THE ECONOMICS OF OUTSIDE INFORMATION
AND RULE 10b-5

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INTRODUCTION

Even the armchair analyst knows that Wall Street is awash in nonpublic outside information. Institutional investors, tender offerors, stock exchange professionals, investment bankers, government officials, and columnists, among others, regularly receive information that cannot be classified as inside information but nevertheless is unavailable to most investors. Outside information is the new frontier of securities regulation.

The antifraud provisions of the federal securities laws, and in particular rule 10b-5, have long proscribed trading in securities,

1 A tender offeror, planning to bid forty dollars a share, might buy 500,000 shares at twenty before disclosure of his impending offer, saving himself ten million dollars. In addition to buying shares for himself, the bidder might share his information with banks and insurance companies in exchange for financing and with management as part of a "total" compensation package. Advance information about major transactions other than tender offers provides a similar opportunity for exploitation of outside information. See, e.g., Reed v. Riddle Airlines, 266 F.2d 314 (5th Cir. 1959); Brascan Ltd. v. Edper Equities Ltd., 477 F. Supp. 773 (S.D.N.Y. 1979).


3 A state employee might trade on the basis of an advantageous highway contract to be awarded in the future. A market analyst might relay to a well-known financial columnist adverse information about a company disclosed in Securities and Exchange Commission (SEC) filings, sell the company short, and then cover "on the news." See, e.g., Nemeroff v. Abelson, 620 F.2d 339 (2d Cir. 1980).


5 See 15 U.S.C. §§ 78m(e), 78n(e), 80b-6 (1976).

6 Rule 10b-5 provides:

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements
either by corporate insiders or tippes, on the basis of nonpublic information that belongs to and emanates from the corporation whose securities are traded ("inside information"). In a number of recent cases, however, courts have expanded the "disclose or abstain" requirement to reach nonpublic information created by and belonging to sources outside the issuer ("outside information").

made, in the light of the circumstances under which they are made, not misleading, or

c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


7 Section 16(b) of the 1934 Act defines insiders as directors, officers, and 10% beneficial owners. 15 U.S.C. § 78p (1976). The SEC and the courts have expanded the insider category for rule 10b-5 purposes to include anyone with privileged access to corporate information. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

8 See, e.g., In re Investors Management Co., 44 S.E.C. 633 (1971).


The uncertainty created by these cases has attracted greater concern in light of structural changes in the stock market that have made use of outside information more prevalent. Today, over 70% of the transactions on the New York Stock Exchange are made by institutional investors who have come to rely almost exclusively on a small number of analysts and brokers. The vast majority of large block trades, by institutions and others, is now handled by only three block trading firms. The concentration of so much market power in so few hands gives valuable outside information not only to these actors, but also to stock exchange professionals who can observe their activities first hand. See generally I. Friend, M. Blum & I. Crockett, Mutual Funds and Other Institutional Investors: A New Perspective (1970).

The "disclose or abstain" rule requires persons with inside information about the value of an enterprise's securities to disclose that information or refrain from trading. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); Brudney, supra note 4, at 322.

Although some commentators have suggested a dichotomy between inside information and "market information" (i.e., information about the market for a company’s securities as distinct from information about its assets and earning power), market information that emanates from the issuer is inside information, and information about assets and earning power obtained from SEC filings is outside information. The same information can therefore be either inside or outside information. A market researcher or columnist who concludes from published information that
Persons who possess such information are neither insiders nor tippees of insiders. Broadly defined, outside information includes perceptive credit analysis based on public information, superior market research, or an investor's intuitive "feel" for the market. When a trader investigates a company and the market for its stock by studying published investment advice, Securities and Exchange Commission (SEC) filings, industry statistics, or other sources of public information, and then performs his own analysis, that analysis itself becomes information. If he trades on the basis of his analysis, he is using a form of outside information. Outside information also includes nonpublic information obtained from corporate sources other than the issuer, such as confidential information concerning a tender offeror's plan to make a bid for the issuer's stock.

If a trader has invested substantial resources into gathering and analyzing outside information, and especially if he plans to engage in significant market action, such as a major purchase, he will possess clear informational advantages over other investors. Courts in the past have concluded that rule 10b-5 ordinarily does not proscribe such activity or require disclosure of outside information under these circumstances. In Cady, Roberts & Co., SEC Chairman Cary distinguished inside information from the "perceptive analysis of generally known facts" that every investor is permitted to exploit.\(^1\) In General Time Corp. v. Talley Industries, Inc., Judge Friendly stated that he knew of "no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale."\(^2\) According to Professor Loss, even "an insider is under no obligation to give the ordinary investor the benefit of his superior financial analysis."\(^3\)

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3. L. Loss, supra note 6, at 1463 (2d ed. 1961). See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) ("Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions"); McGraw v. Matthaei, 388 F. Supp. 84, 92 (E.D.
Recent cases, however, have questioned the reach of these traditional rules. By suggesting that possession of outside information may trigger a duty to disclose, these decisions have focused attention on the often conflicting goals of securities regulation. A principal concern of the securities laws, particularly of the antifraud provisions, has been the prevention of fraud and overreaching, and of the loss of public confidence in the securities markets that is believed to accompany such practices. Of equal importance, however, has been the desire to ensure efficient capital markets and to encourage entrepreneurial market research. The tension between these policies has led to contradictory approaches to outside information, as illustrated by the opinions in Chiarella v. United States.

In Chiarella, the SEC brought a criminal action under rule 10b-5 against a journeyman printer who traded in corporate securities on the basis of confidential information obtained from a source outside the issuer. During 1975 and 1976, Vincent Chiarella, a "mark-up" man at a Wall Street financial printing shop, helped prepare documents for five companies planning takeover bids. The names of five tender offerors and target companies were coded to preserve confidentiality, but in each instance Chiarella cracked the code and purchased target shares. When public announcement of the tender offer drove up the price of target stock, Chiarella sold "on the news" for profits totalling over $30,000.

Although Chiarella was neither an insider nor the tippee of an insider, the SEC found his conduct sufficiently egregious to warrant criminal prosecution. In denying Chiarella's motion to dismiss the indictment, District Judge Owen recognized that the case presented a "novel application" of rule 10b-5, but found Chiarella's alleged conduct a fraud upon both the tender offeror and the selling share-

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15 See cases cited in note 9 supra.
16 See Brudney, supra note 4, at 334 & n.42; Scott, supra note 4, at 805-09.
17 See Brudney, supra note 4, at 334 & n.46; Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 816-17 (1973).
20 445 U.S. at 224.
Chiarella argued that his purchases were no different from those of tender offerors and that he should be treated no differently. Judge Owen agreed that the tender offeror could buy target stock without disclosure, subject to the requirements of the Williams Act, but distinguished such purchases from Chiarella's on the ground that tender offerors' purchases "have a presumptively legitimate business purpose," while Chiarella's were "solely for personal profit." 23

On appeal, the Second Circuit questioned Judge Owen's reasoning, but affirmed Chiarella's conviction.24 Observing that both the tender offeror and Chiarella were motivated by "personal profit," the court concluded that "'business purpose' [could not] be dispositive of liability under Rule 10b-5." 25 Instead, the court proceeded from the premise that rule 10b-5 requires "relatively equal access to material information." 26 Conceding that Chiarella was not an insider, 27 the court sustained the conviction on the ground that Chiarella fell into a new category of "market insiders," holding that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." 28 Judge Meskill dissented from what he considered a drastic expansion of section 10(b). 29

On certiorari, the Supreme Court reversed.30 Writing for the majority, Justice Powell rejected the Second Circuit's "equal access" and "market insider" theories and declined to construe section 10(b) as creating "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." 31 When Congress wished to regulate use of outside infor-

21 450 F. Supp. at 97.
23 450 F. Supp. at 97.
24 588 F.2d 1358 (2d Cir. 1978) (Kaufman, C.J.).
25 Id. 1368 n.15.
26 Id. 1365 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)).
27 588 F.2d at 1364.
28 Id. 1365 (emphasis in original). The court distinguished tender offerors from Chiarella on the grounds that tender offerors do not regularly receive nonpublic information concerning any stock but their own and therefore are not regularly in receipt of "market information," tender offerors create rather than convert confidential information, and tender offerors accept greater economic risk. Id. 1366-67.
29 Id. 1373 (Meskill, J., dissenting).
30 445 U.S. at 222.
31 Id. 233.
information, it did so by enacting "detailed and sophisticated" legislation, such as that governing the activities of specialists and the making of tender offers. In the absence of circumstances that independently require disclosure, such as legislation or the existence of a fiduciary relationship, the Court held that rule 10b-5 does not give rise to an obligation to disclose outside information. There could, therefore, be no duty to disclose outside information where "a complete stranger [purchases from] sellers only through impersonal market transactions." The Court sidestepped the government's argument that Chiarella's theft and use of information belonging to his employer independently violated rule 10b-5, because in its view that theory was not adequately presented to the jury.

Chief Justice Burger dissented on the ground that theft of non-public information is by itself sufficient to trigger an "absolute duty" to disclose, a theory he believed had been presented properly at trial. Justice Blackmun also dissented, in an opinion joined by Justice Marshall. Endorsing the "equal access" theory spurned by the majority, Justice Blackmun argued that rule 10b-5 imposes an affirmative duty of disclosure whenever "structural disparity in access to material information" provides an investor with a trading advantage that cannot be duplicated by others through legal means. Although they agreed with the results reached below, none of the dissenters adopted the reasoning of either the district court or the court of appeals.

Despite its outcome, Chiarella is not a manifesto for unrestricted trading on outside information. One finds in the Court's five opinions neither unqualified approval of such trading nor a secure means of avoiding potentially draconian liability. Although a bare majority held that there is no duty to disclose outside information, it did so by enacting "detailed and sophisticated" legislation, such as that governing the activities of specialists and the making of tender offers. In the absence of circumstances that independently require disclosure, such as legislation or the existence of a fiduciary relationship, the Court held that rule 10b-5 does not give rise to an obligation to disclose outside information. There could, therefore, be no duty to disclose outside information where "a complete stranger [purchases from] sellers only through impersonal market transactions." The Court sidestepped the government's argument that Chiarella's theft and use of information belonging to his employer independently violated rule 10b-5, because in its view that theory was not adequately presented to the jury.

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34 The Court viewed the prohibition against use of inside information as grounded in fiduciary duty. 445 U.S. at 227 n.8.

35 Id. 232-33.

36 Id. 236. In addition to the majority opinion, four Justices wrote separate opinions. Justices Stevens and Brennan each wrote brief concurrences. Chief Justice Burger and Justice Blackmun dissented.

37 Id. 240.

38 Id. 243-44.

39 Id. 251.
mation in the absence of special circumstances, such as applicable legislation or the existence of a fiduciary relation, the majority did not limit the class of circumstances that could trigger such a duty. Four Justices, moreover, either believed that such special circumstances were not required, or that they existed in Chiarella. But for the majority's surprisingly narrow construction of the charge to the jury, Chiarella might well have gone to jail. Those who trade on outside information do so at their peril.

This uncertainty, while discouraging borderline attempts to evade the law, may also chill important market activities. Even those who rely on published information at times may enter uncertain territory. Must a hedge fund planning securities purchases large enough to affect market prices make disclosure before implementing the plan? Must a famous economist refrain from selling before giving a speech he knows will depress the value of securities he owns? Can an investment banker buy large blocks of stock on the basis of its market research, publish the results of that research, and meet the demand so created by selling from inventory for an apparently certain profit? Can the inventor of a revolutionary camera place an order to buy Kodak stock and sell Polaroid after agreeing to sell his invention to Kodak? Can a General Motors employee or associate buy stock in a supplier before General Motors announces award of a major contract? Can General Motors?

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40 Id. 238 (Brennan, J., concurring in the judgment); id. 239 (Burger, C.J., dissenting); id. 245 (Blackmun, J., joined by Marshall, J., dissenting).
41 See, e.g., Some Reflections on Rule 10b-5 and Market Information Remarks by P. Loomis, Second Annual ALI-ABA Course of Study, in San Francisco, at 3 (May 6, 1976) ("it is troublesome not only to lawyers, but also to businessmen, that you cannot say with complete assurance what the law is, or that it will be the same tomorrow as it was today") (on file with the University of Pennsylvania Law Review). At one point, the SEC suggested that it wished to proceed in this area by rulemaking. SEC Exchange Act Release No. 10316 (August 1, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) 79,446. That project failed, leading the Second Circuit to conclude that "the SEC has despaired of providing written guidelines ... ."
SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 10 (2d Cir. 1977).

42 See, e.g., Herman & Hertzberg, Interest Rate Surge Batters Bond Prices, Adds Pressure to Further Elevate Prime, Wall St. J., Dec. 10, 1980, at 44, col. 1 ("bond prices slumped early yesterday, reacting to a gloomy interest-rate outlook by Henry Kaufman, chief economist of Salomon Brothers").

43 Corporations, their associates, and their employees continuously create or receive from countless outside sources information that may affect dramatically the fortunes of competitors, customers, and suppliers. Advance information accessible to even the itinerant salesman about new products, new contracts, accidents, bankruptcies, and other events may have great value to someone trading in the stock of companies only indirectly affected. News reports that a customer is preparing a treble damage antitrust claim, or that a bank has withdrawn credits necessary for a company's sole marketmaker to avoid insolvency, or that a newspaper has erred in
This Article reviews aspects of modern capital market theory in a search for answers to the questions posed by trading on outside as contrasted with inside information. The Article contends that economic theory, and in particular the efficient capital market hypothesis, does not conflict with the premises of federal securities regulation, but indicates that the need to preserve incentives requires some limitations on the duty to disclose outside information. It also contends that the desire to protect investors and promote confidence in the securities markets by preventing fraud, overreaching, and other illegitimate or unfair uses of information does not justify broad application of the disclose or abstain rule to outside information. Instead, it suggests a narrower approach based on common law precedents, and concludes that incorporation of common law fraud rules into rule 10b-5 produces results consistent with both economic efficiency and non-economic goals. The Article relies on this common law approach to rationalize existing case law involving uses of outside information by tender offerors and those with whom they deal, as well as by government officials, columnists, market professionals, and broker/advisors.

I. THE ECONOMICS OF INFORMATION

Given the economic importance of the national securities markets, economic theory seems an obvious source of clues to answer the questions raised by Chiarella v. United States. Many economists have focused on the value of promoting allocationally efficient capital markets and therefore have opposed regulations that might interfere with existing incentives to the systematic collection, use, and incorporation into stock prices of relevant information. Some oppose even the registration and insider trading reporting a supplier's backlog only begin to suggest the possibilities. Outside information also can appear more serendipitously—for example, when a traveller observes an explosion at a company's only plant, frost in the Brazilian coffee fields, or cutbacks in Saudi Arabian oil production, and trades in affected securities. See, e.g., Disclosure of the Impact of Possible Fuel Shortages on the Operations of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws, SEC Exchange Act Release No. 10569 (Dec. 20, 1973), [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,607. See also Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178 (1817) (trading on advance news of the Treaty of Ghent in 1814 brought to New Orleans by the British fleet); Lipton, Market Information, in PRACTISING LAW INSTITUTE, FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 287, 298 n.41 (1974) (post-Institute textual volume) (Nathan Rothschild's trading on advance news of Napoleon's defeat at Waterloo, brought to London by carrier pigeon).

provisions of the federal securities laws as unjustified burdens on the entrepreneurial efforts necessary to sustain free and efficient markets.

These conclusions depend, in part, on neoclassical welfare economics, which posits the goal of the capital markets as a pareto optimal resource allocation.\textsuperscript{46} Ideally, pareto optimality occurs under conditions of perfect competition,\textsuperscript{46} when many fully in-

\textsuperscript{46}An allocation is pareto optimal if there exists no reallocation that would make even one person better off without making anyone worse off. See V. PARETO, THE MIND AND SOCIETY (Bongiorno & Livingston trans. 1935). Although perfect competition and an efficient market are often thought to be the surest means of attaining pareto optimality, perfect competition and efficiency are neither necessary nor sufficient for pareto optimality. A pareto optimal allocation is in theory possible despite taxes and transaction costs which make perfect competition and efficiency impossible. Perfect competition and efficiency may produce a privately optimal but publicly suboptimal allocation of resources when externalities cause a divergence between private and social costs and benefits. Public and private pareto optimality is the ultimate goal of economic analysis and policy.

\textsuperscript{46}Perfect competition means rivalry among large numbers of buyers and sellers when the following conditions are satisfied: (1) no market actor possesses monopoly power (i.e., each actor is a price taker facing a flat demand curve and each actor supplies goods and services at minimum average cost); (2) each actor receives simultaneously with every other actor complete and costless information about existing prices and technology; (3) markets are frictionless (i.e., there are no transaction costs or taxes, all assets are perfectly divisible and marketable, and there are no constraining regulations); (4) all investors can borrow or lend unlimited amounts of capital at a common and exogenously determined riskless rate, there are no restrictions on short sales, and there are no barriers to arbitrage; (5) all investors and potential investors share the same time horizons and homogenous expectations about the means, variances, and covariances of returns among all assets (i.e., about the implications of any given piece of information for security prices), and (6) all investors are risk-averse, single-period, expected-utility-of-terminal-wealth maximizers who trade on the basis of the mean and variance of the distribution of returns. Markets in which these requirements are not completely fulfilled, such as those in which there are transaction costs or taxes, may still exhibit aspects of perfect competition.

An allocationally efficient market is a market that channels scarce resources to their most productive uses. Perfect competition will, by definition, cause prices to continuously reflect all available information and thereby provide reliable signals for resource allocation. Perfect competition is sufficient but not necessary for allocational efficiency. Transaction costs and taxes do not make impossible an efficient allocation of scarce resources.

An allocationally efficient capital market may also be defined as one that efficiently transfers funds between lender/savers and producer/borrowers by generating prices that continuously equate the marginal rates of return (adjusted for risk) for all lenders and producers. Securities prices establish a market-based rate of return. If that rate of return is, for instance, ten percent, all projects promising a risk-adjusted return greater than ten percent will be undertaken as savers lend and producers borrow at ten percent. Lenders who have exhausted all such projects will lend their excess funds to producers at ten percent because that rate is higher than what they can expect to earn on the remaining projects available to them. Producers who have projects promising returns greater than ten percent, but not enough funds to exploit all these opportunities, will borrow at ten percent and will pursue investment projects in declining order of return until they reach an investment project promising only a ten percent rate of return, at which point they will borrow no more. The marginal rate of risk-adjusted return is then the same ten
formed market actors continuously buy and sell securities. Under these conditions, securities prices should continuously reflect all available information, leading to greater accuracy in the pricing of individual securities and to a more efficient allocation of resources. When stocks and their prospects for success or failure are evaluated by a process that reflects all available information, investors can more rationally compare competing companies. Given existing levels of risk aversion, investment funds will migrate to those companies and projects that seem most likely to succeed. This continual redirection of capital from less promising to more promising pursuits benefits the investor and society as a whole because both maximize welfare by allocating scarce resources to investment opportunities promising the greatest return.47

Security prices that reflect all available information also enhance rational capital budgeting by individual companies. When investor purchases cause a firm’s stock price to rise, the firm’s price/earnings ratio increases, and the firm can obtain more capital from the stock market for each increment of earnings if it decides to issue new stock. Similarly, investor purchases of a company’s outstanding debt will lower the interest rate required to sell new debt. This reduction in the cost of capital resulting from investor purchases of the company’s securities occurs even if the company does not plan to issue new securities, because corporate treasurers will rarely pay more for alternative sources of capital.48 When investors who see promise in a company bid up the price of its securities, they enable it to pursue its various projects more intensively by using less expensive capital. Making percent for all lender/savers and producer/borrowers, all projects promising a risk-adjusted return greater than the market rate, and none promising a lesser return, are undertaken, and scarce savings are therefore allocated to projects promising the greatest returns. When prices reflect all available information, the market rate of return provides the most efficient allocation of capital. See, e.g., Mendelson, Economics and the Assessment of Disclosure Requirements, 1 J. COMP. CORP. L. & SEC. REG. 49, 50-51 (1978); Mandelbrot, Forecasts of Future Prices, Unbiased Markets, and “Martingale” Models, 39 J. BUS. 242 (1966); Samuelson, Proof that Properly Anticipated Prices Fluctuate Randomly, 6 INDUS. MANAGEMENT REV. 41 (Spring 1965).

47 See, e.g., CHARLES RIVER ASSOCIATES, AN ANALYSIS OF CAPITAL MARKET IMPERFECTIONS 310 (1976) (capital markets allocate “capital funds among investment projects and . . . risk among investors”) (on file with the University of Pennsylvania Law Review).

capital less expensive to promising companies and more expensive to failing companies improves efficient resource allocation by directing scarce resources to those who can best use them.

The continual impoundment of all available information into stock prices is essential to this process of efficient capital allocation. One way that the federal securities laws seek to promote an efficient capital market is through an elaborate system of compelled disclosure, enforced primarily by reliance on registration and reporting requirements under the Securities Act of 1933[^49] (1933 Act) and the Securities Exchange Act of 1934[^50] (1934 Act), as well as rule 10b-5.[^51] In order to achieve pareto optimality, however, compelled disclosure alone is not enough; the law also must encourage systematic collection, analysis, and use of information that is disclosed.[^52] The amount of market research actually undertaken and the level of market efficiency achieved thereby correlate with the certainty and size of the rewards obtainable through research.[^53] This analysis suggests that the securities laws should preserve incentives to market research by recognizing in the collector of outside information a right to trade without disclosure, and to earn profits at the expense of the less informed.[^54] Although the common law recognized such


[^51]: For the text of rule 10b-5, see note 6 supra.

[^52]: See, e.g., S. ROBBINS, supra note 32, at 47-54.


In a competitive economy, news that market participants in one industry earn above average profits will induce others to enter that industry until increased competition has driven profits down to competitive levels. Resources will be reallocated until there is no difference in risk-adjusted profit between different industries. Resources will be utilized within a particular industry until costs equal revenues and no further profits can be earned by diverting additional resources to that industry. Vigorous competition among securities analysts ensures that information whose value exceeds the cost of discovery will generally be found, but that few security analysts will consistently find enough valuable information to earn above average profits. Over the long run, analysts will uncover only enough valuable information to match the cost (including average profits) of discovery. Insiders, however, may have monopoly access to information that permits monopoly returns.

[^54]: Government could reward market researchers more directly by compensating them with government funds. But even if there were a reliable method of measuring performance, such a program would present an administrative nightmare. In addition, although a compensation program might at first seem consistent with the belief that everyone benefits from an efficient capital market, in fact, market
a right, prominent economists have argued that the system of compelled disclosure enforced by the SEC has interfered with its exercise, and in doing so has robbed the market of needed incentives to entrepreneurial activity.  

A. Issuer Disclosure Requirements

Stigler's review of the 1963 SEC Special Study of Securities Markets 56 fired the opening salvo in this debate. 57 Stigler characterized the report as a "promiscuous collection of conventional beliefs and personal prejudices." 58 Even accepting the SEC's premise that the paramount goal of securities regulation is the protection of "innocent" 59 investors, Stigler's quantitative analysis of pre- and post-1933 new issues led him to conclude 60 that the SEC "had no important effect on the quality of new securities sold to the public [and had not saved] . . . the purchasers of new issues one dollar." 61 Viewing the SEC as an aid to cartelization and a useless clog on free market processes, Stigler believed that market efficiency was a means of investor protection far superior to compelled disclosure. 62

Stigler's assault on the orthodoxy of federal securities regulation prompted a vigorous response from Friend and Herman. Conceding that SEC regulation increases transaction costs, Friend and Herman argued that Stigler had vastly exaggerated its costs while minimizing or ignoring its benefits. 63 Benston moved the debate
into the realm of accounting theory when he published econometric studies showing that the securities laws wasted resources by requiring costly disclosure of information that investors did not want and could not use profitably.\(^4\) He argued that an unregulated market, not compelled disclosure, would provide an optimal amount of relevant information.\(^5\) Other research appeared to support Benston's evidence showed that the SEC had helped unsophisticated investors by reducing the prevalence of "stock-market pools, bucket-shop operations, misuse of inside information and other types of manipulation and fraud," all of which Stigler had allegedly ignored. Id. 388. See also Stock Exchange Practices: Hearings Before the Senate Committee on Banking and Currency, 72nd Cong., 2d Sess. & 73d Cong., 1st & 2d Sess., pts. 1-17 (1933-34) (the Pecora hearings). Although Stigler had interpreted the reduced volatility in the performance of new issues following effectiveness of the 1933 Act as evidence that the SEC had excluded new companies from the market, Friend and Herman argued that reduced volatility resulted from decreased manipulation and improved disclosure. Friend & Herman, supra, at 390-91. These two explanations are not necessarily inconsistent. If investors are risk averse, improved disclosure will prevent especially risky companies from coming to market.


\(^{65}\) See, e.g., Benston, The Value of the SEC's Accounting Disclosure Requirements, 44 Accounting Rev. 515, 516 (1969). Benston attributed the paucity of suits against accountants prior to 1933 to the relative absence of fraudulent financial statements, not to the absence of means of redress. Id. 518-19. Finding that the market discounted the contents of official SEC documents even before they were filed, and that mutual funds and other investors who intensively studied such reports did not outperform the market, Benston concluded that SEC-mandated disclosure was distorted by a conservative bias and was in any event "too late . . . to be relevant." Id. 522-23. The burden of such disclosure, he believed, had discouraged many companies from raising capital in the public markets. Id. 524-28. In later work, Benston reaffirmed his earlier findings and extended his analysis to the 1934 Act, concluding that the disclosure provisions of the 1934 Act did not reduce fraud, require disclosure of useful information beyond what was already disclosed, enable investors to better predict future security price movements, or improve the fairness of investor confidence in the trading markets. Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132, 152-53 (1973). The lack of discernible effects, however, could be explained by the tendency for the increased cost of disclosure to the firm to be counterbalanced by a decreased cost of capital resulting from increased investor confidence. See Charles River Associates, supra note 47, at S-24.

Friend and Westerfield challenged Benston's conclusions. They argued that the correlation between changes in reported accounting data and stock prices was statistically significant and that the 1934 Act improved estimates of expected return, reduced risk and volatility, and increased efficiency. Friend & Westerfield, Required Disclosure and the Stock Market: Comment, 65 Am. Econ. Rev. 467, 468-71 (1975). But see Benston, Required Disclosure and the Stock Market: Rejoinder, 65 Am. Econ. Rev. 473 (1975) (rebuttal of Friend & Westerfield). For another critique of Benston's work, see Backer, Comments on "The Value of the SEC's Accounting
More recently, Kripke has argued that the average investor does not understand SEC-mandated disclosure but relies instead on professional advice, and in any event cannot use SEC information profitably even if he does understand it.67 Like Benston and Stigler, Kripke concludes that an unregulated market will provide optimal disclosure as investor representatives, such as underwriters, bargain with issuers for disclosure of valued information.68


68 In private placements, for example, investors demand and obtain only such information as they deem relevant, saving the issuer and society the cost of providing information, required by the SEC, that no one wants or uses. H. Krippke, supra note 67, at 120-25. Because SEC disclosure concerns only historical information, Krippke believed it was irrelevant to a sophisticated investment decision. Id. 97. The negativism employed to avoid liability further distorted reality. Id. 15. SEC-mandated disclosure, Krippke thought, should be future oriented; it should disclose not only historical costs but also current values and cash flow, especially in times of inflation; it should be comparative, presenting relevant information about the industry and the market as a whole, in addition to financial information about the company, and it should provide information useful for assessments of relative risk. Id. 25-27. See also Krippke, A Search for a Meaningful Securities Disclosure Policy, 31 Bus. Law. 293 (1975); Krippke, The Myth of the Informed
Contrary to Benston's and Kripke's arguments that firm-oriented disclosure based on historical cost accounting conveys no new or useful information beyond that already reflected in stock prices, however, other studies indicate that changes in expected accounting values influence stock prices. Despite the failure of historical cost accounting to reflect accurately a company's true prospects, investors detect distortions and extract valuable information from reports of the type Kripke thought were useless. Gonedes and others have concluded that SEC-mandated disclosure of accounting numbers at times transmits new information upon which investors act. Market prices also respond to a variety of forces in addition to accounting figures. To say, however, that financial information alone does not determine stock prices is not to say that such information has no effect or is useless when disclosed.

The argument that compelled corporate disclosure does not improve upon the level of disclosure that otherwise would be provided by market forces also overlooks important evidence. Even those who argue for more lenient disclosure requirements do not imagine that all material information would be disclosed gratuitously.

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Note: 69 See note 71 infra & accompanying text.


Note: 71 Newly published accounting data is only one variable among many influencing individual investment decisions. Those decisions also depend on world events, changes in government policies, independent market changes, the individual's particular financial and tax situation, and other factors that do not appear in published data and therefore defy measurement. Investors who act solely on official accounting data at the time it is published are perhaps too few to exert a significant impact on market prices.

Although portfolio theory stresses the performance relationships among groups of stocks, instead of focusing solely on the potential gain in one stock, efficient diversification cannot take place in an informational vacuum. The theory of efficient diversification depends on the existence of accurate information about the components of alternative portfolios. Construction of an optimal portfolio therefore requires, *inter alia*, the very information that the SEC requires be disclosed. Other things being equal, a portfolio manager who can use SEC filings will better diversify than the manager working without such information. See, e.g., Beaver, Kettler & Scholes, The Association Between Market Determined and Accounting Determined Risk Measures, 45 Accounting Rev. 654 (1970); Beaver & Manegold, The Association Between Market-Determined and Accounting-Determined Measures of Systematic Risk: Some Further Evidence, 10 J. Financial and Quantitative Analysis 231 (1975); Gonedes, Evidence on the Information Content of Accounting Numbers: Accounting-Based and Market-Based Estimates of Systematic Risk, 8 J. FINANCIAL & QUANTITATIVE ANALYSIS 407 (1973). See also Niederhoffer & Regan, Earnings Changes, Analysts' Forecasts and Stock Prices, 28 FINANCIAL ANALYSTS J. 65 (May/June 1972).
By forcing disclosure of information that otherwise would be withheld, and thereby increasing the amount of accurate information in the marketplace, required disclosure increases market efficiency. Economies of scale in producing and distributing information make the issuer, even when it operates under governmental compulsion, rather than private investors, the cheapest collector and disseminator of information. Far from crowding out private collectors and transmitters of information (such as research services), the regime of required disclosure subsidizes them. Because research services often rely on disclosures contained in SEC filings, and often cannot, at a reasonable cost, regularly obtain reliable information through other means, abandonment of required disclosure would reduce both the number of competing information disseminators and the absolute amount of information conveyed to the market. Finally, required disclosure improves the quality of other disclosures. Despite these limitations, the work of Stigler, Benston, and Kripke requires a fresh look at the economic rationale for compelled disclosure in general.

B. Information as a Public Good

A second strand in the literature has relied on microeconomic theory to analyze the process that brings valuable information to market. Stigler applied marginal cost pricing theory to the search for and production of information concerning market price. Arguing that price dispersion reflected buyer and seller ignorance, he attempted to show that buyers and sellers would expend resources searching for the best price until the expected value of additional searching equalled its cost. Although Stigler’s conclusions were not startling, his work did focus attention on information as an

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72 See Goncedes, Dopuch & Penman, supra note 66, at 101. See also Mendelson, Economics and the Assessment of Disclosure Requirements, 1 J. COMP. CORP. L. & SEC. REG. 49, 53-55 (1978) (noting corporations’ use of various accounting devices to distort disclosure and opposition by other banks to voluntary disclosures by Bank of America, and concluding that “there is really nothing in the free market system that will induce management to supply the optimal amount of information [and no] . . . motivation for management to reveal any of their own manipulative schemes or fraud”). The argument that a free market in information would lead automatically to optimal disclosure through the bargaining of corporate officers with investors ignores inefficiencies in the market for investment information. Because a monopolistic exploitation of valuable information often promises greater returns than a free market sale, there is too often insufficient incentive for the dissemination of information. The possessor of inside information, for instance, will obtain better returns by using that information in trading than by trying to sell it to others.

73 See generally text following note 160 infra.

economic good, akin to other commodities, such as corn, pork bellies, or gold. Following Stigler’s lead, economics of information theorists asked whether a market which, by hypothesis, normally produced an optimal amount of other commodities also produced an optimal amount of investment information.

Arrow concluded that an unregulated market allocated a sub-optimal amount of resources to research and invention because information is a “public good,” like national defense, lighthouses, clean air, weather broadcasts, bridges, and open spaces, for which the market could not simultaneously provide optimal production and consumption.\(^5\) An unregulated market will not provide optimal production of public goods because producers of such goods cannot realize their full value.\(^6\) A producer of oil or an owner of land, for instance, can sell some of his product to one customer and some to another. One sale will not destroy the market. In contrast to these (and most other) commodities, however, pure public goods are nonappropriable, indivisible, and nonexclusive, all of which reduce their potential return. Sale of a pure public good to one person is, to some extent, sale to everyone; the seller cannot effectively divide up his product and sell it incrementally, excluding those who will not pay the price he demands. The national defense cannot feasibly withdraw protection from people who do not pay their taxes, the lighthouse cannot be shut off for ships that do not contribute to its upkeep, and the air cannot be left polluted for those who oppose environmental protection. Because potential consumers of public goods can use them without paying for them, each potential user will conceal his preference and the owner will have great difficulty charging anyone for the good.\(^7\)

Public goods


must be enjoyed by all, regardless of willingness to pay, or enjoyed by none.

While most private goods are produced under conditions of increasing or constant marginal cost, so that significant increments of resources are consumed in serving additional customers, pure public goods are costless to reproduce and distribute. The benefits of increased use of pure public goods will therefore always outweigh the cost.\textsuperscript{78} Under conditions of pareto optimality, where price equals marginal cost, use of pure public goods would be free. Producers of public goods, however, must charge some price to cover their costs, or they will not produce. Charging a price greater than marginal cost will prevent many who could pay the marginal cost from sharing the benefits of the good.\textsuperscript{79} While nonappropriability will lead to underproduction, the attempt to charge a price exceeding marginal cost of use also will cause welfare losses through suboptimal utilization of whatever public goods are produced. Legal protection for producers may reduce the risk of underproduction, but it will exacerbate underutilization. Alternatively, the government can hold the price down to marginal cost either by subsidizing private firms or by producing the public good itself.\textsuperscript{80}

The theory of pure public goods, however, does not always describe what actually happens in the marketplace. Producers can, for instance, build fences around open spaces, scramble weather

\textsuperscript{78} Arrow, \textit{supra} note 76, at 616-69. In a classic series of articles that initiated the modern public goods debate, Samuelson argued that the primary attribute of a public good is that one person's consumption does not reduce another's; instead, one quantity of the good is produced and shared in common by all. \textit{See} Samuelson, \textit{The Pure Theory of Public Expenditure}, 36 Rev. Econ. & Statistics 387 (1954). \textit{See also} Samuelson, \textit{Aspects of Public Expenditure Theories}, 40 Rev. Econ. & Statistics 333 (1958); Samuelson, \textit{Diagrammatic Exposition of a Theory of Public Expenditure}, 37 Rev. Econ. & Statistics 350 (1955).

\textsuperscript{79} Because their production costs are relatively constant at different levels of distribution, sharing public goods neither increases the cost of production nor decreases the value received by others. Economic theory suggests that consumers should be permitted to use a good whenever they can pay at least the marginal cost of its use. If the owner of an investment newsletter, for example, charges ten cents per copy, people who would pay nine cents will not purchase. Because the owner could profitably sell newsletters at any price above variable cost, which may be a penny per copy, total social welfare is reduced by the value of the newsletter to people who would pay something between variable cost and ten cents.

\textsuperscript{80} Arrow's suggestions have provided the theoretical foundation for proposals ranging from government financing for research and development to the creation of an exemption to § 4(2) of the 1933 Act and rule 144 in the case of securities issued by high-technology companies. \textit{See} CHARLES RIVER ASSOCIATES, \textit{supra} note 47. \textit{See generally} authorities cited in note 75 \textit{supra}. \textit{See also} [1980] 571 Sec. Rec. & L. Rep. (BNA) A-13 (easing of regulation of venture capital companies under Investment Company Act of 1940); Wall St. J., Oct. 8, 1980, at 17, col. 1 (loosening of restrictions on sale of unregistered securities by venture capital companies).
broadcasts, and restrict entrance to roads, bridges, and public hospitals. After excluding certain consumers, producers can segment the market and price discriminate, charging each purchaser only what the good is actually worth to him. Consumers may attempt to conceal their true preferences, but there are very sophisticated ways of finding out what they are. In addition, incentives exist for individuals to join and pay fees to organizations that produce public goods in socially optimal amounts. Demsetz has argued that whenever the benefits gained by provision of public goods outweigh transaction and production costs, the private sector will provide the good at an optimizing price. He concludes that where the market does not provide the good, one can infer that total costs of production, distribution, and payment are greater than any benefit received.

84 Demsetz, The Exchange and Enforcement of Property Rights, 7 J.L. & Econ. 11 (1964).
85 Pursuit of optimality does not necessarily require that goods be given away if the marginal cost of their distribution is zero. The marginal cost of production will always be positive, particularly if measured prior to any production. Although pareto optimality requires that goods be sold at a price equal to marginal cost, marginal cost in this context is the average marginal cost of production and distribution, not that of distribution alone. Particularly in the case of large fixed investment goods, a focus on marginal cost of distribution alone may have more theoretical elegance than practical relevance. Once the bridge is built, the marginal cost of the first and all subsequent crossings is virtually zero. Choosing a time before construction in setting the marginal price calculus, however, produces a marginal cost for the first user equal to the total cost of the bridge, for the second user a marginal cost equal to half that, and so forth. Accordingly, if the marginal cost calculation is made before there are any fixed costs, it will exceed zero to the degree prospective fixed costs are characterized as a type of marginal cost. Even after the bridge is completed, moreover, marginal cost will not be zero. Bridges must be maintained, and when the bridge becomes congested, additional use imposes an indirect cost on other users. In addition, if production and distribution are subsidized, and the public good is given away, overproduction and overutilization may result, shifting resources from other more valuable uses to the public good. Charging for public goods at least provides some idea of their value to the public, information that may be useful when the time comes to enlarge the bridge or to build another. See Davis & Whinston, On the Distinction Between Public and Private Goods, 57 Am. Econ. Rev. 360, 367 (1967); Demsetz, supra note 84, at 21.
Coase's study of the British lighthouse system further illustrates the limitations of a purely theoretical public goods approach to real market problems. Lighthouses epitomize the pure public good. The lighthouse owner cannot collect tolls from passing ships by threatening to shut the light off for those who do not pay. Once the lighthouse is constructed, the marginal cost of increasing use is zero. One might conclude that private industry will never build lighthouses, and if it does, that the attempt to recover all costs will place a suboptimal burden on the unlucky ships that pay the toll. Government, apparently, is the only solution. Coase found, however, that private industry had built British lighthouses and had devised an ingenious system of collecting fees for their use commensurate with value received, before the lighthouses were taken over by the government.

Securities information, like most information, is a hybrid good. It is nonappropriable, because profitable appropriation and use necessarily reveals the information to others, at least in part. The purchase of securities without disclosure of nonpublic information, for instance, will drive the price of the security higher. One cannot even negotiate for the sale of information without disclosing some part of it. Information is indivisible and nonexclusive because sale to one is, to some extent, sale to all. Once information is disclosed, the original owner may not be able to prevent others from obtaining the information and using it for themselves. In addition, once collected, information, like weather reports, can be distributed at virtually zero marginal cost, creating social benefits exceeding social costs. Yet there will be inadequate motivation to invest in information production if the product cannot be reduced to legally protected property. These public aspects of information production lead Arrow and others to recommend active government intervention in the market for securities information.

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87 Id. 364-65.
89 The classic definition of pareto optimality, moreover, requires that information be free and available to all. See notes 45 & 46 supra and accompanying text.
Securities information, however, also exhibits some characteristics of private goods. Although trading discloses some information content, it also permits the owner of nonpublic information to realize much of its value. Information can be made appropriable in other ways as well, such as through patent laws, trade secret laws, copyright laws, and private contracts. Sellers of nonpatentable ideas—such as investment advice—have devised a variety of contractual protections. Marginal cost, moreover, is not necessarily close to zero before the information is created, or even afterward, if updating is necessary. The Chicago school therefore sees investment information as a commodity like any other for which market forces are presumed to provide optimal production and distribution. Because securities information exhibits a public aspect but nevertheless may achieve roughly optimal production and distribution in a free market regime, both the Arrow and the Chicago school analyses are applicable. A thoughtful securities policy need not go so far as to require government subsidies for information production, but it should reflect a heightened sensitivity to unjustified interference with existing incentives to private information production.

C. Apologia for Insider Trading

The economics of information attained its most controversial synthesis in the work of Professor Manne. Manne argued against all restraints on the exploitation of investment information. Economic reality, in his view, demanded that rule 10b-5's prohibition against insider trading be discarded as a useless barrier to the efficient production, distribution, use, and impoundment into stock assuming that investor trading does not affect resource allocation: "the community as a whole obtains no benefit, under pure exchange, from either the acquisition or the dissemination (by resale or otherwise) of private foreknowledge") (emphasis in original).

See also Mendelson, Book Review, 117 U. Pa. L. Rev. 470 (1969) (trading will not necessarily disclose information content because the trading may be motivated by extraneous circumstances and is therefore an ambiguous signal; when an investor buys on secret information, his buying pressure will raise price temporarily, but the price will eventually drop again unless the information is disclosed).

Cf. F. Machlup, Knowledge: Its Creation, Distribution, and Economic Significance (1980); F. Machlup, The Production and Distribution of Knowledge in the United States (1962) (arguing that patent protection is required to encourage optimal investment in new ideas, but that patents will necessarily hinder optimal utilization of information once produced; and concluding that enlightened policy requires a balancing of these two goals).

prices of valuable information. Focusing on the corporate manager, Manne argued that insider trading gains were a necessary incentive and just desert for entrepreneurial activity inside the corporation. The ban on insider trading could not be justified on the ground of investor protection because insider trading did not injure investors generally and in fact hurt virtually no one.

Manne, however, assumed that insiders would trade only on positive information and did not consider carefully the case of investors who purchased while insiders were bailing out. He understated the degree to which insiders might actually delay or manipulate disclosure in order to maximize a trading advantage. He ignored the extent to which even long-term investors time trades with an eye on short-term price fluctuations. He failed to explain how the spoils of insider trading could be restricted to entrepreneurs in amounts commensurate with the value of their contribution. Finally, he directed insufficient attention to the economic benefits of a rule imposing on corporate management a duty of undivided loyalty to stockholders.

94 Id. 77-93.
95 Id. 5-77.
96 Arguably, potential purchasers injured by the "unfair" competition of the inside buyer would have a better claim to compensation than sellers who sold at a higher price as a direct result of that competition. Conversely, buyers who buy from the insider pay a lower price than they would have paid if he were not selling.
97 See id. 150-53.
98 See id. 104, 151-52.
100 Persons in the corporate hierarchy with no connection to the entrepreneurial function will inevitably obtain and use inside information, usually while the genius inventor is still in the laboratory.
Other criticisms might be made, but Manne's economic arguments have some validity. The principal flaws in his analysis, moreover, do not apply to outsider trading, where no problems arise concerning conflicting loyalties, identification of the corporate entrepreneur, manipulation of corporate information, or bailouts. Although Manne's focus was on insider trading, his conclusion that trading on nonpublic information produces a net social good, to the degree it is valid, applies a fortiori to outsider trading.

D. The Efficient Capital Market Hypothesis

The efficient capital market hypothesis (ECMH) has moved neoclassical equilibrium theory from ought to is. Economists agree that securities regulation should promote an efficient allocation of resources by encouraging swift impoundment of all available information into stock prices. ECMH theorists, however, go one step farther and assert that market processes already do this: the efficient capital market is in their view a goal that already has been achieved.\(^\text{102}\)

The ECMH asserts that the national capital markets

\(^{102}\)See Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Finance 383 (1970). See also Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 Stan. L. Rev. 1031 (1977); Note, Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend, 29 Stan. L. Rev. 1077 (1977). Definition of an efficient market as one that continuously reflects all information suggests several tests of efficiency. Most tests of capital market efficiency have tried to measure the speed with which stock prices react to news of changes in corporate prospects. Another test, suggested by Friend, examines short-term price continuity on the theory that price continuity is evidence of continuous incorporation of information into stock prices. If information reached the market only in fits and starts, stock price patterns would exhibit sudden dislocations. Once some continuity has been observed, however, this test cannot provide refined results. Although the absence of any continuity may be evidence of inefficiencies, it is impossible to say how much continuity is required to support a finding of efficiency. Even in an efficient market, new developments may appear discontinuously. Conversely, factors having nothing to do with a rapid response to information may smooth price trends, thereby inaccurately suggesting efficiency. A third test, also suggested by Friend, measures the degree to which the stock market maintains equivalent rates of return on investments of the same risk, as required by the efficient allocation theory and the capital asset pricing model. See note 160 infra. If the market reflects all information, it will channel funds to companies commensurately with their promise for success, and investment opportunities sharing equal risk and return will obtain funds at the same rate. Measurements of equivalency in cost of capital between investments of the same risk and return therefore can provide a gauge of market efficiency. See I. Friend, M. Blume & I. Crockett, supra note 9, at 92; Friend, The SEC and the Economic Performance of Securities Markets, in Economic Policy and the Regulation of Corporate Securities, supra note 64, at 185, 190. Risk, however, is notoriously difficult to measure apart from actual returns, \textit{ex ante} and even \textit{ex post}. Finding that rates of return maintain a constant relationship over time, moreover, does not necessarily mean that the underlying prices on which equivalent rates of return are based are always efficient. See, e.g., J. Keynes, The General Theory of Employ-
are perfectly efficient in the sense that they continuously reflect all relevant information, both public and nonpublic. Research attempting to verify this hypothesis cannot, of course, examine the price impacts of all potentially relevant information. Empirical tests of the ECMH have therefore focused on the speed and accuracy with which market prices respond to items of information widely recognized as significant.

Empirical studies of the ECMH purport to show, in ascending order of weak, semi-strong, and strong form tests, that stock prices continuously reflect (1) all information about past prices and trends, and their value in predicting future prices; (2) all available public information as it is generated, even to the point of anticipating the import of new information prior to its public announcement and dissemination, and (3) even nonpublic information, such as information possessed by insiders, as soon as it is developed, whether or not it is publicly disclosed. The weak form efficiency studies conclude that chartists and others who study past trends waste their time because existing prices continuously incorporate whatever information such studies might produce. If, for instance, past trends suggest that a certain stock always gains in the winter, existing prices will continuously reflect the discounted value of that information, and no one who discovers it on his own can outperform the market by trading on it. Semi-strong form studies conclude that investors who maintain an up-to-the-minute watch on new developments, by reading newspapers, listening to the radio, or consulting the ticker, also are wasting their time because market prices will reflect any new information before they can trade on it. The investor who buys a stock simultaneously with the announcement of a dividend increase will, for instance, pay a price that reflects the information value of the increased dividend and will not outperform the market. Finally, strong form studies argue that even the insider who uses inside information will not outperform the market because he will

103 This typology of information follows that originally suggested by Fama. See E. FAMA, FOUNDATIONS OF FINANCE (1976); Fama, supra note 102. See also Fama & Blume, Filter Rules and Stock-Market Trading, 39 J. Bus. 226 (1966); Fama & MacBeth, Risk, Return, and Equilibrium: Empirical Tests, 81 J. Pol. Econ. 607 (1973).
trade at prices that already reflect what he thinks is secret information.

From Wall Street to Main Street, both sophisticated and unsophisticated investors have believed that careful research and analysis, quick reactions, or access to corporate secrets could produce handsome trading profits. Not only the intuitive feeling that a special advantage put one ahead of the crowd, but also anecdotal evidence confirmed the widespread perception that passive price takers could at best stand still, while those with privileged information outperformed the market and accumulated fortunes. The underlying principle of the ECMH, however, is not counterintuitive. Investors are a devoted army of researchers who keep the market continuously informed. By trading, millions of sophisticated and unsophisticated investors continuously transmit to the marketplace valuable information from every corner of the economy. The presence in the market of insiders and of large numbers of wealthy and extremely well-informed investors adds further to the accuracy and speed with which stock prices incorporate all available information. Those with sizeable investments in the stock market will devote significant resources to the development of sophisticated market strategies, and their trading will incorporate their research into market prices.

Because the ECMH holds that all valuable information instantaneously flows into the market via trading, it follows that no one can possess better information than that already incorporated in stock prices. By hypothesis, a perfectly informed trader, who has access to every available information source and means of analysis, will value securities at their existing market prices. Research, investigation, mathematical analysis, and tapewatching can never earn supracompetitive profits because these activities will at best produce only some information, while the stock price will incorporate that information along with all other information. Efforts to identify undervalued stocks, whether by fundamental or

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For dissenting views, see T. Dyckman, D. Downes & R. Magee, Efficient Capital Markets and Accounting: A Critical Analysis (1975); Murphy, Efficient Markets, Index Funds, Illusion, and Reality, 6 J. Portfolio Management 5 (Fall 1975); Zeikel, On the Threat of Change, 31 Financial Analysts J. 17 (Nov./Dec. 1975) (arguing that information seeps into the market only gradually, as some investors act more quickly than others who must rely on sophisticated assistance to interpret new information properly).
technical analysis, or by any other means of research, are costly, but cannot promise better performance than a passive pricetaking strategy. The investor can hope to outperform the market only if he can obtain and use information and analytical tools he knows others do not possess and therefore are not yet incorporated into security prices.

Paradoxically, although an efficient market depends on informed trading in the aggregate, the ECMH suggests that the wise investor should devote no resources to a will o' the wisp search for undervalued stocks, but should instead pursue efficient diversification at the desired level of risk.\(^\text{104}\) Instead of trying to beat the market, and absorbing significant transaction costs that doom the effort to failure, the sophisticated investor should invest in an index fund containing a weighted portfolio of securities. He will then do almost exactly as well as the market, with minimum transaction costs, which is the best anyone can expect under the ECMH. The proliferation of index funds and the steady increase in the monies committed to them over the past decade provide some measure of the degree to which the ECMH has gained acceptance among both sophisticated and unsophisticated investors.\(^\text{105}\)

Taken at face value, the ECMH throws into doubt traditional justifications for almost every phase of securities regulation. According to the ECMH, because valuable information is continuously and instantaneously reflected in market prices, the existing system of compelled disclosure is largely superfluous. The SEC and the securities laws waste resources, by requiring issuers and traders to spend money disclosing information that already is reflected in stock prices and by attempting to police such disclosure. In addition, because trading on inside information will not provide an advantage, and because no one who trades on the basis of market


prices can be cheated, the ECMH suggests that there is no need to regulate insider trading. If market prices incorporate all available information, the outsider who trades at the market price will have the functional equivalent of complete knowledge, which includes and is superior to whatever nonpublic information the insider possesses. Instead of disadvantaging ordinary investors, insider trading contributes to market efficiency and thereby protects outsiders by providing another way for valuable information to come to market. The ECMH therefore suggests that insider trading, and a fortiori trading on outside information, be actively encouraged rather than discouraged.

1. Weak Form or Random Walk Studies

The best-known examples of the ECMH literature are the so-called “random walk” studies, beginning with a 1900 doctoral dissertation by Bachelier. Bachelier found that French commodity prices provided unbiased estimates of future commodity prices, in the sense that they favored neither purchasers nor sellers, but accurately reflected all information available when futures contracts

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106 According to the ECMH, inside information will confer an advantage only when the insider knows that no one else has the information. Such occasions will be extremely rare, if they occur at all. Even the accountant who first prepares the books showing a profit increase cannot be sure that no one has traded ahead of him on the same information. His assistant, for instance, may have accurately extrapolated from interim figures. Similarly, the insider who witnesses an industrial accident can never be sure that someone else did not also see it. If even one other person trades ahead of him, the market price will begin to incorporate the inside information. The insider can never be certain that the market price does not already reflect whatever information he possesses. If it does, but he believes that it does not, his purchases will drive the price beyond what the information warrants and he will pay more for the stock than it is worth. Eventually, the price will return to the level dictated by the information apart from his misguided buying pressure. Transaction costs will compound his loss. According to the ECMH, the insider who buys on inside information will not fare as well as the unsophisticated seller who has sold to him on the premise that the existing price fully reflects all available information. Similarly, an investor who trades on the basis of a foolproof method of analysis will lose money to the degree that his method of analysis is not as novel as he believes. Cf. B. Lev, supra note 103, at 242:

Any prediction model or method of financial analysis that becomes publicly known will quickly lose its usefulness because the value of the derived information (e.g., predictions) will already be reflected in security prices. Analytical tools are therefore self-destructive in efficient markets unless kept secret, and even then their useful life is relatively short. Therefore, ingenuity, originality, and secrecy are necessary conditions for successful financial analysis. Efforts should be continually made to design new models and tools and to obtain access to new information sources. In short, the objective is to transform publicly available information to inside information by the application of original tools and techniques.

were made. Commodity speculation in France was therefore a “fair game”: neither buyers nor sellers could consistently expect to earn profits. Futures prices changed only in response to unanticipated information, which is generally random. If current prices reflect all available information, including the information value of past price changes, and thereafter fluctuate randomly, analysis of past price patterns is worthless.¹⁰⁸

Although Bachelier’s work carried important implications for securities analysis, random walk theories received little attention until 1959, when a physicist provided a mathematical proof showing that securities prices fluctuate randomly.¹⁰⁹ Examining the relationships between weekly, daily, and lagged daily price changes of New York Stock Exchange listed stocks, subsequent econometric studies discerned only a slight serial correlation among price movements over successive periods.¹¹⁰ Another set of studies tested the random walk by examining the degree to which “filter” trading schemes could outperform the market.¹¹¹ Because filter schemes rely solely on past price patterns as guides to future trading, the ability of any filter scheme to generate above average returns would provide strong evidence against the validity of the random walk theory. These studies generally found that refined filter schemes could generate slightly above average returns before transaction costs.¹¹²

¹⁰⁹ Osborne, Brownian Motion in The Stock Market, 7 OPERATIONS RESEARCH 145 (1959).
¹¹⁰ See, e.g., Moore, Some Characteristics of Changes in Common Stock Prices, in THE RANDOM CHARACTER OF STOCK MARKET PRICES, supra note 107, at 139 (finding serial correlation coefficient of 0.03 for daily price changes, and similarly small coefficient for lags; finding also a slightly greater tendency for runs in daily changes to persist). See also C. Granger & O. Morgenstern, Predictability of Stock Market Prices (1970); Fama, Random Walks in Stock Market Prices, 21 FINANCIAL ANALYSTS J. 55 (Sept./Oct. 1965); Fama, The Behavior of Stock Market Prices, 38 J. Bus. 34 (1965); Godfrey, Granger & Morgenstern, The Random-Walk Hypothesis of Stock Market Behavior, 17 KYKLOS 1 (1964); Granger & Morgenstern, Spectral Analysis of New York Stock Market Prices, 16 KYKLOS 1 (1963).
¹¹¹ A typical x/y filter rule instructs the investor to buy a security when the price advances from a lowpoint at least x%; sell and go short when the price declines at least y% from its highpoint; maintain the short position until the security moves up x% from a previous low and then buy again. All moves of less than x% or y% are to be ignored. Filter rules depend on historical evidence suggesting that when a stock moves up x%, or down y%, the movement will continue.
¹¹² These profits were earned by exploiting short-term serial dependencies in price changes. See, e.g., Dryden, Filter Tests of U.K. Share Prices, 1 APPLIED ECON. 261 (1970); Fama & Blume, Filter Rules and Stock Market Trading, 39 J. Bus. 226 (1966); Osborne, Periodic Structure in the Brownian Motion of Stock Prices, 10 OPERATIONS RESEARCH 345 (1962). See also Ambachtsheer, Portfolio Theory and the Security Analyst, 28 FINANCIAL ANALYSTS J. 53 (Nov./Dec. 1972); Jensen, Random Walks: Comment, 23 FINANCIAL ANALYSTS J. 77 (Nov./Dec. 1967); Levy, Random Walks: Reality or Myth, 23 FINANCIAL ANALYSTS J. 69
transaction costs of the many trades required by the filter strategy were subtracted, however, the filter schemes used generally did not outperform the market or a simple buy-and-hold strategy.\footnote{113}

At most, these weak form studies show a fair game, and not a random walk.\footnote{114} Other studies suggest significant departures from randomness and the fair game in the contexts provided by particular companies, short-term trading, seasonal patterns, exogenous market effects, and on exchanges other than the New York Stock Exchange.\footnote{115} Price dependencies in these areas indicate that the national capital markets are not equally efficient with respect to all transactions. In addition, when Black tested the Value Line stock ranking system, which is based almost entirely on ten years of

\footnote{113}{These findings, however, have not daunted the efforts of chartists. See, e.g., Ehrbar, \textit{Technical Analysis Refuses to Die}, \textit{Fortune}, August 1975, at 99; Wall St. J., Jan. 12, 1981, at 23, col. 4. These studies, moreover, were performed prior to the advent of discount brokerage; they do not indicate whether technical analysis might now produce superior profits even after transactions costs.}

\footnote{114}{The random walk studies have relied on three different theories to describe the time series behavior of prices: (1) the fair game model; (2) the martingale or submartingale, and (3) the random walk. In a fair game, the expected return on an asset, represented by its discounted value or price, will on average prove to be its actual return. A fair game implies that expectations incorporated into prices are not biased but are the most reliable indicators of future value, and that investors who speculate against existing prices therefore cannot consistently earn supracompetitive profits. Speculators will win and lose when unexpected fluctuations occur, but over the long run they will not earn more money than the investor who simply buys and holds at existing prices. After transaction costs, they will earn less. By contrast, where expectations incorporated into prices are consistently biased, speculators who recognize that bias can consistently earn supracompetitive profits. A martingale is a fair game in which tomorrow's price is expected to be the same as today's price. A submartingale is a fair game in which tomorrow's price is expected to be greater than today's price. In a submartingale, both a speculating portfolio and a buy-and-hold portfolio will realize the same positive return before transaction costs. Random walks are fair games in which (1) all returns are taken from a return distribution whose characteristics (e.g., mean, variance, skewness, density, and kurtosis) do not vary over time regardless of available information and (2) all returns are statistically independent. Although the existence of a random walk necessarily implies the existence of a fair game, not all fair games amount to a random walk. The random walk studies have generally found slight serial covariances between one-period returns that are consistent with a fair game but inconsistent with a random walk. See generally T. Copeland & J. Weston, supra note 103, at 204-07; Fama, \textit{The Behavior of Stock Market Prices}, 38 J. Bus. 34 (1965).}

\footnote{115}{See, e.g., Dryden, supra note 112 (trends in United Kingdom Share prices); McDonald, \textit{French Mutual Fund Performance: Evaluation of Internationally-Diversified Portfolios}, 28 J. Finance 1161 (1973) (inefficiencies on French Bourse); Solnik, \textit{Note on the Validity of the Random Walk for European Stock Prices}, 28 J. Finance 1151 (1973) (particular companies on foreign exchanges); Thiel & Leenders, \textit{Tomorrow on the Amsterdam Stock Exchange}, 38 J. Bus. 277 (1965).}
published data, he found that the Value Line system generated superior returns before, and in some years after, transaction costs. Black's findings directly contradict the assertion that analysis of past price movements cannot generate supracompetitive profits.

2. Semi-strong Studies

Whereas the random walk or weak form of the ECMH asserts that past security prices are of no use in predicting future prices, the semi-strong form asserts that current prices reflect not only the information value of past prices, but also the value of all public information, continuously and instantaneously. Whereas the random walk theory asserts that technical analysis of past prices is worthless, the semi-strong ECMH asserts that fundamental analysis of companies is worthless as well. To some extent, the random walk model stands or falls with the semi-strong ECMH. Prices will not move randomly if new information is not instantaneously impounded. Rather, price dependencies will arise and trends will persist while the new information slowly seeps into the market; successive changes will move in the same direction because each change will reflect the same influence. Instantaneous and complete incorporation of new information into prices, however, will ensure randomness.

The semi-strong tests attempt to show that security prices adjust rapidly to, and often anticipate, information filed with the SEC, published in the press, or otherwise disseminated to the public. In the first and still the classic test of the semi-strong hypothesis, Fama, Fisher, Jensen, and Roll examined 940 splits in stocks listed on the New York Stock Exchange. They found that splits generally occurred after the issuer's dividend payout and that

116 Black, Yes, Virginia, There is Hope: Tests of the Value Line Ranking System, 29 FINANCIAL ANALYSTS J. 10 (Sept./Oct. 1973). See also A. Bernhardt, INVESTING IN COMMmON STOCKS (1975) (investor who purchased only stocks receiving Value Line's highest recommendation would have outperformed market by over 160% from 1965-1974); Peterson, Are Financial Ratios Worth the Effort?, 2 J. PORTFOLIO MANAGEMENT 51 (Fall 1975); Shelton, The Value Line Contest: A Test of the Predictability of Stock Price Changes, 40 J. Bus. 251 (1967). The Value Line phenomena might also be explained by the market impact of the reports independent of their validity.

117 In addition, Ying has shown that even if price changes are independent of each other, they are not independent of volume changes, suggesting that analysis of historical price and volume data can earn supracompetitive returns. Ying, Stock Market Prices and Volumes of Sales, 34 ECONOMETRICA 676 (1966).

118 The leading authority on fundamental analysis is B. GRAHAM, D. DODD & S. COTTLE, supra note 53.

stock prices rose relative to the market index over several months.\(^{120}\)

Public announcement of a split did not significantly affect prices. Because stock splits, by themselves, do not create new value or alter cash flow, but are merely paper transactions which increase the number of outstanding shares, the failure of stock splits to affect prices (after correction for dilution) is not surprising. The evidence suggested that prosperity and increases in dividend payout generally cause an increase in market price and that a long-continued increase could lead to a split. Management usually decided to split after a period of prosperity and rising prices, perhaps in order to keep share prices within range of small investors, rather than after a period of falling or steady prices. As the evidence also showed, prices will continue to rise after the split only if the dividend payout continues to rise.

Fama and his colleagues, however, hypothesized that news of splits leaked to the market ahead of formal announcement, and that this leakage, rather than improved earnings and dividends, caused the antecedent price rise. They further hypothesized that price rises did not result from investors' reactions to advance news of the split per se, but rather resulted from investors' perceptions that advance news of a split was a signal from management that the company would sustain increased earnings.\(^{121}\) Because investors apparently anticipated the information content of the split, no one could profit by trading on its announcement.\(^{122}\) The authors concluded that the market is highly efficient with respect to news of stock splits in the sense that by the time the split is actually announced, the stock price has already incorporated this information and it is too late to trade on it.\(^{123}\) A more plausible explanation for the available evidence, however, and one which recognizes that splits are effects and not causes, is that most companies will increase (and no company will decrease) dividends while planning a split, and prices therefore will rise right up to the time of the split, which probably will not occur unless prices do rise.\(^{124}\)

\(^{120}\) Id. 2.

\(^{121}\) Id. 3-4.

\(^{122}\) Id. 16-19.

\(^{123}\) Id. 17-20.

\(^{124}\) Although the greater magnitude of the negative as contrasted with the positive average residuals following the split might lend further support to the conclusions of Fama and his colleagues by suggesting that the positive informational value inherent in a split is exhausted before the split occurs, there are other explanations for this phenomenon. Viewed in the abstract, splitting has no economic effect. In practice, however, splitting imposes very real costs on both the company and its shareholders, costs that can be expected to lead to a decrease in price. The company, of course, must bear the administrative costs of the split. Although
If public distribution of annual earnings statements does not affect prices, one might conclude that the market already has anticipated their content—which would support the semi-strong ECMH.\textsuperscript{125} Ball and Brown found that ten to fifteen per cent of the price change attributable to changes in anticipated earnings occurred during the month of the annual report, with the bulk of price changes occurring earlier.\textsuperscript{126} They concluded that the information content of annual earnings statements had largely leaked to the market prior to announcement via more timely media such as interim reports, statements by company officials, and insider trading; profitable trading on such information after transaction costs, therefore, was virtually impossible. Ball and Brown, however, found more significant price adjustments where anticipatory expectations were contradicted by earnings reports.\textsuperscript{127} Any support

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small traders who formerly could not trade in round lots may be able to after a split, thereby reducing their transaction costs, the increase in shares owned will inflate transaction costs for very small traders (who are still unable to purchase round lots) and for very large traders (i.e., for all traders who will trade only odd lots or round lots both before and after the split). Contrary to popular belief, stock splits do not move the issuer's price into an "optimal" price range that maximizes liquidity. Stock splits reduce liquidity. Following a split, trading volume is proportionately lower than before the split, brokerage commissions are proportionately higher, and bid-ask spreads are higher as a proportion of the bid price. See Copeland, *Liquidity Changes Following Stock Splits*, 34 J. Finance 115 (1979). Another weakness in the work of Fama and his colleagues stems from their assumption that dividend increases or decreases will affect price in an efficient market. Other research has shown that in an efficient market the rate of earnings retention as opposed to dividend payout should have no effect on the market price of securities. See Miller & Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. Bus. 411, 412-15 (1961). See also Black & Scholes, *The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns*, J. Financial Economics, May 1974, at 1, 18-19. If the market focuses on dividend decisions rather than on underlying economic realities, allowing firms to mislead the market and generate price changes merely by altering dividends, the market is not efficient.

\textsuperscript{125} But see Mendelson, supra note 46, at 52 ("If investors' errors in expectations were randomly distributed with mean zero, the subsequent price changes would be randomly distributed around mean zero and a simple examination of the price changes at the time of information releases would suggest that the information contained nothing new.").


\textsuperscript{127} Even in an efficient market, there will be room for some profit before transaction costs because there is always an irreducible component of uncertainty with respect to any advance information. Prices will never fully anticipate advance information, but will reflect only its discounted value prior to official confirmation. The act of confirmation is therefore an important economic event removing this discount. While the price may climb to 99% in anticipation of news that will show that the stock is worth 100, the price will not actually reach 100 until official announcement. See, e.g., Rubinstein, *Securities Market Efficiency in an Arrow-Debreu Economy*, 65 Am. Econ. Rev. 812 (1975) (arguing that prices will never fully reflect all information if fully reflected information means information whose arrival in the market creates no incentive to revise portfolios, and concluding that
these findings provide for the semi-strong ECMH is undermined by Beaver’s study of the effects of earnings announcements on stock trading volume.\textsuperscript{128} Finding that the average trading volume for sample securities increased 33% during the week when earnings were publicly announced, Beaver concluded that the content of these announcements was not fully anticipated and that they therefore generally conveyed new and relevant information.\textsuperscript{129}

Scholes attempted to determine whether the adverse price impact of large secondary offerings should be attributed to price pressure caused by a sudden increase in supply or to a negative inference concerning the issuer derived from the seller’s decision to sell.\textsuperscript{130} Because he found no relationship between the size of the offering and the magnitude of the price decline, Scholes argued that increased supply was not responsible for the decline. He concluded that the decline was attributable to the negative inference raised by insider sales. This hypothesis received apparently strong support from evidence showing that the size of the resulting price declines was greatest for sales by corporations and corporate officers, somewhat smaller for sales by mutual funds, and smallest for sales
by banks, estates, and individuals.\textsuperscript{131} The full price decline, moreover, usually occurred within six days after the offering, when the identity of the vendor must be publicly disclosed.\textsuperscript{132} ECMH theorists concluded from Scholes' study that the price decline prior to official identification of the vendor demonstrates that the market anticipates the negative information implicit in large insider sales, making profitable trading on the basis of the vendor announcement impossible and lending further support to the semi-strong hypothesis. More plausible interpretations, however, are available. The 1933 Act requires registration and disclosure of the vendor's identity twenty days before the distribution if the vendor is the issuer or a person in a "control relationship" with the issuer.\textsuperscript{133} Even in situations not requiring registration, brokers, investment bankers, and other parties often know who the vendor is and will disclose his identity to interested buyers. In addition, other studies have shown that it is possible to outperform the market by trading on section 16(b) reports published by the SEC, demonstrating that any anticipatory effect is less than complete.\textsuperscript{134}

According to the semi-strong forms of the ECMH, investors should not be able to earn supracompetitive profits by trading on news of block trades. In their examination of price activity surrounding block trades, however, Kraus and Stoll found that prices tended to fall in the hours immediately prior to block sales, that the decrease accelerated in the last hour prior to the sale, and that the price rose \(0.713\%\) before the end of the day.\textsuperscript{135} Damm, Meyers, and Rabb, using a different sample of block trades, found that price declined at least \(4.56\%\) between the opening of the day's trading and the consummation of the block trade.\textsuperscript{136} An investor who

\textsuperscript{131} Id. 207-9.

\textsuperscript{132} Id.


\textsuperscript{134} See note 148 infra.


relied on a 4.56% filter rule to alert him to impending block trades could in theory earn supracompetitive profits. If he participated in every block in the sample, he could have earned a net annualized return of 203%\textsuperscript{137}. Even if he could not actually participate on the purchase side of the block trade, the alert investor could nevertheless earn supracompetitive profits by purchasing immediately thereafter. The market, however, reacts so quickly to the opportunity presented by block trades that supracompetitive profits net of transaction costs normally disappear within fifteen minutes following the block sale\textsuperscript{138}. Except for those on the floor of the exchange, sufficiently prompt action is impossible. The evidence on block trades is nevertheless inconsistent with instantaneous incorporation of all public information into stock prices.

Studies of the performance of new issues provide even stronger evidence against semi-strong efficiency. If the market generally possesses accurate information about new issues, a strategy of investing in new issues should not produce supracompetitive profits. Ibbotson, however, found from his sample that investing in new issues and selling after one month outperformed the market by 11.4% per month and by over 350% per year\textsuperscript{139}. In an efficient market, an annualized 350% return could not be achieved.

3. Strong Form Studies

The strong form ECMH asserts that not only public information but also nonpublic information is rapidly incorporated into market prices. According to this form of the hypothesis, even insiders with monopolistic access to nonpublic information, and outsiders (such as security analysts) with their private information, cannot realize superior investment results over the long run, because market prices will fully discount whatever information they have. The strong form hypothesis has yet to receive any substantial empirical verification. Indeed, the finding in some semi-strong form tests that the market often anticipates important announcements and transactions provides indirect evidence against the strong

\textsuperscript{137} Id. 18.
\textsuperscript{138} Id.
\textsuperscript{139} Ibbotson, \textit{Price Performance of Common Stock New Issues}, J. \textit{FINANCIAL ECONS.}, Sept. 1975, at 235. Ibbotson found that the market began to price new issues efficiently one month after the offering, suggesting, contrary to the semi-strong ECMH, that information about new issues is not incorporated instantaneously into prices. The transition from over-pricing to efficient pricing entailed negative returns for investors purchasing new offerings one month after issue, further contradicting the ECMH assertion that prices are unbiased estimates of future returns. \textit{Id.} 254-60.
Some anticipation can be ascribed to interim reports, to announcements by company officials, and to other sources that publicly disseminate important information. A portion of the observed anticipation, however, can be explained only by trading on inside or other nonpublic information. In the case of block trades, for instance, there are no interim announcements leading up to the trade, and much of the preceding price decline therefore can be ascribed to trading on advance information. Consistently with the evidence presented in the semi-strong form literature, strong form tests suggest that some investors consistently use non-public information not yet reflected in prices to outperform the market.

Initially, strong form tests focused on the performance of mutual funds rather than on corporate insiders. Mutual funds devote significant resources to collecting and processing a wide variety of securities information and employ the most comprehensive and sophisticated forms of securities analysis. In addition, the proximity of mutual funds’ management to the nation’s financial centers, their connections to market and corporate sources of non-public information, and the speed and expertise with which they can execute transactions all suggest that if anyone can earn superior profits by trading on nonpublic information, they can. Friend, Herman, and Vickers, in the first rigorous test of mutual fund performance, found that roughly half of 189 mutual funds outperformed the market while half did not. In the second major test, Sharpe found that 19 of 34 mutual funds outperformed the Dow Jones Industrial average; after correcting for fund expenses, however, only 11 of 34 outperformed. In the third and best known study, Jensen found that only 43 of 115 funds outperformed the market between 1945 and 1964. He concluded that the number of funds that consistently outperformed the market was no larger than one would expect by chance. Although some later studies tended to confirm Jensen’s findings, others

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The most recent data support the pro-fund


Even if we accept Jensen's results, a failure of mutual funds to consistently outperform the market cannot show that nonpublic information provides no advantage. First, the presumption that mutual funds have nonpublic information has not been verified. To a large degree, mutual funds rely on painstaking collection of public information and the routinized application of the results to trading strategy. An individual investor who carefully follows one stock will usually know more about that stock than the mutual fund, which follows thousands. In addition, mutual fund managers deny any possession or use of inside information, not only because its use is illegal, but more credibly, because they can never be assured of its reliability and can never know whether it has already been used and incorporated into market prices. See, e.g., Wall Street J., Aug. 13, 1980, at 29, col. 3. Management of mutual funds requires selection of reliable routines, and mutual fund managers say that collection of public information is a more reliable, less costly, less risky, and more profitable routine than trying to chase down, verify, and analyze inside information "leaks." Second, when management does receive especially valuable information, whether public or nonpublic, it may trade ahead of the fund, or share it with others who will. Third, even if management uses nonpublic information only for the fund, the institutional routines that must be completed prior to trading take far more time than is the case with an individual investor. Most decisions are made by committee. A trading decision may therefore take several days, allowing maximum opportunity for prior trading by others. Institutional decisionmaking, moreover, is notoriously public. The slowness with which all bureaucracies move may explain better than any other reason why mutuals may perform poorly as a group, and why the largest ones may perform the worst of all. Fourth, because of the significant administrative resources devoted to mutual fund decisionmaking, each trading decision must involve relatively large blocks of shares. Lower level staff are not permitted to perform discretionary trading. When higher level management reaches a decision, the decision must be major enough to justify their attention. This built-in institutional bias in favor of large block trades means that mutual funds must regularly offer discounts whenever they buy or sell. The investor who consistently discounts on both sides of the market, however, will rarely outperform the market. The alternative, spreading purchases or sales over many transactions, merely increases the likelihood of imitation. Fifth, mutual funds commonly share the same investment objectives. A trade meeting one firm's objective is likely to meet other firms' objectives. When a mutual fund decides to sell one particular stock because of changing industry conditions, it will often find that other funds have also decided to sell the same stock, along with close substitutes. Similarly, when one mutual fund buys in one industry, others will as well. This continuous competition further reduces the return any mutual can expect. Sixth, successful performance in one year attracts large numbers of new investors to the mutual fund the following year, increasing market effects, competitive imitation, and bureaucratic inertia, and, consistently with diminishing returns to scale, decreasing the likelihood that such superior performance will be continued commensurately with the increase in mutual share price caused by new investors. Finally, mutuals make up such a large proportion of the market that it is saying very little to assert that they do not outperform the market. Given the institutional constraints burdening mutuals' performance, the real mystery is why they perform as well as they do.
position.\textsuperscript{145}

Studies of the trading performance of corporate insiders also suggest that nonpublic information at times can enable its possessor to outperform the market. One set of studies analyzed insider transactions disclosed in the SEC \textit{Official Summary of Securities Transactions and Holdings}, published pursuant to section 16(b) of the 1934 Act.\textsuperscript{146} The evidence consistently showed that securities prices rose after periods of intensive insider buying and fell after periods of intensive insider selling. These effects allowed insiders, and those who observed insider transactions, to outperform the market after transaction costs.\textsuperscript{147} Even the trader who acts on the

An additional problem with the ECMH tests, particularly the strong form tests which attempt to evaluate the performance of mutual funds, stems from uncertainty regarding measurement. Where market indices are used, choice of the relevant index determines the outcome of any comparison. In 1977, for instance, the American Stock Exchange Index rose 16.4%; the NASDAQ OTC Composite rose 7.3%; the Value Line Composite (mostly comprised of NYSE companies) rose 0.5%; the NYSE Composite declined 9.3%; the Standard and Poor's 500 declined 9.3%; and the Dow Jones Industrial Average declined 17.3%. H. \textsc{Kripke}, \textit{supra} note 48, at 325. Unless one arbitrarily chooses one index, or a composite of indices, as a proxy for "market performance," one cannot specify what performance outperforms the market. Even when researchers have not relied upon existing indices but have instead constructed their own, problems with respect to the correct standard of measurement persist. Friend, for instance, found that the average annual rate of return (compounded annually) on investment in 136 mutual funds was 10.7% from January 1960 through June 1968; equal investment in all NYSE listed stocks would have earned a 12.4% return over the same period, while investment in all stocks in amounts proportional to initial market value would have earned a 9.9% return. L. \textsc{Friend}, M. \textsc{Blume} & I. \textsc{Crockett}, \textit{supra} note 9, at 19. See also Murray, \textit{supra} note 103, at 19 (large companies dominate market-weighted index and do better in downturn, worse in upturn).

\textsuperscript{145} \textsc{Elia}, \textit{Mutual Funds' 10-Year Performance to Sept. 30 Outdid Industrials and S&P 500, Survey Finds}, Wall St. J., Oct. 15, 1980, at 27, col. 4. See also Wall St. J., Dec. 30, 1980, at 21, col. 2 (Investment Company Institute report that average gain on year for mutuals was a supracompetitive 31% to December 24, 1980). Compare studies suggesting that even if some mutual funds consistently outperform the market, available statistical tools, including least squares regression analysis, are too crude to discern them. \textit{E.g.}, J. \textsc{Valentine}, \textit{Investment Analysis and Capital Market Theory} 17 (1975) ("It is statistically impossible to determine the presence or absence of a small number of capable managers if the universe of all other managers has random performance"); Hodges & Brealey, \textit{Portfolio Selection in a Dynamic and Uncertain World}, 29 \textit{FINANCIAL ANALYSTS J.} 50 (March/April 1973) (even extra returns of 5% per year must be continued for 25 years to be detected at the 95% confidence level); Murphy, \textit{supra} note 103, at 10 ("the statistical tools generally used to search for consistently good performance are too weak to find it"); Trieschman & Monroe, \textit{Investment Performance of Property-Liability Insurer's Common Stock Portfolios}, J. \textsc{Risk & Insurance}, Dec. 1972, at 545 (unable to discern statistically significant performance differences among different funds).

\textsuperscript{146} 15 U.S.C. \S 78p(b) (1976).

\textsuperscript{147} \textit{See, e.g.}, H. \textsc{Wu}, \textit{CORPORATE INSIDER TRADING, PROFITABILITY, AND STOCK PRICE MOVEMENT} (1963); Jaffe, \textit{The Effect of Regulation Changes on Insider Trading}, 5 \textit{Bell J. Econ. \& Management Sci.} 93 (1974); Wu, An Economist \textit{Looks at Section 16 of the Securities Exchange Act of 1934}, 68 \textit{COLUM. L. REV.} 260 (1968); Wu, \textit{supra} note 99, at 373.
Official Summary two months after its release can earn abnormal returns. One could infer from this evidence that insiders have nonpublic information which allows them to make more accurate predictions about their firms' prospects than the ordinary outsider. On the other hand, because the pattern of insider trades is officially disclosed within six days following each trade by an insider, one might conclude that outsiders imitate insider trading activities and that news of insider purchases automatically will increase the market price, just as news of insider sales automatically will decrease it, whether or not the insider actually has any nonpublic information. Scholes' study on the information content of secondary issues might appear to support the imitation theory. Scholes found, however, that the information content of insider transactions led to price variations of only one to two per cent, while the section 16(b) studies have found price changes of up to ten per cent. Accordingly, these strong form studies suggest that insiders do earn superior returns, beyond what can be explained by imitative trading, by using nonpublic information before it is incorporated into market prices.

Finally, a study of the marketmaking activities of New York Stock Exchange specialists demonstrated that specialists possess non-

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148 Boland, Canny Insiders: It Usually Pays to Follow Their Lead, BARRON'S, Jan. 26, 1981, at 9 (highly profitable insider purchases of Bangor Punta, Chicago Milwaukee, Clorox, Lear Siegler, Consolidated Foods, Collins Foods; "timely stock accumulation by corporate insiders is one of Wall Street's perennial coincidences"); Wall St. J., Oct. 8, 1980, at 37, col. 4 ("analysts are watching the current selling surge nervously because when the collective action of insiders is so one-sided, it tends eventually to be right"); Zweig, Canny Insiders: Their Transactions Give a Clue to Market Performance, BARRON'S, June 21, 1976, at 4. See also Jaffe, Special Information and Insider Trading, 47 J. Bus. 410 (1974) (finding that price residuals rose 5% in eight months after intensive insider purchases, with 3% occurring during last six months; suggesting that market is not very efficient at incorporating news of insider trades, and that it clearly does not do so instantaneously); Pratt & DeVere, Relationship Between Insider Trading and Rates of Return for NYSE Common Stocks, 1960-66, in MODERN DEVELOPMENTS IN INVESTMENT MANAGEMENT 268 (J. Lorie & R. Brealey eds. 1972).

149 Scholes, supra note 130.

150 Id. 200.

151 See, e.g., Jaffe, supra note 148, at 427.

152 Reliance on the SEC's Official Summary of Securities Transactions and Holdings, which reports transactions by insiders in their firms' securities disclosed pursuant to section 16(b) of the 1934 Act, has caused these insider studies to underestimate the potential gains from trading on inside information. Because of the risk of liability under rule 10b-5 for use of inside information, and under section 16(b) for short sales and short-swing profits, not all transactions by insiders are reported pursuant to section 16(b). In addition, numerous transactions fall outside the scope of section 16(b), such as transactions in which shares are obtained by gift or in connection with a debt previously contracted and transactions by tippees.
public information before it is incorporated into market price and
that they use this information to earn superior profits.\footnote{153} Although
the specialist normally discloses his highest bid and his lowest ask,
he cannot disclose other unexecuted buy and sell orders.\footnote{164} He
can, however, use such information as a guide to the likely direction
of price changes when trading for his own account.\footnote{165} Niederhoffer
and Osborne found that specialists sell above their last purchase
and buy below their last sale on more than 81\% of their trans-
actions, suggesting that nonpublic information on the specialist's
book carries a significant potential for profit.\footnote{166}

As attention shifts from the random walk or weak form ECMH,
through the semi-strong form, to the strong form, evidence tending
to show capital market inefficiencies grows. Although weak form
studies suggest that chartist methods, filter schemes, and other
methods of extrapolating from past prices cannot provide much
information beyond what is already reflected in market prices, even
in this area the evidence is not wholly conclusive; analysis of past
price trends can, in some cases, produce slightly supracompetitive
profits, at least before transaction costs.\footnote{167} Much of the evidence
cited in support of semi-strong efficiency may be explained on other

\footnote{153}Niederhoffer & Osborne, Market Making and Reversal on the Stock Ex-


\footnote{155}See text accompanying notes 294-99 infra.

\footnote{156}Niederhoffer & Osborne, supra note 153, at 908. See also Eiteman,
The S.E.C. Special Study and the Exchange Markets, 21 J. Finance 311 (1966) (supra-
competitive profits earned by specialists and floor traders).

\footnote{157}The failure of academic researchers to identify a method of profitably
analyzing historical price changes or newly-emergent public information, moreover,
does not prove that such methods do not exist or are not being used. See, e.g.,
J. LORIE & M. HAMILTON, supra note 70, at 82 (although researchers have not
found one, it is "quite possible that there exists some select method of looking at
these data which does produce superior investment results"). The ECMH, if
valid, implies that academic researchers could never identify a method of analysis
which consistently produces superior results, even if several existed. If, by chance,
a superior method of analysis became available to academic researchers for testing,
it would necessarily be a part of the public domain and its implications would
already be incorporated into stock prices. No one could earn supracompetitive
profits by using such a scheme even if the market is otherwise inefficient. Proof
that recognized trading schemes of sufficient standing to merit testing do not
produce a supracompetitive return therefore does not demonstrate that there are
no market inefficiencies, or that there are not less well-known schemes which do
produce superior results. Analysts who possess what they believe are successful
trading schemes know they can remain successful only so long as they are secret.
See, e.g., B. LEV, supra note 103, at 222 ("well-known" and "proved" analytical
tools, such as those suggested in security analysis texts or offered to the public
by investment houses, are probably useless by the time they are published). In
short, researchers will test only what cannot work. Cf. 4 J. PORTFOLIO MANAGE-
MENT (Fall 1977) (series of articles testing and verifying profitability of novel
technical and fundamental trading schemes).
grounds. At most, the semi-strong form studies show that the information content of key disclosures, such as corporate earnings announcements, normally reaches investors via more timely sources such as extrapolation from interim reports or insider trading. They do not show that the market is efficient with respect to all other public information. Finally, the strong form tests have failed to demonstrate that investors possessing nonpublic information cannot earn superior returns. The strong form tests have shown instead that insiders, specialists, and perhaps others use nonpublic information to outperform the market and that the average investor may earn supracompetitive profits merely by trading as they do. In short, although the market appears reasonably efficient at reflecting historical price information in current prices, the evidence suggests that it is less efficient with respect to current developments, and noticeably inefficient with respect to nonpublic information.168

By relying largely on New York Stock Exchange price data, moreover, the ECMH studies have necessarily overstated the relative efficiency of the national capital markets in general. The New York Stock Exchange is the most efficient capital market in the world, particularly with respect to major stocks that continuously engage investor attention. The ECMH studies, however, do not

168 Given the varying routes by which valuable information makes its way to market, the varying speeds with which it travels, and the varying ways it can be analyzed, that different types of information are impounded into stock prices at varying speeds and with varying degrees of accuracy accords with the common sense of securities professionals. There is, in addition, considerable anecdotal evidence confirming the existence of significant inefficiencies. See, e.g., Bernstein, In Defense of Fundamental Analysis, 31 FINANCIAL ANALYSTS J. 57 (Sept./Oct. 1975) (balance sheet weaknesses that caused Consolidated Edison to miss a 1974 dividend were evident for years; nevertheless, market reacted as if missed dividend were new information); Smidt, A New Look at the Random Walk Hypothesis, 3 J. FINANCIAL & QUANTITATIVE ANALYSIS 235 (1968) (Control Data stock drops 11% two days after lower earnings announced at annual meeting); Williamson, Corporate Control and the Theory of the Firm, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES, supra note 64, at 332 (market, and even customer Ford Motor Company, failed to perceive supracompetitive profits earned by Champion Spark Plug Company). Other well known examples of inefficiency are the market’s failures to anticipate the collapse of the Penn Central, the bankruptcy of W.T. Grant, and the near-bankruptcy of New York City, even though the imminence of each of these events was apparent from a cursory perusal of accounting information or the newspapers. As these cases indicate, the market may be especially inefficient with respect to bad news, because the securities industry is generally biased toward advising purchases rather than sales, overlooking profitable opportunities for short sales. In addition, short-selling is more complicated than buying and is in some cases prohibited. Because the sell side is more inefficient and the opportunities for profit there are greater, the most aggressive Wall Street hedge funds are often short sellers. See Ellis, The Loser’s Game, 31 FINANCIAL ANALYSTS J. 19 (Mar./Apr. 1975); Miller, How to Win at the Loser’s Game, 4 J. PORTFOLIO MANAGEMENT 17 (Summer 1978); Miller, Risk, Uncertainty, and Divergence of Opinion, 22 J. FINANCE 1151 (1977).
show that the market for all New York Stock Exchange stocks is equally efficient. The market is clearly less efficient with respect to the shares of small issuers not closely followed by major investment media.\textsuperscript{159} The relative lack of efficiency on regional exchanges, on foreign exchanges, and in the over-the-counter market also have attracted increasing investor attention. ECMH studies do not support the conclusion that the nation's capital markets are equally efficient with respect to all types of securities, on all exchanges, at all times.\textsuperscript{160}

\textsuperscript{159} The Financial Analysts Federation reported to the SEC in 1977 that professional analysts were following only 10% of the companies reporting under the 1934 Act. H. Kupfer, supra note 67, at 85-86.

\textsuperscript{160} Infirmities in the theoretical foundations underlying the ECMH further undermine the conclusions of ECMH theorists. Samuelson and Mandelbrot showed that a market will be efficient under conditions of perfect competition that concededly do not fit reality. Mandelbrot, Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models, 39 J. Bus. 242 (1966); Samuelson, Proof that Properly Anticipated Prices Fluctuate Randomly, 6 INDUS. MANAGEMENT REV. 41 (Spring 1965). Fama, however, has argued that these conditions are sufficient but not necessary to guarantee efficiency and has suggested a diluted set of necessary conditions. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, supra note 102, at 387-88. Even assuming Fama's theory to be correct, several studies conclude that market activity does not conform even to these diluted conditions. See generally, Downes & Dyckman, A Critical Look at the Efficient Market Empirical Research Literature As It Relates to Accounting Information, 43 ACCOUNTING REV. 300, 309-16 (1973) (existence in capital markets of, inter alia, monopoly power, information costs, taxes, and transaction costs).

Although Fama may have rescued market efficiency by substantially diluting its factual predicates, no one has rescued by similar means the theoretical keystone of the ECMH and all its tests—the Capital Asset Pricing Model (CAPM). See Lintner, The Valuation of Risky Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, 47 Rev. Econ. & Statistics 13 (1965); Sharpe, Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, 19 J. Finance 425 (1964). Each of the most sophisticated ECMH studies has relied on the CAPM to compare returns for differing securities and portfolios. Because perfect efficiency is one of the conditions required to validate the CAPM, however, the CAPM in effect presumes efficiency. Perfect efficiency is also one of the conditions required to validate the Markowitz-Sharpe Market Model (MSMM), upon which the CAPM is based. See Sharpe, A Simplified Model for Portfolio Analysis, 9 MANAGEMENT Sci. 277 (1963). According to Lorie and Hamilton, the chasm between these necessary conditions and reality may seem "so absurd that the model itself appears unworthy of serious consideration." J. Lorie & M. Hamilton, supra note 70, at 200. See also T. Copeland & J. Weston, supra note 103, at 210. Empirical tests of the validity of the CAPM have shown that it cannot reliably measure investment performance. See, e.g., Charles River Associates, supra note 47, at 309-22 (rejecting use of CAPM in venture capital study); Black, Jensen & Scholes, The Capital Asset Pricing Model: Some Empirical Tests, in STUDIES IN THE THEORY OF CAPITAL MARKETS, supra note 103, at 79; Jackson, Market Psychology and the PSI Theory, 4 J. PORTFOLIO MANAGEMENT 35 (Summer 1978); Jensen, The Foundations and Current State of Capital Market Theory, in STUDIES IN THE THEORY OF CAPITAL MARKETS, supra note 103, at 3; Miller & Scholes, Rates of Return in Relation to Risk: A Re-examination of Some Recent Findings, in STUDIES IN THE THEORY OF CAPITAL MARKETS, supra note 103, at 47.

A similar source of bias in the ECMH tests is their reliance on a micro-economic theory of pricing (of which the CAPM and the MSMM are merely two
Although Professor Posner and others have viewed the ECMH studies as proof that aggressive trading schemes cannot outperform the market, leaving index funds that attempt to mimic the market as the only prudent investment strategy, the evidence does not fairly support that conclusion. While the ECMH studies have demonstrated that potential gains from research, analysis, and quick trading are greatly exaggerated in the popular literature, they have not shown that such activities are a complete waste. Research activity based solely on public information can under some circumstances pay for itself. The greatest gains, however, are likely to come through possession of inside information or other forms of nonpublic information, including outside information, that have not yet been incorporated into market prices.

The existence of perfect efficiency normally creates an almost irrebuttable presumption against regulation, because perfect efficiency is more likely than regulation to provide pareto optimality. If the ECMH were completely valid, and capital markets were perfectly efficient, there would be no need for regulation because the existence of market prices incorporating all relevant information would make manipulation and fraud theoretically impossible. Where the market is not perfectly efficient, however, there is no irrebuttable presumption against regulation. Regulatory action, which in a perfectly efficient market would cause a net loss of efficiency, may be justified if it offsets existing inefficiencies. In a monopolistic market, for instance, regulation may offset monopolistic inefficiency, leading to a more efficient result than would obtain in the absence of regulation.\footnote{162}

Given the existence of varying degrees of inefficiency in the nation’s capital markets, the ECMH studies do not support the claim that the 1933 and 1934 Acts’ system of compelled disclosure of many implied conclusions), which must itself rely on an assumption of efficient markets for its validity. Microeconomic theory posits that in a market with no observable inefficiencies, equilibrium price will provide the best indicator of value. Economists assume that price is always the best indicator of value and generally incorporate other efficiency assumptions, such as the equivalency between price, marginal cost, and expected return, in a variety of subsidiary calculations necessary to design tests of any economic phenomena, including efficient markets. By the time a test of inefficiency is constructed, it is built on many layers that assume efficiency for their validity. The CAPM and the MSMM are only two components of sophisticated economic analysis that take life from the assumption that markets are efficient.


\footnote{162 See, e.g., Markovits, A Basic Structure for Microeconomic Policy Analysis in Our Worse-Than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics, 1975 Wis. L. Rev. 950.}
is superfluous. All available information does not reach the market in advance of compelled disclosure. Trading on insider reports filed pursuant to section 16(b) of the 1934 Act, for instance, can lead to supracompetitive profits, suggesting that other reports also may contain new bits of valuable information that otherwise would not be disclosed. Even if it were shown that 1933 and 1934 Act filings contained no new information, these filings nevertheless may improve market efficiency by inducing and acting as a check on other disclosures. Corporate officers know that at some point they must provide accurate information in compliance with reporting requirements. The incentive to delay disclosure of material information or to disclose misleading information is therefore reduced, as either activity soon would be exposed.\textsuperscript{163} If there were no required 1933 and 1934 Act filings acting as a check on earlier disclosures, investors could not place as much faith as they do in alternative and often more timely media. Even convincing proof that investors do not rely directly on official filings, but instead anticipate their content by seeking out other sources, cannot demonstrate that compelled disclosure under the 1933 and 1934 Acts does not indirectly contribute to market efficiency. Finally, the existence of significant inefficiencies with respect to inside information and other forms of nonpublic information belies the twin ECMH claims that insiders do not possess a trading advantage and that outsiders can never be cheated because the market price at which they transact will always reflect all information.

The 1933 Act registration requirements are a good example of the way regulation aimed at a particular source of inefficiency can produce a more efficient result. In the case of new issues, information about the issuer is not generally available. A new issuer has not filed 1934 Act reports, may have no public earnings history, and may not have received close attention from analysts. Without registration, the new issuer comes to market as a mystery, holding a monopoly on information about itself, a monopoly that can be broken only if some investors are willing to incur substantial transaction costs. Because laissez faire here will lead to significant inefficiencies, the second best solution is to require registration and disclosure by the issuer, who is the least-cost information gatherer and discloser. Allowing investors to enforce these provisions creates a countervailing power that will offset the inefficiency arising from the issuer's monopolistic control over information about itself. Because the issuer ordinarily will possess information about itself

\textsuperscript{163} See text accompanying notes 66-73 supra.
for other reasons, compelled disclosure will not reduce the total amount of information produced. By restricting regulation to a specific area of inefficiency, the 1933 Act registration provisions neutralize that inefficiency without disturbing other areas of the market that may be efficient.\textsuperscript{164}

Although trading on outside information also involves exploitation of an informational monopoly apparently inconsistent with perfect information and efficiency, close examination of costs and benefits does not support increased regulatory action in this area. On the benefits side, requiring disclosure of outside information will minimize or remove trading losses experienced by investors who trade with persons possessing valuable outside information. Because these trading losses are exactly counterbalanced by the trading gains earned by those who possess outside information, however, these losses are of no consequence unless the law, for independent reasons, favors the uninformed or disfavors all such transfers. Trading on outside information might, for instance, offend established notions of fair play, thereby undermining investor confidence in the securities markets. The perceived need to encourage investor confidence is generally cited as the most important justification for the prohibition against insider trading. Yet the available evidence suggests that many investors trade on inside information coming into their possession and that they expect others to do so as part of the gamble of investing in the stock market.\textsuperscript{165} One may reasonably ask whether the effort to instill confidence actually misleads the unsophisticated by suggesting that

\textsuperscript{164} This analysis also applies in varying degrees to regulation of proxy contests and tender offers.


In a \textit{Harvard Business Review} survey on businessmen's ethics, 42% of the businessmen sampled said they would trade on advance news of a merger, and 62% believed that the average executive would. The author concluded that "[a]ctual business practice . . . is probably closer to what respondents say 'the average executive would do' . . . than it is to what they say 'I would do.'" Baumhart, \textit{How Ethical Are Businessmen?}, 39 Harv. Bus. Rev. 6, 16-21 (1981). Commissioner Cary concluded from this evidence that there was a "surprising, and perhaps shocking, number of executives [who] feel that it is perfectly reasonable conduct to use inside information for their personal benefit." Cary, \textit{The Direction of Management Responsibility}, 18 Bus. L. Rev. 29, 33 (1962). \textit{See also} sources cited at notes 147-48 \textit{supra}; Jaffe, \textit{supra} note 148 (tightened enforcement of insider trading rules after \textit{Cady, Roberts} and \textit{Texas Gulf Sulphur} had no statistically significant effect on insider trading).
the stock market is a more secure investment than it really is.\textsuperscript{166} In any event, the argument from fairness and confidence becomes even more attenuated with respect to outside information, because use of outside information presents less of a conflict with fiduciary duties and investor expectations.

The costs of overbroad regulation of outsider trading, however, are potentially more significant. The absence of perfect efficiency implies that existing resource allocation can be improved. Capital markets will be made more efficient and resource allocation will be improved if information can be brought to market and incorporated into security prices more quickly. Giving possessors of outside information a right to trade without disclosure will preserve the necessary incentives. While corporations necessarily produce information about themselves, production of outside information depends on the existence of sufficient rewards. If a general duty to disclose valuable outside information were imposed on investors, the problems associated with the public good aspect of outside information would threaten to extinguish the incentives necessary for private analysis. Although making outside information freely available would, in the abstract, maximize the increasing returns to scale associated with information production, no outside information will be produced without some financial incentive to the producer.\textsuperscript{167}

\textsuperscript{166} Increased investor participation in the stock market benefits public corporations directly, by increasing the supply of capital available in the equity markets and thereby lowering corporations' cost of capital.


The theory of comparative advantage, and its derivative, the theory of least-cost avoidance, see Calabresi & Melamed, \textit{Property Rules, Liability Rules, and Inalienability: One View of the Cathedral}, 85 HARV. L. REV. 1089 (1972), do not support increased regulation of outsider trading. Arguably, if one views outsider trading as fraudulent and therefore costly, the person who possesses the outside information should disclose his information and thereby avoid these ill effects more cheaply than anyone else can by ferreting it out. Placing a burden of disclosure on the possessor of outside information will also apparently minimize transaction and negotiation costs, as the possessor can unilaterally disclose the information. In determining the cost to the knowledgeable party of preventing error (by disclosing information), however, the investment that has been made in acquiring the information also must be counted. This investment will represent a net loss to the possessor of outside information and an increase in transaction costs if the other party can enforce a duty of disclosure. On this analysis, the possessor of outside information is not necessarily the cheapest cost avoider. More importantly, because outsider trading brings benefits that outweigh its costs, we should seek no least-cost avoider. Imposing a duty to disclose on grounds of comparative advan-
Trading on outside information does not create inefficiency; rather, it is one of the ways in which the market removes informational inefficiencies and corrects itself. In theory, an efficient market reflects all relevant information. In practice, an efficient market preserves incentives for the collection and incorporation into prices of all information. The available evidence suggests that the most sophisticated trading strategy, and the one most likely to contribute to efficiency, depends on exploitation of outside information not so public as to be impounded into prices; trading on any other information is either illegal or largely a waste of time. The SEC, however, has sought to regulate and in many cases prohibit use of outside information. The SEC contends that all traders must trade solely on the basis of public information that, to varying degrees, is already incorporated into existing prices and therefore offers little, if any, opportunity for gain. Ironically, the SEC would permit only the least sophisticated form of trading and the one least likely to contribute significantly to an efficient allocation of resources.

The advantage in avoiding cost will instead interfere with a comparative advantage in creating benefits. Market incentives are the cheapest way to bring valuable information to market. Rather than giving the nonpossessor of outside information a right to require disclosure, efficient allocation requires recognizing in the possessor of outside information a right to trade without a special risk of liability. Although the Coase Theorem, see Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960), states that an efficient allocation will result independently of the location of property rights and the imposition of liability in a world with perfect information and without transaction costs, the existence of informational inefficiencies and transaction costs requires that the property right in outside information be left with its possessor. If there were perfect information and no transaction costs, the location of property rights and potential liability for fraud would have no effect because fully informed investors would freely transact at a market price reflecting all information, making fraud impossible, even if it could be hidden consistently with full information. In addition, in a market that is ex hypothesi efficient there is no need for incentives to search out special information. But where informational efficiencies and transaction costs exist and prices do not reflect all information, investors will search out information necessary to reduce inefficiency only if the search brings a return. The search will bring a return only if the possessor of outside information has a right to trade on it. The structure of property rights and liability rules therefore makes a difference. In addition, although Coase acknowledged that perfect information and the absence of transaction costs were essential predicates to his theorem, so are the other aspects of perfect competition and efficient markets. If some actors possess monopoly power, for instance, an efficient allocation will not result independently of the location of property rights and liability; strategic placement of property rights and liability will in some cases exacerbate and in other cases offset inefficiencies created by monopoly power and other sources of inefficiency. See also Calabresi & Melamed, supra (distribution of initial entitlements and wealth may interfere with pareto optimality when market is otherwise efficient); Markovits, The Causes and Policy Significance of Pareto Resource Misallocation: A Checklist for Micro-Economic Policy Analysis, 28 Stan. L. Rev. 1 (1975) (externalities and consumer irrationalities may interfere with pareto optimality when market is otherwise efficient).
II. LEGAL APPROACHES TO OUTSIDE INFORMATION

In its approach to trading advantages based on inside and outside information, the SEC has traditionally focused on fairness and equity, and has given these concerns at least equal weight with efficiency. The SEC's emphasis on fairness appears most clearly in its advocacy of a regime of equality, in which all investors trade on the basis of equal information, or at least equal access to all available information. The SEC's advocacy of an equal access or parity-of-information rule can be traced to Charles Hughes & Co. v. SEC, the case in which the Second Circuit accepted the SEC's argument that "[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreaching of those who do." \(^{168}\) In Cady, Roberts & Co., SEC Chairman Cary emphasized "the inherent unfairness involved where a party takes advantage of [inside] information knowing it is unavailable to those with whom he is dealing." \(^{169}\) In SEC v. Texas Gulf Sulphur Co., the Second Circuit endorsed the SEC contention that rule 10b-5 is "based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." \(^{170}\) The Second Circuit once again accepted this argument in Chiarella v. United States.\(^{171}\) In its rule 19b-2 release, the SEC identified as a major policy goal "the removal or limitation of the special trading advantages which any one group or classification of investors holds over another." \(^{172}\) More recently, the SEC's tender offer rules seem to proceed from a parity-of-information premise.\(^{173}\) Although on

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\(^{168}\) 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).


\(^{170}\) 401 F.2d 833, 848 (2d Cir. 1968) (citations omitted), cert. denied, 394 U.S. 976 (1969).


occasion there have been suggestions that the Commission has not adopted a policy of absolute equality of information for all investors, it has, particularly in litigation, consistently endorsed a policy requiring equal access.

This parity policy has fueled the SEC's historic antagonism toward the use of outside information. A policy which seeks equality cares little whether inequalities stem from inside or outside information. Parity does not demand the existence of a fiduciary or analogous relationship to require disclosure. The SEC, as a result, has sought to regulate the use of outside information by tender offerors, specialists, floor traders, institutional investors, and other market professionals, and has sought to prohibit certain uses by others, such as printers, government officials, and columnists. If construed to prohibit all informational advantages, however, the parity policy will lead to overregulation and inhibition of the research and analysis essential to market efficiency. Even if construed to require only theoretically equal access to relevant information, the parity policy risks overbreadth: the best proof of unequal access is most likely to be unequal results. Commentators have therefore viewed such a policy with caution, and the Supreme Court has explicitly rejected it.

Although many economists have advocated a laissez faire policy permitting unfettered exploitation of outside (and, in some cases, inside) informational advantages, and the SEC has generally advocated a policy of market egalitarianism and disclosure, legal scholars


175 See, e.g., Lipton, Rule 10b-5: The End of Isolation and New Thresholds of Materiality, in PRACTISING LAW INSTITUTE, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 311 (1974). Professor Loss has called this policy "market egalitarianism." Loss, The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States, 33 MOD. L. REV. 34, 35 (1970). See also Bromberg, Corporate Information: Texas Gulf Sulphur and Its Implications, 22 SW. L.J. 731, 736 (1968) ("It is an egalitarian idea . . . that all investors shall have relatively equal access to material information").

176 A variant of the parity policy is the special access test. Like the parity policy, the access test is not sufficiently refined, since the question to be resolved is when special access to certain non-issuer sources of nonpublic information creates a duty to disclose.

177 Chiarella, 445 U.S. at 232-33. Perhaps because of the concerns raised in the investment community by the SEC's advocacy of a parity theory, in 1973 the Commission solicited comments with respect to "the appropriateness of utilizing nonpublic material information directly related to the future market for a given security, which does not emanate from or concern the issuer of that security." SEC Exchange Act Release No. 10316 (August 1, 1973), [1973] 214 SEC. REC. & L. REP. (BNA) at D-1. Public response was almost uniformly negative. Commentators argued that use of outside information should not be restricted, because of the detrimental effects on market incentives and the impossibility of effective regulation.
have tended to take a position somewhere in between. In their groundbreaking 1973 article, Fleischer, Mundheim, and Murphy suggested a modified "fairness" approach, which would require balancing efficiency values against equality values implicated by specific market activity.  

Looking to whether "it is fair for the investor to trade on the basis of the superior knowledge he possesses," this approach would require "in each instance a careful examination of the role of the party whose actions are complained of, the nature of the alleged wrongdoing, and the expectations of the aggrieved parties." They recognized, however, that this balancing approach would substitute for clear standards a "vague guideline [which] . . . could place undesirable inhibitions on investor trading [and which] . . . easily blur[s] into acceptance of a requirement of parity . . . ." Accordingly, they concluded that application of the fairness approach should require disclosure only if such a duty is established by explicit legislation or a "special relationship" between the parties.

Two subcommittees of the American Bar Association articulated a similar position in a 1973 "Comment Letter on Material, Non-Public Information." Rejecting at the outset "ultimate equality of information for investors," the ABA Comment Letter noted that "not every failure to disclose material information constitutes a violation of the antifraud rules." Rather than subject use of outside information to a general duty of disclosure under rule 10b-5, the ABA Comment Letter concluded that "a special relationship between the parties’ and an ‘independent duty to disclose’ is particularly important in imposing requirements or inhibitions to the full utilization of ‘outside facts.’" Like the Supreme Court in Chiarella, however, the ABA letter failed to indicate precisely what relationships and circumstances would be sufficient to impose a duty to disclose such outside facts.

More recently, Professor Brudney has advocated a rule barring securities transactions whenever one party possesses an informational advantage, regardless of the type of information or its source, that

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179 Id. 817, 822.
180 Id. 817.
181 Id. 822.
183 Id. D-2, D-6.
others cannot lawfully overcome.185 Under this approach, investors cannot exploit “lawfully unerodable” informational advantages, aside from information concerning their own actions.186 Possession of any nontrivial outside information, however, confers what is in effect an “unerodable” informational advantage.187 Brudney's approach, therefore, does little to advance analysis beyond the parity position. Granted that use of public information is legitimate, the question is whether and under what circumstances rule 10b-5 should prohibit trading on unerodable outside information. To the degree that Brudney's formula suggests that an investor should never be permitted to trade on outside information that others cannot obtain through reasonable diligence, that formula is overbroad and would interfere with the incentives necessary to maintain efficient capital markets. Existing law permits, under specified circumstances, trading by stock exchange professionals, tender offerors, institutional investors, investment bankers, and others despite their possession of information the public could never duplicate by legal means.188

Reliance on a concept of unerodable advantage introduces a degree of uncertainty that exacerbates the overbreadth inherent in this approach. Not only all nonpublic information, but also many kinds of public information, once analyzed and refined, could be construed to confer an unerodable advantage. Although Brudney states that investment advice available only for a price is not for that reason “lawfully unobtainable,”189 the investor who devotes significant resources to market research, the airplane passenger who sees a plant engulfed in flames, and even the inventor of a new oil pump all possess informational advantages which in practice cannot be lawfully overcome. For these reasons, among others, the Supreme Court in Chiarella refused to endorse Brudney's analysis, explicitly holding that rule 10b-5 does not prohibit use of all nonpublic information or exploitation of all unerodable informational advantages.190

186 Id. 357, 376.
187 Brudney defines nonpublic information as “information that investors may not lawfully acquire without the consent of the source.” Id. 322 n.2. Nonpublic information, however, may be both lawfully acquired and improperly used, as when a corporate employee acquires corporate information for corporate purposes but uses that information to obtain personal profits.
188 See, e.g., Chiarella, 445 U.S. at 233-34.
189 Brudney, supra note 185, at 361.
The American Law Institute's Federal Securities Code (the Code) has adopted a wait-and-see position with respect to outside information, so long as it is not used by a corporate insider or his tippee. Section 1603 of the Code makes it unlawful to trade on the basis of any nonpublic information in the securities of an issuer as to which the trader is an insider or tippee of an insider, whether the information be inside information emanating from the issuer or outside information obtained from other sources. Under the Code, an insider trading in his company's shares can no longer hope to avoid liability by showing that he obtained nonpublic information only from outside sources with no relation to his company. Although the Code apparently provides an expanded concept of insider liability, it will in practice have a negligible effect, because insiders rarely obtain valuable information about their company's securities except by virtue of their position with the company.

Although the Code imposes liability on insiders for trading on any nonpublic information, it makes no provision for imposing liability on outsiders for use of outside information beyond section 1602(a)(1)'s prohibition of any "fraudulent act." Professor Loss, the Code's reporter, states in his commentary to section 1603 that "it is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a 'tippee.' . . . Section 1603 reflects no universally applicable theory of 'market egalitarianism.'" Loss believed it would be "convenient" to have a new category of quasi-insiders to cover persons with special access to sources of outside information, but he found it "difficult in the abstract to opine even on illustrative cases" and concluded that "this area must be left to further judicial development." Some development occurred with the emergence of the "market insider" concept in the Second Circuit's opinion in Chiarella. The Supreme Court's rejection of that approach, however, requires the development of new principles to deal with the problems posed by trading on outside information.

191 ALI FED. SEC. CODE (Mar. 1978 Draft) [hereinafter cited as CODE].

192 See also CODE, supra note 191, § 1603, Comment 2(j).

193 Even if the insider obtains information about his employer independently of his relationship with the company, common law fiduciary principles may require disclosure of all material information to shareholders when trading. See RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

194 CODE, supra note 191, § 1603, Comment 3(d).

195 Id.
III. A Purpose Test for Outsider Trading

A. The Common Law Approach

Section 10(b) and rule 10b-5, like other provisions of the federal securities laws, were designed in part to remedy perceived defects in the common law. A plaintiff pursuing a common law action for fraud or deceit was required to prove misrepresentation of a material fact, as well as scienter, reliance, causation, privity, and damages. Although there were exceptions, the early common law, grounded in an individualistic ethic and tradition of caveat emptor, permitted exploitation of many informational advantages in trading, provided there was no affirmative misrepresentation. According to Page Keeton, writing in 1936, “silence or non-disclosure, however morally censurable it may be, cannot constitute fraud.” Pure silence, as distinguished from a half-truth, is, even today, generally not actionable at common law, unless one party “by concealment or other action intentionally prevents the other from acquiring material information,” or is under a duty to disclose “because of a fiduciary or other similar relation of trust and confidence . . . .”

196 Negligent misrepresentation did not support an action for damages. Derry v. Peek, 14 App. Cas. 337 (1889).


198 Keeton, Fraud—Concealment and Non-Disclosure, 15 TEX. L. REV. 1 (1936). See also Peek v. Gurney, L.R. 6 E. & I. App. 377 (1873); 2 J. KENT, COMMENTARIES ON AMERICAN LAW § 484-85 (“The common law affords to everyone reasonable protection against fraud in dealing; but it does not go the romantic length of giving indemnity against the consequences of indolence and folly, or a careless indifference to the ordinary and accessible means of information”). Non-disclosure was merely nonfeasance.

199 See, e.g., SEC v. Great Am. Indus. Inc., 407 F.2d 453 (2d Cir. 1968), cert. denied, 395 U.S. 920 (1969) (although there is no independent duty to disclose in arm’s length transaction, once defendant speaks, rule 10b-5 requires that he speak the whole truth).


201 Id. § 551(2)(a). See generally G. BOWER, THE LAW RELATING TO ACTIONABLE NON-DISCLOSURE (1915); J. KENT, supra note 198, at 482-92; W. STORY, A TREATISE ON THE LAW OF CONTRACTS §§ 516-24 (2d ed. Boston 1847). The types of confidential or fiduciary relations that supported a duty to disclose were confined within narrow limits, for example, principal and agent, trustee and cestui, parent and child, guardian and ward, and attorney and client. The relationship of tenants in common, for instance, did not in the absence of fraud carry with it a duty of full disclosure. Neill v. Shamburg, 158 Pa. 263, 27 A. 992 (1893). In addition, certain types of contracts, such as those of suretyship and guaranty, insurance, and partnership, were deemed to create confidential relations. See generally G. BOWER & A. TURNER, THE LAW OF ACTIONABLE MISREPRESENTATION 102-03 (1974); W. PROSSER, THE LAW OF TORTS 697 (4th ed. 1971). For additional isolated exceptions, see id. 697-98.
In the well-known case of *Laidlaw v. Organ*, a New Orleans tobacco merchant purchased a large quantity of tobacco at depressed prices after receiving advance news of the Treaty of Ghent ending the War of 1812. When the news of peace became public, and the British lifted their blockade of New Orleans, the value of the tobacco increased greatly. The Supreme Court held that failure to disclose the news of peace did not constitute fraud. Similarly, if a buyer knows that a railroad will soon be constructed near certain property, failure to disclose this information when purchasing the property is privileged. Another line of cases holds that a buyer of real estate who knows of valuable minerals or other resources underlying the property is not required to disclose his knowledge. Although a seller of real estate might be required to disclose to a buyer latent defects, the seller is presumed to know what he is selling and generally cannot enforce on the buyer any disclosure obligation with respect to the property sold. Early common law cases even allowed the seller to remain silent with respect to latent defects, and in some states that doctrine has lasted well into this century.

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204 See, e.g., Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933); Caples v. Steel, 7 Or. 491 (1879); Fox v. Macketh, 30 Eng. Rep. 148 (1788). See also Hotchkyn v. Third Nat'l Bank, 127 N.Y. 329, 27 N.E. 1050 (1891) (buyer has no duty to disclose insolvency when purchasing on credit). Cf. 3 S. Williston, *Contracts* § 1521, at 2707 (1920) (arguing buyer should have duty to disclose insolvency when buying on credit).


206 See, e.g., Swinton v. Whittinsville Savings Bank, 311 Mass. 677, 42 N.E.2d 808 (1942) (no duty to disclose termite infestation). See also Hendrick v. Lynn, 37 Del. Ch. 402, 144 A.2d 147 (1958); PBR Enterprises v. Perren, 243 Ga. 250, 253 S.E.2d 765 (1979); Feges v. Sherrill, 218 Md. 472, 147 A.2d 223 (1958); Perin v. Mardine Realty Co., 5 A.D.2d 685, 168 N.Y.S.2d 647 (1957). By contrast, the Roman law at one time apparently insisted upon full disclosure and a strict equality of information. See G. Bowim, *supra* note 201, App. C, § 2. Cicero cited a case where a trader sent corn from Alexandria to Rhodes where there was a famine and sold the corn at vastly inflated prices, withholding the information that he had passed on the way other ships loaded with corn heading for Rhodes. Cicero argued that the law should not permit one to profit by such conduct because it was against the law of nature for one man to profit by the ignorance of another. See 3 M. Cicero, *Decl Oficis* (Loeb Classical Library 1975). The common law, however, took a contrary view, and Cicero's theory was criticized by Pothier, Grotius, Puffendorf, Kent, Story, and Fry. See G. Bowim, *supra* note 201, App. C, § 2. Section 472(1)(b) of the *Restatement of Contracts* (1932), for instance, provided that "there is no duty of disclosure, by a party who knows that the other party is acting under a mistake as to undisclosed material facts, and the mistake if mutual would render voidable a transaction caused by relying thereon . . . ."
Although the early common law permitted exploitation of a variety of informational advantages, the later common law permitted rescission in most cases of mutual mistake,\(^{207}\) and also in some cases of unilateral mistake where one party was mistaken and his mistake was known (or should have been known) by the other party.\(^{208}\) Kronman has suggested economic efficiency as a means of rationalizing the common law privilege of nondisclosure with the duty of disclosure in certain cases of unilateral mistake.\(^{209}\) He argues that nondisclosure was permitted when the knowledge involved was the product of a costly search, such as would normally be the case when the information concerns market conditions or the value of securities.\(^{210}\) Allowing nondisclosure under these circumstances preserves incentives for desirable entrepreneurial activity. By contrast, in cases requiring disclosure, such as cases involving a unilateral mistake known to the other party or the failure to disclose latent defects in real estate, the knowledgeable party's informational advantage usually is not the fruit of a deliberate search. Because such information typically emerges as the result of mere chance, or would be acquired despite the imposition of a duty to disclose, a disclosure requirement in these cases will contribute to better informed transactions and efficiency without reducing the amount of such information actually produced.\(^{211}\) In cases of unilateral mistake known to the other party, the party who is aware of the mistake is the "last clear chance" cheaper-cost avoider because he has made no investment in the information, which will be produced whether or not there are legal incentives.\(^{212}\) This analysis distinguishes insider trading from most cases of trading on outside information. Kronman does not examine common law cases permitting rescission on the basis of mutual mistake, but these cases also confirm the efficiency principle, because a transaction in which both parties are under a misapprehension concerning the true facts is likely to be an inefficient one. While this analysis does not adequately explain the tendency of the common law to permit

\(^{207}\) See Restatement of Contracts § 502 (1932).

\(^{208}\) See 3 S. Williston, Contracts § 1548 n.47, § 1557 n.89 (1920). See also Restatement of Restitution § 12 (1936). But see Restatement of Contracts § 472 (1932).


\(^{211}\) Kronman, supra note 209, at 9.

\(^{212}\) Id. 8.
nondisclosure in situations where the knowledgeable party obtained information fortuitously,\textsuperscript{213} it does suggest that efficiency concerns played an important role in creating and limiting whatever disclosure duties were imposed.\textsuperscript{214}

Although the common law tolerated exploitation of many informational advantages, it never condoned informational advantages obtained by a tortious or illegal act, but denied to the wrongdoer the fruits of his wrongdoing even if he otherwise would have been permitted to exploit the type of informational advantage at issue. According to Bower and Turner, "suppression by a purchaser of facts affecting the value of the property which are not merely within his own knowledge, but [are] the issue of his . . . wrongful action, is equivalent to a misrepresentation."\textsuperscript{215} In an early English case, a purchaser of a mine concealed from the vendor information he had obtained by secretly trespassing on the property and mining the coal.\textsuperscript{216} Although ordinarily the purchaser would not be required to disclose what he knew about the value of the mine, the court held that the trespass created a duty to disclose any information so obtained. According to Keeton, "[a]ny time information is acquired by an illegal act . . . there should be a duty to disclose that information . . . ."\textsuperscript{217}

In an analogous area, common law trade secret cases granted relief when information was tortiously acquired, as by theft or bribery. In \textit{Tabor v. Hoffman}, a manufacturer wrongfully induced a contractor possessing plaintiff's machinery patterns to allow him to copy them. The court denied the manufacturer the benefits of the information and awarded damages. According to the court, "because this discovery may be by fair means, it would not justify the use of unfair means, such as the bribery of a clerk."\textsuperscript{218} In

\textsuperscript{213} In \textit{Laidlaw v. Organ}, 15 U.S. (2 Wheat.) 178 (1817), for instance, the Supreme Court found the nondisclosure to be privileged even though the information was obtained by chance rather than through a costly search. Kronman suggests that this result can nevertheless be justified on the ground that the type of market information at issue in \textit{Laidlaw} usually was obtained through a deliberate effort and that a case-by-case analysis of market information cases to separate out instances where the information was obtained fortuitously would not be worth the effort. Kronman, \textit{supra} note 209, at 17-18.

\textsuperscript{214} See generally M. Horwitz, \textit{The Transformation of American Law} (1978).

\textsuperscript{215} G. Bower & A. Turner, \textit{supra} note 201, at 107.

\textsuperscript{216} Phillips v. Homfray, L.R. 6 Ch. 770 (1871).


\textsuperscript{218} 118 N.Y. 30, 23 N.E. 12 (1889).
Ohio Oil Co. v. Sharp, the court held that a third party who had induced a geophysicist to disclose confidential information concerning an oil company survey was a constructive trustee. According to the Restatement of Torts, "[a]mong the means which are improper are theft, trespass, bribing or otherwise inducing employees or others to reveal the information in breach of duty, fraudulent misrepresentations, threats of harm by unlawful conduct, wire tapping, procuring one's own employees or agents to become employees of the other for purposes of espionage, and so forth."

Prohibiting use of information obtained by an illegal or tortious act is consistent with the common law's concern to promote economic efficiency. A privilege to exploit information improperly obtained would reduce the incentive to invest in legitimate information production by exacerbating free rider problems and by placing on producers the risk of misappropriation. Less information would be produced, because at least some producers would shift resources from additional production to theft of what others had produced. In addition, tolerance of theft offends common morality and undermines confidence in the fairness of the securities markets, further decreasing economic efficiency.

Because officers, directors, and controlling shareholders do not normally obtain inside information through illegal or tortious acts, and were not, until recently, treated as fiduciaries, insiders who purchased or sold stock in their corporation were generally not subject to a duty to disclose at common law. The "majority," or "strict," common law rule imposed on insiders a fiduciary obligation only to the corporation and not to its stockholders; insiders could therefore trade in the securities of the corporation without disclosure so long as there was no misrepresentation, half-truth, or

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219 135 F.2d 303 (10th Cir. 1943). Courts also have found for plaintiffs in unfair competition cases in which defendants used knowledge that they themselves did not obtain illegally or tortiously, but which they knew was revealed by mistake or in breach of obligation. In Pressed Steel Car Co. v. Standard Steel Car Co., 210 Pa. 464, 60 A. 4 (1904), for instance, the court held a manufacturer to be a constructive trustee when a railroad that received blueprints from one of its suppliers revealed them to the manufacturer in an effort to foster greater competition. Even when disclosure was received innocently, and notice of breach of duty was received only at a later time, the information was held to be inequitably retained. See Vulcan Dethinning Co. v. American Can Co., 75 N.J. Eq. 542, 73 A. 603 (Ct. Err. & App. 1909). See generally Restatement of Restitution § 201(2) (1936).

220 Restatement of Torts § 759, Comment e (1939). See also Jackson v. Smith, 254 U.S. 586 (1920); In re Calton Crescent, Inc., 173 F.2d 944, 951 (2d Cir.), aff'd sub nom. Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949); Midstate Amusement Corp. v. Rivers, 54 F. Supp. 738 (E.D. Wash. 1944); Restatement (Second) of Agency §§ 388, 395 (1957) (agent must account to principal for use of confidential information); Restatement of Restitution §§ 200, 201 (1936); Restatement of Torts § 757(a) (1939).
active concealment. The “minority,” or “fiduciary,” rule, however, imposed on insiders a fiduciary obligation to both the corporation and its stockholders; in jurisdictions adhering to this newer rule, insiders were treated as trustees and were required to disclose all material facts before purchasing their company’s securities.

In Strong v. Repide, the Supreme Court adopted an intermediate position, holding that the insider’s duty of disclosure depended on the existence of “special facts.”

B. Section 10(b) and Rule 10b-5

Until recently, legal commentary, SEC administrative actions, and decisions at all levels of the federal judiciary have charted an almost unbroken expansion of the reach of section 10(b) and rule 10b-5. Recent Supreme Court decisions cutting back on this trend, however, have required closer attention to both the legislative history and language of these provisions. Neither give any indication that these provisions were intended to expand upon the most progressive common law rules. Rather, the available evidence suggests that section 10(b) and rule 10b-5 were intended to remedy perceived deficiencies in the less restrictive common law rules by federalizing the most progressive, without going beyond them to reach all outside information.

Section 10(b) was designed to deal primarily with manipulative and deceptive devices that artificially affect stock prices, and not

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223 213 U.S. 419 (1909). In Strong, the defendant was the controlling stockholder and general manager of a corporation that owned land in the Philippines. Because of the government’s failure to police guerrilla activity, the land was believed virtually worthless. Defendant, however, had entered into negotiations to sell the land to the United States government. Before the negotiations were completed, he employed an agent, who did not disclose his principal, to buy the plaintiff’s shares for what proved to be one-tenth their value after the government purchase. In the Court’s view, although a duty of full disclosure would not be imposed on all insiders, in Strong the insider’s responsibility for the negotiations to sell the corporate assets, his special knowledge of the company, and his efforts to conceal his identity as purchaser were sufficient “special facts” to trigger a duty to disclose.

224 The Administration’s spokesman, Thomas Corcoran, devoted one sentence in his congressional testimony to what is now section 10(b): “Subsection (c) says, ‘Thou shalt not devise any other cunning devices.’” Stock Exchange Regulation: Hearings on H.R. 7952 & H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934). See also 6 L. Loss, supra note 6, at 3528.
with nondisclosure when trading on the basis of outside information that does not artificially distort stock prices. The language now comprising section 10(b) initially was included as section 9(c) of the bills introduced in the Senate and House. Section 9 deals with puts, calls, straddles, price pegs, short sales, wash sales, matched orders, stop loss orders, and other devices that were commonly used to manipulate prices. The original section 10(b) was aimed at unforeseen means of achieving the same results. Trading without disclosure of outside information, by contrast, will move market prices in the right direction rather than distort them. Although there is evidence suggesting that Congress intended section 16(b) of the 1934 Act to be the exclusive sanction against insider trading, the judicially implied extension of section 10(b) to cover insider trading does not expand on the common law, but is consistent with reading section 10(b) as a federalization of the most progressive common law rules.

Rule 10b-5 was adopted in response to an SEC Regional Administrator's report regarding a corporate president who, while misrepresenting that the corporation was faring poorly, purchased shares shortly before the announcement that the corporation's profits had quadrupled. The misrepresentation was fraud at common law. Realizing that the antifraud provisions contained in section 17 of the 1933 Act applied only to the "offer or sale" of securities, and not to their purchase, the Commission staff drafted rule 10b-5 to close this perceived loophole. When the staff presented the new rule to the Commission, the only comment came from Sumner Pike, who said "Well . . . we are against fraud, aren't we?" The explanatory SEC release stated that rule 10b-5 was adopted to close "a loophole in the protections against fraud administered by the [SEC] by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." Nowhere did this release suggest that trading without disclosure of

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229 See generally Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Inten,
outside information might violate rule 10b-5 when it did not violate any common law fraud rule.

If the wording of section 10(b), which is aimed at "manipulative or deceptive" devices, suggests that its reach is limited to stock manipulations and other devices that are deceptive within the meaning of common law fraud or deceive, the wording of rule 10b-5 suggests even more clearly an intent to proscribe activity unlawful under the most progressive common law rules without going beyond them. Rule 10b-5(a) and (c) prohibit "fraud" and "deceit." Rule 10b-5(b) does not by its terms refer to fraud or deceit, but proscribes misrepresentations and misleading half-truths which were illegal in every jurisdiction at common law. No section of the rule explicitly prohibits silence or pure nondisclosure of material facts. The wording of rule 10b-5 states only that acts amounting to common law fraud or deceit violate the rule.

The common theme running through this legislative and administrative history is a desire to establish comprehensive federal sanctions against "fraud." Fraud was a term of art, the meaning of which could be determined at that time only by reference to common law standards. Although there may be some doubt as to which common law fraud standard was intended to be federalized, there is no evidence suggesting any intent to define fraud more broadly than the special facts or fiduciary rules. Dissatisfaction with common law standards focused on the majority rule, which imposed no duty of disclosure on insiders. While the antifraud provisions were designed to incorporate the most progressive common law fraud rules, the explicit and repeated use of the word "fraud" in key provisions suggests that they were designed to go no further. The Supreme Court, moreover, has endorsed the principle that rule 10b-5 and other antifraud rules incorporate the most progressive common law fraud rules without enlarging them. In Ernst & Ernst v. Hochfelder, the Court held that use of the words "manipulative or deceptive device" imported into section 10(b) common law standards of scienter. Similarly, in Chiarella v.


233 Professor Loss has argued that construction of rule 10b-5 according to federal law creates a presumption in favor of the "special circumstances" doctrine of Strong v. Repide. 3 L. Loss, supra note 6, at 1448-49 n.10; 6 L. Loss, supra note 6, at 3587. See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (5th Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); N. LATTIN, THE LAW OF CORPORATIONS 275 (1959); Ruder, supra note 229.

234 Cf. Santa Fe Indus. Inc. v. Green, 430 U.S. 462 (1977) (rule 10b-5 requires "manipulation" or "deception").

235 425 U.S. 185, 204-06 (1976).
United States, the Court relied on the common law standard contained in the Restatement (Second) of Torts in holding that "Section 10(b) is aptly described as a catch-all provision, but what it catches must be fraud." Even the most progressive common law fraud rules do not impose a general duty of disclosure on outsiders.

Uses of outside information in connection with a securities transaction that were illegal at common law, however, are presumptively illegal under rule 10b-5. The common law did not sanction all uses of outside information but inquired into the purpose for which the information was created and the means by which it was obtained. No expansion of existing common law doctrine is required to hold impermissible all uses of nonpublic information, including outside information, obtained through fraud or by tortious or criminal acts. Because of its history, the common law rule is relatively well defined and predictable in its application, ensuring dependable guidance for private conduct. The common law rule also conforms to the efficiency principle, by preserving incentives to legitimate production and use of valuable information, while discouraging activities that impair public confidence in the securities markets.

Applied to transactions involving outside information, the common law approach directs attention to the purpose for which the information was created. Although such a purpose should be construed liberally, it cannot include illegal acts. If the information is used consistently with the purpose for which it was created, the common law generally does not impose a duty to disclose. Most inventors, for example, intend for any information they create

236 445 U.S. 222, 228 (1980) (quoting section 551(2)(a) of the Restatement (Second) of Torts (1976)). See also 445 U.S. at 229 (reference to common law rule); id. 228 n.9 (reference to common law authorities); id. 228 n.10 (reference to "special facts" doctrine of Strong v. Repide); id. 233 (reference to "established [common law] doctrine").

237 Allowing investors a cause of action against a defendant who trades without disclosing information obtained in violation of law solves the problem that otherwise would arise if the party from whom the information were misappropriated decided not to sue, as might often be the case. When an employee misuses corporate information, the corporation itself rarely will take any action beyond dismissal. The corporation's damages usually will be too small to justify a civil action, and the attendant negative publicity may greatly outweigh the value of any recovery. In addition; the buyer-seller requirement of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), may leave a corporate employer who has not traded with the defendant without a remedy under rule 10b-5. In Chiarella, the employer did no more than discharge the defendant. Although the SEC could be given an exclusive power to proceed against such a defendant, those who trade with him also should be permitted to recover their losses, not only because the defendant should in equity make them whole, but because enforcement would be more effective if private investors have an incentive to add their efforts to the resources of the SEC.
uses that fall generally under the rubric of personal profit, whether it be earned by selling inventions, by speculating on their results, by selling information, or by other means. Investors who analyze public information intend the same.

By contrast, when a corporation employs agents to produce information, the corporation normally does not intend that the information be used by its employees to generate personal profits. Because profitable but unauthorized uses of corporate information, such as disclosure of confidential information to a competitor or buying ahead of a tender offer, risk interfering with corporate interests, corporations can be presumed not to intend such uses. This presumption might be rebutted by evidence such as an employment contract indicating that the right to use corporate information in trading was intended as partial compensation. In the absence of due authority, however, the common law approach prohibits use of corporate information for personal trading profits. This prohibition extends to employees, executives, and officers of a corporation who properly receive corporate information when they use that information in unauthorized ways, and a fortiori to persons who improperly obtain information by theft, bribery, duress, fraud, or under circumstances inconsistent with the purpose for which the information was created. Application of this common law test to uses of outside information would not be new to the jurisprudence of rule 10b-5. Instead of focusing on the parity theory adumbrated in the second part of the Cady, Roberts test, application of the common law rule to outsider trading would direct attention to the first part of that test, which prohibited misuse of “information intended only for a corporate purpose and not for the personal benefit of anyone . . . .”

C. Tender Offers

Tender offers present the prototypical uses of outside information. Not only the corporation making the tender offer, but also its officers and employees, other agents such as bank depositaries, and institutional allies that provide financing, may seek to exploit advance information concerning the tender offer. Following the Supreme Court’s holding in Chiarella that possession of outside information is by itself insufficient to trigger a duty to disclose under rule 10b-5, the SEC has promulgated a series of detailed rules pursuant to section 14(e) of the 1934 Act which prohibit trading on

239 Id.
material nonpublic information concerning tender offers obtained from either the tender offeror or the target. These rules, however, do not cover all possible uses of outside information even in the tender offer context. The common law approach will therefore be important not only with respect to uses of tender information falling outside the reach of the SEC tender offer rules (or in the event those rules are limited or declared invalid), but also with respect to uses of corporate-sourced outside information in other contexts.

Under the common law approach, a corporation planning a tender offer (or other market action) can exploit in trading whatever information its agents have developed from public sources. This information, when combined with the tender offeror’s knowledge of his own plans, is clearly outside information giving him a significant advantage over those with whom he trades prior to announcement. Yet the common law approach does not prohibit exploitation of this advantage. The tender offeror has developed the information without violating recognized duties or any other provision of law, and can be presumed to have intended to use it to purchase target shares at prices that may not reflect his plan to make a tender offer. Where information is used consistently with the purposes for which it was created, the common law approach merely implements other provisions of law and has no independent effect. An executive of the tender offeror, legal counsel, underwriters, the depository bank, a financial printer, or any other agent or employee who uses such information without authority to trade for his personal account, however, violates rule 10b-5 because, while each has legitimately come into possession of the information for a proper purpose, each has used the information for unauthorized purposes.

Breach of this duty to use the information only for an

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241 See Brudney, supra note 185, at 353-67. But cf. Fleischer, Mundheim & Murphy, supra note 178, at 822-23 (fairness and expectations theory leads to conclusion that unauthorized purchases of target stock by executive of bidder are not actionable under rule 10b-5).
authorized purpose, whether such a duty be explicit in a contract of employment or be implied in law, violates the common law rule and therefore triggers the disclose or abstain mandate of rule 10b-5.

A defendant charged with unauthorized use of outside information might avoid liability under the common law approach by showing, *inter alia*, lack of scienter or due authority. The common law scienter requirement, which the Supreme Court in *Ernst & Ernst v. Hochfelder*242 reaffirmed as an essential component of rule 10b-5, could allow a defendant to avoid liability on the ground that he did not know his use was unauthorized and had no intent to defraud.243 A defendant claiming that his use was authorized might show that his conduct was in conformity with the purposes for which information was created, in conformity with duly authorized expansions of those purposes, or in conformity with a discretion in himself to determine the contours of authorized use. Alternatively, he might point to the terms of a contract. Because information is created for a variety of often vaguely defined purposes that do not exclude other purposes, there is no reason to restrict the creator's authority to define the legitimate purposes for which information is created and can be used. Although creators of information will rarely, if ever, create information for the use of anyone for any purpose, and will rarely delegate to another person unlimited authority to expand legitimate uses of information to encompass personal trading, some may wish to add to employees' compensation by explicitly authorizing use of information created by the employer and its agents. A corporation pursuing an aggressive plan of acquisitions, for instance, may believe that it will obtain better performance from certain executives if it pays them only a nominal salary but allows them free use of information that the corporation and its agents assemble. A tender offeror may believe that such an agreement allows it to save more in compensation than the increased cost of making tender offers caused by pre-tender employee purchases.

A corporate decision to maximize the return and minimize the costs of any information created by sharing the information with designated employees is consistent with economic efficiency, because it minimizes the resources expended in achieving a more efficient result. If the corporation minimizes the cost of assembling the information, the economic benefits accruing from impounding valuable information into stock prices are obtained at minimum

cost in private and social resources. Uninformed investors have no reason to complain, because they are in the same position whether the corporation or its agents, pursuant to due authority, use the information. Whereas other approaches to rule 10b-5 either proscribe such agreements or place them in a twilight zone, the common law approach gives to the creator of information the right to exchange it for other consideration and does not interfere with such agreements so long as they do not violate independent rules of law.\footnote{244}

The common law approach resolves many of the questions that have recurred with respect to the application of rule 10b-5 to tender offers. Relying on authority to regulate tender offers provided to it by section 14(e) of the 1934 Act, however, the SEC has promulgated a series of detailed rules that supplement the common law approach.\footnote{245} The new SEC regulations require full disclosure of any tender offer plans whenever a potential bidder does anything more than "test the market"\footnote{246} in purchasing target stock. The new regulations also forbid even duly authorized use of advance information concerning a tender offer by agents and employees of the tender offeror, such as an executive or printer, by their tippees, by institutional allies, or by anyone else.\footnote{247} These rules will end

\footnote{244}{See Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967) (officer of tender offeror acquires target's stock with consent of employer; held no violation of rule 10b-5). But see Chiarella v. United States, 445 U.S. at 246 (Blackmun, J., dissenting).}

Private regulatory organizations have restricted trading on outside information in a variety of ways. \textit{See, e.g.}, Chicago Board of Options Rule 4.18 (rule against exploiting nonpublic information concerning block trades) & Rule 4.19 (rule against "tape racing," or trading on basis of telephonic information concerning NYSE trades before they are registered on the Chicago tape); SEC \textit{Special Study}, supra note 2, pt. 1, at 435 (NYSE disciplined broker who traded on advance information about tender offer divulged by president of company).

\footnote{245}{SEC Rules 14e-1 to 14e-3, 17 C.F.R. § 240.14e (1980).}


not only certain compensation agreements, but also a financing practice known as "warehousing." In the past, a tender offeror without sufficient funds to cover the cost of a major acquisition might obtain needed financing by sharing advance information with institutional lenders who purchased target stock and later tendered it. In exchange for paying institutional "allies" a profit equal to the tender price less the price they paid for their shares, the tender offeror obtained financing and assured itself that sufficient shares would be in friendly hands and tendered at the right moment. Although the common law approach does not proscribe such arrangements, rule 14e-3 clearly does. Because rule 14e-3 applies only to tender offers subject to the Williams Act, however, warehousing arrangements should be valid in other contexts under the common law approach.248

FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1975). See also Wall St. J., Nov. 12, 1980, at 37, col. 4 (SEC action against attorney who allegedly purchased target shares on the basis of information obtained from a client planning a tender offer).

248Because warehousing and similar practices can be an efficient means of financing, the result under the common law approach is consistent with economic efficiency. Thomas, however, has argued that warehousing should violate rule 10b-5 independently of rule 14e-3. Thomas, Warehousing, 3 Rev. Sec. Rec. 975 (1970). Wander has argued that sharing such information amounts to waste of a corporate asset in connection with a securities transaction and therefore should be actionable in a derivative suit brought under rule 10b-5. Wander, Takeovers: Preparing the Attack, in PRACTISING LAW INSTITUTE, SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 7 (1970). When Wander's argument was made in litigation, however, the district court held that there was no deception between the tender offeror and the warehousers, and therefore no violation of rule 10b-5. Penn Mart Realty Co. v. Becker, 300 F. Supp. 731 (S.D.N.Y. 1969). Cf. Cohen v. Colvin, 266 F. Supp. 677 (S.D.N.Y. 1967) (acquiring corporation can enlist aid of board of directors by encouraging them to purchase target stock).

See generally E. ARAGON, H. EINHORN & G. BERLSTEIN, TENDER OFFERS FOR CORPORATE CONTROL 24 (1970); Fleischer, Mundheim & Murphy, supra note 178, at 811-17 ("fairness" approach does not permit warehousing); 1 INSTITUTIONAL INVESTOR STUDY REPORT, supra note 144, at xxxi-xxxiii (rule 10b-5 should not be construed to prohibit warehousing, which should instead be dealt with by specific rules); Sandler & Conwell, Texas Gulf Sulphur, Reform in the Securities Marketplace, 30 Omro St. L.J. 225, 254-55 n.145 (1969) (warehousers are agents of bidder and have no greater duty of disclosure than he does).

On the other hand, unauthorized use of tender offer information by a warehouser's agents and employees should trigger a duty to disclose under rule 10b-5 for the reasons stated in the text. Warehousing activity by the target and its allies also may violate rule 10b-5 because the target will owe a fiduciary duty to those from whom stock is purchased and because knowledge of the tender offer received by target's management is inside information. A target executive who trades on news of an imminent bid almost certainly will have received that information by virtue of his corporate position. The ALI Federal Securities Code makes this presumption irrebuttable. See generally Flom, Warehousing, in PRACTISING LAW INSTITUTE, SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 79 (1970) (post-Institute textual volume) (potential risks to warehouser under 1933 and 1934 Acts). See also Reed v. Riddle Airlines, 266 F.2d 314 (5th Cir. 1959) (improper for insider to purchase stock without disclosing intention of financier to purchase large blocks of stock) (dictum); In re Hughes & Treat, 22 S.E.C. 623, 626 (1946) (dictum).
Because the new SEC rules cover only uses of outside information obtained from the tender offeror or the target, they do not reach all possible uses of outside information even in the tender offer context. For instance, the new rules do not by their terms prevent a depository institution that receives shares as they are tendered from trading on information obtained pursuant to its official functions. Under the common law approach, however, a depository institution cannot use such information absent contractual provisions permitting such use. A depository that knows from its count of tendered shares that shares sufficient to mature the bidder’s duty to buy at a specified price will soon be collected cannot exploit that information by buying and tendering target shares. Neither can a depository that knows the offer will fail sell its shares. The depository agreement does not contemplate such use. The common law approach therefore proscribes unauthorized use of tender information by depositories, even though the SEC has not promulgated a rule explicitly prohibiting such activity.

D. Government Officials

The common law approach to rule 10b-5 resolves cases involving use of outside information by government officials into questions of due authority. Government officials enforce a wide range of compelled disclosure designed to serve the public good. It scarcely needs mentioning that the purpose of this regulatory system is not to make profits for government officials. Most government employment contracts specifically proscribe use of official information for personal gain. Administrative regulations and conflict-of-interest statutes, as well as case law, add a further layer of prohibitions against personal use of information collected pursuant to official authority. Accordingly, a public official using official information

249 See generally Fleischer, Mundheim & Murphy, supra note 178, at 821 (use of tender offer information by depository is “unfair”). A stock exchange specialist may also become aware of the expected success or failure of a tender offer by means of his knowledge of trading activity in target shares. Although the SEC has not promulgated a tender offer rule explicitly dealing with specialists, for a number of years the American Stock Exchange enforced a rule preventing the specialist from tendering more shares than he held when the offer was announced. ASE Rule 187(2)(a) (commentary), 2 Am. Stock Ex. Guide (CCH) ¶ 9327 (1965) (rescinded 9/29/76). Violation of rules of this type might also trigger a violation of rule 10b-5. Cf. In re Herbert L. Honahan, 13 S.E.C. 754 (1943) (a broker-dealer, having learned maximum price at which bond sinking fund would accept tendered bonds, purchased bonds in the market and tendered them at maximum acceptable price; held defendant defrauded other bondholders in violation of rule 10b-5). See also note 265 infra.

250 See, e.g., Haas v. Henkel, 216 U.S. 462 (1910) (conspiracy to obtain information from employee in Department of Agriculture); United States v. Keane,
for private gain violates a panoply of legal restrictions that trigger a
disclose or abstain obligation under the common law and rule
10b-5. Because these rules of law also prohibit unauthorized
disclosure, their effect is to proscribe any use beyond that contained
in the purpose for which the information was collected.

In United States v. Peltz, an attorney conspired with an
employee of the SEC to trade in the stock of a company on the
basis of confidential information concerning imminent SEC litiga-
tion against that company. The Second Circuit held that the at-
torney's use of information improperly revealed by a government
employee violated a federal criminal statute condemning conspir-
acies "to defraud the United States, or any agency thereof in any
manner or for any purpose . . . ." The federal conspiracy
statute invoked in Peltz might not confer standing on an investor
injured by improper use of official information. The common law
approach to rule 10b-5, however, would confer standing, because
the use of information in violation of the conspiracy statute would
trigger a disclose or abstain obligation under the rule enforceable
by anyone with whom the official and his co-conspirators trade.

In Blyth & Co., a broker improperly obtained confidential
information concerning the terms of new Treasury Department
financings from an employee of the Federal Reserve. The broker
exploited this information by effecting a series of transactions in
outstanding government securities whose value was certain to be
affected by announcement of the terms of the new offerings.

Because the defendant used information improperly obtained from

522 F.2d 534 (7th Cir. 1975) (government official's personal use of official information in violation of mail fraud statute).

251 See, e.g., 18 U.S.C. §§ 1902-1903, 1905 (1976) (illegal for government official to use for personal trading information received by Department of Agriculture); 18 U.S.C. §§ 201, 205, 208, 371 (1976) (illegal to use government information for private benefit); Prescribing Standards of Ethical Conduct for Government Officers and Employees, Exec. Order No. 11,222, 3 C.F.R. 306 (1964-65). Viewing government officials as public fiduciaries would provide an additional ground for imposing a common law duty of disclosure. Despite these prohibitions, substantial evidence indicates that government officials and their tippees trade on official information. See, e.g., Wall St. J., Dec. 3, 1980, at 31, col. 4-6 (attempts by Labor, Commerce, and Agriculture Departments to "plug leaks of economic data").


the issuer to trade in the issuer's securities, the SEC could have rested its holding that such trading violated rule 10b-5 solely on accepted insider trading principles. Yet the SEC opinion also suggested that any use of material nonpublic information, whether it be inside or outside information, would violate rule 10b-5. Reliance on a broader-based parity theory stemmed at least in part from concern that the insider trading rules alone would not reach the situation where a defendant used confidential information about imminent Treasury offerings to trade in securities of other issuers that are directly affected by the terms of any new Treasury offerings. The common law approach, however, reaches both situations, making unnecessary invocation of a parity approach which threatens to chill information production and trading. Because official information will necessarily be produced and disclosed pursuant to government mandate even when it cannot be used for private profit, the common law approach closes off improper use without threatening legitimate information production.

E. Columnists

In Zweig v. Hearst Corp.,256 plaintiffs alleged that financial columnist Alex N. Campbell had failed to disclose in a column recommending certain stock that he had purchased the stock for himself immediately prior to the column's publication and planned to sell immediately thereafter.257 The Ninth Circuit reversed the district court's dismissal of the complaint. Although there was no allegation that Campbell used inside information, the Ninth Circuit held that his position nevertheless imposed upon him a duty to disclose under rule 10b-5, citing the Second Circuit's opinion in Chiarella.258 The court found further support for this duty by analogizing to cases involving explicit statutory duties or fiduciary relationships.259 No prior decision, however, had ever imposed on a columnist a duty of disclosure in the absence of explicit statutory

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256 594 F.2d 1261 (9th Cir. 1979).
258 594 F.2d at 1266-67.
command, and the Ninth Circuit conceded that Campbell's "relationship to the public was not a fiduciary one . . . ." 260 The court nevertheless concluded that "Campbell's duty to his readers is well established." 261 Having created a duty of disclosure to the column's readers, the court extended this duty of disclosure to persons, like the plaintiffs, who had neither read the column nor acted in reliance on it, but who could show pecuniary damage from its publication. 262 These expansions of existing doctrine were required because the court believed that "in traditional common-law terms it is difficult to make out a duty owed by Campbell to a [plaintiff] that did not . . . read his writings . . . ." 263

The common law approach, however, provides abundant means of redress against Campbell's conduct and against other instances of "scalping" which require no expansion of existing law. First, as the Zweig court noted, scalping may violate a variety of independent rules of law, depending on the particular factual situation, which could under the common law approach trigger a duty to disclose or abstain. In SEC v. Capital Gains Research Bureau, 264 for instance, the Supreme Court held that an investment advisor's failure to disclose his intent to scalp amounts to a "fraud or deceit" within the meaning of section 206 of the Investment Advisers Act of 1940. 265

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260 594 F.2d at 1269. See generally sources cited in note 265 infra.

261 594 F.2d at 1269.

262 A duty of disclosure to readers would in any event provide little protection, because disclosure in the column of an intent to scalp would come too late for investors who had sold to the columnist before publication.

263 594 F.2d at 1270.


Although Campbell arguably was acting as an investment advisor within the meaning of the Investment Advisers Act, plaintiffs in Zweig did not press such a claim. Second, plaintiffs could have argued, but did not, that Campbell's purchase of the subject stock at a bargain price from the company amounted to receipt of consideration prohibited by section 17(b) of the 1933 Act. Third, plaintiffs did not allege that Campbell had deliberately manipulated the market in violation of section 9(a)(2) of the 1934 Act, perhaps because that section applies only to manipulation of securities listed on a national securities exchange. Even in the case of unlisted securities, however, section 10(b) proscribes the use of "any manipulative or deceptive device . . . ." Fourth, plaintiffs could have alleged that Campbell's publication of his recommendation without disclosing other material facts amounted to a half-truth, actionable at common law even in arms-length transactions. Finally, Campbell's use of information obtained from corporate officials to trade in the issuer's stock before publication may have constituted insider trading simpliciter, but this too was not alleged. In short, existing rules of law are more than sufficient to handle the facts in Zweig.
Although the Zweig court purported to follow the holding of the Supreme Court in SEC v. Capital Gains Research Bureau, Capital Gains did not expand on the common law rule as Zweig did. In Capital Gains, an investment advisor several times had purchased stock immediately before publishing a favorable recommendation in an investment newsletter and in each case had sold out immediately after publication. The district court held that section 206 of the Investment Advisers Act did not expand on common law fraud concepts and that mere nondisclosure of the intent to scalp was therefore not actionable. The Second Circuit also read section 206 "as confined by traditional common law concepts of fraud and deceit," and affirmed.

The Supreme Court reversed. Although there was at common law no general duty of disclosure, a fiduciary's failure to disclose all material facts in his dealings with his cestui was fraud at common law. The Supreme Court found that the Investment Advisers Act created a federally recognized fiduciary relationship between the investment advisor and his customers. Accordingly, the Act imposed upon the investment advisor a fiduciary obligation to make full disclosure, breach of which was fraud at common law and under the Act. Because fiduciary relations can be created by statute as well as by private contract, and in either case give rise to a duty to disclose at common law, Capital Gains is fully consistent with the common law approach. Because there is no statute or

also stretches beyond recognition the purchaser-seller requirement of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).


276 306 F.2d 606, 608 (2d Cir. 1962).


278 Justice Harlan dissented. Although he agreed that a federally mandated fiduciary obligation required full disclosure of all material facts, he believed that the facts defendant failed to disclose in Capital Gains were not material. 375 U.S. at 203.

279 The existence of a fiduciary duty under the Investment Advisers Act also renders the purchase or sale of a security in advance of a recommendation or discretionary transaction fraudulent unless disclosed when dealing with customers, even in the absence of scalping. In Kidder, Peabody & Co., SEC Exchange Act Release
other rule of law creating a fiduciary relation between a columnist and his readers, *Capital Gains* does not support the result in *Zweig*.

Even assuming that a defendant could implement a scalping scheme without directly violating a federal or state statute, under the common law approach a plaintiff nevertheless could proceed on a theory alleging that the information at issue was received improperly or used inconsistently with the purpose for which it was created. Ordinarily, corporate officials who speak to columnists provide information for publication and not for the columnist’s personal profit. To do otherwise would risk liability for tipping inside information in violation of rule 10b-5. When a columnist exploits such information for personal profit before publication, he has used it inconsistently with the purpose contemplated by its transfer, aside from any tippee liability for use of inside information. On the other hand, if a corporate official intends personal use by the columnist, the columnist becomes an accomplice in the official’s manipulative scheme. When a columnist consults only public sources, allegations of improper use and scalping will focus on his employment agreement and the publication’s articulated policy.\(^\text{280}\) Arguably, any information obtained within the scope of employment by a columnist or investment advisor belongs to the employer and cannot be used for the personal profit of the employee absent explicit authority. Scalping may also breach an implied obligation to the employer to the degree it devalues the advice to the employer and those to whom he sells it.

Several commentators have suggested implication of a warranty of disinterestedness under federal securities law that would require a columnist to disclose his interest in any stock he writes about.\(^\text{281}\)

\(^{280}\) *Sec*, *e.g.*, *SEC Special Study*, *supra* note 2, pt. 3, at 76 n.130 (TIME magazine policy statement).

Although the common law approach does not imply a warranty of disinterestedness, its effective prohibition of a variety of improper uses and manipulative schemes produces much the same result, contributing to the reliability of available information and to the overall level of market efficiency. This contribution to efficiency more than compensates for any marginal diminution in the incentive to search out valuable information caused by removing the opportunity to scalp, which produces gains entirely apart from the validity of any underlying research, and even when there is no underlying research.\textsuperscript{282}

\textbf{F. Market Professionals}

More difficult problems arise when outside information is used for personal profit by stock exchange professionals such as specialists, marketmakers, block traders, arbitrageurs, registered floor traders, and others. The position which some have on the floor of the exchange, their minute-by-minute knowledge of developments concerning major transactions by significant market actors, their familiarity with plans of their own which may have a market impact, their knowledge of the activities of and constraints operating on other market professionals, their continuous awareness of even public developments before they are disseminated via the media or the tape, and their ability instantaneously to execute transactions without paying broker fees, all combine to give these market professionals an incalculable advantage over the average investor.\textsuperscript{283} Specialists, for instance, might earn over $100,000 in a series of nearly risk-free transactions within the space of a few hours.\textsuperscript{284} The price of a seat on the New York Stock Exchange (NYSE), now roughly $250,000, represents in part the net discounted value of the superior access to outside information which a seat provides.

\textsuperscript{282}In other actions brought against other financial columnists, plaintiffs have alleged that the columnists' sources rather than the columnists themselves benefited by trading on advance information concerning the content of particular columns. \textit{See}, e.g., Nemeroff v. Abelson, 620 F.2d 339 (2d Cir. 1980); Welles, \textit{supra} note 281, at 27-28.


\textsuperscript{284} \textit{See generally} Note, \textit{The Downstairs Insider: The Specialist and Rule 10b-5}, 42 N.Y.U. L. Rev. 695, 708 (1967). \textit{See also} sources cited in note 293 infra.
By acting as the nerve center of the organized stock exchanges, specialists solve two problems.\textsuperscript{285} First, specialists acting as brokers provide a means of handling orders "away from market"—i.e., orders that are below current asks or above current bids but that can be executed when prices change. If a customer gives his broker an order to sell when and if the price of a particular stock falls by two points, the broker's agent on the floor of the exchange need not wait at the specialist's post until the hoped-for fall occurs, but can leave the order with the specialist who enters it on his "book" for execution at a later time. Second, specialists acting as dealers for their own account provide continuity and liquidity in the market, and reduce random price fluctuations unrelated to changes in the intrinsic value of securities, by trading at narrower spreads than customer orders provide. For instance, if the lowest ask is $25 and the highest bid is $24, there would be no trading. Orders to trade "at market," however, would create a situation in which the "market price" continually gyrates between $25 for "market" purchases and $24 for "market" sales, without any change in the underlying value of the stock. The specialist ameliorates this problem by dealing for his own account at narrower spreads—for example, by buying at $24\textsuperscript{3/4} and selling at $24\textsuperscript{1/2}.

The specialist's book, which lists all unexecuted orders and the prices at which each can be executed, enables the specialist to gauge the degree of buying and selling interest at prices "away from market."\textsuperscript{286} Private access to his book, together with his power to administer prices and his position on the floor of the exchange, gives to the specialist a unique informational advantage over other investors when he deals for his own account. When the lowest ask is $25 and the highest bid is $24, for instance, he may sell from his inventory at $24\textsuperscript{1/2} with the knowledge that there are few, if any, buyers at $24\textsuperscript{1/2} or higher, but many sellers at lower prices; and the price of the stock may drop precipitously as a result of his decision to sell off a large portion of his inventory. Similarly, he may buy for his own account at $25\textsuperscript{3/4} when he knows that higher prices will soon unleash buying activity by customers who are waiting for the price of the stock to rise to $25\textsuperscript{3/4} or more. If a


\textsuperscript{286} The specialist's book is "an indicator of public interest in a particular security." SEC SPECIAL STUDY, supra note 2, pt. 2, at 76.
specialist acts as broker in a particular transaction, fiduciary obligations could provide some ground for requiring disclosure of any material information he possesses, but federal law explicitly prohibits disclosure of information on the specialist's book.287

Congress and the SEC, however, have regulated specialists in other ways. Section 11(b) of the 1934 Act and Commission rules promulgated thereunder require that the specialist's transactions for his own account be "necessary to . . . maintain fair and orderly markets." 288 In theory, the specialist cannot trade as principal for any other purpose.289 Rule 11b-1 provides that stock exchange rules governing specialists include, inter alia: (1) requirements that the specialist's trades as principal assist maintenance of a "fair and orderly market"; (2) provisions defining the responsibilities of specialists acting as brokers, and (3) procedures for surveillance.290 Existing NYSE rules governing a specialist's trading as principal also generally prohibit (1) purchases above the last sale price in the same session; (2) purchase of all stock offered on the book at a price equal to the last sale ("cleaning up" the book); (3) supplying as dealer all the stock bid for at a particular price (liquidating inventory in preference to offers of sale by customers); and (4) opening a stock in a way that manipulates the price.291 When acting for his own account, the specialist is generally restricted to "stabilizing"


The "quid pro quo" for permitting exploitation of outside information by market professionals "has been the imposition of regulation to ensure that in trading for his own account [the market professional] uses these privileges for the benefit of the market generally . . . ." Albert Fried & Co., SEC Exchange Act Release No. 15993, 16 SEC Docket 100, 104 n.7 (Nov. 3, 1978). See also SEC SPECIAL STUDY, supra note 2, pt. 2, at 78-83, 90-94, 123-28, 135, 220-25; HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS, 96th Cong., 1st Sess. 1-4 (Comm. Print 1978) ("traditionally, market professionals have been permitted to enjoy these market information and competitive advantages because they have an obligation to the markets . . . and have made a significant contribution to the continuity, liquidity and depth of the markets . . . .").

289 See SEC SEGREGATION REPORT, supra note 2, at 63.


291 NEW YORK STOCK EXCHANGE (NYSE) Rule 104, 2 NYSE GUIDE (CCH) ¶ 2104 (1980). See also NYSE Rules 93-127, 2 NYSE GUIDE (CCH) ¶¶ 2098-2127 (1980).
transactions, and cannot buy on an uptick or sell on a downtick in the absence of special circumstances.

Despite their detail, these regulations do not remove all opportunity to exploit outside information. A specialist who wishes to liquidate his inventory of a particular stock during the course of a steep market decline can unload an amount equal to half of all bids at his price on the appearance of a momentary uptick. Similarly, he can purchase during the course of a major rally an amount equal to half of all offers at his price on the appearance of the first downtick.\textsuperscript{292} Even sustained changes in prices do not occur without numerous reverse ticks.\textsuperscript{293} The specialist can therefore exploit whatever outside information his position brings him so long as he engages in a sufficient percentage of transactions which are at least in form “stabilizing.”

Floor traders also are subject to detailed regulations.\textsuperscript{294} Yet they too can exploit outside information obtained on the floor of the exchange.\textsuperscript{295} Historically, floor traders could trade for their own account without restriction. In 1964, the SEC required that seventy-five percent of a floor trader’s transactions be “stabilizing,” in terms of the tick test, but this stabilization requirement does not remove all opportunities for exploitation of outside information, and it does not apply to block trades.\textsuperscript{296} The Securities Act Amendments of 1975 prohibit floor trading except as permitted by the

\textsuperscript{292} NYSE Rule 104.10, 2 NYSE Guide (CCH) ¶ 2104 (1980).

\textsuperscript{293} See SEC Special Study, supra note 2, pt. 2, at 101-06, 112-13, 122-25 (specialists generally trade with trends; over 80% of their trades in steep market declines were found to be sales). The Special Study also suggests that specialists often used their informational advantages to help preferred customers. Id. 159. See also Horror Stories, Forbes, Sept. 14, 1971, at 43-44 (specialist sells short to fill order then covers at lower price).


\textsuperscript{294} See, e.g., NYSE Rules 110-112, 2 NYSE Guide (CCH) ¶¶ 2110-12 (1980) (establishing minimum capital requirements, requiring that priority be yielded to off-floor orders, prohibiting domination of one stock, segregating functions of floor trader and floor broker in the same session, and requiring that 75% of the floor trader’s trades be stabilizing).


Commission, which has recently moved to end all floor trading -solely for personal accounts. Floor traders who qualify as “competitive traders” by earning fifty percent of their income from commissions, however, can continue to trade for their own account -on the floor of the exchange for the other fifty percent, providing ample opportunity to exploit outside information.

Despite the limitations apparent in existing regulations, the Commission has, until recently, hesitated to announce broad-based rules under section 10(b) which could affect adversely delicate market mechanisms on the floor of the exchanges. Attempts to apply a generalized parity theory to stock exchange professionals would require restructuring of the exchanges or restructuring of the theory. For instance, requiring a specialist to disclose his book would merely add to the sum of outside information available to market professionals and available to the public only after delay. Newspapers would not carry such information, inclusion on the tape would add to existing delays, and requiring the specialist or his agents to respond to inquiries by telephone would be cumbersome and of limited utility. Disclosure to other market professionals at the time trades are effected would not reach the principal until too late, if at all.

In Chiarella, however, the SEC relied on its parity principle in pressing criminal charges against the defendant, and argued that application of that principle was made especially appropriate by the defendant’s regular access to outside information concerning market conditions. Perhaps the SEC intended to apply the parity principle to market professionals who were not yet subject to detailed regulation. The Second Circuit accepted the SEC’s invitation to announce a broad rule and held that a duty to disclose outside information applies to all “market insiders.” On certiorari, the Securities Industry Association—a trade association representing brokers, dealers, and other market professionals—filed a brief as


298 Id. See also Eiteman, The S.E.C. Special Study and the Exchange Markets, 21 J. Finance 311 (1966) ( supra-competitive profits earned by floor traders and specialists). Similar advantages are enjoyed by other exchange members, particularly in connection with their knowledge of impending block trades. 4 INSTITUTIONAL INVESTOR STUDY, supra note 144, at 1603-07, 1732-35. See also SEC SPECIAL STUDY, supra note 2, pt. 2, at 208-12. AMERICAN STOCK EXCHANGE (ASE) Rule 54, 2 AM. STOCK EX. GUIDE (CCH) ¶ 9242B (1979), and NYSE Rule 112.10, 2 NYSE GUIDE (CCH) ¶ 2112 (1979), however, have severely restricted full exploitation of such information by generally requiring, inter alia, that exchange members wait until two minutes after block trade information has appeared on the tape before attempting to exploit such information.

299 588 F.2d at 1365-66.
amicus curiae arguing that the standard articulated by the Second Circuit was "overly broad" and "could adversely affect the trading activities of market professionals." In reversing the conviction, the Supreme Court stressed that "neither Congress nor the Commission has ever adopted a parity-of-information rule," but had dealt with market professionals by means of "detailed and sophisticated regulation."  

The questions left open in *Chiarella* with respect to market professionals are largely answered by the common law approach. Market professionals can trade on outside information so long as they do not violate applicable regulations and rules of law. The existence of regulations explicitly contemplating use of outside information for personal profit will tend to rebut any claim that use in conformity with those regulations was inconsistent with the purpose for which the information was conveyed to the market professional. Investors who place orders with specialists will be presumed to know that Congress and the Commission do not consider improper the specialist's personal use of the information in conformity with regulations. Such regulations, however, cannot override other rules of law, such as the insider trading rules in the event that the specialist knew the information was inside information, or laws against theft in the event he knew the information was stolen, or existing fiduciary obligations. A block trader who receives a large sell order, for instance, cannot sell ahead of his customer. So long as market professionals do not obtain outside information by improper means and have no reason to believe that it was improperly revealed to them, use in conformity with existing regulations and rules of law is presumptively valid.

On this analysis, *Chiarella* presents an easier case. Chiarella appropriated information from his employer in violation of his employment agreement, company policy, and laws condemning theft. This theft not only gave rise to a cause of action by the employer for damages under the common law; it also triggered a duty under rule 10b-5 to disclose or abstain from trading on the basis of that information. Enforcement under these circumstances should not depend on the employer, which may lack both incentive

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301 445 U.S. at 233.
and standing to sue under rule 10b-5.\textsuperscript{304} Although the Supreme Court considered this theory, and Chief Justice Burger relied on it in voting to affirm, a majority of the Court held that the common law approach had not been adequately presented to the jury.

G. Broker/Advisors

Wall Street broker/advisors have considered several ways to minimize free-riding and maximize the return on their investment recommendations. When a broker/advisor devotes resources to market research and publishes the results in a market letter, the client who attempts to use that information frequently discovers that the price of the recommended security has been bid up to reflect the value of the recommendation before he can trade on it, usually even before he receives the letter. Ironically, in many cases it is market professionals and other competitors of the broker/advisor who benefit most from these recommendations. Many broker/advisors therefore view investment research as a loss-leader, a necessary activity whose cost can be recovered only indirectly. This inability to appropriate directly the value of investment research implies that a socially suboptimal amount of resources is being devoted to such research.

Just as the eighteenth century lighthouse builders devised solutions to free-riding on their services, however, broker/advisors have considered various strategies for more completely appropriating the value of their investment research. After completing some research, but before announcing any recommendation, the broker/advisor might accumulate an inventory of the stock it plans to recommend. After making the recommendation, he may sell some or all of the stock. Alternatively, the broker/advisor might hold this inventory primarily for sale to its customers, at market prices, or at prices somewhere between its purchase price and the post-recommendation price.\textsuperscript{305} Some writers have questioned the use of these strategies.

The common law approach, however, resolves any uncertainty here. Investors who sell, even to the broker/advisor, before publication, will have no claim under the common law approach. The broker/advisor has gathered and analyzed public information for legitimate purposes—to sell it to clients and perhaps to trade on

\textsuperscript{304} See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

\textsuperscript{305} Cf. SEC Special Study, supra note 2, pt. 3, at 245-48 (brokerage firms frequently use research reports to invest for own account or for accounts of individual members).
it as principal—and has used the information consistently with those purposes. He has violated no independent rule of law and he stands in no relationship to any seller that requires disclosure of his research and plans. Permitting purchases of stock on the basis of this research before it is publicized provides a just return for legitimate industry and encourages economically efficient behavior. Investors who buy after the recommendation is published also have no claim. So long as there is no manipulation, they are buying at market prices that reflect research and recommendation, as do all market prices to varying degrees.

Purchases from clients before publication may present a closer question. Section 206 of the Investment Advisers Act and section 15(c) of the 1934 Act place the broker/advisor in a fiduciary relationship with his clients under federal law. Such a relationship requires full disclosure of all material facts and the utmost good faith.306 A client who sold to his broker/advisor after the research was completed and before publication might allege breach of this duty on the ground that the results of the forthcoming report were material information. A broker/advisor might seek to avoid this problem by purchasing only from sellers who were not clients, but this strategy would not be possible with respect to exchange transactions. Attempts to disclose the potential existence of the inventory strategy and to obtain waivers from clients in advance would be cumbersome, and any waivers received might not be enforced because of a lack of full information or for other reasons.

A client who purchases after publication, however, will have difficulty showing damages. In addition, if the broker/advisor discloses before or at the time of sale the results of his research and his inventory strategy, he has made full disclosure. A client nevertheless may argue that the broker/advisor has not shown the utmost good faith because he is dealing with clients and others in a way which will almost always earn profits regardless of the validity of the research—and which may do so at the client's expense if the value of the stock falls after the market impact of the recommendation is spent. A client might contend that the broker/advisor can comply with the standard of utmost good faith only by selling the stock to clients at the same price for which it was purchased. Even at common law, however, a fiduciary can engage in profitable transactions with his cestui provided there is full disclosure and no substantive unfairness. Otherwise, a trustee could not charge for

his services and a broker could not sell stock at a mark-up. Because there is nothing inherently unfair about the terms of the broker/advisor's offer to share potential research gains with clients, full disclosure is enough under the common law approach.307

Inevitably, the price rise following publication of the recommendation will result both from the validity of the research effort and from the market impact of publication entirely apart from the soundness of the research. Although the common law approach and considerations of economic efficiency would allow the broker/advisor to appropriate whatever value inheres in bona fide research activity, a closer question may arise concerning the component of the price rise attributable solely to publication. One might argue that earning profits from this component of the price rise rewards market power and influence, and not research or other economically beneficial activity. On this view, the component of the price rise attributable solely to publication is an exercise of a power to influence stock prices. A cautious broker/advisor who wishes to avoid charges of manipulation might therefore attempt to sell stock after publication at prices reflecting only research value and not publication value. But even if such a calculus were possible, the broker/advisor might conceivably risk liability to others who had transacted with third parties at prices that did not reflect this adjustment.308

The common law approach, however, does not support liability under these circumstances. To do so would remove the incentive to research by threatening every investment advisor with incalculable liability to unknown investors whenever a recommendation affected prices. The broker/advisor, moreover, has a legitimate claim to appropriate the increase in price attributable solely to publication. The size of the market impact will depend on the size of the audience, the strength of the recommender's reputation, and the inherent credibility of the report, all of which depend in

307 When, however, an investment banker possesses inside information concerning a particular issuer, such as a client planning a new offering, accumulation of an inventory position in the stock of that issuer could lead to litigation charging use of inside information. Proprietary trading might weaken the credibility of any chinese wall defenses. See generally Lipton & Mazur, The Chinese Wall Solution to the Conflict Problems of Securities Firms, 50 N.Y.U. L. Rev. 459 (1975).

308 See also Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979). Zweig and other cases involving columnists, however, present a different question, because those defendants are in a position analogous to employees of the broker/advisor. Their employment agreements and company policy ordinarily do not permit exploitation of the publication value of any recommendations made. By contrast, a broker/advisor who publishes an investment newsletter is not restricted by employment agreements, company policy, investor expectations, or common law rules where there is full disclosure.
part on the validity of previous research activity and recommendations. An investment advisor with a poor reputation for accuracy will soon discover that his recommendations exert no discernible impact. The market impact of publication is therefore a delayed return for earlier research activity that properly belongs to the advisor if he can devise a means to appropriate it.

When a broker/advisor sells recommended stock immediately after publication, however, an inference of purely manipulative activity could arise. Immediate sale may weaken the claim that pre-recommendation purchases demonstrate a good faith belief in the value of the recommendation. True, once the recommendation is published, the broker/advisor may believe that both research value and publication value are fully impounded into existing prices and that no additional gain is likely in the near future despite the validity of the research and recommendation. Although this reasoning would explain the sale of recommended stock shortly after publication, so would a belief that the recommendation was worthless. In addition, sale immediately after publication will tend to depress price, further strengthening a claim of manipulation. Even sales solely to clients could be consistent with such a charge. Accordingly, in order to avoid triggering action by the SEC, or by others who might claim to be damaged by manipulative activity, the cautious broker/advisor may choose to hold a portion of recommended stock for a reasonable period after publication.

IV. Conclusion

The Supreme Court has, on several occasions, registered its concern with the expanding range of liability possible under rule 10b-5. The limitations on liability inherent in the common law approach are responsive to this concern. If any additional limiting principles are required, they should not exclude from the reach of rule 10b-5 uses of information in securities trading that are fraudulent at common law. Instead, the creation of certain evidentiary presumptions should sufficiently curb the frequency and costs of baseless or vexatious litigation. Use of outside information to effect long-term transactions eligible for capital gains treatment under the Internal Revenue Code, for instance, might support a rebuttable presumption that such information was not obtained or used improperly. The common law approach suggests a rebuttable presumption in favor of proper use by the creator of outside information and against improper use by one other than the creator. Such a presumption would require employees and persons who had
received information from others to justify their use, but would place on the plaintiff the burden of showing impropriety if a creator, such as an inventor or researcher, traded on his own information. Although such a presumption may place an unwarranted burden on defendants who are not creators, this approach is superior to a parity approach, where such a presumption applies to all investors and is in effect virtually irrebuttable. Other limitations on the scope of rule 10b-5 will appear as the courts fine tune the law of damages.\textsuperscript{369}