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Start Making Sense: An Analysis and Proposal for Insider Trading Regulation

Jill E. Fisch
University of Pennsylvania Law School, jfisch@law.upenn.edu

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When Charles Dickens wrote “the law is a[n] ass,”1 he might well have been describing the law governing insider trading.2 The history of government enforcement in this area, including the recent litigation over broker Robert Chestman’s trading in Waldbaum stock,3 demonstrates that the legal restrictions on trading securities while in possession of material nonpublic information are confused and confusing.4 The legal uncertainty has been attrib-
uted to the absence of a statute defining the prohibited conduct.\(^6\) Because the government has devoted increased time and resources to the battle against insider trading and has taken an aggressive litigation posture whereby it seeks to draw an ever-greater scope of activity into the web of prohibited conduct,\(^6\) the ambiguity of the regulations is particularly troubling.


When Congress promulgated the Insider Trading Sanctions Act of 1984 it considered including a definition of insider trading but decided not to do so, believing that the existing substantive law was adequately clear. *Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 33-39 (1984); *Definition of Insider Trading (Part I): Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 3 (1987) (statement of Sen. D’Amato) (calling it “absolutely unrealistic to go by the standard which says, ‘Well, I know it when I see it but I can’t tell you what it is. I can’t define it.’”); cf. 133 CONG. REC. S8246 (daily ed. June 17, 1987) (statement of Sen. Riegle) (“[U]ncertainties in the law are bad for both the government and law abiding market participants. . . . [U]ncertainty about what conduct is or is not illegal creates confusion, causes needless anxiety for persons who desire to obey the law . . . and promotes disrespect for the law.”).

\(^6\) See *infra* notes 90-113 and accompanying text for examples of this expanded prohibition.
The lack of clear guidelines can be attributed, at least in part, to the legislative policy of keeping the scope of prohibited conduct as broad as possible. The consequence, however, is that traders are receiving prison sentences for conduct that, at the time of prosecution, presents judicial issues of first impression. The imposition of prison terms in such cases implicates obvious due process concerns.

By defining insider trading, some legislators fear they will be creating a “roadmap for fraud” by providing guidance to traders as to activities that do not fall within the statutory prohibition. See, e.g., Stuart J. Kaswell, An Insider’s View of the Insider Trading and Securities Fraud Enforcement Act of 1988, 45 BUS. LAW. 145, 150 (1989) (detailing opposition of Chairman Dingell of Subcommittee on Oversight and Investigations of House Committee on Energy and Commerce to enacting statutory definition). Although the government’s concern that a definition will constrain enforcement attempts is valid, the alternative is expansion of the criminal law through a form of judicial legislation, a process that is contrary to traditional constitutional and historical limitations on the development of criminal law. See John C. Coffee, Jr., The “Tip” of the Bunny’s Nose: Sniffing Out Crime Where None Exists, LEGAL TIMES, Sept. 25, 1989, at 34, 35 (noting that law of insider trading is developing through after-the-fact judicial decisionmaking and that this practice violates separation-of-powers doctrine).

The SEC has continually opposed the enactment of a statutory definition. See H.R. REP. No. 355, 98th Cong., 1st Sess. 14, reprinted in 1984 U.S.C.C.A.N. 2274, 2287 (relying on SEC recommendation that “any effort to define insider trading would result in . . . a rule that leaves gaping holes”). The General Accounting Office, however, recommended that Congress enact a statutory definition. UNITED STATES GENERAL ACCOUNTING OFFICE. REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS COMM. ON ENERGY AND COMMERCE, HOUSE OF REPRESENTATIVES. SECURITIES REGULATION. EFFORTS TO DETECT, INVESTIGATE, AND DETER INSIDER TRADING 3, 61-63 (1988).

Robert Chestman was sentenced to two years in jail, some of which had been served by the time his conviction for insider trading was reversed by the Second Circuit panel. United States v. Chestman, 903 F.2d 75 (2d Cir. 1990), vacated in part on reh’g, 947 F.2d 551 (2d Cir. 1991) (en banc); Martin Flumenbaum & Brad S. Karp, Second Circuit Review, 203 N.Y. L.J. 3, 5 (1990). R. Foster Winans was sentenced to an 18-month term in prison. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), rev’d by an equally divided Court, 484 U.S. 19, 24 (1987); Martin Kimel, Note, The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters, 38 STAN. L. REV. 1549, 1549 n.1 (1986). Even in the 1970s, before the emphasis on prison sentences for insider trading, Vincent Chiarella, a financial printer, was sentenced to serve one month in prison. United States v. Chiarella, 588 F.2d 1358, 1364 n.7 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980).

See Kaswell, supra note 7, at 151 (describing Congressman Rinaldo’s position in favor of enacting a definition). According to Kaswell, Congressman Rinaldo believed it was “unreasonable for the securities industry and the public to be subject to severe penalties for a crime that some say can be understood only after a detailed textual exegesis of court decisions and administrative proceedings.” Id.

The Chestman case demonstrates the difficulties associated with the “flexible” concept of insider trading espoused by the SEC. Chestman argued to the Second Circuit that a criminal prosecution under the existing insider trading regulation violated his due process rights. See, e.g., Reply Brief for Appellant at 24, United States v. Chestman, 903 F.2d 75 (2d
The absence of a clear definition of the prohibited conduct may also hamper the efficient functioning of the capital markets. In an efficient market, all available information about a corporation and its securities will be incorporated into the stock price. If, however, analysts and traders must investigate fully the source of all trading information in order to protect themselves from prosecution, they will be unable to trade rapidly on rumors, hearsay, and other common sources of information. Similarly, if all market participants are subject to a duty to disclose or abstain based simply on their possession of material nonpublic information, they will be discouraged from attempting to seek out superior information because of their inability to profit from it. The Supreme Court

Cir. 1990) (No. 89-1276) ("It is thus fundamentally unfair to punish as a felon a stockbroker who could not possibly have been expected to understand and conform to esoteric theories construing undefined laws under ambiguous circumstances.") (on file with the Georgia Law Review).

When Judge Jon O. Newman inquired at the en banc reargument of the Chestman decision why the SEC had not promulgated a definition of insider trading, Paul Gonson, arguing on behalf of the SEC, responded that the SEC had been unable to do so because defining insider trading was "too daunting a task." Karl Groseman, The SEC's Enforcement Nose Dive, LEGAL TIMES, Dec. 16, 1991, at 21. The obvious response to this argument, as observed by the court, is that if the SEC cannot define insider trading, how can Chestman be expected to?

At least one commentator has also argued that this form of judicial legislation violates constitutional principles of separation of powers. Coffee, supra note 7, at 35.


12 Many traders, notably risk arbitrageurs, make their profit by trading on information that is not wholly public, at least in the sense that such information is not yet fully reflected in stock prices. See Coffee, supra note 7, at 34.

13 As Professor Brudney observes, "[e]xploitation for relevant corporate and economic information is a service of value in the functioning of the market." Victor Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 HARV L. REV. 322, 341 (1979). This exploitation is costly, however, and will not be undertaken unless the discoverer of the information has the opportunity to capitalize on his discovery. The most direct way for the discoverer to capitalize on the informational advantage is by buying
has expressly recognized that securities analysts perform an essential function in making the markets more efficient by disseminating market information and causing that information to be reflected in stock prices.\textsuperscript{14} This role cannot survive in a market in which trading is permitted only upon a parity of information.\textsuperscript{15}

The litigation history of insider trading reveals fundamental disagreement over the rationale behind the prohibition as well as its scope. The prohibition has been developed within the framework of federal securities fraud, and the resulting case law contains logical as well as interpretive flaws. Moreover, litigation under the theories of liability developed by the courts illustrates the practical drawbacks to a judge-made crime. The existing doctrines fail to give adequate notice of prohibited conduct and present issues of interpretation that are simply unacceptable in a criminal statute.

Concern that prohibited conduct be properly delineated has intensified with congressional authorization of increased penalties for insider trading, the devotion of greater resources to criminal insider trading prosecutions, and the government’s announced intention to seek prison sentences more frequently.\textsuperscript{16} This enforcement activity poses a grave threat to due process concerns in the absence

\textsuperscript{14} Dirks v. SEC, 463 U.S. 646, 658 (1983).

\textsuperscript{15} Thus, in Dirks, the Court noted, “Imposing a duty to disclose or abstain solely because a person knowingly receives material, nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.” Id. at 658.


The Committee’s interest in the maximum jail term is an explicit congressional statement of the heightened seriousness with which insider trading and other securities fraud offenses should be viewed. Although the legislation does not include an explicit mandatory minimum sentence the Committee believes in the strongest possible manner that courts should impose jail terms for the commission of these crimes, and expects that raising the ceiling will increase the certainty of substantial prison sentences.

of clear standards for traders as to the legality of their conduct. Finally, because the United States was one of the first countries to develop extensive insider trading regulations and enforcement mechanisms, its experience has served as a model for much recently enacted regulation by foreign sovereigns\(^\text{17}\) and is receiving increased attention from the European Economic Community (EEC) in connection with its harmonization of European securities regulations.\(^\text{18}\)

This Article will demonstrate that the doctrine under which insider trading is regulated is seriously flawed. Many of the flaws can be attributed to the fact that insider trading regulation has been developed on an ad hoc basis, with insufficient thought given to its rationale. The Article will review this development and examine, in particular, the judicial determination that insider trading is deceptive and thereby fraudulent because of the insider’s breach of a fiduciary duty. After identifying the problems with this approach, the Article will turn to the question of whether insider trading should be illegal and, if so, why. Concluding that regulation can be justified by both political and market forces, the Article will propose a revised regulatory scheme that clarifies the application of the prohibition while removing the twisted logical basis upon which the existing regulation is founded.

I. Overview of Insider Trading

Many of the difficulties with existing insider trading law result from its uneasy legal source. The federal securities laws do not

\(^{17}\) See Langevoort, supra note 2, at 483-521 (describing development and status of insider trading regulation in various foreign jurisdictions). Insider trading (or insider dealing, as it is commonly referred to abroad) is also receiving increased attention overseas due to the proliferation of recent insider trading scandals outside the United States. Notable among these were the Tateho Chemical Industries Co. scandal and the Recruit Cosmos Co. scandal in Japan and the Pechiney affair in France. For a description of the Tateho Chemical scandal, see Tomoko Akashi, Note, Regulation of Insider Trading in Japan, 89 COLUM. L. REV 1296, 1302-03 (1989). For a description of the Recruit Cosmos scandal, see David Williams, A Primer for Japan’s Latest Political Scandal, L.A TIMES, Apr. 16, 1989, pt. 5, at 2. For details on the Pechiney affair, see H.R. REP. No 240, 101st Cong., 1st Sess. 6-7 (1989); Langevoort, supra note 2, at 499-500.

contain an express prohibition of insider trading. Instead, the conclusion that insider trading is illegal has evolved from SEC and judicial interpretation of the general antifraud provisions of the federal securities laws, section 10(b) of the Securities Exchange Act (the Exchange Act) and SEC Rule 10b-5 thereunder.

The only sections of the Securities Exchange Act of 1934 that directly address trading by insiders are section 16, 15 U.S.C. § 78p (1988) (sometimes referred to as the “other insider trading statute,” see, e.g., DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ch. 10 (1991) (describing section 16 as a “secondary tool” in fight against insider trading)) and section 20A, 15 U.S.C. § 78t-1 (1988) (added by the 1988 amendments to the Exchange Act). Broadly speaking, section 16(b) provides that profits earned by statutory insiders—defined as officers, directors, and 10% stockholders—through short-term trading in their company’s stock belong to the corporation. Section 16(a) requires the reporting of all insider trades to the SEC on a monthly basis, and section 16(c) prohibits certain insider trading outright, including short sales and selling against the box. Section 16(b) describes as its purpose the prevention of “the unfair use of information which may have been obtained by [an insider] by reason of his relationship to the issuer.” Liability under section 16 does not require the misuse of inside information; the provision imposes strict liability on the basis of short-term trading. 15 U.S.C. § 78p (1988). Nor does its coverage extend to trading on the basis of inside information, if that trading does not take place within the statutory six-month period. Id. Because of these limitations, commentators frequently have described section 16 as a “blunt tool” for the regulation of insider trading and have expressed dissatisfaction with it. See, e.g., Steve Thel, The Genius of Section 16: Regulating the Management of Publicly Held Companies, 42 HASTINGS L.J. 389, 396 nn.9 & 10 (1991) (citing descriptions of section 16 as “crude” and “arbitrary”). When the Exchange Act was passed, however, Congress felt that identifying and prosecuting insider trading directly was too difficult. Although it recognized that section 16 was not an airtight provision against insider trading, Congress believed the Exchange Act would encourage voluntary abstention from insider trading.

Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity . . . . The Committee is aware that these requirements are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage . . . .

H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934). But see Thel, supra (arguing that section 16 is not aimed at regulation of insider trading but rather focuses on preventing management manipulation of corporate events to create trading opportunities).


Section 10(b) 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—
Neither section 10(b) nor Rule 10b-5 explicitly refers to insider trading. Instead, the SEC and the courts have concluded\(^{22}\) that the language prohibiting deception and fraud bars insider trading. Based on the reasoning accepted by the Supreme Court, insider trading is a fraudulent omission and therefore securities fraud.\(^{23}\)

Under the common-law tort of fraudulent misrepresentation, upon which much of the Court’s interpretation of Rule 10b-5 is based, liability may be premised on omissions—the failure to speak—as well as affirmative misstatements.\(^{24}\) An omission is deceptive or fraudulent under Rule 10b-5, however, only under circumstances in which the defendant has a duty to speak.\(^{25}\) Someone who trades on the basis of inside information has not deceived an-
yone unless he had a duty to disclose the information prior to trading. Under circumstances in which the trader has a duty to make such disclosure, trading in the absence of the disclosure constitutes securities fraud. 26

The requirement of a duty has resulted in some confusing judicial rhetoric. The courts have developed two lines of reasoning whereby a trader may be said to breach a duty by trading on non-public information. These lines of reasoning, which form two distinct bases for liability, are commonly known as the classical, or traditional, theory and the misappropriation theory.

A. THE CLASSICAL THEORY OF INSIDER TRADING

Classical insider trading theory has its roots in the regulation of trading by true corporate insiders. 27 Insiders are privy to confidential inside information about their corporation by virtue of their corporate responsibilities. In addition, corporate insiders perform these responsibilities subject to a fiduciary duty which has its origins in statute and common law. 28 In 1961, the SEC decided that the acquisition of nonpublic information by insiders gave rise to an obligation either to refrain from trading on that information or to disclose it. 29 In the landmark decision In re Cady, Roberts & Co., 30

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27 The term "insider" has not been defined by statute or by the Supreme Court. See 3 BROMBERG SECURITIES LAW § 7.4(6)(b) at 180-81 & n.169.1 (1969). Section 16(b) classifies directors, officers, and 10% stockholders as insiders, 15 U.S.C. § 78p(a) & (b) (1988), but its language is not necessarily applicable to Rule 10b-5. See Moss v. Morgan Stanley Inc., 719 F.2d 5, 10 n.8 (2d Cir. 1983) ("Ordinarily, 'insiders' include such corporate figures as directors and vice presidents, persons who have access to confidential corporate information and therefore owe a duty to a corporation's shareholders not to trade on that information."); cert. denied, 465 U.S. 1025 (1984).


29 In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). Prior to 1961, there had been a
the Commission held that corporate insiders who receive inside information by virtue of their position have a duty to disclose the information to persons with whom they deal (or to the public at large) or to refrain from trading.\footnote{A failure to adhere to the "disclose or abstain" rule constituted fraud and hence violated Rule 10b-5.}{\footnote{The courts have accepted the classical theory of insider trading. In \textit{Chiarella v. United States}, the Supreme Court adopted the \textit{Cady, Roberts} rationale that insider trading can violate Rule 10b-5 as a fraudulent omission or failure to disclose but explained that liability must be premised on a duty to disclose.}{\footnote{The Court}}}

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few court decisions that found insider trading illegal as a violation of either Rule 10b-5 or state common-law doctrines. One of the best known is \textit{Speed v. Transamerica Corp.}, 99 F. Supp. 808 (D. Del. 1951), in which Chief Justice Leahy permitted recovery under Rule 10b-5 by minority stockholders of the Axton-Fisher Tobacco Company who were bought out by the majority stockholder, Transamerica, at an unfairly low price. Transamerica had information, which it did not disclose to the other stockholders, that Axton-Fisher's tobacco inventory was greatly undervalued. \textit{Id.} at 812. \textit{Speed} was not technically an insider trading case; liability was premised on a fraudulent failure to disclose, which was actionable because of Transamerica's fiduciary duties as majority stockholder. \textit{Id.} at 828.

Additionally, the transaction in \textit{Speed} was a face-to-face transaction so there was no need for the court to consider the general duties of an insider to the marketplace based on the possession of superior information. In general, judicial decisions during this period imposed insider trading liability only in circumstances that involved face-to-face transactions between the insider and those to whom the insider owed fiduciary duties, typically stockholders. Bainbridge, \textit{supra} note 22, at 37-38.

See also \textit{In re Ward La France Truck Corp.}, 13 S.E.C. 373, 381 (1943), in which, in one of the first SEC opinions interpreting Rule 10b-5, the Commission reached the same conclusion as the \textit{Transamerica} court and held that insiders who purchased stock on behalf of the issuer without disclosing material information to the stockholders with whom they traded violated the rule. Again, liability was based on the fiduciary obligations of the issuer and its officers to stockholders. "The failure to [disclose] placed shareholders at an unfair disadvantage in dealing with their own corporation and those in control." \textit{Id.} at 380-81.

\footnote{40 S.E.C. 907, 911 (1961).}{\footnote{445 U.S. 222 (1980). Notably, according to the Supreme Court, \textit{Chiarella} was the first case in which criminal liability was imposed upon a defendant for insider trading. \textit{Id.} at 235 n.20. \textit{Chiarella} involved the prosecution of a financial printer who deciphered the identities of targets of upcoming takeover bids from documents he received for printing. Without disclosing the information he had obtained, \textit{Chiarella} purchased the stock of the target companies before the takeover attempts were made public. United States v. \textit{Chiarella}, 588 F.2d 1358, 1362 (2d Cir. 1978), \textit{rev'd}, 445 U.S. 222 (1980).}}
stated that this duty may arise "from a relationship of trust and confidence between parties to a transaction." It concluded that this type of relationship exists between corporate insiders and stockholders, based on the insiders' obligation to put the stockholders' welfare before their own. The Court consequently reversed Chiarella's conviction on the grounds that he neither was a corporate insider nor owed any duties to the stockholders of the corporation in whose stock he traded.

One obvious difficulty with the classical theory is that it fails to explain why the fiduciary relationship between insiders and the corporation gives rise to a duty in the financial marketplace to speak. In other words, why is trading by a corporate fiduciary deceptive, and who is deceived? Some scholars have attempted to base the insider's duty to disclose on common-law principles of agency. A corporate insider receives inside information in order to effectuate his role as agent for the corporation. Agency law prohibits an agent from obtaining a personal benefit in the course of serving as agent. Under traditional agency rules, any profit an

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35 Chiarella, 445 U.S. at 230.
36 The Court stated that a corporate insider owes a duty to present stockholders because of his fiduciary obligations to such stockholders; thus, the insider who purchases stock from such stockholders on the basis of inside information has breached this fiduciary duty. Id. at 227-28. The Court concluded that it would be irrational to allow insiders to abuse their position by selling stock based on inside information, even though sales would not breach any duty to existing stockholders. Id. at 227 n.8.
37 Id. at 231-35. The Court expressly rejected the argument that anyone who has inside information owes a general Cady, Roberts duty to the marketplace. For a detailed analysis of the opinions in Chiarella and the bases for regulation espoused by the various Justices, see Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information, 1981 Sup. Ct. Rev. 309, 314-30.
38 E.g., Langevoort, supra note 26, at 19-21.
40 See Restatement (Second) of Agency § 388 & cmt. c (1957); see also Restatement (Second) of Agency § 395 (1957).

Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

Id. (emphasis added). This common-law rule is designed to remove the agent's temptation
agent receives in the course of his agency is received in trust for the principal.41

Applying agency principles to insider trading is problematic, however, because agency law does not generate an obligation to the trading counterparty or to the market. Rather, agency law suggests that a corporate insider is unjustly enriched by making use of corporate information for his personal benefit and that any trading profits are rightfully the property of the owner of the information—the corporation.42 This unjust enrichment takes place, though, whether or not the insider discloses the information prior to trading. More importantly, unjust enrichment is not the legal equivalent of deception. An agent who receives a personal benefit and thereby enriches himself unjustly does not necessarily deceive his principal.43 Thus, the agency analogy neither supports the Cady, Roberts duty to disclose or abstain nor explains how the breach of that duty violates section 10(b).

Another possible explanation for the Cady, Roberts duty is a level-playing-field notion of the securities markets. This approach assumes investors are entitled to equal access to securities information.44 Any informational inequality based on unequal access,
such as the receipt of inside information, compels a duty to disclose or abstain. The deception, under this approach, is of others trading in the security. The level-playing-field concept is based on the view that traders should not be able to take advantage of information they know cannot lawfully be obtained by others.\textsuperscript{45} The duty to disclose or abstain is premised on principles of fairness: it is unfair for corporate insiders to trade on the basis of information to which they have access solely because of their position as insiders.\textsuperscript{46}

The third potential source for the insider’s duty lies in the corporation’s own duty of disclosure. Trading\textsuperscript{47} by the corporation itself, while in possession of material nonpublic information, would constitute securities fraud because of the issuer’s duty, under the federal securities laws, to disclose all material information relevant to investors before trading.\textsuperscript{48} When corporate insiders obtain information from the corporation, which itself may not lawfully trade, they arguably inherit the corporation’s duty to disclose.

The foregoing discussion focuses on the absence of an identifiable source for the \textit{Cady, Roberts} duty. The second problem with the classical approach is its failure to articulate the beneficiary of that duty, i.e., the person(s) to whom the duty is owed. Even if one
accepts the premise that a corporate insider has a common-law duty to abstain from using inside information for personal trading, it does not necessarily follow that the duty is to the market. The fiduciary duty viewed by the Chiarella Court as the source of the insider's obligation to disclose or abstain is a duty to the corporation, not to the market at large.49 The breach of a fiduciary duty to the issuer, however, does not obviously constitute the deception required for a violation of section 10(b). Moreover, the case law under section 10(b) makes clear that every violation of a common-law duty does not give rise to a violation of the statute's antifraud provisions.50 Congress clearly did not intend, through the enactment of section 10(b), to federalize common-law doctrines of fiduciary duty.51

Accordingly, the breach of duty must, in some way, implicate the policies behind the federal securities laws. The violation of an agency-law based principle of fiduciary duty fails to do so. If the insider's trading is wrongful because of his fiduciary obligations to the corporation, it is not therefore deceptive or fraudulent. The corporation has not been deceived in connection with the purchase or sale of a security. The courts have attempted to deal with this problem by inferring a fiduciary duty to the corporation's stockholders.52 A corporate insider has a direct fiduciary duty to the corporation; he also has a fiduciary duty to the corporation's stockholders. When an insider trades with stockholders without disclosing his superior information, the insider has deceived them in vio-

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50 See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977) (holding statute bars only "manipulative or deceptive" conduct).

51 See id. at 479 (rejecting application of securities laws that would have federal courts applying a "'federal fiduciary principle' under Rule 10b-5").

52 E.g., Chiarella, 445 U.S. at 227. This reasoning suggests that insider trading in debt securities would not violate Rule 10b-5, at least under classical insider trading theory. The applicability of the prohibition to trading in debt securities has not been definitively addressed by the courts. See SEC Staff Examining Junk Bonds for Insider Trading, Breeden Says, 23 Sec. Reg. & L. Rep. (BNA) No. 15, at 525 (April 12, 1991) (quoting Chairman Breeden's statement to Senate Banking Committee Chairman Donald Riegle that applicable theories have not yet been tested in courts). Some opinions appear to have assumed, without analysis, that such trading is prohibited. See, e.g., United States v. Milken, 759 F. Supp. 109, 122-23 (S.D.N.Y. 1990) (finding defendant did not receive material nonpublic information but assuming that liability could be based upon defendant's trades in corporate bonds).
It is not immediately obvious why the existence of a corporate-law fiduciary duty makes the insider's trading with the corporation's stockholders deceptive. Apparently, the deception stems from a higher duty of disclosure or a duty of absolute fairness arising from the fiduciary relationship. For example, if the fiduciary relationship generates a duty of objective candor, the stockholder, as beneficiary of this duty, may expect that when an insider trades with stockholders, the insider has disclosed all material information. If the insider does not disclose all material facts, the stockholder is deceived.

One legal source for a greater duty of disclosure in the fiduciary relationship is the special facts doctrine, an exception to the general principle that there is no duty of absolute disclosure. 56 If the parties to a transaction stand in some confidential or fiduciary relationship, dealings between them require the "utmost good faith, and full and fair disclosure of all material facts." 57

An alternative source for a greater duty of disclosure is the law of trusts. Particularly in older cases, the position of a corporate insider has been analogized to that of a trustee. 58 The law of trusts governs transactions between fiduciary and beneficiary. In such transactions, it imposes upon the trustee a duty of the "utmost fairness" to the beneficiary, including disclosure of all information known to the trustee. 59 Again, the stockholder as beneficiary would

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53 See Chiarella, 445 U.S. at 227 ("[T]he relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation.").

54 See id. at 228 n.10; Langevoort, supra note 26, at 4-5.


56 Id. at 738-39. Traditionally, the special-facts doctrine did not apply to transactions that took place on organized stock exchanges. See, e.g., HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 23-24 (1966).

57 See, e.g., Oliver v. Oliver, 118 Ga. 362, 367, 45 S.E. 232, 234 (1903) (holding that officer or director is "a quasi trustee as to the shareholder's interest in the shares"); Stewart v. Harris, 77 P. 277, 279 (Kan. 1904) ("The managing officers of a corporation are not only trustees in relation to the corporate entity and the corporate property, but they are also to some extent and in many respects trustees of the corporate shareholders."); People ex rel. Manice v. Powell, 94 N.E. 634, 637 (N.Y. 1911) ("The relation of the directors to the stockholders is essentially that of trustee and cestui que trust.").


If a trustee enters into a transaction with a beneficiary relating to the interest of the beneficiary under the trust, the trustee owes the beneficiary a duty to display the utmost fairness, which ordinarily involves disclosure to the benefi-
expect the insider to disclose all material facts unknown to the stockholder.

Finally, the insider’s duty can be viewed not as a disclosure obligation but as a duty of overall or objective fairness. This duty may be linked to the corporate-law duty of loyalty, under which an insider may not compete with the corporation or engage in transactions in which he has a personal interest unless those transactions are objectively fair to the corporation and its stockholders.\textsuperscript{59} Transactions in which the insider has a personal stake present a special risk that the insider will abuse his fiduciary position.\textsuperscript{60} Under this standard of objective fairness, an insider who fails to disclose material information prior to trading with stockholders has misled those stockholders into entering an unfair transaction.

The foregoing explanations provide a logical basis for finding that corporate stockholders have been deceived when an insider buys their stock (or sells them additional stock) without disclosing information obtained by virtue of the insider’s position. Although the use of the fiduciary relationship to extend the insider’s duties to a class of intended beneficiaries of the securities laws is widely accepted,\textsuperscript{61} it applies only to trades between an insider and stockholders of the insider’s corporation. It is thus one-sided in operation. A corporate insider who purchases stock is trading with present stockholders and arguably defrauds those to whom he owes a fiduciary obligation. On the other hand, a corporate insider who sells stock is dealing with someone who has no current relationship with the corporation. In this second case, the fiduciary obligations of the insider to the corporation generate no duty to disclose or abstain.\textsuperscript{62}

\begin{footnotesize}
\begin{enumerate}
\item The doctrine applies to all fiduciaries and also to persons in a confidential relationship.\textsuperscript{. . . . }
\item See Anderson, supra note 40, at 760-61 (noting situations in which likelihood of cheating is particularly great).
\item Chiarella v. United States, 445 U.S. 222, 227 n.8 (1980).
\item The Supreme Court’s only effort at addressing this dilemma is contained in footnote eight of Chiarella, in which the Court cites the reasoning of Judge Learned Hand that “it would be a sorry distinction to allow [the insider] to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.” \textit{Id.} (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), cert.
\end{enumerate}
\end{footnotesize}
Moreover, Rule 10b-5 requires that the fraud occur in connection with the sale or purchase of securities. This requirement has two elements: the fraud must affect the financial marketplace, and the plaintiff must be a defrauded purchaser or seller. It is the latter element that is of significance here, for as the Court found in Blue Chip Stamps v. Manor Drug Stores, Rule 10b-5 is aimed only at "injury suffered 'in connection with the purchase or sale' of securities." Indeed, the Blue Chip Court specifically found that two classes of plaintiffs to whom corporate insiders owed fiduciary duties lacked standing to recover under 10b-5 for the insiders' fraud because there was an insufficient connection between the fraud and a securities transaction.

Thus, in Blue Chip, the Court specifically rejected the notion that every fraud or breach of fiduciary duty practiced by a corporate insider upon shareholders constitutes securities fraud. The Court restricted the class of actionable claims under 10b-5 to those in which the fraud resulted in the purchase or sale of stock by the victim. As the next section will demonstrate, this connection be-

denied, 341 U.S. 920 (1951)). Although the distinction may well be a "sorry" one, it is difficult to understand how this reasoning gives rise to a duty by insiders not to sell their stock on the basis of inside information. Importantly, the opinion of Judge Hand to which the Chiarella Court refers addressed the constitutionality of section 16(b), not the obligations imposed by section 10(b). See Gratz, 187 F.2d at 49.


64 As Judge Friendly explained:
The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be. Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 943 (2d Cir.) (emphasis added), cert. denied, 469 U.S. 884 (1984); see also Hemming v. Alfin Fragrances, Inc., 690 F. Supp. 239, 244 (S.D.N.Y. 1988) (distinguishing certain consumer-oriented statements as not invoking antifraud provisions of federal securities laws because not directed to investors).

65 See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 755 (1975) (refusing standing to defrauded investors who did not trade on basis of misrepresentations).

66 Id. at 733; cf. United States v. Naftalin, 441 U.S. 768, 772-76 (1979) (refusing to limit application of section 17(a)(1) of Securities Act of 1933 to frauds injuring investors, on basis that investor protection was not sole purpose of Securities Act).

67 The Court's holding in Blue Chip denies standing to present stockholders of a corporation who are defrauded through management misrepresentations into not selling their stock and to stockholders (and creditors) who suffer a loss in the value of their stock as a result of the insiders' fraudulent practices. See Blue Chip, 421 U.S. at 737-38.

68 Id. at 723. On this basis the Southern District of New York dismissed insider trading charges in United States v. Newman, holding that the defendant could not be liable for
between the fraud and the securities transaction has been completely eviscerated in cases applying the misappropriation theory.\footnote{For a discussion of the misappropriation theory, see infra notes 80-129 and accompanying text.} Even under the classical doctrine of insider trading, however, the connection between the insider’s fraud and the victim’s injury is not altogether clear.

Although courts have found that trading by an insider or tippee furnishes the necessary purchase or sale to satisfy the “in connection with” requirement, they have not required any tie between the securities transaction and the breach of duty.\footnote{The insider’s (or tippee’s) trading is the securities transaction with which the fraud is connected. See, e.g., \textit{SEC v. Materia}, 745 F.2d 197, 203 (2d Cir. 1984), \textit{cert. denied}, 471 U.S. 1053 (1985); \textit{Newman}, 664 F.2d at 18.} The problem lies in distinguishing between an insider who sells confidential corporate information to a competitor and one who sells such information to a prospective trader. The misappropriation of information from the company is the same, as is the breach of the insider’s fiduciary duty. Indeed, the damage to the company is likely to be greater in the former case. Yet, only the second situation violates insider trading law, and that violation results from the fortuity that the recipient of the information intends to use it in the securities markets.

In addition, unlike traditional securities fraud, there is no direct relationship between the corporate insider’s breach of a duty—the decision to engage in insider trading—and the transaction that causes harm to other stockholders—the ‘ignorant’ trade.\footnote{\textit{Cf. infra} note 185 (discussing commentators’ views of whether insider trading directly harms contemporaneous traders). Some commentators have argued that insider trading causes market makers and specialists to adjust the spread for stocks in which insider trading is likely. E.g., \textit{William J. Carney, Signaling and Causation in Insider Trading}, 36 Cath. U. L. Rev. 862, 888-91 (1987). If insider trading induces any trading, it is likely to induce copycat trades by investors who, although not privy to the inside information directly, hope to take indirect advantage of such information by duplicating the trades of insiders. This process has been described as “trade decoding.” See Gilson & Kraakman, \textit{supra} note 11, at 573 (describing widespread trading practice by uninformed traders of duplicating trading by insiders based on assumption that insiders are likely to possess valuable information).} The cor-

porate insiders who purchased stock on the basis of inside information in SEC v. Texas Gulf Sulphur Co.,\textsuperscript{72} for example, did not induce present stockholders to sell their stock but simply bought stock for themselves before any public announcement of the discovery of extraordinarily rich mineral deposits.\textsuperscript{73} Those stockholders who decided contemporaneously to sell did so based on extraneous factors and in ignorance of the existence of insider trading. Their decision to sell the stock for a price that did not reflect the mineral deposit opportunity was the direct cause of their loss and was, presumably, a decision they would have made even if the insiders had stayed out of the market.\textsuperscript{74} Accordingly, while the insiders may have breached a duty to the company by making a personal profit with corporate information, it is difficult to see any relationship between that breach and the harm suffered by the selling stockholders, who supposedly were the defrauded victims.\textsuperscript{75}

There is another problem with premising the fraudulent aspect of insider trading on the insiders' fiduciary duties to the corporation's stockholders: the premise is not implicated unless trading is effected by a traditional insider and the insider trades in the securities of his own corporation. For example, an insider, by virtue of his inside position in corporation A, receives material inside infor-

\footnotesize{
public on a monthly basis in the Official Summary of Security Transactions and Holdings, printed by the U.S. Government Printing Office in Washington, D.C. A number of investment newsletters, books, and databases are marketed on the premise that merely copying the reported trading activities of corporate insiders is likely to produce superior returns. \textit{E.g.}, \textit{Vickers Weekly Insider Report}; \textit{The Insiders' Chronicle} (a weekly publication of American Banker-Bond Buyer edited by William Mehlman); \textit{Aaron B. Feigen & Don Christensen. Investing with the Insiders Legally} (1988); \textit{cf.} Dan Givoly & Dan Palmon, \textit{Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence}, 58 J. Bus. 69, 71 (1985) (suggesting that, because of copycat effect generated when insiders trade, such trading may generate abnormal returns in absence of any misuse of inside information).

\textsuperscript{72} 401 F.2d 833 (2d Cir. 1968) (en banc), \textit{cert. denied}, 394 U.S. 976 (1969).

\textsuperscript{73} \textit{Id.} at 847, 852-57.

\textsuperscript{74} \textit{See Carney, supra} note 71, at 886-91 (finding no causal relationship between undetected insider trading and harm to particular investors).

\textsuperscript{75} Indeed, it is not clear that Texas Gulf Sulphur could itself have traded stock during the time period in question, being in possession of material information that it had a duty to disclose to stockholders if it traded. \textit{See supra} notes 26-29. Thus, the direct victim of the insiders' breach of duty could not suffer an injury through engaging in securities transactions. This divorce of the duty breached from the harm suffered is carried to an extreme by the contemporaneous traders provision of the Insider Trading and Securities Fraud Enforcement Act of 1988, \textsection{20A}, 15 U.S.C. \textsection{78t-1} (1988). Section 20A permits investors who trade contemporaneously with an insider to recover a private damage award. \textit{Id.}
information concerning corporation B, such as the fact that corporation A is about to terminate its long-term supplier/purchaser relationship with corporation B or that corporation A is planning a tender offer for the stock of corporation B. Knowing that disclosure of this information will have a substantial effect on the price of B's securities, the insider trades in the securities of corporation B. Under the principles described above, the insider has not committed securities fraud. Whether the insider buys or sells, his transaction is not with the stockholders of corporation A, to which he owes a fiduciary duty, but with the stockholders or future stockholders of corporation B, to which no such duty is owed.76

Trading of this type is frequently described as "outsider trading," so denominated because the traders are outsiders with respect to the issuer of the securities they trade.77 Outsider trading commonly occurs in connection with tender offers and other takeover transactions. Insiders of the acquiring company, for example, knowing of the impending tender offer, may purchase stock in the target company prior to public announcement of the offer. Outsider trading also has been used to describe trading by persons who are not traditional insiders but perhaps could be described as market insiders based on their regular access to confidential information likely to affect market prices. This group includes securities analysts, reporters, and financial printers.

Prohibition of outsider trading requires a theory of liability that does not depend on a fiduciary relationship between the trader and the issuer of the securities traded. It therefore demonstrates the limitations of the classical theory. These limitations are illustrated by the Court's finding in Chiarella that the Cady, Roberts duty to disclose or abstain could not support Chiarella's conviction because he had no fiduciary duty to the companies in whose stock he traded.78 This decision generated dissatisfaction with the classical theory as the sole basis for imposing liability for insider trading. Although Chiarella was a setback, the SEC and the courts, most

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76 See Phillips & Zutz, supra note 5, at 85 (arguing that fiduciary duty standard results in inability to apply section 10(b) and Rule 10b-5 to persons trading stock of one company based on information learned while employed at another company).
77 See SEC v. Clark, 915 F.2d 493, 443 (9th Cir. 1990) (defining "outsiders" as "persons who are neither insiders of the companies whose shares are being traded, nor tippees of such insiders").
notably the Second Circuit,\textsuperscript{79} found within \textit{Chiarella} the seeds of an alternative approach to insider trading: the misappropriation theory.

**B. THE MISAPPROPRIATION THEORY**

The misappropriation theory bases liability on the breach of a duty other than the insider's fiduciary duty to his corporation.\textsuperscript{80} As the Second Circuit explained in \textit{SEC v. Materia}, a person who misappropriates or steals confidential information defrauds the source of the information.\textsuperscript{81} It concluded that the use of confidential corporate information for personal gain by an outsider is misappropriation. In \textit{Materia}, the court held that a financial printer who had engaged in wrongdoing similar to that of Chiarella had defrauded his employer, not the target companies. This fraud on the source was found by the court to be a sufficient predicate for an insider


\textsuperscript{80} The Ninth Circuit has described the elements of the misappropriation theory as follows:

Rule 10b-5 is violated when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.

\textit{Clark}, 915 F.2d at 443.

\textsuperscript{81} \textit{Materia}, 745 F.2d at 201; see also \textit{Chiarella}, 445 U.S. at 239-40 (Burger, C.J., dissenting) (applying duty to disclose or abstain whenever informational advantage is obtained "by some unlawful means"). \textit{Materia} involved the same factual scenario as \textit{Chiarella}; notwithstanding efforts by clients to keep the identities of takeover targets confidential, Materia, a copyholder for a financial printer, was able to ascertain the identities of the targets. Materia purchased stock in the target companies and made substantial profits. Unlike Chiarella, Materia was charged with trading on the basis of information that had been misappropriated from his employer. \textit{Materia}, 745 F.2d at 199-200.

\textit{Materia} was not the first Second Circuit decision to adopt the misappropriation theory. The concept that insider trading liability could be predicated on the defendant's defrauding the source of the information was first adopted by that court in United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981), \textit{cert. denied}, 464 U.S. 863 (1983). The Second Circuit has continued to apply the misappropriation theory. See, \textit{e.g.}, United States v. Grossman, 843 F.2d 78, 85-86 (2d Cir. 1988), \textit{cert. denied}, 488 U.S. 1040 (1989).
trading conviction. 82

Fraud under the misappropriation theory is not premised upon a duty to disclose or abstain. Indeed, the Materia court explicitly rejected the argument that insider trading liability must be based on a duty to disclose. 83 Instead, the court found that the misappropriation of confidential information which defrauds the source84 satisfies Rule 10b-5's requirement that the fraud operate "on any person." 85

The separate opinions in Chiarella contain the seeds of the misappropriation theory. Justice Stevens's concurring opinion, which provided the crucial fifth vote in Chiarella, explained that the Court had not addressed whether Chiarella's breach of a duty of silence to his employer could serve as a basis of liability. 86 Similarly, both Chief Justice Burger's dissenting opinion and Justice Brennan's opinion concurring in the judgment stressed that a trader could violate Rule 10b-5 by trading on the basis of information that was improperly obtained. 87 The Second Circuit seized upon the language in these opinions and expanded it. Eschewing any requirement that the trader actually steal inside information, courts have permitted prosecution under the misappropriation theory whenever the trader obtains or uses inside information in breach of a "fiduciary or similar duty of trust and confidence." 88 The requirement of "a relationship of trust and confidence" reflects the Supreme Court's language in Chiarella. 89

82 Materia, 745 F.2d at 203.
83 Id. at 203.
84 Id. at 201-02; see also SEC v. Clark, 915 F.2d 439, 447 ("[O]utsider trading liability is premised on the common law principle that when a fiduciary profits from confidential information that he had received because of his fiduciary status, he breaches a legal duty to the person or entity that entrusted him with the information.") (quoting United States v. Reed, 601 F. Supp. 685, 700 (S.D.N.Y.), rev'd in part on other grounds, 773 F.2d 477 (2d Cir. 1985)).
85 Materia, 745 F.2d at 201.
86 Chiarella, 445 U.S. at 238 (Stevens, J., concurring).
87 See id. at 239 (Brennan, J., concurring) (stating that Rule 10b-5 is violated whenever person improperly obtains or converts nonpublic information to his own use and then trades on it); id. at 243-45 (Burger, C.J., dissenting) (information obtained through theft, conversion, or other unlawful means cannot be used as basis for trading).
89 See Chiarella, 445 U.S. at 230 (predicating liability under section 10(b) for fraudulent omission "upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction") (Powell, J., delivering the opinion of the Court).
The misappropriation theory, as employed by the Second Circuit, imposes liability whenever a trader uses information in breach of this duty of trust and confidence. It thus applies in situations where the trader owes no fiduciary duty to the source of the information or to stockholders of the issuer of the security traded.

The district court decision in United States v. Reed demonstrates the degree to which this theory expands liability. The court held that the breach of a relationship of trust and confidence between family members was a sufficient basis for alleging fraud. The indictment in Reed charged the following facts: Gordon Reed, the father, was a director of a company that was the subject of merger negotiations. Gordon Reed told his son, Thomas, of the merger proposal before it was publicly announced. The son bought stock on the basis of the tip. The court found that, although the family relationship alone did not give rise to the necessary duty for 10b-5 liability, because the father had a long-standing pattern of confiding in his son, there was sufficient evidence of a duty to permit prosecution.

Recently, the same court concluded that the relationship between psychiatrist and patient was also sufficient to give rise to 10b-5 liability. In United States v. Willis, the district court held that the United States could prosecute a psychiatrist who breached his doctor-patient duty of confidentiality by trading on information he received in the course of treating a patient, on the basis

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81 Reed, 601 F. Supp. at 690-91.
82 The court did not explain whether the confidential relationship gave rise to a duty to disclose (presumably it did not), a duty to abstain from trading, or some other kind of duty that made Reed's use of the information improper.
85 The psychiatrist learned through his treatment of Joan Weill that her husband was attempting to become chief executive officer (CEO) of BankAmerica. The psychiatrist then purchased BankAmerica stock on the basis of this information. Id. at 271. It is not clear from the opinion that Sanford Weill's efforts to become CEO were generally confidential. See Janet Bush, Psychiatrist who Traded on Patient's Anxieties, The Financial Times, May 19, 1990, at 13 (discussing psychiatrist's claim that he was unsure information he traded on was confidential). According to the SEC complaint, however, Mrs. Weill also told Willis that her husband's plans for the company included making a significant capital infusion. See SEC v. Willis, Exchange Act Release No. 12,754, 1991 SEC LEXIS 152, at *2 (Jan.
that this breach supplied the necessary element for insider trading.96

The misappropriation theory raises more questions about the scope and source of the underlying duty than the classical theory. At the forefront is the relationship between the wrongful conduct and securities fraud. As alluded to earlier, the questions about whether the fraud in an insider trading case is in connection with a securities transaction are exacerbated when the victim of the misappropriation is not a market participant. This difficulty is apparent in United States v. Carpenter.97 Foster Winans, a columnist for the Wall Street Journal, and his tippees were prosecuted for trading on information that Winans had gathered for use in a Journal column, “Heard on the Street,” containing stock market recommendations.98 The columns in which the information would appear had been prepared and publication dates set, but the issues containing the columns had not been published at the time the defendants traded.99 The defendants were convicted of insider trading on the theory that Winans misappropriated property of the Journal by using information about the upcoming columns as a basis for trading.100

Although Winans had clearly violated a Journal rule prohibiting prepublication trading by employees, there was no indication that this violation injured investors.101 Nonetheless, the Second Circuit

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97 791 F.2d 1024 (2d Cir. 1986), aff’d by an equally divided Court, 484 U.S. 19 (1987).

98 Id. at 1026.

99 Id. at 1027.

100 Id. at 1025. The Wall Street Journal had a formal policy prohibiting prepublication trading and making the contents of upcoming columns the exclusive property of the Journal. Id. at 1026.

101 A direct injury to investors could be demonstrated if Winans published information that was false, intending to induce investors to trade, and thereby profiting from the market.
affirmed Winans's conviction for insider trading and, in doing so, failed to adhere to the Blue Chip requirement that, in order for liability to attach under Rule 10b-5, the defendant's fraud must result in a securities transaction by the victim. Describing the lower courts' findings, the Supreme Court explained,

Although the victim of the fraud, the Journal, was not a buyer or seller of the stocks traded in or otherwise a market participant, the fraud was nevertheless considered to be "in connection with" a purchase or sale of securities within the meaning of the statute and rule. The courts reasoned that the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents.

The Supreme Court affirmed Winans's insider trading convictions by an equally divided vote. The Supreme Court's opinion is not explicit, but it is likely that the four Justices who voted to reverse in Carpenter were troubled by the issue of whether, under the misappropriation theory, there is a sufficient connection between the fraud and a purchase or sale of securities.

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102 Carpenter, 791 F.2d at 1033. Winans's conviction for securities fraud was affirmed by an equally divided Supreme Court. The Supreme Court unanimously affirmed his convictions for wire and mail frauds. Carpenter v. United States, 484 U.S. 19 (1987).

103 The Second Circuit had previously established its position that Blue Chip did not require liability to be based on the breach of a duty to a purchaser or seller of securities. United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983). The district court in Newman dismissed the indictment because Newman had not breached a duty to, and thereby defrauded, any seller of securities. Id. at 14. The Second Circuit reversed, finding that Rule 10b-5 does not require the defrauding of a buyer or seller of securities and holding that liability could be premised on Newman's breach of his duty to his employer. Id. at 17.

104 Carpenter, 484 U.S. at 24. The Second Circuit had previously used similar reasoning to find a connection with the purchase or sale of securities in its development of the misappropriation theory. For example, in Newman, the court concluded that "since appellee's sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between the fraud and the purchase." 664 F.2d at 18.

105 Indeed, under the Blue Chip doctrine, see supra notes 65-68 and accompanying text, the Journal, the victim of the fraud, would lack standing to bring a private civil claim against Winans for securities fraud because it was not a purchaser or seller. Barbara B. Aldave, The Misappropriation Theory: Carpenter and its Aftermath, 49 Ohio St. L.J. 373, 376-77 (1988); Nicholas Georgakopoulos, Note, Classical and Cross Insider Trading: Variations on the Theme of Rule 10b-5, 28 Am. Bus. L.J 109, 136 (1990). Nor is the Second
Although it may be wrong to violate a relationship of trust and confidence by breaching an employer confidentiality policy, as Winans did in *Carpenter*,\(^{106}\) or by using information obtained in the course of rendering psychiatric services, as in *Willis*,\(^{107}\) these wrongs are not fraudulent or deceptive. It is difficult to understand how trading on information obtained through such a relationship defrauds\(^{108}\) the source of the information or anyone else.\(^{109}\) If Dr. Willis trades on confidences obtained from his patients or discloses them at a cocktail party, he has done harm to the trust that his patients have reposed in him. The disclosure, however, while it violates the psychiatrist-patient privilege, does not constitute fraud. Unlike the *Cady, Roberts* duty to disclose or abstain, the acquirer's duty to the source under the misappropriation theory is one of simple nondisclosure. The source is harmed if its confidences are disclosed, regardless of whether the acquirer subsequently trades, and the harm is not exacerbated by his trading.

It is important to recall, in this context, that section 10(b) is triggered only by deception. We do not think of the doctrine of common-law fraud as applicable to a son who makes use of information received from his father in a relationship of trust and confidence, even if by using the information the son is breaching that trust.\(^{110}\) Once again, we must reconcile the notion of what constitutes a fraud under section 10(b) with the Supreme Court's reminder that this section was aimed only at fraud, as well as the

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\(^{106}\) Commentators have argued that the *Journal* suffered damage to its reputation. See, e.g., *Macey*, supra note 44, at 43 ("If readers thought that the *Journal* 's financial news was tainted by its reporters' quest for personal profit, the paper's influence, and therefore its readership and advertising revenues, would decline.").


\(^{108}\) In general, in order for the government to obtain a conviction on the basis of fraud, it must prove that the defendant contemplated some harm or injury to his victim. See, e.g., United States v. Starr, 816 F.2d 94, 98 (2d Cir. 1987) (reversing mail fraud convictions because government failed to prove that defendants intended to harm customers).

\(^{109}\) The court in *Willis* explained that "[b]y not advising his patient of his intention to disclose her confidential information and to profit personally from it, Dr. Willis fraudulently induced his patient to confide in him in connection with his purchase and sale of securities." *Willis*, 737 F. Supp. at 274.

\(^{110}\) See supra notes 90-93 and accompanying text (discussing United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.) rev'd in part on other grounds, 773 F.2d 477 (2d Cir. 1985)).
It is hard to see how any breach of a private duty of nondisclosure can implicate the objectives of the securities laws, which are concerned with duties to the market. Protection of the securities markets and innocent investors does not seem to bear any relation to whether an employee breached a duty of confidentiality to his employer, or a son to his father. Is it any different to a third party trading contemporaneously in the market if Winans traded with permission of the Journal, if Reed lacked any sort of relationship of trust and confidence with his father, or if confidential information was overheard by a third party who had no duty whatsoever to the source of the information?

Finally, it is not clear that expansion of insider trading under the misappropriation theory is necessary. There are alternative ways to address much of the conduct to which the theory has been applied. One of the thorniest areas in the insider trading debate is the extent to which the prohibition should cover trading by outsiders. In particular, classic outsiders, such as Winans, do not obtain their information as corporate insiders or tippees. Thus, prosecution of such outsiders requires doctrine to be stretched very thin. It might be preferable to remove these cases from the insider trading area altogether. After all, Winans was not trading on classic "inside" information; the information that formed the basis of his

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111 See supra text accompanying note 68 (discussing Blue Chip decision).

112 In United States v. Newman, the Second Circuit expressly cautioned that the indictment was based on a breach by the defendants of a duty to their employer and the employer's clients, not on a duty to the marketplace or to the shareholders of the target companies. 664 F.2d 12, 15 n.1 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983). The Second Circuit subsequently explained, in Moss v. Morgan Stanley Inc., that the breach of a duty to the source under the misappropriation theory cannot be "stretched to encompass an employee's 'duty of disclosure' to the general public." 719 F.2d 5, 13 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984). But see Norman S. Poser, Misuse of Confidential Information Concerning a Tender Offer as Securities Fraud, 49 Brook. L. Rev. 1265, 1270 (1983) ("Regardless of how the defendant received the information ... public investors are equally in need of protection.").

113 An example of this last scenario is provided by SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984), in which the SEC attempted to prosecute a football coach who traded based on discussions he overheard while in the stands at a game. The court rejected the SEC's argument since Switzer was not in a fiduciary position and did not know the information on which he traded was the result of an insider breach. Id.
columns was all in the public domain.\textsuperscript{114}

Winans conceivably might have been prosecuted for “scalping,” a legal theory that does not depend on an insider trading analysis.\textsuperscript{115} Scalping is trading by an investment advisor for his own account based on the market effect of his recommendations to investors.\textsuperscript{116} Although scalping is prohibited by the Investment Advisors Act of 1940,\textsuperscript{117} these prohibitions probably do not apply to newspaper reporters.\textsuperscript{118} Alternatively, prepublication trading may be viewed as traditional securities fraud.\textsuperscript{119} One might treat a columnist’s recommendations as a representation to the public, upon which the column’s readers rely in purchasing and selling securities. Clearly, when a financial columnist publishes a column of stock recommendations, he intends to convey information to the financial marketplace and expects readers to make trading decisions in reliance on those recommendations. The columnist who makes prepublication trades in order to benefit from the publication effect of his column has a conflict of interest.\textsuperscript{120} The purchases

\textsuperscript{114} See Brudney, supra note 13, at 368-71 (discussing liability for trading on information within public domain).

\textsuperscript{115} See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963) (holding scalping to be fraud or deceit upon client or prospective client).

\textsuperscript{116} Id. at 196. Although an investment advisor may readily anticipate the market effect of a good faith recommendation, the danger in scalping is that an advisor will recommend a given security not because of its potential for a long-term price increase but because of its potential for a short-term price reaction to the advisor’s recommendation.


\textsuperscript{118} The definition of investment advisor under the 1940 Act explicitly excludes “the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.” 15 U.S.C. § 80b-2(a)(11) (1988). The statute does not address the status of reporters or employees of a publisher. See Cox, supra note 5, at 385 (placing Winans and the Journal beyond reach of Investment Advisors Act).

\textsuperscript{119} See, e.g., Zweig v. Hearst Corp., 594 F.2d 1261, 1271 (9th Cir. 1979). In Zweig, the court found that a newspaper columnist who made a practice of engaging in prepublication trading could be civilly liable under Rule 10b-5 for failing to disclose the conflict of interest inherent in his trading. See also SEC v. Campbell, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,580, at 92,703 (C.D. Cal. 1972) (reporting prosecution of investment columnist under Rule 10b-5 for prepublication trading).

\textsuperscript{120} As the Ninth Circuit stated in Zweig, “[R]easonable investors who read the column would have considered the motivations of a financial columnist such as Campbell important in deciding whether to invest in the companies touted.” Zweig, 594 F.2d at 1266; see Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (requiring broker/dealer to disclose fact that it was a market maker in recommended stock); see also Brudney, supra note 13, at 369 (arguing that columnist makes implied warranty of disinterestedness, which is breached by scalping); Cox, supra note 5, at 385 (arguing that client is aided in assessing strength of analyst’s recommendation by knowledge that analyst “is serving two masters,
will increase in value, based on the columnists favorable recommendation, whether or not the stock is actually worth more than the current market price. Thus, it seems that Winans could be prosecuted for failure to disclose his own trading to the paper’s readers,\textsuperscript{121} who are then defrauded in connection with their subsequent sale or purchase in reliance on the column.\textsuperscript{122}

Similarly, misappropriation theory covers a range of wrongful conduct that can be addressed with standard criminal laws,\textsuperscript{123} such as theft and mail fraud.\textsuperscript{124} The burglar who breaks into an office in order to obtain confidential corporate information for trading is stealing as well as engaging in insider trading.\textsuperscript{125} Moreover, the theft of corporate information through less dramatic means may qualify as conversion or embezzlement.\textsuperscript{126}

Many of the proposed definitions of insider trading would only exacerbate this problem. With their emphasis on the wrongful acquisition of inside information, the proposals would increase the

\textsuperscript{111} One commentator suggests that the alternative is to have the newspaper publish a statement disclosing that employees are permitted to engage in prepublication trading. Martin Kimel, Note, The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters, 38 Stan. L. Rev. 1549, 1571 (1986).

\textsuperscript{122} The theories whereby scholars claim Winans’s scheme damaged the reputation of the Journal are based on the belief that the Journal’s readers will perceive the content of the columns as tainted by Winans’s personal profit motive and accord them less reliability. See supra note 106.

\textsuperscript{123} Misappropriation theory has also been criticized on the basis that it duplicates state agency law. Georgakopoulos, supra note 105, at 137 n.93.

\textsuperscript{124} In Chiarella, Chief Justice Burger quoted with approval a passage from a 1936 law review article that stated, “[a]ny time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.” Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (quoting W. Page Keeton, Fraud—Concealment and Non-Disclosure, 15 Tex. L. Rev. 1, 25-26 (1936)). The mere fact that the acquisition has taken place through an illegal act suggests, however, that an alternative mechanism exists for redressing the wrong. See United States v. Carpenter, 791 F.2d 1024, 1036-37 (2d Cir. 1986) (Miner, J., dissenting in part) (arguing that broadening federal securities laws to cover Winans’s conduct is unnecessary because conduct could be adequately addressed by mail and wire fraud statutes), aff’d, 484 U.S. 19 (1987).


\textsuperscript{126} See, e.g., Macey, supra note 44, at 28-29 (arguing that Chiarella’s use of tender offer information for his personal trading was breach of contract and theft).
duplication between insider trading and current criminal statutes. For example, the SEC’s proposed insider trading bill would prohibit the use of, among other things, information that has been obtained by or as a result of “theft, bribery, misappropriation or espionage.”\textsuperscript{127} The proposed Insider Trading Proscriptions Act of 1987\textsuperscript{128} would prohibit the use of information obtained by “theft, conversion, [or] misappropriation.”\textsuperscript{129}

II. APPLICATIONS OF CURRENT INSIDER TRADING LAW

Notwithstanding the logical flaws, many commentators accept the judicially developed theories of insider trading, based on a fundamental perception that insider trading is unfair and wrong.\textsuperscript{130} Given this perception, one might conclude that those who engage in such trading should be held liable in spite of the difficulties in articulating the rationale for such liability. Even with this approach, however, the problems associated with insider trading regulation are evident. The viability of a theory of liability does not depend only on whether liability is reasonable but also on whether it can be imposed in a logical manner.

A. LIABILITY FOR TIPPING

One fundamental difficulty is determining how to impose liability for tipping. Who, if anyone, should be prosecuted when an insider, rather than trading himself, tips the information to others who trade in reliance on that information? Under both the classical and the misappropriation theories of insider trading liability, the original acquirer of the information and anyone who receives the information from that acquirer may be held liable for insider trading. Indeed, in Cady, Roberts, the defendant who traded on the basis of inside information was not a corporate insider but the information.

\textsuperscript{129} Id. § 3; see Kimel, supra note 121, at 1564 (“Federal securities laws are not needed to protect employers from theft.”).
\textsuperscript{130} E.g., Brudney, supra note 13, at 364-55; Bainbridge, supra note 22, at 55-62.
partner of a director. The Commission failed to explain how the tippee inherited his partner's fiduciary duty; it simply based liability on the fact that the broker knew the information was nonpublic and had been received from an insider.131

The courts appear to predicate the liability of a tippee on the tipper's breach of some duty. As the Court in Chiarella explained, "[t]he tippee's obligation [not to profit from the inside information] has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."132 Thus, it is necessary for the tipper to act wrongfully in order for his tippee to incur liability. The extent of this requirement was clarified in Dirks v. SEC,133 in which the Supreme Court found that Secrist, the corporate insider and source of the information,134 had committed no breach of fiduciary duty in disclosing the information to a securities analyst, Dirks.135 Accordingly, Dirks could not have been a participant after the fact in a breach of fiduciary duty and hence could have no derivative liability as a tippee.136

The SEC has taken the position that a tippee stands in the shoes of the tipper, inheriting the tipper's fiduciary duty. If the tipper would be barred from trading by virtue of his insider position, the tippee is similarly barred.137 The Court in Dirks, however, rejected this position.138 The Court held that, before a court imposes liability upon a tippee, the government must satisfy a two-part test. In addition to proving a primary breach of fiduciary duty by the tip-

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134 Secrist, a former officer of Equity Funding of America (EFA), disclosed to Dirks, a securities analyst, that a major fraud was being perpetrated at EFA. Secrist "urged Dirks to verify the fraud and disclose it publicly." Id. at 649.
135 Id. at 666. The Court's method of determining whether Secrist breached a fiduciary duty in revealing the fraud to Dirks may have been overly simplistic. The Court concluded that the test for whether an insider acted improperly in revealing inside information was "whether the insider personally will benefit, directly or indirectly, from his disclosure." Id. at 662. Thus, an insider breaches his duty in revealing inside information only if he receives a personal benefit from the disclosure, such as a pecuniary gain or a benefit to his reputation that will translate into future earnings. Id. Since Secrist received no money or personal benefit, the Court held he had breached no duty to EFA. Id. at 662.
136 Id. at 667. The Court concluded that tippees do not inherit the insider's duty to disclose or abstain merely because they receive inside information; tippees only inherit the insider's duty if the information "has been made available to them improperly." Id. at 660.
137 Id. at 655.
138 Id. at 655-59.
per, the government must show that the tippee knew or had reason to know that the information was nonpublic and had been wrongfully obtained. 139

Neither requirement fills the void in the Cady, Roberts opinion. The Court in Dirks still did not explain how a tippee who does not obtain (or pass on) inside information—in breach of a fiduciary duty to the stockholders, the source of the information, or someone else—can commit securities fraud by trading on the basis of that information. How can such trading be a fraudulent omission if the tippee has no duty to speak? 140 Agency principles do not supply an answer. Even if the original insider had a fiduciary duty to his shareholders, the tippee does not inherit that same duty upon receiving a tip. Moreover, if the insider tips in breach of a duty of nondisclosure, it is illogical to find that this duty of nondisclosure is converted, in the hands of the tippee, into a duty to disclose.

The problem is further complicated by the willingness of Congress 141 and the courts to impose insider trading liability upon an insider who tips but does not trade. 142 Such liability is really secondary in nature; the insider is aiding and abetting the violation committed by the tippee’s trading. But if the insider abstains from trading, he is not violating the Cady, Roberts duty. Moreover, unless disclosure of the inside information harms the company (or

139 Id. at 661-64.
140 It has been suggested that a tippee “inherits” the duty from the tipper as long as the tippee knew or should have known that the information was improperly obtained. SEC v. Musella, 578 F. Supp. 425, 439 (S.D.N.Y. 1984); see Phillips & Zutz, supra note 5, at 89 (terming this the “‘inheritance’ theory.”); cf. Dirks, 463 U.S. at 655-56 (rejecting notion that tippee inherits Cady, Roberts duty absent breach of that duty by tipper).
142 See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 241 (2d Cir. 1974) (holding stockbroker liable for tipping institutional clients based on information Merrill Lynch received as result of performing underwriting work); see also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (describing duty of insider who possesses material nonpublic information to “abstain from trading in or recommending the securities concerned while such inside information remains undisclosed”) (emphasis added), cert. denied, 394 U.S. 976 (1969). Indeed, Dirks did not himself trade in the stock of Equity Funding. Dirks, 463 U.S. at 665. These cases can be addressed, as the District of Columbia Circuit did in Dirks, by finding that securities professionals, by virtue of their position, have a fiduciary duty to the marketplace not to engage in selective disclosure. Dirks v. SEC, 681 F.2d 824, 840 (D.C. Cir. 1982), rev’d, 463 U.S. 646 (1983); see infra note 265.
results in personal gain to the insider), it is difficult to find a breach of fiduciary duty, even when the disclosure is selective.\footnote{An example is a recently settled action by the SEC against Phillip Stevens, the former CEO of Ultrasystems Corp., SEC v. Stevens, 91 Civ. 1869 (CSH) (S.D.N.Y. Mar. 19, 1991). See \textit{Ex-CEO Settles Charges He Disclosed Adverse Inside Information to Analysts}, 23 Sec. Reg. & L. Rep. (BNA) No. 12, at 439 (Mar. 22, 1991) [hereinafter \textit{Ex-CEO}]. Stevens allegedly conveyed nonpublic information to securities analysts that Ultrasystems would have lower earnings than expected. The SEC claimed that Stevens tipped in order to improve “his status as a corporate manager.” \textit{Id.} Apparently Stevens believed tipping would enhance his credibility among analysts and enable him to function as a more effective CEO. Thus, Stevens’s tips can be viewed as attempts to help the issuer rather than as a breach of his fiduciary duties.}

Thus, the courts impose liability for a tipper’s breach of a duty of nondisclosure alone. But this breach is no more deceptive if a tippee purchases securities based on the information disclosed than if the tippee sells the information to a competitor or otherwise uses the information to his business advantage. This contradiction is the result of focusing on the tipper’s fiduciary obligations to assess whether the insider trading prohibitions have been violated. Whether the tippee trades is irrelevant. Nevertheless, the SEC does not appear to have taken the position that disclosure by corporate insiders of inside information is, by itself, insider trading or securities fraud, as long as no subsequent recipient of the information trades securities in reliance on the information.

\section*{B. CHOOSING BETWEEN CLASSICAL THEORY AND MISAPPROPRIATION}

A major difficulty in applying the existing insider trading theories is choosing which theory to use. Courts have not always distinguished clearly between the two theories\footnote{Some commentators believe that derivative or tippee liability should be treated as a distinct category of insider trading regulation. \textit{E.g.}, LANGEVOORT, \textit{supra} note 2, at 101-39. This belief is based, in part, on the fact that derivative liability brings additional analytical problems to the insider trading debate. \textit{See id.} at 363-94 (noting gray areas of insider trading liability).} in reviewing insider trading convictions.\footnote{When used to refer to insider trading litigation, the term “conviction” should be read broadly to include cases in which the government has been successful in a civil enforcement action or administrative proceeding as well as a criminal \textit{prosecution}.} Nor is it always intuitively obvious which theory is appropriate. For example, professionals such as investment bankers and lawyers are frequent targets in insider trading prosecutions based on their misuse of information conveyed to them for professional purposes. Such traders can be prosecuted
under the classical theory based on the view that they became temporary insiders when they received information for a corporate purpose. Alternatively, under the misappropriation theory, the traders may be prosecuted as outsiders who have misappropriated the information through the process of converting it to their personal use. Professionals also may be viewed as tippees, although, after *Dirks*, such a predicate for liability appears dubious because corporate officers do not breach a fiduciary duty in communicating information to professionals for business purposes.

The problem is illustrated by the recent prosecution of Robert Chestman. Chestman, a broker, was prosecuted under the misappropriation theory for trading on information about a forthcoming tender offer for the stock of Waldbaum, Inc. Chestman obtained the information from Keith Loeb, a nephew by marriage of a Waldbaum insider. Loeb had no inside position in the company, and he disclosed the information to Chestman voluntarily; between Loeb and Chestman there was no theft or breach of confi-

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146 The Court stated in *Dirks*:

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.


When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than as a tippee. Thus, for example, in *SEC v. Musella*, 578 F. Supp. 425, 441 (S.D.N.Y. 1984), in which the office manager of a law firm disclosed information about the merger and acquisition plans of the firm's clients, liability might more appropriately have been based on the treatment of the defendant as a constructive insider. Instead, the court determined that the defendant had, in tipping, misappropriated the information. *Id.* at 438-39.

147 United States v. Chestman, 903 F.2d 75, 82, 84 (2d Cir. 1990), *vacated in part on reh’g*, 947 F.2d 551 (2d Cir. 1991) (en banc). The court’s decision *en banc* reversed Chestman's conviction for insider trading under Rule 10b-5 but upheld his conviction under Rule 14e-3, see *infra* note 150.

148 The government’s theory of the case was that Chestman had received inside information about Waldbaum stock from Loeb. *Id.* at 75. Chestman maintained that his trading was motivated by his independent analysis of Waldbaum stock. Chestman claimed that he did not discuss Waldbaum stock with Loeb prior to making the purchases for which he was prosecuted. *Id.* at 555. Chestman’s testimony at trial was corroborated by that of his administrative assistant, who testified that as of late morning or early afternoon of the day Chestman purchased Waldbaum stock, Chestman had not spoken to Loeb. Flumenbaum & Karp, *supra* note 8, at 3.
dence. Thus, Chestman could be prosecuted only as a tippee and, at that, only as a remote tippee.149

The panel of the Second Circuit that heard Chestman came to three separate conclusions with respect to Chestman’s conviction under Rule 14e-3150 but unanimously reversed Chestman’s conviction under Rule 10b-5.151 Upon rehearing en banc, a sharply divided Second Circuit agreed with the panel and reversed the conviction under Rule 10b-5.152 The court held that prosecution under the misappropriation theory, under which Chestman was charged,153 required proof that Chestman knew Loeb was breaching a relationship of trust and confidence, that is, misappropriating information.154 The evidence with respect to Loeb’s misappropriation was shaky at best—the information had been passed down a chain of family members, in each case upon a pledge of secrecy that was broken.155 Loeb received the information from his wife, who was not a Waldbaum insider, who had no fiduciary duties to the company, and who was expressly authorized to disclose the in-

149 Chestman, 947 F.2d at 570-71; see Coffee, supra note 93, at 5 (“Put simply Chestman was a fourth-level tippee.”).
150 SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (1991), regulates trading whenever a bidder has either taken substantial steps to commence or has commenced a tender offer. Absent public disclosure, the rule prohibits trading by anyone who is in possession of material nonpublic information concerning the offer and who knows or has reason to know that the information came from the bidder or the target company, directly or indirectly. The bidder is exempted from this prohibition.

The Second Circuit panel reversed Chestman’s conviction under Rule 14e-3 by a two-to-one vote. Judge Mahoney felt that Rule 14e-3 was an invalid exercise of the SEC’s rulemaking power. Chestman, 903 F.2d at 84 (Mahoney, J., concurring in part and dissenting in part). Judge Carman determined that Rule 14e-3 required proof of fraudulent acts and determined that, because the trial court did not instruct the jury on the elements of fraud, Chestman’s conviction must be reversed. Id. at 86 (Carman, J., concurring in part). The en banc court, however, disagreed with the panel and concluded both that Rule 14e-3 was an appropriate exercise of the SEC’s rulemaking power and that Chestman’s conviction under the rule was proper. Chestman, 947 F.2d at 556-64. The validity of Rule 14e-3 obviously implicates a number of the issues discussed herein, but a comprehensive treatment of the rule is beyond the scope of this Article.
151 Chestman, 903 F.2d at 80, 84, 86.
152 947 F.2d 551 (2d Cir. 1991) (en banc). Five judges dissented from the reversal of Chestman’s convictions under 10b-5. Id. at 571.
153 Chestman was convicted of both aiding and abetting insider trading by assisting Loeb’s purchase of stock and of trading as a tippee with respect to purchases on behalf of himself and others. Chestman, 947 F.2d at 564.
154 Id.
155 See Chestman, 903 F.2d at 77; Chestman, 947 F.2d at 579 (Winter, J., dissenting in part).
formation to her husband.\textsuperscript{156} Moreover, there was no evidence that Loeb ever agreed to keep the information confidential.\textsuperscript{157} Under those circumstances, the court found it impossible to conclude that Loeb had breached a duty in disclosing the information to Chestman.\textsuperscript{158} If there was no breach of duty, then Chestman, notwithstanding the fact that his conduct suggested consciousness of guilt,\textsuperscript{159} could not have knowledge of such a breach.

At oral argument before the \textit{en banc} court, the prosecution tried to base a duty on the family relationships involved, in particular on the marital relationship between Keith and Susan Loeb. The prosecution argued that the marital relationship was persuasive, if not conclusive, evidence of a relationship of trust and confidence.\textsuperscript{160} From this relationship, the government tried to infer a duty to hold interspousal communications confidential.\textsuperscript{161} The difficulties with this approach are apparent. It would be difficult enough for the family member involved, much less his tippee, to evaluate every conversation with a relative and to distinguish reliably confidential conversations from ordinary family gossip.\textsuperscript{162}

Of course, the government was not required to prosecute Chestman under the misappropriation theory. Intuitively, the classical theory of insider trading seems better suited to the facts of the \textit{Chestman} case. Ira Waldbaum, the original source of the confidential information, was a traditional insider.\textsuperscript{163} The information was passed from Waldbaum to Chestman through a series of Waldbaum family members.\textsuperscript{164} Why is this not a classic case of remote tippee liability? One answer is that the case illustrates the above-described logical difficulties with derivative liability for tip-

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\textsuperscript{156} \textit{Chestman}, 947 F.2d at 579 (Winter, J., dissenting in part).
\textsuperscript{157} Id. at 571.
\textsuperscript{158} Id.
\textsuperscript{159} Id. This conduct included his denial that he had ever discussed the Waldbaum stock with Loeb. See \textit{id.} at 555-56.
\textsuperscript{160} In his opinion, dissenting on the reversal of Chestman's convictions under Rule 10b-5, Judge Winter attempted to articulate a test for recognizing a fiduciary duty based on a familial relationship. \textit{Id.} at 579-80 (Winter, J., dissenting in part).
\textsuperscript{161} \textit{Id.} The \textit{Chestman} indictment charged that Loeb had breached a duty of trust and confidence to his wife and her family when he tipped Chestman. Chestman allegedly aided and abetted this breach by trading. Coffee, supra note 93, at 5.
\textsuperscript{162} See \textit{Chestman}, 947 F.2d at 582-83 (Miner, J., concurring) (criticizing "familial relationship" rule as difficult to apply and inhibiting family discourse).
\textsuperscript{163} Id. at 555.
\textsuperscript{164} Id.
Ira Waldbaum disclosed the information to Shirley Witkin, his sister, for valid business purposes—Witkin had to assemble her stock certificates in order to effect the upcoming sale of the business. Since Waldbaum’s disclosure of the sale was for valid business purposes and not for improper personal gain, it was not a breach of any fiduciary duty. Under the reasoning of Dirks, if Waldbaum breached no duty in disclosing the information, Witkin could not be liable as a tippee for subsequent disclosure or trading.

Accordingly, any culpable conduct in this case is limited to the disclosure of the transaction by Loeb to Chestman and the subsequent trading by Loeb and Chestman. But this conclusion brings us back to the question asked by the Chestman court: why was the information confidential in the hands of Loeb? Is the sanctity of the marital relationship really the basis for the jury’s determination that Chestman’s conduct constituted insider trading? Should insider trading prosecutions be a tool to enforce the maintenance of spousal confidences? If the concern of the securities laws is the protection of investors through complete disclosure of investment information, why should Chestman’s liability for insider trading be dependent upon whether the Loeb’s marriage constituted a relationship of trust and confidence?

Professor Langevoort notes that tippee-derivative liability, especially based on tips to friends or relatives, constitutes one of the “gray areas” in insider trading regulation. Langevoort, supra note 2, at 389-94.

It can be argued that Witkin, too, was an insider, since she owned Waldbaum’s stock and was a party to the sale that Ira Waldbaum had negotiated. Assuming that Witkin was an insider, one must analyze her disclosure to determine if it was an improper tip. Witkin was Susan Loeb’s mother, and when Susan Loeb became anxious that her mother’s activities reflected a problem with her health, Witkin disclosed the upcoming sale to ease her daughter’s anxiety. Chestman, 903 F.2d at 77. Witkin did not disclose the sale for personal gain or to make her daughter a gift, so, under Dirks, Witkin’s disclosure was not a breach of any insider’s duty. Chestman, 947 F.2d at 579 (Winter, J., dissenting in part). Moreover, Witkin told Susan Loeb she could tell her husband about the sale, so when Susan disclosed the transaction to Keith she breached neither a duty as a tippee nor a relationship of trust and confidence. Id. at 555.

The Third Circuit’s opinion in Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), provides an equally compelling illustration of the problem of identifying the appropriate theory upon which to predicate insider trading liability. Defendant Rosenbloom was an insider of Nytronics, a corporation engaged in an attempt to take over Gulton Industries. Rosenbloom tipped Rothberg as to both Nytronics’s intention to take over Gulton and his expectancy that the attempt would be successful, based on Nytronics’s favorable contacts on
C. LIMITATIONS OF BOTH THEORIES

The Chestman case is not the only difficult factual situation under current lines of insider trading analysis. Consider the situation of a business acting as a major supplier to a corporation. The supplier is advised by the corporation's executives that the corporation has significant expansion plans, as yet unannounced, and accordingly will be substantially increasing its orders with the supplier. If the supplier trades on that information, has it engaged in insider trading? The supplier is, in a sense, a tippee, but the information was communicated to the insider for business purposes rather than securities trading. Arguably the supplier may be viewed as a temporary insider when it receives the tip, but it is unlikely that a supplier that only receives payment from the corporation for material provided can be viewed as owing a fiduciary duty to the corporation and its shareholders. Nor can the supplier be considered to have misappropriated the information, even if the executives describe the corporation's plans as confidential.

The Third Circuit concluded that Rosenbloom's tip violated insider trading law under the misappropriation theory because Rosenbloom "owed [Nytronics] a duty not to disclose secret information which would cause others to buy Gulton stock, thereby making it more difficult for Nytronics to consummate a merger on favorable terms." In his concurring opinion, Judge Higginbotham agreed with the majority's conclusion but found its reliance on the misappropriation theory to be misplaced. According to Judge Higginbotham, the significance of the tip was based on the disclosure of the Gulton board's likely receptiveness to the offer, information that came not from Nytronics, the acquirer, but as a leak from Gulton, the target. Even under a fraud-on-the-source theory, Rosenbloom did not owe a fiduciary duty to Gulton as source of the information. Judge Higginbotham concluded that Rosenbloom should instead be found to have violated insider trading law under the classical doctrine based on the fact that Dr. Gulton, the Gulton insider who had contact with Rosenbloom, breached a fiduciary duty under the Dirks analysis in leaking the information.

Professor Brudney would argue that the supplier has access to an informational advantage that is not available to the general public and hence should be barred from trading. See Brudney, supra note 13, at 359 (arguing that supplier/customer situation invokes disclose-or-refrain rule). Id. at 359 ("[N]o legal doctrine seals a supplier's knowledge of a significant increase in orders by a customer.").

One commentator refers to situations in which insiders, by virtue of their position, receive knowledge about other corporations, to which they owe no fiduciary duty, as "cross trading." Georgakopoulos, supra note 105, passim. The author suggests that, although cross-trading is not classical insider trading, it can be reached under the misappropriation theory. Further, according to the author, it should be reached because the policy considerations for banning cross-trading are even stronger than those underlying the general regulation of in-
The corporation cannot unilaterally impose restrictions on information the supplier has legitimately obtained.\textsuperscript{172}

Those who argue that trading by the supplier in this case does not present the same dangers of manipulation of corporate events and harm to the corporation as trading by insiders may consider the converse factual scenario, in which the supplier decides to cut off the supply of material to the corporation and, in anticipation of that decision, sells the corporation's stock short.\textsuperscript{173} Should insider trading regulation be expanded to cover someone who acts in breach of a contractual duty to the corporation, such as that imposed by a supply contract, and trades "in connection with" that breach?\textsuperscript{174}

Finally, consider a corporation that deems itself a possible takeover target. Management, fearing a hostile takeover attempt, approaches other companies as prospective white knights, seeking to enter into a merger on friendly terms.\textsuperscript{175} Although the disclosure of

\textsuperscript{172} The corporation could, with the consent of the supplier, restrict the supplier's right to use the information by contract. This possibility raises the question of whether the supplier's breach of that contract could be bootstrapped into an insider trading violation like that in the Carpenter case.

\textsuperscript{173} Professors Carlton and Fischel describe the situation of a short seller as providing the same moral hazard as that of an insider. Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 874 (1983).

\textsuperscript{174} Professors Carlton and Fischel suggest that there is no real possibility of insider trading prosecution in this situation. Id. The supplier, however, might logically be indicted under the misappropriation theory, based on the claim that he had a contractual duty not to use information derived from his business relationship for his personal gain, or under the classical theory, based on the argument that he has become a temporary insider of the supplied firm. See infra note 175 (discussing situations involving temporary insiders).

\textsuperscript{175} This factual scenario is similar to those in a number of reported cases. For example, in SEC v. Ingram, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,788, at 98,720 (C.D. Cal. 1988), Ingram, a securities analyst, was asked by the corporation to look for a merger partner. Ingram, who was not compensated for his services, located a partner and sat in on the merger negotiations. During the course of the negotiations, he tipped several of his brokerage clients about the deal. The court held that Ingram, by virtue of his participation in the deal, had become a temporary insider who inherited a Cady, Roberts duty. Id. Earlier, in SEC v. Lund, 570 F. Supp. 1397, 1399-400 (C.D. Cal. 1983), a corporate insider asked Lund if he was interested in participating in a lucrative joint venture with the corporation. Lund declined to join in the deal but purchased stock in the corporation, realizing a $12,500 profit. The district court found that Lund was guilty of insider trading, holding that the insider's approach to Lund made him a temporary insider of the corporation and imposed upon him the obligation to keep the information confidential. Id. at 1403. But see Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (holding that financial advisor of acquiring entity has no duty to target entity even when target disclosed confidential infor-
confidential corporate information about the issuer is, in these situations, generally subject to an appropriate confidentiality agreement that prevents the white knight from trading on the basis of the information obtained, there is nothing to prevent a prospective white knight from rejecting the suitor’s advances and purchasing target stock based on the knowledge that the target is seeking an acquirer or “shopping the company.” These initial contacts may precede public disclosure by the corporation that it is a target.

III. THE BASIS FOR THE INSIDER TRADING PROHIBITION

The foregoing analysis of the Chestman decision demonstrates the gap that has developed between the regulation of insider trading and the traditional goals of the securities laws. It also calls into question what should be done to regulate insider trading regulation. Development of the existing case law has been logically inconsistent and possibly unfair, a result that is hardly surprising in the absence of any clear statutory or common-law prohibition. Commentators have observed that the law is sorely in need of clarification; many have called for a clear definition of the prohibited conduct. This outcry requires some reflection on the basic rationale for prohibiting insider trading. If there is no clearly defined prohibition, why have the courts and the SEC decided that insider trading is illegal? Are they correct? In other words, having determined that section 10(b) does not provide an appropriate basis for prosecuting misuse of inside information, we are left to question

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176 Whether the firm’s trading violated SEC Rule 14e-3 would be a separate issue. See supra note 150 (discussing Rule 14e-3).

177 In the initial stages a corporation is typically shopped through an investment banker without disclosure of its identity to avoid this kind of trading. Many in the industry believe that if those approached can ascertain the identity of the company being shopped, they are free to trade.

178 See supra note 5.

179 In considering the purposes of regulating insider trading, this Article will not consider the general objectives behind the antifraud provisions. Those objectives have been described as including the protection of public investors against overreaching by issuers, the enhanced market efficiency that results from increased disclosure of relevant corporate information, and the regulatory function ascribed by Justice Brandeis to disclosure as a direct deterrent to fraud. See Louis Brandeis, Other People’s Money and How the Bankers Use It 62-63 (1933). For a general discussion of the functions of the antifraud provision and citation to the relevant legislative history, see Brudney, supra note 13, at 334-36.
whether such a prohibition is desirable and, if so, what form it should take.

A. ECONOMICS, FAIRNESS, AND PROPERTY RIGHTS: POPULAR RATIONALES FOR REGULATION

Scholars have debated at great length whether insider trading should be regulated. Although an extensive analysis of this debate is beyond the scope of this Article, the battle lines are commonly drawn between those commentators who believe that insider trading increases the efficient operation of the markets and those who view insider trading as harmful to the markets, the firms whose securities are traded, or both. Professor Henry Manne has been generally credited with focusing the insider trading debate by rejecting criticisms of insider trading in terms of fairness and instead basing the analysis on the perceived costs and benefits.

It has been suggested that insider trading causes a decline in investor confidence and ultimately a decrease in the flow of money to the capital markets. As the Supreme Court has observed, “who would knowingly roll the dice in a crooked crap game?” Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988) (citation omitted). Moreover, one of the congressional purposes in adopting the federal securities laws was to restore investor confidence in the securities markets. See, e.g., In re Faberge, Inc., 45 S.E.C. 249, 254 (1973) (“One of [the Exchange Act’s] primary objectives was to restore and maintain investor confidence in the capital markets of the United States.”); see also Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1988) (explaining “[n]ecessity for regulation”); cf. Spencer Cerek, Note, Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence, 16 Hofstra L. Rev. 665, 675 (1988) (arguing that SEC’s emphasis on high-profile insider trading prosecutions may do more harm than good with respect to investor confidence).

In addition, the ability to engage in insider trading may create perverse incentives for corporate management, encouraging management to manipulate corporate decisions in order to create trading opportunities and to delay reporting of operations to accommodate trading by insiders. The former problem is commonly described as “moral hazard.” See, e.g., Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 Va L. Rev. 117, 149 (1982) (arguing that insiders can structure corporate transactions in order to profit from a decrease in corporate stock prices); Schotland, supra note 180, at 1451 (discussing belief that insider’s trading in shares may impede insider’s commitment to corporation’s business); Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L.J. 1083, 1095 (1985) (discussing inside trader’s ability to manipulate release of news, adopt riskier practices to detriment of shareholders, and profit by...
of such trading. This analysis, while interesting on a theoretical level, has not generated any clear consensus, probably because of the absence of empirical data.\textsuperscript{183} Unless the effect of the legalization of insider trading on investor confidence or management behavior can be quantified, it is impossible to determine whether such effects justify retaining the existing prohibition.\textsuperscript{184}

Alternatively, the debate can be returned to the issue of fairness. A common view of insider trading is that it is unfair to other traders. Insiders possess an informational advantage by virtue of their position or through fortuity and should not reap a windfall by using that information for personal gain.\textsuperscript{185} Whether other traders

\textsuperscript{183} See, e.g., Bainbridge, \textit{supra} note 22, at 63-65.

\textsuperscript{184} See Easterbrook, \textit{supra} note 37, at 338 (arguing that questions of whether insider trading restrictions are justified are ultimately empirical).

\textsuperscript{185} Many also believe that insider trading directly hurts contemporaneous traders in the market by causing them to trade at an improper time or price. See, e.g., William K.S. Wang, \textit{Trading on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5}, 34 S. Cal. L. Rev. 1217 (1981). Professor Wang has argued that insider trading may have the effect of inducing others to trade or preempting the trades of other investors. \textit{Id.} at 1235-36. He explains that all trading in securities is subject to the "law of conservation of securities," under which the profits gained by an insider must be directly offset by losses sustained by other investors. \textit{Id.} at 1235. Professor Wang concludes that, if insiders profit, other investors must be harmed, although it may be difficult to determine who those investors are. \textit{Id.} at 1236-38. But see Bainbridge, \textit{supra} note 22, at 42-45 (arguing that insider trading causes securities to be priced more accurately in situations in which corporation is permitted to withhold material information); Easterbrook, \textit{supra} note 37, at 324-27 (arguing that insider trading is unlikely to result in unfair transactions for other traders); Gilson & Kraakman, \textit{supra} note 11, at 630-34 (arguing that insider trading is unlikely to have any effect on market price unless private information is effectively transmitted to market).
are harmed directly, such as by inducement to trade at an incorrect price, or indirectly, through the presence in the market of other traders who possess an overwhelming informational advantage, inequality of information is at the heart of the fairness rationale. Yet, few suggest that insider trading be regulated by a parity-of-information standard. Instead, the unfairness associated with insider trading has been attributed to inequality of access to information. As Professor Brudney explains, the unfairness associated with the insider's use of corporate information is based on the fact that the insider has a "lawful monopoly on access to the information involved . . . which cannot be competed away." 188

Apart from insiders who gain access to information by theft or its equivalent, when does the insider's access to information make his trading activity unfair? Obviously, participants in the market

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186 At least one commentator has suggested that Congress enact a parity-of-information approach by statute. Seligman, supra note 181, at 1137-40.

187 The Supreme Court has expressly rejected the theory that all traders are entitled to equal information. See Dirks v. SEC, 463 U.S. 646, 657 (1983) ("Judge Wright correctly read our opinion in Chiarella as repudiating any notion that all traders must enjoy equal information before trading: 'T]he “information” theory is rejected.'") (quoting Dirks v. SEC, 681 F.2d 824, 837 (D.C. Cir. 1982), rev'd, 463 U.S. 646 (1983)).

Although many argue that the level-playing-field theory is addressed not to equal information but to equal access, the Court in Chiarella also rejected unequal access to information as a basis for imposing liability. Chiarella v. United States, 445 U.S. 222, 235 n.20 (1980). Even the Second Circuit, with its expansive view of insider trading, does not take the position that the regulation of insider trading is designed to equalize access to information. "We do not say that merely using information not available or accessible to others gives rise to a violation of Rule 10b-5 . . . . There are disparities in knowledge and the availability thereof at many levels of market functioning that the law does not presume to address." United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986) (emphasis added).

188 Brudney, supra note 13, at 346.

189 It is unclear why disparate access to information and the exploitation of that access present a unique problem in the securities industry. Business transactions are routinely predicated on the fact that one party to the transaction has superior information of which it intends to take advantage. An obvious example is the series of real estate purchases that gave rise to the insider trading opportunity in the Texas Gulf Sulphur case. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 844 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). Texas Gulf Sulphur was buying land because of its superior knowledge that there were extraordinary mineral deposits in that land, without revealing its discovery to the sellers. Id. Although the purchases may have been unfair to the sellers, they surely were not fraudulent. Indeed, the Ontario High Court of Justice, in a case arising out of the same factual situation as that litigated before the Second Circuit, found that Texas Gulf Sulphur had done what any prudent mining company would do in pursuing the purchases without disclosing the discovery. Leitch Gold Mines, Ltd. v. Texas Gulf Sulphur Co., 1 O.R. 469, 492-93 (1969). For a further discussion, see Anthony Kronman, Mistake, Disclosure, Information, and the Law of Contracts, 7 J. Legal Stud. 1, 20-21 (1978).
do not possess equivalent information. For example, the average analyst or other market professional has a great deal more information about the stocks he trades than the average small investor. Although this inequality may be unfair, it is not seriously suggested that analysts be precluded from taking advantage of this informational asymmetry. Market professionals expend a great deal of effort trying to obtain information that does not duplicate what everyone else has, through discussions with corporate in-

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190 Even advocates of the equal access theory of regulation accept that there is "systematic inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence." Brudney, supra note 13, at 360. It has been suggested that the unfairness of allowing investment analysts to trade on and sell superior information is addressed by the fact that, while every investor cannot become a corporate insider or the confidante of such an insider, everyone can obtain the services of an investment analyst. Donald C. Langevoort, Investment Analysts and the Law of Insider Trading, 76 Va. L. Rev. 1023, 1032 (1990). Therefore, all investors do have access to analyst information.

This argument overlooks two factors. First, even among the customers of an investment analyst, there is asymmetrical access to information. Many analysts selectively allocate the information they obtain, auctioning valuable information off to the highest bidder, or disclosing the most significant information only in oral conversations with favored clients. The information received by the typical investor, such as in the form of the firm's newsletter, is often markedly inferior. Id. at 1039. Indeed, in the Dirks case, it was Dirks's allocation of his information to his large institutional clients at the expense of smaller investors that the District of Columbia Circuit found to be unfair. Dirks v. SEC, 681 F.2d 824, 841 (D.C. Cir. 1982), rev'd, 463 U.S. 646 (1983).

Second, the customers of an investment analyst pay for the information they obtain. While an analyst is not an absolute free rider, it is unclear why he should be compensated for the information acquired. That is, why has the analyst acquired some sort of property right in the information by virtue of the tip? Even if the analyst system achieves market efficiency, why is it socially preferable to allowing corporate insiders to sell information directly to the public?

191 Analysts may garner personal advantage from trading for their proprietary accounts, from bonuses and other compensation schemes that reward superior information, and from benefit to their reputations. Moreover, because superior information generates greater business and the market for financial services is highly competitive, an analyst who has access to inside information furthers his career substantially. See Langevoort, supra note 190, at 1042-43.

192 The average small investor is automatically at a disadvantage due to his inability to follow the market and its developments on a full-time basis. Charles C. Cox & Kevin S. Fogarty, Bases of Insider Trading, 49 Ohio St. L.J. 353, 360 n.23 (1988). Some scholars, such as Professor Brudney, would not be concerned with this disparity, arguing that the relevant distinction is not equality of information but equality of access and that as long as any investor may, through expending sufficient resources, obtain the equivalent information, the investment professional's informational advantage is not unfair. Brudney, supra note 13, at 322. This argument begs the question: Should the inquiry focus on actual access or theoretical access? See Easterbrook, supra note 37, at 330 (pointing out that access to information is function of cost of obtaining information and that inequality of access is thus natural
siders, following the progress of important litigation, or monitoring news reports and the Dow Jones tape constantly. Should the arbitrageur who keeps close watch on an important lawsuit be precluded from trading as soon as the court announces its ruling because he has an informational advantage over the rest of the investing public? If not, how can legal informational advantages be distinguished from those that form an impermissible basis for trading? The method employed by existing legal theory is to brand as impermissible those informational advantages acquired through the breach of a fiduciary duty. Yet, for the investor-victim, it is irrelevant whether the trader has acquired inside information through the breach of a duty or not; anyone who trades based on superior information not available to the investing public has obtained a trading advantage that is arguably unfair. Moreover, as previously result of unequal distribution of intelligence, wealth, and investment of human capital).

Indeed, arbitrageurs go much further, attempting to ferret out information directly from corporate insiders. An arbitrageur's assessment of an investment opportunity may be based on factors that include not merely what an insider says, but also his "tone of voice, . . . the way a question was answered or avoided, or . . . the fact that a telephone call was not returned." Sarah Bartlett, *Business and Law: Cases Illustrate Wall St.'s Edge*, N.Y. TIMES, Aug. 28, 1989, at D2.

As Professor Brudney observes, the search for relevant corporate and economic information is a service of value to the functioning of the capital markets. The search entails research costs that will not be allocated for that purpose unless the investor is able to receive the rewards of the informational benefits so obtained. Brudney, *supra* note 13, at 341. On the other hand, it is possible that the selective favorable treatment of the financial community leads to excessive research and competition for superior information.

This question assumes that all informational asymmetry is not unfair. Although the Supreme Court has rejected the level-playing-field underpinning for insider trading regulation and has refused to uphold liability in the absence of a breach of duty, see *supra* note 187, Congress could choose to impose such a standard.

An example of trading that appears improper but involves no breach of a fiduciary duty is pre-offer trading by a prospective tender offeror. When an individual who is about to make a tender offer for the stock of a target company purchases stock prior to announcing the tender offer, he is, in some sense, trading on inside information about the forthcoming announcement, but since the bidder owns the information, the trading is legal. See *Chiarella v. United States*, 445 U.S. 222, 231-32 n.14 (1980) ("The Court of Appeals for the Second Circuit previously held, in a manner consistent with our analysis here, that a tender offeror does not violate § 10(b) when it makes preannouncement purchases precisely because there is no relationship between the offeror and the seller . . . .") (citing *General Time Corp. v. Tailey Indus.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*. 393 U.S. 1026 (1969)). Yet, if the bidder tells a friend about the offer, which, as owner of the information, he should be entitled to do, and the friend proceeds to trade in the target company's stock, the friend's trading violates Rule 14e-3. See *supra* note 150 (discussing Rule 14e-3).
discussed, neither the insider's fiduciary duty to the firm nor the misappropriator's duty to the source forms a logical and consistent justification for prohibiting trading. Most importantly, in this regard, applying the Court's rules regarding fiduciary duty requires reference to the parties' private agreement. For example, if the Wall Street Journal had not had a rule maintaining the confidentiality of its columns, Winans would not have breached a fiduciary duty by trading on the information contained in those columns. Similarly, if a corporation, through charter amendment, stockholder vote, or the equivalent, authorized its management to trade on the basis of inside information, there would be no breach of management's duty to stockholders upon which to predicate classical insider trading liability.197

This analysis has led some commentators to view insider trading in terms of property rights.198 If corporate information is considered the property of the firm, then the conversion of the property for the insider's personal use is a theft.199 Under this theory, an insider or misappropriator is a thief, and his tippee is receiving stolen property.200 The property rights theory provides a justification for prosecuting Winans for stealing information about upcoming columns from his employer, even though the Wall Street Journal would have been free to trade on the information in question.201

197 Although it is rarely argued that corporations should be able to authorize insider trading directly by treating corporate information as property and contractually bargaining with management about the allocation of rights in that property, some commentators assert that corporations would be able to authorize such trading indirectly by relieving management of a fiduciary obligation not to trade. E.g., Nicholas Wolfson, Trade Secrets and Secret Trading, 25 SAN DIEGO L. REV. 95, 113 (1988).


199 Additionally, use of the information by the insider may impair the corporation's ability to exploit it further. The corporate owner may require that confidentiality be maintained in order to profit fully. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (finding that corporation maintained confidentiality of drilling results in order to confirm results and acquire land), cert. denied, 394 U.S. 976 (1969).

200 Lawson, supra note 125, at 767 (“Mr. Levine was thus a garden-variety thief, and Mr. Boesky, who traded on the information and split the profits with Mr. Levine, was a fence.”).

201 According to the defendants in Carpenter, this anomaly meant their trading could not violate the law. The court responded by explaining that, while the Journal might lawfully
The property rights approach also offers a method for dealing with two of the examples posed earlier: that of the corporate supplier and that of the prospective white knight.\textsuperscript{202} While neither has unilaterally created the inside information in the sense that would give rise to an unequivocal ownership interest, both are trading on the basis of information voluntarily imparted by a third party for the purpose of business dealings. The third party has the opportunity to preclude trading on the basis of those dealings by contract, thereby restricting property rights in the information. Absent such a contractual provision, there is no misuse or theft in trading on the information.

A more troubling aspect of treating inside information as property is that such treatment does not justify government intervention to allocate the property rights to information. If inside information is the property of the firm producing it, why is it different from any other firm property, which the firm may allocate, as it chooses, by contract?\textsuperscript{203} This view would enable a firm to authorize its officers or employees to trade on the basis of inside information. The firm would, in effect, be opting out of the government enforcement of its property rights.\textsuperscript{204} In other words, viewing inside information as property justifies treating the misappropriation of that

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\textsuperscript{202} See supra text accompanying notes 169-177.

\textsuperscript{203} This argument is detailed in the seminal article by Professors Carlton and Fischel. They argue that insider trading would be regulated more efficiently if firms were free to authorize insiders to trade. Carlton & Fischel, supra note 173, passim. Professor Fischel and Judge Easterbrook have observed that private contract theory may not achieve optimal allocation of the property rights in information due to a variety of factors, including the difficulty in enforcing contracts that restrict insider trading because of the practical problems of detecting improper trades. Frank H. Easterbrook, \textit{Insider Trading as an Agency Problem}, in \textit{Principals and Agents: The Structure of Business} 81, 90-97 (John W. Pratt & Richard J. Zeckhauser eds., 1985) [hereinafter Easterbrook, \textit{Agency Problem}]; Easterbrook, supra note 37, at 332-35; Frank H. Easterbrook & David R. Fischel, \textit{Trading on Inside Information}, 36 \textit{Law Sch. Rec.} 10, 14 (1990).

Although these observations may explain why firms have not chosen to regulate insider trading by private contract, they do not justify a government ban on such contracts. “Public enforcement of antitheft laws does not imply that consensual transfers of property ought to be forbidden; just so with inside trading rules.” \textit{Id.} at 14.

\textsuperscript{204} Additionally, the firm would be able to sell the information to others. See Jonathan R. Macey, \textit{From Judicial Solutions to Political Solutions: The New, New Directions of the Rules Against Insider Trading}, 39 \textit{ Ala. L. Rev.} 355, 376 (1988).
property as theft but correspondingly requires the government to defer to firm decisions contractually allocating the entitlement to that property. 205

If the wrong associated with insider trading is a harm to the issuer or to the source, as suggested by the classical and misappropriation theories, respectively, the harm might be addressed through a regulation that protects property rights in information but allows firms to bargain away those rights voluntarily, restricting the government's involvement to enforcement of the privately negotiated bargain. 206 But perhaps existing theories of insider trading misapprehend the significance of insider trading. Is the rationale for the public perception that insider trading is wrong actually based on a perception that corporate insiders damage the issuer when they trade? This perspective seems unlikely. It is more plausible that the public views insider trading as damaging to traders and to the trading markets. The insider, by virtue of his position, has obtained an unfair informational advantage over other traders. Thus, the traditional views of insider trading distort the doctrine by ignoring the concepts of market duty and market harm.

B. JUSTIFYING REGULATION ON THE BASIS OF AN INSIDER'S DUTY TO THE MARKET

It might be argued that the Court in Chiarella rejected a general duty of disclosure to the market and that such a duty, therefore,

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205 According to Coase's theorem, in the absence of substantial transaction costs, property rights will be transferred to those who can exploit them most profitably. See generally David D. Haddock & Jonathan R. Macey, A Coasian Model of Insider Trading, 80 NW. U. L. Rev. 1449 (1987) (concluding, based on Coasian analysis, that ordinary shareholders would be better off if firms were allowed to opt out of proscriptions of current insider trading law). The SEC has not taken the position that informational rights can be transferred as property. For example, SEC Rule 14e-3 is inconsistent with the property rights approach because it prohibits a bidder from consensually transferring its property rights in information about a prospective tender offer to third parties. See, e.g., 17 C.F.R. § 240.14e-3 (1991); Morgan, supra note 198, at 113 (arguing that, under a property rights approach, bidder should be free to do whatever he wants with such information, including giving it to others).

206 This approach would address the concern that private enforcement is too difficult and costly to be effective in banning insider trading, even where such trading is inefficient. See Easterbrook, Agency Problem, supra note 203, at 94-95 (arguing that, if firm cannot meet costs of establishing program to prohibit insider trading and of detecting improper trades, it is unlikely to adopt private prohibition, even where prohibition is socially beneficial). See generally supra note 203.
cannot be the basis for imposing insider trading liability.\textsuperscript{207} There are two responses to this argument. First, the Court in \textit{Chiarella} rejected the concept that everyone, corporate insider or not, has a general duty to the market.\textsuperscript{208} The Court, however, did not consider the specific question of whether a corporate insider such as an officer or director, by virtue of his position, has a duty to the trading market not to misuse nonpublic information.

Second, the \textit{Chiarella} decision represents an interpretation of fiduciary duties under the existing statutory language of section 10(b).\textsuperscript{209} As demonstrated earlier, section 10(b) is a poor statutory choice for regulating insider trading.\textsuperscript{210} If regulation is to be effected by a new statute, however, the limitations of \textit{Chiarella} need not apply. Moreover, if we are engaged in a search for an appropriate statutory definition, it seems appropriate to tie that definition to the rationale for regulation. Finally, imposing a market duty upon insiders is consistent with the overall structure and objectives of the federal securities laws, which are aimed primarily at the protection of investors and the capital markets, not at the protection of such fiduciary relationships as the physician-patient relationship.\textsuperscript{211}

Accordingly, a revised statutory approach to insider trading regulation can be predicated on the theory that a corporate insider has a duty to the marketplace not to misuse nonpublic information. Why is the insider’s use of nonpublic information unfair? The answer can be explained, in part, by the importance of the capital markets to the large publicly held corporation. Absent a system in which corporations have ready access to capital markets, access which is facilitated by the availability of safe, liquid, regulated markets for secondary trading, the public corporation would be unlikely to attain the same size and dominance. This growth, in turn, provides management with unparalleled opportunities for wealth and status. Thus, in a sense, the corporate insider’s superior access, due to his position, may be partially attributed to government and public participation in the markets. It is the fact that an in-


\textsuperscript{208} \textit{Id.}

\textsuperscript{209} See \textit{id.} at 232-35 (premising holding on language of section 10(b)).

\textsuperscript{210} See \textit{supra} Part II.

sider has obtained his informational advantage because of his position, and the fact that this position is attributable to the presence of other less-privileged transactors in the market, that makes the insider’s use of nonpublic information unfair. This conclusion does not necessarily imply that other market transactors are hurt by insider trading.  

C. A POLITICAL EXPLANATION FOR REGULATION OF INSIDER TRADING

Before considering the new proposal, it is necessary to consider one additional factor: why the status quo prohibits insider trading. The preceding analysis suggests that the proffered justifications for regulating insider trading, particularly under the existing statutory scheme, are unconvincing. Yet in spite of the logical inconsistencies, insider trading enforcement continues as a high priority, and the SEC continues to expand its enforcement efforts with more aggressive prosecutions and calls for stiffer sentences. The expansion of liability under section 10(b) is particularly surprising in view of the fact that the objectives of existing insider trading theory could be achieved more precisely by strengthening state law doctrines of fiduciary duty, coupled with the existing federal prohibition on short swing trading and short sales by corporate insiders. Before attempting to address the deficiencies in the existing regulatory scheme, it is important to understand the reasons for its evolution. This question can be answered, in part, by looking to who benefits from insider trading regulation.

This Article contends that at least three major interest groups are beneficiaries of the existing regulatory scheme. One of these
groups is the securities analysts. Securities analysts earn their livelihood by analyzing publicly available information and attempting to determine when a particular security represents a good investment. Because they have the time and expertise to acquire superior information, analysts are at an informational advantage over many members of the investing public. Moreover, under existing insider trading law, securities analysts enjoy a position of distinct legal advantage over the general public. After Dirks, disclosure by corporate insiders to analysts for reasons other than personal gain will be treated as lawful. This means that analysts enjoy a unique position in the market—regular access to material nonpublic information without restrictions on its use.

215 Publicly available information is used in its broadest sense in describing the work of securities analysts. Frequently, analysts have access to sources of information that are not available to the general public. See supra notes 190-194 (discussing disparity of information among market participants); see also Brudney, supra note 13, at 365 (questioning whether analyst who makes overt inquiries to firm’s executives about future of company has received nonpublic information).

216 Indeed, some commentators have described such market professionals as “quasi-insiders” due to their persistent advantage over all other traders. E.g., Macey, supra note 204, at 377.

217 See Langevoort, supra note 190, at 1024 (concluding that investment analysts receive special treatment because of their perceived role in increasing market efficiency); Macey, supra note 204, at 377 (stating that market professionals who are permitted, even encouraged, to trade on basis of their lawfully acquired informational advantage benefit from general proscription on insider trading).

218 Langevoort, supra note 190, at 1023-24. As Professor Langevoort observes, there are many reasons why an issuer might find it desirable to disclose information through an analyst rather than a press release or SEC filing. See id. at 1028-31 (citing four reasons for preferring disclosure through analysts: ability to release substance without specifics, avoiding liability, overcoming moral hazard, providing incentive to analysts).

219 Cf. SEC v. Stevens, 91 Civ. 1869 (CSH) (S.D.N.Y. Mar. 19, 1991); Ex-CEO, supra note 143, at 439. In Stevens, an ex-CEO settled insider trading charges based on selective tipping to securities analysts. The SEC charged that the CEO tipped in order to enhance his professional reputation and his future earnings power as CEO. Id.

220 Many scholars have attempted to justify disclosure of nonpublic information to analysts as in the best interests of the corporations. Among the arguments proffered are the claims that such disclosure is faster, more credible, less expensive, and more accurate than disclosure to the general public would be. E.g., Daniel R. Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra L. Rev. 127, 140-42 (1984); Helen Garten, Insider Trading in the Corporate Interest, 1987 Wis. L. Rev. 573, 625. This Article does not take the position that selective disclosure is justified. See, e.g., Langevoort, supra note 190, at 1023 (arguing “special treatment” given to investment analysts under existing insider trading law is excessive and unwarranted). Moreover, the SEC has indicated that it does not accept the notion that the Dirks decision gives corporate insiders carte blanche to make selective disclosure to ana-
In an ideal world, the information provided by investment analysts would be useless. Perfectly efficient markets would cause informational changes to be reflected immediately in stock prices, with the result that an analyst could not, on the basis of public information, provide advice that would produce a better-than-average return. The continued use of investment analysts can be justified only by the conclusion that, under the current regulatory scheme, analysts are able to provide superior information. Analysts' ability to provide this information might be explained as proof that the markets are not perfectly efficient. In the alterna-

The special treatment of the analyst has been justified by the important role that analysts play in market efficiency. Congress explicitly stated that the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered subsections of 15 U.S.C. § 78 (Supp. 1988)), was not intended to cut back on the deference to analyst tipping recognized by Dirks:


Modern portfolio theory suggests that it is impossible to outperform the stock market systematically without the use of nonpublic information. See, e.g., Macey, supra note 44, at 21 n.55.

Professor Coffee explains that the disclosure provisions of the Securities Exchange Act of 1934 actually subsidize the investigatory activities of investment analysts by providing them with extensive detailed information at low cost—information that is more useful to the professional analyst than the individual trader. John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 728-29 (1984).

See, e.g., Stanford J. Grossman, On the Efficiency of Competitive Stock Markets Where Trades Have Diverse Information, 31 J. Fin. 573, 574 (1976); Stanford J. Grossman & Joseph E. Stiglitz, Information and Competitive Price Systems, 66 Am. Econ. Rev. 246, 248 (1976). Grossman argues that it would be paradoxical to conclude that markets are perfectly efficient given the superior information and returns attributed to analysts. He therefore concludes that analysts are able to discover information that is not fully reflected in
tive, analysts may have access to information that is not available to the general public. The policy of permitting corporations to make disclosures by tipping analysts is one plausible explanation of how analysts gain such access.

Deregulation of insider trading would have two effects on analysts, effects that this Article will describe as the “better source effect” and the “embarrassment effect.” The better source effect reflects the fact that an analyst’s information is seldom as good as a true insider tip. In a world in which insider trading and tipping are legal, investors would have access to a marketplace of better information than that provided by analysts, rendering the analyst’s information second-rate. The embarrassment effect results from the fact that a free flow of inside information would result in the entry into the marketplace of superior information to that provided by the analyst—information resulting from tipping and information generated by the occurrence of insider trades. This information would be likely to make the analyst’s information appear dated and of poor quality. The derogation of the analyst’s information would generate the implicit message that the analyst is not really a high-level specialist and does not provide a valuable service to investors.

A second group threatened by insider trading is the professional stock prices.

Indeed, through their practice of selective disclosure, analysts may further informational disparities in the market. As Professor Langevoort observes, the analyst may favor the high-paying institutional investor over the retail client. Langevoort, supra note 190, at 1043; see also Fleischman, Presentation, supra note 220.

See supra notes 193, 215-218. This policy does not, however, answer concerns raised by advocates of the level-playing-field approach to the securities markets that analysts’ possession of this informational advantage is unfair. For example, the analysts in Stevens did not disclose their superior information to the world; they simply told a few of their favored clients, who were able to sell their holdings in the computer and defense equipment manufacturer and avoid losses. See Ex-CEO, supra note 143, at 439.

In countries in which insider trading prohibitions are absent or loosely enforced, the value of inside information is so significant as to cause investors to advertise for such information openly. See How Asia Regards Insider Trading: Awareness Up But Some Countries Call It Part of Business, L.A. Times, Mar. 28, 1989, § 4, at 9 (describing practice in New Zealand of traders running newspaper ads openly asking for inside information at height of pre-October 1987 bull market).

The embarrassment effect partially explains why analysts feel the need to tread close to the legal line by attempting to ferret out information that is not widely available to the public. See Dirks v. SEC, 463 U.S. 646, 658-59 (1988).
This diverse group might be viewed broadly as including risk arbitrageurs, broker-dealers trading for their own accounts, and institutional investors, such as mutual funds, pension funds, and insurance companies. Investment professionals spend a great deal of money to acquire superior market and firm information. Although they do not have the access of an insider, their resources enable them to be "next in line" in terms of quality of information. To the extent that insiders are able to trade, they preempt or reduce the professional investors' informational advantage.

Stockholders of publicly held companies are also direct beneficiaries of the regulation of insider trading. The existing regulation allows stockholders to be passive. Stockholders need not weigh the costs and benefits of allowing insiders to trade the corporation's stock or monitor the agency problems that may result from such trading. If insider trading problems were relegated to state-law derivative suits, based on allegations of breaches of the insider's fiduciary duty or duty of loyalty, the burden of enforcement would be on stockholders. Instead, the SEC has assumed the enforcement

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229 As Professor Langevoort explains, professional investors benefit from insider trading regulation because they are "'next in line' [after corporate insiders] with respect to the opportunity to trade immediately upon disclosure." Langevoort, supra note 5, at 400 n.6.

230 Arbitrageurs generate profits through in-depth monitoring of corporations coupled with large investments when those corporations present "trading opportunities." The arbitrageur is rewarded when this monitoring results in timely information of which he can take advantage by taking a large position before that information is fully reflected in the marketplace. In a sense, the arbitrageur profits from the fact that the securities markets are not perfectly efficient. The public announcement of material effects is not immediately reflected in stock prices; the market requires an adjustment period. Arbitrageurs are threatened by insider trading because such trading is able to beat them at their own game. Not only can insiders profit from information before it is available to arbitrageurs, but the leakage effect of their trading also may reduce the trading opportunity available to the arbitrageur.

231 To the extent that an analyst makes proprietary investment decisions as opposed to rendering investment advice to others, this category overlaps with the previous one.

232 Langevoort, supra note 5, at 400 n.6. Professional investors also serve as major customers of securities analysts.

233 This is not to say that the informational advantage of the professional investor is a bad thing. To the extent that professionals expend resources to gather securities information, they improve market efficiency. See Easterbrook, supra note 37, at 329-30 (arguing that information is quickly reflected by stock prices and that it "would be a colossal waste if the information . . . had to be presented to everyone").

role. Absent this enforcement, stockholders would have to exercise more vigilance in monitoring the extent and cost of insider trading in their corporations. Moreover, returning insider trading regulation to the purview of such common-law doctrines would rekindle the ongoing debate over the efficacy of using the stockholder derivative suit to enforce insiders’ fiduciary duties to the corporation.\(^{238}\)

Most importantly, the general public, unexposed to many of the legal analyses discussed above, appears to believe that insider trading is harmful to the markets. The concepts of insider trading as unfair, as misappropriation of corporate property, and as destructive of investor confidence, while controversial and vigorously debated among scholars,\(^{236}\) reflect the perception of the average stockholder. Stockholders, rightly or wrongly, are likely to view insider trading regulation as an effective way of disciplining their corporate managers with little cost or effort.

This feeds into the popular mentality\(^{237}\) that “greed is bad.”\(^{238}\) In the view of typical members of the public, someone who trades on inside information obtains a benefit from information for which he has not paid, information in which the trader has no ownership interest or other legitimate expectation of gain. The successful inside trader has won the lottery without buying a ticket. While they may be jealous of the trader’s good fortune, typical members of the public see no reason to approve of activity in which they cannot also participate and which leads to what they perceive as undeserved gains.\(^{239}\)

Thus, it is possible to identify at least three politically significant groups that benefit from the current regulation of insider trading. Securities analysts and professional investors support in-


\(^{236}\) See supra note 181.

\(^{237}\) See Langevoort, *supra* note 5, at 400-01 (describing restriction of insider trading as “emotional in its genesis” and as political attempt to satisfy “those who feel unfairly disadvantaged by the absence of power, size, or status”).

\(^{238}\) Hence the villain in the movie *WALL STREET*, Gordon Gekko, can be identified by his philosophy: “Greed . . . is good.” *WALL STREET* (20th Century Fox Film Corp. 1987).

sider trading regulation and strict enforcement efforts by the SEC because, after insiders, they are the next best able to obtain and use market-sensitive information. Stockholders support insider trading regulation because of their perception that insider trading is harmful and because it is easier to have that judgment made by Congress than to analyze the question firsthand.

In contrast, those who oppose such regulation are not in a position to mount a public campaign for deregulation. Corporate insiders would betray their beneficiaries by endorsing a regulatory system that allows insiders to exploit their positions for private gains. Individual tippees generally receive inside information on an unpredictable and fortuitous basis. Absent systematic access to such information, they are not likely to agitate for change. Temporary insiders, such as lawyers and investment bankers, risk the same type of disapproval as that faced by traditional insiders if they support deregulation. In addition, promoting the freedom of professionals to trade on information provided by their clients would be likely to result in contractual modification that, at a minimum, would require the outsiders to disgorge such trading profits to their corporate clients.

This combination of public disapproval and industry support virtually guarantees the continued regulation of insider trading. Industry professionals constitute active and knowledgeable participants in SEC and congressional decisionmaking on regulation and enforcement of the securities markets. They often serve as advisors to Congress and are, directly and indirectly, the source of congressional perceptions as to the effect of insider trading regulation on the securities markets and the economy. Congress is particularly

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240 Some scholars, such as Professor Macey, argue that market professionals try to persuade the public that insider trading is wrong because the successful influence of public opinion will result in increased regulation and enforcement of the prohibition against insiders, and those who are next best able to use the information will profit thereby. Jonathan R. Macey, Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm, 11 Harv. J.L. & Pub. Pol’y 785, 803 (1988).

241 See David D. Haddock & Jonathan R. Macey, Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation, 30 J.L. & Econ. 311, 329-30 (1987) (arguing that insider trading regulation results in greater distribution of trading profits to industry professionals than to general public and that this distribution results in political efforts by such professionals in support of greater regulation and enforcement).

242 See id. at 319-24 (describing insider trading regulation as responsive to the political constituency that benefits from such regulation, primarily market professionals).
unlikely to disregard the recommendations of these professionals in light of the public aversion to insider trading. A member of Congress would be loathe to risk disapprobation by taking on the deregulation of insider trading, a reform that enjoys no substantial public support.

IV. The Result of the Analysis: A New Proposal for Regulation of Insider Trading

The foregoing analysis demonstrates that continued regulation of insider trading is likely because of political realities, regardless of whether economists can demonstrate an empirical effect of insider trading on the market or advocates of market fairness can tie insider trading to the availability of capital. This Article also has demonstrated that the existing system of regulation is unsound and that the best justification for prohibiting insider trading is that insiders owe a fiduciary duty to the market not to abuse their position by taking personal advantage of nonpublic corporate information.

Today, it appears that resistance to a statutory definition of insider trading may be weakening; Congress, commentators, and even the SEC have been attempting to draft a definition. These principles may serve to inform decisions about the appropriate statutory scheme. In developing a statutory scheme, we should be aware that calling it a statutory definition of insider trading precludes the issue. In the absence of a strict parity-of-information standard, the statute will be deciding, in effect, who should be free to use material nonpublic information.

A number of legislative proposals defining insider trading have been developed in the past several years. These include a proposal drafted by a group of private securities lawyers (the "Ad Hoc Committee") at the request of Senators Riegle and D'Amato, which was introduced as S. 1380, 100th Cong., 1st Sess. (1987), reprinted in Symposium, supra note 127, at 531-34 app.; a proposal developed by the New York Stock Exchange Legal Advisory Committee, Report of the New York Stock Exchange Legal Advisory Committee, Proposed Statutory Definition of Insider Trading (1987), reprinted in Symposium, supra note 127, at 543-44 app.; and a proposal prepared by the SEC, reprinted in Symposium, supra note 127, at 535-42 app., which was subsequently modified to conform to the approach of the Ad Hoc Committee's proposal. See SEC Modified Proposal, supra note 127. Congress requested that members of the Ad Hoc Committee meet with the SEC and prepare Reconciliation Draft of S. 1380, reprinted in Symposium, supra note 127, at 552-58 app. The draft never garnered the full support of either the Committee or the SEC. For a detailed analysis of these proposals, see Phillips & Lavoie, supra note 5, at 457-62.
The proposal suggested by this Article departs most radically from existing proposals and literature by rejecting the focus on the method by which a trader acquires nonpublic information. By premising liability on an insider’s duty to the marketplace, this proposal is able to avoid the quagmire of analyzing the method of acquisition, as well as the private contractual and other relationships between the trader, the issuer, and the source of the information. The current proposals for a statutory definition of insider trading analyze whether the information has been acquired wrongfully.\(^\text{244}\) Through the requirement of wrongfulness, they attempt to incorporate current law on breach of duty, breach of relationship of trust and confidence, and so forth.\(^\text{245}\) This approach is misguided.

Additionally, regulation of insider trading would be improved by reclassifying such trading as a regulatory violation rather than a crime. A complete examination of the effect of decriminalizing insider trading is beyond the scope of this Article, but it should be noted that Congress would be justified in prohibiting a broader range of trading, based on concerns about market fairness, if such trading were not penalized by criminal sanctions.

Given the lack of consensus on whether insider trading should be regulated and, if so, the justification for such regulation, it is surprising that insider trading has generated so much recent media and enforcement attention. Although public and judicial opinion appear to condemn insider trading as the moral equivalent of theft,\(^\text{246}\) it is not clear that this perception is accurate. Treating

\(^{244}\) See, e.g., S. 1380, 100th Cong., 1st Sess. § 2(b)(1) (1987) (prohibiting use of nonpublic information if trader "knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information"), reprinted in Symposium, supra note 127, at 532 app.; SEC Modified Proposal, supra note 127, § 2(b)(1) (prohibiting use of nonpublic information if trader "knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information").


For the purposes of this subsection, such trading while in possession of material, nonpublic information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, a breach of any fiduciary duty, any personal or other relationship of trust and confidence, or any contractual or employment relationship.

\(^{246}\) For example, the Second Circuit described insider trading in *United States v. Carpen...*
insider trading as stealing is consistent with a property-rights approach, but if the regulation is refocused on the harm to the marketplace and the insider’s duty to disclose to that marketplace, the insider trading violation might more accurately be likened to lying.

A moral evaluation of lying, however, is more difficult. Societal views of lying are equivocal: society treats some lies as worse than others. Moreover, in view of the fact that insider trading results only in omissions and not in affirmative misrepresentations, it is not necessarily the moral equivalent of lying. There is a distinction in moral terms between affirmative misrepresentations and omissions. To a certain extent, it is anomalous that the jurisprudence of common-law fraud has accepted the concept that liability may be predicated upon material omissions, a concept that has worked its way into statutory theory as well. Traditional philosophical theory supports the view that it is far worse, from a moral perspective, to mislead than simply to omit relevant facts of which no inquiry has been made. Indeed, this principle is reflected in current jurisprudence. These philosophical roots support the argument that insider trading is not the moral equivalent of lying.

If insider trading cannot readily be equated with either stealing or lying, it is difficult to condemn such trading as immoral or inherently wrong. Therefore, from a moral perspective, classifying such trading as criminal and penalizing it with stiff prison

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\item 247 See, e.g., SISSELLA BOK. LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE (1978) (examining reprehensibility of lying in variety of settings).
\item 248 Such liability requires, of course, the presence of a duty. See supra Part I.A (discussing requirement of duty to disclose in classical theory of insider trading).
\item 249 See, e.g., MARCUS CICERO. DE OFFICIS BK. III 321 (W. Miller trans. 1968) ("It is one thing to conceal, ... not to reveal is quite a different thing."). For a detailed analysis of the relative ethical or moral culpability of nondisclosure and misrepresentation as viewed by a number of classic-philosophical scholars, see Lawson, supra note 125, at 737-43.
\item 250 See supra note 189 (discussing nondisclosure in Texas Gulf Sulphur case).
\item 251 If insider trading constitutes lying, decisions by insiders based on nonpublic information to refrain from trading should also be actionable as fraudulent omissions. Insider non-trading, although perhaps difficult to prosecute, presents the same moral issue as insider trading. See Easterbrook, supra note 37, at 336-37 (arguing that insider non-trading may affect stock prices just as insider trading does). Nonetheless, a decision by an insider or tippee to refrain from selling stock, for example, based on superior information about an upcoming corporate development, is apparently legal.
\item 252 See, e.g., WAYNE R. LAFAYE & AUSTIN W. SCOTT, JR. HANDBOOK ON CRIMINAL LAW § 1.2, at 11 (2d ed. 1986) (explaining that major purpose of criminal laws is enforcement of
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sentences should be reconsidered.253

A. THE FIRST REQUIREMENT: INSIDER STATUS

Although the presence of a fiduciary duty may be a factor in determining insider status, it should not determine when information can be used as a basis for trading.254 Rather, a legislative solution should focus on defining the insider class.255 Once the class is defined, thereby identifying the class of persons for whom the personal use of nonpublic information breaches their duty to the marketplace, insider class status alone should be the basis of restricting trading.256 Status as an insider should be determined by


Although the EEC Insider Dealing Directive prohibits insider trading, it does not require member states to make such trading criminal. See generally Raffaello Fornasier, The Directive on Insider Dealing, 13 Fordham Int'l L.J. 149 (1990) (discussing legal basis and effects of EEC Insider Dealing Directive); Hopt, supra note 18, at 56-57 (arguing that by leaving sanctions to member states, directive is a compromise).

The difficulty of applying the duty approach is aptly illustrated by both Reed and Chestman. In Reed, the court searched through principles of trust law, fiduciary law, and even the law of restitution in an attempt to locate some clear standard as to when an actionable breach of duty results from betrayal of a family confidence. See United States v. Reed, 601 F. Supp. 685, 703-18 (S.D.N.Y.), rev'd in part on other grounds, 773 F.2d 477 (2d Cir. 1985). Notably, although the court did not go so far, sources relied on by the court suggest that a close family relationship is, by itself, sufficient to confer a relationship of trust and confidence. See 4 George E. Palmer, The Law of Restitution § 19.3, at 113 (1978) (explaining that "there is a strong inclination to find a confidential relationship from the fact of a close family connection") (quoted in Reed, 601 F. Supp. at 710).

Additionally, predating insider trading liability on the breach of a fiduciary duty would, presumably, allow a corporation to authorize insiders to trade in its securities by submitting the issue to the board or the shareholders for approval. Wolfson, supra note 197, at 113.

As the Supreme Court explained in Dirks, the point of insider trading regulation is "to focus on policing insiders and what they do . . . rather than on policing information per se and its possession." Dirks v. SEC, 463 U.S. 646, 663 (1983) (quoting In re Investors Mgmt. Co., 44 S.E.C. 633, 648 (1971) (Smith, C., concurring in result)).

The idea of a status-based restriction has its seeds in the insider trading regulations of Great Britain, which, inter alia, restrict trading by persons "connected with" a company. "Connected with" means holding a position such as director, officer, or employee, or having a professional relationship, such as a lawyer-client relationship, that affords access to nonpublic information. See Company Securities (Insider Dealing) Act, 1985, ch. 8 (Eng.). The provisions of the British statute are described in Mark A. Spitz, Note, Recent Developments in Insider Trading Laws and Problems of Enforcement in Great Britain, 12 B.C. Int'l & Comp. L. Rev 265, 275-83 (1989). The EEC Insider Dealing Directive also focuses on status as a basis for liability, although it defines "insider" broadly, including within that category virtually all persons who have a relationship with the issuer and obtain information by vir-
considering the objectives of market regulation rather than principles of agency law. Viewing insider trading regulation in terms of market regulation does not place the emphasis on harm to the corporation or its stockholders, issues more appropriately left to state fiduciary law. Moreover it makes no sense to focus on the wrongful nature of acquisition; there is no tie between injury to the informational source and the objectives of securities regulation. Rather, the definition should be designed to address the harm that insider trading causes to the marketplace.

One important element of the regulation is its relationship to the statutory disclosure system. To the extent that an insider controls disclosure of corporate information, that insider has not only superior access to information but also the opportunity to manipulate the timing and quality of disclosure. Limiting the incentives for such manipulation serves the objectives of prompt and complete disclosure as well as the insider trading regulation objectives of market fairness.

Accordingly, the class of insiders should include those who are in a position to control corporate disclosure. In addition, much of the perceived unfairness of insider trading is based on the idea that management is able to beat the market; even in circumstances in which information is disclosed promptly, management is able to trade immediately prior to or concurrently with the disclosure, obtaining as a windfall the value of the market reaction to that disclosure. Thus, corporate insiders have an unerodable advantage in terms of access. The quality of this advantage depends, in part, on the level of the employee. High-level employees have a systematic advantage in terms of access because they are in a position to

tue of that relationship, as well as tippees. See Hopt, supra note 18, at 62-65 (describing groups included by directive in category of insider); see also Langevoort, supra note 5, at 411 (suggesting system of insider trading regulation that focuses on whether trader has "position of access").


258 See supra note 181 (discussing possible harms of insider trading to marketplace); see also H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934) (discussing importance of disclosure in functioning of markets and correlating market price with value). "[T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." Id.

learn about all significant corporate events as well as plans for disclosure of those events.

It is important not to draw the class of insiders too broadly. The superior access of corporate employees must be balanced against the difficulty an employee may have in determining, before the fact, whether he is in possession of material nonpublic information. Virtually any employee is likely to have an advantage over the general public in evaluating his own company, but this superiority alone should not preclude the employee from trading. Assuming employee stock ownership is desirable,260 deeming this advantage unfair is overbroad. Moreover, for lower-level employees, unlike officers and directors, the trading opportunities created by exposure to significant corporate events are likely to be random and occasional in nature and are less likely to interfere with corporate decisionmaking. Occasional access to nonpublic information can be addressed through the category of secondary insiders described below.

For purposes of section 16 of the Exchange Act, insiders are defined as officers, directors, and ten percent stockholders.261 This proposal takes that definition as the starting point for purposes of insider trading and includes those persons as “primary insiders”262

260 The practice of permitting corporate insiders to trade the stock of their company is generally defended on the grounds that this practice aligns management interests more closely with those of the stockholders and minimizes the agency costs associated with the separation of ownership from control in the large publicly held corporation. See generally Eugene F. Fama, Agency Problems and the Theory of the Firm, 88 J. Pol. Econ. 288 (1980); Oliver Hart, An Economist’s Perspective on the Theory of the Firm, 89 Colum. L. Rev. 1757 (1989); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). Absent such a view, corporate insiders could simply be precluded from trading in their company’s stock, a practice that would substantially reduce opportunities for insider trading. See Levmore, supra note 181, at 129-32, 157-58 (acknowledging systematic advantage that corporate insiders have when trading in their company’s stock and suggesting investment through blind trust as alternative remedy).


262 The terms “primary insiders” and “secondary insiders” were used by the European Economic Commission during its preparation of the Insider Dealing Directive, although they do not appear in the directive itself. Hopt, supra note 18, at 62. Usage of the terms herein differs in that the EEC used the term “primary insiders” to refer to all classes of persons who have a relationship with the issuer, including employees, lawyers, auditors, suppliers, etc., and used the term “secondary insiders” to refer to tippees. Id. at 62-65. Because this proposal does not impose liability on the trading activities of tippees, it is possible to be more precise in the classification of insiders.
because they generally have (1) the ability to affect the content and timing of corporate disclosure; (2) regular access to information on significant corporate events; and (3) the ability to affect the decisionmaking process about such events. This proposal then adds to the category of primary insiders other persons employed by the corporation who by virtue of their employment have regular access to decisions on corporate policy and disclosure. The purpose of this addition is to make the section 16 class of insiders more flexible by treating insider status as a function of responsibility and access as well as position.263

To this class of primary insiders, the proposal adds a second category denominated “secondary insiders.” Secondary insiders are those who by virtue of an employment or other contractual relationship receive nonpublic information relating to the issuer or its securities for the purpose of advising or rendering services to the corporation or its management.264 Secondary insiders include both outsiders, such as lawyers and investment bankers, who are hired to advise or represent the corporation,265 and employees who have

263 The modification is akin to that introduced by the SEC in its recent amendments to the regulations under section 16, in which the SEC determined that the category of officer should be defined in terms of “policy-making function” rather than title. See 17 C.F.R. § 240.16a-1(f) (1991).

264 The receipt of nonpublic information by a secondary insider need not be a regular occurrence; insider status under this provision may be based on an isolated exchange of information, such as that which occurs when a lawyer is hired to represent a corporation with respect to a single transaction.

265 The proposal would not classify as insiders those traders sometimes described as “market insiders” (i.e., those who by virtue of their position or the types of services they perform have regular industry access to nonpublic information). See Maria T. Galena, Note, Drawing the Line on Insiders and Outsiders for Rule 10b-5: Chiarella v. United States, 4 HARV. J.L. & PUB. POL’Y 203, 233-41 (1981) (arguing that those with regular access to nonpublic information should be treated as insiders based on claim that those traders breach their duty because they have obtained information “by virtue of a structural position within the market”).

The use by market insiders of nonpublic information can take two forms: insiders may trade on the information directly or allocate the information, effecting wealth distribution through disclosure to clients. The former problem can be addressed by prohibiting analysts or their firms from trading on nonpublic information. Such a prohibition would not affect the market dissemination function addressed by Congress and the Supreme Court. See supra notes 220-221.

The latter problem was the basis for the District of Columbia Circuit’s concern in Dirks. See Dirks v. SEC, 681 F.2d 824, 840-41 (D.C. Cir. 1982), rev’d, 463 U.S. 646 (1983); see also supra note 225 (discussing analysts’ selective disclosure as aggravating existing informational disparities). It is clearly possible to conclude, as the court did in Dirks, 681 F.2d at 840-42, that securities professionals, by virtue of their position, owe fiduciary duties to the
access to nonpublic corporate information on an irregular or infrequent basis.266

Trading by the above-described classes of insiders would be restricted as follows: it would be a violation of federal law for primary insiders who possess material nonpublic information relative to any security,267 obtained by virtue of their status as an insider, to take advantage of that information by trading or tipping.268 It would be a violation of federal law for secondary insiders who possess material nonpublic information relative to any security, obtained by virtue of their relationship with the corporation, to take advantage of that information by trading or tipping. Trading by either class of insiders would be defined to include effecting trades, for the insider’s personal account or the account of others, on the basis of nonpublic information. The provision would contain a statutory presumption that an insider who possesses material non-public information has based his trading on that information; this presumption could be rebutted through a showing, by the insider, of a distinct legitimate basis for the trading in question.

B. THE MEANING OF INSIDE INFORMATION

Removing the emphasis on fiduciary duty demonstrates that a major issue in defining insider trading is the question of what constitutes inside information. Although many issues are presented in constructing a statutory definition of inside information, including specifying when information is material and when it is nonpublic,
one that seems most difficult is deciding when information is "inside" with respect to a class of insiders. Is an insider barred from trading on the basis of nonpublic information that relates only to the corporation to with the insider is connected269 or from using any information he receives by virtue of insider status, even if that information relates to the stock of another issuer?

Both the British statute and the EEC directive seek to prohibit the use of any information acquired by virtue of the insider’s status or position,270 but it is not clear that this broad scope is appropriate. Again, it is necessary to look at the rationale behind the prohibition and the availability of alternative methods of regulation.

The economic rationales for prohibiting insider trading are weakest when the trader is an outsider with respect to the issuer of the securities traded. A corporate employee who learns, in the course of his employment, of information relevant to another issuer is not in a position to control disclosure of that information, to manipulate corporate events of the issuer, or to abuse a fiduci-

269 There are two separate issues in this analysis. First, does an outsider violate insider trading rules by using information obtained by virtue of business relations with the source? And second, even if such trading would be permissible when effected by an outsider as principal (i.e., a corporation or an individual), is it illegal if the outsider is an employee (or otherwise an agent) of a corporation and acquires the information by virtue of his employee status?

270 Under the British statute, this issue was resolved by defining inside information, to include information relating to any actual or contemplated transaction between the insider’s company and another company. Insiders are prohibited from trading in the securities of the other company while in possession of such information. Thus, inside information for purposes of the British law includes information both about the issuer and about the issuer’s transactions with other companies. Company Securities (Insider Dealing) Act, 1985, ch. 8 (Eng.); see Spitz, supra note 256, at 277.

The coverage of the EEC Insider Dealing Directive is similar. It defines inside information as simply

information which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question.

Council Directive 89/592 Coordinating Regulations on Insider Dealing, art. 1, 1989 O.J. (L 334) 30, 31, quoted in Hopt, supra note 18, at 57. Thus, inside information can relate to the securities or the issuer. Under the directive’s provisions, inside information cannot be utilized by insiders, who, for the purposes of the Directive, include, inter alia, anyone who obtains inside information by virtue of his profession, duties, or business relationship with the issuer. Thus, insiders might include suppliers, clients, or participants in a planned merger. Council Directive 89/592 Coordinating Regulations on Insider Dealing, art. 2, 1989 O.J. (L 334) 30, 31; Hopt, supra note 18, at 64.
ary position with respect to the issuer's stockholders. Nor is the employee appropriating property that belongs to the issuer as long as the information was legally obtained by the employee or the corporate employer. Moreover, information relating to third parties often falls within a grey area with respect to confidentiality. Although both the bidder and the target would hope to maintain confidentiality of information relative to a prospective tender offer, information relating to the business plans, orders for supplies, etc., may not be explicitly proprietary or secret. 271

The British and EEC positions272 take the broadest approach, defining as inside information all material nonpublic information with respect to either the employer or the second corporation. 273 The fact that information is nonpublic, however, does not make it either confidential or proprietary. As a practical matter, some investor is always going to be the first to discover new information about a company, and it seems unreasonable to disqualify the investor from using the information simply because he acquired it by virtue of employment.

An alternative approach would include as inside information all material nonpublic information that either the target or the employer wants to keep confidential. 274 The difficulty with this approach is that the ability of the investor to use the information may depend on decisions of a corporation that does not employ him, to which he may owe no duties, and that, arguably, should not be able to bind him. Moreover, the target clearly could not restrain third-party individuals or entities directly, absent a contractual agreement; it should not be able to restrain traders simply by virtue of their status as corporate employees.

271 Both Rothberg v. Rosenbloom, 771 F.2d 818, 820 (3d Cir. 1985), see supra note 175, and SEC v. Lund, 570 F. Supp. 1397, 1401 (C.D. Cal. 1983), see supra note 168, involved such nonproprietary information. The ambiguity in both cases is illustrated by the courts' assumptions that, although the individual defendants' trading was illegal, trading by the defendants' business employer would have been legal. 272 See supra note 270 (discussing British and EEC provisions). 273 Thus, under these definitions, both the tender offeror and the supplier in the examples in Part II.C. of this Article would be precluded from trading. The British statute provides that a prospective bidder may buy the stock of the target company in order to effect the takeover, but not otherwise. Company Securities (Insider Dealing) Act, 1985, ch. 8, § 1(5) (Eng.). The provision is ambiguous as to whether preannouncement trading by the bidder is legal. 274 This provision could be strengthened by requiring that the corporation take affirmative steps to maintain the confidentiality of the information.
The third option is to preclude the employee from trading on information that is confidential and proprietary in the hands of his employer. Thus, the test of whether information is “inside” under this approach is not whether it relates to the securities of the company with which the insider is connected, but rather whether the corporation has some sort of interest, proprietary or property, in the information. This test may be analogized to the corporate opportunity doctrine, in which a corporate employee may not appropriate a business opportunity that is of value to the corporation for his personal benefit.275 Whenever a corporate employee uses information that has a value to his employer for personal use, there is a diversion of value from the corporation to the employee.276

This approach to inside information views a corporation’s information as a form of intangible property. The corporation may, through confidentiality regulations, employment contracts, or otherwise,277 restrict its employees’ abilities to use that information.278

275 See, e.g., Guth v. Loft, Inc., 5 A.2d 503, 511 (Del. 1939) (discussing corporate opportunity doctrine).
276 One might observe that firms are taking a broader view of proprietary information in areas other than securities trading. For example, contractual arrangements that restrict an employee’s ability to compete with the firm after termination of employment are premised on the notion that the firm has a proprietary interest in the employee’s human capital, the knowledge and skill acquired by the employee during his tenure at the firm. See Kitch, supra note 198, at 684-86 (describing firm’s interest in “human capital”).
277 Many employer-employee cases present difficult problems of proof under this approach because of the absence of any explicit effort by the employer to maintain the information as confidential. It has been suggested that, even in the absence of a written agreement, there may be an implicit contractual agreement by the employee to maintain corporate information as confidential. See Wolfson, supra note 197, at 107-08. This is particularly true with respect to certain market-sensitive information such as the existence of merger negotiations or a pending change in dividend policy, which is likely to be viewed by the corporation as confidential and treated as such even in the absence of contractual restrictions.
278 This approach conversely would permit corporations to opt out of insider trading regulation, at least in part, by refusing to treat corporate information as proprietary or confidential. The treatment of information as intangible property would make the employee’s use of the information a breach of his duty to the corporation based on the combination of the contractual provisions and the obligations of confidentiality thereunder. This definition is a way of clarifying the breach of duty articulated by the court in Rothberg v. Rosenbloom. As the court stated, “[a]n insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality.” Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985). The shortcoming in the Rothberg court’s analysis is its failure to analyze the source of the defendant’s duty of confidentiality. Instead, the court seems to premise a general duty of confidentiality on the general duties inherent in the employment
As a property rights theory, this approach is logical. Moreover, this notion of insider trading bears the greatest relation to the agency principles from which insider trading liability has evolved.

Finally, the least restrictive view of inside information is to categorize information as "inside" only if it relates to the issuer or the securities of the issuer to which the insider is connected. The justifications for this approach include the fact that only in this situation are concerns about manipulation, moral hazard, and delay of disclosure justified. Moreover, this view of inside information speaks to the rationale behind the level-playing-field theory of regulation. Arguably, the situation in which insider trading is most unfair to the marketplace is the case in which a corporate insider, by virtue of his position, obtains material information that enables the insider to value the corporation's stock more accurately than outside investors.

C. REGULATION OF TIPPIING

The proposed provision would deal more harshly than current law with insiders who tip confidential information to others. Tipping by insiders would be defined as selective disclosure of information by an insider under circumstances in which trading by the insider would be illegal. The proposal presumes that such tipping benefits the insider, directly or indirectly. Accordingly, the provision would impose liability on tippers regardless of whether a personal relationship.

One difficulty with this approach is that it does not limit the corporation's ability to restrict the use of corporate information. While certain corporate information, such as trade secrets or developments created by corporate action, may well be proprietary in nature, it is not obvious that all corporate information is proprietary simply because it comes into the possession of the corporation or because a corporation has property rights in all the information it possesses. For a detailed discussion of the Lockean theory of information as property and the corporation's rights to such property, see Lawson, supra note 125, at 763-69.

This definition of inside information would make cross-trading legal. See supra note 171 (discussing cross-trading). The same approach is taken by the 1988 Japanese statute. Shōken torikikihō (SEL), Law No. 25 of 1948, amended by Law to Amend a Part of the SEL, Law No. 75 of 1988; see Akashi, Note, supra note 17, at 1306-10.

See Akashi, Note, supra note 17, at 1312 (describing unfairness of allowing persons who have special relationship with issuer whereby they are able to generate, or at least obtain, ready access to information about issuer to use information in trading with public investors).

The case of an insider who tips by mistake could be addressed by applying Rule 10b-5's requirement of scienter to insider trading. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). Thus, to be liable, the tipper must have acted with at least recklessness.
cuniary motive could be established for tipping.\footnote{This, the provision would abolish the standard set by \textit{Dirks} that an insider breaches his fiduciary duty by tipping only if he receives a pecuniary benefit thereby. \textit{Dirks} v. \textit{SEC}, 463 U.S. 646, 662-63 (1983). Liability would not require proof of financial gain or proof that the tipper intended to make a gift to the tippee.}{282} Insiders would be liable for profits earned by tippee trading based on a two-part test. Insiders who disclose confidential corporate information to third parties who subsequently trade on that information would be liable for the profits earned through such trading, if the insiders acted negligently or wrongfully in disclosing the information\footnote{In other words, an insider who discloses to a third party for transactional reasons (i.e., for a valid, non-disclosure-related corporate purpose) will not be liable if the recipient of the information uses the information to trade. The tippee may, however, incur liability as a secondary insider. For example, a corporate officer, who discloses a prospective tender offer to the firm’s attorneys so they can assist with preparation of the tender offer documents, will not be liable if the attorneys trade on the information. The attorneys in this case would be treated as secondary insiders under the statute.}{283} and if the tippee’s trading was reasonably foreseeable.

The purpose of broadening liability for tippers is to deter the creation by corporate insiders of informational inequalities through selective disclosure. If insider trading is harmful to the markets because those on the inside enjoy unfairly superior access to information compared to average investors, the types of insider-analyst relationships that create superior access should also be minimized. This formulation responds to two concerns: the SEC’s concern that corporations improperly use investment analysts to make selective disclosure,\footnote{Fleischman, \textit{Presentation}, \textit{supra} note 220.}{284} and commentators’ concern that investment analysts contribute to a market in which insiders in a broad sense, such as professional investors, have an unerodable and unfair informational advantage.\footnote{\textit{See supra} notes 220-221, 226 (highlighting debate over whether analysts’ informational advantage is unfair).}{285}

While dealing more harshly with tippers, the proposed regulation would abolish the regulation of insider trading by tippees. The only trading on the basis of nonpublic information that would be restricted is that engaged in by statutory insiders.\footnote{Thus, this proposal takes the opposite position from that of the EEC directive, which imposes liability on tippees “who with full knowledge of the facts possess[] inside information, the direct or indirect source of which could not be other than a [primary insider].” \textit{Hopt}, \textit{supra} note 18, at 71 (quoting Insider Dealing Directive, art. 4 (EEC)). Under the directive, tippees are prohibited from trading regardless of whether the primary insider has disclosed the information lawfully. \textit{Id.} Thus, the directive also rejects the “wrongfulness”}{286} Rather, tippee
trading would be regulated indirectly by requiring tippers to be responsible for the economic consequences of tippee trading.287

The rationale behind this provision is that the concept of derivative liability, or derivative duty, is too difficult to apply, both for the courts and for traders. It is impractical,288 and perhaps inefficient,289 to require a tippee to analyze the source of his information to determine if, somewhere up the chain of information, there has been a misappropriation or a breach of fiduciary duty. Indeed, the SEC appears to be making a practice of investigating and prosecuting tippees on circumstantial evidence that trading was based on inside information.290 Some in the industry have described the

focus of the draft congressional definitions. See supra notes 243-245 and accompanying text.

287 Although circumstances in which the tipper is judgment-proof and the tippee has garnered large trading profits appear to present an enforcement problem, most such cases would never arise under this proposal. The common (and most troubling) objective for the tipper is pecuniary gain, and the disgorgement remedy addresses that gain. Additionally, as a practical matter, most of those within the class of statutory insiders, by virtue of their position, will have attained substantial personal wealth such that, even if their motive for tipping in a particular case is not pecuniary, the risk of a severe monetary penalty will deter tipping.

288 Much of the information analyzed by traders and arbitrageurs consists of market rumors and “soft” information. Moreover, empirical evidence suggests that many significant corporate disclosures are leaked to the extent that the price of the stock has already begun to reflect the information prior to any public disclosure of the information. See, e.g., Gregg A. Jarrell, Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation, 5 J.L. Econ & Org. 225, 226-27 (1989) (finding price of target companies increased prior to first public announcement of a tender offer or merger); Paul H. Malatesta & Rex Thompson, Partially Anticipated Events: A Model of Stock Price Reactions with an Application to Corporate Acquisitions, 14 J. Fin. Econ. 237, 240 (1985) (same); see also Levinson v. Basic, Inc., 786 F.2d 741, 744-45 (6th Cir. 1986) (describing how stock price rose during merger negotiations despite public denials of corporate developments), vacated, 485 U.S. 224 (1988). It may be virtually impossible for a market participant to engage in the necessary line-drawing in such cases.

289 See supra note 15 (discussing Court’s concern in Dirks that such a requirement would interfere with valuable function of market analysts).

290 In a recent prosecution in the Southern District of New York, for example, the SEC sought preliminary injunctive relief as well as an order freezing the defendants' assets, based solely on circumstantial evidence of insider trading combined with curiously timed trades. SEC v. Foundation Hai, 736 F. Supp. 465, 471-73 (S.D.N.Y. 1990). The district court granted the requested relief but was reversed in part by the Second Circuit, which, although not condemning the SEC’s failure even to identify the alleged tipper, found that the SEC had not established a prima facie case entitling it to injunctive relief. SEC v. Unifund SAL, 910 F.2d 1028, 1037 (2d Cir. 1990); see also SEC v. Heider, No. 90 Civ. 4636, 1990 U.S. Dist. LEXIS 16246, at *11-12 (S.D.N.Y. Dec. 3, 1990) (denying motion to dismiss complaint that failed to identify tipper). Defendant Heider explained his curiously timed trading to the SEC by stating that he “overheard discussion in a restaurant to the effect that the price of Contel stock would increase because something was going to happen with the company.”
SEC's stance as prosecuting on the basis of “curiously timed trades.” Given the enforcement tools available to the SEC, it is difficult for traders to defend themselves against such prosecutions, in which the SEC may require the trader to come up with independent justification\textsuperscript{291} for his curiously timed trades.\textsuperscript{292} In addition, the proposed judicial and statutory tests that require the tippee to have actual or constructive knowledge that he has received inside information are difficult to apply to the realities of tipping situations.\textsuperscript{293}

Nor does tippee trading implicate the economic objectives of early and complete disclosure that underlie regulation of insider trading. A tippee is not in a position to control disclosure or to manipulate corporate affairs to create trading opportunities. Moreover, to the extent that tipping is harmful to the firm’s interests, the penalty for tipping should be borne by the tipper, who is responsible for protecting those interests.\textsuperscript{294} Finally, by imposing substantial civil liability on tippers, it is likely that the practice of tipping, whether for profit or otherwise, will be adequately

\textsuperscript{291} For example, the defendant in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), explained his trades in Waldbaum stock to the SEC by stating that the trades were the product of research “consistent with previous purchases of Waldbaum stock and other retail food stocks and were supported by reports in trade publications as well as the unusually high trading volume of the stock on Nov. 25.” \textit{Id.} at 555.

\textsuperscript{292} The implication is that a trader has not simply done a good job of analysis. The SEC has taken the position that, if the trader demonstrates a pattern of anticipating market information, such prescience indicates the use of inside information rather than effective research techniques.

\textsuperscript{293} In \textit{Chestman}, for example, Keith Loeb testified on behalf of the government that he told Chestman he had “some definite, some accurate information” that would favorably affect the price of Waldbaum stock. 947 F.2d at 555. Loeb did not explain the source of his information or the basis for his belief that it was favorable. \textit{Id.} A similar example is provided by Dennis Levine’s description of the information he gave to Ivan Boesky in his tips: I wasn’t telling Ivan anything very specific—it was more a matter of suggesting that, say, his investment in XYZ Corp. seemed worth holding on to. I never told him my oblique suggestions were based on nonpublic information, but over time he evidently learned their value.


Levine did not disclose to Boesky his sources of information, which included both his employer, Drexel Burnham Lambert, Inc., and investment bankers at other brokerage firms. \textit{Id.}

\textsuperscript{294} Of course, these values are not served to the extent that tipping may further the interests of the firm. See Garten, \textit{supra} note 220, at 626-32.
"nip[ped] in the bud."295

Although eliminating tippee liability would prevent prosecution of many outsiders for insider trading, the provision does not abolish all remedies against those who acquire inside information through improper or illegal means. Outsiders who acquire information through theft or the equivalent can be prosecuted under the existing criminal laws. A source of information that is otherwise injured or defrauded by an outsider trade also will be able to bring a civil claim under traditional common-law and contractual remedies, such as a civil suit for theft of trade secrets or breach of a confidentiality agreement. Additionally, in the case of a lawyer, accountant, psychiatrist, or other professional who misappropriates confidential client information, the breach of a professional relationship of trust may be remedied through disciplinary proceedings, which might result in disbarment, license revocation, or public censure.

D. PENALTIES

The penalties authorized under this proposal would be commensurate with those applicable to other violations of the securities laws. In particular, courts could order disgorgement from the tipper of up to three times any profit earned by insider trading.296 In addition, tippers, under this proposal, would be liable for up to three times the trading profits earned by their personal trading as well as the trading of their tippees.

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295 As the Supreme Court explained:
The true insider or the broker-dealer is at the fountainhead of the confidential information . . . If the prophylactic purpose of the law is to restrict the use of all material inside information until it is made available to the investing public, then the most effective means of carrying out this policy is to nip in the bud the source of the information, the tipper, by discouraging him from "making the initial disclosure which is the first step in the chain of dissemination."

296 The SEC might also be authorized to seek civil fines to enhance the financial penalty for insider trading consistent with its recently provided power under Section 21. See 78 U.S.C.A. § 78u(d)(3) (West Supp. 1991) (authorizing imposition of civil penalties for violations of securities laws).
Conclusion

Congress and the courts have spent the last forty years attempting to articulate a rationale for regulating insider trading. Most of the justifications for the current system of prohibiting insider trading as securities fraud under SEC Rule 10b-5 are seriously flawed. Public perception of insider trading as a problem coupled with a securities industry that would be seriously injured by deregulation suggests that deregulation is unlikely. If regulation is to continue, Congress should replace the current regime with a statute that is clear and predictable. A statutory definition of insider trading would provide the requisite notice to traders of the potential illegality of their conduct and would not chill legitimate trading, thereby promoting market efficiency.

This Article’s proposal attempts to replace the current system of regulation with more of a bright-line test. In so doing, it proposes three substantial changes: (1) moving the emphasis in insider trading enforcement from criminal prosecution to civil disgorgement; (2) changing the system to place the full burden of tippee trading on the insiders who act as sources of the tips; and (3) replacing the concept of regulation based on the trader’s fiduciary and other duties with a system of regulation based on insider status. These changes would produce a logical, coherent approach to insider trading regulation.