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BOOK REVIEW

THE RELATIONSHIP BETWEEN MANDATORY DISCLOSURE AND PROHIBITIONS AGAINST INSIDER TRADING: WHY A PROPERTY RIGHTS THEORY OF INSIDE INFORMATION IS UNTENABLE

Roberta S. Karmel*


INTRODUCTION

Virtually every country that has an active and mature stock market either has adopted or has under consideration a law prohibiting trading on inside information. Professor Gaillard’s book, Insider Trading: The Laws Of Europe, The

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United States and Japan, is an excellent compilation of the laws on this subject in Europe, the United States and Japan. These laws are roughly similar in substance, which is not surprising in view of the aggressive leadership exercised by the United States Securities and Exchange Commission ("SEC") and the influence of the Directive on Insider Dealing adopted by the Council of the European Communities ("EC") on November 13, 1989. Such a convergence of law and interpretation probably is salutary in view of the opportunities for the extraterritorial application of law provided by insider trading cases.

Yet, despite the popularity of laws prohibiting insider trading, there is little discussion or agreement by regulators or commentators as to the philosophical objectives or precise parameters of such prohibitions. The SEC generally argues that insider trading is unfair and destructive of investor confidence. In contrast, the law and economics school argues that insider trading prohibitions create market inefficiencies and should be eliminated. In Inside Information and Securities Trading: A Legal and Economic Analysis of Liability in the USA and European Community, Mr. Bergmans sets forth the various arguments and theories of the regulators and deregulators and finds them both wanting. He therefore posits a new approach that would treat inside information as intellectual property and protect it as such. Professor Macey, in Insider Trading: Economics, Politics and Policy, makes a similar

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6 See generally BERGMANS, supra note 5.
7 See generally MACEY, supra note 5.
argument. The similarity of views of Mr. Bergmans, a European bank lawyer, and Professor Macey, a professor at a United States law school is interesting. Both authors are sympathetic to the law and economics deregulators. Confronted by the reality of worldwide bans on insider trading, however, they feel constrained to set forth a minimalist rationalization of these prohibitions that focuses on protecting the property rights of those who develop or obtain inside information.

The difficulty with an approach that views insider trading from a property rights perspective is that it ignores the theories and policies of the primary proponent of insider trading restrictions—the SEC. Admittedly, the law on insider trading is, at the edges, unclear and confusing because the SEC’s views concerning insider trading have not been wholly accepted by the United States Supreme Court. Yet, the Court has neither wholly rejected these views nor has it articulated any alternative theories that explain all of the cases. The SEC, therefore, has continued to prosecute insider trading cases to the extent possible and has persuaded the United States Congress, foreign legislatures and foreign securities regulators to cooperate in its campaign to stamp out insider trading as unfair and inequitable.

A further problem with treating inside information as a form of intellectual property entitled to legal protection is that such a theory fails to integrate insider trading regulation into the overall scheme of securities regulation. The prohibitions against trading on inside information complement the mandatory disclosure provisions of the securities laws. If insider trading were generally permitted, the mandatory disclosure system would be fatally undermined. One senses that such destruction is the hidden agenda of some of the deregulators whose views are generally both political and nihilistic.

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8 Some of the differences between the two authors also are interesting. Although Mr. Bergmans received a Master of Laws in the United States, he is a European lawyer. His civil law background makes him unsympathetic to a common law approach to the development of legal principles. Professor Macey is enamored with economic models and formulas. This leads both authors to a search for certainty that misses the political interplay between the SEC and the courts that best explains the development of insider trading law.

9 For example, Professor Macey states: “the SEC, then, has it exactly backward when it argues that investors will not invest if they think the market is rigged. In fact, investors will not invest if they think the market is not rigged.”
As Part I of this Book Review will explain, the SEC initially proposed a “parity-of-information” theory as the underpinning for a general ban against insider trading. Although such a theory would have assured that all material corporate information was disseminated into the securities markets through the SEC’s mandatory disclosure system—and only through that system—the principle that all buyers and sellers of securities should have access to the same information was overly broad. It would have generated unacceptable civil liability and outlawed legitimate business practices regarding the protection of confidential information. Further, an all encompassing definition of inside information would have impaired market efficiency and liquidity. Nevertheless, exceptions to the prohibitions against trading on inside information should not be mistaken for or distorted into the norm. Part II of this Book Review criticizes the property rights theory and concludes that insider trading prohibitions should not be viewed as isolated wrongs, but as necessities that make the mandatory continuous disclosure system work.

I. SOURCES OF U.S. LAW ON INSIDER TRADING

The prohibitions against trading on inside information under the United States federal securities laws derive from four sources: section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 10b-5 promulgated thereunder; section 16 of the Exchange Act; section 14(e) of the Exchange Act and Rule 14e-3 promulgated thereunder; and the 1984 and 1988 statutory amendments to the Exchange


Act, which increased the sanctions for insider trading violations. The most important of these sources for insider trading jurisprudence is Rule 10b-5, which makes it unlawful for any person in connection with the purchase or sale of a security

(1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or (3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person . . . .

Rule 10b-5 makes no reference to insiders, but prohibits certain fraudulent conduct by any person upon any other person.

The typical insider trading case involves silence by a buyer or seller of securities. The buyer or seller's complete failure to disclose that it is in possession of material, nonpublic information generally is not viewed as a violation of subsection (2) of Rule 10b-5, which relates only to the making of untrue or misleading statements. Such inaction, however, can be interpreted as "a device, scheme or artifice to defraud" or as an "act, practice or course of business which operates . . . as a fraud or deceit" upon a third person. And while Rule 10b-5 generally prohibits fraudulent and deceptive practices in the public secu-

17 Id.
18 Under an extreme version of the fraud-on-the-market theory, which is a corollary of the Efficient Capital Market Hypothesis ("ECMH"), silence could be considered misleading. The ECMH posits that a corporation's share price will accurately reflect all publicly disclosed material information. See Christopher P. Saari, Note, The Efficient Capital Market Hypothesis, Economic Theory, and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031 (1977). When the market is deprived of material information, however, the fraud-on-the-market theory posits that the corporation's share price will inaccurately reflect its true value. Simply put, the market will be misled. Nevertheless, no liability under Rule 10b-5 will be imposed for silence absent a duty of disclosure. See infra notes 106-09 and accompanying text.
19 See supra note 16 and accompanying text.
The first insider trading case under Rule 10b-5, *In re Cady Roberts & Co.*, was an SEC administrative proceeding in which the director of an issuer, who was also a principal of a brokerage firm, used undisclosed, adverse information—a dividend reduction—to recommend and effect the sale of securities.

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20 See Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (parent company offering grossly inadequate price to minority shareholders in freeze-out merger does not violate Rule 10b-5 so long as it made truthful and accurate statements in required SEC disclosure statements).


for customers of the broker. In finding that these actions violated Rule 10b-5, the SEC stressed the existence of a relationship that afforded the director access to inside information intended to be available only for a corporate purpose and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.\footnote{Cady Roberts, at 911-13.}

The first major court case affirming the use of Rule 10b-5 as the basis for prohibiting trading on inside information was SEC v. Texas Gulf Sulphur Co.\footnote{401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).} In Texas Gulf Sulphur, the SEC obtained an injunction against an issuer, its officers and employees, forbidding them from trading and tipping others to trade stock and options on the basis of material, undisclosed information about a potentially major copper strike by the issuer in Canada. Texas Gulf Sulphur was predicated on the theory that Rule 10b-5 is based on the justifiable expectation in the securities marketplace that investors who trade on impersonal exchanges should have relatively equal access to material information. It 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 whose securities are sold.\footnote{See Strong v. Repide, 213 U.S. 419, 431 (1909) (no fraud liability for defendant-corporate officer who bought shares in his corporation without disclosing to seller that land owned by corporation may have valuable ore deposits). But see Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933) (defendant-director under a duty to disclose information materially affecting value of stock before purchasing it from shareholders).}

In Texas Gulf Sulphur and in subsequent decisions the SEC broadly argued that the antifraud provisions of the Exchange Act require a parity of information among all traders in the public securities markets. Accordingly, an insider or his tippee that comes into possession of confidential, nonpublic information either should disclose that information or refrain from trading on it.\footnote{This view was adopted in Texas Gulf Sulphur, 401 F.2d at 848.} As pointed out by Mr. Bergmans,\footnote{See BERGMANS, supra note 5, at 54-57.} though, there are two problems with this argument. First, it appears to encourage non-disclosure rather than to mandate it. Second, the Supreme Court has rejected the parity-of-infor-
mation theory articulated in Texas Gulf Sulphur and its continuing doctrinal validity is therefore questionable.\(^{30}\)

The Court rejected the parity-of-information theory because it quickly became apparent that a theory mandating that a seller of securities either disclose any material information about the securities known to the seller but not generally known to the marketplace or abstain from trading was much too broad. Instead, security analysts and other market professionals whose job was to ferret out information about securities should be given the opportunity to trade on such information as a matter of policy because such permitted trading would foster better disclosure about securities and lead to more accurate stock valuations. Furthermore, in situations involving market information rather than inside corporate information, a blanket prohibition against trading on information not generally known would impede market liquidity. Accordingly, the law on inside information developed to balance a policy favoring fairness to investors generally against legitimate business needs to keep information confidential or to permit professionals to trade on information that they have not obtained through improper or surreptitious means.

Differences in opinion at the SEC as to a theoretical basis for insider trading bans narrower than the one articulated in Cady Roberts arose in In re Investors Management Co.\(^{31}\) The SEC brought this administrative proceeding against investment advisers and mutual fund managers who sold stock in McDonnell Douglas Corp. because of selective disclosure of a reduction in Douglas' earnings to institutional investors by Merrill Lynch, Pierce, Fenner & Smith.\(^{32}\) The Commission held 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 superi-


\(^{32}\) 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. In re Merrill Lynch, Exchange Act Release No. 8459, 43 S.E.C. 933 (Nov. 25, 1968).
or to other investors, thereby acquires a relationship with respect to that information, giving rise to a legal duty within the purview and restraints of the antifraud provisions. \(^{33}\) In a concurring opinion, Commissioner Smith asserted that tippee responsibility must be related back to insider responsibility such that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information. Further, the information must be shown not only to be material and nonpublic, but also to have substantially contributed to the trading that occurred. \(^{34}\)

Thereafter, the United States Supreme Court limited the scope of insider trading violations in \textit{Chiarella v. United States}. \(^{35}\) \textit{Chiarella} involved a printer who learned about upcoming tender offers for several target companies, purchased shares in the companies prior to the offer and then sold his shares at a premium after the offer had been announced. The Court held that silence in connection with a purchase or sale constitutes fraud only if liability is premised on a duty to disclose arising from a relationship of trust and confidence, and not merely upon one's ability to utilize information because of his position in the marketplace. \(^{36}\) Thus, unlike the relationship of trust and confidence between a corporate insider and a shareholder recognized in \textit{Cady Roberts}, \(^{37}\) \textit{Chiarella} simply availed himself of information learned during his employment, and was therefore under no affirmative duty of disclosure. \(^{38}\) Although the defendant's conduct may have been reprehensible, the Supreme Court pointed out that not every instance of financial unfairness necessarily violates Rule 10b-5.

Then, in \textit{Dirks v. SEC} \(^{39}\) the Supreme Court clarified its views as set forth in \textit{Chiarella} by essentially adopting the rationale of Commissioner Smith's concurring opinion in \textit{Investors Management}. \(^{40}\) Dirks, a securities analyst and an officer

\(^{33}\) \textit{Investors Management}, 44 S.E.C. at 640-41.

\(^{34}\) \textit{Id.} at 649-51.

\(^{35}\) 445 U.S. 222 (1980).

\(^{36}\) \textit{Id.} at 230.

\(^{37}\) \textit{See supra} notes 24-25 and accompanying text.

\(^{38}\) \textit{Chiarella}, 445 U.S. at 231-33.


\(^{40}\) \textit{See supra} note 34 and accompanying text.
of a broker-dealer firm, received information from a former officer of Equity Funding Corporation of America to the effect that the business of Equity Funding was permeated with fraud and that its assets were grossly overstated. In the course of a futile effort by Dirks to publicize this information generally, institutions informed by Dirks about these facts sold their Equity Funding stock, causing its price to drop from twenty-six dollars to fifteen dollars per share. Dirks did not have a client or fiduciary relationship with Equity Funding. Nevertheless, the SEC sanctioned him, holding that “where tippees—regardless of their motivation or occupation—come into possession of material corporate information that they know is confidential and know or should know came from a corporate insider, they must either publicly disclose that information or refrain from trading.”

The Supreme Court reversed the Commission, holding that an affirmative duty of disclosure arises from the relationship between parties and not merely from a person’s ability to utilize information because of his position in the market. 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. 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 had entered into a special confidential relationship in the conduct of the business of the enterprise and were given access to information solely for corporate purposes.

B. Short Swing Profit Prohibitions

Cady Roberts, Texas Gulf Sulphur, Investors Management and Dirks were all cases that involved classic leaks of undis-

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42 Dirks, 463 U.S. at 656 n.15 (“Mere possession of non-public information does not give rise to a duty to disclose or abstain; only a specific relationship does that.”).
43 Id. at 662-63.
44 Id. at 657-58.
closed material information emanating from a corporate source. As explained in the collection of articles in Professor Gaillard's book, this type of activity is banned in every country that has an insider trading law.\(^{45}\) In the United States, this ban is reinforced by the provisions of section 16 of the Exchange Act,\(^{46}\) which requires officers, directors and holders of ten percent or more 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 to the issuer any profits realized as a result of purchase and sale transactions effected within a six-month period. The purpose of section 16 is to prevent the unfair use of information that may have been obtained by insiders in the purchase and sale or sale and purchase of securities. The prohibition is designed to eliminate transactions for profit by officers, directors and shareholders in the stocks of their own companies with the benefit of advance information.\(^{47}\) Section 16 is a crude rule of thumb. An insider's liability for short swing profits does not depend on actual use of inside information.\(^{48}\)

Section 16 is a remarkably effective prophylactic tool for preventing trading on inside information by officers, directors and shareholders. There have been many insider trading cases over the years since *Texas Gulf Sulphur*, but few have involved direct trading by corporate officials. Most other countries do not have a law comparable to section 16.\(^{49}\) Countries lacking such a law may find it difficult to police or curtail insider trading, particularly if the only enforcement mechanism for such trading violations is criminal prosecution. While there has been debate in the United States as to whether there is a continuing need for the section 16 reporting and short swing profit prohibitions in view of heightened SEC and civil enforcement


\(^{49}\) An exception is Japan, which does have a short swing trading rule modeled after U.S. law. See Gaillard, *supra* note 1, at 328; see also Elyse Diamond, Note, *Outside Investors, A New Breed of Insider Traders?*, 60 FORDHAM L. REV. s319, s325-31 (1992) (reviewing insider trading laws of Europe and Japan and noting that only Japan has short swing profit prohibition).
of insider trading violations and other shareholder reporting requirements, there are strong policy arguments against repealing section 16.

The principle that corporate insiders should not profit from trading on material, undisclosed information has been challenged by only a few law and economics extremists. The interpretive problems involve trading by remote tippees, especially when there is no business or professional relationship between an insider and the tippee. Such a situation arose in United States v. Chestman, where the defendant had tipped a stockbroker who traded on the information. The husband had learned the information from his wife, who learned it from her mother, who learned it from her brother, a corporate insider. The court could find no fiduciary relationship in this chain of tippers that would make the husband culpable under Rule 10b-5. Kinship did not suffice and the husband-defendant did not explicitly assume a duty of confidentiality concerning the information he received. A strongly worded dissent criticized the majority as drawing an unrealistic line leading to a perverse and circular result.

The doctrinal difficulties presented by Chestman derive
from Chiarella's and Dirks' requirement that a fiduciary relationship exist to sustain an obligation either to disclose material nonpublic information or to refrain from trading. The lower federal courts and the SEC seized upon Chief Justice Burger's dissent in Chiarella to develop the misappropriation theory under which anyone who misappropriates material nonpublic information in breach of an employment, fiduciary or similar duty to anyone and then trades on or tips that information to his own advantage violates Rule 10b-5. This stress on protecting an employer's right to keep information confidential has prompted Mr. Bergmans and Professor Macey to theorize that there is a property right inherent in inside information. However, these theories are anomalous because they stress the rights of insiders rather than the protection of investors. The SEC has found the misappropriation theory a convenient tool for antifraud enforcement. In the final analysis, however, it is faulty because it has the potential for turning employee work rules into criminal statutes and for extending Rule 10b-5's coverage to those outside the securities markets. In short, the misappropriation theory may be "merely a pretext for enforcing equal opportunity in information." Yet, the SEC has

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58 Charles C. Cox & Kevin S. Fogerty, Bases of Insider Trading Law, 49 OHIO ST. L.J. 353, 365 n.54 (1988) ("This is particularly striking in a newspaper case [where] . . . liberal recognition of property rights in confidential information might subject reporters who rely on 'leaks' to prosecution for fraud by misappropriation.").
59 As one author has noted:
An examination of . . . Carpenter indicates that some members of the Court may have agreed with the Petitioners that the Second Circuit erred in construing rule 10b-5 to protect persons other than buyers and sellers of securities. Even if they accepted the results in Newman and Materia, some Justices may have balked at interpreting the misappropriation theory to encompass the misuse of information belonging to a 'market observer' rather than to a 'market participant.' Barbara Bader Aldave, The Misappropriation Theory: Carpenter and its Aftermath, 49 OHIO ST. L.J. 373, 376 (1988) (footnotes omitted); see also United States v. Carpenter, 791 F.2d 1024, 1036 (2d Cir. 1986) (Miner, J., dissenting), aff'd, 484 U.S. 19 (1987).
60 Cox & Fogerty, supra note 58, at 366 (footnote omitted). Without a doubt, one of the greatest shortfalls of Carpenter—and perhaps of the entire misappropriation theory—is that while "Winans committed a felony in trading on his
not developed an alternative to the parity of information theory on the one hand and the fiduciary duty-misappropriation theory on the other hand.

C. Insider Trading in Advance of Tender Offers

The fiduciary duty-misappropriation theory is incapable of providing broad investor protection in situations involving market information, especially with regard to advance information concerning tender offers. After the *Chiarella* decision the SEC adopted Rule 14e-3 to deal with the misuse of information regarding prospective tender offers. That rule sets forth a disclose-or-abstain prohibition 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 nonpublic 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 . . . ."62

The SEC justified Rule 14e-3, arguing that trading by persons in possession of material nonpublic information relating to a tender offer results in unfair disparities in market information and causes market disruptions because securityholders who purchase from or sell to such persons are effectively denied protection of the mandatory disclosure provisions of the Williams Act. If furnished with information about the tender offer, however, they could make an informed investment decision.63 This is essentially the parity-of-information theory in the context of a tender offer. In addition, Rule 14e-3 clearly was intended to enforce the disclosure provisions of the Exchange Act relating to tender offers.

The Second Circuit addressed a persistent question concerning the validity of Rule 14e-3 in the above-described case publisher's confidential information, the publisher might have traded with impunity." Id.

62 Id.
of *United States v. Chestman.* In the first opinion issued by the Second Circuit, 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 one hand, Judge Carman found Rule 14e-3 to be 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. Judge Mahoney, on the other hand, 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), under which Rule 14e-3 was promulgated, as limiting the SEC's rulemaking authority to prohibiting traditional common law fraud, which requires that a duty exist and be breached as a precondition to liability. This radical view that the SEC's rulemaking authority is constrained by the common law was squarely rejected by a subsequent *en banc* decision (with one dissent). 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 allows the SEC to define fraud in ways that go beyond the common law. 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.\textsuperscript{71}

Professor Macey criticizes Rule 14e-3 because it is based on a fairness rather than a property rights perspective and "inexplicably" protects the rights of shareholders of target firms as against bidders.\textsuperscript{72} However, this criticism ignores Congress' fundamental purpose in passing the Williams Act, under which Rule 14e-3 was enacted, which was to provide shareholders with sufficient information to evaluate a tender offer and to reduce the pressure on such shareholders when making their investment decisions.\textsuperscript{73} Similarly, Mr. Bergmans regards Rule 14e-3 as an exception to his rights-in-information theory.\textsuperscript{74} Under his approach a prospective tender offeror would be free to do anything he wished with the information that he was planning to make a tender offer, including tip others.\textsuperscript{75} The trouble with the Macey-Bergmans property rights theory is that it ignores the Wall Street scandals of the 1980s and the many successful criminal prosecutions of, among others Dennis Levine, Martin Siegel, Ivan Boesky and Michael Milken concerning trading on advance information about tender offers.\textsuperscript{76}

D. Recent Statutory Developments

Although Professor Macey and Mr. Bergmans may believe that inside information is property to which insiders have rights they should be permitted to utilize, Congress, in the face of the insider trading cases of the 1980s, determined otherwise. In 1984 and again in 1988 Congress amended the Exchange Act to increase the sanctions for insider trading and to make SEC enforcement of the prohibitions against insider trading more effective. Before describing the 1984 and 1988 statutes,
however, some background on damage claims under Rule 10b-5 is necessary.

In *Shapiro v. Merrill Lynch*, a case growing out of the widespread insider trading in McDonnell Douglas stock that led to SEC administrative proceedings described above, the Second Circuit implied a private right of action against traders and tippees in favor of any 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 principle had enormous civil liability potential and could have resulted in possible unfairness in the context of a suit against an issuer, by shifting losses from one group of shareholders who had purchased or sold before material information was released to those shareholders at the time a litigation is concluded. Moreover, litigation costs in this type of situation are an added burden on the issuer. Although in a world of perfect informational efficiency stock prices should reflect such liabilities, stock market activity takes place in the real world, not in a theoretical economic model.

The courts, therefore, backed away from the implications of *Shapiro*. In *Elkind v. Liggett & Myers, Inc.* 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 shareholders." In addition to reducing the measure of damages, the court subsequently cut back the number of plaintiffs who could sue in insider trading cases. After *Chiarella* and *Dirks*, the Second Circuit, in *Moss v. Morgan Stanley*, declined to imply a private right of action in favor of a selling shareholder of a target corporation where an investment banker and his tippees had purchased the target's shares after learning about the takeover bid. The investment banker's employer represent-

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77 495 F.2d 228 (2d Cir. 1974).
78 See *supra* notes 31-54 and accompanying text.
79 635 F.2d 156 (2d Cir. 1980).
80 *Id.* at 170.
ed the bidder. The court held that there was no duty owed by the bidder’s investment banker to the target or its shareholders. Ironically, under the misappropriation theory, the court sustained a criminal conviction against the insider traders.82

The Elkind and Moss cases were criticized for failing to provide a meaningful monetary sanction against insider traders; courts simultaneously were sending people to jail for conduct for which they were not being penalized in financial terms.83 In the Insider Trading Sanctions Act of 1984 (“ITSA”),84 Congress therefore 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 directed at the wrongdoer.85

The insider trading scandals of the 1980s were publicly exposed after the enactment of the ITSA. Therefore, the law unfortunately was perceived as ineffective. In an atmosphere of impending elections, Congress, in October 1988, passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”).86 This law created a private right of action on behalf of contemporaneous traders (overriding Moss v. Morgan Stanley),87 inserted a new bounty provision into the statute for persons who provide information on insider trading violations,88 increased criminal fines to one million dollars for individuals and 2.5 million dollars for non-natural persons89 and

gave the SEC greater authority to investigate international securities law violations. In addition, broker-dealers and investment advisers were required to establish Chinese walls and other procedures designed to prevent the misuse of material nonpublic information.

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: "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."

The SEC objected to this definition and introduced its own bill to revise the definition of insider trading. After hearings, a revised bill, different from the initial Senate bill or the SEC's initial proposal was introduced that would have prohibited trading while in possession of material nonpublic information only if such information has been obtained by, or its communication 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.

The substitution of a "possession" for a "use" standard proved so controversial that no action was taken on the insider trading issue until the next session of Congress when the ITSFEA was passed. The ITSFEA contained no statutory

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53 Id. § 2.
definition of insider trading because such a definition potentially could lead to narrower judicial construction. However, the legislative history endorsed both a broad fiduciary duty standard and the misappropriation theory.

II. CRITIQUE OF THE PROPERTY RIGHTS THEORY

The view that inside information is a property right that insiders should be permitted to exploit is morally obnoxious and legally unsound. Simply put, it is an attempt to transform the dark side of capitalism into a public good but it wholly ignores the public interest and public opinion. The "greed is good" creed of Ivan Boesky should have been discredited by academics long ago. However, the law and economics defense of nefarious Wall Street traders has had a peculiarly persistent appeal and has even been embraced by some members of the judiciary.

On the other hand, the SEC's arguments for prohibiting insider trading often have been pushed too far. Also, during the 1980s the SEC seemed to be concentrating exclusively on insider trading cases and ignoring more important matters such as market manipulation. Further, the government's crimi-
nal prosecution of marginal tippers and tippees has led to a number of defeats, starting with *Chiarella*, that have undermined the legal and policy foundations for insider trading prohibitions.

What the law on insider trading could use is a balanced perspective. First, there needs to be a greater appreciation for the relationship between the mandatory continuous disclosure system (including affirmative disclosure obligations during tender offers) and insider trading restrictions. Second, there needs to be some principled basis for drawing a line between insiders, culpable tippers and tippees and other stock market traders. Most importantly, these should not be unrelated endeavors.

The Exchange Act requires public companies to make continuing disclosure of material information. In addition to regular annual and quarterly reporting requirements, certain material events must be reported in a timely fashion. Furthermore, any group that agrees to purchase, sell or hold publicly traded securities if the holdings of such a group aggregate five percent of the issuer's stock must file a timely disclosure schedule with the SEC. Any person making a tender offer must similarly file a timely disclosure schedule with the SEC. The Exchange Act regulations are complemented by rules of the national securities exchanges that impose on listed companies a duty to release quickly to the public any news or information that might be expected to affect materially the market for its securities.

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102 Annual reports must be filed within 90 days of the end of an issuer's fiscal year, Rules 13a-1 and 15d-1, 17 C.F.R. §§ 240.13a-1, .15d-1 (1993), and proxies sent in connection with the annual meeting of shareholders must be accompanied or preceded by an annual report. Rule 14a-3, 17 C.F.R. § 14a-3(b) (1993). Quarterly reports must be filed within 45 days after the end of an issuer's first 3 quarters. Rules 13a-13 and 15d-13, 17 C.F.R. §§ 240.13a-13, .15d-13 (1993). When certain enumerated material developments occur, a report on Form 8-K must be filed within 15 days after the material event. Rules 13a-11 and 15d-11, 17 C.F.R. §§ 240.13a-11, .15d-11 (1993).


105 New York Stock Exchange Listed Company Manual § 202.05, 3 Fed. Sec. L.
Nevertheless, public companies have no general duty to disclose material corporate developments or other material inside information.\(^\text{106}\) In \textit{Basic v. Levinson},\(^\text{107}\) a case involving preliminary merger negotiations, the Supreme Court clarified the test for materiality of information under Rule 10b-5, reaffirmed an issuer’s liability for materially misleading disclosure and adopted a presumption of reliance for causation purposes premised upon the fraud-on-the-market theory.\(^\text{108}\) Also, by way of dictum, the Court stated that “[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5.”\(^\text{109}\)

The principle that public companies may keep silent about material events conflicts with the underlying policies of full and continuous disclosure embodied in the securities laws. However, premature disclosure of business negotiations or competitively sensitive matters could harm a company and its existing shareholders. Therefore, the SEC and the courts have balanced investors’ needs for disclosure against management’s legitimate need for secrecy.\(^\text{110}\) This same solicitude for confidentiality in order to protect legitimate business purposes has been accorded to bidders in tender offers until the tender offer is commenced.

Nevertheless, the prohibitions against insider trading are necessary in order to ensure that confidentiality is not abused and utilized for the personal and secret profit of corporate

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\(^{106}\) Brown, supra note 73, at 750.


\(^{108}\) See supra note 18.

\(^{109}\) Basic, 485 U.S. at 239 n.17.

\(^{110}\) See Brown, supra note 73, at 752. For an excellent example of the SEC’s attempt to balance investors’ needs for disclosure against a corporation’s legitimate need for confidentiality, see the instruction to Schedule 14D-9, Item 7, which requires a company that is the target of a tender offer to disclose that it is negotiating with a third party for a recapitalization or merger:

\text{If no agreement in principle has yet been reached, the possible terms of any transactions or the parties thereto need not be disclosed if in the opinion of the Board of Directors of the subject company such disclosure would jeopardize continuation of such negotiations. In such event, disclosure that negotiations are being undertaken or are underway and are in the preliminary stages will be sufficient.}\n
managers and employees or persons associated with a bidder in a tender offer. For silence not to be misleading, it must mean silence, and not selective disclosure. This does not imply that issuers, bidders or insiders have a property right in the information not disclosed. That information must be made publicly available to investors as soon as its dissemination will no longer do more harm than good to shareholders—as soon as it becomes ripe for disclosure. Generally, this occurs when an issuer or bidder begins to take the action to which the information relates.

The prohibition against tipping and the use of inside information by tippees for personal profit is necessary to prevent those persons from circumventing the basic prohibitions against insider trading. However, the foregoing principles are limited by exceptions for security analysts who assist in the disclosure process by ferreting out information or other market professionals who contribute liquidity to the trading markets. At the time that the ITSFEA was under consideration by Congress, the Legal Advisory Committee of the New York Stock Exchange (“Committee”) prepared a Report proposing a statutory definition of insider trading. The Committee recognized and agreed that the insider trading doctrine is founded on the need to preserve investor confidence in the market. “That confidence is undermined when investors come to regard the market as a ‘rigged’ game because corporate insiders and others who are entrusted with valuable nonpublic information use that information for their own trading purposes.” However, the Committee also noted that there is an important interest to be served in preserving the ability of investors to ferret out information by honest means.

In view of these policies, the Committee agreed that a statutory definition of insider trading should ensure that no one be permitted to trade in the securities markets on the

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112 LEGAL ADVISORY COMM., NEW YORK STOCK EXCHANGE, PROPOSED STATUTORY DEFINITION OF INSIDER TRADING (June 30, 1987). At the time this report was prepared and published the author was a director of the New York Stock Exchange and was an ex officio member of the Legal Advisory Committee.

113 Id. at 5.
basis of material nonpublic information that either has been entrusted to him or her for legitimate trading purposes or that he or she knows has been obtained by theft, misappropriation or other improper means. However, such a definition "should not chill a vigorous search for information by securities analysts, shareholders and investors who probe corporate managers with questions that go behind the disclosures in financial and other reports." Instead of being limited by the misappropriation theory, the Committee focused on prohibiting trading on information that either was wrongfully obtained or wrongfully used in four situations: information obtained by theft or conversions; use of information in breach of a fiduciary duty; use of information in violation of a personal or other relationship of trust or confidence; and, use of information in violation of a contractual or employment duty.

An earlier effort to distinguish between the legitimate and illegitimate use of informational advantages in the securities markets was more encompassing because it addressed market as well as inside corporate information. In an article written before the Supreme Court decided Chiarella, Professor Victor Brudney suggested that the rule against trading on inside information should forbid exploiting unerodable informational advantages that one trader has over another, such as is advantages in having information that a public investor could not lawfully acquire. In Professor Brudney's view, the purpose of the antifraud provisions of the securities laws was to prevent overreaching of public investors; efficiency was a more peripheral goal. In addition, disclosure was intended to serve a regulatory function and to mitigate temptations by insiders to manipulate security prices through delayed, inaccurate or misleading reports.

Professor Brudney's theory extended to outside informa-

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114 Id. at 4-5.
115 Id. at 14-18.
116 Victor Brudney, Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322, 359, 376 (1979). Professor Brudney's article might have been more influential if the Supreme Court had relied on his theories in Chiarella and Dirks. See supra notes 35-44 and accompanying text.
117 Id. at 334.
118 Id. at 335.
tion as well as inside corporate information. He noted that stock exchange specialists enjoy unerodable informational advantages but their trading is heavily regulated to prevent misuse of these advantages. The insider trading for which Ivan Boesky, Michael Milken and their cohorts were notorious should properly be viewed as the misuse of informational advantages by members of a pool-like operation who had the informational advantages of monopolists, but unlike exchange specialists, were not regulated to prevent manipulative activity. While specialists, market makers and other traders who add liquidity to the public securities markets may be entitled to an exception from insider trading prohibitions similar to the one enjoyed by securities analysts, regulation of their activities is nevertheless appropriate. In addition, their tippees, who serve no similar function of providing liquidity to the markets, should not be excused from insider trading prohibitions.

CONCLUSION

Although the Supreme Court has on occasion tried to place a common law limitation on Rule 10b-5, at other times it has interpreted the antifraud provisions more expansively. The securities markets clearly are dynamic and the law should be equally responsive to changing conditions. The fiduciary duty theories of Chiarella and Dirks, even as amplified by the misappropriation theory, are simply inadequate to cover the fact patterns of cases in which some have been enjoined by the SEC or have even gone to prison. Further, despite the criticisms of insider trading prosecutions as unjust because insider trading remains statutorily undefined, people who hide their activities in secret foreign accounts and run around with suitcases full of cash know they are engaging in illegal conduct. A re-examination of policies and principles by the SEC, the courts and Congress would therefore be salutary.

A theory that attempts to protect inside information as

119 Id. at 330-33.
121 See, e.g., BERGMANS, supra note 5, at 42.
122 STEWART, supra note 76, at 72, 73, 76, 96, 97, 132, 143, 151, 152.
intellectual property, however, is very wide of the mark. The purpose of the securities laws is to protect investors by mandating the continuous disclosure of information by public companies and, in addition, by mandating the disclosure of information by bidders in a takeover. The prohibitions against trading on inside information are a necessary supplement to this disclosure regime. In allowing issuers and bidders to maintain confidentiality until information is ripe for disclosure, the securities laws do not require that all information be publicly disclosed on a real-time basis. However, in order to preserve the fairness, honesty and integrity of the public securities markets, any failure to disclose material information must be accompanied by an absence of trading informed by such information.

As a practical matter, the law cannot enforce a blanket parity-of-information rule and capture every tipper and every tippee. Accordingly, insider trading prohibitions must draw a line between the legitimate use of informational advantages and insider trading. It should be recognized, however, that such line-drawing will necessarily be imperfect and that even a tipper or tippee who escapes the reach of a principled rule is engaged in conduct that should not be condoned, and certainly should not be lauded as contributing to market efficiency.