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OUTSIDER TRADING ON CONFIDENTIAL INFORMATION—A BREACH IN SEARCH OF A DUTY

*Roberta S. Karmel**

INTRODUCTION

Insider trading cases are a key part of the enforcement program of the Securities and Exchange Commission (“SEC”).¹ Many prosecutions of insider trading, however, do not involve true insider trading. Rather, they involve trading by outsiders, that is, persons who are not employed by the issuer whose securities are traded, and who trade on nonpublic market information. A frequent type of outsider trading is trading in anticipation of a tender offer not yet announced. Because of the egregious facts underlying these cases, the SEC has been able to prosecute hundreds of cases without formulating a reasoned analysis of the legal and policy issues involved. Also, despite the large number of articles discussing insider trading, a general consensus among commentators has not developed as to why insider trading is unlawful.²

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¹ In 1995 the SEC prosecuted 45 insider trading cases out of 486 total enforcement cases. See SEC ANN. REP. 1, 13 (1995). Over the past ten years, the SEC has brought over 400 insider trading cases. See WILLIAM R. MCLUCAS & NANCY E. ALLIN, *INSIDER TRADING—RECENT DEVELOPMENTS OUTLINE 1* (1997).

² Articles on insider trading are too numerous to cite. Some of the more significant articles are as follows: Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309; Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179 (1991). See also DONALD C. LANGEVOORT, *INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION* (1991); HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* (1996).

The United States Supreme Court rejected some of the SEC's early theories about insider trading, causing the government to increasingly rely upon the misappropriation theory, especially in prosecutions relating to tender offers.³ Although the Court recently approved the misappropriation theory in *United States v. O'Hagan*,⁴ it did not develop a broad doctrine or policy rationale that will assist the lower courts in distinguishing between lawful and unlawful outsider trading. Furthermore, while the SEC is now free to prosecute misappropriation cases, it does not have a framework for deciding whether to pursue traders on outside information in other factual situations. Therefore, a theoretical and policy justification for the ban on insider trading remains necessary.

Part I of this Article traces the development of the law prohibiting trading on inside information in the United States. Part II of this Article discusses the most common theories justifying the ban on such trading, which are as follows: fairness, parity of information, fiduciary duty, misappropriation, efficiency, and property rights. Part III then discusses the author's view that prohibitions against trading on inside information should be justified as necessary to enforce the mandatory disclosure provisions of the securities laws but should extend no further. Also, this Part argues that instead of trying to suppress the use of nonpublic information, the SEC and other securities regulators should encourage more rapid disclosure of material information. In this regard, perhaps the SEC has been overly concerned about the welfare of securities analysts and bidders in takeovers.

Often, the prosecution of traders on inside information by the SEC has been pursued as an end in itself to rid Wall Street of such flamboyant and controversial personalities as Ray Dirks and Michael Milken.⁵ Also, the SEC has utilized insider trading scandals to expand its reach into cases involving misconduct by securities attorneys and other finance professionals.⁶ Yet, market profes-

³ See *infra* Part II.C-D.

⁴ 117 S. Ct. 2199 (1997).

⁵ See generally CONNIE BRUCK, *THE PREDATORS' BALL* (1989); RAY L. DIRKS & LEONARD GROSS, *THE GREAT WALL STREET SCANDAL* (1974); JESSE KORNBLUTH, *HIGHLY CONFIDENT* (1992).

⁶ Attorneys, more than any other group, have been prosecuted for insider trading. These cases include the notorious "Yuppie Five" scandal and the prosecutions of Ilan Reich and Carlo Florentino, partners of Wachtell, Lipton, Rosen & Katz; Israel Grossman, associate at Kramer, Levin, Nessin, Kamin & Frankel; and Kenneth Rubinstein of Fried, Frank, Harris, Shriver & Jacobson. See Donald Baer, *A Yuppie Fable*, *AM. LAW.*, July-Aug. 1986, at 114; Bryan Burrough, *Fates Are Disparate for Those Charged with In-*

sionals who enjoy time and place advantages with respect to market information do not owe a general duty to investors and therefore are not inhibited from profiting from market information to the fullest extent possible.⁷ The failure of securities regulators and courts to highlight this principle and articulate when, and why, insiders, their tippees, and other professionals do owe a duty to refrain from taking advantage of market information has maintained the continuing confusion concerning the parameters of the crime of trading on inside information.

I. DEVELOPMENT OF INSIDER TRADING LAW

A. Sources of U.S. Law on Insider Trading

There are four sources for the prohibitions against trading on inside information under the United States federal securities laws. They are: section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")⁸ and SEC Rule 10b-5 ("Rule 10b-5") thereunder,⁹ section 16 of the Exchange Act;¹⁰ section 14(e) of the Exchange Act¹¹ and SEC Rule 14e-3 ("Rule 14e-3") thereunder,¹² and the statutory amendments to the Exchange Act passed in the 1980s that increased the sanctions for insider trading violations.¹³ The most important of these sources in the jurisprudence of insider trading is Rule 10b-5 which makes it unlawful for any person in connection with the purchase or sale of a security:

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

Insider Trading, WALL ST. J., Nov. 18, 1987, at A22. See generally Stephen M. Bainbridge, *Insider Trading Under the Restatement of Law Governing Lawyers*, 19 IOWA J. CORP. L. 1 (1993); Simon M. Lorne & W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC*, 50 BUS. LAW. 1293, 1313 (1995).

⁷ In *scalping* and *front-running* cases, both of which involve trading on nonpublic market information, breach of a fiduciary duty to an investment advisory or broker-dealer customer may be actionable. See *infra* Part II.G.

⁸ 15 U.S.C. § 78j(b) (1994).

⁹ 17 C.F.R. § 240.10b-5 (1998).

¹⁰ 15 U.S.C. § 78p.

¹¹ 15 U.S.C. § 78n(e).

¹² 17 C.F.R. § 240.14e-3.

¹³ The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered subdivisions of 15 U.S.C. § 78); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered subdivisions of 15 U.S.C. §§ 78, 80b-4a). This article does not discuss the prosecution of insider trading under the mail fraud or wire transfer statutory provisions in 18 U.S.C. §§ 1341, 1343. These provisions have sometimes formed the basis for insider trading violations. See, e.g., *Carpenter v. United States*, 484 U.S. 19 (1987); see also WANG & STEINBERG, *supra* note 2, at 733-60.

make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements 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 on any person.¹⁴

Rule 10b-5 makes no reference to insiders. It simply prohibits certain fraudulent conduct by *any* person upon *any* other person.¹⁵

The typical insider trading case involves silence. The complete failure to disclose that a buyer or seller of securities is in possession of material nonpublic information is not generally viewed as a violation of subsection (b) of Rule 10b-5, which relates only to the making of untrue or misleading statements.¹⁶ Rather, such inaction can be interpreted as "a device, scheme or artifice to defraud" in violation of subsection (a) or as an "act, practice or course of business which operates as a fraud or deceit" upon a third person in violation of subsection (c). Although Rule 10b-5 generally prohibits fraudulent and deceptive practices in the public securities markets, it does not, however, extend so far as to outlaw all breaches of fiduciary duty or overreaching.¹⁷

The term *inside information*, initially meant nonpublic information that concerns events or circumstances related to a company's assets or earning power that is known only to corporate management and its confidants and that can reasonably be expected to materially affect the market price of the company's stock.¹⁸ Classic insider trading involves trading upon such information by corporate directors, officers, employees, or their tippees. However, a current definition is more expansive for it includes "unlawful trading in securities, by persons who possess material nonpublic information about the company whose shares are traded or the market for its shares."¹⁹ This definition includes "market information," which is information about events or circumstances

¹⁴ 17 C.F.R. § 240.10b-5.

¹⁵ *See id.*

¹⁶ Under an extreme version of the "fraud on the market theory," silence could be misleading. *See Basic Inc. v. Levinson*, 485 U.S. 224 (1988). There are many situations in the business world where one party to a business transaction can take advantage of another by remaining silent. In some contexts such silence is actionable, while in others it is not. To some extent it depends upon whether the parties are dealing at arms length or whether the silent party owes a fiduciary duty to the disadvantaged party. *See Deborah A. Demott, Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994).

¹⁷ *See Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

¹⁸ *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

¹⁹ LANGEVOORT, *supra* note 2, at 5.

that affect the market for a company's securities but does not affect the company's assets or earning power.²⁰ Market information may be referred to as "outside information" because it relates to activities generated by investors, traders, market makers, brokerage firms, and others. Information concerning a tender offer is market information, and Rule 14e-3 generally prohibits anyone other than a bidder obtaining information about an unannounced tender offer from trading on that information.²¹

B. *Insider Trading as a Fraud Under Rule 10b-5*

At common law, trading on inside information over a stock exchange was not regarded as unlawful or a breach of fiduciary duty by a director to a shareholder because directors were deemed to owe fiduciary duties to their corporations, not individual shareholders.²² However, the *special facts* doctrine articulated an affirmative duty to disclose material, nonpublic facts in face-to-face dealings between an insider and a shareholder.²³ These concepts were carried over into private litigation through the anti-fraud provisions.²⁴

The SEC broadened the scope of an insider's duty under Rule 10b-5 in *In re Cady, Roberts & Co.*,²⁵ an SEC administrative proceeding in which the director of an issuer, who was also a principal of a brokerage firm, used undisclosed adverse information—the issuer's decision to cut a dividend—to recommend and effect the sale of securities for customers of the broker. In holding that this was a violation of Rule 10b-5, the SEC stressed the existence of a relationship affording access to inside information intended only for a corporate purpose and the unfairness in allowing a corporate insider to take advantage of that information by trading without disclosure.²⁶

Shortly after *Cady, Roberts*, the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*,²⁷ broadly endorsed the prin-

²⁰ See *United States v. Chiarella*, 588 F.2d 1358, 1365 n.8 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980); Arthur Fleischer Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973).

²¹ See 17 C.F.R. § 240.14e-3 (1998).

²² See *Goodwin v. Aggasiz*, 180 N.E. 659, 660 (Mass. 1933).

²³ See generally *Strong v. Repide*, 213 U.S. 419 (1909).

²⁴ See *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Geller v. Transamerica Corp.*, 53 F. Supp. 625 (D. Del. 1943).

²⁵ 40 S.E.C. 907 (1961). An earlier section 21(a) report predated Rule 10b-5. See *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943).

²⁶ See *Cady, Roberts*, 40 S.E.C. at 917-18.

²⁷ 375 U.S. 180 (1963).

principle that a fiduciary in the possession of market information must abstain from trading on such information. This case arose under section 206 of the Investment Advisers Act of 1940, an antifraud provision worded very similarly to section 10(b) of the Exchange Act ("section 10(b)").²⁸ *Capital Gains* involved an effort by the SEC to require registered investment advisers to disclose to their clients the practice of purchasing shares of a security for their own accounts shortly before recommending that security for long term investment, and then immediately selling the shares at a profit upon the rise in the market price following the recommendation. The Court found that such undisclosed "scalping" was a "practice which operates as a fraud or deceit" upon clients.²⁹

The first major court case affirming the use of Rule 10b-5 in actions against those who trade on undisclosed, material corporate information was *SEC v. Texas Gulf Sulphur Co.*³⁰ In *Texas Gulf Sulphur*, the SEC sought to enjoin an issuer, its officers, and employees from trading and tipping others to trade stock and options where there was material, undisclosed information about a copper strike in Canada. The *Texas Gulf Sulphur* decision was predicated

²⁸ 15 U.S.C. § 80b-6 (1994) provides, in pertinent part:

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

²⁹ *Capital Gains*, 375 U.S. at 181. Investment advisers have a fiduciary relationship to their clients, and therefore trading on market information ahead of client transactions breaches a fiduciary duty to such clients. *See id.* In cases where no such fiduciary relationship exists, it has been necessary to utilize other theories to charge antifraud violations. *See United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd in part by an equally divided Court*, 484 U.S. 19 (1987); *cf. In re E.F. Hutton & Co.*, Exchange Act Release No. 25,887, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988).

³⁰ 401 F.2d 833 (2d Cir. 1968).

on the theory that Rule 10b-5 is based on the justifiable expectation of the securities marketplace that investors trading on impersonal exchanges should have relatively equal access to material information.³¹ The case reversed the common law rule that an action by a stockholder against a seller of securities cannot be predicated upon mere silence even if the seller is a director of the issuer.³²

In *Texas Gulf Sulphur*, the SEC argued, and the United States Court of Appeals for the Second Circuit accepted, the theory that the antifraud provisions of the Exchange Act require a parity of information among all traders in the public securities markets. This did not mean that all investors should have precisely the same information; rather, they should all enjoy access to the same information. Accordingly, an insider or his tippee who comes into possession of confidential nonpublic information should disclose that information or refrain from trading on it.³³ There are two problems with this argument. First, by stressing the obligation to refrain from trading, it sanctions nondisclosure rather than mandating prompt disclosure.³⁴ Second, the parity of information theory has not been accepted by the Supreme Court or the SEC itself.

The reason the parity of information theory was eventually rejected was that it quickly became apparent that a theory mandating a seller of securities to either disclose *any* material information about securities known to the seller, but not generally known to the marketplace, or to abstain from trading, was much too broad. It also became apparent that security analysts and other market professionals whose job it was to ferret out information about securities should be given the opportunity to trade on such information because permitting such trading would provide an incentive for better disclosure about, and more efficient pricing of, securities. Furthermore, in situations involving market information, rather than inside corporate information, a blanket prohibition against trading on information, not known throughout the markets, would impede market liquidity. Accordingly, the law on

³¹ See *id.* at 848.

³² See *id.*

³³ See *id.* In *Basic Inc. v. Levinson*, a corporate officer denied the existence of merger negotiations when his corporation was conducting such negotiations. 485 U.S. 646 (1983). Neither he nor his company had engaged in trading the company's stock. The Court's opinion broadly affirmed the case against a person who was neither a purchaser nor seller, as well as the definition of materiality enunciated in *Texas Gulf Sulphur*, thus giving new life to *Texas Gulf Sulphur* as an important precedent under Rule 10b-5.

³⁴ See BERNHARD BERGMANS, *INSIDE INFORMATION AND SECURITIES TRADING: A LEGAL AND ECONOMIC ANALYSIS OF LIABILITY IN THE U.S.A. AND THE EUROPEAN COMMUNITY* 54-57 (1991).

inside information proceeded to balance a policy favoring fairness to investors in general with legitimate business needs in keeping information confidential or in permitting professionals to trade on information not obtained through improper or surreptitious means. Left open was the question of when outsiders could trade on material, undisclosed corporate or market information.

Differences in opinion at the SEC as to a theoretical basis for insider trading bans that was narrower than the one articulated in *Cady, Roberts* arose in *Investors Management Co.*³⁵ This administrative proceeding was brought against investment advisers and mutual funds that sold stock in McDonnell Douglas Corporation, as the result of selective disclosure to institutional investors of nonpublic adverse information by Merrill Lynch, Pierce, Fenner & Smith.³⁶ The SEC opinion set forth the doctrine that one who obtains material, nonpublic corporate information, which he has reason to know emanates from a corporate source and which by itself places him in a position superior to other investors, and thereby, with respect to that information, falls within the purview and restraints of the antifraud provisions. In a concurring opinion, Commissioner Smith posited the view that tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given in breach of a duty by one having a special relationship to the issuer and an obligation not to disclose the information.³⁷ Further, the information must be shown not only to be material and nonpublic, but to have substantially contributed to the resulting trading.³⁸

Soon thereafter, the Supreme Court limited the scope of insider trading violations in *Chiarella v. United States*.³⁹ This case involved a printer who learned about upcoming tender offers to purchase stock in target companies. The Court held that silence in connection with a purchase or sale of securities may operate as a fraud only if liability is premised on a duty to disclose, arising out of a relationship of trust and confidence, not merely on one's abil-

³⁵ Exchange Act Release No. 9267, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163 (July 29, 1971).

³⁶ Merrill Lynch had learned of this information in its role as underwriter of McDonnell Douglas debentures. In a separate proceeding, Merrill Lynch consented to a sanction and established a "Chinese Wall" between its investment banking and brokerage departments to prevent such misuse of inside information. See *In re Merrill Lynch, Pierce, Fenner, & Smith*, 43 S.E.C. 933 (1968).

³⁷ See *Investors Management Co.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 80,523-24 (Smith, C., concurring).

³⁸ See *id.*

³⁹ 445 U.S. 222 (1980).

ity to utilize information because of his position in the marketplace. The Court pointed out that, although the defendant's conduct may have been reprehensible, not every instance of financial unfairness violates Rule 10b-5. In a dissenting opinion, Chief Justice Burger set forth the view that anyone who misappropriates material, nonpublic information in breach of an employment, fiduciary, or similar duty and then trades on, or tips, that information to his own advantage violates Rule 10b-5.⁴⁰

Later, in *Dirks v. SEC*,⁴¹ the Supreme Court clarified its views set forth in *Chiarella* by essentially adopting the rationale of Commissioner Smith's concurring opinion in *Investors Management*. In *Dirks*, a securities analyst and an officer of a broker-dealer firm received information from a former officer of Equity Funding Corporation of America to the effect that the corporation was permeated with fraud. In the course of Dirks's futile effort to publicize this information generally, institutions informed by Dirks about the fraud sold Equity Funding stock. Dirks did not have a client or fiduciary relationship with Equity Funding, nor did his tipper breach a fiduciary duty to Equity Funding when he tipped Dirks. Still, the SEC sanctioned Dirks, holding that when tippees, regardless of their motivation or occupation, come into possession of material information that they know is confidential and know, or should have known, came from a corporate insider, they must publicly disclose that information or otherwise refrain from trading.

The Supreme Court reversed the circuit court's affirmation of the SEC's opinion, holding that a duty to disclose arises from the relationship between parties, not merely from a person's ability to utilize information because of his market position.⁴² The Court stated in dictum that under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, outsiders may become fiduciaries of the stockholders and, thus, be regarded as "temporary insiders."⁴³ However, the court stressed that the basis for recognizing this fiduciary duty is not simply that such persons have acquired nonpublic corporate information, but rather that they have entered into a special, confidential relationship and

⁴⁰ See *id.* at 243, 245. The misappropriation theory was not, however, presented to the jury.

⁴¹ 463 U.S. 646 (1983).

⁴² See *id.* at 657-58.

⁴³ *Id.* at 655 n.14.

are given access to information solely for corporate purposes.⁴⁴

C. *The Misappropriation and Remote Tippee Cases*

After *Chiarella* and *Dirks*, the SEC and private plaintiffs had difficulty prosecuting insider trading cases without alleging some breach of a fiduciary duty. However, in cases involving trading on market or tipped information, a fiduciary relationship was often lacking. The charges in these cases were, therefore, based on either the misappropriation theory articulated in Chief Justice Berger's dissent in *Chiarella*,⁴⁵ or the Court's dictum in *Dirks* stating that agents of a corporation may become "temporary insiders" and therefore fiduciaries of the stockholders.⁴⁶

These theories proved quite serviceable in numerous cases. The United States Courts of Appeals for the Second,⁴⁷ Third,⁴⁸ Seventh,⁴⁹ and Ninth⁵⁰ Circuits adopted the misappropriation theory and applied it in a variety of fact patterns involving both temporary insiders⁵¹ and the use of market information.⁵² The limitations of these theories became apparent, however, even in the Second Circuit, where the theory had been utilized in some marginal cases.⁵³ In *United States v. Chestman*,⁵⁴ a husband tipped a stockbroker concerning information—subsequently traded by the stockbroker—that the husband had learned from his wife, who had learned it from her mother, who had learned it from her brother, a corporate insider. The court could find no fiduciary relationship in this chain of tipsters that would make the husband culpable under Rule 10b-5. The court held that kinship did not suffice and that

⁴⁴ See *id.*

⁴⁵ See *supra* text accompanying note 40; see *infra* text accompanying notes 152-53.

⁴⁶ See *Dirks*, 463 U.S. at 655 n.14. A wide variety of special relationships and tippees have been implicated in insider trading cases. See WANG & STEINBERG, *supra* note 2, at 283-344.

⁴⁷ See, e.g., *United States v. Libera*, 989 F.2d 596, 599-600 (2d Cir. 1993); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc).

⁴⁸ See, e.g., *Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986).

⁴⁹ See, e.g., *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *SEC v. Cherif*, 933 F.2d 403, 408-09 (7th Cir. 1991).

⁵⁰ See, e.g., *SEC v. Clark*, 915 F.2d 439, 443-44 (9th Cir. 1990).

⁵¹ See, e.g., *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *U.S. v. Teicher & Co.*, 785 F. Supp. 1137, 1150 (S.D.N.Y. 1992); *SEC v. Musella*, 748 F. Supp. 1028, 1038 (S.D.N.Y. 1989), *aff'd*, 898 F.2d 138 (2d Cir. 1990).

⁵² See *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983).

⁵³ See, e.g., *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided Court*, 484 U.S. 19 (1987); *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

⁵⁴ 947 F.2d 551 (2d Cir. 1991) (en banc).

the husband-defendant did not explicitly assume a duty of confidentiality because of the information he received.⁵⁵ A strongly worded dissent criticized this opinion as drawing an unrealistic line in leading to a perverse and circular result.⁵⁶

Moreover, in *Carpenter v. United States*,⁵⁷ the Court shed doubt on the continued application of Rule 10b-5 in preventing outsiders from trading on material, nonpublic market information even under the misappropriation theory. This case involved the trading by a *Wall Street Journal* financial reporter in the stocks of issuers scheduled to be written up in his "Heard on the Street" column. The defendant's conviction on mail fraud charges was affirmed by the Supreme Court, but there was a four to four split, with no opinion issued, on his securities fraud conviction. Further, this case was unique in that the information was lawfully obtained. In fact, according to the lower courts, the inside information he "misappropriated" for personal profit was the *Journal's* publishing schedule, not information specifically regarding the securities' issuers.⁵⁸

Despite its acceptance in four other circuits, the misappropriation theory was rejected by the United States Court of Appeals for the Fourth Circuit in *United States v. Bryan*,⁵⁹ a case involving corruption in the awarding of contracts by the Director of the West Virginia Lottery ("Lottery"). In addition to the defendant's fraudulent manipulation of two government contracts resulting in his conviction on mail and wire fraud charges, the defendant used confidential, nonpublic information in the purchase of securities of companies doing business with the Lottery, resulting in his conviction on securities fraud charges. The court upheld all charges except the conviction under Rule 10b-5. The court held that criminal liability under section 10(b) could not "be predicated upon the mere misappropriation of information in breach of a fiduciary duty owed to one who is neither a purchaser nor seller of securities, or in any way connected with, or financially interested in an actual or proposed purchase or sale of securities."⁶⁰

In *United States v. O'Hagan*, the Eighth Circuit joined the Fourth Circuit in rejecting the misappropriation theory.⁶¹ This was

⁵⁵ See *id.* at 567-68.

⁵⁶ See *id.* at 580 (Winter, J., dissenting).

⁵⁷ 484 U.S. 19 (1987).

⁵⁸ See *Carpenter*, 791 F.2d at 1027, 1031.

⁵⁹ 58 F.3d 933 (4th Cir. 1995).

⁶⁰ *Id.* at 952.

⁶¹ See 92 F.3d 612 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

a much more conventional case involving trading in the securities of a target company by an attorney representing the prospective bidder. The Eighth Circuit took the position that the misappropriation theory conflicts with those Supreme Court cases holding that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not "deception" within the meaning of section 10(b).⁶² Moreover, the court reasoned that the misappropriation theory permits a case to be predicated on a breach of duty to one who is neither a buyer nor a seller of securities, thus omitting a necessary element of a section 10(b) violation.⁶³ Accordingly, the defendant's conviction for securities fraud, which was based on the misappropriation theory, was overturned.

The Supreme Court reversed the Eighth Circuit and affirmed the defendant's Rule 10b-5 conviction under the misappropriation theory. Unfortunately, the majority opinion, authored by Justice Ginsburg, did not offer any theoretical justification for banning insider trading or endorsing the misappropriation theory other than that it insures honest securities markets and promotes investor confidence.⁶⁴ Rather, the Court attempted to show how the insider trading laws fit into the various theories used to justify the ban.⁶⁵ According to the Court, the breach of a duty of loyalty or confidentiality by a fiduciary, which deprives a principal of the exclusive use of confidential information, and the self-serving use of that information to purchase or sell securities satisfy the "deception" and "in connection with" requirements of Rule 10b-5.⁶⁶ Since the Court limited the misappropriation theory to situations where the defendant was entrusted with access to confidential information and deceived the source of the information by using that information for personal trading, it is unclear how the Court would hold

⁶² See *id.* at 616-19.

⁶³ See *id.* at 617. The purchaser-seller requirement comes from *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The view of the *O'Hagan* circuit court that this requirement is not a standing requirement but rather an interpretation of the "in connection with" language of section 10(b) was contrary to the Supreme Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 646 (1983), and was rejected by the Supreme Court. See *supra* note 33. Justice Thomas, dissenting, agreed with the Eighth Circuit's analysis.

⁶⁴ See *O'Hagan*, 117 S. Ct. at 2210. Justice Scalia filed an opinion, concurring in part and dissenting in part, rejecting the misappropriation theory, in a criminal case under Rule 10b-5 on grounds of lenity. Justice Thomas, joined by the Chief Justice, filed an opinion concurring in the judgment on the defendant's mail fraud convictions but dissenting on his conviction under the securities laws.

⁶⁵ In its discussion of the harm to the investing public, the breach of fiduciary duty, and the deception of the source of the confidential information, the Court invokes the parity of information, fiduciary duty, and property rights theories. See *id.* at 2208, 2210.

⁶⁶ See *id.* at 2210.

on a variety of other fact patterns.

In dictum, the Court stated that if a fiduciary discloses to his source his plans to trade on nonpublic information, there is no deception and, therefore, no Rule 10b-5 violation.⁶⁷ The Court stressed that such disclosure must be made to all whom the trader owes a duty of loyalty and confidentiality,⁶⁸ although the source could presumably trade on the information. From a theory and policy perspective, this is the weakest part of the Court's opinion simply because it fails to tie the ban against insider trading to the overarching disclosure policies of the securities laws that mandate disclosure to public investors. There is little justification for making the breach of an agency or fiduciary duty to an employer, client, or similar beneficiary a federal, rather than a state law, claim unless a national economic interest is implicated. The securities laws generally mandate public disclosure about issuers and transactions in their securities, in order to foster investor confidence in the fairness of the public securities markets. The theories making insider trading illegal should be tied to these general federal disclosure policies.

D. *Insider Trading in Advance of Tender Offers*

In addition to section 10(b) and Rule 10b-5, the SEC has utilized the 1968 Williams Act amendments to the Exchange Act, and in particular, section 14(e)⁶⁹ and Rule 14e-3⁷⁰ thereunder, to combat trading on nonpublic information regarding potential tender offers. The Williams Act was enacted to protect investors when confronted with an offer to purchase their shares in a change of control transaction through its requirements of disclosure and equal or fair rights to participate in the tender offer. Rule 14e-3 was adopted not long after *Chiarella* in order to provide the SEC with a better tool than Rule 10b-5 for dealing with the misuse of information in the tender offer arena.⁷¹

Rule 14e-3 imposes a disclose or abstain requirement upon any person, other than a bidder or prospective bidder, who is in possession of material information relating to a tender offer

which information he knows or has reason to know is non-

⁶⁷ See *id.* at 2209.

⁶⁸ See *id.* at 2226 n.7.

⁶⁹ 15 U.S.C. § 78n(e) (1994).

⁷⁰ 17 C.F.R. § 240.14e-3 (1998).

⁷¹ Tender Offers, Exchange Act Release No. 17,120, 20 SEC Docket (CCH) 1241 (Sept. 4, 1980). The author was a Commissioner of the SEC when this rule was proposed.

public and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) . . . [the target], or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person . . .⁷²

The SEC, in a release adopting Rule 14e-3, justified the rule on the grounds that trading by persons in possession of material, nonpublic information relating to a tender offer results in unfair disparities in market information and market disruption because security holders who purchase from, or sell to, such persons are effectively denied the protections of the Williams Act. If furnished with information about the tender offer, however, these investors could make an informed investment decision.⁷³ No breach of a fiduciary duty need be demonstrated under this theory, which is essentially the parity of information theory in the context of a tender offer. In addition, Rule 14e-3 was clearly intended to enforce the disclosure provisions of the Exchange Act relating to tender offers.

Because Rule 14e-3 avoids some important elements required in a Rule 10b-5 action, in particular the need to prove breach of a fiduciary duty and scienter,⁷⁴ persistent questions existed concerning its validity since its adoption. These questions were first addressed by the Second Circuit in the aforementioned case of *United States v. Chestman*.⁷⁵ In an en banc decision (with one dis-

⁷² 17 C.F.R. § 240.14e-3.

⁷³ See Tender Offers, Exchange Act Release No. 17,120, 20 SEC Docket (CCH) 1241 (Sept. 4, 1980). Sections 13(d) and 14(e) of the Exchange Act require more than five percent shareholders and bidders to disclose various matters, including any intention to make a tender offer. See 15 U.S.C. §§ 78m(d), n(e). In addition to disclosure obligations running from a bidder or prospective bidder to the shareholders of a target company, the Williams Act also imposes duties of fairness on bidders to such target shareholders. Among other things, section 14(d) of the Exchange Act requires that tendered shares are withdrawable for a specific period; if the offer is for less than 100% and more shares are tendered than desired, that acceptance must be pro rata; and that if the offer price is raised within 10 days of the commencement of the offer, those shareholders who have already tendered are entitled to the higher price. See 15 U.S.C. § 78n(d). A target company shareholder who sells in advance of a tender offer announcement loses these protections. But, why is he worse off if he sells to a buyer with inside information about the forthcoming tender offer? This Article argues there should be some relationship between the buyer and the bidder for the rule to be justified as prophylactic.

⁷⁴ The scienter requirement stems from the Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

⁷⁵ 947 F.2d 551 (2d Cir. 1991) (en banc); see *supra* notes 54-55 and accompanying text. In the circuit court's first opinion in this case, a majority found that a Rule 14e-3 criminal conviction was invalid, but the two majority judges set forth different reasons for their finding. On the one hand, Judge Carman found that Rule 14e-3 was a valid exercise of the SEC's authority, but only because he read the rule as requiring proof of scienter and a breach of a fiduciary relationship. He, nevertheless, voted to reverse Chestman's conviction because the district court failed to instruct the jury as to those elements. See *United*

sent), Judge Meskill, writing for the majority, upheld the defendant's conviction and the SEC's authority to promulgate Rule 14e-3 on two grounds. First, the statutory power to define and prescribe means reasonably designed to prevent fraudulent acts and practices permits the SEC to define fraud beyond the common law definition.⁷⁶ Second, the power to prevent fraud in the tender offer context necessarily encompasses the power to proscribe conduct outside the purview of common law or SEC-defined fraud.⁷⁷ The Seventh and Tenth Circuits subsequently joined in this rationale.⁷⁸

Likewise, in the *O'Hagan* case,⁷⁹ the Supreme Court held that by giving the SEC the authority to regulate nondeceptive activities as a reasonably designed means of preventing manipulative acts under section 14(e), the "[c]ommission may prohibit acts, not themselves fraudulent under the common law or § 10(b)," if the prohibition is reasonably designed to prevent fraudulent acts and practices.⁸⁰ Further, under either a definitional or preventive analysis, the Court gave the SEC rulemaking deference regarding Rule 14e-3.⁸¹

There is a difference between interpreting a broad or ambiguous statute or rule by referring to the common law, and holding, as the Eighth Circuit appeared to do in *O'Hagan*, that a statute and rule is limited by the common law. Congress passed broad, remedial securities legislation, like the Exchange Act, in order to make the public securities markets fair and equitable because of the inadequacies in the common law. Further, it is clear from recent amendments to the Exchange Act that Congress intends for insider trading to be unlawful. However, the Supreme Court, in *O'Hagan*, did not rely upon the argument, accepted elsewhere,⁸²

States v. Chestman, 903 F.2d 75, 87-88 (2d Cir. 1990) (Carman, J., concurring). On the other hand, Judge Mahoney took the position that Rule 14e-3 was beyond the SEC's authority because it does not require that any fiduciary duty exist or be violated. He interpreted the "deceptive acts or practices" language of section 14(e) as limiting the SEC's rulemaking authority to common law fraud, and he further took the position that such fraud requires a pre-existing duty. *See id.* at 85 (Mahoney, J., concurring).

⁷⁶ *See* United States v. Chestman, 947 F.2d at 558.

⁷⁷ *See id.*

⁷⁸ *See* SEC v. Maio, 51 F.3d 623 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162 (10th Cir. 1992).

⁷⁹ *See* discussion *supra* text accompanying notes 61-68.

⁸⁰ *See* United States v. O'Hagan, 117 S. Ct. 2199, 2217 (1997).

⁸¹ *See id.* at 2218 n.19. The Court relied upon the deference standard of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The Court pointed out that the language of section 14(e) more closely resembles section 15(c)(2) than section 10(b). *See O'Hagan*, 117 S. Ct. at 2217 n.16.

⁸² *See* Maio, 51 F.3d at 633.

that Congress had amended the Exchange Act to impose sanctions for violation of Rule 14e-3, which by implication approved the rule as interpreted by the SEC.⁸³ Perhaps this was because Congress has never defined insider trading nor set forth any theories as to why it is wrong.

E. *Statutory Developments in the 1980s*

In 1984 and 1988 the Exchange Act was amended both to increase the sanctions for insider trading and make SEC enforcement more effective. Before describing the 1984 and 1988 statutes, some background on damage claims brought under Rule 10b-5 is necessary. In *Shapiro v. Merrill Lynch*,⁸⁴ a case growing out of the widespread insider trading in McDonnell Douglas stock, the Second Circuit implied a private right of action against traders and tippees for investors who purchased securities in the open market during the period of the illegal sales and prior to public disclosure of the adverse news. This private action had enormous civil liability potential and, in the context of a suit against an issuer, could have resulted in the possible unfairness, shifting the losses from one group of shareholders, who purchased or sold before material information was released, to those shareholders owning stock at the time an insider trading case concluded.

In response, the courts backed away from the implications of *Shapiro*. In *Elkind v. Liggett & Myers, Inc.*,⁸⁵ the Second Circuit announced a disgorgement measure of damages in insider trading cases. In explaining why an out-of-pocket measure should be rejected, the court pointed to the "potential for imposition of Draconian, exorbitant damages, out of all proportion to the wrong committed, lining the pockets of all interim investors and their counsel at the expense of innocent corporate stockholders."⁸⁶ In addition to cutting down on the measure of damages, the court subsequently cut back on the scope of the permissible plaintiff class in insider trading cases. After *Chiarella* and *Dirks*, the Second Circuit in *Moss v. Morgan Stanley, Inc.*,⁸⁷ declined to imply a private right of action in favor of a selling shareholder of a target corporation where there had been purchases of the target's shares

⁸³ See *id.* at 635 n.11.

⁸⁴ 495 F.2d 228 (2d Cir. 1974).

⁸⁵ 635 F.2d 156 (2d Cir. 1980).

⁸⁶ *Id.* at 170. In *Wilson v. Comtech Communications Corp.*, the Second Circuit also limited the class of plaintiffs to "contemporaneous traders." 648 F.2d 88, 94-95 (2d Cir. 1981).

⁸⁷ See 719 F.2d 5 (2d Cir. 1983).

by an investment banker and his tippees, all of whom had learned about a takeover bid. In *Moss*, the investment banker's employer represented the bidder, and the court held that there was no duty owed by the bidder's investment banker to the target or its shareholders. Ironically, the court sustained a criminal conviction against the insider traders under the misappropriation theory.⁸⁸

The *Elkind* and *Moss* cases were criticized for failing to provide a significant monetary sanction against insider traders while at the same time sending people to jail for conduct for which they were not civilly liable.⁸⁹ Thus, in the Insider Trading Sanctions Act of 1984 ("ITSA"),⁹⁰ Congress gave the SEC the authority to seek up to three times the profits made, or losses avoided, as a civil penalty against insider traders. This penalty was intended to be imposed over and above any other remedies against the wrongdoer.⁹¹

The insider trading scandals of the 1980s received national attention after the enactment of the ITSA of 1984 so this law was perceived as ineffective. In an atmosphere of impending elections, Congress responded by passing the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA").⁹² This law reversed *Moss* by creating a private right of action on behalf of contemporaneous traders,⁹³ inserted a new bounty provision for persons who provide information on insider trading violations,⁹⁴ increased criminal fines to \$1,000,000 for individuals and \$2,500,000 for non-natural persons,⁹⁵ and gave the SEC greater authority to investigate international securities law violations.⁹⁶ In addition, broker-dealers and investment advisers were required to establish Chinese

⁸⁸ See *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981); *United States v. Courtois*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981).

⁸⁹ See Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 396-97 (1984).

⁹⁰ Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered subsections of 15 U.S.C. § 78 (1994)).

⁹¹ See Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1280-81 (1984) [hereinafter Langevoort, *Insider Trading Sanctions Act*].

⁹² Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered subsections of 15 U.S.C. §§ 78, 80b-4a; see Larry R. Lavoie, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 22 REV. SEC. & COMM. REG. 1 (1989).

⁹³ See Securities Exchange Act of 1934 § 20A, 15 U.S.C. § 78t-1(a). In effect, the holding of *Wilson v. Comtech Communications Corp.*, 648 F.2d 88 (2d Cir. 1981), was adopted as law. See *supra* note 86.

⁹⁴ See Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1(e).

⁹⁵ See Securities Exchange Act of 1934 § 32(a), *id.* § 78ff(a).

⁹⁶ See Securities Exchange Act of 1934 § 2(1), *id.* § 78b(1).

Walls and other procedures designed to prevent the misuse of material, nonpublic information.⁹⁷ By providing a remedy to open market sellers of a target company's stock to a bidder's tippees, Congress endorsed the liability of traders on market information in such situations.

In 1987 a serious legislative attempt was made to codify a definition of insider trading. A committee of securities lawyers suggested a definition that was then introduced as part of the Insider Trading Proscriptions Act of 1987.⁹⁸ It read: "information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal, or other relationship of trust and confidence."⁹⁹

The SEC objected to this definition and proposed a different bill.¹⁰⁰ After hearings, a revised bill, different from the initial Senate bill and the SEC initial proposal, was suggested that stated:

[T]rading while in possession of material, non-public information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.¹⁰¹

The substitution of a "possession" for a "use" standard proved so controversial that no action was thereafter taken until the next session of Congress when ITSFEA was passed.¹⁰² That 1988 statute contained no definition of insider trading on the theory that a statutory definition could have a potentially narrowing effect.¹⁰³ However, the legislative history endorsed a broad fiduci-

⁹⁷ See Securities Exchange Act of 1934 § 15(f), *id.* § 78o(f); Investment Advisers Act of 1940 § 204A, 15 U.S.C. § 80(b)-4(a).

⁹⁸ S. 1380, 100th Cong. (1987).

⁹⁹ *Id.* § 2.

¹⁰⁰ See Text of Draft "Insider Trading Act of 1987" Submitted by Securities & Exchange Commission, 19 Sec. Reg. & L. Rep. (BNA) 1284 (Aug. 7, 1987).

¹⁰¹ SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by *Ad Hoc* Legislation Committee, 19 Sec. Reg. & L. Rep. (BNA) 1817 (Nov. 18, 1987).

¹⁰² See generally Thomas Lee Hazen, *United States v. Chestman—Trading Securities on the Basis of Nonpublic Information in Advance of a Tender Offer*, 57 BROOK. L. REV. 595, 616 (1991).

¹⁰³ Cf. H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048.

ary duty standard and the misappropriation theory.¹⁰⁴

F. *Short Swing Profit Prohibitions*

Cady, Roberts, Texas Gulf Sulphur, Investors Management, and Dirks were all cases that involved classic leaks of undisclosed material information emanating from a corporate source. The ban against insider trading is also reinforced by the provisions of section 16 of the Exchange Act ("section 16"),¹⁰⁵ which require officers, directors, and holders of more than ten percent of any Exchange Act reporting issuer's stock to report all of their purchase and sale transactions in the equity securities of that issuer and to disgorge any profits on transactions effected within a six month period to the issuer. Section 16 sets out to prevent the unfair use of information that may have been obtained by insiders in the purchase or sale of securities. The prohibition is designed to inhibit officers, directors, and shareholders, who, with the benefit of advance information, trade in the stocks of their own companies.¹⁰⁶ Section 16 is thus a crude rule of thumb since the liability of an insider for short swing profits does not require the actual use of inside information.¹⁰⁷

Section 16 is a remarkably effective prophylactic tool for preventing trading on inside information by officers, directors, and major stockholders.¹⁰⁸ Since the *Texas Gulf Sulphur* case, there have been many insider trading cases over the years, but most have not involved direct trading by corporate officials. As a result, it has been debated as to whether there is a continuing need for the section 16 reporting requirements and short swing profit prohibitions. However, in light of stepped up SEC and civil enforcement of insider trading violations and other shareholder reporting requirements,¹⁰⁹ there are strong policy arguments against repealing section 16, as it plays a dual role in curbing trading on inside information while permitting insiders to own stock in their firms.¹¹⁰

¹⁰⁴ "[I]ndividuals have a duty not to 'misappropriate' information from their employers or otherwise in breach of a fiduciary or other relationship of trust and confidence, and commit securities fraud when they trade in possession of misappropriated information or tip others who trade." *Id.* at 10, 1988 U.S.C.C.A.N. at 6047.

¹⁰⁵ 15 U.S.C. § 78p (1994).

¹⁰⁶ *See id.*

¹⁰⁷ *See Park & Tilford v. Schulte*, 160 F.2d 984, 987 (2d Cir. 1947); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 236 (2d Cir. 1943).

¹⁰⁸ *See Merritt B. Fox, Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088 (1994).

¹⁰⁹ *See Securities Exchange Act of 1934* § 13(d), 15 U.S.C. § 78m(d).

¹¹⁰ *See Committee on Federal Regulation of Securities, Report of the Task Force on*

G. *Scalping and Front Running*

The practice of front running involves trading on the basis of nonpublic market information, regarding impending market transactions, by broker-dealers or investment advisers.¹¹¹ Such conduct embraces a variety of scenarios including: *trading ahead* or *scalping* a customer order in the same security; front running a noncustomer block transaction; or taking a position in stock index futures or options contracts in advance of a principal block transaction.¹¹² Brokers who have customers' orders in hand and trade ahead of them, or investment advisers who trade ahead of their recommendations to clients, breach their fiduciary duties and therefore violate the antifraud provisions if they fail to disclose such trading ahead.¹¹³ If a dealer learns about a large block and trades on that information, it is doubtful whether he has violated Rule 10b-5 as interpreted by the Supreme Court. Nevertheless, both front running a non-customer block transaction and intermarket front running have been interpreted by the SEC and securities self-regulatory organizations as misuses of market information that can violate just and equitable principles of trade.¹¹⁴

It has been suggested by one commentator that scalping and front running should not be regarded as insider trading.¹¹⁵ However, in *United States v. Carpenter*,¹¹⁶ the SEC prosecuted a financial journalist for trading ahead of write-ups about issuers in his stock market gossip column. At first, one of the SEC's arguments was that this was a breach of duty to the journalist's readers. However, after protests about the SEC's interference with the First Amendment rights of financial journalists, the case was prosecuted on the misappropriation theory.¹¹⁷ This case is better

Regulation of Insider Trading—Part II: Reform of Section 16, 42 BUS. LAW. 1087 (1987).

¹¹¹ See Mahlon M. Frankhauser & David S. Frye, *Front Running*, 21 REV. SEC. & COMM. REG. 19 (1988).

¹¹² See *id.* The question of whether, or how, trading in derivatives is trading on inside information that violates section 10(b) or 16(b) has long been vexing. See Karl Shumpei Okamoto, *Oversimplification and the SEC's Treatment of Derivative Sec. Trading by Corporate Insiders*, 1993 WIS. L. REV. 1287; Steve Thel, *Closing a Loophole: Insider Trading in Standardized Options*, 16 FORDHAM URB. L.J. 573 (1988).

¹¹³ See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181-82 (1963); Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 673 (S.D.N.Y. 1966); E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988).

¹¹⁴ See Frankhauser & Frye, *supra* note 111, at 179-86.

¹¹⁵ See Fisch, *supra* note 2, at 206.

¹¹⁶ 484 U.S. 19 (1987); see discussion *supra* text accompanying notes 57-58.

¹¹⁷ See R. FOSTER WINANS, TRADING SECRETS 282, 303 (1986). But see *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1271 (9th Cir. 1979); SEC v. Campbell, [1972-1973 Transfer

analyzed as a “scalping” case since it is factually similar to the activity of an investment adviser trading ahead of his own research recommendations. Nevertheless, if the journalist owes no duty to investors, and breach of a fiduciary duty is legally required under the Court’s jurisprudence, a scalping theory is not available under Rule 10b-5.

II. JUSTIFICATIONS FOR THE BAN ON INSIDER TRADING

A. *Fairness and Parity of Information*

The preamble to the Exchange Act provides that it is an “[a]ct to provide for the regulation of securities exchanges and of over-the-counter markets . . . to prevent inequitable and unfair practices on such exchanges and markets.”¹¹⁸ The necessity for SEC regulation, as spelled out in section 2 of the Exchange Act,¹¹⁹ refers to the national public interest in securities transactions conducted upon public securities markets, the importance of the prices established in such transactions, and the need to insure the maintenance of fair and honest securities markets.¹²⁰ The SEC’s insider trading policy is best understood as an effort to achieve fair pricing in the public securities markets in furtherance of the general goals of the statute.

In *Cady, Roberts*, the SEC enunciated its view that the antifraud provisions of section 10(b) go beyond the common law and are not dependent upon an insider’s relationship to stockholders.¹²¹ Rather, the SEC was concerned about “the plight of the buying public—wholly unprotected from the misuse of special information.”¹²² Further, the classes of persons upon whom an obligation to disclose material information rests is not limited to corporate insiders such as officers, directors, and controlling shareholders because such an obligation relies upon two principal elements:

[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party

Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,580 (C.D. Cal. 1972).

¹¹⁸ Securities Exchange Act of 1934 pmb1., 15 U.S.C. § 78 (1994).

¹¹⁹ See 15 U.S.C. § 78b.

¹²⁰ See *id.*

¹²¹ See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 n.13, 913 n.21 (1961).

¹²² *Id.* at 913.

takes advantage of such information knowing it is unavailable to those with whom he is dealing.¹²³

Over the next decade, the Supreme Court and the Second Circuit endorsed the views that the SEC had enunciated in *Cady, Roberts* concerning the reach of section 10(b). In *SEC v. Texas Gulf Sulphur Co.*,¹²⁴ the Second Circuit adopted a parity of information theory in imposing liability on corporate insiders and their immediate and remote tippees.¹²⁵ In *Affiliated Ute Citizens v. United States*,¹²⁶ which involved the failure of securities purchasers to disclose the higher, prevailing market price that the sellers could not readily ascertain, the Supreme Court found that the defendants could not "stand mute" under the first and third subparagraphs of Rule 10b-5.¹²⁷ In this outsider trading case involving taking unfair advantage by remaining silent, the Court found a duty to speak under section 10(b) and essentially affirmed the equal access or parity of information theory.¹²⁸

After these cases were decided, but before the *Chiarella* decision, Professor Victor Brudney provided a theoretical affirmation of the parity of information theory.¹²⁹ Brudney's theory was that section 10(b) prohibits the exploitation of unerodable informational advantages in the securities marketplace, that is not only the informational advantages of insiders, but also of outsiders who do not lawfully disclose material information about securities.¹³⁰ Since the securities laws were intended to promote public confidence in the securities markets, the application of section 10(b) to insiders emanated from the disclosure obligations of corporations and their officials, and to outsiders from investors' anticipations regarding fairness in the marketplace.¹³¹ For this reason, according to Brudney, the inability of the public investor to lawfully acquire the undisclosed information was the foundation upon which the "disclose

¹²³ *Id.* at 912.

¹²⁴ 401 F.2d 833 (2d Cir. 1968).

¹²⁵ *See id.* at 861, 864.

¹²⁶ 406 U.S. 128 (1972).

¹²⁷ *Id.* at 153. The buyers were two individuals and a bank, not a broker-dealer, and therefore the antifraud provisions specifically applicable to broker-dealers were not at issue. *Id.* at 154 n.16.

¹²⁸ *See id.*; *cf.* *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). Later these cases were distinguished or ignored, and in *Chiarella v. United States*, 445 U.S. 222, 233-35 (1980), the parity of information theory was rejected.

¹²⁹ *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

¹³⁰ *See id.* at 357.

¹³¹ *See id.* at 353.

or refrain" rule rested.¹³²

Brudney struggled with the two problems inherent in the parity of information theory: the suppression of information and the breadth of the rule. Although Brudney conceded that section 10(b) may sometimes force disclosure to the marketplace, he viewed it generally as a regulatory device prohibiting trading by those with an unfair informational advantage.¹³³ Brudney felt that the problems with the rule's breadth could be solved to some extent by requiring proof of scienter in section 10(b) cases. Nevertheless, he conceded that the principles were not without difficulty in application.¹³⁴

Other scholars also have condemned insider trading as unfair and wrong.¹³⁵ Because the Supreme Court has rejected the parity of information doctrine, some scholars have advocated that Congress enact the parity of information theory in statutory form, under the guise of either equal access to information or equal information.¹³⁶ Professor Kim Lane Scheppele has used contractarian ethics for a more recent justification for the parity of information theory.¹³⁷ She argued that equity cases generally support the principle that those with asymmetrical information cannot take advantage of those unable to obtain such information, even in arms length bargaining transactions.¹³⁸ This is because "shallow secrets" can be investigated and ascertained, whereas "deep secrets" cannot.¹³⁹ Furthermore, the principle that persons with asymmetrical informational advantages must refrain from exploiting them comports with psychological and ethical behavioral assumptions, given the complicated and anonymous relationships that now characterize corporate America.¹⁴⁰

¹³² See *id.* at 359.

¹³³ See *id.* at 338-39.

¹³⁴ See *id.* at 365-67.

¹³⁵ See Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 55-62 (1986); Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention from Trading: An Analysis of Gaps in the Insider Trading Laws*, 68 WASH. L. REV. 307 (1993); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1234-35 (1981).

¹³⁶ See Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1137-40 (1985).

¹³⁷ See Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123.

¹³⁸ See *id.* at 131-34.

¹³⁹ *Id.* at 159-61.

¹⁴⁰ See *id.* at 134-40, 150-68. On the other hand, banning all trading by persons with asymmetrical informational advantages would be impractical, and probably damaging, to

The SEC has never wholly abandoned the parity of information theory, but rather has based its actions on the egregious facts of numerous cases, public outrage concerning these cases, and whatever theories the Supreme Court appeared to permit. Regardless, with respect to the insider trading scandals of the 1980s involving Dennis Levine, Ivan Boesky, Michael Milken, and numerous other traders, theory hardly mattered in prosecuting and settling cases and persuading Congress to increase the penalties for trading on insider information.¹⁴¹ At the height of these scandals then Chairman of the SEC, John Shad, justified the ban on insider trading stating:

Countries with broad public ownership of securities generally enjoy the greatest economic and political stability. Insider trading benefits the few at the expense of the many. It impugnes the integrity of the securities markets. It is hardly fair to pit the investing public against those who have access to inside information. It is and should be illegal.¹⁴²

It is noteworthy that most of the cases discussed thus far involved outside information about upcoming tender offers. Undoubtedly, it would have surprised the defendants in these cases to learn that judges and academics were debating not only whether, but also why they were behaving illegally. Most of the cases were settled, often with guilty pleas and huge penalties.¹⁴³ Moreover, the denizens of Wall Street who opened secret foreign bank accounts and travelled with cash-filled suitcases believed their conduct to be unlawful.¹⁴⁴

In not reinstating the parity of information theory in its broadest form, the *O'Hagan* court stated that "informational disparity is inevitable in the securities markets."¹⁴⁵ The Court did, however, recognize fundamental fairness and honesty in the securities markets as essential in promoting investor confidence:

[I]nvestors likely would hesitate to venture their capital in a

market liquidity.

¹⁴¹ See JAMES B. STEWART, *DEN OF THIEVES* (1991); Karen W. Arenson, *How Wall St. Bred an Ivan Boesky*, N.Y. TIMES, Nov. 23, 1986, § 3 (Business), at 1; James B. Stewart & Daniel Hertzberg, *Spreading Scandal: Fall of Ivan F. Boesky Leads to Broader Probe of Inside Information*, WALL ST. J., Nov. 17, 1986, at A1; *supra* text accompanying notes 92-97.

¹⁴² John Shad, *Misperceptions Plague View of Agency Role*, WALL ST. J., May 28, 1986, at 34.

¹⁴³ See DOUGLAS FRANTZ, LEVINE & CO.: WALL STREET'S INSIDER TRADING SCANDAL 331-48 (1987); STEWART, *supra* note 141, at 272, 296, 337, 437.

¹⁴⁴ See STEWART, *supra* note 141, at 73, 97, 132, 143.

¹⁴⁵ 117 S. Ct. 2199, 2210 (1997).

market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.¹⁴⁶

In the tender offer arena, since breach of fiduciary duty is not required, parity of information is a more viable theory. In this setting, the theory states that information about a forthcoming tender offer should only be known to the bidder until the bid is publicly announced. Further, the only appropriate channel for such an announcement is through the disclosure provisions of the Williams Act.

B. *Fiduciary Duty and Misappropriation*

In enacting the federal securities laws, Congress obviously decided that common law protections for investors were insufficient. Yet, in *Chiarella v. United States*, the Supreme Court sharply narrowed the application of section 10(b) to insider trading cases by the radical device of limiting the content of section 10(b) to a common law breach of duty, and by the use of a restrictive view of the common law.¹⁴⁷

It is easy to criticize the fiduciary duty theory since it is unduly narrow from both a legal and a policy perspective. The common law imposes much broader duties on those with superior informational advantages than the *Chiarella* Court would require under section 10(b).¹⁴⁸ To narrow the reach of section 10(b) the Court engaged in specious logic in analyzing the common law and its relationship to the Exchange Act and in distinguishing a prior Rule

¹⁴⁶ *Id.*

¹⁴⁷ 445 U.S. 222 (1980). Writing for the majority, Justice Powell reasoned:

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent.

Id. at 233.

¹⁴⁸ Dissenting in *Chiarella*, Justice Blackmun pointed out that the common law of actionable misrepresentation had long treated the possession of "special facts" as a key to the duty to disclose. He argued that the Court's narrow construction of section 10(b) put the federal securities laws in the rearguard of the movement to make the markets fairer, "a position opposite to the expectations of Congress at the time the securities laws were enacted." *Id.* at 248; see Deborah A. Demott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994); Scheppele, *supra* note 137.

10b-5 case, which held that affirmative misrepresentations were not required under section 10(b).¹⁴⁹ This precedent disabled the Court in *O'Hagan* from setting forth a theoretical basis for the misappropriation theory, since the Court was impelled to distinguish *Chiarella* on the ground that fiduciary relationships, in addition to those between securities traders, could be the basis for an insider trading violation.¹⁵⁰ Yet, the blame for the confusion in these decisions lies with the SEC and Congress as well as the Supreme Court. Section 10(b) is impermissibly vague for a criminal statute, and Rule 10b-5 enlarges, rather than clarifies, its parameters.¹⁵¹ Further, the SEC has stubbornly adhered to the parity of information theory in cases where the misappropriation theory is unavailable, without explaining or justifying it.

Instead of going to Congress for clarification of the duty of traders with superior information to disclose such information or abstain from trading, the SEC after *Chiarella* chose to follow the misappropriation theory as set forth by Chief Justice Burger in his *Chiarella* dissenting opinion. According to Chief Justice Berger, a rule permitting parties to an arm's length transaction to refrain from disclosing information absent a confidential or fiduciary relation "permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting."¹⁵² Yet, these very policies should limit the rule so that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."¹⁵³

The classical theory on prohibiting trading on inside information applies to corporate insiders or their tippees. The misappropriation theory, however, also applies to outsiders who trade on market information. In general, the misappropriation theory provides that a person violates Rule 10b-5 when he

- (1) misappropriates material nonpublic information, (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the sharehold-

¹⁴⁹ See *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1971).

¹⁵⁰ See 117 S. Ct. 2199, 2212 (1997).

¹⁵¹ This was the basis of Justice Scalia's dissent in *O'Hagan*. See *id.* at 2220. It is also why the court was unable to uphold *Chiarella*'s conviction under the misappropriation theory as it was never presented to the jury.

¹⁵² *United States v. Chiarella*, 445 U.S. 222, 240 (1980).

¹⁵³ *Id.*

ers of the traded stock.¹⁵⁴

The misappropriation theory is based on fraud on the part of the source of the material, nonpublic information, a fact which gives rise to both the strength and the weakness of this theory. First, it is extremely flexible, capable of capturing so many types of fact patterns that, according to Professor Donald C. Langevoort, it "has all but preempted the abstain or disclose standard restrained in *Chiarella* and *Dirks*."¹⁵⁵ This trend is likely to continue after *O'Hagan*. Second, commentators have argued that the misappropriation theory casts too wide a net over insider trading without sufficient clarity to determine which traders will be caught in that net. These critics generally advocate a definition of insider trading by statutory amendment or SEC rulemaking.¹⁵⁶ Other critics have argued that the misappropriation theory is too narrow because it does not prevent those who possess material, nonpublic information from trading on it, even though such trading becomes illicit when the information is "stolen" by an employee, agent, or confidant.¹⁵⁷

It is unlikely that these debates will be resolved by the endorsement of the misappropriation theory given by *O'Hagan*. The SEC is more unlikely than ever to seek statutory clarification of this amorphous crime. But, *O'Hagan* leaves open the question of illegality of many forms of outsider trading on material, nonpublic information—for example: cases involving family or other personal relationships rather than fiduciaries; outsider trading on market information other than tender offers; and warehousing.

The most perplexing aspect of the misappropriation theory is the way it transforms a breach of duty to an employer or client under state law into a fraud under the federal securities laws. Professor Langevoort has suggested that this should be justified under the theory that it is the public investor who is deceived.¹⁵⁸ While

¹⁵⁴ SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

¹⁵⁵ Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 876 (1995) [hereinafter Langevoort, *Words from on High*].

¹⁵⁶ See Jonn R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1141-47 (1996); Fisch, *supra* note 2, at 235-51; Hazen, *supra* note 102, at 616-17.

¹⁵⁷ Beeson, *supra* note 156, at 1137-40; Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992).

¹⁵⁸ See Langevoort, *Words from on High*, *supra* note 155. Perhaps the theory should be that the public investor is not advised that the insider trader has obtained information in an unfair way.

this pragmatic approach borrows from the equal access to information theory, but limits it to a definable group, it is not satisfying from a policy perspective. Why should investors be protected against traders who have stolen information but not from other traders who also have unerodable informational advantages? A better theory would provide a linkage between the prohibition against trading and the obligations of issuers, tender offerors, and securities industry fiduciaries to disclose material, nonpublic information.

C. *Efficiency*

The academic literature on insider trading has devoted a considerable amount of attention to the question of whether trading on inside information contributes to, or undermines, market efficiency. This debate was initiated by Professor Henry Manne, who argued that insider trading contributes to efficiency in stock market pricing because information becomes embedded in stock prices more quickly than it would if insiders waited until such information was ripe for disclosure.¹⁵⁹ Further, the profits made by insiders on such trades are an appropriate reward for their labor. Manne's argument gained some respectability when it was adopted by scholars like Professors Frank Easterbrook and Daniel Fischel.¹⁶⁰

In response to Manne and others, there is now a substantial body of academic literature arguing that insider trading makes the public securities markets inefficient and that, therefore, it should be banned. There are several aspects to this argument. First, allowing such trading would encourage insiders to manipulate corporate decisionmaking and withhold information from the market. In contrast, prohibiting insider trading removes an impediment to

¹⁵⁹ See MANNE, *supra* note 2.

¹⁶⁰ See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 251 (1991); Carlton & Fischel, *supra* note 2. The notion that insider trading contributes to market efficiency is dependent on the efficient market hypothesis. This theory of the relationship between disclosure of financially significant information and changes in securities prices gained enormous acceptance in the law and economics literature of the 1980s. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanics of Market Efficiency*, 70 VA. L. REV. 549, 549-50 (1984). According to this theory, market efficiency can occur on three different levels. The weak form of market efficiency exists when securities prices reflect all the information embodied in the past prices of that security. The semi-strong form of market efficiency exists when security prices reflect all available public information. The strong form of market efficiency exists when security prices reflect all information, whether publicly available or not. See Eugene T. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). Manne took this finance theory and endorsed the strong form of market efficiency as a goal for SEC regulatory policy.

the prompt release of information and promotes economic efficiency by assuring that share prices reflect their true value. Such informational efficiency assures that capital is allocated efficiently.¹⁶¹ Also, permitting insider trading would discourage research and analysis because the public information available to an analyst would not reflect all of the facts upon which trading is occurring.¹⁶²

Even in the 1980s, scholars began to argue that the public securities markets are not, in fact, efficient.¹⁶³ A combination of factors, including investor psychology, economic developments and trading technologies, and not informational efficiency, influenced stock market prices on October 19-20, 1987, when the Dow Jones averages lost approximately thirty percent of their value.¹⁶⁴ There are many such days in the market, either for the averages generally or for individual securities, when investor preferences or fashions, or macroeconomic, political, or psychological forces, rather than company-specific material facts, are the primary determinants of stock market pricing.¹⁶⁵

The efficient market hypothesis has influenced the SEC in some rulemaking proceedings, notably in its adoption of the integrated disclosure system.¹⁶⁶ Some court cases also have been influenced by this theory.¹⁶⁷ Nevertheless, the federal securities laws, and particularly the antifraud provisions, were primarily enacted to promote investor confidence in the fairness and honesty of the markets, and only secondarily to achieve efficiency in stock market pricing. To the extent Congress made a connection between fairness and efficiency, it was to stress that when markets are ma-

¹⁶¹ See Brudney, *supra* note 129, at 334; Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1053-60 (1982); Wang, *supra* note 135.

¹⁶² See Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 355 (1988).

¹⁶³ See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Lynne A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988); William K.S. Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986).

¹⁶⁴ See TIM METZ, BLACK MONDAY: THE CATASTROPHE OF OCTOBER 17, 1987, 144, 248-51 (1988); DIVISION OF MARKET REGULATION, SEC, THE OCTOBER 1987 MARKET BREAK xi-xii (1988).

¹⁶⁵ See John R. Dorfman, *Sputnik Launch Spooked Stocks*, WALL ST. J., Oct. 7, 1996, at C1; *Mind over Matter*, ECONOMIST, Apr. 23, 1994, at 73.

¹⁶⁶ See Adoption of Integrated Disclosure System, Exchange Act Release No. 6383, 24 SEC Docket (CCH) 1262 (Mar. 3, 1982); Proposed Rules, Securities Act Release No. 6335, 23 SEC Docket (CCH) 401, 409 (Aug. 6, 1981).

¹⁶⁷ See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), and cases cited therein.

nipulated or controlled, there can be excessive speculation which will hinder the proper appraisal of a security's value.¹⁶⁸ This is more of a moral and political rationale, rather than one based on financial economics.

D. *Property Rights*

Another popular academic theory justifying the ban on insider trading argues that it is a means of protecting business property.¹⁶⁹ Permitting insider trading, on the other hand, would defeat the desire for confidentiality of issuers and tender offerors. This theory was developed by law and economics theorists as a response to Professor Manne¹⁷⁰ and others who argued that insider trading should be permitted, and also in support of the misappropriation theory. In his concurring opinion in *United States v. Chestman*,¹⁷¹ Judge Winter focused his analysis of the misappropriation theory on the protection of business property rights.¹⁷² The *O'Hagan* Court also relied on this theory. According to the Court, "[a] company's confidential information . . . qualifies as property to which the company has a right of exclusive use. . . . The undisclosed misappropriation of such information, in violation of a fiduciary duty . . . constitutes fraud akin to embezzlement"¹⁷³

The property rights theory appeals to those who believe that securities regulation should be predicated on principles of economics, rather than on principles of fairness.¹⁷⁴ However, the federal securities laws were based on the principle that when an issuer goes public, investors are entitled to information about its business

¹⁶⁸ See Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994). Public indignation about insider trading abuses do not stem from calculations of economic efficiency. See Cox & Fogarty, *supra* note 162, at 357.

¹⁶⁹ See JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS AND POLICY* (1991); Carlton & Fischel, *supra* note 2, at 878; Easterbrook, *supra* note 2; Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 718-19 (1980); Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727, 759 (1988); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79 (1987).

¹⁷⁰ Manne's thoughts are dismissed as a "romantic theory of authorship" in James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413, 1508 (1992).

¹⁷¹ 947 F.2d 551 (1991).

¹⁷² See *id.* at 576-78 (Winter, J., concurring).

¹⁷³ 117 S. Ct. 2199, 2208 (1997) (citation omitted).

¹⁷⁴ See, e.g., Jonathan R. Macey, *From Fairness to Contract: The New Direction of Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

and affairs.¹⁷⁵ The easiest criticism of the property rights theory is that when Congress passed and subsequently amended the Exchange Act, it was concerned about fairness and the protection of investors, not the protection of property rights in information held by issuers and traders. Protecting the source of confidential information is illogical when the parties injured by traders possessing informational advantages are those who purchase or sell securities without access to the material information.¹⁷⁶ Further, the property rights theory seems to be concerned with interests in information that are generally protected by state law.¹⁷⁷ The federal securities laws impose disclosure duties on issuers, bidders, and other market participants and the insider trading laws should be viewed as a means to enforce the investing public's right to this information.

III. INSIDER TRADING AND MANDATORY DISCLOSURE

A. *Continuous Disclosure*

This Article proposes that the ban on insider trading be related to the disclosure obligations of issuers, bidders, and other market participants under the federal securities laws, as a means to enforce those obligations and accelerate the release of material information. Although the ban is regulatory, its necessity arises from gaps in the disclosure system administered by the SEC, gaps that can only be filled by the disclose or abstain doctrine.

The federal securities laws set forth a scheme of mandated disclosure concerning the business and affairs and financial condition of public companies. The specific disclosure requirements are established by the SEC pursuant to the Securities Act of 1933 ("Securities Act")¹⁷⁸ and the Exchange Act. The Securities Act is primarily concerned with initial distributions of securities. It requires that securities issuances be registered with the SEC prior to sale, unless an appropriate exemption from registration exists.¹⁷⁹ The registration statement must contain specified information about the security, the issuer, and the underwriter.¹⁸⁰

The Exchange Act is primarily concerned with post-

¹⁷⁵ See S. REP. No. 73-47, at 6-7 (1933); H.R. REP. No. 73-85, at 1-2 (1933).

¹⁷⁶ See Langevoort, *Words From on High*, *supra* note 155, at 878.

¹⁷⁷ See *id.*; *United States v. Bryan*, 58 F.3d 933, 951-52 (4th Cir. 1995).

¹⁷⁸ Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1994).

¹⁷⁹ See Securities Act of 1933 § 5, 15 U.S.C. § 77e.

¹⁸⁰ See Securities Act of 1933 § 7, 15 U.S.C. § 77g.

distribution trading in securities. It requires publicly held companies to file annual and periodic reports with the SEC, including audited annual financial statements.¹⁸¹ The Exchange Act also regulates proxy solicitations¹⁸² and trading by insiders of public companies¹⁸³ and requires disclosure regarding tender offers for shares of public companies.¹⁸⁴ Under the SEC's integrated disclosure regulations, material in the Exchange Act reports can be incorporated by reference in Securities Act registration statements.¹⁸⁵

From 1934 until 1964, the year section 12(g) was added to the Exchange Act,¹⁸⁶ the only companies subject to the registration provisions of the Exchange Act were those listed on national securities exchanges. Under section 12(g), all publicly traded companies of a certain size became subject to the reporting provisions of the Exchange Act. Today, any corporation with 500 shareholders and ten million dollars in assets must register its securities under section 12(g)¹⁸⁷ and, therefore, must file an annual report that contains audited financial information with the SEC within ninety days of the company's year-end.¹⁸⁸ Information in the annual report, including the year-end financial statements, must also be sent to shareholders in order to solicit proxies for the corporation's annual meeting.¹⁸⁹ Exchange Act reporting companies also must file unaudited quarterly earnings reports.¹⁹⁰

Although the Exchange Act's regime for corporate disclosure is frequently referred to as a continuous disclosure system, it does not, in fact, require corporations to make continuous disclosure of material information. In addition to annual and quarterly reports, the Exchange Act also requires companies to report certain material events on Form 8-K. However, the events that trigger a mandatory filing are limited to: changes in control; the acquisition or disposition of significant assets not in the ordinary course of business; bankruptcy or receivership; a change of accountants; resigna-

¹⁸¹ See *id.* §§ 12-13, 15 U.S.C. §§ 78l, 78m.

¹⁸² See *id.* § 14, 15 U.S.C. § 78n.

¹⁸³ See *id.* § 16, 15 U.S.C. § 78p.

¹⁸⁴ See *id.* §§ 13(e), 14(e), 15 U.S.C. §§ 78m(e), n(d).

¹⁸⁵ See Adoption of Integrated Disclosure System, Exchange Act Release No. 6383, 24 SEC Docket (CCH) 1262 (Mar. 3, 1982).

¹⁸⁶ Securities Act Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 576-77.

¹⁸⁷ 15 U.S.C. § 78l(g) (1994); see SEC Rule 12(g)-1, 17 C.F.R. § 240.12(g)-1 (1998).

¹⁸⁸ See Form 10-K, 5 Fed. Sec. L. Rep. (CCH) §§ 31,101-07 (Apr. 22, 1998).

¹⁸⁹ See Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a).

¹⁹⁰ See Form 10-Q, 5 Fed. Sec. L. Rep. (CCH) §§ 31,031-35 (Sept. 17, 1997).

tion of directors; and a change in fiscal years.¹⁹¹ These are watershed events in the life of a corporation, not events of routine materiality that nevertheless can affect stock prices significantly. Although a public corporation may report on Form 8-K any other event the company “deems of importance to securities holders,” the reporting of events of every day materiality is voluntary, not mandatory.¹⁹² Furthermore, a report on Form 8-K concerning changes in control, asset acquisitions or dispositions, bankruptcy, or change in accountants is not required to be filed until fifteen days after the event and other reports are not required to be filed until five days after the event.¹⁹³ These are lengthy time lags in today’s securities marketplace.

The stock exchanges have long had policies that require the continuous disclosure of material information. For example, the New York Stock Exchange provides that a listed company “is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities.”¹⁹⁴ The Securities Act Amendments of 1964—imposing continuous reporting requirements on all public companies—were patterned after the disclosure obligations of the stock exchanges.¹⁹⁵ Congress believed that a system of mandated public disclosure was necessary under federal law to reinforce the essentially voluntary obligations set forth in the exchange listing agreements.¹⁹⁶ By 1964, Congress felt that all public companies, not only listed issuers, should be required to provide shareholders with current information.¹⁹⁷

Even after 1964, there remained gaps in the SEC’s disclosure system. Two years later, Milton A. Cohen, head of the Special Study of the Securities Markets,¹⁹⁸ which preceded the 1964

¹⁹¹ See Form 8-K, Items 1, 2, 3, 6, 8, 5 Fed. Sec. L. Rep. (CCH) §§ 31,001-04, at 21,992-96 (Apr. 22, 1998).

¹⁹² See Form 8-K, Item 5, 5 Fed. Sec. L. Rep. (CCH) §§ 31,001-04, at 21,994 (Sept. 13, 1996).

¹⁹³ See Form 8-K, General Instructions, 5 Fed. Sec. L. Rep. (CCH) §§ 31,001-04, at 21,991-92 (Apr. 9, 1997).

¹⁹⁴ New York Stock Exchange Listed Company Manual (NYSE) § 202.05 (1997). The American Stock Exchange and National Association of Securities Dealers Automated Quotation System (“NASDAQ”) have similar policies.

¹⁹⁵ See 1 ADVISORY COMM. ON CORPORATE DISCLOSURE, 95TH CONG., REPORT TO THE SECURITIES AND EXCHANGE COMM’N 574 (Comm. Print 1977) [hereinafter CORPORATE DISCLOSURE REPORT].

¹⁹⁶ See *id.*

¹⁹⁷ See *id.* at 601-05.

¹⁹⁸ See SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 88-95 (1963).

Amendments, advocated an integration of the Securities Act and the Exchange Act in order to focus SEC disclosure policy on the obligations of public companies to provide information to the trading markets on a continuous basis and not primarily in connection with issuances of securities.¹⁹⁹ The SEC achieved partial integration of these two statutes through rulemaking in 1982.²⁰⁰ The recent Advisory Committee on the Capital Formation and Regulatory Processes ("Wallman Commission") has recommended further integration through a system of company, as opposed to securities, registration.²⁰¹

B. *Transaction Reporting Requirements*

Time lags also exist in the SEC requirements concerning the reporting and disclosure of securities transactions. Officers and directors of an issuer that has a class of equity securities registered under the Exchange Act and persons who beneficially own more than ten percent of any class of such securities must report their securities transactions to the SEC.²⁰² These insiders are required to report their initial statements of beneficial ownership and any changes in ownership and must file an annual report of their securities ownership.²⁰³ Transaction reports, however, do not need to be filed until ten days after the close of the calendar month in which any change in beneficial ownership occurred,²⁰⁴ and the annual report of securities ownership is not due until forty-five days after the end of an issuer's fiscal year.²⁰⁵

There is a similar transaction reporting requirement for persons who acquire more than five percent of any class of equity securities registered under the Exchange Act. Such reports are required to be filed within ten days after such an acquisition.²⁰⁶ This ten-day window may provide an opportunity for persons who know about an upcoming tender offer bid to trade in the target company's securities before the announcement of a bidder's toe-

¹⁹⁹ See Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966).

²⁰⁰ See Adoption of Integrated Disclosure System, Exchange Act Release No. 6383, 24 SEC Docket (CCH) 1262 (Mar. 3, 1982).

²⁰¹ See ADVISORY COMM. ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, REPORT TO THE SECURITIES AND EXCHANGE COMM'N, Fed. Sec. L. Rep. (CCH) No. 1725 (Extra Issue), at 8-10 (July 24, 1996) [hereinafter WALLMAN COMMISSION REPORT].

²⁰² See Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a).

²⁰³ See *id.*

²⁰⁴ See *id.*

²⁰⁵ See SEC Rule 16a-3(f), 17 C.F.R. § 240.16a-3(f) (1998).

²⁰⁶ See Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d).

hold position and intentions regarding a tender offer.²⁰⁷ Further, persons making a tender offer need not disclose information about themselves or the offer until the date on which the offer is first announced to security holders.²⁰⁸

C. *Williams Act Disclosure Requirements*

The legislative history of the Williams Act indicates Congress's concern that, although disclosure was required in proxy contests and exchange offers, regarding a proposed change in corporate control, large blocks of stock could still be acquired in complete secrecy through cash tender offers, market transactions, and other arrangements.²⁰⁹ Absent information concerning a proposed change in corporate control, and because the persons seeking control of a company possessed information that might substantially affect the assumptions underlying the market value of a corporation's securities, investors were forced to make investment decisions based on a market price that did not necessarily reflect a fair valuation of the target company's securities.²¹⁰

Accordingly, any five percent holder of Exchange Act registered securities or any person making a tender offer must publicly disclose his background and source of funds, any intention to make a tender offer, any plans for major changes in the target company, and any other similar information.²¹¹ Furthermore, the target company must publicly disclose its opinion as to whether the offer should be accepted or rejected, or its inability to take a position on the matter.²¹²

In *Schreiber v. Burlington Northern, Inc.*,²¹³ the Supreme Court held that collusion between a bidder and target management resulting in a lower bid price—even if fraudulent under state law—was not “fraudulent, deceptive, or manipulative” under section 14(e), since that section only refers to fraudulent nondisclosure. Thereafter, it was sometimes argued, for example, by the Eighth Circuit in *O'Hagan*,²¹⁴ that *Schreiber* put the same constraints on the SEC's rulemaking power under section 14(e) as the

²⁰⁷ See Schedule 13D, 17 C.F.R. § 240.13D.

²⁰⁸ See SEC Rule 14d-4, 17 C.F.R. § 240.14d-4.

²⁰⁹ See CORPORATE DISCLOSURE REPORT, *supra* note 196, at 610.

²¹⁰ See H.R. REP. No. 90-1711, at 2 (1968); S. REP. No. 90-550, at 2 (1967).

²¹¹ See Schedules 13D, 14D, 17 C.F.R. §§ 240.13D, .14D.

²¹² See SEC Rule 14e-2, 17 C.F.R. § 240.14e-2; see also SEC Rule 14d-9, 17 C.F.R. § 240.14d-9.

²¹³ 472 U.S. 1 (1985).

²¹⁴ 92 F.3d 612, 623 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

Court had determined the agency has under section 10(b). Others questioned this interpretation and confined *Schreiber* to its facts, which involved allegations of a breach of duty by directors rather than fraudulent, manipulative, or deceptive activities by traders in the public securities markets. The Supreme Court, in *O'Hagan*, distinguished *Schreiber* on the ground that it involved an interpretation of the term "manipulative," rather than the term "fraudulent."²¹⁵

In *SEC v. Peters*,²¹⁶ the Tenth Circuit noted that section 14(e) gives the SEC a broader mandate than section 10(b) because it specifically authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."²¹⁷ Further, the court questioned whether section 14(e) was intended to prohibit only fraudulent nondisclosure, but held that even if this were the case, Rule 14e-3 was reasonably designed to achieve that goal. In *O'Hagan*, the Supreme Court found it unnecessary to go this far in upholding the defendant's conviction under Rule 14e-3. After observing that a "prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited,"²¹⁸ the Court found that "[s]ensibly read [Rule 14e-3] is an exercise of the Commission's full authority. Logically and practically, such a rule may be conceived and defended, alternatively, as definitional or preventive."²¹⁹

The legislative history of the Williams Act suggests that Congress was not interested in favoring bidders or target companies in takeovers, but instead was concerned about disclosure to investors. Trading in anticipation of tender offers was one of the mischiefs that Congress attempted to address in requiring investors to be informed about a takeover bid before deciding to sell or hold securities in a target company.²²⁰ Permitting trading and tipping by per-

²¹⁵ *United States v. O'Hagan*, 117 S. Ct. 2199, 2216 (1997).

²¹⁶ 978 F.2d 1162 (10th Cir. 1992).

²¹⁷ Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n(e) (1994).

²¹⁸ *O'Hagan*, 117 S. Ct. at 2217.

²¹⁹ *Id.* at 2218 n.19.

²²⁰ See 116 CONG. REC. 3023, 3023 (1970) (statement of Sen. Williams). For legislative history, see generally *Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemption for Small Businessmen: Hearings on S. 336 and S. 3431 Before the Subcomm. on Sec. of the Senate Comm. on Banking and Currency*, 91st Cong. (1970); *Investor Protection in Corporate Takeovers—Increase in Regulation A Exemption: Hearings on H.R. 4285, S. 3431 and S. 336 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce*, 91st Cong. (1970); *Takeover Bids: Hearings on H.R. 14475 and S. 510 Before the Subcomm. on Commerce*

sons other than the bidder who know about an upcoming tender offer, prior to the time of the public announcement, would defeat the legislative intent in enacting the Williams Act.²²¹

D. *A Theory of Disclosure and Abstention Relationships*

As the foregoing explains, contrary to popular belief, there is no general legal rule that a public company must make prompt disclosure of all material, corporate developments.²²² The SEC, therefore, has adopted several investor protection strategies to encourage disclosure of price sensitive information. First, while a company may be permitted to remain silent about an important development, if it does speak, it may not make misleading statements.²²³ Second, the SEC has fostered the prompt release of material information, historically through exhortation and voluntary corporate disclosure policies,²²⁴ but in recent years by compelling issuers to disclose and update forward-looking information.²²⁵ Third, and most importantly, the SEC, by developing and enforcing a ban upon trading on material, undisclosed corporate information, has tried to prevent the selective release of confidential corporate information.

The SEC's prosecution in *Texas Gulf Sulphur* and the SEC's development of the disclose or abstain doctrine with respect to material corporate information occurred shortly after the 1964

and Fin. of the House Comm. on Interstate and Foreign Commerce, 90th Cong., (1968).

²²¹ See Laura Ryan, Comment, *Rule 14e-3's Disclose-or-Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449 (1991).

²²² See MEREDITH M. BROWN, *DISCLOSURE AND THE CORPORATE ISSUER*, reprinted in 2 *THE CONTINUING DISCLOSURE SYSTEM: PROBLEMS AND PARTICIPANTS* (Franklin E. Gill ed., 1991) (1988).

²²³ See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988); *SEC v. Rana Research, Inc.*, 8 F.3d 1358 (9th Cir. 1993); *In re Fidelity Fin. Corp.*, Exchange Act Release No. 18,927, 25 SEC Docket (CCH) 1056 (July 30, 1982).

²²⁴ In a 1970 release concerning timely disclosure of material corporate developments, the SEC stated:

Not only must material facts affecting the company's operations be reported; they must also be reported promptly. Corporate releases which disclose . . . favorable developments but do not even suggest existing adverse corporate developments do not serve the public needs and may violate anti-fraud provisions of the Securities Exchange Act of 1934.

Timely Disclosure of Material Corporate Developments, Exchange Act Release No. 8995 [1970-1971] Fed. Sec. L. Rep. (CCH) ¶ 77,915 (Oct. 15, 1970).

²²⁵ See Regulation S-K, Item 303, 17 C.F.R. § 229.303 (1998). The duty to update prior corporate statements is unclear. See *Ross v. A.H. Robins Co., Inc.*, 465 F. Supp. 904, 908 (S.D.N.Y. 1979). Compare *id.* with *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990). But, the SEC has brought enforcement cases based on a corporation's failure to correct forward-looking statements in prior MD&A disclosures. See *In re Bank of Boston*, Exchange Act Release No. 81, 60 SEC Docket (CCH) 2695 (Dec. 22, 1995).

amendments to the Exchange Act. These amendments gave the SEC a significantly increased mandate to regulate annual and periodic disclosure by public companies. In the author's view, the timing of these events was not accidental. The need to police the disclosure of such a vast universe of public companies made it necessary to develop an enforcement remedy to compel such disclosure. Although justifying the ban against insider trading law under the antifraud rules may be difficult from a doctrinal and theoretical perspective, it is easier to prove the facts of an insider trading case than to prove facts demonstrating that an issuer committed fraud in the timing of a disclosure item. The *Texas Gulf Sulphur* case involved trading on material, undisclosed corporate information by insiders and their tippees, and a misleading press release by the issuer. The disclose or abstain doctrine was, and still is, ancillary to the SEC's primary mandate to compel prompt and honest disclosure of information relevant to investors. Yet, it is an important ancillary doctrine because it enables corporations to maintain their confidential information that is uncertain or not ripe for disclosure, while preventing insiders from using such information for their personal gain at the expense of public investors.

In the tender offer arena, the disclose or abstain doctrine has likewise maintained the fairness and equity of the trading markets until a person subject to disclosure obligations makes such disclosure. The Williams Act essentially imposes on a bidder a disclosure duty to target company shareholders, even though under corporate law no fiduciary duty runs from the bidder to the target company or its shareholders. The long term objective of the disclose or abstain doctrine is disclosure; the short term objective is to prevent the misuse of information required to be disclosed in the future, prior to such disclosure. Regardless of who is the source of the information, target company shareholders will be deprived of the informed decisionmaking opportunity as envisioned by the Williams Act if market prices are distorted by trading by those in the know about the tender offer.

Scalping and front running involve different disclosure obligations. In these situations, there is a conflict of interest between a securities industry professional and either customers or traders in the market. In some cases, a duty to the customer is breached because the customer's agent is making a secret profit. In this situation, a disclosure obligation arises under classic agency law.²²⁶ In

²²⁶ An agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal. *See*

other cases, a dealer with time and place market advantages overreaches other market participants. This scenario is difficult to fit into the analysis that relates the evils of insider trading to a disclosure obligation. Rather, it is more closely related to the responsibilities of fair dealing that the securities laws have customarily placed on specialists and market makers.²²⁷

There must be derivative liability of tippees for trading on material, undisclosed information emanating either from a corporate or market source. One of the problems with the misappropriation fraud on the source doctrine is that it does not require the source to have any disclosure obligation or other fair dealing obligation to investors. However, such a requirement was articulated in *Dirks v. SEC*.²²⁸ In *Dirks*, the Supreme Court took the position that since a tippee's liability is derivative, the tipper must have a disclose or abstain obligation.²²⁹ Further, the Court suggested that some outsiders become temporary insiders because they have a relationship of trust and confidence with the source of nonpublic information.²³⁰

Although the Supreme Court has given the SEC a green light to prosecute insider trading cases under the misappropriation doctrine, the *O'Hagan* decision does not provide guidance as to what type of fact patterns—other than trading by a lawyer on confidential information misappropriated from a client bidder—will be upheld under this theory. It would be easier to distinguish which

RESTATEMENT OF AGENCY § 388 (1933). For the application of this principle to directors and their fiduciary relationship to shareholders, see *Brown v. Halbert*, 76 Cal. Rptr. 781 (Ct. App. 1969).

²²⁷ Specialists have negative and affirmative obligations to the marketplace in assuring a fair and orderly market. See ROBERT A. SCHWARTZ, *RESHAPING THE EQUITY MARKETS* 27-42 (1991). Over-the-counter market makers are less regulated on the theory that competition constrains unfair dealing. See *id.* at 54-62. Recently, the SEC has endeavored to more aggressively police informational advantages and manipulative activity in the over-the-counter market through enforcement action and rulemaking. See Exchange Act Rules 11Ac1-1, 11Ac1-4, 17 C.F.R. §§ 240.11Ac-1, .11Ac1-4; Exchange Act Release No. 37,619, 62 SEC Docket (CCH) 1795 (Aug. 29, 1996); Exchange Act Release No. 37,619A, 62 SEC Docket (CCH) 2083 (Sept. 6, 1996) (ordering execution obligations); Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 regarding the National Association of Securities Dealers ("NASD"), the NASDAQ Market, and NASDAQ Market Makers, Exchange Act Release No. 37,542, 62 SEC Docket (CCH) 1385 (Aug. 8, 1996). The SEC has begun to address the issue of how informational advantages should be regulated in electronic and international marketplaces. See *Regulation of Exchanges*, Exchange Act Release No. 38,672, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,942 (May 23, 1997).

²²⁸ 463 U.S. 646 (1983).

²²⁹ See *id.* at 659.

²³⁰ See *id.* at 655 n.14.

cases should be actionable and which should not, if the misappropriation doctrine and other insider trading cases became more directly linked to disclosure obligations of the source of the information. Such a theory could be enforced either by the courts in future interpretations of Rule 10b-5 or by the SEC as a matter of prosecutorial discretion. Some of the controversial cases previously prosecuted were not upheld under this theory, but others might have been if the theory had been argued.

One type of fact pattern that has frustrated the courts involves information that the source had no duty to disclose, either immediately or even when the information became ripe for disclosure. Courts have had problems with these cases because they seem to have little to do with the fundamental disclosure obligations of the securities laws. In *United States v. Bryan*,²³¹ for example, the Lottery was held to have no duty under the securities laws to disclose to investors what companies would receive equipment contracts. Therefore, the defendant's misappropriation of such information for trading in the issuers' securities in advance of the contract awards should not have been, and was not, deemed a violation of Rule 10b-5. Nevertheless, trading by government officials on confidential information may be prohibited by other laws.²³² Similarly, the case against Foster Winans in *United States v. Carpenter*²³³ should have failed because the *Wall Street Journal* was not subject to a disclose or abstain obligation with respect to the contents of its "Heard on the Street" column.²³⁴ By contrast, in *United States v. O'Hagan*,²³⁵ the defendant's client had a duty, as a bidder in a tender offer, to disclose its intentions to make a tender offer after buying more than five percent of the target's stock. Therefore, the defendant, as a tippee of that information and as a temporary insider, indirectly caused the breach of a disclosure obligation.

²³¹ 58 F.3d 933 (4th Cir. 1995).

²³² See *United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970). Some commentators have argued that government employees who use undisclosed information, obtained solely by reason of their official positions, for personal benefit in the sale or purchase of a security violate Rule 10b-5. See Herbert T. Krimmel, *The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine*, 47 S. CAL. L. REV. 1491 (1974). But others do not find a duty to disclose for outsiders who are not tippees. See Federal Securities Code § 1603 cmt. 3(d) (Proposed Official Draft 1978).

²³³ 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided Court*, 484 U.S. 19 (1987). The dissenting judge in the Second Circuit expressed the view that this was not a securities case. See *id.* at 1037 (Miner, C.J., dissenting).

²³⁴ Other problematic cases include *United States v. Liberia*, 989 F.2d 596 (2d Cir. 1993), and *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990), both of which supported convictions based on the misappropriation theory.

²³⁵ 117 S. Ct. 2199 (1997).

Another questionable type of fact pattern involves a chain of family tippees where there are no fiduciary relationships, although the initial tipper may have owed a fiduciary duty to a source and may have mentioned the need for confidentiality to the initial tippee. Under the misappropriation theory, the courts have sometimes upheld and sometimes dismissed these cases.²³⁶ In some cases, personal, not family, relationships were involved.²³⁷ Whether a family or other non-fiduciary personal relationship will suffice for liability under *O'Hagan* remains to be seen. Further, a distinction could be drawn between a failure to disclose information about a merger, which could be prosecuted only under Rule 10b-5, and information about a tender offer, which could be prosecuted also under Rule 14e-3 and, thus, would not require proof of breach of a fiduciary duty. This is illogical.

A better rule would be that whenever a public company officer or director, or a bidder or target, tips anyone about material, nonpublic information and the tippee knows that the information is confidential, trading by the tippee or (if there is knowledge of the information's confidentiality) the tippee's tippees should be illegal. However, legal culpability should be dependent upon a relation back to the source's disclosure obligation, whether the source is a public company, a bidder, or a target. A connection to the disclose or abstain obligation can be found in the tender offer context whether the source is a bidder or target, despite the fact that disclosure obligations under the Williams Act are primarily placed on the bidder, since a target company is required to advise its shareholders of the board of directors' views concerning a tender offer and also has fiduciary obligations to its shareholders under state law.²³⁸

The law today regarding remote tippees—at least in non-tender offer cases—requires proof of a breach of fiduciary duty by an initial tipper in order for trading by second or third tier tippees to be related back to that breach.²³⁹ But, what about the cases

²³⁶ Compare *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), and *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev'd*, 773 F.2d 477 (2d Cir. 1985), with *SEC v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996).

²³⁷ See, e.g., *Carpenter v. United States*, 484 U.S. 19 (1987) (case in which one defendant was the roommate of the reporter). In *SEC v. Thayer*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,607 (1984), a "personal relationship" was involved.

²³⁸ The need for both the offeror and target to disclose or abstain in order to eliminate unfair trading in advance of an announcement of a tender offer is an argument for regulating such "outsider" trading apart from Rule 10b-5 under Rule 14e-3.

²³⁹ See *United States v. Victor Teicher & Co.*, 785 F. Supp. 1137, 1150 (S.D.N.Y. 1992); *SEC v. Musella*, 748 F. Supp. 1028, 1038 (S.D.N.Y. 1989), *aff'd*, 898 F.2d 138 (2d Cir.

where a trader, lawfully or inadvertently, comes into the possession of inside information? In *SEC v. Lund*,²⁴⁰ the defendant came into possession of inside information through a business negotiation. In *SEC v. Switzer*,²⁴¹ the defendant overheard a lawful business conversation at a sporting event. In *SEC v. Willis*,²⁴² a psychiatrist found out about material, nonpublic information from a patient and then traded on it. Only the *Willis* case could be argued under the misappropriation theory.

A better analysis would inquire first whether the source of the information had a disclosure obligation, and then whether the trader knew that the information was confidential and material, and thus subject to public disclosure before it could be traded upon. Since the purpose of prosecution is to enforce the disclosure obligations of securities markets participants, it would be reasonable to further limit liability, at least for criminal cases, to situations where a fiduciary, family, employment, or other confidential relationship exists between the source and the tippee or the first tier and later tier tippees. If an outside trader has neither a personal nor derivative disclosure obligation, mere possession of insider information should not prevent him from trading. What has made it so difficult to formulate a clear rule based on disclosure obligations is the Supreme Court's refusal to find that a trader on insider information breaches a duty to contemporaneous traders and the SEC's refusal to be constrained by any theories that might limit liability even in borderline cases. Yet, as one commentator has observed, "final resolution of the controversy surrounding insider trading awaits a coherent policy rationale that would simultaneously support and limit insider trading liability."²⁴³

E. *SEC Policies Regarding Silence*

A good question is why does the SEC devote so many resources to insider trading cases instead of developing policies to compel the more rapid release of material information by issuers and securities market professionals? The 1969 Wheat Report pointed out that "[t]here is growing recognition in the investment community of the need for prompt, current reporting by publicly-

1990).

²⁴⁰ 570 F. Supp. 1397 (C.D. Cal. 1983).

²⁴¹ 590 F. Supp. 756 (W.D. Okla. 1984).

²⁴² 737 F. Supp. 269 (S.D.N.Y. 1990).

²⁴³ Jonathan E.A. ten Oever, *Insider Trading and the Dual Role of Information*, 106 YALE L.J. 1325 (1997).

held corporations of material changes in their affairs."²⁴⁴ Yet, the Wheat Report acknowledged that continuing disclosure obligations arise more from stock exchange listing requirements than from the Exchange Act. Therefore, it was recommended that public companies be required to include quarterly reports in their SEC filings. The Wheat Report also acknowledged the need for the SEC to "balance the requirements . . . considered essential for meaningful current reports against the time to be allowed for filing them."²⁴⁵ Nevertheless, the Wheat Report recognized that SEC filings were merely a "backstop" for stock exchange disclosure policies and that, in keeping the marketplace informed, news reports and the efforts of research analysts in ferreting out and disseminating information were of greater importance.²⁴⁶

These insights have been reiterated and updated in the Wallman Report which recommends that a system of company registration replace the current system of transactional registration. One objective of the new system would be to improve the quality, integrity, and reliability of a registered company's disclosure on an ongoing basis to a level comparable to that which is traditionally provided in primary offerings.²⁴⁷ This goal would be achieved in a variety of ways, including enhancements to Form 8-K to mandate disclosure of additional material developments, some of which are currently required to be reported in Form 10-Q.²⁴⁸ Significantly, the Wallman Report recommends that the period within which a Form 8-K must be filed accelerated from fifteen calendar days to five business days.²⁴⁹

Even if the recommendations of the Wallman Report are adopted, gaps in the continuous disclosure system will remain, making the continuing ban on trading on inside information necessary. This linkage between improving disclosure and prohibiting insider trading was recognized in the Wheat Report, which observed that:

²⁴⁴ FRANCIS M. WHEAT, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS, REPORT AND RECOMMENDATIONS TO THE SEC FROM THE DISCLOSURE POLICY STUDY 331 (1969) [hereinafter WHEAT REPORT].

²⁴⁵ *Id.* at 332.

²⁴⁶ *See id.*

²⁴⁷ WALLMAN COMMISSION REPORT, *supra* note 202, at 10, 21.

²⁴⁸ *See id.* at 30. The recommended enhancements are material modifications to the rights of securities holders, resignation or removal of any top five executive officers, defaults of senior securities, sales of a significant percentage of a company's stock, and certain advice from the issuer's auditors.

²⁴⁹ *See id.*

publicly-owned corporations have come under increasing obligations and incentives to make timely disclosure of information which might materially affect the market for their securities. These developments include both the expanded policy on timely disclosure adopted by the major stock exchanges and the principle with respect to "insider trading" developed in *Texas Gulf* and other cases.²⁵⁰

An interesting issue left open by *O'Hagan* is the legality of trading on corporate disclosure other than that made in SEC filings. The current practice by public companies of releasing material information in multi-party telephone calls with analysts does not contravene the misappropriation theory, yet it nevertheless raises real questions. In an era when companies can make electronic disclosure through the EDGAR system and this information can be accessed by anyone with a computer modem, why should public disclosure be made via financial intermediaries, thus favoring institutional over public investors? There may be sound reasons for this customary practice, but since the SEC has developed its insider trading policies through ad hoc enforcement cases, it is not clear exactly what policies the SEC is fostering. Some pending insider trading cases may address this issue but none involve issuer disclosures to analysts. They do, however, involve the question of when material information becomes "public" in today's marketplace.²⁵¹

The SEC's longstanding reluctance to mandate the *prompt* disclosure of *all* material information by public companies can be explained in a number of ways. First, the SEC and the courts have respected an issuer's need to keep information confidential either to serve a corporate purpose or to keep facts confidential until ripe for disclosure.²⁵² Second, the SEC has relied upon financial analysts to ferret out, sift through, and form conclusions about material facts.²⁵³ The reluctance of both the SEC and the courts to in-

²⁵⁰ WHEAT REPORT, *supra* note 245, at 133.

²⁵¹ See *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996) *cert. denied sub nom. Cusimano v. United States*, 117 S. Ct. 2509 (1997); *SEC v. Lenfest*, 949 F. Supp. 341 (E.D. Pa. 1996). The telephone conference call between issuers and analysts has begun to trouble the SEC. See Floyd Norris, *In Search of a More Democratic Grapevine*, N.Y. TIMES, Mar. 3, 1998, at D1.

²⁵² See, e.g., *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); *Elkind v. Liggett & Myer, Inc.*, 472 F. Supp. 123 (S.D.N.Y. 1978); *In re Carnation Co.*, Securities Exchange Act Release No. 22,214, 33 SEC Docket (CCH) 884 (July 8, 1985). The premature release of information could mislead investors and expose issuers to liability. See Norman S. Poser, *Chinese Walls in the U.S. and the U.K.*, 21 REV. SEC. & COMM. REG. 207, 217 (1988).

²⁵³ See *In re Investors Management Co.*, Exchange Act Release No. 9267, [1970-1971

hibit the investigative work of analysts is a factor that has made defining insider trading difficult.²⁵⁴ Third, the SEC is a prosecutorial agency that has long articulated the view that detailed regulations will be a blueprint for fraud and therefore it is better to rely upon general antifraud concepts to police the securities markets.²⁵⁵

It can be argued that the SEC's solicitude towards securities analysts is an example of agency capture and that this concern for the role analysts play in disseminating corporate information to the marketplace has kept the SEC from imposing more stringent obligations on public companies to disclose material facts promptly.²⁵⁶ There are at least two responses to this criticism. First, even a populist securities regulator like William O. Douglas was skeptical of the ability of the ordinary individual investor to analyze complex financial information and believed that such information needed to be analyzed by professionals to give the securities markets integrity.²⁵⁷ Second, assuming ongoing disclosure of all material information on a real time basis is practicable, it is unlikely that in 1934, 1964, or today the SEC would be given the kind of power over public companies needed to compel such disclosure.²⁵⁸ Recently, the SEC has threatened to take action against analysts who trade on, or selectively disclose, corporate information immediately before a news release, but it is unclear whether such conduct involves any breach of a fiduciary duty under Rule

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,163 (July 29, 1971); *Loomis on Inside Information*, FIN. ANALYSTS J., May-June 1972, at 20.

²⁵⁴ See *Dirks v. SEC*, 463 U.S. 646, 658-59 (1983).

²⁵⁵ For elaboration on the idea that SEC enforcement thrives on the absence of standards, see ROBERTA S. KARMEL, REGULATION BY PROSECUTION 95-98, 193-202, 227-29 (1982).

²⁵⁶ The theory of agency capture is that there are built-in tendencies toward ultimate domination of an agency and the regulatory process by regulated industry. See EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 181 (1981).

²⁵⁷ See William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 523-24 (1934).

²⁵⁸ SEC power over public companies has generally been indirect and has been added to only by accretion as a result of various scandals. For example, the sensitive payments scandals of the 1970s led to the passage of the Foreign Corrupt Practices Act which gave the SEC direct authority regarding accounting systems and controls of public companies. The insider trading scandals of the next decade led to the SEC power to bar persons as officers and directors, but only in court, not SEC administrative proceedings. Fiduciary duties of directors to shareholders remain a matter of state, rather than federal, law. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 477-80 (1977). Whether Congress would even be willing to enact a system of company registration as envisioned by the *Wallman Commission Report*, as opposed to a system of securities registration, thus giving the SEC direct, rather than indirect, power over regulated corporations is an interesting question not addressed in the *Wallman Commission Report*.

10b-5 violation.²⁵⁹

Both the SEC and the courts also have demonstrated a solicitude for bidders in takeovers that has inhibited more stringent regulation that would accelerate their notification of an intention to commence a tender offer. The basic policy of the Williams Act is to promote neutrality between bidders and target companies in takeovers, and the focus of SEC concern is investor protection.²⁶⁰ This neutrality to some extent fosters takeovers, however, and the SEC has opposed measures that would tilt federal policy against takeovers. Although the SEC did make efforts to close the ten day window of section 13(d) of the Exchange Act, it did so in the context of opposition to proposed legislation designed to thwart hostile takeovers and this effort was therefore unsuccessful.

In 1980 the then Chairman of the SEC recommended to Congress significant changes to the Williams Act, which among other things, would have required shareholders owning more than five percent of a reporting company's shares to: make a public announcement within one business day after reaching the five percent level; file a Schedule 13D within five business days thereafter; and refrain from making further acquisitions until two business days after the filing.²⁶¹ The 1983 Report of the Blue Ribbon Advisory Committee on Tender Offers ("Advisory Committee") found that because of the ten-day window between the acquisition of more than a five percent interest and the required filing of a Schedule 13D, the requirement to report the acquisition of more than five percent of an outstanding class of an issuer's equity securities had failed to give notice of potential changes in control.²⁶² The Advisory Committee found this window to present a substantial opportunity for abuse, so it recommended that no person be permitted to acquire ownership of more than five percent of an

²⁵⁹ See Paul Beckett & Rebecca Buckman, *SEC's Levitt Warns Analysts on Some Trades*, WALL ST. J., Mar. 9, 1998 at A11.

²⁶⁰ The Williams Act is comprised of sections 13(d) and 14(e) of the Exchange Act, 15 U.S.C. §§ 78m(d), 78n(e) (1994), and the various SEC rules thereunder. In the words of the Supreme Court, a major aspect of this legislation "to protect the investor was to avoid favoring either management or the takeover bidder." *Edgar v. Mite Corp.*, 457 U.S. 624, 633 (1982).

²⁶¹ See Letter from Harold M. Williams, Chairman, SEC, to the Senate Banking Committee (Feb. 15, 1980) (on file with author). See James H. Fogelson et al., *Changing the Takeover Game: The SEC's Proposed Amendments to the Williams Act*, 17 HARV. J. ON LEGIS. 409 (1980).

²⁶² ADVISORY COMMITTEE ON TENDER OFFERS, SEC, REPORT OF RECOMMENDATIONS (July 8, 1983), reprinted in Fed. Sec. L. Rep. (CCH) No. 1028 (Extra Edition) 21-22.

outstanding class until such person has filed a Schedule 13D and it has been on file with the SEC for forty-eight hours.²⁶³

The SEC's 1980 recommendation and the Advisory Committee's variation would have protected shareholders in target companies from selling shares to those with information of an upcoming change of control bid. The SEC's own legislative package, which followed the Advisory Committee's Report, recommended closing the ten day window,²⁶⁴ a recommendation which was also included in the Tender Offer Report Act of 1984, a bill approved by the House Energy and Commerce Committee.²⁶⁵ However, this bill contained a variety of anti-bidder provisions, requiring, for example, a tender offer be kept open for forty days rather than twenty, and the issuance of a community impact statement. These provisions were accordingly criticized by the Reagan White House and the SEC, and as a result the bill died.²⁶⁶ Further, in the following year, the SEC dealt an even greater blow to tender offer reform when it withdrew support from its own legislative proposal, stating it would support a bill narrowing the ten day window and nothing more.²⁶⁷

In 1987 despite the SEC's general opposition to pending take-over legislation, it continued to support measures requiring more timely disclosure of substantial acquisitions under section 13(d) of the Exchange Act. Specifically, it recommended that any person acquiring more than five percent of a class of equity securities be required to disclose that acquisition within five business days and that the purchaser be prohibited from making additional acquisitions until the disclosure is made.²⁶⁸ The SEC's rationale for this proposal was that it would promote prompt disclosure without unduly inhibiting the ability of market participants to trade freely.²⁶⁹ There was no mention of curbing insider trading in the tender offer arena.

The insider trading scandals of the time were a backdrop to the proposed tender offer legislation of the 1980s. An address by

²⁶³ See *id.* at 22.

²⁶⁴ See Letter from John S.R. Shad, Chairman, SEC, to Congressman Timothy E. Wirth, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,630 (May 21, 1984).

²⁶⁵ H.R. 5693, 98th Cong. (1984).

²⁶⁶ See *The Battle over Tender Offer Reform: From the States and the Courts to Congress*, 20 Sec. Reg. & L. Rep. (BNA) 60, 61 (Jan. 15, 1988).

²⁶⁷ See *id.*

²⁶⁸ See *Hearings Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce Concerning Pending Legislation Regarding Contests for Corporate Control*, 100th Cong. 2 (1987) (statement of David S. Ruder, Chairman, SEC).

²⁶⁹ See *id.* at 14.

then Commissioner Joseph A. Grundfest criticized as misguided the takeover critics who were linking insider trading with hostile takeovers.²⁷⁰ In speaking out against anti-takeover legislation, he also attacked the "easy but illogical arguments that seek to prevent insider trading by stopping takeovers."²⁷¹ Commissioner Grundfest was correct in arguing that "[i]nsider trading is not caused by hostile takeovers, nor is it uniquely associated with hostile takeovers."²⁷² Nevertheless, narrowing or closing the ten-day window would clearly have had a prophylactic effect of curbing some insider trading in advance of a tender offer announcement. The SEC can be criticized for failing to pursue this legislative initiative more aggressively before and after Congress abandoned takeover reform legislation.²⁷³ Moreover, the SEC's policies are illogical since a bidder can make purchases up to five percent of an issuer's securities without disclosure, and can continue to purchase securities in secret for ten days—or up until the time a tender offer is announced—but a bidder's tippee cannot buy securities in advance of a public announcement of a tender offer.

The SEC's reluctance to inhibit takeovers or interfere with merger negotiations led to its decision in *Carnation Co.*,²⁷⁴ which permitted companies engaged in merger or takeover negotiations to remain silent about such discussions by refusing to comment on market rumors. Although the stock exchanges have elaborate policies mandating continuous disclosure and prohibiting selective disclosure,²⁷⁵ where it is possible for a corporation to keep information confidential, premature public disclosure of material information may properly be avoided.²⁷⁶ The *Carnation* decision provides issuers with a mechanism for avoiding disclosure of fluid or uncertain information but also creates a disclosure gap that could be misused if there was no ban against insider trading.

²⁷⁰ JOSEPH A. GRUNDFEST, SEC, POLITICS AND TAKEOVERS: A BRIEF WASHINGTON PERSPECTIVE (National Bureau of Econ. Research Panel on the Economic Effects of Mergers and Acquisitions, 1987).

²⁷¹ *Id.* at 3.

²⁷² *Id.* at 4.

²⁷³ After *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), the decision upholding as constitutional an anti-takeover state statute, federal takeover reform became bogged down in debates about federal preemption. As a result, the business community became unenthusiastic about federal legislation. While it can be argued that the SEC was a captive of the securities industry with regard to these issues, the SEC was relegated to the sidelines in any event, since most of the action was occurring in Congress.

²⁷⁴ *In re Carnation Co.*, Exchange Act Release No. 22,214, 33 SEC Docket (CCH) 874 (July 8, 1985).

²⁷⁵ See New York Stock Exchange Listed Company Manual (NYSE) § 202 (1997).

²⁷⁶ See *id.* § 202.01.

The SEC extensively relied upon the insider trading doctrine in taking enforcement action against manipulative activity that resulted from the excesses of the market for corporate control that was fueled by the junk bond financing of the 1980s.²⁷⁷ In part, this was because manipulation in this context is extremely difficult to prove under existing statutory norms.²⁷⁸ It was easier to prosecute Ivan Boesky, Michael Milken, and their cohorts on insider trading charges than on other theories. The SEC could have ameliorated the evils of tender offers in the 1980s through regulation, but the agency was ideologically committed to fostering a market for corporate control. Accordingly, it selected the ban on insider trading as a weapon to attack those miscreants that the SEC believed should be chased out of the securities industry.²⁷⁹

In *O'Hagan*, the Supreme Court elliptically casted doubt on the use of Rule 14e-3 to prohibit *warehousing*, the practice by a bidder of suggesting to other traders that they might purchase stock of a company that the bidder is (secretly or more openly) prospecting as a takeover target.²⁸⁰ This type of manipulative activity was prevalent in the 1980s when a loose confederation of market players put target companies in play.²⁸¹ The Supreme Court may be troubled by *Schreiber's* limiting interpretation of "manipulative" as opposed to *O'Hagan's* expansive interpretation of "fraudulent."²⁸²

With regard to outsider trading on confidential information concerning impending market transactions other than takeovers, the SEC has preferred to rely on its authority to regulate broker-dealers, especially specialists and market makers, rather than to rely on insider trading prohibitions to make the markets fairer.²⁸³ In addition, the SEC has relied on the just and equitable principles of the self-regulatory organizations in situations involving overreaching by market participants with superior information.²⁸⁴ In this area, the SEC has been concerned about undermining market

²⁷⁷ See James B. Stewart & Daniel Hertzberg, *SEC Accuses Drexel of a Sweeping Array of Securities Violations*, WALL ST. J., Sept. 8, 1988, at A1.

²⁷⁸ See *United States v. Mulheren*, 938 F.2d 364 (2d Cir. 1991).

²⁷⁹ See generally STEWART, *supra* note 141.

²⁸⁰ *United States v. O'Hagan*, 117 S. Ct. 2199, 2217 n.17 (1997).

²⁸¹ If the confederates became a "group," a section 13(d) filing was required.

²⁸² See *supra* text accompanying notes 214-15. Further development of this topic is beyond the scope of this Article.

²⁸³ See, e.g., SEC Rules 11Ac1-1, 11Ac1-4; 17 C.F.R. 240.11Ac1-1, 11Ac1-4 (1998) (quote and order exposure rules).

²⁸⁴ See, e.g., *In re E.F. Hutton & Co.*, Exchange Act Release No. 25,887, [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988).

liquidity, just as it has been concerned about discouraging research analysis or takeovers by too heavy handed an insistence on disclosure of information that might be premature and make the securities markets less efficient and less fair rather than more efficient and more fair. Regulating the informational advantages of various market participants is an important challenge for the SEC, but it is too complicated and delicate a task for a broad brush insider trading rule like Rule 10b-5. The SEC has ample authority under its national market system mandate and even section 15(c) of the Exchange Act to deal with these problems.²⁸⁵

CONCLUSION

This Article has argued that the ban against trading on inside information should be justified in terms of the SEC's mandate to compel the disclosure of material, market information, especially by corporations, and others participating in tender offers. Although a corporate official's tippee might not owe any duty to the shareholders of the corporation, officials who give such persons material, nonpublic information generally do owe such a duty. Although a prospective bidder's tippee may not owe a duty to shareholders of the target company, the bidder is under an obligation to make certain disclosures before a tender offer can go forward. So is a target. Where securities industry participants have unfair informational advantages, the SEC generally can equalize trading advantages through its ample rulemaking power with regard to market structure. Accordingly, an all encompassing theory, which would include scalping, front running, and similar types of outsider trading, is not necessary.

Although the doctrine of equal access to information has been partially rejected by the Supreme Court, fairness is still at the bottom of the insider trading ban. The *Cady, Roberts* formulation concerning the unfairness of using confidential information for personal advantage remains valid. Perhaps this is too vague a standard upon which to predicate criminal prosecutions. However, where one party to a securities transaction has obtained an asymmetrical information advantage over another party, not through diligent research or similar efforts, but through nefarious means, a buyer from, or seller to, such a person would justifiably perceive such trading to be unfair. Further, where information

²⁸⁵ See *supra* note 228. *O'Hagan* analogizes the SEC's prophylactic authority under section 14(e) to that under section 15(c). See 117 S. Ct. at 2217.

about a security is hidden from the market, the pricing of that security is manipulative and deceptive. The misappropriation and property rights theories are both too narrow to encompass all of the insider trading cases and, while useful in some contexts, are problematic in that they are based upon the suppression of information rather than its dissemination.

The argument that the ban on insider trading is necessary to enforce the mandatory disclosure provisions of the securities laws seems self-evident. Surprisingly, however, the SEC, the courts, and the commentators seem to have become so bogged down in the details of the misappropriation theory, as well as other theories, that they have overlooked a basic rationale for prohibiting insider trading. In a marketplace where information is ever more accessible with ever fewer time delays, it is important for the SEC to go back to basics on this issue so, to the extent feasible, regulatory policies can focus on preventing insider trading by compelling more prompt disclosure of material information by public companies, bidders, and market participants with informational advantages. Hopefully, if the SEC and the courts focus their attentions on the relationship between disclosure policy and the ban against trading on inside information, the parameters of this crime, under sections 10(b) and 14(e) of the Exchange Act, will be easier to delineate.

