232; accord Dirks v. SEC, 463 U.S. 646, 653-55 (1983).

[125] E.g., Dirks v. SEC, 463 U.S. 646, 654 (1983); Chiarella v. United States, 445 U.S. 222, 232 (1980).

[126] SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

establish that the defendant violated a fiduciary duty arising out of the fiduciary relationship in question.[127]

In any fiduciary relationship, however, a variety of duties may arise. Which is the duty whose violation triggers insider trading liability? Again, the Court has not been very precise on this score. It has spoken mainly of a duty to disclose before trading.[128] While so describing the duty perhaps sufficed for purposes of applying the disclose or abstain rule to trading insiders, it created analytical problems when the insider tipped information rather than trading on it. The duty to disclose phraseology created even greater problems when the misappropriation theory was created. Given that Chiarella owed no fiduciary duties to the investors with whom he traded, for example, he plainly owed those investors no duty to disclose nonpublic information before trading.

Faced with these problems, some lower courts switched the inquiry to whether the defendant was subject to a duty of confidentiality.[129] Using a duty of confidentiality as the requisite fiduciary duty, however, makes little sense in the insider trading context. Unlike most types of tangible property, the same piece of information can be used by more than one person at the same time; an insider's use of the information, moreover, does not necessarily lower its value to its owner. When an executive that has just negotiated a major contract for his employer thereafter inside trades in the employer's stock, for example, the value of the contract to the employer has not been lowered nor, absent some act of disclosure, has the executive violated his duty of confidentiality. Using nonpublic information for personal gain thus is not inconsistent with a duty of confidentiality, unless one's trades somehow reveal the information.

The fiduciary duty requirement therefore should be satisfied only by a duty to refrain from self dealing in nonpublic information. This conclusion finds considerably greater support in *Dirks* than does the duty of confidentiality approach. Justice Powell, for example, described the elements of an insider trading violation as: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[130] Another passage likewise

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[127] This conclusion is supported by the Supreme Court's treatment of tippee liability. It is not enough to show that the tipper was party to a fiduciary relationship with the source of the information. As we have seen, there must also be a breach of the tipper's fiduciary duty before tippee liability can result. That this requirement extends to insider trading liability generally seems reasonably clear from *Dirks*' discussion of *Chiarella*. See *Dirks*, 463 U.S. at 653-54.

[128] See, e.g., *Dirks*, 463 U.S. at 654; *Chiarella*, 445 U.S. at 235.

[129] See, e.g., United States v. Libera, 989 F.2d 596 (2d Cir. 1993), cert. denied, 510 U.S. 976 (1993); United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987). Note that these cases arose in the employment context, in which it is thought that an implicit duty to refrain from self dealing is created by agency law. Those courts thus did not have to face, let alone resolve, the potential disparity between a duty of confidentiality and a duty to refrain from self dealing.

[130] *Dirks*, 463 U.S. at 653-54 (quoting Chiarella v. United States, 445 U.S. 222, 227 (1980)).

described insider trading liability as arising from "the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"[131] Yet another noted that insiders are "forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage."[132] The focus in each instance is on the duty to refrain from self dealing.

The emphasis on self dealing, rather than confidentiality, is further confirmed by the result in *Dirks*. Secrist violated his duty of confidentiality by disclosing the information to Dirks. Yet, the fact of the tip alone did not suffice for liability to be imposed. Rather, as we have seen, the court held that liability could be imposed only if Secrist had made the tip for personal gain, in other words, only if the tip involved self dealing. Hence, mere violation of the duty of confidentiality is not enough. Rather, a duty to disclose before trading arises only if trading would violate a duty to refrain from self dealing in confidential information owed by the trader to the owner of that information.

2. A state or federal duty?

Having identified the requisite fiduciary duty, a question remains: Whence comes that duty? Courts and commentators uniformly treat the *Chiarella* fiduciary duty as a species of federal law. True enough, in the sense that the underlying cause of action arises under federal law. But while the prohibition is tied to a federal statute and the regulations there under, we have seen that there is nothing in either the text or legislative history of Exchange Act § 10(b) or Rule 10b-5 to support the modern substantive definition of insider trading. Instead, it is wholly a judicial creation. Like the rest of modern Rule 10b-5 jurisprudence, the definition of insider trading is "a judicial oak which has grown from little more than a legislative acorn."[133] The federal insider trading prohibition thus is best classified within the genus of federal common law. It is an example of interstitial lawmaking in which the courts are using common-law adjudicatory methods to flesh out the bare statutory bones.[134]

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[131] Id. at 654 (quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

[132] Id. at 659.

[133] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Even a former SEC solicitor admits that "modern development of the law of insider trading is a classic example of common law in the federal courts. No statute defines insider trading; no statute expressly makes it unlawful." Paul Gonson & David E. Butler, In Wake of '*Dirks*,' Courts Debate Definition of 'Insider,' Legal Times, Apr. 2, 1984, at 16.

Gabaldon notes that federal courts have often borrowed state law to define the elements of the implied cause of action under Rule 10b-5. Theresa A. Gabaldon, State Answers to Federal Questions: The Common Law of Federal Securities Regulation, 20 J. Corp. L. 156, 160 (1994). As we do, she treats the insider trading prohibition as a species of federal common law in which courts should borrow state law. Id. at 198-99.

[134] Pre-*O'Hagan*, it appeared that this conclusion would run afoul of *Central Bank* and other recent Supreme Court decisions in which the Court adopted a narrow approach to interpreting

Once the problem is seen as one to be solved by application of federal common law, a choice of law question arises. Federal common law often is influenced by, and not infrequently incorporates, state law. In *Burks v. Lasker*,[135] for example, a shareholder of a federally regulated investment company brought suit under the federal securities laws against the company's board of directors. The Supreme Court held that state law controls the board of directors' ability to use a special litigation committee to terminate the litigation. In *Kamen v. Kemper Financial Services, Inc.*,[136] the Court extended *Burks*, describing the federal law governing derivative suits brought under the Investment Company Act as a species of federal common law, and incorporating state law governing excusal of the demand requirement in such suits. Until quite recently, for another example, the federal courts applied state statutes of limitation to private party lawsuits under Rule 10b-5. Although the Supreme Court adopted a unique federal limitations period in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[137] the Court indicated that it would continue to borrow state statutes of limitations in appropriate cases.

To be sure, while many of these examples involve the use of state common law to fill the interstices of the federal securities laws, and thus suggest that state law could appropriately play a role in insider trading prohibition as well, none directly addresses the use of state common law to define the elements of a federal claim. This too is possible, however. In *DeSylva v. Ballentine*,[138] for example, the court looked to the state law definition of "children" for purposes of interpreting a federal statute.

In light of these precedents, the question is not whether state law is relevant to the task of defining insider trading, but rather the extent to which it should be incorporated into the federal prohibition. In particular, the question at hand is the extent to which state law fiduciary duty concepts should be incorporated into the fiduciary duty requirement established by *Chiarella* and its progeny. In answering that question, courts have two options. First, they may create a unique rule of federal common law that applies uniformly throughout the nation. The courts could draw on state law by analogy in doing so, but the rule would remain wholly federal. Second, they may adopt state law as the federal rule. If this option is selected, the substantive content of the federal rule will vary depending on which state's law controls.

Yet again, this is a question the Supreme Court failed to answer with clarity. On the one hand, the *Dirks* court contended "that '[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal

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Rule 10b-5 that purports to focus on the text of the rule and § 10(b). See Bainbridge, supra note 22, at 1201-07. As we have seen, however, O'Hagan blithely ignored those doctrinal complications.

[135] 441 U.S. 471 (1979).

[136] 500 U.S. 90 (1991).

[137] 501 U.S. 350 (1991).

[138] 351 U.S. 570 (1956).

emolument of corporate office.'"[139] If so, one would assume that the fiduciary duty arises out of federal law. As we have seen, however, this contention is at best an overstatement.

The Court's repeated references to a "*Cady, Roberts* duty" may also point towards a federal source for the requisite duty. There is at least the implication that *Cady, Roberts* created a federal duty to refrain from self dealing in confidential information, which has become part of the overall bundle of fiduciary duties to which insiders are subject. This analysis, however, suffers from two flaws. First, it reads an awful lot into some vague passages of both *Dirks* and *Cady, Roberts*. Second, as we shall see, creation of such a duty is inconsistent with the Court's holding in *Santa Fe*.

On the other hand, the *Dirks* Court also implied that the requisite duty arose out of state common law:

> In the seminal case of In re Cady, Roberts & Co., the SEC recognized that the common law in some jurisdictions imposes on "corporate 'insiders,' particularly officers, directors, or controlling shareholders" an "affirmative duty of disclosure . . . when dealing in securities." The SEC found that . . . breach of this common law duty also establish[ed] the elements of a Rule 10b-5 violation . . . .[140]

In other words, the federal securities laws are violated only upon breach of this purported state common-law duty. This interpretation of *Dirks* also would seem to be supported by the misappropriation theory: The focus in most misappropriation cases is on violation of duties arising out of the employment relationship, which in turn implicates agency law and thus points towards a state law source for the requisite duty.

How then should courts choose between these options? Unfortunately, the standards governing that choice are not particularly well-developed. The basic test, however, is the impact incorporation of state law would have on the relevant federal statutory policies. In *Lampf*, for example, the Court created a unique federal statute of limitations for implied federal rights of action because borrowing a state limitations rule would frustrate the purpose of the underlying federal statute.[141] In *Burks*, the Court used state law to fill the interstices of a federal statute affecting the powers of directors because doing so did not permit acts prohibited by the federal statute and was otherwise not inconsistent with the statutory policy.[142] In *Kemper Financial Services*, the Court reaffirmed what it termed "the basic teaching of Burks v. Lasker: Where a gap in the federal securities laws must be bridged by a rule that bears on the allocation of governing powers within the corporation, federal courts should incorporate state law into federal common law unless the particular

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[139] Dirks v. SEC, 463 U.S. 646, 653 n.10 (1983) (quoting In re Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

[140] Id. at 653. In a noninsider trading case, the Seventh Circuit interpreted *Dirks* as holding that "the existence of a requirement to speak [under Rule 10b-5] . . . is itself based on state law . . . ." Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 436 (7th Cir. 1987), cert. dismissed, 485 U.S. 901 (1988).

[141] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 356 (1991).

[142] Burks v. Lasker, 441 U.S. 471, 479 (1979).

state law in question is inconsistent with the policies underlying the federal statute."[143] The bottom line then is whether there are important federal interests that would be adversely affected by adopting state law fiduciary duty principles as the federal rule of decision.[144]

What federal interests might be adversely affected by incorporation of state common law as the source of the requisite fiduciary duties?[145] Here are some possibilities:

- Some contend that Congress intended to prohibit insider trading. If so, and if incorporation of state law would make it harder to prosecute inside traders, the requisite federal interest might exist. As we have seen, however, the evidence of legislative intent is scanty, at best.
- Some contend that a prohibition of insider trading is necessary to protect the federal mandatory disclosure system, but this argument proves unpersuasive upon examination.
- Some contend that a prohibition of insider trading is necessary to protect investors from harm and/or to preserve their confidence in the integrity of the markets. These arguments also prove unpersuasive, however.
- Some contend that a federal prohibition of insider trading is necessary to protect property rights in information, which is true but also does not justify a unique federal rule.

In sum, there is no compelling federal interest at stake that would justify creating a unique federal fiduciary duty respecting insider trading.

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[143] Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108 (1991).

[144] This interpretation is consistent with the test laid out in the leading case of United States v. Kimball Foods, 440 U.S. 715 (1979), in which the Supreme Court laid out the following criteria for deciding when state law should be incorporated into federal common-law rules:

> Undoubtedly, federal programs that "by their nature are and must be uniform in character throughout the nation" necessitate formulation of controlling federal rules. Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision. Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests. Finally, our choice-of-law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law.

Kimball Foods, 440 U.S. at 728-29. To be sure, *Kimball Foods* is not squarely on point because the occasion for creating federal common law arose in that case because the United States was a party to the litigation rather than because the claim arose under federal law. It does confirm, however, the importance of determining whether incorporating state law would adversely affect some federal policy.

[145] See generally Bainbridge, supra note 22, at 1228-1245.

Indeed, to the contrary, creation of such a unique federal duty is inconsistent with the Supreme Court's Rule 10b-5 jurisprudence. In *Santa Fe Industries, Inc. v. Green,*[146] the Supreme Court held that creation of corporate fiduciary duties is a task that must be left to state law. If so, why is insider trading be singled out for special treatment? As we have seen, *Dirks* and *Chiarella* simply ignored the doctrinal tension between their fiduciary duty-based regime and *Santa Fe*. In *O'Hagan*, Justice Ginsburg's majority opinion at least recognized that *Santa Fe* presented a problem for the federal insider trading prohibition, but her purported solution is quite unconvincing. Justice Ginsburg correctly described *Santa Fe* as "underscoring that § 10(b) is not an all-purpose breach of fiduciary duty ban; rather it trains on conduct involving manipulation or deception."[147] Instead of acknowledging that insider trading is mainly a fiduciary duty issue, however, she treated it as solely a disclosure issue. It is thus the failure to disclose that one is about to inside trade that is the problem, not the trade itself: "A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain' . . . 'dupes' or defrauds the principal."[148] As Justice Ginsburg acknowledged, this approach means that full disclosure must preclude liability. If the prospective inside trader informs the persons with whom he or she is about to trade that "he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."[149]

Justice Ginsburg's approach fails to solve the problem. Granted, insider trading involves deception in the sense that the defendant by definition failed to disclose nonpublic information before trading. Persons subject to the disclose or abstain theory, however, often are also subject to a state law-based fiduciary duty of confidentiality, which precludes them from disclosing the information. As to them, the insider trading prohibition collapses into a requirement to abstain from trading on material nonpublic information. As such, it really is their failure to abstain from trading, rather than their nondisclosure, which is the basis for imposing liability. A former SEC Commissioner more or less admitted as much: "Unlike much securities regulation, insider trading rules probably do not result in more information coming into the market: The 'abstain or disclose' rule for those entrusted with confidential information usually is observed by abstention."[150] Yet, *Santa Fe* clearly precludes the creation of such duties.

In any event, Justice Ginsburg's solution also is essentially circular. Failure to disclose material nonpublic information before trading does not always violate Rule 10b-5. In omission cases, which include all insider trading on impersonal stock exchanges, liability can be imposed only if the defendant had a duty to disclose before trading. If Rule 10b-5 itself creates the requisite duty, however, this requirement is effectively negated. As such, the requisite duty must come from outside the securities laws. Indeed, given *Santa Fe*, it

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[146] 430 U.S. 462 (1977).

[147] *O'Hagan*, 521 U.S. at 655.

[148] Id. at 653-54 (citations omitted).

[149] Id. at 655.

[150] Cox and Fogarty, supra note 76, at 353.

must come from outside federal law. Yet, as we have seen, the *Dirks/O'Hagan* framework appears to violate this requirement through circularity—creating a federal disclosure obligation arising out of Rule 10b-5.

Repealing the federal prohibition in fact would be the simplest means of resolving the tension between *Dirks/O'Hagan* and *Santa Fe*. The simplest approach, however, is not always the best. As we shall see, there are sound pragmatic reasons to retain a federal prohibition of insider trading. None of those reasons, however, necessitates the creation of a unique federal fiduciary duty against insider trading. Nor do any of them resolve the doctrinal tension between *Dirks/O'Hagan* and *Santa Fe*. Rather, that tension is best resolved by adopting state law standards as the requisite fiduciary duty. This approach strikes an appropriate balance between the federalism concerns expressed by *Santa Fe* and the policies that favor federalizing the prohibition.

The Court's decision in *Burks v. Lasker* is especially supportive of this approach. In *Burks*, the Court applied state law governing termination of derivative litigation to a case arising under the federal Investment Company Act. Although the cause of action clearly arose under federal law, the Court applied state law because state law "is the font of corporate directors' powers" and because application of state law did not pose a "significant threat to any identifiable federal policy or interest."[151] Burks thus strongly argues in favor of using state law to supply the fiduciary duty element of the federal insider trading prohibition. State law is the "font" of corporate fiduciary duties, while we have seen that incorporation of state law poses no threat to "any identifiable federal policy or interest."

Although the Supreme Court's decision in *DeSylva v. Ballentine*[152] arose outside the securities law area, it is also quite instructive. In that case the Supreme Court considered what familial relationships were encompassed by the term "children" as used in a federal statute. The Court looked to state law for a definition of the term. It did so in large measure because there is no federal law of domestic relations:

> The scope of a federal right is, of course, a federal question, but that does not mean that its content is not to be determined by state, rather than federal law. This is especially true where a statute deals with a familial relationship; there is no federal law of domestic relations, which is primarily a matter of state concern.[153]

DeSylva is an especially apt precedent for the insider trading prohibition. Just as there was no general body of federal domestic relations law, *Santa Fe* teaches that there is no general federal law of fiduciary duty. Just as the Court incorporated state law in *DeSylva,* it thus should incorporate state law here.

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[151] Burks v. Lasker, 441 U.S. 471, 477-78 (1979).

[152] 351 U.S. 570 (1956).

[153] Id. at 580.

C. Who is an insider?

The term insider trading is something of a misnomer. It conjures up images of corporate directors or officers using secret information to buy stock from (or sell it to) unsuspecting investors. To be sure, the modern federal insider trading prohibition proscribes a corporation's officers and directors from trading on the basis of material nonpublic information about their firm, but it also casts a far broader net. Consider the following people who have been convicted of insider trading:

- A partner in a law firm representing the acquiring company in a hostile takeover bid who traded in target company stock.[154]
- A Wall Street Journal columnist who traded prior to publication of his column in the stock of companies he wrote about.[155]
- A psychiatrist who traded on the basis of information learned from a patient.[156]
- A financial printer who traded in the stock of companies about which he was preparing disclosure documents.[157]

Consequently, the phrase insider trading thus includes a wide range of individuals who trade in a corporation's stock on the basis of material information unknown by the investing public at large.

It seems reasonably clear that the principal task in this area is to determine whether a fiduciary relationship exists between the inside trader and the person with whom he or she trades. Whether that determination is made as a matter of state or federal law, unfortunately, remains unclear. *O'Hagan* confirms that the attorney-client relationship is a fiduciary one.[158] Dictum in all three Supreme Court precedents tells us that corporate officers and directors are fiduciaries of their shareholders. Beyond these two categories we must make educated guesses. Until a majority of the Supreme Court has held that a particular relationship is fiduciary in nature, however, we cannot know for sure.

1. Classic insiders

At common law, the insider trading prohibition focused on corporate officers and directors. The short-swing profit insider trading restrictions provided by §16(b) similarly are limited to officers, directors, and shareholders owning more than 10 percent of the company's stock. One of the many issues first addressed in the seminal *Texas Gulf Sulphur* case was whether § 10(b) was restricted to that class of persons. Some of the *Texas Gulf Sulphur* defendants were middle managers and field workers. The *Texas Gulf*

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[154] U.S. v. O'Hagan, 521 U.S. 642 (1997).

[155] United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987).

[156] United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990).

[157] Chiarella v. United States, 445 U.S. 222 (1980).

[158] Although one could plausibly argue to the contrary. See Stephen M. Bainbridge, Insider Trading under the Restatement of the Law Governing Lawyers, 19 J. Corp. L. 1 (1993).

Sulphur court had little difficulty finding that such mid-level corporate employees were insiders for purposes of § 10(b). But that holding followed directly from the court's equal access test: "Insiders, as directors or management officers are, of course, by this Rule, precluded from [insider] dealing, but the Rule is also applicable to one possessing [nonpublic] information who may not be strictly termed an 'insider' within the meaning of [section] 16(b) of the Act."[159] *Chiarella*'s rejection of the equal access test thus reopened the question of how far down the corporate ladder Rule 10b-5 extended.

Recall that the Supreme Court had said Chiarella could not be held liable under Rule 10b-5 because, as to the target companies' shareholders, "he was not their agent, he was not a fiduciary, [and] he was not a person in whom the sellers had placed their trust and confidence."[160] Were the TGS geologists who discovered the ore deposit persons in whom TGS' shareholders placed their trust and confidence? Presumably, TGS' shareholders did not even know of their existence. On the other hand, the geologists were agents of TGS and, as such, likely would be deemed a fiduciary of TGS' shareholders for purposes of Rule 10b-5. Although the question of whether all corporate employees will be deemed insiders remains open, there seems little doubt that the insider trading prohibition includes not only directors and officers, but also at least those key employees who have been given access to confidential information for corporate purposes. In *Chiarella*, the majority opinion implied that the duty to disclose or abstain applies to anyone in "a relationship [with the issuer] affording access to inside information intended to be available only for a corporate purpose."[161] The Second Circuit likewise has stated that: "it is well settled that traditional corporate 'insiders'—directors, officers and persons who have access to confidential corporate information—must preserve the confidentiality of nonpublic information that belongs to and emanates from the corporation."[162]

Suppose, however, that one of the TGS geologists had written a memo to his or her supervisor describing the ore discovery. A TGS janitor discovered a draft of the memo in the geologist's trash and bought a few shares. Although the janitor may be an agent of TGS, he is not a key employee given access to confidential information for a corporate purpose. It is therefore doubtful whether he should be regarded as an insider for Rule 10b-5 purposes.

2. Constructive insiders

In *Dirks*, the Supreme Court made clear that the disclose or abstain rule picks up a variety of nominal outsiders whose relationship to the issuer is sufficiently close to justify treating them as "constructive insiders":

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[159] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert denied, 394 U.S. 976 (1969).

[160] Chiarella v. United States, 445 U.S. 222, 232 (1980).

[161] *Chiarella*, 445 U.S. at 227.

[162] Moss v. Morgan Stanley Inc., 719 F.2d 5, 10 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.[163]

A firm's outside legal counsel are widely assumed to be paradigmatic constructive insiders.[164] Yet, there still must be a relationship with the issuer. In *O'Hagan*, for example, the defendant could not be held liable under the disclose or abstain rule as a constructive insider because he worked for the bidder but traded in target company stock.

Although *Dirks* clearly requires that the recipient of the information in some way agree to keep it confidential, courts have sometimes overlooked that requirement. In *SEC v. Lund*,[165] for example, Lund and another businessman discussed a proposed joint venture between their respective companies. In those discussions, Lund received confidential information about the other's firm. Lund thereafter bought stock in the other's company. The court determined that by virtue of their close personal and professional relationship, and because of the business context of the discussion, Lund was a constructive insider of the issuer. In doing so, however, the court focused almost solely on the issuer's expectation of confidentiality. It failed to inquire into whether Lund had agreed to keep the information confidential.

Lund is usefully contrasted with *Walton v. Morgan Stanley & Co.*[166] Morgan Stanley represented a company considering acquiring Olinkraft Corporation in a friendly merger. During exploratory negotiations Olinkraft gave Morgan confidential information. Morgan's client ultimately decided not to pursue the merger, but Morgan allegedly later passed the acquired information to another client planning a tender offer for Olinkraft. In addition, Morgan's arbitrage department made purchases of Olinkraft stock for its own account. The Second Circuit held that Morgan was not a fiduciary of Olinkraft: "Put bluntly, although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan owed no duty to observe that confidence."[167] Although *Walton* was decided under state law, it has been cited approvingly in a number of federal insider trading opinions and is generally

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[163] Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

[164] See, e.g., United States v. Elliott, 711 F. Supp. 425, 432 (N.D. Ill. 1989).

[165] 570 F. Supp. 1397 (C.D. Cal. 1983).

[166] 623 F.2d 796 (2d Cir. 1980).

[167] Id. at 799.

regarded as a more accurate statement of the law than *Lund*.[168] Indeed, a subsequent case from the same district court as *Lund* essentially acknowledged that it had been wrongly decided:

> What the Court seems to be saying in *Lund* is that anytime a person is given information by an issuer with an expectation of confidentiality or limited use, he becomes an insider of the issuer. But under *Dirks*, that is not enough; the individual must have expressly or impliedly entered into a fiduciary relationship with the issuer.[169]

Even this statement does not go far enough, however, because it does not acknowledge the additional requirement of an affirmative assumption of the duty of confidentiality.

3. Tippers and tippees

Recall that under *Dirks* tippees are only liable if two conditions are met: (1) the tipper breached a fiduciary duty to the corporation by making the tip and (2) the tippee knew or had reason to know of the breach. The requirement that the tip constitute a breach of duty on the tipper's part eliminates many cases in which an insider discloses information to an outsider. Hence, the SEC's decision to adopt Regulation FD as a mechanism for proscribing selective disclosure without reliance on the *Dirks* formulation.

Indeed, not every disclosure made in violation of a fiduciary duty constitutes an illegal tip. What *Dirks* proscribes is not just a breach of duty, however, but a breach of the duty of loyalty forbidding fiduciaries to personally benefit from the disclosure. An instructive case is *SEC v. Switzer*,[170] which involved Barry Switzer, the well-known former coach of the Oklahoma Sooners and Dallas Cowboys football teams. Phoenix Resources Company was an oil and gas company. One fine day in 1981, Phoenix's CEO, one George Platt, and his wife attended a track meet to watch their son compete. Coach Switzer was also at the meet, watching his son. Platt and Switzer had known each other for some time. Platt had Oklahoma season tickets and his company had sponsored Switzer's television show. Sometime in the afternoon Switzer laid down on a row of bleachers behind the Platts to sunbathe. Platt, purportedly unaware of Switzer's presence, began telling his wife about a recent business trip to New York. In that conversation, Platt mentioned his desire to dispose of or liquidate Phoenix. Platt further talked about several companies bidding on Phoenix. Platt also mentioned that an announcement of a "possible" liquidation of Phoenix might occur the following Thursday. Switzer overheard this conversation and shortly thereafter bought a substantial number of Phoenix shares and tipped off a number of his friends. Because Switzer was neither an insider or constructive insider of Phoenix, the main issue was whether Platt had illegally tipped Switzer.

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[168] See, e.g., Dirks v. SEC, 463 U.S. 646, 662 n.22 (1983); United States v. Chestman, 947 F.2d 551, 567-68 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992); Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

[169] SEC v. Ingram, 694 F. Supp. 1437, 1440 n.3 (C.D. Cal. 1988).

[170] 590 F. Supp. 756 (W.D. Okla. 1984).

Per *Dirks*, the initial issue was whether Platt had violated his fiduciary duty by obtaining an improper personal benefit: "Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider [to his stockholders], there is no derivative breach [by the tippee]."[171] The court found that Platt did not obtain any improper benefit. The court further found that the information was inadvertently (and unbeknownst to Platt) overheard by Switzer. Chatting about business with one's spouse in a public place may be careless, but it is not a breach of one's duty of loyalty.

The next issue is whether Switzer knew or should have known of the breach. Given that there was no breach by Platt, of course, this prong of the *Dirks* test by definition could not be met. But it is instructive that the court went on to explicitly hold that "Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider."[172]

4. Nontraditional relationships

Once we get outside the traditional categories of Rule 10b-5 defendants—insiders, constructive insiders, and their tippees—things get much more complicated. Suppose a doctor learned confidential information from a patient, upon which she then traded? Is she an insider? As the Second Circuit observed in *United States v. Chestman*:

> [F]iduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts. Tethered to the field of shareholder relations, fiduciary obligations arise within a narrow, principled sphere. The existence of fiduciary duties in other common law settings, however, is anything but clear. Our Rule 10b-5 precedents . . ., moreover, provide little guidance with respect to the question of fiduciary breach, because they involved egregious fiduciary breaches arising solely in the context of employer/employee associations.[173]

At issue in that case was inside trading by a member of the Waldbaum family in stock of a corporation controlled by that family. Ira Waldbaum was the president and controlling shareholder of Waldbaum, Inc., a publicly-traded supermarket chain. Ira decided to sell Waldbaum to A&P at $50 per share, a 100% premium over the prevailing market price. Ira informed his sister Shirley of the forthcoming transaction. Shirley told her daughter Susan Loeb, who in turn told her husband Keith Loeb. Each person in the chain told the next to keep the information confidential. Keith passed an edited version of the information to his stockbroker, one Robert Chestman, who then bought Waldbaum stock for his own account and the accounts of other clients. Chestman was accused of violating Rule 10b-5. According to the Government's theory of the case, Keith Loeb owed fiduciary duties to his wife Susan, which he violated by trading and tipping Chestman.

The Second Circuit held that in the absence of any evidence that Keith regularly participated in confidential business discussions, the familial relationship standing alone did not create a fiduciary relationship between Keith and Susan or any members of her

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[171] Id. at 766.

[172] Id.

[173] 947 F.2d 551, 567 (2d Cir. 1991) (citations omitted), cert. denied, 503 U.S. 1004 (1992).

family.[174] Accordingly, Loeb's actions did not give rise to the requisite breach of fiduciary duty.

In reaching that conclusion, the court laid out a general framework for dealing with nontraditional relationships. The court began by identifying two factors that did not, standing alone, justify finding a fiduciary relationship between Keith and Susan. First, unilaterally entrusting someone with confidential information does not by itself create a fiduciary relationship.[175] This is true even if the disclosure is accompanied by an admonition such as "don't tell," which Susan's statements to Keith included. Second, familial relationships are not fiduciary in nature without some additional element.[176]

Turning to factors that could justify finding a fiduciary relationship on these facts, the court first identified a list of "inherently fiduciary" associations:

> Counted among these hornbook fiduciary relations are those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder. While this list is by no means exhaustive, it is clear that the relationships involved in this case—those between Keith and Susan Loeb and between Keith Loeb and the Waldbaum family—were not traditional fiduciary relationships.[177]

A rather serious problem with the *Chestman* court's glib assertion that the specified relationships are "inherently fiduciary" is the resulting failure to seriously evaluate whether any duty arising out of such relationships was violated by the defendant's conduct. In *United States v. Willis*,[178] for example, the court determined that a psychiatrist violated the prohibition by trading on information learned from a patient. In determining that the requisite breach of fiduciary duty had occurred, the court relied in large measure on the Hippocratic Oath. In relevant part, the Oath reads: "Whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even apart therefrom, which ought not to be noised abroad, I will keep silence thereon, counting such things to be as sacred secrets."[179] While the Oath thus imposes a duty of confidentiality on those who take it, it does not forbid them from self dealing in information learned from patients so long as the information is not thereby disclosed. As such, it is not at all clear that the requisite breach of duty was present in *Willis*. Unfortunately, as *Willis* illustrates, these issues routinely are swept under the rug.

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[174] Id. at 570.

[175] Repeated disclosures of business secrets, however, could substitute for a factual finding of dependence and influence and, accordingly, sustain a finding that a fiduciary relationship existed in the case at bar. Id. at 569. Hence, the court's emphasis on the absence of such repeated disclosures as between Keith and Susan or her family.

[176] Id. at 570 ("Kinship alone does not create the necessary relationship.").

[177] Id. at 568.

[178] 737 F. Supp. 269 (S.D.N.Y. 1990).

[179] Id. at 272.

In any event, once one moves beyond the class of "hornbook" fiduciary relationships, *Chestman* held that the requisite relationship will be found where one party acts on the other's behalf and "great trust and confidence" exists between the parties:

> A fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use.[180]

In the insider trading context, of course, the relevant property is confidential information belonging to the principal. Because the relationship between Keith and Susan did not involve either discretionary authority or dependency of this sort, their relationship was not fiduciary in character.[181]

In 2000, the SEC addressed the *Chestman* problem by adopting Rule 10b5-2, which provides "a nonexclusive list of three situations in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory . . . ."[182] First, such a duty exists whenever someone agrees to maintain information in confidence. Second, such a duty exists between two people who have a pattern or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the speaker expects the recipient to maintain the information's confidentiality. Third, such a duty exists when someone receives or obtains material nonpublic information from a spouse, parent, child, or sibling. On the facts of *Chestman*, accordingly, Rule 10b5-2 would result in the imposition of liability because Keith received the information from his spouse who, in turn, had received it from her parent.

5. What does "other relationship of trust and confidence" mean?

In *Chiarella*, the Supreme Court referred to a disclosure obligation arising out of a relationship of trust and confidence.[183] In *Chestman*, the Second Circuit juxtaposed that phrase with the related concept of fiduciary relationships. Consequently, the court

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[180] Id. at 569.

[181] The *Chestman* framework is yet another area in which the federalism concerns raised by *Santa Fe* ought to have figured more prominently than they did. As we have seen, the requisite fiduciary duty cannot be derived from Rule 10b-5 itself without making the rule incoherently circular and, moreover, violating *Santa Fe*. Unfortunately, the *Chestman* court simply ignored this problem. The court created a generic framework for deciding whether a fiduciary relationship is present, which purports to take its "cues as to what is required to create the requisite relationship from the securities fraud precedents and the common law." Id. at 568. The court thus mixed both federal and state law sources without much regard either for potential circularity or federalism.

[182] Exchange Act Rel. No. 43,154 (Aug. 15, 2000).

[183] Chiarella v. United States, 445 U.S. 222, 230 (1980).

observed, the requisite relationship could be satisfied either by a fiduciary relationship or by a "similar relationship of trust and confidence."[184]

So expanding the class of relationships that can give rise to liability may lead to a results-oriented approach. If a court wishes to impose liability, it need simply conclude that the relationship in question involves trust and confidence, even though the relationship bears no resemblance to those in which fiduciary-like duties are normally imposed. Accordingly, courts should be loath to use this phraseology as a mechanism for expanding the scope of liability. The *Chestman* court was sensitive to this possibility, holding that a relationship of trust and confidence must be "the functional equivalent of a fiduciary relationship" before liability can be imposed.[185] *Chestman* also indicates that regardless of which type of relationship is present the defendant must be shown to have been subject to a duty (incorrectly described by the court as one of confidentiality) and to have breached that duty. Finally, the court indicated that at least as to criminal cases, it would not expand the class of relationships from which liability might arise to encompass those outside the traditional core of fiduciary obligation.[186] Accordingly, for most purposes it should be safe to disregard any possible distinction between fiduciary relationships and other relationships of "trust and confidence."

D. Possession or use?

The SEC long has argued that trading while in knowing possession of material nonpublic information satisfies Rule 10b-5's scienter requirement. In *United States v. Teicher*,[187] the Second Circuit agreed, albeit in a passage that appears to be dictum. An attorney tipped stock market speculators about transactions involving clients of his firm. On appeal, defendants objected to a jury instruction pursuant to which they could be found guilty of securities fraud based upon the mere possession of fraudulently obtained material nonpublic information without regard to whether that information was the actual cause of their transactions. The Second Circuit held that any error in the instruction was harmless, but went on to opine in favor of a knowing possession test. The court interpreted *Chiarella* as comporting with "the oft-quoted maxim that one with a fiduciary or similar duty to hold material nonpublic information in confidence must either 'disclose or abstain' with regard to trading."[188] The court also favored the possession standard because it "recognizes that one who trades while knowingly possessing material inside information has an informational advantage over other traders."[189] The difficulties with

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[184] *Chestman*, 947 F.2d at 568.

[185] Id.

[186] Id. at 570.

[187] 987 F.2d 112 (2d Cir. 1993). See generally Allan Horwich, Possession Versus Use: Is there a Causation Element in the Prohibition on Insider Trading? 52 Bus. Law. 1235 (1997); Donna M. Nagy, The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden, 67 U. Cin. L. Rev. 1129 (1999).

[188] Id. at 120.

[189] Id.

the court's reasoning should be apparent. In the first place, a mere possession test is inconsistent with Rule 10b-5's scienter requirement, which requires fraudulent intent (or, at least, recklessness). In the second, contrary to the court's view, *Chiarella* simply did not address the distinction between a knowing possession and a use standard. Finally, the court's reliance on the trader's informational advantage is inconsistent with *Chiarella*'s rejection of the equal access test.

In *SEC v. Adler*,[190] the Eleventh Circuit rejected *Teicher* in favor of a use standard. Under *Adler*, "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade—i.e., that the information was not used."[191] Although defendant Pegram apparently possessed material nonpublic information at the time he traded, he introduced strong evidence that he had a plan to sell company stock and that that plan predated his acquisition of the information in question. If proven at trial, evidence of such a pre-existing plan would rebut the inference of use and justify an acquittal on grounds that he lacked the requisite scienter.

The choice between *Adler* and *Teicher* is difficult. On the one hand, in adopting the Insider Trading Sanctions Act of 1984, Congress imposed treble money civil fines on those who illegally trade "while in possession" of material nonpublic information. In addition, a use standard significantly complicates the government's burden in insider trading cases, because motivation is always harder to establish than possession, although the inference of use permitted by *Adler* substantially alleviates this concern. On the other hand, a number of decisions have acknowledged that a pre-existing plan and/or prior trading pattern can be introduced as an affirmative defense in insider trading cases, as such evidence tends to disprove that defendant acted with the requisite scienter. Dictum in each of the Supreme Court's insider trading opinions also appears to endorse the use standard. In light of the Circuit split that now exists between *Teicher* and *Adler*, the Supreme Court may eventually have to resolve the conflict.

Or, perhaps not. In 2000, the SEC addressed this issue by adopting Rule 10b5-1, which states that Rule 10b-5's prohibition of insider trading is violated whenever someone trades "on the basis of" material nonpublic information.[192] Because one is deemed, subject to certain narrow exceptions, to have traded "on the basis of" material nonpublic information if one was aware of such information at the time of the trade, Rule 10b5-1 formally rejects the *Adler* position. In practice, however, the difference between *Adler* and Rule 10b5-1 may prove insignificant. On the one hand, *Adler* created a presumption of use when the insider was aware of material nonpublic information. Conversely, Rule

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[190] 137 F.3d 1325 (11th Cir. 1998). The Ninth Circuit recently agreed with *Adler* that proof of use, not mere possession, is required. The Ninth Circuit further held that in criminal cases no presumption of use should be drawn from the fact of possession—the government must affirmatively prove use of nonpublic information. United States v. Smith, 155 F.3d 1051 (9th Cir. 1998).

[191] *Adler*, 137 F.3d at 1337.

[192] Exchange Act Rel. No. 43,154 (Aug. 15, 2000).

10b5-1 provides affirmative defenses for insiders who trade pursuant to a pre-existing plan, contract, or instructions. As a result, the two approaches should lead to comparable outcomes in most cases.

E. Is there liability for trading in debt securities?

One of the areas in which the Supreme Court's failure to specify the source and nature of the fiduciary obligation underlying the disclose or abstain rule has proven especially problematic is insider trading in debt securities. Yet, the prohibition's application to debt securities has received surprisingly little judicial attention. One court has held that insider trading in convertible debentures violates Rule 10b-5,[193] but this case is clearly distinguishable from nonconvertible debt securities. Because they are convertible into common stock at the option of the holder, both the market price and interest rate paid on such instruments are affected by the market price of the underlying common stock. Federal securities law recognizes the close relationship of convertibles to common stock by defining the former as equity securities. As such, the status of nonconvertible debt remains unresolved. A strong argument can be made, however, that the prohibition should not extend to trading in nonconvertible debt.

In most states, neither the corporation nor its officers and directors have fiduciary duties to debtholders. Instead, debtholders' rights are limited to the express terms of the contract and an implied covenant of good faith.[194] Cases in a few jurisdictions purport to recognize fiduciary duties running to holders of debt securities, but the duties imposed in these cases are more accurately characterized as the same implied covenant of good faith found in most other jurisdictions.[195]

The distinction between this implied covenant and a fiduciary duty is an important one for our purposes. An implied covenant of good faith arises from the express terms of a contract and is used to fulfill the parties' mutual intent. In contrast, a fiduciary duty has little to do with the parties' intent. Instead, courts use fiduciary duties to protect the interests of the duty's beneficiary. Accordingly, a fiduciary duty requires the party subject to the duty to put the interests of the beneficiary of the duty ahead of his own, while an implied duty of good faith merely requires both parties to respect their bargain.

A two-step move thus will be required if courts are to impose liability under the disclose or abstain rule on those who inside trade in debt securities. First, the clear holdings of *Chiarella* and *Dirks* must be set aside so that the requisite relationship can be expanded to include purely contractual arrangements and the requisite duty expanded to include mere contractual covenants. Second, the implied covenant of good faith must be

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[193] In re Worlds of Wonder Securities Litigation, [1990-1991 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689 (N.D.Cal. 1990).

[194] See, e.g., Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989); Katz v. Oak Indus., 508 A.2d 873 (Del. Ch. 1986).

[195] See, e.g., Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.), cert. denied, 454 U.S. 965 (1981); Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669 (S.D.N.Y. 1984), vacated, 754 F.2d 478 (2d Cir. 1985); Fox v. MGM Grand Hotels, Inc., 187 Cal. Rptr. 141 (Cal. Ct. App. 1982).

interpreted as barring self dealing in nonpublic information by corporate agents. In that regard, consider the leading *Met Life* decision, which indicates that a covenant of good faith will be implied only when necessary to ensure that neither side deprives the other of the fruits of the agreement.[196] The fruits of the agreement are limited to regular payment of interest and ultimate repayment of principal. Because insider trading rarely affects either of these fruits, it does not violate the covenant of good faith.[197]

To be sure, the courts could simply ignore state law. Yet, the Supreme Court has consistently held that insider trading liability requires an agency or fiduciary relationship. As to common stock, *Dirks* created what appears to be a federal fiduciary obligation, but recall that that obligation was extrapolated from state common law. It seems unlikely that the courts will treat the state law status of debtholders as irrelevant.

F. Remedies and penalties

Woe unto those who violate the insider trading prohibition, for the penalties are many, cumulative, and severe. The Justice Department may pursue criminal charges. The SEC may pursue a variety of civil penalties. Private party litigants may bring damage actions under both federal and state law.

The SEC has no authority to prosecute criminal actions against inside traders, but it is authorized by Exchange Act §21(d)(1) to ask the Justice Department to initiate a criminal prosecution. In addition, the Justice Department may bring such a prosecution on its own initiative. Under §32(a), a willful violation of Rule 10b-5 or 14e-3 is a felony that can be punished by a $1 million fine ($2.5 in the case of corporations) and up to 10 years in jail. Since the mid-1980s insider trading scandals, criminal prosecutions have become fairly common in this area.

The SEC long has had the authority to pursue various civil penalties in insider trading cases. Under Exchange Act §21(d), the SEC may seek a permanent or temporary injunction whenever "it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation" of the Act or any rules promulgated thereunder. Courts have made it quite easy for the SEC to obtain injunctions under §21(d). The SEC must make a "proper showing," but that merely requires the SEC to demonstrate a violation of the securities laws occurred and there is a reasonable likelihood of future violations.[198] The SEC is not required to meet traditional

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[196] Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989).

[197] Various alternative theories of liability may come into play in this context. In particular, the misappropriation theory might apply. Suppose a corporate officer traded in the firm's debt securities using material nonpublic information belonging to the corporation. As the argument would go, even though the officer owes no fiduciary duties to the bondholders, he owes fiduciary duties to the corporation. The violation of those duties might suffice for liability under the misappropriation theory. The misappropriation theory clearly would not reach trading by an issuer in its own debt securities, which would come under the disclose or abstain rule.

[198] See SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 99-100 (2d Cir. 1978). But cf. SEC v. Lund, 570 F. Supp. 1397, 1404 (C.D. Cal. 1983) (court denied an injunction on the grounds

requirements for equitable relief, such as irreparable harm.[199] The SEC is not required to identify particular individuals who were wronged by the conduct, moreover, but only that the violation occurred.

"Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy."[200] Thus, in addition to or in place of injunctive relief, the SEC may seek disgorgement of profits, correction of misleading statements, disclosure of material information, or other special remedies. Of these, disgorgement of profits to the government is the most commonly used enforcement tool.

The SEC may also punish insider trading by regulated market professionals through administrative proceedings. Under §15(b)(4) of the 1934 Act, the SEC may censure, limit the activities of, suspend, or revoke the registration of a broker or dealer who willfully violates the insider trading prohibition. Similar sanctions may be imposed on those associated with the broker or dealer in such activities. The SEC may issue a report of its investigation of the incident even if it decides not to pursue judicial or administrative proceedings, which may lead to private litigation.

During the 1980s, Congress significantly expanded the civil sanctions available to the SEC for use against inside traders. The Insider Trading Sanctions Act of 1984 created a civil monetary penalty of up to three times the profit gained or loss avoided by a person who violates rules 10b-5 or 14e-3 "by purchasing or selling a security while in the possession of material nonpublic information." An action to impose such a penalty may be brought in addition to or in lieu of any other actions that the SEC or Justice Department is entitled to bring. Because the SEC thus may seek both disgorgement and treble damages, an inside trader faces potential civil liability of up to four times the profit gained.

In the Insider Trading and Securities Fraud Act of 1988 (ITSFEA), Congress made a number of further changes designed to augment the enforcement resources and penalties available to the SEC. Among other things, it authorized the SEC to pay a bounty to informers of up to 10 percent of any penalty collected by the SEC. The treble money fine was extended to controlling persons, so as to provide brokerage houses, for example, with greater incentives to monitor the activities of their employees.[201]

Although it has long been clear that persons who traded contemporaneously with an inside trader have a private cause of action under Rule 10b-5 (and perhaps Rule 14e-3), and may also have state law claims, private party litigation against inside traders has been rare and usually parasitic on SEC enforcement actions. Private party actions were further

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that the defendant's action was "an isolated occurrence" and that his "profession [was] not likely to lead him into future violations").

[199] See SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

[200] SEC v. Manor Nursing Centers, 458 F.2d 1082, 1103 (2d Cir. 1972).

[201] On control person liability, see Marc I. Steinberg and John Fletcher, Compliance Programs for Insider Trading, 47 S.M.U. L. Rev. 1783 (1994).

discouraged by the Second Circuit's decision in *Moss v. Morgan Stanley, Inc.*,[202] which held that contemporaneous traders could not bring private causes of actions under the misappropriation theory. ITSFEA attempted to encourage private actions by overruling *Moss*. Under Exchange Act §20A, contemporaneous traders can sue to recover up to the amount of profit gained or loss avoided. Tippers and tippees are jointly and severally liable. The amount recoverable is reduced by any amounts disgorged to the Commission. As yet, however, it does not appear that plaintiffs have made very frequent use of §20A.

VI. Insider trading under state corporate law today

Although the federal securities laws did not preempt state corporate law, federal regulation has essentially superseded them insofar as insider trading is concerned. State law is not just a historical footnote, however. Some cases still fall though the federal cracks, being left for state law to decide. Plaintiffs still sometimes include a state law-based count in their complaints. Most important, as we have seen, state law ought to provide the basic analytical framework within which the federal regime operates. Having said that, however, it must be admitted that the post-*TGS* focus on federal law aborted the evolution of state common law in this area. With one important exception, discussed below, we are still more or less where we were in the late 1930s.

A. Do directors have a state law fiduciary duty prohibiting insider trading today?

The special circumstances and minority rules continued to pick up adherents during the decades after 1930.[203] Perhaps surprisingly, however, a number of states continue to

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[202] 719 F.2d 5 (2d Cir. 1983).

[203] See, e.g., Broffe v. Horton, 172 F.2d 489 (2d Cir. 1949) (diversity case); Childs v. RIC Group, Inc., 331 F. Supp. 1078, 1081 (N.D.Ga. 1970), aff'd, 447 F.2d 1407 (5th Cir. 1971) (diversity case); Hobart v. Hobart Estate Co., 159 P.2d 958 (Cal. 1945); Hotchkiss v. Fischer, 16 P.2d 531 (Kan. 1932); Jacobson v. Yaschik, 155 S.E.2d 601 (S.C. 1967). For an especially useful discussion of state common law, along with a holding "that a director, who solicits a shareholder to purchase his stock and fails to disclose information not known to the shareholder that bears upon the potential increase in the value of the shares, shall be liable to the shareholder," see Bailey v. Vaughan, 359 S.E.2d 599, 605 (W.Va. 1987).

An early line of federal cases arising under Rule 10b-5 applied the special circumstances and, more often, the fiduciary duty rules to face-to-face insider trading transactions. See, e.g., Kohler v. Kohler Co. 319 F.2d 634 (7th Cir. 1963); Speed v. Transamerica Corp., 99 F. Supp. 808 (D.Del. 1951).

adhere to the no duty rule.[204] Insofar as stock market transactions are concerned, moreover, *Goodwin v. Aggassiz*[205] apparently remains the prevailing view.[206]

At least insofar as trading on secondary markets is concerned, the SEC thus seriously erred when it asserted in *Cady, Roberts & Co.* that state common law imposed fiduciary duties on corporate insiders that trade with shareholders.[207] As we have seen, the law varied substantially from state to state, and even in the jurisdictions where the requisite duty existed, it was arguably limited to face-to-face transactions involving unusual fact situations. *Dirks*' invocation of the *Cady, Roberts* duty as the basis for imposing federal insider trading liability was thus something of a stretch.[208]

B. Derivative liability for insider trading under state corporate law

Although *Goodwin* rejected the argument that directors "occupy the position of trustee towards individual stockholders,"[209] it also recognized that directors are fiduciaries of the corporate enterprise. Holdings barring shareholders from seeking direct relief thus do not necessarily prohibit corporate actions against insider traders. Granted, a leading case did not emerge until the 1960s but lawyers eventually stumbled on the possibility of derivative litigation against inside traders.

All of the cases we have been discussing thus far were brought as direct actions; i.e., cases in which the plaintiff shareholder sued in his own name seeking compensation for the injury done to him by the insider with whom he traded. In derivative litigation, by contrast, the cause of action belongs to the corporation and any recovery typically goes into the corporate treasury rather than directly to the shareholders. One would normally expect the corporation's board or officers to prosecute such suits. Corporate law recognizes, however, that a corporation's managers sometimes may be reluctant to enforce the corporation's rights. This seems especially likely when the prospective defendant is a fellow director or officer. The derivative suit evolved to deal with such

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[204] See, e.g., Goodman v. Poland, 395 F. Supp. 660, 678-80 (D.Md. 1975); Lank v. Steiner, 224 A.2d 242 (Del. 1966); Fleetwood Corp. v. Mirich, 404 N.E.2d 38, 46 (Ind. Ct. App. 1980); Yerke v. Batman, 376 N.E.2d 1211, 1214 (Ind. Ct. App. 1978); Gladstone v. Murray Co., 50 N.E.2d 958 (Mass. 1943); cf. Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 375 (2d Cir. 1980) (restating no liability rule as applied by New Jersey state courts, albeit subject to caveat that New Jersey might no longer follow rule).

[205] 186 N.E. 659 (Mass. 1933).

[206] 3A Fletcher Cyc Corp ¶ 1168.1 (Perm. Ed. 1986). But see American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 5.04 (1992) (opining that a duty to disclose exists in both face-to-face and stock market transactions). Somewhat amusingly, the only state law support offered by the Reporter for the proposition that this duty extends to secondary market transactions is a "but see" cite to *Goodwin*. See id. at 282.

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

[208] See Dirks v. SEC, 463 U.S. 646, 653 (1983).

[209] *Goodwin*, 186 N.E. at 660.

situations, providing a procedural device for shareholders to enforce rights belonging to the corporation.

In *Diamond v. Oreamuno*,[210] the leading insider trading derivative case, defendants Oreamuno and Gonzalez were respectively the Chairman of the Board and President of Management Assistance, Inc. ("MAI"). MAI was in the computer leasing business. It sub-contracted maintenance of leased systems to IBM. As a result of an increase in IBM's charges, MAI's earnings fell precipitously. Before these facts were made public, Oreamuno and Gonzalez sold off 56,500 shares of MAI stock at the then-prevailing price of $28 per share. Once the information was made public, MAI's stock price fell to $11 per share. A shareholder sued derivatively, seeking an order that defendants disgorge their allegedly ill-gotten gains to the corporation. The court held that a derivative suit was proper in this context and, moreover, that insider trading by corporate officers and directors violated their fiduciary duties to the corporation.[211]

Diamond has been a law professor favorite ever since it was decided. A plethora of law review articles have been written on it, mostly in a favorable vein. *Diamond* also still shows up in most corporations case books. In the real world, however, *Diamond* has proven quite controversial. A number of leading opinions in other jurisdictions have squarely rejected its holdings.[212]

Why has *Diamond* proven so controversial? No one contends that officers or directors never can be held liable for using information learned in their corporate capacities for personal profit. An officer who uses information learned on the job to compete with his corporate employer, or to usurp a corporate opportunity, for example, readily can be held liable for doing so. Insider trading differs in an important way from these cases, however. Recall that derivative litigation is intended to redress an injury to the corporate entity. Where an employee uses inside information to compete with her corporate employer, the

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[210] 248 N.E.2d 910 (N.Y. 1969).

[211] There is a procedural oddity inherent in *Diamond*'s willingness to permit derivative suits against inside traders. As is generally the case in corporate law, New York only allows shareholders to bring a derivative suit if they meet the so-called continuing shareholder test: they held stock at the time the wrong was committed, suit was filed, and judgment reached. See, e.g., Bronzaft v. Caporali, 616 N.Y.S. 2d 863, 865 (N.Y. Sup. Ct. 1994) (holding that plaintiffs, who were former shareholders, lacked standing to bring a derivative action after a cash-out merger); Karfunkel v. USLIFE Corp., 455 N.Y.S. 2d 937, 939 (N.Y. Sup. Ct. 1982) (stating "it is settled law that plaintiff must demonstrate that she was a shareholder at the time of the transaction, at the time of trial and at the time of entry of judgment"). In cases like *Diamond*, in which outsiders bought the selling insiders' shares, the purchasers were not shareholders until after the wrong was committed. In the flip category of cases, those in which insiders buy from existing shareholders, the sellers (if they sold all their shares) are no longer shareholders. The effect of the continuing shareholder rule should be obvious: no shareholder in the class most would regard as the inside trader's principal victims can serve as a named plaintiff in a *Diamond*-type suit. Where insiders buy, moreover, the allegedly injured selling shareholders cannot even share in any benefit that might flow from a successful derivative suit.

[212] See, e.g., Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (Indiana law); Schein v. Chasen, 313 So.2d 739, 746 (Fla. 1975).

injury to the employer is obvious. In *Diamond*, however, the employees did not use their knowledge to compete with the firm, but rather to trade in its securities. The injury, if any, to the corporation is far less obvious in such cases. Unlike most types of tangible property, information can be used by more than one person without necessarily lowering its value. If an officer who has just negotiated a major contract for her corporation thereafter buys some of the firm's stock, for example, it is far from obvious that her trading necessarily reduced the contract's value to the firm.

The *Diamond* court relied on two purportedly analogous precedents to justify allowing a derivative cause of action against inside traders: The Delaware Chancery court's decision in *Brophy v. City Service Co.*[213] and the law of agency. On close examination, however, neither provides very much support for *Diamond.*

In *Brophy,* the defendant insider traded on the basis of information about a stock repurchase program the corporation was about to undertake. In a very real sense, the insider was competing with the corporation, which both agency law and corporate law clearly proscribe. While the *Brophy* court did not require a showing of corporate injury, the insider's conduct in fact directly threatened the corporation's interests. If his purchases caused a rise in the stock price, the corporation would be injured by having to pay more for its own purchases. In contrast, the *Diamond* insiders' conduct involved neither competition with the corporation nor a direct threat of harm to it. The information in question related to a historical fact. As such, it simply was not information MAI could use. Indeed, the only imaginable use to which MAI could put this information would be to itself buy or sell its own securities before announcing the decline in earnings. Under the federal securities laws, however, MAI could not lawfully make such trades.

The *Diamond* court made two moves to evade this problem. First, it asserted that proof of injury was not legally necessary, which seems inconsistent with the notion that derivative suits are a vehicle for redressing injuries done to the corporation. Second, the court inferred that MAI might have suffered some harm as a result of the defendants' conduct, even though the complaint failed to allege any such harm. In particular, the court surmised that the defendants' conduct might have injured MAI's reputation. As we shall see, however, this is not a very likely source of corporate injury. Accordingly, it is quite easy to distinguish *Brophy* from *Diamond*.

Agency law proves an equally problematic justification for the *Diamond* result. According to the Restatement (Second) of Agency, the principal-agent relationship is a fiduciary one with respect to matters within the scope of the agency relationship. More to the point for present purposes, § 388 of the Agency Restatement imposes a duty on agents to account for profits made in connection with transactions conducted on the principal's behalf. The comments to that section further expand this duty's scope, requiring the agent to account for any profits made by the use of confidential information even if the principal is not harmed by the agent's use of the information. Section 395 provides that an agent may not use for personal gain any information "given him by the principal or acquired by him during the course of or on account of his agency."

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[213] 70 A.2d 5 (Del. Ch. 1949).

One can plausibly argue, however, that the apparent bar on insider trading created by agency law is not as strict as it first appears. The broad prohibition of self dealing in confidential information appears solely in the comments to Sections 388 and 395. In contrast, the black letter text of § 388 speaks only of profits made "in connection with transactions conducted by [the agent] on behalf of the principal." One must stretch the phrases "in connection with" and "on behalf of" pretty far in order to reach insider trading profits. Similarly, § 395, which speaks directly to the issue of self dealing in confidential information, only prohibits the use of confidential information for personal gain "in competition with or to the injury of the principal." Arguably, agency law thus requires an injury to the principal before insider trading liability can be imposed.

This argument is supported by *Freeman v. Decio*,[214] the leading case rejecting *Diamond*'s approach. In *Freeman*, the court noted both *Diamond* and the comments to Sections 388 and 395, but nonetheless held that corporate officers and directors could not be held liable for insider trading as a matter of state corporate law without a showing that the corporation was injured by their conduct.[215] *Freeman* conceded that if all confidential information relating to the firm were viewed as a corporate asset, plaintiffs would not need to show an injury to the corporation in order for the insider's trades to constitute a breach of duty. The court said, however, such a view puts the cart before the horse. One should first ask whether there was any potential loss to the corporation before deciding whether or not to treat the information in question as a firm asset. The court further concluded that most instances of insider trading did not pose any cognizable risk of injury to the firm. According to the court, any harm caused by insider trading was borne mainly by the investors with whom the insider trades, rather than the firm. Unlike *Brophy*, moreover, there was no competition with the firm or loss of a corporate opportunity, because there was no profitable use to which the corporation could have lawfully put this information.

Which of these cases was correctly decided as a matter of public policy? Unfortunately, we are not yet ready to decide between *Diamond* and *Freeman*. The basic issue that divides them is whether or not all confidential information relating to the firm is treated as a corporate asset. Put another way, did MAI have a protected property right in all such information? Answering that question is a task best deferred until we have examined the arguments in favor of and against regulating insider trading.

VII. The economics of insider trading and policy implications thereof

The policy case against insider trading traditionally sounded in the language of equity. The SEC, for example, justifies the prohibition as necessary to address "the inherent unfairness" of insider trading.[216] But why is insider trading unfair? In *Texas Gulf Sulphur*, the Second Circuit opined that all investors were entitled to "relatively equal

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[214] 584 F.2d 186 (7th Cir. 1978).

[215] Id. at 192-95. Accord Schein v. Chasen, 313 So. 2d 739 (Fla. 1975).

[216] In re Merrill Lynch, 43 S.E.C. 933, 936 (1968).

access to material information."[217] But whence comes this entitlement? The difficulty, of course, is that fairness and equality are high-sounding but essentially content-less words. We need some standard of reference by which to measure the fairness or lack thereof of insider trading. This section begins with an examination of the political economy of insider trading—why has the SEC so persistently insisted on an expansive prohibition? It then critically evaluates the various arguments that have been made in favor of and against regulating insider trading. In each case, we will ask two questions: Does the argument make sense? Can it explain the prohibition as it exists?

A. The political economy of insider trading

In evaluating the political economy of insider trading, we rely on a well-established economic model of regulation in which rules are sold by regulators and bought by the beneficiaries of the regulation.[218] Into that model we can plug slightly different, but wholly compatible, stories about insider trading. One explains why the SEC wanted to sell insider trading regulation,[219] while the other explains to whom it has been sold.[220] By putting these stories together, we obtain a complete answer to the question of why insider trading became a matter of federal concern.

On the supply side, the federal insider trading prohibition may be viewed as the culmination of two distinct trends in the securities laws. First, as do all government agencies, the SEC desired to enlarge its jurisdiction and enhance its prestige. Administrators can maximize their salaries, power, and reputation by maximizing the size of their agency's budget. A vigorous enforcement program directed at a highly visible and unpopular law violation is surely an effective means of attracting political support for larger budgets. Given the substantial media attention directed towards insider trading prosecutions, and the public taste for prohibiting insider trading, it provided a very attractive subject for such a program.

Second, during the prohibition's formative years, there was a major effort to federalize corporation law. In order to maintain its budgetary priority over competing agencies, the SEC wanted to play a major role in federalizing matters previously within the state domain.[221] Insider trading was an ideal target for federalization. Rapid expansion of the

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[217] Texas Gulf Sulphur Co., 401 F.2d at 848.

[218] For a description of this general model, see William A. Landes & Richard A. Posner, The Independent Judiciary in an Interest-Group Perspective, 18 J. L. & Econ. 875 (1975).

[219] See generally Michael P. Dooley, Fundamentals of Corporation Law 816-57 (1995).

[220] See David D. Haddock and Jonathan R. Macey, Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation, 30 J.L. & Econ. 311 (1987); see also Jonathan R. Macey, Insider Trading: Economics, Politics, And Policy (1991).

[221] In the seminal *Cady, Roberts* decision, the Commission acknowledged and embraced the federalization process: "The securities acts may be said to have generated a wholly new and far-reaching body of Federal corporation law." In re Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961). In addition, during the late 1970s the Commission considered imposing a variety of corporate governance rules, which would have essentially superseded state corporation law in

federal insider trading prohibition purportedly demonstrated the superiority of federal securities law over state corporate law. Because the states had shown little interest in insider trading for years, federal regulation demonstrated the modernity, flexibility, and innovativeness of the securities laws. The SEC's prominent role in attacking insider trading thus placed it in the vanguard of the movement to federalize corporate law and ensured that the SEC would have a leading role in any system of federal corporations law.

The validity of this hypothesis is suggested by its ability to explain the SEC's devotion of significant enforcement resources to insider trading during the 1980s. During that decade, the SEC embarked upon a limited program of deregulating the securities markets. Among other things, the SEC adopted a safe harbor for projections and other soft data, the shelf registration rule, the integrated disclosure system, and expanded the exemptions from registration under the Securities Act. At about the same time, however, the SEC adopted a vigorous enforcement campaign against insider trading. Not only did the number of cases increase substantially, but the SEC adopted a "big bang" approach under which it focused on high visibility cases that would produce substantial publicity.[222] In part this may have been due to an increase in the frequency of insider trading, but the public choice story nicely explains the SEC's interest in insider trading as motivated by a desire to preserve its budget during an era of deregulation and spending restraint.

The public choice story also explains the SEC's continuing attachment to the equal access approach to insider trading. The equal access policy generates an expansive prohibition, which federalizes a broad range of conduct otherwise left to state corporate law, while also warranting a highly active enforcement program. As such, the SEC's use of Rule 14e-3 and the misappropriation theory to evade *Chiarella* and *Dirks* makes perfect sense. By these devices, the SEC restored much of the prohibition's pre-*Chiarella* breadth and thereby ensured that its budget-justifying enforcement program would continue unimpeded.

Turning to the demand side, the insider trading prohibition appears to be supported and driven in large part by market professionals, a cohesive and politically powerful interest group, which the current legal regime effectively insulates from insider trading liability.[223] Only insiders and quasi-insiders such as lawyers and investment bankers have greater access to material nonpublic information than do market professionals. By basing insider trading liability on breach of fiduciary duty, and positing that the requisite fiduciary duty exists with respect to insiders and quasi-insiders but not with respect to

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many respects. See Stephen M. Bainbridge, The Short Life and Resurrection of SEC Rule 19c-4, 69 Wash. U. L.Q. 565, 603 n.176 (1991).

222 Bainbridge, supra note 50, at 466-67.

223 See Macey, supra note 220, at 17-18. Macey argues that Rule 14e-3, which is so strikingly different than the rest of the federal insider trading prohibition, is designed to protect the interests of target managers, another well-defined and politically powerful interest group. Id. Rule 14e-3 prohibits the practice of warehousing takeover securities, which hostile bidders otherwise could use to put target company securities into friendly hands before commencing a bid. Id. at 19-20.

market professionals, the prohibition protects the latter's ability to profit from new information about a firm.

When an insider trades on an impersonal secondary market, the insider takes advantage of the fact that the market maker's or specialist's bid-ask prices do not reflect the value of the inside information. Because market makers and specialists cannot distinguish insiders from noninsiders, they cannot protect themselves from being taken advantage of in this way.[224] When trading with insiders, the market maker or specialist thus will always be on the wrong side of the transaction. If insider trading is effectively prohibited, however, the market professionals are no longer exposed to this risk.

Professional securities traders likewise profit from the fiduciary-duty based insider trading prohibition. Because professional investors are often active traders, they are highly sensitive to the transaction costs of trading in securities. Prominent among these costs is the specialist's and market-maker's bid-ask spread. If a ban on insider trading lowers the risks faced by specialists and market-makers, some portion of the resulting gains should be passed on to professional traders in the form of narrower bid-ask spreads.

Analysts and professional traders are further benefited by a prohibition on insider trading, because only insiders are likely to have systematic advantages over market professionals in the competition to be the first to act on new information. Market professionals specialize in acquiring and analyzing information. They profit by trading with less well-informed investors or by selling information to them. If insiders can freely trade on nonpublic information, however, some portion of the information's value will be impounded into the price before it is learned by market professionals, which will reduce their returns.

Circumstantial evidence for the demand-side hypothesis is provided by SEC enforcement patterns.[225] In the years immediately prior to *Chiarella*, enforcement proceedings often targeted market professionals. The frequency of insider trading prosecutions rose dramatically after *Chiarella* held insider trading was unlawful only if the trader violated a fiduciary duty owed to the party with whom he trades. Yet, despite that increase in overall enforcement activity, there was a marked decline in the number of cases brought against market professionals.

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It is not a very appealing story. Taken together, the demand and supply side stories demonstrate that the insider trading prohibition advances no important federal policy. Instead, the prohibition is driven largely by the venal interests of bureaucrats and the entities they supposedly regulate. The remaining question is whether it is nevertheless possible to identify a public-regarding justification for the federal insider trading prohibition.

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[224] See William K.S. Wang, Stock Market Insider Trading: Victims, Violators and Remedies—Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect, 45 Villanova L. Rev. 27, 38-40 (2000).

[225] See Dooley, supra note 219, at 829-34.

B. The Case for Deregulation

In the policy debate over insider trading, the seminal event was the 1966 publication of Henry Manne's book INSIDER TRADING AND THE STOCK MARKET. It is only a slight exaggeration to suggest that Manne stunned the corporate law world by daring to propose the deregulation of insider trading. The response by most law professors, lawyers, and regulators was immediate and vitriolic rejection.

In one sense, Manne's project failed. Insider trading is still prohibited. Indeed, the sanctions for violating the prohibition have become more draconian—not less—since Manne's book was first published. In another sense, however, Manne's daring was at least partially vindicated. He changed the terms of the debate. Today, the insider trading debate takes place almost exclusively in the language of economics. Even those who still insist on treating insider trading as an issue of fairness necessarily spend much of their time responding to those who see it in economic terms.

Manne identified two principal ways in which insider trading benefits society and/or the firm in whose stock the insider traded. First, he argued that insider trading causes the market price of the affected security to move toward the price that the security would command if the inside information were publicly available. If so, both society and the firm benefit through increased price accuracy. Second, he posited insider trading as an efficient way of compensating managers for having produced information. If so, the firm benefits directly (and society indirectly) because managers have a greater incentive to produce additional information of value to the firm.

1. Insider Trading and Efficient Pricing of Securities

Basic economic theory tells us that the value of a share of stock is simply the present discounted value of the stream of dividends that will be paid on the stock in the future. Because the future is uncertain, however, the amount of future dividends, if any, cannot be known. In an efficient capital market, a security's current price thus is simply the consensus guess of investors as to the issuing corporation's future prospects. The "correct" price of a security is that which would be set by the market if all information relating to the security had been publicly disclosed. Because the market cannot value nonpublic information and because corporations (or outsiders) frequently possess material information that has not been made public, however, market prices often deviate from the "correct" price. Indeed, if it were not for this sort of mispricing, insider trading would not be profitable.

No one seriously disputes that both firms and society benefit from accurate pricing of securities. Accurate pricing benefits society by improving the economy's allocation of capital investment and by decreasing the volatility of security prices. This dampening of price fluctuations decreases the likelihood of individual windfall gains and increases the attractiveness of investing in securities for risk-averse investors. The individual corporation also benefits from accurate pricing of its securities through reduced investor uncertainty and improved monitoring of management's effectiveness.

Although U.S. securities laws purportedly encourage accurate pricing by requiring disclosure of corporate information, they do not require the disclosure of all material information. Where disclosure would interfere with legitimate business transactions, disclosure by the corporation is usually not required unless the firm is dealing in its own securities at the time.

When a firm withholds material information, its securities are no longer accurately priced by the market. In *Texas Gulf Sulphur*, when the ore deposit was discovered, TGS common stock sold for approximately eighteen dollars per share. By the time the discovery was disclosed, four months later, the price had risen to over thirty-one dollars per share. One month after disclosure, the stock was selling for approximately fifty-eight dollars per share. The difficulty, of course, is that TGS had gone to considerable expense to identify potential areas for mineral exploration and to conduct the initial search. Suppose TGS was required to disclose the ore strike as soon as the initial assay results came back. What would have happened? Landowners would have demanded a higher price for the mineral rights. Worse yet, competitors could have come into the area and bid against TGS for the mineral rights. In economic terms, these competitors would "free ride" on TGS's efforts. TGS will not earn a profit on the ore deposit until it has extracted enough ore to pay for its exploration costs. Because competitors will not have to incur any of the search costs TGS had incurred to find the ore deposit, they will have a higher profit margin on any ore extracted. In turn, that will allow them to outbid TGS for the mineral rights.[226] A securities law rule requiring immediate disclosure of the ore deposit (or any similar proprietary information) would discourage innovation and discovery by permitting this sort of free riding behavior—rational firms would not try to develop new mines if they knew competitors will be able to free ride on their efforts. In order to encourage innovation, the securities laws therefore generally permit corporations to delay disclosure of this sort of information for some period of time. As we have seen, however, the trade-off mandated by this policy is one of less accurate securities prices.

Manne essentially argued that insider trading is an effective compromise between the need for preserving incentives to produce information and the need for maintaining accurate securities prices. Manne offered the following example of this alleged effect: A firm's stock currently sells at fifty dollars per share. The firm has discovered new information that, if publicly disclosed, would cause the stock to sell at sixty dollars. If insiders trade on this information, the price of the stock will gradually rise toward the correct price. Absent insider trading or leaks, the stock's price will remain at fifty dollars until the information is publicly disclosed and then rapidly rise to the correct price of sixty dollars. Thus, insider trading acts as a replacement for public disclosure of the information, preserving market gains of correct pricing while permitting the corporation to retain the benefits of nondisclosure.[227]

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[226] Suppose TGS spent $2 per acre on exploration costs and is willing to pay $10 per acre to buy the mineral rights from the landowners. TGS must make at least $12 per acre on extracted ore before it makes a profit. Because competitors do not incur any exploration costs, they could pay $11 per acre for the mineral rights and still make a profit.

[227] Henry Manne, Insider Trading and the Stock Market 77-91 (1966). On the signaling effect of insider trading, see William J. Carney, Signaling and Causation in Insider Trading, 36 Cath. U. L. Rev. 863 (1987); Dennis S. Corgill, Insider Trading, Price Signals, and Noisy Information, 71 Ind. L.J. 355 (1996); Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 Duke L.J. 977 (1992).

Despite the anecdotal support for Manne's position provided by *Texas Gulf Sulphur* and similar cases,[228] empirical evidence on point remains scanty. Early market studies indicated insider trading had an insignificant effect on price in most cases.[229] Subsequent studies suggested the market reacts fairly quickly when insiders buy securities, but the initial price effect is small when insiders sell.[230] These studies are problematic, however, because they relied principally (or solely) on the transactions reports corporate officers, directors, and 10% shareholders are required to file under § 16(a). Because insiders are unlikely to report transactions that violate Rule 10b-5, and because much illegal insider trading activity is known to involve persons not subject to the §16(a) reporting requirement, conclusions drawn from such studies may not tell us very much about the price and volume effects of illegal insider trading. Accordingly, it is significant that a more recent and widely-cited study of insider trading cases brought by the SEC during the 1980s found that the defendants' insider trading led to quick price changes.[231] That result supports Manne's empirical claim, subject to the caveat that reliance on data obtained from SEC prosecutions arguably may not be conclusive as to the price effects of undetected insider trading due to selection bias, although the study in question admittedly made strenuous efforts to avoid any such bias.

Does efficient capital markets theory support Manne's hypothesis? Although Manne's assertion that insider trading moves stock prices in the "correct" direction—i.e., the direction the stock price would move if the information were announced—seems intuitively plausible, the anonymity of impersonal market transactions makes it far from obvious that insider trading will have any effect on prices. Accordingly, we need to look more closely at the way in which insider trading might work its magic on stock prices.

If you studied price theory in economics, your initial intuition may be that insider trading affects stock prices by changing the demand for the issuing corporation's stock. Economics tells us that the price of a commodity is set by supply and demand forces. The equilibrium or market clearing price is that at which consumers are willing to buy all of the commodity offered by suppliers. If the supply remains constant, but demand goes up, the equilibrium price rises and vice-versa.

Suppose an insider buys stock on good news. The supply of stock remains constant (assuming the company is not in the midst of a stock offering or repurchase), but demand has increased, so a higher equilibrium price should result. All of which seems perfectly

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[228] Recall that the TGS insiders began active trading in its stock almost immediately after discovery of the ore deposit. During the four months between discovery and disclosure, the price of TGS common stock gradually rose by over twelve dollars. Arguably, this price increase was due to inside trading. In turn, the insiders' profits were the price society paid for obtaining the beneficial effects of enhanced market efficiency.

[229] See Roy A. Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 Va. L. Rev. 1425, 1443 (1967) (citing studies).

[230] Dan Givoly & Dan Palmon, Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence, 58 J. Bus. 69 (1985).

[231] Lisa K. Meulbroek, An Empirical Analysis of Illegal Insider Trading, 47 J. Fin. 1661 (1992).

plausible, but for the inconvenient fact that a given security represents only a particular combination of expected return and systematic risk, for which there is a vast number of substitutes. The correct measure for the supply of securities thus is not simply the total of the firm's outstanding securities, but the vastly larger number of securities with a similar combination of risk and return. Accordingly, the supply/demand effect of a relatively small number of insider trades should not have a significant price effect. Over the portion of the curve observed by individual traders, the demand curve should be flat rather than downward sloping.

Instead, if insider trading is to affect the price of securities, it is through the derivatively informed trading mechanism of market efficiency. Derivatively informed trading affects market prices through a two-step mechanism.[232] First, those individuals possessing material nonpublic information begin trading. Their trading has only a small effect on price. Some uninformed traders become aware of the insider trading through leakage or tipping of information or through observation of insider trades. Other traders gain insight by following the price fluctuations of the securities. Finally, the market reacts to the insiders' trades and gradually moves toward the correct price. The problem is that while derivatively informed trading can affect price, it functions slowly and sporadically. Given the inefficiency of derivatively informed trading, the market efficiency justification for insider trading loses much of its force.

2. Insider Trading as an Efficient Compensation Scheme

Manne's other principal argument against the ban on insider trading rested on the claim that allowing insider trading was an effective means of compensating entrepreneurs in large corporations. Manne distinguished corporate entrepreneurs from mere corporate managers. The latter simply operate the firm according to predetermined guidelines. By contrast, an entrepreneur's contribution to the firm consists of producing new valuable information. The entrepreneur's compensation must have a reasonable relation to the value of his contribution to give him incentives to produce more information. Because it is rarely possible to ascertain information's value to the firm in advance, predetermined compensation, such as salary, is inappropriate for entrepreneurs. Instead, claimed Manne, insider trading is an effective way to compensate entrepreneurs for innovations. The increase in the price of the security following public disclosure provides an imperfect but comparatively accurate measure of the value of the innovation to the firm. The entrepreneur can recover the value of his discovery by purchasing the firm's securities prior to disclosure and selling them after the price rises.[233]

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[232] See generally Ronald Gilson and Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984).

[233] Manne, supra note 227, at 131-41. In evaluating compensation-based justifications for deregulating inside trading, it is highly relevant to consider whether the corporation or the manager owns the property right to the information in question. Some of those who favor deregulating insider trading deny that firms have a property interest in information produced by their agents that includes the right to prevent the agent from trading on the basis of that information. In contrast, those who favor regulation contend that when an agent produces information the property right to that information belongs to the firm. As described below, the latter appears to be the better view. The implication of that conclusion for the compensation

Professors Carlton and Fischel subsequently suggested a further refinement of Manne's compensation argument. They likewise believed *ex ante* contracts fail to appropriately compensate agents for innovations. The firm could renegotiate these contracts *ex post* to reward innovations, but renegotiation is costly and subject to strategic behavior. One of the advantages of insider trading, they argued, is that an agent revises his compensation package without renegotiating his contract. By trading on the new information, the agent self tailors his compensation to account for the information he produces, increasing his incentives to develop valuable innovations.[234]

Manne argued salary and bonuses provide inadequate incentives for entrepreneurial inventiveness because they fail to accurately measure the value to the firm of innovations.[235] Query, however, whether insider trading is any more accurate. Even assuming the change in stock price accurately measures the value of the innovation, the insider's compensation is limited by the number of shares he can purchase. This, in turn, is limited by his wealth. As such, the insider's trading returns are based, not on the value of his contribution, but on his wealth.

Another objection to the compensation argument is the difficulty of restricting trading to those who produced the information. Where information is concerned, production costs normally exceed distribution costs. As such, many firm agents may trade on the information without having contributed to its production.

A related criticism is the difficulty of limiting trading to instances in which the insider actually produced valuable information. In particular, why should insiders be permitted to trade on bad news? Allowing managers to profit from inside trading reduces the penalties associated with a project's failure because trading managers can profit whether the project succeeds or fails. If the project fails, the manager can sell his shares before that information becomes public and thus avoid an otherwise certain loss. The manager can go beyond mere loss avoidance into actual profit-making by short selling the firm's stock.

A final objection to the compensation thesis follows from the contingent nature of insider trading. Because the agent's trading returns cannot be measured in advance, neither can the true cost of his reward. As a result, selection of the most cost-effective compensation package is made more difficult. Moreover, the agent himself may prefer a less uncertain compensation package. If an agent is risk averse, he will prefer the certainty of $100,000 salary to a salary of $50,000 and a ten percent chance of a bonus of $500,000 from

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debate is that agents should not be allowed to set their own compensation by inside trading. Instead, if insider trading is to be used as a form of compensation, it should be so used only with the consent of the firm.

[234] Dennis W. Carlton and Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 869-72 (1983). But see Easterbrook, supra note 22; Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 Va. L. Rev. 117 (1982); Saul Levmore, In Defense of the Regulation of Insider Trading, 11 Harv. J. L. & Pub. Pol. 101 (1988); Robert Thompson, Insider Trading, Investor Harm, and Executive Compensation, 50 Case West. Res. L.Rev. 291 (1999).

[235] Manne, supra note 227, at 134-38.

insider trading. Thus, the shareholders and the agent would gain by exchanging a guaranteed bonus for the agent's promise not to trade on inside information.

C. The Case For Regulation

The arguments in favor of regulating insider trading can be separated into one set sounding in economic terms and a second set premised on fairness, equity, and other nonefficiency grounds. The noneconomic arguments break down into two major sets: a claim that regulating insider trading is necessary to protect the mandatory disclosure system and a claim that insider trading is unfair. The economic arguments can be divided as follows: claims that insider trading injures investors; claims that insider trading injures firms; and claims relating to property rights in information.

1. Mandatory disclosure

Mandatory disclosure is arguably the central purpose of the federal securities laws. Both the Securities Act and the Exchange Act are based on a policy of mandating disclosure by issuers and others. The Securities Act creates a transactional disclosure regime, which is applicable only when a firm is actually selling securities. In contrast, the 1934 Exchange Act creates a periodic disclosure regime, which requires on-going, regular, disclosures.

As we have seen, neither Act requires a firm to disclose all nonpublic information relating to the firm. Instead, when premature disclosure would harm the firm's interests, the firm is generally free to refrain from disclosing such information. Even proponents of the mandatory disclosure system acknowledge that it is appropriate to strike this balance between investors' need for disclosure and management's need for secrecy.

It has been suggested that the federal insider trading prohibition is necessary to the effective working of this mandatory disclosure system.[236] The prohibition supposedly ensures "that confidentiality is not abused and utilized for the personal and secret profit of corporate managers and employees or persons associated with a bidder in a tender offer."[237] Many reputable corporate law scholars, of course, doubt whether mandatory disclosure is a sound policy.[238] If the mandatory disclosure system ought to be done away with, this line of argument collapses at the starting gate. For present purposes, however, we shall take the mandatory disclosure system as a given and limit our inquiry to whether a prohibition of insider trading is necessary to protect the mandatory disclosure system from abuse.

Insider trading seems likely to adversely affect the mandatory disclosure regime only insofar as it affects managers' incentives to manipulate the timing of disclosure. As the

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[236] Roberta S. Karmel, The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Insider Information Is Untenable, 59 Brook. L. Rev. 149, 169-70 (1993). See generally James D. Cox, Insider Trading Regulation and the Production of Information: Theory and Evidence, 64 Wash. U. L.Q. 475 (1986).

[237] Karmel, supra note 236, at 170-71.

[238] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure Of Corporate Law 276-314 (1991); Roberta Romano, The Genius Of American Corporate Law 91-96 (1993).

argument goes, a manager might delay making federally mandated disclosures in order to give herself more time in which to trade in her company's stock before the inside information is announced. As we shall see below, however, it is doubtful whether insider trading results in significant delays in corporate disclosures.

Indeed, insider trading seems more likely to create incentives for insiders to prematurely disclose information than to delay its disclosure. While premature disclosure threatens the firm's interests, that threat has little to do with the mandatory disclosure system. Instead, it is properly treated as a breach of the insider's fiduciary duty.

In any event, concern for ensuring timely disclosure cannot justify a prohibition of the breadth it currently possesses. As we have seen, the prohibition encompasses a host of actors both within and outside the firm. In contrast, only a few actors are likely to have the power to affect the timing of disclosure. A much narrower prohibition thus would suffice if this were the principal rationale for regulating insider trading. Indeed, if this were the main concern, one need not prohibit insider trading at all. Instead, one could strike at the problem much more directly by proscribing failing to disclose material information in the absence of a legitimate corporate reason for doing so.

2. Fairness

There seems to be a widely shared view that there is something inherently sleazy about insider trading. Given the draconian penalties associated with insider trading, however, vague and poorly articulated notions of fairness surely provide an insufficient justification for the prohibition. Can we identify a standard of reference by which to demonstrate that insider trading ought to be prohibited on fairness grounds? In short, we cannot.

Fairness can be defined in various ways. Most of these definitions, however, collapse into the various efficiency-based rationales for prohibiting insider trading. We might define fairness as fidelity, for example, by which we mean the notion that an agent should not cheat her principal. But this argument only has traction if insider trading is in fact a form of cheating, which in turn depends on how we assign the property right to confidential corporate information. Alternatively, we might define fairness as equality of access to information, as many courts and scholars have done, but this definition must be rejected in light of *Chiarella*'s rejection of the *Texas Gulf Sulphur* equal access standard. Finally, we might define fairness as a prohibition of injuring another. But such a definition justifies an insider trading prohibition only if investors are injured by insider trading, which seems unlikely. Accordingly, fairness concerns need not detain us further; instead, we can turn directly to the economic arguments against insider trading.

3. Injury to investors

Insider trading is said to harm investors in two principal ways. Some contend that the investor's trades are made at the "wrong price." A more sophisticated theory posits that the investor is induced to make a bad purchase or sale. Neither argument proves convincing on close examination.

An investor who trades in a security contemporaneously with insiders having access to material nonpublic information likely will allege injury in that he sold at the wrong price; i.e., a price that does not reflect the undisclosed information. If a firm's stock currently sells at $10 per share, but after disclosure of the new information will sell at $15, a shareholder who sells at the current price thus will claim a $5 loss.

The investor's claim, however, is fundamentally flawed. It is purely fortuitous that an insider was on the other side of the transaction. The gain corresponding to the shareholder's loss is reaped not just by inside traders, but by all contemporaneous purchasers whether they had access to the undisclosed information or not.[239]

To be sure, the investor might not have sold if he had had the same information as the insider, but even so the rules governing insider trading are not the source of his problem. On an impersonal trading market, neither party knows the identity of the person with whom he is trading. Thus, the seller has made an independent decision to sell without knowing that the insider is buying; if the insider were not buying, the seller would still sell. It is thus the nondisclosure that causes the harm, rather than the mere fact of trading.[240]

The information asymmetry between insiders and public investors arises out of the mandatory disclosure rules allowing firms to keep some information confidential even if it is material to investor decisionmaking. Unless immediate disclosure of material information is to be required, a step the law has been unwilling to take, there will always be winners and losers in this situation. Irrespective of whether insiders are permitted to inside trade or not, the investor will not have the same access to information as the insider. It makes little sense to claim that the shareholder is injured when his shares are

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[239] To be sure, insider trading results in outside investors as a class reaping a smaller share of the gains from new information. William K. S. Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?, 54 S. Cal. L. Rev. 1217, 1234-35 (1981). In Texas Gulf Sulphur Co., for example, the price of TGS's stock rose from about $18 to about $55 during the relevant time period. Assuming all of that gain can be attributed to information about the ore strike, and further assuming that TGS has 1 million shares outstanding, the total gain to be divided was about $37 million. If insiders pocketed $2 million of that gain, there will be $2 million less for outsiders to divide. See Wang, supra note 224, at 28-40 (discussing the "law of conservation of securities"). This is not a strong argument for banning insider trading, however. First, it only asserts that investors as a class are less well-off by virtue of insider trading. It cannot identify any particular investor who suffered losses as a result of the insider trading. Second, if we make the traditional assumption that the relevant supply of a given security is the universe of all securities with similar beta coefficients, any gains siphoned off by insiders with respect to a particular stock are likely to be an immaterial percentage of the gains contemporaneously earned by the class of investors as a whole. (Even in Texas Gulf Sulphur Co., trading by insiders amounted to less than 10% of the trading activity in TGS stock and, of course, a vastly smaller percentage of trading activity in the class of securities with comparable betas.) Finally, although the law of conservation of securities asserts that some portion of the gains flow to insiders rather than to outside investors, that fact standing alone is legally unremarkable. To justify a ban on insider trading, you need a basis for asserting that it is inappropriate, undesirable, or immoral for those gains to be reaped by insiders. The law of conservation of securities does not, standing alone, provide such a basis.

[240] On an impersonal exchange, moreover, the precise identity of the seller is purely fortuitous and it is difficult to argue that the seller who happened to be matched with the insider has been hurt more than any other contemporaneous seller whose sale was not so matched.

bought by an insider, but not when they are bought by an outsider without access to information. To the extent the selling shareholder is injured, his injury thus is correctly attributed to the rules allowing corporate nondisclosure of material information, not to insider trading.

Arguably, for example, the TGS shareholders who sold from November through April were not made any worse off by the insider trading that occurred during that period. Most, if not all, of these people sold for a series of random reasons unrelated to the trading activities of insiders. The only seller we should worry about is the one that consciously thought, "I'm going to sell because this worthless company never finds any ore." Even if such an investor existed, however, we have no feasible way of identifying him. *Ex post*, of course, all the sellers will pretend this was why they sold. If we believe Manne's argument that insider trading is an efficient means of transmitting information to the market, moreover, selling TGS shareholders actually were better off by virtue of the insider trading. They sold at a price higher than their shares would have commanded but for the insider trading activity that led to higher prices. In short, insider trading has no "victims." What to do about the "offenders" is a distinct question analytically.

A more sophisticated argument is that the price effects of insider trading induce shareholders to make poorly advised transactions. It is doubtful whether insider trading produces the sort of price effects necessary to induce shareholders to trade, however. While derivatively informed trading can affect price, it functions slowly and sporadically. Given the inefficiency of derivatively informed trading, price or volume changes resulting from insider trading will only rarely be of sufficient magnitude to induce investors to trade.

Assuming for the sake of argument that insider trading produces noticeable price effects, however, and further assuming that some investors are misled by those effects, the inducement argument is further flawed because many transactions would have taken place regardless of the price changes resulting from insider trading. Investors who would have traded irrespective of the presence of insiders in the market benefit from insider trading because they transacted at a price closer to the correct price; i.e., the price that would prevail if the information were disclosed. In any case, it is hard to tell how the inducement argument plays out when investors are examined as a class. For any given number who decide to sell because of a price rise, for example, another group of investors may decide to defer a planned sale in anticipation of further increases.

An argument closely related to the investor injury issue is the claim that insider trading undermines investor confidence in the securities market. In the absence of a credible investor injury story, it is difficult to see why insider trading should undermine investor confidence in the integrity of the securities markets.

There is no denying that many investors are angered by insider trading. A Business Week poll, for example, found that 52% of respondents wanted insider trading to remain unlawful. In order to determine whether investor anger over insider trading undermines their confidence in the markets, however, one must first identify the source of that anger. A Harris poll found that 55% of the respondents said they would inside trade if given the opportunity. Of those who said they would not trade, 34% said they would not do so only because they would be afraid the tip was incorrect. Only 35% said they would refrain from trading because insider trading is wrong. Here lies one of the paradoxes of insider trading. Most people want insider trading to remain illegal, but most people (apparently including at least some of the former) are willing to participate if given the chance to do so on the basis of accurate information. This paradox is central to evaluating arguments based on confidence in the market. Investors that are willing to inside trade if given the opportunity obviously have no confidence in the integrity of the market in the first instance. Any anger they feel over insider trading therefore has nothing to do with a loss of confidence in the integrity of the market, but instead arises principally from envy of the insider's greater access to information.

The loss of confidence argument is further undercut by the stock market's performance since the insider trading scandals of the mid-1980s. The enormous publicity given those scandals put all investors on notice that insider trading is a common securities violation. At the same time, however, the years since the scandals have been one of the stock market's most robust periods. One can but conclude that insider trading does not seriously threaten the confidence of investors in the securities markets.

In sum, neither investor protection nor maintenance of confidence have much traction as theoretical justifications for any prohibition of insider trading. Nor do they have much explanatory power with respect to the prohibition currently on the books. An investor's rights vary widely depending on the nature of the insider trading transaction; the identity of the trader; and the source of the information. Yet, if the goal is investor protection, why should these considerations be relevant?

Recall, for example, *United States v. Carpenter*:[241] R. Foster Winans wrote the Wall Street Journal's "Heard on the Street" column, a daily report on various stocks that was said to affect the price of the stocks discussed. Journal policy expressly treated the column's contents prior to publication as confidential information belonging to the newspaper. Despite that rule, Winans agreed to provide several co-conspirators with prepublication information as to the timing and contents of future columns. His fellow conspirators then traded in those stocks based on the expected impact of the column on the stocks' prices, sharing the profits. In affirming their convictions, the Second Circuit anticipated *O'Hagan* by holding that Winans's breach of his fiduciary duty to the Wall Street Journal satisfied the standards laid down in *Chiarella* and *Dirks*. From either an investor protection or confidence in the market perspective, however, this outcome seems bizarre at best. For example, any duties Winans owed in this situation ran to an entity that had neither issued the securities in question nor even participated in stock market transactions. What Winans's breach of his duties to the Wall Street Journal had to do with the federal securities laws, if anything, is not self evident.

The incongruity of the misappropriation theory becomes even more apparent when one considers that its logic suggests that the Wall Street Journal could lawfully trade on the same information used by Winans. If we are really concerned with protecting investors and maintaining their confidence in the market's integrity, the inside trader's identity ought to be irrelevant. From the investors' point of view, insider trading is a matter of concern only because they have traded with someone who used their superior access to information to profit at the investor's expense. As such, it would not appear to matter

[241] United States v. Carpenter, 791 F.2d 1024, 1026-27 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987).

whether it is Winans or the Journal on the opposite side of the transaction. Both have greater access to the relevant information than do investors.

The logic of the misappropriation theory also suggests that Winans would not have been liable if the Wall Street Journal had authorized his trades. In that instance, the Journal would not have been deceived, as *O'Hagan* requires. Winans' trades would not have constituted an improper conversion of nonpublic information, moreover, so that the essential breach of fiduciary duty would not be present. Again, however, from an investor's perspective, it would not seem to matter whether Winans's trades were authorized or not.

Finally, conduct that should be lawful under the misappropriation theory is clearly proscribed by Rule 14e-3. A takeover bidder may not authorize others to trade on information about a pending tender offer, for example, even though such trading might aid the bidder by putting stock in friendly hands. If the acquisition is to take place by means other than a tender offer, however, neither Rule 14e-3 nor the misappropriation theory should apply. From an investor's perspective, however, the form of the acquisition seems just as irrelevant as the identity of the insider trader.

All of these anomalies, oddities, and incongruities have crept into the federal insider trading prohibition as a direct result of *Chiarella*'s imposition of a fiduciary duty requirement. None of them, however, are easily explicable from either an investor protection or a confidence in the market rationale.

4. Injury to the issuer

Unlike tangible property, information can be used by more than one person without necessarily lowering its value. If a manager who has just negotiated a major contract for his employer then trades in his employer's stock, for example, there is no reason to believe that the manager's conduct necessarily lowers the value of the contract to the employer. But while insider trading will not always harm the employer, it may do so in some circumstances. This section evaluates four significant potential injuries to the issuer associated with insider trading.

Delay. Insider trading could injure the firm if it creates incentives for managers to delay the transmission of information to superiors. Decisionmaking in any entity requires accurate, timely information. In large, hierarchical organizations, such as publicly traded corporations, information must pass through many levels before reaching senior managers. The more levels, the greater the probability of distortion or delay intrinsic to the system.[242] This inefficiency can be reduced by downward delegation of decisionmaking authority but not eliminated. Even with only minimal delay in the upward transmission of information at every level, where the information must pass through many levels before reaching a decision-maker, the net delay may be substantial.

If a manager discovers or obtains information (either beneficial or detrimental to the firm), she may delay disclosure of that information to other managers so as to assure herself sufficient time to trade on the basis of that information before the corporation acts

[242] See generally Robert J. Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 80 Mich. L. Rev. 1051 (1982).

upon it. Even if the period of delay by any one manager is brief, the net delay produced by successive trading managers may be substantial. Unnecessary delay of this sort harms the firm in several ways. The firm must monitor the manager's conduct to ensure timely carrying out of her duties. It becomes more likely that outsiders will become aware of the information through snooping or leaks. Some outsider may even independently discover and utilize the information before the corporation acts upon it.

Although delay is a plausible source of harm to the issuer, its importance is easily exaggerated. The available empirical evidence scarcely rises above the anecdotal level, but does suggest that measurable delay attributable to insider trading is rare.[243] Given the rapidity with which securities transactions can be conducted in modern secondary trading markets, moreover, a manager need at most delay corporate action long enough for a five minute telephone conversation with her stockbroker. Delay (either in transmitting information or taking action) also often will be readily detectable by the employer. Finally, and perhaps most importantly, insider trading may create incentives to release information early just as often as it creates incentives to delay transmission and disclosure of information.

Interference with Corporate Plans. Trading during the planning stage of an acquisition is a classic example of how insider trading might adversely interfere with corporate plans. If managers charged with overseeing an acquisition buy shares in the target, and their trading has a significant upward effect on the price of the target's stock, the takeover will be more expensive. If significant price and volume changes are caused by their trading, that also might tip off others to the secret, interfering with the bidder's plans, as by alerting the target to the need for defensive measures.

The risk of premature disclosure poses an even more serious threat to corporate plans. The issuer often has just as much interest in when information becomes public as it does in whether the information becomes public. Suppose Target, Inc., enters into merger negotiations with a potential acquirer. Target managers who inside trade on the basis of that information will rarely need to delay corporate action in order to effect their purchases. Having made their purchases, however, the managers now have an incentive to cause disclosure of Target's plans as soon as possible. Absent leaks or other forms of derivatively informed trading, the merger will have no price effect until it is disclosed to the market, at which time there usually is a strong positive effect. Once the information is disclosed, the trading managers will be able to reap substantial profits, but until disclosure takes place, they bear a variety of firm-specific and market risks. The deal, the stock market, or both may collapse at any time. Early disclosure enables the managers to minimize those risks by selling out as soon as the price jumps in response to the announcement.

If disclosure is made too early, a variety of adverse consequences may result. If disclosure triggers competing bids, the initial bidder may withdraw from the bidding or demand protection in the form of costly lock-ups and other exclusivity provisions. Alternatively, if disclosure does not trigger competing bids, the initial bidder may

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[243] Dooley, supra note 22, at 34.

conclude that it overbid and lower its offer accordingly. In addition, early disclosure brings the deal to the attention of regulators and plaintiffs' lawyers earlier than necessary.

An even worse case scenario is suggested by *SEC v. Texas Gulf Sulphur Co*.[244] Recall that insiders who knew of the ore discovery traded over an extended period of time. During that period the corporation was attempting to buy up the mineral rights to the affected land. If the news had leaked prematurely, the issuer at least would have had to pay much higher fees for the mineral rights, and may well have lost some land to competitors. Given the magnitude of the strike, which eventually resulted in a 300-plus percent increase in the firm's market price, the harm that would have resulted from premature disclosure was immense.

Although insider trading probably only rarely causes the firm to lose opportunities, it may create incentives for management to alter firm plans in less drastic ways to increase the likelihood and magnitude of trading profits. For example, trading managers can accelerate receipt of revenue, change depreciation strategy, or alter dividend payments in an attempt to affect share prices and insider returns. Alternatively, the insiders might structure corporate transactions to increase the opportunity for secret-keeping. Both types of decisions may adversely affect the firm and its shareholders. Moreover, this incentive may result in allocative inefficiency by encouraging over-investment in those industries or activities that generate opportunities for insider trading.

Judge Frank Easterbrook has identified a related perverse incentive created by insider trading.[245] Managers may elect to follow policies that increase fluctuations in the price of the firm's stock. They may select riskier projects than the shareholders would prefer, because, if the risks pay off, they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss. In contrast, Professors Carlton and Fischel assert that Easterbrook overstates the incentive to choose high-risk projects.[246] Because managers must work in teams, the ability of one or a few managers to select high-risk projects is severely constrained through monitoring by colleagues. Cooperation by enough managers to pursue such projects to the firm's detriment is unlikely because a lone whistle-blower is likely to gain more by exposing others than he will by colluding with them. Further, Carlton and Fischel argue managers have strong incentives to maximize the value of their services to the firm. Therefore they are unlikely to risk lowering that value for short-term gain by adopting policies detrimental to long-term firm profitability. Finally, Carlton and Fischel alternatively argue that even if insider trading creates incentives for management to choose high-risk projects, these incentives are not necessarily harmful. Such incentives would act as a counterweight to the inherent risk aversion that otherwise encourages managers to select lower risk projects than shareholders would prefer. Allowing insider trading may encourage management to select negative net present value investments, however, not only because shareholders

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[244] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[245] Easterbrook, supra note 22, at 332.

[246] Carlton and Fischel, supra note 234, at 875-76. See generally Lucian Arye Bebchuk and Chaim Fershtman, Insider Trading and the Managerial Choice among Risky Projects, 29 J. Financial & Quantitative Anal. 1 (1994).

bear the full risk of failure, but also because failure presents management with an opportunity for profit through short-selling. As a result, shareholders might prefer other incentive schemes.

Injury to Reputation. It has been said that insider trading by corporate managers may cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.[247] Reputational injury of this sort could translate into a direct financial injury, by raising the firm's cost of capital, if investors demand a premium (by paying less) when buying stock in a firm whose managers inside trade. Because shareholder injury is a critical underlying premise of the reputational injury story, however, this argument is a nonstarter. As we have seen, it is very hard to create a plausible shareholder injury story.

5. Property rights

In short, the federal insider trading prohibition is justifiable solely as a means of protecting property rights in information. There are essentially two ways of creating property rights in information: allow the owner to enter into transactions without disclosing the information or prohibit others from using the information. In effect, the federal insider trading prohibition vests a property right of the latter type in the party to whom the insider trader owes a fiduciary duty to refrain from self dealing in confidential information. To be sure, at first blush, the insider trading prohibition admittedly does not look very much like most property rights. Enforcement of the insider trading prohibition admittedly differs rather dramatically from enforcement of, say, trespassing laws. The existence of property rights in a variety of intangibles, including information, however, is well-established. Trademarks, copyrights, and patents are but a few of the better known examples of this phenomenon. There are striking doctrinal parallels, moreover, between insider trading and these other types of property rights in information. Using another's trade secret, for example, is actionable only if taking the trade secret involved a breach of fiduciary duty, misrepresentation, or theft. This was an apt summary of the law of insider trading after the Supreme Court's decisions in *Chiarella* and *Dirks* (although it is unclear whether liability for theft in the absence of a breach of fiduciary duty survives *O'Hagan*).

In context, moreover, even the insider trading prohibition's enforcement mechanisms are not inconsistent with a property rights analysis. Where public policy argues for giving someone a property right, but the costs of enforcing such a right would be excessive, the state often uses its regulatory powers as a substitute for creating private property rights. Insider trading poses just such a situation. Private enforcement of the insider trading laws is rare and usually parasitic on public enforcement proceedings. Indeed, the very nature of insider trading arguably makes public regulation essential precisely because private enforcement is almost impossible. The insider trading prohibition's regulatory nature thus need not preclude a property rights-based analysis.

The rationale for prohibiting insider trading is the same as that for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce

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[247] Compare Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) (discussing threat of reputational injury) with Freeman v. Decio, 584 F.2d 186, 194 (7th Cir. 1978) (arguing that injury to reputation is speculative).

socially valuable information. As the theory goes, the readily appropriable nature of information makes it difficult for the developer of a new idea to recoup the sunk costs incurred to develop it. If an inventor develops a better mousetrap, for example, he cannot profit on that invention without selling mousetraps and thereby making the new design available to potential competitors. Assuming both the inventor and his competitors incur roughly equivalent marginal costs to produce and market the trap, the competitors will be able to set a market price at which the inventor likely will be unable to earn a return on his sunk costs. *Ex post*, the rational inventor should ignore his sunk costs and go on producing the improved mousetrap. *Ex ante*, however, the inventor will anticipate that he will be unable to generate positive returns on his up-front costs and therefore will be deterred from developing socially valuable information. Accordingly, society provides incentives for inventive activity by using the patent system to give inventors a property right in new ideas. By preventing competitors from appropriating the idea, the patent allows the inventor to charge monopolistic prices for the improved mousetrap, thereby recouping his sunk costs. Trademark, copyright, and trade secret law all are justified on similar grounds.

This argument does not provide as compelling a justification for the insider trading prohibition as it does for the patent system. A property right in information should be created when necessary to prevent conduct by which someone other than the developer of socially valuable information appropriates its value before the developer can recoup his sunk costs. As we have seen, however, insider trading often has no effect on an idea's value to the corporation and probably never entirely eliminates its value. Legalizing insider trading thus would have a much smaller impact on the corporation's incentive to develop new information than would, say, legalizing patent infringement.

The property rights approach nevertheless has considerable power. Consider the prototypical insider trading transaction, in which an insider trades in his employer's stock on the basis of information learned solely because of his position with the firm. There is no avoiding the necessity of assigning a property interest in the information to either the corporation or the insider. A rule allowing insider trading assigns a property interest to the insider, while a rule prohibiting insider trading assigns it to the corporation.

From the corporation's perspective, we have seen that legalizing insider trading would have a relatively small effect on the firm's incentives to develop new information. In some cases, however, insider trading will harm the corporation's interests and thus adversely affect its incentives in this regard. This argues for assigning the property right to the corporation, rather than the insider.

That argument is buttressed by the observation that creation of a property right with respect to a particular asset typically is not dependent upon there being a measurable loss of value resulting from the asset's use by someone else. Indeed, creation of a property right is appropriate even if any loss in value is entirely subjective, both because subjective valuations are difficult to measure for purposes of awarding damages and because the possible loss of subjective values presumably would affect the corporation's incentives to cause its agents to develop new information. As with other property rights, the law therefore should simply assume (although the assumption will sometimes be wrong) that assigning the property right to agent-produced information to the firm maximizes the social incentives for the production of valuable new information.

Because the relative rarity of cases in which harm occurs to the corporation weakens the argument for assigning it the property right, however, the critical issue may be whether one can justify assigning the property right to the insider. On close examination, the argument for assigning the property right to the insider is considerably weaker than the argument for assigning it to the corporation. The only plausible justification for doing so is the argument that legalized insider trading would be an appropriate compensation scheme. In other words, society might allow insiders to inside trade in order to give them greater incentives to develop new information. As we have seen, however, this argument appears to founder because, *inter alia*, insider trading is an inefficient compensation scheme. The economic theory of property rights in information thus cannot justify assigning the property right to insiders rather than to the corporation. Because there is no avoiding the necessity of assigning the property right to the information in question to one of the relevant parties, the argument for assigning it to the corporation therefore should prevail.[248]

The property rights rationale explains many aspects of the (pre-*O'Hagan*) insider trading prohibition far better than do any of the more traditional securities fraud-based justifications.[249] The basic function of a securities fraud regime is to ensure timely disclosure of accurate information to investors. Yet, it seems indisputable that the insider trading prohibition does not lead to increased disclosure. Instead, as we have seen, the disclose or abstain rule typically collapses into a rule of abstention.

Consider also the apparent incongruity that Winans (the defendant in *Carpenter)* could be held liable for trading on information about the Wall Street Journal's "Heard on the Street," but the Journal could have lawfully traded on the same information. This result makes no sense from a traditional securities law perspective. From a property rights perspective, however, the result in *Carpenter* makes perfect sense: because the information belonged to the Journal, it should be free to use the information as it saw fit, while Winans' use of the same information amounted to a theft of property owned by the Journal.

A property rights-based approach also helps make sense of a couple of aspects of *Dirks* that are quite puzzling when approached from a securities fraud-based perspective. One is the Court's solicitude for market professionals. After *Dirks*, market analysts were essentially exempt from insider trading liability with respect to nonpublic information

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[248] The argument in favor of assigning the property right to the corporation becomes even stronger when we move outside the prototypical situation to cases covered by the misappropriation theory. It is hard to imagine a plausible justification for assigning the property right to those who steal information.

[249] To be sure, not all aspects of the federal prohibition can be so explained. For example, because property rights generally include some element of transferability, it may seem curious that federal law, at least in some circumstances, does not allow the owner of nonpublic information to authorize others to use it for their own personal gain. See, e.g., 17 C.F.R. 240.14e-3(d) (a tender offeror may not divulge its takeover plans to anyone likely to trade in target stock). This does not undermine the general validity of the property rights justification. Rather, if protection of property rights is taken as a valid public-regarding policy basis for the prohibition, it gives us a basis for criticizing departures from that norm.

they develop because they usually owe no fiduciary duty to the firms they research. *Dirks* thus essentially assigned the property right to such information to the market analyst rather than to the affected corporation. From a disclosure-oriented perspective, this is puzzling; the analyst and/or his clients will trade on the basis of information other investors lack. From a property perspective, however, the rule is justifiable because it encourages market analysts to expend resources to develop socially valuable information about firms and thereby promote market efficiency.

The property rights rationale also supports our view that the fiduciary duty at issue in *Chiarella* and *Dirks* is the duty against self dealing. From a disclosure oriented approach, in which maximizing disclosure is the principal policy goal, reliance on a self dealing duty makes no sense because requiring such a breach limits the class of cases in which disclosure is made. In contrast, from a property rights perspective, an emphasis on self dealing makes perfect sense, because it focuses attention on the basic issue of whether the insider converted information belonging to the corporation.

In *O'Hagan*, the Supreme Court thus could have treated the insider trading prohibition's location in the federal securities laws as a historical accident, which has some continuing justification in the SEC's comparative advantage in detecting and prosecuting insider trading on stock markets. The Court should have then focused on the problem as one of implicating fiduciary duties with respect to property rights in information, rather than one of deceit or manipulation. Unfortunately, the majority chose not to do so.

The majority opinion began promisingly enough with an acknowledgement that confidential information belonging to corporations "qualifies as property."[250] The Court's authorized trading dictum is also consistent with the property rights rationale, while being demonstrably inconsistent with traditional securities law-based policy justifications for the insider trading prohibition. There is a general presumption that property rights ought to be alienable. Accordingly, if we are concerned with protecting the source of the information's property rights, we generally ought to permit the source to authorize others to trade on that information. In contrast, legalizing authorized trading makes little sense if the policy goal is the traditional securities fraud concern of protecting investors and maintaining their confidence in the integrity of the markets. Would an investor who traded with O'Hagan feel any better about doing so if she knew that Dorsey and Whitney had authorized O'Hagan's trades?

Did Justice Ginsburg intend to validate the property rights approach to insider trading? Probably not. The opinion quickly shifted gears towards treating the problem as one sounding in traditional securities fraud: "Deception through nondisclosure is central to the theory of liability for which the Government seeks recognition," and which the majority accepted.[251] Indeed, the incoherence of the majority opinion on policy issues is well-illustrated by its arguable revival of the long-discredited equal access theory of liability. For example, in justifying her claim that the misappropriation theory was consistent with § 10(b), Justice Ginsburg opined that the theory advances "an animating purpose of the Exchange Act: to insure [sic] honest securities markets and thereby

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[250] *O'Hagan*, 521 U.S. at 654.

[251] Id.

promote investor confidence."[252] She went on to claim that "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law," because those who trade with misappropriators suffer from an informational disadvantage "that cannot be overcome with research or skill."[253] The parallels to *Texas Gulf Sulphur* are obvious. If we want to protect investors from informational disadvantages that cannot be overcome by research or skill, moreover, the equal access test is far better suited to doing so than the *Chiarella/Dirks* framework.

Yet, predictably, the majority showed no greater fidelity to equality of access to information than it did to protection of property rights. In *O'Hagan*, the majority made clear that disclosure to the source of the information is all that is required under Rule 10b-5. If a misappropriator brazenly discloses his trading plans to the source, and then trades (either with the source's approval or over its objection), Rule 10b-5 is not violated.[254]

This brazen misappropriator dictum is inconsistent with both an investor protection rationale for the prohibition and the property rights justification. As to the former, investors who trade with a brazen misappropriator presumably will not feel any greater confidence in the integrity of the securities market if they later find out that the misappropriator had disclosed his intentions to the source of the information. As to the latter, requiring the prospective misappropriator to disclose his intentions before trading provides only weak protection of the source of the information's property rights therein. To be sure, in cases in which the disclosure obligation is satisfied, the difficult task of detecting improper trading is eliminated. Moreover, as the majority pointed out, the source may have state law claims against the misappropriator. In some jurisdictions, however, it is far from clear whether inside trading by a fiduciary violates state law. Even where state law proscribes such trading, the Supreme Court's approach means that in brazen misappropriator cases we lose the comparative advantage the SEC has in litigating insider trading cases and the benefit of the well-developed and relatively liberal remedy under Rule 10b-5.

In sum, *O'Hagan* fails to cohere as to either policy or doctrine. It forecloses neither the equal access nor the property rights policy rationale for the Rule, while also failing to privilege either rationale. Just as a child might break his toy by attempting to force a square peg into a round hole, the Supreme Court made a farce of insider trading law (and Rule 10b-5 generally) by attempting to force insider trading into securities fraud—a paradigm that does not fit.

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[252] Id. at 658.

[253] Id. at 658-59.

[254] See id. at 655.

D. Scope of the prohibition

In *Diamond v. Oreamuno*,[255] the New York Court of Appeals concluded that a shareholder could properly bring a derivative action against corporate officers who had traded in the corporation's stock. The court explicitly relied on a property rights-based justification for its holding: "The primary concern, in a case such as this, is not to determine whether the corporation has been damaged but to decide, as between the corporation and the defendants, who has a higher claim to the proceeds derived from exploitation of the information."[256] Critics of *Diamond* have frequently pointed out that the corporation could not have used the information at issue in that case for its own profit. The defendants had sold shares on the basis of inside information about a substantial decline in the firm's earnings. Once released, the information caused the corporation's stock price to decline precipitously. The information was thus a historical accounting fact of no value to the corporation. The only possible use to which the corporation could have put this information was by trading in its own stock, which it could not have done without violating the antifraud rules of the federal securities laws.

The *Diamond* case thus rests on an implicit assumption that, as between the firm and its agents, all confidential information about the firm is an asset of the corporation. Critics of *Diamond* contend that this assumption puts the cart before the horse: the proper question is to ask whether the insider's use of the information posed a substantial threat of harm to the corporation. Only if that question is answered in the affirmative should the information be deemed an asset of the corporation.[257]

Proponents of a more expansive prohibition might respond to this argument in two ways. First, they might reiterate that, as between the firm and its agents, there is no basis for assigning the property right to the agent. Second, they might focus on the secondary and tertiary costs of a prohibition that encompassed only information whose use posed a significant threat of harm to the corporation. A regime premised on actual proof of injury to the corporation would be expensive to enforce, would provide little certainty or predictability for those who trade, and might provide agents with perverse incentives.

E. State or federal?

While it seems clear that society needs some regulation of insider trading to protect property rights in corporate information, it is not at all clear that securities fraud is the right vehicle for doing so. Consequently, even among those who agree that insider trading should be regulated on property rights grounds, there is disagreement as to how insider trading should be regulated. Some scholars favor leaving insider trading to state corporate law, just as is done with every other duty of loyalty violation, and, accordingly, divesting the SEC of any regulatory involvement. Others draw a distinction between SEC monitoring of insider trading and a federal prohibition of insider trading. They contend that the SEC should monitor insider trading, but refer detected cases to the affected

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[255] 248 N.E.2d 910 (N.Y. 1969).

[256] Id. at 912.

[257] See, e.g., Freeman v. Decio, 584 F.2d 186, 192-94 (7th Cir. 1978).

corporation for private prosecution. A third set favors a federal prohibition enforced by the SEC.

This debate is a wide-ranging one, encompassing questions of economics, politics, and federalism. The analysis here focuses on the question of whether the SEC has a comparative advantage vis-à-vis private actors in enforcing insider trading restrictions. If so, society arguably ought to let the SEC carry the regulatory load.

That the SEC has such a comparative advantage is fairly easy to demonstrate. Virtually all private party insider trading lawsuits are parasitic on SEC enforcement efforts, which is to say that the private party suit was brought only after the SEC's proceeding became publicly known. This condition holds because the police powers available to the SEC, but not to private parties, are essential to detecting insider trading. Informants, computer monitoring of stock transactions, and reporting of unusual activity by self regulatory organizations and/or market professionals are the usual ways in which insider trading cases come to light. As a practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC.

Unlike private parties, who cannot compel discovery until a nonfrivolous case has been filed, the SEC can impound trading records and compel testimony simply because its suspicions are aroused. As the agency charged with regulating broker-dealers and self regulatory organizations, the SEC also is uniquely positioned to extract cooperation from securities professionals in conducting investigations. Finally, the SEC is statutorily authorized to pay bounties to informants, which is particularly important in light of the key role informants played in breaking most of the big insider trading cases of the 1980s.

Internationalization of the securities markets is yet another reason for believing the SEC has a comparative advantage in detecting and prosecuting insider trading.[258] Sophisticated insider trading schemes often make use of off-shore entities or even off-shore markets. The difficulties inherent in extraterritorial investigations and litigation, especially in countries with strong bank secrecy laws, probably would preclude private parties from dealing effectively with insider trading involving off-shore activities. In contrast, the SEC has developed memoranda of understanding with a number of key foreign nations, which provide for reciprocal assistance in prosecuting insider trading and other securities law violations. The SEC's ability to investigate international insider trading cases was further enhanced by the 1988 act, which included provisions designed to encourage foreign governments to cooperate with SEC investigations.

[258] On the relationship between globalization of capital markets and insider trading regulation, see generally Merritt B. Fox, Insider Trading in a Globalizing Market: Who Should Regulate What?, 55 L. & Contemp. Prob. 263-302 (1992); Donald C. Langevoort, Fraud and Insider Trading in American Securities Regulation: Its Scope and Philosophy in a Global Marketplace, 16 Hastings Int'l & Comp. L. Rev. 175 (1993); Steven R. Salbu, Regulation of Insider Trading in a Global Market Place: A Uniform Statutory Approach, 66 Tulane L. Rev. 837 (1992).