Bases of Insider Trading Law

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CHARLES C. COX* AND KEVIN S. FOGARTY**

I. INTRODUCTION

In the last several years unprecedented public attention has focused on insider trading. While intensified law enforcement has made insider trading riskier than ever, the temptations are substantial. Takeover bids generate large price changes, bankable for those with advance knowledge; options purchases can multiply profits even from information indicating modest price changes.

The wave of major insider trading prosecutions has been taken by many as a symptom of cancerous greed on Wall Street. The federal securities laws, which already provide extra civil penalties for insider trading that are not applicable to more overt types of fraud, may be amended to increase criminal penalties.¹ Other legislation is pending to define insider trading, a practice currently prosecuted under general antifraud statutes.²

The purpose of this Article is to look behind this furor and examine the reasons why insider trading is considered wrong, describe the influence of these different considerations on the development of insider trading law, and, in light of them, to analyze pending proposals to define insider trading.

Unlike much of securities regulation, insider trading restrictions are not limited to securities professionals or to the securities issuers who rely on public markets for their financing. Unlike much securities regulation, insider trading rules probably do not result in more information coming into the market: the “abstain or disclose” rule for those entrusted with confidential information usually is observed by abstention. Nonetheless, suppression of insider trading is increasingly considered a vital point of securities regulation.

Arguments against insider trading tend either to have an economic emphasis or a moral one—issues of efficiency (wealth increases) or fairness (wealth transfers). The economic arguments against insider trading are inconclusive. The contention that the existence of insider trading will cause investors to desert the securities markets is doubtful and certainly unproven. Arguments concerning the effect of insider trading on pricing efficiency and corporate welfare cut both ways.

The more important argument against insider trading is that it is unfair, either in the sense that it is dishonest or in the sense that it simply does not allow everyone an equal opportunity to profit. The development of insider trading law has reflected a

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¹ See S. 1323, 100th Cong., 1st Sess., § 14 (1987) (authorizing criminal fines of $1,000,000 and ten year prison terms for insider trading).

² See infra section VI.
tension between traditional principles of fraud and fiduciary duty on the one hand and a more general desire to provide equal access to material information and economic opportunity on the other.

The case law has arrived at a rule that respects the former notions in principle while serving the latter goal in effect. The safest course remains not to trade while in possession of material nonpublic information, although the actual law and recent attempts to codify it are considerably more subtle than this.

Before looking at the multiple fairness notions that have influenced the law, we will briefly consider some of the economic arguments raised against insider trading. For purposes of the economic discussion, we will define "inside information" broadly as material, nonpublic information, as the economic discussions usually do.

II. Economic Considerations

Perhaps the economic argument most frequently invoked (though not often by economists) against insider trading is that investors will desert the securities markets if they believe other market participants hold an unfair informational advantage. The argument is plausible but has never been systematically studied. Nor has it been confirmed by casual observation. We do not know how investors would react to a market where insider trading was entirely open and widespread; however, stock markets functioned successfully—whether or not optimally we cannot say—long before insider trading prosecutions became as common as they have in the last twenty-five years. Markets appear to function successfully in nations where official attitudes toward insider trading traditionally have been more benign than in the United States. Moreover, the highly publicized insider trading prosecutions of 1986, including the Dennis Levine and Ivan Boesky cases, although widely interpreted as evidence of pervasive insider trading, seemed to have had no substantial long-term impact on investment in securities, which continued to increase. While the market crash of October 1987 has been attributed to a number of factors, disillusionment over insider trading has not been prominently mentioned. When and if investors desert the market, it will likely be for reasons having little to do with insider trading. Finally, the argument that investors would desert a market perceived as unfair seems to assume that alternative investments exist in markets where information is more readily available and evenly distributed and which have the tremendous liquidity and

3. From 1981 through 1986, the SEC brought 129 insider trading cases, compared to 77 in the preceding 47 years. Statement of SEC Chairman John Shad before Securities Subcomm. of Sen. Banking Comm. at 8 (May 13, 1987). The 1961 decision in In re Cady, Roberts & Co., 40 S.E.C. 907 (1961), discussed infra at text accompanying notes 33–37, while hardly the first insider trading case, is in some respects the font of modern insider trading theory.


5. The Dow Jones Industrial Average stood at 1873.59 before the Boesky case was announced, closed at 1860.52 the next business day, at 1893.56 after a week, at 1922.81 after a month, and at 2325.49 after six months. See the Dow Jones Industrial Averages for Nov. 14, Nov. 17, Nov. 21, and Dec. 15, 1986, and May 14, 1987, available in the 1986 and 1987 Wall St. J. Index. Most people believed insider trading was common even before that case. See Wall St. J., June 6, 1986, at 3, col. 4 (poll reporting two out of three adults believed insider trading was common, and even more investors did). Moreover, if insider trading were regarded as legitimate, rather than prosecuted and publicized as scandal, it is possible that, for a given amount of insider trading, the damage to public confidence would be less.
related advantages of the securities markets. Market desertion should be a matter of particular concern to the stock exchanges themselves. It would be interesting to study to what extent the exchanges have undertaken, on their own initiative rather than under government pressure, efforts to prevent insider trading, including "front-running" transactions made by securities firms in anticipation of the price impact of customer orders. At the same time, any conclusions would have to consider whether regulatory efforts would be worth the trouble for an exchange, given its limited policing powers.6

A second argument turns on pricing. There is some agreement that allocation of resources will become more efficient the more share prices reflect information relevant to their value.7 Research and analysis promote these objectives, but insider trading may discourage such activity by sending false signals to the market. For example, the analyst who buys because publicly available information indicates he has spotted a bargain may turn out to be a chump if the low price was simply the result of insiders selling on undisclosed bad news.8 However, may not the same effect on price result from sales by traders who possess unique insights rather than unique information? In any case, insider transactions, at least to the extent not offset by traders seizing the false bargain, have moved the price in the correct direction and helped to satisfy the expectations of those traders relying neither on inside information nor fake bargains but on the general efficiency of the market in gauging value. Indeed, if anything is likely to frustrate the efforts of researchers and analysts, it is that this general efficiency, even apart from the machinations of insiders, makes it quite difficult to "beat" the market. Still, the industry of securities analysis endures.

Moreover, the efforts of analysts and researchers are arguably chilled by the existence of insider trading prohibitions. Analysts seek as much information as they can glean as soon as they can glean it; their efforts to bring such information to markets and prices occur because of the obvious financial incentives. A prohibition that discourages use of information other than that already discovered necessarily discourages the discovery of new information and inhibits the use of information whose public or nonpublic status is uncertain. Prohibitions on "tipping" may inhibit even the discussion of matters important to investors but withheld by a corporate issuer.9

Few believe that a rule requiring the possessor of inside information to disclose or abstain from trading results in more disclosure than abstention. But it has been proposed that the possibility of insider trading discourages insiders from making prompt disclosure to the general market, with attendant improvements in pricing

6. A parallel argument concerning enforcement efforts by the corporation itself is discussed infra text accompanying note 15. See also infra text accompanying note 79.


efficiency.\textsuperscript{10} This argument, however, is inapplicable when the trading insiders are not in a position to determine the timing of disclosure and is of diminished force when the traders are "tippees." In addition, price continuity, ordinarily considered desirable, is less likely when the impact of information is concentrated at the point of its official release, whenever made.

Another price related argument is that manipulated price run-ups may be more readily recognized if not justified by publicly available information and if the investor can be reasonably confident that trading is not based on nonpublic information. However, legal prohibitions can no more assure the absence of insider trading than of manipulation, and an investor would have no reason to assume he has identified illegal manipulation rather than illegal insider trading.

A third type of argument focuses on the harm insider trading may do to the corporation itself. Insofar as investors fear being victimized by insider traders, they may demand a risk discount for shares they purchase, and to that extent reduce the amount the corporation can raise when it issues shares.\textsuperscript{11} One might also argue that any corporate loss ascribable to the risk discount, insofar as it is captured by corporate employees who trade, can be regarded as compensation and as no more alarming than high executive salaries or perquisites, or any other incentive in a manager's or employee's compensation package.\textsuperscript{12} The compensation argument has no application, of course, to persons unrelated to the issuer or its insiders who may nonetheless have acquired material, nonpublic information. And, there are reasons to question the efficiency of this form of compensation,\textsuperscript{13} which is both difficult to monitor and presents a particular "moral hazard" in that insiders can profit as much by harming the corporation and selling short as by improving it and buying.\textsuperscript{14} If it were otherwise

\textsuperscript{10} Mendelson, supra note 8, at 476--77, 489. But see Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1, 33--34 (1980).

\textsuperscript{11} Several studies have suggested a correlation between insider trading and the bid/ask spreads of market makers. See, e.g., Seyhun, Insiders' Profits, Costs of Trading, and Market Efficiency, 16 J. Fint. Econ. 189 (1980); Copeland & Galai, Information Effects on the Bid-Ask Spread, 38 J. Fint. 1457 (1983). To the extent market makers' inventories are larger because they purchased from insiders who knew nonpublic bad news, or smaller because they sold to insiders who knew nonpublic good news, market makers will lose money, and, according to this theory, increase their spreads to recoup it, since they can never know when they are dealing with an insider. The risk premium thus charged on all transactions renders shares less valuable and may ultimately affect the original price available to the issuing corporation.

\textsuperscript{12} See H. Mann, supra note 7, at 131--46; Carlton & Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857 (1983). It is argued, for example, that corporations would historically have shown more interest in restricting insider trading if it were harmful to the company. See id. at 866; Dooley, supra note 10, at 44--47. Even without purporting to know the historical record in this matter, however, one might still assume that some role was played by the practical difficulty of undertaking policing efforts whose effectiveness would justify their cost, by the willingness of public authorities to assume some of this burden, and by the imperfect identity of interests between managers and the corporation. If such factors played no role, we would at least expect to see corporate efforts to curb the "moral hazard" trading described below.

\textsuperscript{13} See Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEGAL STUD. 801, 808 (1980); Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 352--54 (1981). While the possibility of insider trading on corporate "good news" may encourage executives to produce more good results to announce, the same incentive can be achieved less dangerously by compensating executives with stock options or with salary increases tied to stock prices. In fact, most major corporations do employ such incentives. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 DEL. J. CORP. L. 540, 558--62 (1984).

\textsuperscript{14} It has been argued that the same risk is presented by outsiders, such as critical suppliers or customers, who might be in a position to short the stock and stiff the company. See Carlton & Fischel, supra note 12, at 874--75. It may
feasible to regulate insider trading compensation by contract, however, the "moral hazard" could be eliminated by a contract that simply forbids selling on bad news.

Reversing the argument that trading by insiders can bring to market valuable clues as to the fortunes of the corporation, it has also been argued that such clues could harm the corporation, which might have legitimate business reasons for keeping business information confidential. It is the rare circumstance, however, in which a price change per se, or even open trading by insiders, could provide information sufficiently concrete to be of use to, for example, competitors, or anyone other than creditors, investors or financiers of some type. As to the latter groups, it is not clear why there should be less social utility in informing them than in protecting the corporation.

Overall, it cannot conclusively be said that the economic benefits outweigh the costs of prohibiting insider trading. The comparative costs and benefits have not been quantified. Arguments on both sides make plausible points as to how rational investors or markets might react to the pressure or possibility of insider trading, but it is more difficult to establish how in fact they do react and whether, balanced against countervailing reactions, it really makes much difference. In the abstract, it seems plausible that insofar as insider trading actually is inefficient it will be prohibited contractually, whether by corporate charter, employment contract, or stock exchange rule. The market does not ordinarily grant persons things of value without exacting a price. Those with access, at least with systematic access, to valuable information could be expected either to give up something else in return (e.g., take a lower salary, in the executive compensation hypothetical), in which case they really have no special advantage, or be forbidden to use the information, at least if this prohibition is enforceable. If the government's role is confined to enforcing and/or policing such obligations, the economic question may simply be how the government can know when its enforcement efforts are costing more than they are worth.

It is obvious, however, that the indignation insider trading arouses does not stem from calculations of economic efficiency. Rather it is the notion of fairness that brought insider trading prohibitions into our law, and that is what will keep them there. What we pay for enforcing public prohibitions against insider trading, for surveillance, litigation, private compliance efforts, as well as what we pay in pricing efficiency or other economic costs, are the price we pay for justice. The question is not so much whether insider trading augments or diminishes society's net wealth, but whether it allocates wealth to those fairly entitled to it. However, the form insider trading prohibitions should take depends upon what one's idea of fairness comprises.

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It is not completely clear what people believe is fair from the standpoint of personal morality. Not long after announcement of the Boesky case, a public opinion poll was published showing that, while most people believed insider trading should be illegal, most people also would do it themselves if they had the chance. This may simply be a confession of weakness, but it may also reflect a feeling that such trading is not really wrong in itself, however desirable its prohibition may be as social policy.

A. Fairness and Affirmative Misconduct

One view of fairness finds a transaction fair if it is what both parties want at the time, that is, if it is consensual. And it is consensual if there is no duress and no deceit. Insider trading rarely involves duress, of course; and the inside trader typically trades in silence, neither expressing nor implying anything untrue about the securities involved. He may fail to disclose facts that could change the other party’s mind, but it is hard to say that this by itself amounts to what is commonly understood as deceit or vitiates the consensual nature of the transaction. In the ordinary commercial transactions of everyday life, probably very few people feel bound to volunteer all material information. The seller of a house may fail to warn of noisy neighbors, a salesman is not expected to apprise his customer of what better deals a competitor might offer, and not many job or loan applicants initiate discussions of the weak points in their backgrounds. Similarly, transactions conducted on behalf of undisclosed principals are common and generally deemed legitimate. Is it hypocritical to hold stock traders to a different standard?

There is, however, a sense in which one who makes no misrepresentations may nevertheless be considered culpable for another’s decision to trade. This is arguably the case when the first party has in some respect undertaken to look after the interests of the other, but instead takes advantage of the other’s ignorance. In this situation the trade involves wrongful conduct, in that it violates a relationship of trust and confidence, and is therefore distinguishable from the case when the better informed party’s only offense is being better informed. For this reason, the corporate insider, who is given his employment and position of access in order to serve the corporation, and ultimately the shareholders, may be considered to occupy a different position from others in the market. This reasoning from fiduciary principles infers a kind of agreement between insider and shareholder, though one that is rarely spelled out.

Also, there is the idea that valuable information disclosed subject to restrictions is a species of property, whether or not the restrictions arise from intracorporate duties. In this analysis the inside trader is a thief, or at least a converter. While

16. Stuart, *Business Week/Harris Poll: Outsiders Aren’t Upset by Insider Trading*, Bus. Week, Dec. 8, 1986, at 34. Even of those who said they would not trade on an inside tip, most did not give the “just plain wrong” choice as their main reason. See also H. Mann, *supra* note 7, at 1–2 (arguing insider trading regarded as wrong only relatively recently).

17. Indeed, no less an ethical authority than Thomas Aquinas considered it acceptable for a grain merchant during a shortage to sell at high prices even while knowing that new supplies were on the way. While St. Thomas did not regard such conduct as “exceedingly virtuous,” neither did he deem it “contrary to justice.” T. Aquinas, *Summa Theologica*, Part II (second part), Question 77, Art. 3, Objection 4 and Reply (English Dominican trans. 1918).
information generally is not "owned" by anyone, the law in limited situations recognizes proprietary rights in valuable information, and recognizes such rights against the world and not solely against those who have agreed to keep the information confidential. 18 This additional protection is usually meant to create incentives for socially useful activity, such as invention. At bottom, therefore, the property notion is another efficiency argument, except insofar as one may find moral repugnance not only in permitting a person to profit by his own breach of confidence, but also in allowing anyone knowingly to exploit another's breach of confidence.

B. Fairness and Equal Access to Information

A broader "fairness" objection to insider trading does not turn upon any "theft" or breach of trust. Instead, it regards the trade as unfair—and dishonest—based upon the simple unavailability of inside information to all parties, a point distinguishing in some degree some of the common transactions mentioned above. This high standard of honesty may be especially appropriate to impersonal securities markets in which an elaborate public reporting system has created an expectation that material information is generally accessible, and in which investors have no opportunity to inquire of one another as to the possible use or possession of nonpublic information. 19 When the focus is on a transaction's consensual nature, however, accessibility seems besides the point: the other party's decision to consent arises from information of which he is aware, not from information that is merely available to him. Moreover, in the absence of positive law, how many would feel compelled by conscience to disclose, for example, their own intentions to make further purchases that could materially affect prices, even though the knowledge of that intention may be absolutely inaccessible to others? 20

An additional complication in analyzing insider trading as a type of dishonesty—whether or not affirmative wrongful conduct is required—arises when looking for the victim. Certainly someone would have held the shares that the insider bought on undisclosed good news, and someone ends up with those he sells on secret bad news. But that person is rarely the person whose intermediary meets the insider's intermediary on the exchange floor. The latter person was already in the market and probably would have bought or sold even if the insider had abstained. The person

18. See, e.g., infra note 57.
19. See Brudney, supra note 7, at 326–27, arguing the expectations point. It should also be noted, however, that the law of insider trading is not confined to publicly owned companies filing periodic SEC reports or to transactions on an exchange. (The Swiss, perhaps in recognition of the possibility of inquiry in face-to-face transactions, are currently enacting an insider trading law that apparently is limited to transactions on "quoted stocks, or those listed on the . . . exchange . . . ." N.Y. Times, Dec. 19, 1987, at 40.) Brudney also cites several common law sources finding disclosure duties in certain situations when information is uniquely available to one party. See Brudney, supra note 7, at 355 n.110.
20. The Williams Act, Securities Exchange Act of 1934 §§ 12(d)-(c) and 14(d)-(f), 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982 & Supp. IV 1986) [hereinafter Exchange Act] requires just such disclosure in situations that may lead to changes in corporate control. This obligation, however, does not apply to purchases below 5% of shares outstanding and was added to the law as tender offer, not insider trading, regulation. See Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1982).
“harmed” by the failure to abstain is not necessarily the person “cheated” by the failure to disclose.21

Fairness as equal access to information may be seen, then, as more than a standard of honesty and not as fraud in any traditional sense, but as an attempt to prevent exploitation of unearned informational advantages, to promote equality of opportunity in the securities markets, or, more starkly, to transfer wealth from the informed to the uninformed. In this respect, insider trading is unfair much in the sense that inheritances, or even good luck, are unfair;22 and an insider trading prohibition is not so much an antifraud rule as a law against easy money.

A general prohibition on using unearned commercial advantages would be a hopelessly intrusive and impractical undertaking. This may be less true, however, of informational advantages in the securities markets, where information is of great and reasonably determinable value, and where both information and transactions are closely monitored and sedulously recorded. Here a limited parity of opportunity seems almost within the government’s power to guarantee.

Too much should not be claimed for this type of equality, however. Its greatest beneficiaries would appear to be market professionals who trade with frequency and who are the first to learn newly public information.23 It has been argued that in fact this group is the chief source of political pressure for insider trading prohibitions.24 As to professionals who trade on behalf of public investors, any wealth transfer they effect still may benefit mainly higher income groups, hardly the most compelling context for governmental intervention in private economic arrangements.25

To sum up, what seems to be the question in the ethical discussions of insider trading is whether trading on material, nonpublic information is generally dishonest, sometimes dishonest, or not necessarily dishonest but undesirable in that it distributes income arbitrarily.


22. And what should be made of insider nontrading, i.e., the situation in which the insider refrains from a trade he would otherwise have made but for his learning nonpublic information? Is its prohibition so rarely proposed because of the impracticality of enforcement? Because, despite its theoretical similarity to insider trading, no one would really feel guilty doing it? Or because it fails to excite feelings of envy?

23. The occasional investor will always be at some type of disadvantage to the professional. Unless he abandons his regular job to watch the Dow Jones tape all day, the individual investor will still find there are frequent public reports of material news to which stock prices will adjust before he has had an opportunity to react to, or has even learned of, the new information. Those who follow the market full time can react immediately, although their trading advantage is diminished by the fact that announcements of material news are often made after domestic markets have closed or while exchange trading has been halted.


25. Even the typical “small investor” is probably in the upper stratum of society as a whole. Most families own no stock, and only among families with annual incomes above $30,000 are stock investors a majority. Samuelson, A Perspective on the Stock Market Collapse, Wash. Post, Oct. 21, 1987, at F1–F2 (citing Federal Reserve figures). However, many others probably also benefit from stockholdings through pension funds, although much may depend on whether or not the pension plan calls for payments to fund beneficiaries that vary with fund investment performance. Pension funds account for over 20% of the shares held in the U.S. See Report of the Presidential Task Force on Market Mechanisms II–12 (1988).
IV. Development of Insider Trading Theories in Federal Case Law

Insider trading is prosecuted under the antifraud provisions of the federal securities laws. The law on the subject, like general fraud law, has therefore been tied to a requirement of affirmatively wrongful acts. However, it seems clear that the desire to create conditions of equal access to information has had a large role in the development of ever more sensitive standards of "wrongfulness." Courts not only have found relationships of trust and confidence where they were not previously thought to exist, they seem also to have accepted the proposition that when an informational advantage has been dishonestly acquired from one person, it may not be employed even in trading with a different person. In practical effect, the law now reflects a kind of composite of the various notions of fairness. In something akin to the equitable tradition of disgorgement, which disallows profits derived from wrongdoing even in the absence of a plaintiff who is to be "made whole," insider trading law prohibits profiting from any informational advantage traceable to wrongful acts. There is no law of "equal access," but it has been approached by a law of "honest access."

At the time the Securities Act and the Securities Exchange Act were passed, classic insider trading—transactions between uninformed shareholders and corporate officials possessing inside information—was not regarded as fraudulent in most jurisdictions. The corporate official's fiduciary duties were considered to run to the corporation as an entity, not to individual shareholders. Even Strong v. Repide, one of several decisions to the contrary, acknowledged the general rule but found it inapplicable in the egregious circumstances of that case. Insider trading decisions under the federal securities laws have nonetheless characterized the relationship between corporate official and shareholder as one creating affirmative disclosure duties. The SEC invoked rule 10b-5, its general antifraud rule, in a nondisclosure case soon after the rule was promulgated, although with little analysis of what

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26. Insider trading is usually prosecuted under § 10(b) of the Exchange Act, 15 U.S.C. § 78j, and rule 10b-5, 17 C.F.R. § 240.10b-5 (1987), thereunder, which define and prohibit "manipulative or deceptive" practices "in connection with the purchase or sale of any security." Although the SEC's tender offer regulations include rule 14e-3, 17 C.F.R. § 240.14e-3 (1987), which prohibits trading with insider information regardless of any deception or special duty to disclose, the rule is applicable only in tender offer contexts, and its validity, insofar as it goes beyond rule 10b-5, has had no major court test.


circumstances created the duty to disclose. Federal court decisions also indicated insider disclosure duties under rule 10b-5, but not whether such duties could extend to persons having no special relationship with one another.

The modern era in insider trading law opened with the SEC's 1961 decision of In re Cady, Roberts & Co. The case involved a stock broker who began selling after being tipped by a director of the Curtiss-Wright Corporation that the company was about to reduce its dividend. The decision was important in at least three respects. First, it stated a rationale for requiring insiders to disclose or abstain from trading:

the existence of a relationship giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and . . . the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Second, the prohibition was extended beyond the corporate director to his "tippee."

And third, the opinion made clear that the prohibition covered selling as well as buying.

The two bases the Commission cited for the abstain or disclose rule could suggest a "wrongfulness" conception of fairness if the "relationship giving access" is equated with a position of trust and confidence, and the "inherent unfairness" basis is regarded as inadequate standing alone. However, the opinion does not compel such a reading. It explicitly noted that its rule was not confined to traditional insiders, such as officers, directors, and majority shareholders, and it did not argue tippee liability on the ground that the tippee is merely an accessory after-the-fact to a wrong really done by the insider—the one having a special relationship with the shareholders. Finally, the Commission dismissed the contention that since those who purchased from insiders were not necessarily stockholders theretofore, no special disclosure duty was owed them. Although the Commission gave short shrift to this argument, it is not clear whether the Commission may have felt that a relationship of trust also existed as to share purchasers, or whether it simply didn't matter.

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31. See In re Ward LaFrance Truck Corp., 13 S.E.C. 373 (1943) (purchases by issuer itself and by prospective acquiror while possessing material nonpublic information as to merger plan and profitability).

32. See, e.g., Speed v. Transamerica Corp., 235 F.2d 369 (3d Cir. 1956) (purchases by majority shareholder knowing of undisclosed increase in inventory value); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (officers purchased stock having secretly arranged to sell company; however, affirmative misrepresentations also involved).


34. Id. at 912.


37. The Commission quoted Learned Hand's opinion in Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), cert. denied, 314 U.S. 920 (1951) (concerning § 16(b) of the Exchange Act) that the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one. In re Cady, Roberts & Co., 40 S.E.C. 907, 914 n.23 (1961). It appears from Gratz, however, that Judge Hand may have regarded the simple informational advantage as the reason for the rule for fiduciaries. See Grutz v. Claughton, 187 F.2d 46, 49--50 (2d Cir.), cert. denied, 314 U.S. 920 (1951).
At any rate, within a few years some courts had taken the position that the rule against insider trading "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information. . . . Thus, anyone in possession of material insider information must either disclose it . . . or . . . abstain from trading. . . ."38

The Supreme Court, however, moved the law firmly back in the direction of the wrongfulness notion. Vincent Chiarella, an employee of a financial printer, had been convicted of securities fraud in the southern district of New York based on his purchases of stock in tender offer targets. Chiarella knew the targets before the public did because he was involved in printing the offering documents. Although the bidder and the printing firm that employed Chiarella took measures to prevent any leak of the targets' identities, Chiarella had been able to circumvent these. The Second Circuit Court of Appeals upheld Chiarella's conviction,39 reasoning that anyone with regular access to material nonpublic information was obliged to abstain from trading if he could or would not disclose. The Supreme Court reversed,40 holding that Chiarella's silence could not be fraudulent absent a duty to disclose and that such duties arose from specific relationships of trust and confidence, not simply from regular access to nonpublic information. Since Chiarella had no relationship whatsoever with the target companies or their shareholders, he owed them no duty to volunteer information.41 The Court did not consider the question of whether Chiarella's duties to his employer or its bidder customers may have been relevant to a fraud, since it held that theory had not been presented to the jury.42

Three years later the Supreme Court reaffirmed that access to material nonpublic information did not in itself create a duty to disclose or abstain. In Dirks v. SEC,43 it exonerated Raymond Dirks, a securities analyst who "tipped" his clients and others who sold stock, after he learned from a former corporate official that the corporation's books concealed massive fraud.44 Dirks had no particular duty to

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38. SEC v. Texas Gulf Sulphur Corp., 401 F.2d 833, 848 (2d Cir.), cert. denied, 394 U.S. 976 (1968). This broad statement may have been dictum in Texas Gulf Sulphur itself since the individual defendants in that case were employees of the issuer, and thus liable on narrower grounds. The material information concerned a mineral strike on one of the company's Canadian properties. Compare General Time Corp. v. Talley Indus., 403 F.2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969), a decision from the same circuit, in the same year, stating that, subject to the independent requirements of the Williams Act, rule 10b-5 did not require a prospective tender offeror to disclose its material intentions while making open market purchases. The SEC took a similar position in an amicus curiae submission in Pacific Ins. Co. v. Blot, 267 F. Supp. 956 (S.D.N.Y. 1967), Memorandum of SEC, at 5–7.


41. Chiarella has been described as an "outsider" trading on "outside" or "market" information. That is, he had no relationship to the issuers whose stock he bought, and the information he used, though highly material and confidential, did not originate within the issuer corporations.

42. Id. 236 However, Justice Brennan, concurring, and Chief Justice Burger, dissenting, felt that Chiarella had defrauded his employer and its customers in connection with his stock purchases. Id. at 238–39 and 239–43. Justice Stevens, concurring, said the question was open. Id. at 238. Justices Blackmun and Marshall dissented, basically accepting the Second Circuit's theory. Id. at 251.


44. Dirks' offense basically derived from discussing what he had learned with clients and investment advisers. Although Dirks had sought to interest both the SEC and the Wall Street Journal in his discovery, the information remained nonpublic until a California state agency took action. See the discussion of tipping infra Section VI.
buyers in the market, in no way misled them, and therefore could not be held accountable for instigating sales to them unless in some manner he participated in a fraud perpetrated by the corporate official. But, the Court held, no personal gain or benefit to the corporate official had been shown; he had, therefore, not taken advantage of the shareholders to whom his own special duties ran, and so there was no wrong in which Dirks could have participated. The tippee’s duty, like the insider’s, related not to bare access but to affirmative wrongful conduct.

No longer able to bring cases based solely on access to material, nonpublic information, the government turned to the “misappropriation theory” adumbrated in several of the separate opinions in Chiarella. Now a new concept of affirmative misconduct gained prominence in the insider trading wars, one containing a notion of information as property, not far different from certain state law decisions regarding inside information as a corporate asset which is “converted,” “stolen,” or “misappropriated” when used for personal gain.

Already in 1981 the Second Circuit had adopted the misappropriation theory, affirming the securities fraud conviction of James Newman, who received and traded upon information concerning targets of various takeover plans. Newman’s confederates were employees of investment banking firms, and the plans were those of the firms’ clients. The court found a fraud against the investment banks and their clients and held it to be in connection with securities purchases since securities purchases were the whole point of the fraud.

Other decisions elaborated the requirement that misappropriated information be received in confidence, not merely be nonpublic, and held that, since the misappropriator violated his responsibilities to the source of his information and not to other traders in the market, the latter had no private claim against him.

The great test of the misappropriation theory was expected to come in United States v. Carpenter, the “Winans case.” R. Foster Winans, a reporter for the Wall Street Journal, frequently wrote columns for that paper reflecting favorably or poorly on particular companies. The column had a perceptible impact on the companies’

45. The Court allowed that the requisite benefit to the corporate insider could take many forms, even the ability to confer an informational “gift” on a favored individual or some valuable enhancement to the insider’s own reputation with his tippee. The record before the Court, however, did not indicate either situation. Dirks v. SEC, 463 U.S. 646, 663–64, 667 (1983). The Court also recognized that some persons, though not Dirks, could acquire the duties of insiders, even if they were neither employees of the corporation nor tippees within the rule the Court laid down. These “temporary insiders” would be people such as attorneys or investment bankers, who received information in confidence from the corporation and were obligated to it, and through it, to its shareholders in the market, not to trade on the information. See id. at 655 n.14. This notion was advanced to somewhat more informal relationships in SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983) (longtime friend and business associate was solicited to participate in material, nonpublic deal; declined but purchased stock).


stock prices. Winans and his tippees exploited this impact by buying or selling shortly before publication, in clear contravention of the Journal's internal rules. On the theory that the publication schedule was proprietary information of the Journal, misappropriated by Winans and his friends, they were convicted both of securities fraud and mail and wire fraud. The Second Circuit upheld the convictions on grounds similar to those in Newman.

On certiorari to the Supreme Court, the convictions were upheld again, unanimously as to mail and wire fraud, and by a 4-4 split on securities fraud. Presumably the split on the securities fraud count was attributable to doubt over whether the unanimously acknowledged fraud was "in connection with" securities transactions, as required by the Securities Exchange Act. Nevertheless, one of the principal objections to the misappropriation theory—that it made employer work rules into criminal statutes—apparently carried no weight. The notion now is firmly established that misappropriation of confidential information is a legal fraud, and one must doubt whether, having gone that far, courts will hesitate to find the requisite connection to a purchase or sale of securities.

The Supreme Court's heavy emphasis in Carpenter upon confidential information as property was indispensable to upholding the mail fraud conviction, since the mail fraud statute required the Journal to have been deprived of "money or property." The Journal's "contractual right to [Winans'] honest and faithful service [was] an interest too ethereal in itself to fall within the protection of the mail fraud statute. . . ." The notion of a publication schedule as property is a handy one for thinking about misappropriation, but it is also a somewhat novel application of the property concept. In most of the cases that Carpenter cites as recognizing property in information, the idea was to preserve the benefit of the information to the one whose efforts and resources had been invested in discovering or assembling it. That idea

51. It is essential to understanding the theory of the case to realize that Winans was not accused of slanting his columns to achieve a particular price effect and that the columns themselves contained no information that was material and previously nonpublic. Knowledge of the articles' purport and the fact that thousands of investors would read them were the important thing.

52. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd, 108 S. Ct. 316 (1987). In some passages, the appellate opinion seemed to suggest that Chiarella had transmuted the "equal access" rule of Texas Gulf Sulphur, into an "honest access" rule that created some sort of obligation toward other traders. See id. at 1031:

 Obviously, one may gain a competitive advantage in the marketplace through conduct constituting skill, foresight, industry and the like . . . . But one may not gain such an advantage by . . . secreting, stealing, purloining or otherwise misappropriating. . . .

The notion of "advantage" relates to other traders, not to the person misappropriated from. See also id. at 1034, indicating that the securities fraud could be avoided by disclosure of the confidential information. Does this suggest that the securities fraud is against the other party to the trade, or merely that the fraud against the Journal would no longer have been "in connection with" the securities transaction had disclosure been made? However, there was no need in a criminal case to pursue these questions. Compare Moss v. Morgan Stanley, Inc., 719 F.2d 5, 5 (2d Cir. 1980), cert. denied, 465 U.S. 1025 (1984).


54. This is particularly striking in a newspaper case when a very legitimate concern could arise that liberal recognition of property rights in confidential information might subject reporters who rely on "leaks" to prosecution for fraud by misappropriation.


V. MISAPPROPRIATION: THE LIMIT OF WRONGFULNESS

The misappropriation theory takes the "wrongfulness" oriented approach to insider trading about as far as it can go. It is not an entirely satisfactory theory of securities fraud. The putative victim may himself have no cause of action for securities fraud, since he will not necessarily have been party to a securities transaction.\(^{58}\) Second, the theory's logic could extend not only to informational advantages but to any trading advantage that can be traced to fraud or breach of trust.\(^{59}\) Third, the disclose or abstain rule cannot, of course, apply if there is an obligation to keep the information confidential. The rule is then to abstain. Finally, the breach involved may seem trivial in terms of the harm done to the person to whom the duty is owed, suggesting that the whole theory is merely a pretext for enforcing equal opportunity in information.\(^{60}\) At the same time, the theory fails to achieve equal opportunity: anyone whose informational advantage was not wrongfully obtained remains free to exploit it. Thus, when Winans committed a felony in trading on his publisher's confidential information, the publisher might have traded with impunity.\(^{61}\)

Nonetheless, as a composite reflection of various ideas of right, wrong, honesty, and equal opportunity, the misappropriation theory has some perverse political kind of merit. It does require at least some species of affirmative dishonesty before a trader can be called to account by the government; it does not wholly sacrifice this libertarian value to an ideal of equal access that arguably is: (a) partly illusory; (b) not demonstrably in the public interest in terms of additions to net social wealth; and (c) in any case largely a reshuffling of assets among members of the bourgeoisie.\(^{62}\)

\(^{58}\) This is a prerequisite for standing in a private action under § 10(b). See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), reh'g denied, 423 U.S. 884 (1975). This would change under legislation proposed by the SEC. See infra text accompanying note 80.

\(^{59}\) If A and B both want in on a "hot issue," B steals a car, gets to the broker's office before A and buys the last shares available, has B committed securities fraud? What if he purchases with stolen money?

\(^{60}\) One must seriously question, to say the least, whether R. Foster Winans would have been sent to prison had he disclosed the Wall Street Journal's publication schedule to the New York Times or some other competitor, instead of using it to trade securities.

\(^{61}\) The Second Circuit expressly declined to take a position on this question. United States v. Carpenter, 791 F.2d 1024, 1033 n.10 (2d Cir. 1986), aff'd, 108 S. Ct. 316 (1987). The SEC's civil case against Winans, settled by a consent decree, alleged a "scraping" theory in addition to the misappropriation theory alleged in the U.S. Attorney's criminal action. See SEC v. Brant, No. 84-3470 (S.D.N.Y. May 17, 1984). "Scraping" occurs when an investment adviser acquires securities, recommends them without disclosing his interest, and then cashes in on the price increase his recommendation causes. A scraping charge presupposes a certain confidential relation between the adviser and his readers. See Capital Gains Research Bureau v. SEC, 375 U.S. 180 (1963). It may reasonably be asked whether the 50 cents readers pay for the Wall Street Journal establishes such a relationship. Moreover, it is clear only that the scaler must disclose at the time he advises, not when he buys. If one feels that the problem is the easy money and not the possibility of prejudiced analysis, then disclosure at the time of publication would be of limited usefulness. There might be a price impact just the same.

\(^{62}\) See supra notes 23-25 and accompanying text.
At the same time, current insider trading theory, even with its wrongfulness requirement, covers very much of the ground a straight parity of access rule would cover, and to that extent serves the public confidence and other benefits claimed for that approach. Equal access is not an easy thing to define. Victor Brudney's excellent attempt referred to an informational advantage that could not be overcome by any lawful efforts on the part of other traders. This, like so many others, is a test of uncertain application. Brudney would not employ it against the trader whose exclusive knowledge of his own future plans is material. Moreover, most informational advantages can be lawfully overcome by making inquiry of the appropriate people (if only one realized who they were), unless they are under a duty to hold the information in confidence. Insofar as they are bound by strictures of confidence, they are covered by current law.

Equal access may also be defined simply by whether the material information is or is not "nonpublic." Obviously, for persons other than reporters, this limits incentives to bring new information to market. It also is a definition that turns on differences in degree, rather than in kind; it can become especially difficult with stocks of small issuers not regularly followed in the financial press; and it can pose particular problems in possible tipping situations, as the Dirks case illustrated. Moreover, a trader may not have reason to know the extent to which information he receives has circulated to others unless he also knows that he or his source has received the information in confidence. That is to say, as long as scienter—intent—is a required element of an insider trading offense, we may again be brought back toward something close to a "wrongfulness" or "honest access" test.

VI. PROPOSED LEGISLATION

In 1987, widespread concern over insider trading and the acceleration of criminal prosecutions for this offense revived calls for its clear definition. Two alternatives emerged. One was recommended by the SEC; the other was proposed by a group of private securities lawyers, and introduced by Senator Donald Riegle as S. 1380. Both proposals purported to codify current law and to adopt a "wrongfulness" approach to defining insider trading, although neither does so entirely.

63. See Brudney, supra note 7.
64. Id. at 362.
65. Brudney's scheme suggests the problem of information also shared by a number of tippees, and to that extent accessible to still others. Cf. Note, Drawing the Line on Insiders and Outsiders for Rule 10b-5: Chiarella v. United States, 4 Harv. J. L. & Pub. Pol'y 203, 230–32 (1981) (asking if information is lawfully available if its possessor is willing to disclose to anyone for a fee). Brudney does identify one class of case in which his rule is more extensive than a wrongfulness approach: when a supplier's knowledge of a significant increase in a customer's orders gives it an informational advantage in trading the customer's stock, or a supplier's customer knows he is about to reject the supplier's new product and sells the supplier's stock in anticipation. See Brudney, supra note 7, at 359.
66. Information is "nonpublic" if it has not been disseminated in a manner making it available to investors generally. See, e.g., Texas Gulf Sulphur, 401 F.2d 833, 854 (2d Cir.), cert. denied, 394 U.S. 976 (1969); In re Investors Management Co., 44 S.E.C. 633, 643 (1971).
67. Defining insider trading was also considered prior to passage of the Insider Trading Sanctions Act of 1984, but the SEC advised Congress that a definition was not necessary.
68. This was the Ad Hoc Legislative Committee chaired by Harvey L. Pitt, a former SEC general counsel.
As revised after efforts at compromise, both proposals forbid trading while in possession of material, nonpublic information

only if such information has been obtained by, or its use would constitute . . . theft, bribery, misrepresentation, espionage[, . . . conversion, misappropriation[, . . . breach of a fiduciary duty[, . . . relationship of trust and confidence, or . . . any contractual or employment relationship. 70

Although the definition did not stop with “while in possession of material nonpublic information,” its “wrongfulness” provisions are broad and flexible. 71

However, terms such as “conversion” and “misappropriation” may be read only so loosely. There is no law indicating that anything can be converted or misappropriated that is not in some respects proprietary or that information becomes proprietary simply by virtue of not being generally known. Nor does the fact that information was transmitted for one purpose necessarily make a “misappropriation” out of its use for some other purpose, unless the circumstances of its transmittal indicated an understanding of confidentiality. 72 If something broader, such as a Brudney-style definition, were meant, statutory references to “wrongfulness” could only cloud the meaning of the prohibition. The proposed statute would say so if it intended a straight prohibition on the use of material nonpublic information and the abandonment of whatever guidance current case law provides as to the meaning of insider trading.

Both proposals also make express applications of the wrongfulness concept in transactions when it might not otherwise apply. Thus, trading in debt as well as equity is covered, even though it is far from clear that insiders are fiduciaries for debtholders. 73 Such trades may be regarded as misappropriation of corporate information, 74 but it is harder here than with equity securities to make the case that trading is a use inconsistent with corporate purposes. At any rate, the explicit prohibition would settle the question.

Both proposals depart entirely from the wrongfulness requirement on some of the big-money questions. Thus S. 1380 flatly prohibits tipping one’s own intentions (regardless of any duty or misappropriation) concerning the acquisition or disposition

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71. One of the drafters of S. 1380 has even characterized it as a bill that “simply interdicts trading in securities while in possession of material, nonpublic information.” Pitt, Winans Case: The Limits of Securities Law, LEGAL TIMES, Nov. 23, 1987, at 19. Clearly, this is an overstatement, or the core of the bill is meaningless. The SEC regards the bill as continuing the fraud-based approach of current law. See 20 Sec. Reg. & L. Rep. (BNA) 279, 280 (Feb. 19, 1988) (reprint of SEC proposed legislative history for insider trading definition) [hereinafter SEC Proposed Legislative History].


of an issuer, or transactions in material blocks of stock, if the purpose is to influence or encourage trading. The SEC proposal incorporates the current rule 14e-3 under the Securities Exchange Act, which forbids trades made in possession of material nonpublic information concerning tender offers, (unless made by the tender offeror) and which also addresses tipping tender offer plans. While this rule is not consistent with the wrongfulness rationale applied elsewhere, it was a part of the current law the Commission was attempting to codify and addressed a context in which, to many, disparity of access seemed unfair enough by itself.

To some extent rule 14e-3 may be viewed more as tender offer regulation than as insider trading regulation. It prevents bidders from giving tips to get stock into the hands of those believed to be friendly, though not actually part of a "group" whose holdings would be aggregated for purposes of Williams Act reports; in this respect, it bolsters the Williams Act requirement to report 5 percent positions.

Despite its theoretical anomaly as an insider trading prohibition, the rule 14e-3 provision covers trading situations involving sums that may dwarf some of those covered by the "main" trading prohibition. On the other hand, every major case the SEC has successfully brought involving tender offers has been plead under rule 10b-5, a provision requiring wrongfulness, as well as under rule 14e-3. There is a great deal of practical overlap.

Outside the tender offer context, the SEC's proposal treats inside information much as an asset of the firm that generates it, either because (a) as in Carpenter, it is specifically marked as such and access given to it on that understanding; or (b) it is material to the fortunes of the firm's own shareholders and, on an extrapolation from traditional fiduciary principles, is held for their sole benefit.

75. An exception is made for persons being solicited to join forces with the "transacting person" and form a group with him of the type whose holdings above 5% of an issuer must be reported under the Williams Act. Also, trading must actually occur, with someone other than the transacting person. See S. 1380's proposed § 16A(c)(2), S. 1380, 100th Cong., 1st Sess. (1987).


77. S. 1380, 100th Cong., 1st Sess. (1987), and the SEC proposal differ in several other respects, but these are not directly relevant to the question of wrongfulness.

78. The SEC proposal also applied to trading done in possession of material nonpublic information, rather than to trading on the basis of such information. The drafters of S. 1380 have also accepted this approach. It may be hard to see the wrong of trading in the knowledge of facts legitimately received in confidence, if the facts are not actually "converted" to the possessor's use. The broad possession standard, however, is perhaps best viewed as a prophylactic one aimed primarily at evidentiary problems. Similarly, the absence of a Dirks-style personal benefit test for insiders who tip, see supra text accompanying notes 43-45, can be seen as reflecting in some measure a presumption of a personal benefit (at least on the "gift" theory suggested in Dirks) and in some measure an understanding of inside information as property committed to the insider's care which he has no right to give away.

79. In both situations implicit understandings are inferred from circumstances. Would it be possible to prevent such inferences by positive statements to the contrary, such as a statement in a corporate charter that insiders may trade? Although it is not generally possible to "contract around" the Exchange Act prohibitions, see § 29, 15 U.S.C. 78cc (1982), this one depends for its initial existence on the violation of standards (theft, bribery, misappropriation, breach of a fiduciary or employment duty, etc.) external to the Exchange Act. Even though the courts have found, and presumably would continue to find, corporate duties in insider trading cases that may not have existed under the state law that defined the relevant corporate relationships, it would be much more difficult to do so in the face of an express ex ante repudiation of any such duties. Insider trading as compensation might get a tryout after all, although this is highly unlikely for three reasons. First, "short swing" profits would still be prohibited under the Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1982). Second, few firms would have the nerve, even when state law posed no obstacles, to announce such a policy. Third, if they did so, they could be precluded by securities exchanges. An exchange could declare "no inside information" an implied term for each contract of purchase or sale consummated through its facilities. It would effectively
Two other factors should be considered, however. First, proceeds from the use of the "firm's" property would not be returned to the firm except insofar as it could prove damages; instead, the proposal contemplates that insider trading profits (or losses avoided) would go to contemporaneous traders or the government. Second, the "proprietary information" idea supplements but does not replace theories based on fiduciary or other duties. Thus, in a case like Dirks, trading by the insider himself could be attacked even though information concerning a fraud could not reasonably be called proprietary. Still, there is more involved here than the violation of one's own undertakings or understandings, since the proposed prohibition, like present law, prevents a tippee from using information obtained in violation of arrangements of which he has notice but to which he is not a party. This outcome has been more controversial when tipping rather than trading liability is involved.

Both S. 1380 and the SEC proposal forbid tipping information that the tipper could not legally use himself. How would this rule have applied to the insider in Dirks? Did he "tip" Dirks?

Moreover, to be liable for tipping, the tipper must understand the nature of the information he imparts. But it is not clear how far a tipper must realize the nature of the information while he imparts it. What about the executive who inadvertently leaves a sheaf of sensitive papers in a taxi cab? Could a "slip" be a tip, possibly exposing the loose-lipped insider to liability for communications that are merely negligent? Maybe a careless executive who lets a corporate asset roll out of his mouth should be held liable for the millions of dollars strangers make from it; and perhaps proving a slip was not a tip could be a formidable evidentiary obstacle for the government or other plaintiffs. But there are still further questions as the information is transmitted to others. Is the information made "public" or is it "tipped" if published in an analyst's report? A newsletter? An obscure magazine? Surely the right to report information is not reserved to established publications of large circulation.

There was a great deal of consternation over chilling corporate communications to securities analysts, and the SEC originally proposed a limited "analyst exemption" to deal with the problem. However, a majority of the Commission subsequently was persuaded that its concerns could be addressed by providing instead that tipping bring government enforcement and surveillance powers to bear on behalf of its rule, since any violation would be the breach of a "contractual relationship" and thus a violation of proposed § 16A(b).

In general, exchanges dissatisfied with the wrongfulness approach of § 16A could expand it through contract. Appropriate exceptions could be drawn for firms that innocently took customer orders based on inside information, and customers could be drawn into the contract by having member firms require a representation in their customer agreements that a trade is not made in possession of or on behalf of one possessing material nonpublic information. Some room for actual experimentation with insider trading rules might thus be allowed. Cf. Macey, supra note 15, at 9.

80. Proposed § 16A(g). Both the legislative proposals provide express private rights of action against insider trading, while preserving the government's existing disgorgement remedy. See, e.g., proposed § 16A(g), SEC bill, supra note 70, at 1818.


82. "It shall be unlawful for any person whose own purchase or sale would violate ... this section ... wrongfully to communicate information ... that such person knows or recklessly disregards is material and nonpublic to any other person who [trades or tips another whose trade is reasonably foreseeable]." Proposed § 16A(c), SEC bill, supra note 70.
required not just that one communicate information known to be confidential, but that one "wrongfully" communicate it.\textsuperscript{83}

This had the equitable advantage of holding conversations between analysts and executives to the same legal standard as those of ordinary mortals. And it provided an indication to future courts not to be unduly demanding in judging such conversations. No one circulating news of a fraud, as Raymond Dirks did, should find himself liable for tipping simply because trading might be foreseeable by any one of the numerous persons he alerts. Even in less egregious circumstances, we should hesitate to threaten people with heavy liability for merely repeating information they have heard.\textsuperscript{84}

But at this point it is not entirely clear what the "wrongfulness" requirement for tipping entails. The proposed provision states that a wrongful communication is only one where the information was obtained by, or its communication would constitute, one of the wrongs described in the subsection on trading. Assuming that neither Dirks nor the insider he spoke with had any responsibility for keeping frauds quiet, the addition of wrongfulness to the tipping subsection would seem to save them. The Dirks situation represents a narrow class of cases, however, and it is not obvious that the addition of a wrongfulness element to tipping insulates the inadvertent tip, or slip, or prevents small-scale publication from being tagged as tipping.

The Commission has suggested that a tip should be in breach of a duty.\textsuperscript{85} However, as analyzed in Dirks, breach of duty may rule out negligence and certainly excludes any tip not made for the tipper's personal benefit.\textsuperscript{86} One of the SEC's primary aims in proposing legislation, however, was to avoid the personal benefit test;\textsuperscript{87} and not all the breaches of duty recited in the trading and tipping subsections

\textsuperscript{83.} This language was accepted by both the SEC and the drafters of S. 1380, as was a provision for further exemption by rule.

\textsuperscript{84.} For example, say a corporate employee tips his grandmother who invests $1,000 and explains to her broker the reason for what she thinks is a shrewd business move; the broker then quietly invests $6 million. Should the broker subsequently become insolvent or remove himself from the jurisdiction of the United States, grandmother, whose own profits were modest, and employee, who had no profit, may be liable to private plaintiffs for the profit on the broker's $6 million investment. Conceivably the same result could obtain even if grandmother had invested nothing, but, upon being introduced to a broker at a church social, sought to impress him with her knowledge of confidential corporate affairs. As noted above, private actions against inside traders and tippers are provided in proposed § 16A(g). See SEC bill, supra note 70 at 1818. The private rights are provided for the person from whom information is misappropriated, if he can show damage, and for contemporaneous traders. The latter group will include persons not actually harmed by the unlawful trade, see supra note 21 and accompanying text. However, given the impracticability of identifying harmed persons and the desire to deprive the insider and deter the tipper, distributing profits among contemporaneous traders is at least a solution.

\textsuperscript{85.} Statement of David S. Ruder, Chairman of SEC, before Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm. concerning the Commission's revised proposal to define insider trading, Dec. 15, 1987, at 12 & n.21. Chairman Ruder's testimony indicated that the Commission did not believe the outcome of the Dirks case would be altered by the Commission's legislative proposal, on the theory that Dirks' tipper (who was disclosing a fraud) violated no duty. Cf. Macey, supra note 15 (criticizing the Dirks "personal benefit" test and arguing instead for a "proper subject of contract" test which regards fiduciary obligations as a species of contract and finds Dirks' tipper could have had no valid contract to conceal a fraud). See also supra note 80.

\textsuperscript{86.} 463 U.S. 646, 662 (1983).

\textsuperscript{87.} It may, however, be impossible to keep the test out, at least in the case involving information about a fraud, if we wish to allow the insider to tell an analyst but not, for example, his brother-in-law. As to other types of information that can be more properly characterized as proprietary, the personal benefit test may be dispensed with. Arguably, legislation may not be necessary to obtain this result, since Dirks, the source of the test, did involve information about fraud.
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(e.g., breach of a contractual duty) appear to require intent. The consequences of the tipping provision may thus still appear to some to be draconian. It will be left to the legislative history of any statute finally adopted to more clearly spell out the distinction between the informational asset which is "wrongfully" passed, and the one that is just passed.

The Commission's proposed legislative history states that an insider's communication to an analyst does not create tipping liability unless made in knowing or reckless disregard of the insider's duty; it goes on to say that when the analyst relays the information, the analyst will not be liable, assuming he is under no (independent) duty to hold the information in confidence. It therefore appears that the requirement of a "wrongful" communication means (1) that generally no liability will attach to inadvertent communications; (2) that somewhere along the line, someone must have violated a duty of confidentiality to which he is himself a party; and (3) the violation must have occurred through knowing or reckless conduct. Thus both the analyst and the insider would be protected when there was an inadvertent leak, or a legitimate attempt to make the information public. If Congress wishes to provide further protection against "tipper" liability for relatively remote but foreseeable trades, it would be well-advised to supplement the legislative history proposed. At any rate, the legislative situation remains in flux, and it is not certain what, if any, statutory definition will emerge in this session of Congress.

VII. Conclusion

Prohibitions against insider trading rest basically on notions of honesty and fairness. These sentiments themselves comprise a multitude of impulses, and insider trading law has been shaped both by an idea of fraud that requires affirmative wrongful acts and an ideal of equal informational opportunities. Current law and pending proposals to codify it retain, with a few significant exceptions, the requirement of wrongfulness. In so doing, however, they largely accomplish the results of an equal access-to-information program.

88. See SEC Proposed Legislative History, supra note 71, at 281–82.
89. The proposed legislative history does not expressly address the possibility that an analyst deliberately tricks the insider into an inadvertent, improper revelation. Liability may still be a possibility there (unless, of course, the analyst makes the information public prior to any trading); allowing the analyst's scienter to attach to the insider's breach clearly presents the danger, however, that the most aggressive and effective interrogators could be accused of recklessly inducing an insider's breach of confidence.