THE INSIDER TRADING SANCTIONS ACT: INCORPORATING A MARKET INFORMATION DEFINITION

Michael KARSCH *

1. Introduction

Capital formation, economic growth and stability depend on investor confidence in the fairness and integrity of the capital markets. The U.S. securities markets generally are liquid, efficient, and fair. The prices of the vast majority of actively traded securities reflect available public information concerning companies and the economy [1]. In recent years, however, insider trading has been viewed as a significant threat to the fairness and integrity of the U.S. securities markets.

Insider trading refers to the practice of trading in the securities markets by those in possession of material nonpublic information. Corporate officers and other corporate insiders, as well as persons who obtain nonpublic information ("tippees"), can reap large profits by purchasing or selling securities prior to the announcements of important corporate events. Neither the Securities Act of 1933 [2] nor the Securities Exchange Act of 1934 [3] (the "Exchange Act") provides a direct prohibition against insider trading. The courts and the Securities and Exchange Commission ("SEC") have attacked insider trading through section 10(b) [4] of the Exchange Act, a general antifraud provision, and through rule 10b-5 [5], adopted by the SEC under its rulemaking authority.

The prevention of insider trading has become one of the SEC's major enforcement goals [6]. In 1983, the SEC filed twenty-four insider trading cases, twice as many as two years earlier [7]. The SEC also has attempted to prevent those trading on material nonpublic information from retaining anonymity by trading through a foreign financial institution. In many countries those institutions are legally obligated not to divulge the trader's name because of relevant bank secrecy or blocking legislation [8].

In contrast to the efforts of the SEC, the U.S. Supreme Court has limited

* Articles Editor, Journal of Comparative Business and Capital Market Law, University of Pennsylvania Law School, 3400 Chestnut Street, Philadelphia, PA 19104, U.S.A.

0167-9333/84/$3.00 © 1984, Elsevier Science Publishers B.V. (North-Holland)
the efficacy of using section 10(b) and rule 10b-5 to combat insider trading. In Chiarella v. United States [9] and Dirks v. SEC [10], the Supreme Court rejected the “market information” theory, which posits that a person engages in insider trading whenever he trades on the basis of material nonpublic information [11]. Instead, the Court adopted the “fiduciary duty” theory under which the basis of liability for insider trading is the insider’s violation of a duty owed to one of the parties related to the transaction [12]. This contrast between the SEC’s enforcement efforts and the Chiarella and Dirks decisions has created uncertainty as to whether outsiders who trade on the basis of material nonpublic information engage in insider trading or merely use lawfully attained knowledge in making their investment decisions.

Congress is presently considering the Insider Trading Sanctions Act of 1983 [13], which amends the Exchange Act and is designed to deter insider trading by increasing the civil and criminal penalties for violations. The legislation, as presently drafted, does not include a definition of insider trading. Rather, the scope of insider trading would continue to be defined by the fiduciary duty analysis adopted by the Supreme Court under rule 10b-5.

This comment argues that while section 10(b) and rule 10b-5 have proved adequate for prosecuting cases involving corporate insiders, they are inappropriate for prosecuting cases involving “outsider trading” where the trader owes no fiduciary duty to the shareholder even though he has traded on material nonpublic information [14]. In order to provide market participants, the courts and the SEC with a clear standard for determining outsider liability, Congress should include a definition of insider trading in the Insider Trading Sanctions Act of 1983. This definition should not be based on the present fiduciary duty theory but on the “market information” theory.

In 1980, England adopted a comprehensive insider trading statute as part of the Companies Act of 1980 [15]. This Act incorporates a definition of insider trading based on the market information theory. Under this statute, an insider or a tippee is prohibited from using material nonpublic information regarding a specific company obtained from a person knowingly connected with that company. Only one case has been decided under the Companies Act, and there are ambiguities in the statute that need to be resolved by the British courts. Congress, however, can use this statute as an example in formulating an American definition of insider trading, avoiding its weaknesses but adopting the market information approach which it incorporates.

2. The proposed Insider Trading Sanctions Act of 1983

2.1. Purpose and contents

The proposed legislation would increase the alternative enforcement remedies which the SEC may use against those engaging in insider trading. In its
report accompanying the bill, the House Committee on Energy and Commerce stated that additional legislation was necessary because the existing remedies have proved inadequate to deter violations and because there is a public perception that the risk of detection is slight. Changes in the markets, such as the introduction of new financial instruments and the proliferation of tender offers and proxy contests, have necessitated additional SEC enforcement tools and remedial actions. The SEC also needs added flexibility to mold the remedy to the egregiousness of the violation [16].

The proposed legislation would amend section 21(d) [17] of the Securities Exchange Act by creating a new section 21(d) (2) as follows:

(A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States District Court to seek, and the court shall have jurisdiction to impose a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring [18].

The SEC would be permitted to use the new remedy in addition to existing ones, so that in appropriate cases the SEC may seek: (1) a court order enjoining the violator from breaking the law again; (2) disgorgement of ill-gotten gains which may, if appropriate, be paid into an escrow fund so that traders or other private parties damaged by the insider trading can obtain compensation for their losses; and (3) the imposition of the new civil money penalty payable to the U.S. Treasury [19].

Additionally, the Insider Trading Sanctions Act would amend section 32(c) [20] to increase the potential criminal fine from $10,000 to $100,000. The fine was enacted in 1934 and has never been increased, so that inflation has eroded its deterrent effect.

2.2. Inclusion of a definition of insider trading

A major point of controversy concerning the Insider Trading Sanctions Act is whether a statutory definition of insider trading is desirable. The present text of the Act does not include such a definition, even though many experts have advocated one [21]. The Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce heard the testimony of many securities experts on this question during its hearings on the bill and looked to the SEC for guidance.
A.A. Sommer, Jr., a former SEC Commissioner, expressed his strong opposition to the inclusion of a definition. He stated that the SEC has wisely ignored repeated complaints that the standards are too vague and uncertain, believing that there are situations in which the best rulemaking is through litigation. Although this course is often more protracted, it results in standards that reflect the complexities of actual cases, standards that constantly mature to reflect changed ways of doing business, new problems, and innovative schemes to avoid or thwart the law [22]. Adoption of a specific definition would require Congress to maintain a continuing vigilance to assure that the statute did not inadvertently become an opportunity for wrongdoing rather than a deterrent [23].

In a letter dated 29 June, 1983, SEC Chairman John Shad articulated the following SEC position opposing the inclusion of a definition of insider trading in the Insider Trading Sanctions Act:

Existing law provides a sound legal framework for judicial analysis and review of new and unforeseeable trading devices and strategies. Decades of legal thinking have contributed to the development of existing antifraud law under rule 10b-5. The Commission is opposed to abandoning those principles for an untried definition of insider trading. Any definition would incorporate new terms and concepts which would have to be interpreted in subsequent litigation. Thus, a definition would not provide the clarity sought; to the contrary, it would inevitably create new uncertainties [24].

The House Committee, in its report to the House recommending passage of the Act, adopted the SEC position. The Committee believed that the law with respect to insider trading is sufficiently well developed to provide adequate guidance. It also believed that the SEC has used its broad rulemaking authority to respond to market developments and that any new definition would tend to create new ambiguities which would increase rather than limit uncertainty [25].

The Committee also cited the conclusions of the drafters of the proposed Federal Securities Code [26] that hard-core insider trading only could be "vaguely defined" [27]. The drafters believed that all other types of questionable conduct involving illicit misappropriation of market and insider information should be left to the courts, which should determine whether the particular conduct amounts to a "fraudulent act" or a "misrepresentation" [28]. They concluded that "this area must be left to further judicial development" [29].

Furthermore, the Committee believed that Dirks, because of its unique facts, would not affect the SEC's ability to pursue insider trading cases as long as the opinion was "properly and narrowly construed by the courts" [30]. Soon after the decision was rendered, SEC officials reported that a review of the thirty-four insider trading cases brought by the SEC in the past two years revealed that only one case might have been affected by Dirks [31]. Nevertheless, the Committee directed the SEC to monitor closely the effects of Dirks for at least two years because the ultimate impact of the case depends on future judicial interpretations.
The Hearings and Report of the House Committee on Energy and Commerce indicate that both the Committee and the SEC opposed the inclusion of a definition of insider trading in the Insider Trading Sanctions Act. Although proposed section 21(d)(2)(A) could be read to replace the fiduciary duty theory with the market information theory by its use of the language "while in possession of material nonpublic information", the House Committee and the SEC both took the position that the outermost contours of insider trading still should be defined by the case law under section 10(b) and rule 10b-5 [32].

3. The insider trading cases under rule 10b-5

Section 10(b) and the rulemaking provisions of the Securities Exchange Act of 1934 give the SEC broad powers to regulate the securities markets. Although the language of rule 10b-5 does not specifically prohibit insider trading, the SEC and the courts have liberally construed the broad antifraud language in sections (a) and (c) of the rule to regulate that activity [33]. The initial cases decided under rule 10b-5 analyzed insider trading as fraud in the traditional sense. These cases dealt with corporate insiders — officers, directors or employees — who had breached their fiduciary duty to investors or had deceived them by trading on inside information or by disclosing that information solely for the purpose of utilizing that information [34]. The scope of the rule was eventually extended to penalize certain outsiders, such as underwriters, attorneys, bankers, and brokers who had misused material nonpublic information. Such an extension was consistent with earlier cases because these outsiders were deemed to have entered into a fiduciary relationship with the corporation and its shareholders and, accordingly, were treated as if they were insiders [35].

The SEC believed that outsider trading was as much an evil as insider trading. Eventually, it brought cases against outsiders who traded while in possession of material nonpublic information, whether or not they had entered into a fiduciary relationship with the corporation and its shareholders [36]. The SEC sought to bring all outsider trading within the scope of rule 10b-5 by adopting the position that anyone in possession of material nonpublic information has a duty to either disclose it to the investing public or abstain from trading or tipping. Failure to comply with the "disclose-or-abstain" rule constituted fraud for the purposes of rule 10b-5. Many lower courts approved the SEC position on the basis that it supported the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information" [37].

The development of rule 10b-5 as a broad enforcement mechanism against outsider trading has run into strong resistance from the Supreme Court. In Chiarella v. United States [38], the Court held that nondisclosure of inside
information is actionable as fraud under rule 10b-5 only where there is a duty to disclose or abstain arising “from a relationship of trust and confidence between the parties to a transaction” [39]. Chiarella was employed by a financial printer engaged in printing tender offer documents for certain companies planning takeover bids. Although the acquiring and target companies’ names were omitted from the documents until the final printing, Chiarella deduced the identities of the target companies, purchased shares of the targets anticipating that the share prices would rise once the offer was announced, and sold the shares at a profit after the announcement [40]. His actions did not constitute a violation of rule 10b-5 because the requisite duty had not arisen.

In response to the Chiarella decision, the SEC promulgated rule 14e-3 [41] to prohibit insider trading in the specific context of tender offers. This rule, adopted under the antifraud provision of section 14 [42], was designed to circumvent the specific holding of Chiarella [43]. It is unclear, however, whether the SEC’s statutory authority extends to transactions entered into prior to the actual making of a tender offer [44]. Thus, the applicability of rule 14e-3 to Chiarella-type activities remains uncertain.

In Chiarella, the Court refused to consider the “misappropriation theory” because it was not raised at the trial level [45]. In United States v. Newman [46], the Second Circuit found that the tippers had a duty to their employers and the employers’ clients not to misappropriate, for their personal benefit, information entrusted to the employers by the clients. The breach of that duty resulted in liability for both the tippers and tippees [47]. This case is significant because the court found liability even though there was no violation of a fiduciary duty as defined by Chiarella. The court, in effect, expanded the duty to Newman’s employer and the employer’s clients. While the opinion has been subject to criticism [48], the SEC scored a major victory in winning a criminal conviction for outsider trading.

In O’Conner & Associates v. Dean Witter Reynolds, Inc. [49], the U.S. District Court for the Southern District of New York concluded that an insider owes a general duty to the marketplace not to trade on nonpublic information obtained through a breach of duty. O’Conner, an options trading firm, sued several companies alleging that unknown insiders had given inside information regarding a takeover bid to Dean Witter, who then purchased stock options for customers and themselves at the same time that the plaintiff was selling its options. Citing Newman, the court held that a breach of fiduciary duty owed to any party constitutes a fraudulent practice [50]. This holding, however, seemed to ignore the Supreme Court’s rejection of the Second Circuit’s “general duty to the public” holding in Chiarella [51].

In Dirks v. SEC [52], the Supreme Court demonstrated its continued adherence to the fiduciary duty standard when it reversed the SEC’s censure of Raymond Dirks, a securities analyst instrumental in exposing the Equity Funding fraud. Dirks was charged by the SEC with violating section 10(b) for
investigating rumors of fraud, discovering from employees of Equity Funding that the allegations were true, and divulging the results of his investigation to clients of his firm who then sold their holdings prior to public disclosure [53].

The Dirks court concluded that in some cases an outsider tippee can become derivatively bound to his tipper’s fiduciary duty to disclose his information or abstain from trading. This duty, first enunciated in In re Cady, Roberts & Co. [54], attaches when the insider has breached his fiduciary duty to the shareholders of a corporation by disclosing inside information and the tippee knows or should know that there has been such a breach. An insider violates his Cady, Roberts duty to disclose or abstain only when he will personally benefit, either directly or indirectly, from the use of the confidential information [55]. Applying this new test of tippee liability, the court concluded that Dirks had not committed any actionable wrong because, as an outsider, he could be liable only by extension of the duty of his tippers [56]. The court found that the tipper derived no personal gain from tipping Dirks so that Dirks acquired no derivative duty to disclose [57].

Only weeks after Dirks was decided, the U.S. District Court for the Central District of California articulated the “temporary insider” doctrine in SEC v. Lund [58]. Lund had purchased stock after receiving nonpublic information from a corporate insider. The court concluded that the insider had not breached his fiduciary duty because the information was disclosed for the legitimate corporate purpose of a possible investment in a new venture and because disclosure was within the scope of his authority as an officer of the corporation. Consequently, Lund was not liable as a tippee [59]. The court, however, found that Lund had violated rule 10b-5. It focused on footnote 14 of Dirks [60], which stated that corporate outsiders may become fiduciaries of the shareholders when corporate information is revealed legitimately to them because they have entered into a special confidential relationship in the conduct of the enterprise. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential [61]. The court concluded that Lund was a “temporary insider” and was subject to the insider’s duty to disclose or abstain.

4. Incorporation of a market information definition of insider trading into the Insider Trading Sanctions Act

4.1. The 10b-5 cases do not provide predictable standards of liability

Prior to the Supreme Court’s decision in Chiarella, the courts and the SEC generally believed that the prohibition of insider trading was predicated on the market information approach [62]. Chiarella and Dirks narrowed the definition of illegal trading on inside information by favoring the fiduciary duty ap-
proach. An analysis of the post-Chiarella cases under rule 10b-5 indicates that the fiduciary duty approach is ambiguous and subject to manipulation by the courts. As such, it provides little guidance as to the outermost contours of illegal insider trading.

The *Lund* case demonstrates the SEC's latest enforcement tool, the "constructive insider" theory. In *Dirks*, the Supreme Court had held that absent a breach of duty by the tipper there cannot be a violation of section 10(b) [63]. Lund was convicted, even though the court found that there was no breach of duty by the tipper and thus no derivative breach by Lund [64]. The court manipulated the duty analysis to hold that Lund was a "temporary insider" subject to the same duty to disclose or abstain as an insider.

Another example of the lower courts' manipulation of the duty analysis is demonstrated by *SEC v. Musella* [65], a pending case where various people, including the office manager of a New York law firm, traded on tips passed by the office manager who was privy to the takeover plans of the firm's clients. In a motion for a preliminary injunction, the district court noted the distinction between shareholders of the corporations from which the nonpublic information emanated and those of the corporations in which the defendants traded:

The rather anomalous result of *Chiarella*, at least from a policy perspective, is that an individual who obtains nonpublic information regarding a tender offer from the acquiring company, rather than the target company, is not subject to liability, if he or she chooses to capitalize on this information by trading in the target company's securities [66].

The court thus found that just as Chiarella had no fiduciary duty, neither did the office manager. The court held instead that he had a duty similar to *Newman*, based on his common law duty of silence owed to his employer. By following this "commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair", the court, in effect, held that distinctions premised on the source of the information underlying the prophylactic intent of the securities laws should not be allowed [67].

Another ambiguity in the law is exhibited in a classic insider trading hypothetical [68]. An outsider overhears two corporate insiders discussing nonpublic price-sensitive information at a restaurant or at a sporting event. The two insiders neither know nor have reason to know that an outsider is overhearing their conversation, which is being held for legitimate purposes. If the outsider trades on this information, has he violated rule 10b-5?

An examination of the two sentences of footnote 12 of *Chiarella* gives conflicting results. The footnote reads:

> Tippees of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider.... The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty [69].
By reading only the first sentence, the outsider is liable because he should know that he obtained confidential price-sensitive information from corporate insiders. The second sentence, however, states that the tippee is not liable unless there has been a breach by the insider. Since the insiders did not breach any duty, there can be no derivative breach by the outsider. Thus, even the Supreme Court has sent out conflicting signals.

A problem related to the ambiguities of the present case law is the lack of notice to market participants. The Insider Trading Sanctions Act contains greatly increased penalties for violations. If these punitive damages are to be fairly applied, then traders should have notice of what constitutes a violation. In *Newman*, the district court, after reviewing the historical development of rule 10b-5, concluded that "there was no clear and definite statement in the federal securities laws that proscribed the acts alleged" [70]. Section 10(b) is operative only to the extent that the SEC has adopted rules "necessary or appropriate in the public interest or for the protection of investors" [71]. Rule 10b-5 does not, however, define any specific practices. Because the rule does not proscribe specific acts, criminal proceedings should not be brought, and if brought, should not be upheld by the courts unless the particular practice that is the subject of the prosecution was one that had clearly been proscribed by the courts or by SEC administrative proceedings at the time of the alleged actions by the defendant [72].

The role of market analysts is also unclear. Congress has recognized that "market professionals contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of nonpublic information" [73]. Analysts such as Dirks perform a valuable function by seeking information which contributes to market efficiency in pricing that would not otherwise be available to the general investing public [74].

When an analyst acquires nonpublic information not by virtue of any insider status, but through the lawful exercise of his own diligence, and when the information involved would not soon have been revealed to the market in the natural course of events, the analyst ought to be permitted to trade or advise without making a public disclosure or assuming the risk of liability [75]. Neither the Supreme Court nor the SEC have developed standards that allow analysts any confidence that their activities will not later be deemed unlawful [76]. Without a definition articulating the proscribed conduct, legitimate traders and analysts might limit their trading because of fear of violating rule 10b-5. These market participants, acting on legitimate information, should profit from their diligence and superior skills without the risk of penalty. Absent a clear definition of the conduct to which the Act applies, legitimate activity may be forsaken, and heavy compliance costs incurred, all ultimately borne by the investing public [78].
4.2. Rule 10b-5 is inappropriate for the regulation of insider trading

The implication of the previous subsection is that rule 10b-5 does not provide adequate guidance to the courts, the SEC, and participants in the securities markets as to what conduct is proscribed with regard to using nonpublic price-sensitive information. The reason for the ambiguities is that section 10(b) and rule 10b-5 are general antifraud provisions with no explicit mention of insider trading. The prohibition on the use of market information is a judicially-created concept not based on the wording of the statute and the rule. This judicial interpretation is inappropriate because it focuses attention on the traditional elements of common law fraud rather than on the policies for regulating the use of nonpublic price-sensitive information.

The courts have interpreted section 10(b) as proscribing fraud by corporate insiders and those who knowingly trade on information received from insiders who have breached their duty to their corporation and its shareholders. Outsider trading on inside information, however, is not fraud because the traditional elements of fraud — duty, misrepresentation, and deception — are absent. The prohibition on outsider trading based on inside information is rather a judicially-created concept, grounded more on notions of fairness than on the specific activities outlined by section 10(b) and rule 10b-5 [79]. Consequently, the Supreme Court has circumscribed the use of section 10(b) and rule 10b-5 in the context of outsider trading. As noted by the Chiarella court, “section 10(b) is aptly described as a catchall provision, but what it catches must be fraud” [80].

In Chiarella, the court argued clearly and persuasively that no fraud occurred as required under section 10(b), stating that “when an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak…. A duty to disclose under 10(b) does not arise from the mere possession of nonpublic market information” [81]. Although the decision may be correct if read with respect to rule 10b-5, it is not convincing if analyzed in the context of insider trading. The duty analysis is not compatible with the impersonal marketplace where there are no face-to-face dealings between buyers and sellers.

Further confusion in applying the duty analysis was evident in the Newman decision. In that case, the Second Circuit held that the defendants breached a duty to their investment bank employer and the bank’s offeror clients by trading in the targets’ securities, even though there was no pre-existing duty or other link between the defendants and the selling shareholders of the targets [82]. The immediate injury resulting from the breach of that duty, however, was not to the investment bank, but to the clients, whose impending tender offer was affected by the insider trading. This situation is troublesome because it is not clear whether employees, by virtue of their employment relationship, acquire the firm’s confidential relationship with its client. While employees
may have a separate duty to their employers not to take advantage of their employment, it is questionable whether the duty also extends to the clients so as to impose liability under rule 10b-5 [83]. That the analysis can depend on whether the client is a target or offeror is also problematic because violation of section 10(b) would depend on the identity of the particular client. That is true despite the fact that the trading of each has both the identical perceived unfairness and identical effects on the market and should be considered equally reprehensible [84].

The O'Conner case best exemplifies the difficulty of applying a duty analysis to the marketplace because of its holding that a separate duty exists to disclose or abstain that is "owed to the investing public" [85]. This duty was distinct from the fiduciary duty owed to the corporation and its shareholders not to profit from the use of inside information. The separate duty created in O'Conner to the investing public is overbroad and incompatible with the narrow holding of Chiarella, yet it is a manifestation of the desire for a new standard. The standard of liability applied in this case, although based on the fiduciary duty analysis, is indistinguishable from the market information analysis [86].

4.3. The definition of insider trading should incorporate the market information theory and reject the fiduciary duty approach

While the increased sanctions of the Insider Trading Sanctions Act are a potent response to the problem of insider trading, the new legislation also should contain a definition of insider trading. The cases show the need to clarify the underlying policies of the prohibition, to set forth who is prohibited from trading, and to define what information cannot be used by traders. A basic problem with the case law under rule 10b-5 is that the opinions only briefly touch upon the ongoing debates over the rationale for prohibiting insider trading and the considerations of economic efficiency. Rather than grappling with these difficult issues, the courts instead have relied on the fraud provisions of section 10(b). Instead of asking what legal rule would enhance the efficiency of the markets or seeking ways to insure the markets' integrity, the courts have relied entirely on formalistic notions of "fiduciary duty" and "special relationship" [87]. However, these common law formulas, based upon a norm of face-to-face dealings, are simply "unsuited to an institutional, anonymous marketplace such as the New York Stock Exchange" [88].

In formulating the definition of insider trading, Congress should recognize the realities of insider trading in an anonymous market and adopt the market information theory [89]. Two fundamental tenets of securities regulation suggest this approach. First, unequal information equals money. An investor with price-sensitive information will always make a profit or avoid a loss to the detriment of an investor without that information. Second, as the SEC has
observed, one of the primary objectives of the Exchange Act was to restore and maintain investor confidence in the capital markets [90]. This sense of integrity and fairness cannot be achieved if the system condones transactions in which one party has price-sensitive information which is not available to others. If individual or small noninstitutional investors perceive the lack of equal opportunity, they will lose confidence in the fairness of the market and withdraw their capital. The result would be a reduction in investor confidence in the securities markets, which in turn would reduce the markets' depth and liquidity.

As indicated previously, a definition of insider trading based on the fiduciary duty standard makes little sense with respect to insider trading on impersonal markets. Instead, Congress should define insider trading based on the underlying policies of the securities acts: preservation of the liquidity, efficiency and fairness of the U.S. securities markets. Achievement of these policies requires adoption of a market information approach in defining insider trading.

The lack of precision associated with the duty analysis "is a burden on law enforcement and on society in general" [90]. The courts and the SEC are sending conflicting messages to the marketplace. In order for the SEC to effectively regulate the market, it must have effective tools with the imprimatur of Congress. The SEC has expressed fears that a new standard would create uncertainty and would not provide sufficient flexibility to attack unforeseeable trading devices [91]. Although any definition would incorporate new terms and concepts which would have to be interpreted in subsequent litigation, a properly drafted statute would provide the courts and the SEC with a sufficient framework in which to deal with present and future abuses [92]. The solution to this problem is legislation specifically addressing the issue of outsider trading [93].

Great Britain recently adopted a comprehensive insider trading statute based on the market information theory. Congress should look closely at this law as a guide to adopting a modern definition as part of the Insider Trading Sanctions Act.

5. The British definition of insider trading in the Companies Act of 1980

Prior to the enactment of the Companies Act 1980 ("the 1980 Act") [94], only limited attempts were made to prohibit insider trading in Great Britain. Before 1980, the London Stock Exchange and the City Panel on Takeovers and Mergers could sanction members or disgorge profits made through insider trading and return them to the company which had been the object of the takeover attempt. These remedies, however, lacked the authority of law so that no truly effective penalty was possible [95]. These forms of self-regulation were
so ineffective that one commentator referred to insider trading as being "virtually legal in Britain" until the adoption of the 1980 Act [96].

The 1980 Act made significant changes in the corporate law of Great Britain. It implements the European Economic Community Second Directive on Company Law [97], expands regulations on director conflicts of interest, requires directors to consider employee interests, facilitates minority shareholder access to the courts, and prohibits insider dealing. Much of the Act, including Part V on insider dealing, was proposed in earlier Companies Bills in 1973 and 1978 which were not enacted [98].

Great Britain decided to prohibit insider trading for many of the same reasons articulated in the United States. The securities industry and Parliament believed that widespread insider dealing threatened public confidence in the securities markets, as well as in directors and others closely associated with companies. One Member of Parliament summed up the problem: "Insider dealing is wrong" [99]. It was hoped that the new law, containing only criminal sanctions, would "represent a fair and reasonable balance between deterring wrongdoers and not discouraging those who are doing no wrong at all" [100].

The 1980 Act, in sections 68–73, deals with insider trading (termed "insider dealing") on the basis of unpublished price-sensitive information. Under section 72, an insider dealing violation is punishable by a conviction of up to two years, a fine, or both [101]. Section 73 defines unpublished price-sensitive information as that which:

(a) relates to specific matters relating or of concern (directly or indirectly) to that company, that is to say, is not of general nature relating or of concern to that company; and (b) is not generally known to those persons who are accustomed or would be likely to deal in those securities but would, if it were generally known to them, be likely materially to affect the price of those securities [102].

The statute regulates the behavior of four groups of individuals. The first group includes those connected with a company (insiders). The term "connected with a company" is defined in section 73(a) [103] and individuals falling within the definition have duties not to trade as described in sections 68(1-2) [104]. Additionally, under sections 68(6-7), such individuals are prohibited from tipping information to those who may trade on the basis of such information [105] or who may pass such information to others [106]. These prohibitions are limited by the exceptions contained in sections 68(8) [107] and 68(10) [108].

The second group are those individuals contemplating or having contemplated a takeover offer. Subject to the exceptions in sections 68(8) and 68(10) [109], such individuals are prohibited from dealing in the securities of that company to the extent defined in section 68(4) [110] and from tipping the information described in section 68(6-7) [111].
Tippees are the third group regulated by the statute. Under section 68(3) [112], tippees may not trade on the basis of information obtained from certain individuals connected with a company. Under section 68(5) [113], tippees of certain individuals contemplating or having contemplated a takeover offer are prohibited from trading. Once again, sections 68(8) and 68(10) [114] limit tippees' liability. Finally, the fourth group regulated by the Act are Crown servants. Under section 69 [115], Crown servants are prohibited from trading on the basis of unpublished price-sensitive information or from tipping that information to others.

The only case brought before a Crown Court for insider trading under the 1980 Act resulted in convictions for the two defendants. In the Titheridge [116] case, a case not unlike Chiarella, Mrs. Titheridge, a secretary at a merchant bank, learned of an impending takeover and passed the information to her husband, an employee at another merchant bank, who then purchased shares for both his own account and for a client. Mr. Titheridge was charged with secondary insider dealing under section 68(3) and counselling or procuring under section 68(6), and his wife was charged with the latter offense. Both pleaded guilty and were fined £4000 each. The judge was critical of their conduct, stating that “others must be deterred from doing similar things, because the mischief of offenses of this type tend, quite wrongly, to put the integrity of the entire City at risk” [117]. One noted authority applauded the judge’s stern attitude since the judge correctly identified the primary justification for seeking to regulate insider dealing – the preservation and maintenance of investor confidence [118].

A detailed critique of the insider dealing provisions in the Companies Act of 1980 is beyond the scope of this comment [119]. Only one case has been decided under the 1980 Act, and the British courts are left to resolve a number of ambiguities in applying the statutory language.

For example, would an individual be liable under section 68(3) for purchasing stock in a company after being counselled to do so by an insider if the tippee was not given the reasons underlying the advice? Clearly, the insider would be liable for counselling or procuring under section 68(6). Whether the tippee would be liable under section 68(3), however, is more problematic. Under that section, the tippee would have to be deemed to have received unpublished price-sensitive information and would have to know or have reasonable cause to believe that it was unreasonable for the insider to disclose the information except in the proper performance of his duties. It is not clear whether a tip simply to buy stock without disclosure of the underlying reasons represents unpublished price-sensitive information under section 72.

Despite the ambiguities of the statutory language, however, the insider trading provisions of the 1980 Act have two advantages over insider trading regulation within the United States. First, by providing a definition of insider trading, instead of using a broad antifraud statute, Parliament has given more
extensive and clearer notice to the courts, to the administrative agencies charged with regulating the securities markets, and to the investing public as to what constitutes a violation. Second, by adopting a market information approach to insider trading, Parliament has avoided the troublesome fiduciary duty analysis. As this comment has argued, the fiduciary duty analysis is ambiguous, is subject to manipulation by the courts, and ignores the realities of the securities markets.

6. Conclusion

The SEC faces a number of difficulties in enforcing the prohibition on insider trading within the U.S. securities markets. Problems of detection, investigation, and identification of abusers, as well as limited resources, militate against the SEC ever totally eradicating insider trading. The Supreme Court’s Chiarella and Dirks decisions also are problematic because they rejected the market information theory of insider trading, adopting instead the more narrow and ambiguous fiduciary duty theory. While the SEC still can bring the “hard-core” cases, its efforts to curtail tipping and to enhance the integrity of the marketplace may be considerably weakened by these two decisions [120].

The proposed Insider Trading Sanctions Act of 1983 offers Congress the opportunity to amend the Exchange Act to include a much needed definition of insider trading. This definition should be predicated on the market information theory rather than the fiduciary duty theory. Toward this end, the definition of insider trading contained in the British Companies Act of 1980 should provide guidance to Congress.
Notes


It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, 
(a) To employ any device, scheme, or artifice to defraud, 
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or 
(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

[6] SEC Chairman Shad has stated: "We're going to come down on insider trading with hobnail boots." SEC Director of Enforcement John Fedders stated: "It is the rawest kind of misconduct without broken windows (from looting); simply put, it's stealing by people in white shirts and suspenders." Illegal Insider Trading Seems to Be on Rise - Ethics Issues Muddled, Wall St. J., March 2, 1984, at 1, col. 6.
[7] Id. In the last two and a half years the SEC has brought fifty-one cases of insider trading, more than in the previous forty-seven years of existence. Report, supra note 1, at 2.
[16] Report, supra note 1, at 5.

[22] Hearings, supra note 21, at 235 (testimony of A.A. Sommer, Jr.).

[23] Milton Freeman, draftsman of rule 10b-5, has stated that the rule was originally aimed at corporate insiders in the breach of their fiduciary duties. In his view, the SEC is wrongly trying to prosecute outsider trading cases under rule 10b-5 because of the lack of a fiduciary duty. To outlaw the use of inside information in tender offers, Congress should adopt entirely new legislation that would define specifically the wrongful conduct and would deal with outside information differently from the abuse of inside information. Id. at 168 (testimony of Milton V. Freeman). The rule was written in response to a report that “the president of some company…is…buying up the stock from his own shareholders at $4.00 a share, and he had been telling them that the company is doing very badly, whereas in fact the earnings are going to be quadrupled and will be $2.00 a share for the coming year.” Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 922 (1967).


[31] Id. This statistic, however, fails to differentiate between traditional insider trading cases clearly within the scope of rule 10b-5, and the outsider cases in which 10b-5 is arguably an inadequate standard.


[34] See, e.g., In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) (broker–dealer liable for selling stock based on tip from board member that board had voted to reduce company dividend); SEC v. Texas Gulf Sulphur, 401 F. 2d 833 (2d Cir. 1968) (en banc), cert denied, 394 U.S. 976 (1969) (company officials liable for insider trading when bought TGS stock knowing of a valuable copper strike, well before that information was known even to full board of directors).


[39] Id. at 228. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholders’ welfare before their own, will not benefit personally through fraudulent use of material nonpublic information. See, e.g., Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 Calif. L. Rev. 1 (1982).

[40] Chiarella, 445 U.S. at 228. Chiarella purchased and sold shares on five separate tender offers.

[41] 17 C.F.R. section 240.14e-3 (1982). The rule is designed to prohibit trading on inside information or tipping of inside information concerning tender offers.
300

M. Karsch / The Insider Trading Sanctions Act

[43] See Release Nos. 33-6239; 34-17120; and IC-11336, 569 Sec. Reg. L. Rep. (BNA) L-1 (Sept. 10, 1980). One of the major issues left open by Dirks is the validity of rule 14e-3, which, although adopted after Chiarella, fails to incorporate Chiarella’s fiduciary duty criterion. This provision has consistently been construed in pari materia with rule 10b-5, see, e.g., Panter v. Marshall Field & Co., 646 F.2d 271, 282 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); accordingly, Dirks and Chiarella should be relevant precedents. See Block and Barton, Insider Trading – The Need for Legislation, 10 Sec. Reg. L.J. 350, 366 (1983).


[47] Id. at 17; see also SEC v. Materia [Current Binder] Fed. Sec. L. Rep. (CCH) ¶99,526 at 97,025 (S.D.N.Y. Nov. 16, 1983), where, on facts similar to Chiarella, the court denied a motion to dismiss because the complaint sufficiently alleged a violation of rule 10b-5 based on the Newman misappropriation theory.


[50] Just as the insiders owed no fiduciary duty to the persons with whom they traded in Newman, the insiders here may have owed no fiduciary duty to the writers of call options. Nevertheless, under the Newman rationale, because their trading or tipping breached fiduciary duties owed to other parties, the alleged conduct constituted a fraudulent practice within the meaning of the securities laws.

529 F. Supp. at 1185.


[53] Id. at 3258.
[54] 40 S.E.C. 907 (1961); see supra note 34.
[55] Id. at 912.
[56] Dirks, 103 S.Ct. at 3265.
[57] Id. at 3267.
[59] Id. at 1402.
[60] Dirks, 103 S.Ct. at 3261 n.14:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. See SEC v. Monarch Fund, 608 F.2d 938, 942 (2d cir. 1979); In re Investors Management Co., 44 S.E.C. 633, 645 (1971); In re Van Alystne, Noel & Co., 43 S.E.C. 1080, 1084-1085 (1969); In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937

https://scholarship.law.upenn.edu/jil/vol6/iss3/8
(1968); Cady, Roberts, 40 S.E.C., at 912. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (investment banker had access to material information when working on a proposed public offering for the corporation). For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

[61] Lund, 570 F. Supp. at 1403.
[62] “Anyone in possession of material inside information must either disclose it to the investing public...or abstain from trading in the securities concerned while such inside information remains undisclosed.” SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). “The essence of the rule is that anyone who, trading for his own account in the securities of a corporation has access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone may not take advantage of such information knowing it is unavailable to those with whom he is dealing, i.e., the investing public.” Cady, Roberts, 40 S.E.C. 907, 912 (1961).

[64] 103 S. Ct. at 3261.
[66] Id.
[67] Id.; see also Poser, Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud, 49 Brooklyn L. Rev. 1265, 1270 (1983). Under Chiarella, however, there is no duty of silence under rule 10b-5.

[72] Poser, supra note 67, at 1279.
[73] Dirks, 103 S.Ct. at 3262 n. 16 (citing Chiarella).
[74] See id. at 3263 n. 17; see also, Manne, Insider Trading and the Stock Market (1966).
[75] Investors can obtain such information from analysts by paying a fee or a commission on trades. See Note, The Supreme Court, 1982 Term, 97 Harv. L. Rev. 1, 293 n. 61 (1983).
[77] Dirks, 103 S. Ct. at 3263.
[78] Hearings, supra note 21, at 41 (memorandum from Office of the General Counsel to SEC Chairman Shad); Fedders, A Call for Stronger Deterrents, N.Y. Times, July 17, 1983, section 3 (Business), at 2. Arguments could also be made that market participants have a due process right to notice in light of the punitive penalties.
[80] Block and Hoff, supra note 35, at 24; see also LaFave and Scott, Criminal Law, section 25 (1972).
[82] Newman, 664 F.2d at 15.
[83] Block and Hoff, supra note 35, at 20.
[84] Id.
[85] 529 F. Supp. at 1185.
[86] Block and Hoff, supra note 35, at 20. If the duty is owed to the investing public, then any person in possession of such information has a duty to the marketplace not to trade on the information. The market information theory is essentially this idea without the duty analysis.
[89] Professor Louis Loss has argued for a “market egalitarian” approach to regulating insider trading which parallels the market information theory. Professor Loss reasoned that investors should be confident that the market quotations given for their securities represent an objective valuation of the investment they hold. He believes that investors should be confident that they can deal in the securities markets on a basis of relative informational equality and not be subject to the mercy of a buyer or seller with unpublished price-sensitive information. Loss’s approach considers both the economic and moralistic policies inherent in market regulation. Loss, The Fiduciary Concept as Applied to Trading by Corporate “Insiders” in the United States, 33 Mod. L. Rev. 34, 36–7 (1970); see Fabergé, Inc., 45 S.E.C. 249, 254 (1973). Commentators have approved this view. See W. Painter, The Federal Securities Code and Corporate Disclosure section 5.10 at 250 (1978); Brudney, id. at 336. One commentator argues that the economic effects of securities regulation are irrelevant in light of the legislative goal of improving the “morality” of the marketplace. Ferber, The Case Against Insider Trading: A Response to Professor Manne, 23 Vand. L. Rev. 621, 622 (1970); see also L. Loss, Securities Regulation (2d ed. 1961 & Supp. 1969) passim, but especially ch. 9.
[92] Fedders, supra note 78.
[93] This conclusion has been drawn by several practitioners. See, e.g., Block and Hoff, supra note 35; Brodsky, Trading on Inside Information, N.Y.L.J., Aug. 17, 1983 at 1; Pitt and Ain, Dirks Deals Blow to Insider Trading Program, Legal Times of Washington, July 11, 1983, at 13; Sporkin, Setback to SEC’s Enforcement Drive, N.Y. Times, July 17, 1983, section 3 (Business), at 3 (Former director SEC enforcement division); Brodsky, supra note 21. But see Fedders, supra note 78.
[95] 10 International Capital Markets and Securities Regulation, section 1.08(7)(b) (H. Bloomenthal ed. 1982). The City Panel on Takeovers and Mergers is a self-regulatory body established to monitor takeover transactions.
(1) For the purposes of this Part of this Act, an individual is connected with a company if, but only if, —
(a) he is a director of that company or a related company; or
(b) he occupies a position as an officer (other than director) or employee of that company or a related company or a position involving a professional or business relationship between himself (or his employer or a company of which he is a director) and the first company or a related company which in either case may reasonably be expected to give him access to information which, in relation to securities of either company, is unpublished price sensitive information, and which it would be reasonable to expect a person in his position not to disclose except for the proper performance of his functions.

1980 Act, section 73(1).

(1) Subject to subsection (8) below, an individual who is, or at any time in the preceding six months has been, knowingly connected with a company shall not deal on a recognised stock exchange in securities of that company if he has information which —
(a) he holds by virtue of being connected with the company;
(b) it would be reasonable to expect a person so connected and in the position by virtue of which he is so connected not to disclose except for the proper performance of the functions attaching to that position; and
(c) he knows is unpublished price sensitive information in relation to those securities.

(2) Subject to subsections (8) and (10) below, an individual who is, or at any time in the preceding six months has been, knowingly connected with a company shall not deal on a recognised stock exchange in securities of any other company if he has information which
(a) he holds by virtue of being connected with the first company;
(b) it would be reasonable to expect a person so connected and in the position by virtue of which he is so connected not to disclose except for the proper performance of the functions attaching to that position;
(c) he knows is unpublished price sensitive information in relation to those securities of that other company; and
(d) relates to any transaction (actual or contemplated) involving both the first company and that other company or involving one of them and securities of the other or to the fact that such transaction is no longer contemplated.

Id. at sections 68(1), (2).

(6) Subject to subsections (8) and (10) below, an individual who is for the time being prohibited by any provision of this section from dealing on a recognised stock exchange in any securities shall not counsel or procure any other person to deal in those securities, knowing or having reasonable cause to believe that that person would deal in them on a recognised stock exchange.

---

[103]

[104]

[105] (6)
Io. at section 68(6).

[106] (7) Subject to subsections (8) and (10) below, an individual who is for the time being prohibited as aforesaid from dealing on a recognised stock exchange in any securities by reason of his having any information, shall not communicate that information to any other person if he knows or has reasonable cause to believe that that or some other person will make use of the information for the purpose of dealing, or of counselling or procuring any other person to deal, on a recognised stock exchange in those securities.

Io. at section 68(7).

[107] (8) The provisions of this section shall not prohibit an individual by reason of his having any information from—
(a) doing any particular thing otherwise than with a view to the making of a profit or the avoidance of a loss (whether for himself or another person) by the use of that information;
(b) entering into a transaction in the course of the exercise in good faith of his functions as liquidator, receiver or trustee in bankruptcy; or
(c) doing any particular thing if the information—the
(i) was obtained by him in the course of a business of a jobber in which he was engaged or employed; and
(ii) was of a description which it would be reasonable to expect him to obtain in the ordinary course of that business; and he does that thing in good faith in the course of that business.

Io. at section 68(8).


[110] (4) Subject to subsections (8) and (10) below, where an individual is contemplating, or has contemplated, making, whether with or without another person, a takeover offer for a company in a particular capacity, that individual shall not deal on a recognised stock exchange in securities of that company in another capacity if he knows that information that the offer is contemplated or is no longer contemplated is unpublished price sensitive information in relation to those securities.

1980 Act at § 68(4).


[112] (3) Subject to subsections (8) and (10) below, where—
(a) any individual has information which he knowingly obtained (directly or indirectly) from another individual who is connected with a particular company, or was at any time in the six months preceding the obtaining of the information so connected and who the former individual knows or has reasonable cause to believe held the information by virtue of being so connected; and
(b) the former individual knows or has reasonable cause to believe that, because of the latter’s connection and position, it would be reasonable to expect him not to disclose the information except for the proper performance of the functions attaching to that position; then, the former individual—
(i) shall not himself deal on a recognised exchange in securities of that company if he knows that the information is unpublished price sensitive
(ii) shall not himself deal on a recognised stock exchange in securities of any other company if he knows that the information is unpublished price sensitive information in relation to those securities and it relates to any transaction (actual or contemplated) involving the first company and the other company or involving one of them and securities of the other or to the fact that any such transaction is no longer contemplated.

[113]

(5) Subject to subsections (8) and (10) below, where an individual has knowingly obtained (directly or indirectly), from an individual to whom subsection (4) above applies, information that the offer referred to in subsection (4) is being contemplated or is no longer contemplated, the former individual shall not himself deal on a recognised stock exchange in securities of that company if he knows that the information is unpublished price sensitive information in relation to those securities.

1980 Act at section 68 (5).

Id. at section 68(3).


[115] (1) This section applies to any information which –
(a) is held by a Crown servant or former Crown servant by virtue of his position or former position as a Crown servant or is knowingly obtained by an individual (directly or indirectly) from a Crown servant or former Crown servant who he knows or has reasonable cause to believe held the information by virtue of any such position;
(b) it would be reasonable to expect an individual in the position of the Crown servant or former position of the former Crown servant not to disclose except for the proper performance of the functions attaching to that position; and
(c) the individual holding it knows is unpublished price sensitive information in relation to securities of a particular company (relevant securities).

(2) This section applies to a Crown servant or former Crown servant holding information to which this section applies and to any individual who knowingly obtained any such information (directly or indirectly) from a Crown servant or former Crown servant who that individual knows or has reasonable cause to believe held the information by virtue of his position or former position as a Crown servant.

1980 Act at section 69.


[118] Id. (quoting B.A.K. Rider (British securities expert)).


[120] Poser, supra note 67, at 1270; Hetherington, Insider Trading and the Logic of the Law, 1967 Wisc. L. Rev. 720, 737 n. 81 (arguing that "the 'unfairness' would appear substantially the same from the standpoint of an outsider who deals with an informed trader" regardless of the source of the inside information); see also Note, Rationalizing Liability for Non-disclosure Under 10b-5: Equal Access to Information in United States v. Chiarella, 1980 Wis. L. Rev. 163.