Insider Trading and the Infringement of Property Rights

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INTRODUCTION

The regulation of insider trading in the United States has been a failure, both in analytical and practical terms. Even though the Securities and Exchange Commission and the federal courts devote substantial resources to the eradication of insider trading, insider trading continues to flourish. Notwithstanding the numerous efforts of scholars, judges,7 the SEC and, occasionally, Congress to rationalize and articulate principled and workable restrictions on insider trading, no coherent regulatory scheme has yet emerged. Indeed, even now, twenty-five years after insider trading in market transactions was first regulated under Rule 10b-5, there is not even agreement on the fundamental question of whether insider trading ought to be regulated.

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3. See Dooley, supra note 1, at 1; Scott, supra note 1, at 818; Is the SEC Big Enough for the Job?, supra note 1. But representatives of the SEC believe that insider trading enforcement is working well. See Goelzer, Symposium on Insider Trading—Introduction, 13 Hofstra L. Rev. 1, 7 n.16 (1984); remarks of Chairman Shad, reprinted in Arizona Republic, July 7, 1986, at Cl.


5. Carlton and Fischel, supra note 1, at 859 n.12; Dooley, supra note 1, at 1, 7; Wall Street’s Army of Insiders, supra note 1; Is the SEC Big Enough for the Job?, supra note 1.

6. There is an enormous amount of scholarly writing concerning insider trading, some of which is cited in Carlton and Fischel, supra note 1, at 857 n.1; in Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 50 Iowa L. Rev. 1051, 1053 n.8 (1982); and in Macey, supra note 4, at 10 nn. 2 and 4 .

7. According to Professor Scott, by 1980 there were approximately 180 judicial opinions dealing with insider trading under Rule 10b–5. Scott, supra note 1, at 815. Since many cases settle during the trial and appellate process, and since many court decisions do not result in reported opinions, this number is presumably only a small part of the litigation activity concerning insider trading.

8. The SEC has the opportunity to influence policy in this area through its rule making and amendment powers, through the enforcement positions it takes, through the advocacy of its appellate briefs, through speeches and articles of its representatives, and through decisions that it makes in administrative proceedings brought before it.


10. See, e.g., Dooley, supra note 1, at 1; Macey, supra note 4, at 11–12; Scott, supra note 1, at 804–05.

While the SEC and the federal courts clearly and uniformly answer this question in favor of regulation (with the dissenting views coming from some in the academic community), there are major disagreements among the SEC and the various federal courts as to the scope and rationale of insider trading restrictions under Rule 10b-5. These disagreements are illustrated by the SEC and lower court efforts to read as narrowly as possible those Supreme Court opinions that curtail the scope of the insider trading restrictions, and by the Supreme Court’s repeated rejection of the view—formerly held by the SEC and at least some lower courts—that the use of any material informational advantage in securities trading is actionable under Rule 10b-5. The result of these disagreements is a jurisprudence of insider trading that is neither coherent nor predictable.

It is not surprising that disagreements should arise and continue regarding the propriety, scope, and rationale of insider trading restrictions, since the SEC and the courts that have developed the doctrine in this area have, being analytically bound as they are to Section 10b and Rule 10b-5, never had the freedom to analyze and develop an optimal doctrinal position free of these restraints. For this reason, the analytical underpinnings of restrictions on insider trading, if any, may not have been fully explored by the judges and administrators who make policy in this area. The purpose of this Article is to articulate a coherent policy basis for the regulation of insider trading, one that is based on the notion of inside information as property that can be owned and used by or for the benefit of the owner or creator of that property.

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2. See supra note 11.


4. See, e.g., the cases cited supra note 11; Release No. 17120, supra note 11.


6. Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1982), provides in relevant part: It shall be unlawful for any person, directly or indirectly, by the use of means or instrumentalities of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

7. Others have suggested that inside information may be viewed as a form of property. See, e.g., Diamond v. Oreamuno, 24 N.E.2d 920, 301 N.Y.S. 2d 78 (1969); Carlton and Fischel, supra note 1, at 866; Dooley, supra note 1, at 21, 64; Easterbrook, supra note 2, at 310, 331; Haft, supra note 6, at 1064 n.33; Macey, supra note 4, at 12, 27-29, 36-39; Scott, supra note 1, at 814; Speech of SEC Commissioner Grundfest, reported in V. 18 BNA Sec. Rts. & L. Rep. 935-36 (1986). The purpose of this Article is to demonstrate that a property rights approach to insider trading regulation solves most, if not all, of the problems that courts and commentators have found in our present, problematic insider trading doctrine, while at the same time responding adequately to the economic criticism leveled at present insider trading doctrine.
This Article begins with a brief overview of the development of insider trading restrictions under Rule 10b-5 and of certain of the analytical difficulties inherent in the present doctrine in this area. The Article next articulates a proposed property rights approach to the analysis of insider trading restrictions, and demonstrates how such an approach resolves the analytical problems inherent in the present doctrine, while at the same time serving to protect investors in accordance with the purpose of the Securities Exchange Act. The Article then considers certain economic and other arguments against the regulation of insider trading, and concludes that the proposed property rights approach adequately deals with the concerns of the proponents of those arguments. Finally, the Article considers whether the proposed approach can be implemented under Section 10b and Rule 10b-5 or under state corporation law.

I. The Development of Our Current, Problematic Regulation of Insider Trading

A. The Development of Restrictions on Insider Trading

At common law, there were few, if any, restrictions on trading on the basis of inside information in market transactions. The early cases in this area held that it was not a breach of any fiduciary duty to the corporation or its shareholders for an insider to trade in the market on material, undisclosed information. While there were cases suggesting that the use of material, undisclosed information by a corporate officer, director, or substantial shareholder could violate a fiduciary duty, and thus be actionable under state corporate law, those cases involved face-to-face transactions, in which there was at least a substantial possibility of misrepresentations or partially truthful statements. Some of those cases also involved "special" (i.e., egregious) facts of a type possible only in face-to-face dealings.

Not until 1969 did a major court recognize that market trading by corporate officers and directors on the basis of material, undisclosed information could constitute a state law breach of corporate fiduciary duty. Once recognized, this duty was promptly repudiated, as a matter of state law, by a number of other courts. Thus, state corporation and common law has never definitively proscribed insider trading in market transactions (although some states now have securities laws or "Blue Sky" provisions that attempt to implement this proscription).

A possible reaction to the failure of state common law to regulate insider trading in the securities markets would be to conclude that such regulation was deemed to be

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19. Freeman v. DeCio, 584 F.2d 186 (7th Cir. 1978); Carlton and Fischel, supra note 1, at 860 n.14, 889; Dooley, supra note 1, at 46; Fischel, supra note 2, at 135.
20. See, e.g., Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933); and authorities cited supra note 19.
22. See supra note 21.
24. Freeman v. DeCio, 584 F.2d 186 (7th Cir. 1978); Schein v. Chasen, 313 So.2d 739 (Fla. 1975).
unwise and unnecessary by the courts (which refused to impose such regulation),\textsuperscript{26} by
the state legislatures (which at least initially failed to adopt regulatory legislation),\textsuperscript{27}
by the corporations in whose securities the trading took place (since they did not
adopt charter provisions forbidding insider trading),\textsuperscript{28} and by investors (since they
continued to participate in securities markets in which insider trading was present).
Indeed, as will be discussed more fully within,\textsuperscript{29} it has been forcefully argued that
insider trading provides benefits to the marketplace, by providing an indirect means
of information regarding corporate developments; to investors, by moving the
prevailing market prices in the proper direction; to corporate managers, by providing
them with a means of extraordinary compensation for their developmental efforts on
behalf of the enterprise; and to the corporation, by providing corporate shareholders
and managers with the benefits mentioned above. Thus, it is possible that the decision
of state policy makers to refrain from regulating insider trading was deliberately and
thoughtfully made.

That possibility did not deter Congress, however, from concluding that insider
trading in the securities markets was an evil in need of regulation. Faced with the
Great Depression that followed the 1929 stock market crash, Congress considered
and enacted broad and sweeping federal securities regulation, including the Securities
Exchange Act of 1934.\textsuperscript{30} That statute, which was enacted to deal with a myriad of
securities abuses, included in Section 16 a provision that was designed by Congress
to deal with the congressionally identified problem of insider trading by regulating so
called ‘‘short-swing’’ trading by officers, directors, and ten percent shareholders of
publicly held corporations.\textsuperscript{31} Section 16, which until the adoption in 1984 of the
Insider Trading Sanctions Act\textsuperscript{32} was Congress’ only enactment specifically concern-
ing insider trading, does not actually regulate the use of inside information; it simply
provides a mechanism for corporate recapture of profits made by certain corporate
insiders who engage in purchases and sales or sales and purchases of corporate
securities within a six month period.

Although Section 16 is Congress’ specific response to the problem of insider
trading,\textsuperscript{33} it is another section of the Securities Exchange Act—Section 10b—\textsuperscript{34} that
has formed the basis for most of the administrative and judicial attempts to regulate
actual insider trading. That section is a general anti-fraud provision that authorizes the
SEC to adopt rules and regulations designed to prevent manipulative and deceptive
conduct in the purchase and sale of securities. In the legislative history of the
Securities Exchange Act there is no indication that Congress intended to regulate
insider trading through Section 10b or, indeed, through any section other than Section

\textsuperscript{26} See supra notes 19 and 20.
\textsuperscript{27} Id.
\textsuperscript{28} See Carlton and Fischel, supra note 1, at 858, 866; Dooley, supra note 1, at 45–46; Easterbrook, supra note
2, at 333 n.103; Fischel, supra note 2, at 135.
\textsuperscript{29} See infra notes 192–205 and accompanying text.
\textsuperscript{31} Id. at § 78p(b).
\textsuperscript{32} See supra note 9.
\textsuperscript{33} See Dooley, supra note 1, at 57; Phillips and Zutz, supra note 4, at 71.
\textsuperscript{34} See supra note 16.
Yet the SEC and the courts have used Section 10b (and Rule 10b-5 promulgated thereunder) as their primary tools in the administrative and judicial war against insider trading. As is discussed more fully within, Section 10b and Rule 10b-5 are not necessarily well suited to this role since 1) Congress did not intend that statute to apply to insider trading situations; 2) the SEC adopted Rule 10b-5 to deal with the problem of affirmative misrepresentation, not the problem of non-disclosure in the insider trading context; 3) Section 10b and Rule 10b-5 are grounded on the notion of fraud, which (as defined by the Supreme Court in its recent insider trading jurisprudence) makes somewhat difficult, unpredictable, and perhaps irrational, the determination of what sort of trading is in fact proscribed under Rule 10b-5 as “insider trading.”

Notwithstanding the apparent difficulties with grounding an administrative and judicial doctrine of insider trading regulation on authorities as ill-suited as Section 10b and Rule 10b-5, the lower courts and the SEC proceeded to do just that. Beginning in the mid-1940s, shortly after the SEC’s adoption of that rule in 1942, the SEC and a number of lower federal courts applied Rule 10b-5 to prohibit insider trading in face-to-face transactions in which officers, directors, substantial shareholders, or the corporation itself used undisclosed information regarding corporate developments in their investment decisions. That an anti-fraud proscription such as Rule 10b-5 should be applied in these face-to-face securities dealings between corporate insiders and potential buyers or sellers of the corporation’s securities is not surprising, for, as indicated earlier, in such transactions there is a great potential for misrepresentations to be made or for nondisclosure of certain information (known to the insider) to render misleading other communications, or statements provided by the insider to his seller or buyer. Rule 10b-5 was adopted to deal with just this sort of misrepresentation and half truth.

Because Rule 10b-5 and Section 10b were not specifically enacted to deal with insider trading situations (in which the defendant, who allegedly possesses an informational advantage, silently trades without making any statement or representation).
tation whatever), it is surprising in hindsight that the lower courts chose to announce the broad proposition that insider trading by corporate insiders is prohibited by Rule 10b-5, whether or not that trading is accompanied by any misrepresentational or half truthful statement. Yet this is what the courts did, in a number of cases involving corporate insiders in face-to-face transactions, in opinions that were largely devoid of forceful reasoning to support that broad proposition. Without a great deal of analysis, the lower courts concluded in these cases that insider trading was generally a bad thing that ought to be prohibited by some federal statute or regulation. Rule 10b-5 and Section 10b were the vehicles that allowed the lower courts to implement this regulation.

While the use of Rule 10b-5 to regulate insider trading first arose in cases involving face-to-face transactions, the language of the courts in those early opinions and the attitude of the SEC were such that it was clearly foreseeable that Rule 10b-5's proscription on insider trading would not be confined to such cases. Indeed, in 1961 the SEC clearly established its view that insider trading in impersonal market transactions violates Rule 10b-5. In the famous Cady, Roberts decision, an administrative decision of the SEC sanctioning a registered stock brokerage for participating in insider trading in market transactions, the SEC rejected the argument that Rule 10b-5 proscribed insider trading only in face-to-face transactions.

The decision of the SEC to apply Rule 10b-5's insider trading proscription to market transactions was judicially confirmed just a few years later, in the famous case of SEC v. Texas Gulf Sulphur Co. That case (seeking injunctive and ancillary relief) was brought by the SEC against a number of defendants, all of whom were officers, directors, or employees of the corporation in whose securities they traded, in market transactions, allegedly on the basis of material, undisclosed information regarding the corporation's affairs. The Second Circuit Court of Appeals concluded, without any difficulty, that Rule 10b-5 proscribed insider trading in impersonal market transactions.

Thus, by 1968 the lower courts and the SEC had firmly established that Rule 10b-5 proscribed insider trading in both face-to-face and market transactions. Indeed, this SEC and lower-court-made doctrine remains so firmly established that neither Congress nor the Supreme Court has had the temerity to challenge it.

45. See supra note 42.
46. See Scott, supra note 1, at 803-04; Dooley, supra note 1, at 39.
47. See R. JENNINGS and H. MARSH, supra note 42, at 912.
49. Id. at 910-12.
51. Id. at 839-41.
52. Id. at 864.
53. In Chiarella v. United States, 445 U.S. 222 (1980), the Supreme Court relied heavily on lower court precedent in concluding that insider trading is proscribed by Rule 10b-5. Id. at 226-29. In its deliberations leading up to the enactment of the Insider Trading Sanctions Act of 1984, Congress considered the scope of the administratively and judicially created restrictions on insider trading. See supra note 9. Congress declined, however, to give legislative definition to the concept of insider trading, preferring to leave that definition process to the courts and the SEC. Thus, a good argument can be made that Congress has endorsed the scope of the judicially and administratively developed insider trading doctrine. See, e.g., Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 360-67 (1982).
What had not been decided in 1968 was what constitutes insider trading. As previously indicated, the early insider trading cases under Rule 10b-5 all involved the use of material, undisclosed information by the corporation or its officers, directors, substantial shareholders, or employees. Thus, although the courts did not always recognize this fact, in all of these cases there was a relationship, direct or indirect, between the defendant and the corporation in whose securities the trading occurred.

While the existence of such a relationship would later assume considerable importance in the Supreme Court's analysis and development of insider trading doctrine, in the late 1960's and early 1970's the significance that the Supreme Court would later place on that relationship was not fully appreciated by the SEC and the lower courts.

Thus, having succeeded in establishing the propositions that Rule 10b-5 proscribes insider trading and that this proscription applies in both face-to-face and market transactions, the SEC set out during the 1970's to establish a broad definition of insider trading—one that would literally preclude the use of informational advantages in securities trading transactions. The SEC (aided at times by private plaintiffs) set out to implement and enforce the pronouncement of the Second Circuit in Texas Gulf Sulphur that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . or chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." This pronouncement was, of course, gratuitously broad, since the defendants in Texas Gulf Sulphur (like the defendants in the earlier cases) were not just "anyone"; they were all people who, as officers, directors, and employees of Texas Gulf, had a relationship to that corporation.

Notwithstanding indications that the courts would not tolerate an absolute prohibition on the use of informational advantages and warnings by influential commentators that such an absolute prohibition was unwise, the SEC proceeded to take the position that anyone in possession of material, undisclosed information—i.e., a person with an informational advantage—must either disclose that information or refrain from trading or tipping on it. That position was taken most dramatically in Chiarella v. United States, the case which ultimately afforded the Supreme Court

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54. See supra notes 41-44, and accompanying text.
55. See R. JENNINGS AND H. MARSH, supra note 42, at 912, 1008.
57. For a definition of "insider trading" that is consistent with this SEC approach (and that was formulated by a leading commentator in 1980, prior to Chiarella and Dirks), see Dooley, supra note 1, at 3.
58. 401 F.2d 833, 848 (2d Cir. 1968).
59. Id. at 843-47.
its first opportunity to contribute to the jurisprudence concerning the regulation of insider trading through Section 10b and Rule 10b-5.

In Chiarella, the defendant clearly benefitted from an informational advantage that he had obtained in a most unseemly way. The defendant, who worked for a financial printer, used his employment position to gain access to confidential information regarding planned corporate takeover attempts. He then used that information to purchase securities of the target companies, prior to the public announcement of the planned tenders. Following such public announcements, he sold those securities at a nice profit to himself. The unseemly nature of this conduct was too much for the defendant's employer, which fired him, and for the SEC, which brought a civil action against the defendant that resulted in the disgorgement of his trading profits through a consent decree.

Notwithstanding the justice to which the defendant had already been brought by his employer and the SEC's earlier civil action, the SEC made a criminal reference of the case to the Justice Department for criminal prosecution. In that prosecution, the government contended (and the district court instructed the jury) that the defendant could be convicted of violating Rule 10b-5 if he traded on material, undisclosed information. Ignored by the government (at least until the last minute) and by the district court was the fact that the defendant had no relationship with the target corporations in whose securities he traded.

In its first encounter with insider trading doctrine under Rule 10b-5, the Supreme Court confirmed that insider trading is actionable under Rule 10b-5. It disavowed, however, the notion that the Rule proscribes the use of any informational advantage. Rather, the court said that Rule 10b-5 and Section 10b proscribes fraudulent conduct, and that use of material, undisclosed information is only fraudulent when that use violates a fiduciary or similar duty to the corporation in whose securities the trading takes place (or to the shareholders of that corporation).

While the Supreme Court's actual holding in Chiarella has been the subject of considerable debate and is arguably very narrow, it is clear that Chiarella 1) confirms that Rule 10b-5 can be used as a regulator of insider trading; 2) rejects the

63. Id. at 224.
64. Id.
65. Id.
66. Id. at 224–25.
67. Id. at 235–36.
68. Id. at 232–33.
69. Id. at 225–26.
70. Id. at 227.
view that all informational advantages are proscribed under Rule 10b-5;\textsuperscript{74} and 3) emphasizes the importance of fiduciary and similar relationships in determining liability for insider trading under Rule 10b-5.\textsuperscript{75} This emphasis was based on the Court’s view that Section 10b and the rules thereunder can only proscribe fraud;\textsuperscript{76} that trading in silence (which is the usual situation in insider trading cases involving market transactions) is only fraudulent if there is a duty to speak;\textsuperscript{77} and that such a duty arises from a fiduciary or similar relationship between the defendant and the corporation in whose securities he or she trades.\textsuperscript{78}

In this analysis, the Supreme Court relied heavily upon common law notions of fraud.\textsuperscript{79} Also, in its analysis the Court left open the possibility that the breach by the defendant of a duty to someone other than the corporation might support a finding of liability under Rule 10b-5 in insider trading cases.\textsuperscript{80} The Court did not consider this possibility in \textit{Chiarella}, for the government constructed very late (and the jury never had a chance to consider) the argument that Mr. Chiarella had acted fraudulently (and in breach of a duty to his employer and his employer’s clients) when he stole confidential information from his employer and those clients.\textsuperscript{81}

The ink on the \textit{Chiarella} decision was hardly dry, as Harold Marsh has said,\textsuperscript{82} before the SEC and the lower courts set out to undo it. The first assault came from the SEC,\textsuperscript{83} which promptly adopted new Rule 14e-3\textsuperscript{84} (under the authority of Section 14e of the Securities Exchange Act)\textsuperscript{85} for the purpose of prohibiting conduct of the type in which Mr. Chiarella had engaged and which had been found by the Supreme Court to be outside the scope of Rule 10b-5. Rule 14e-3, which is discussed more fully below,\textsuperscript{86} applies only to the use of undisclosed information in connection with tender offers, since Section 14e is limited in its application to tender offer situations.\textsuperscript{87} Notwithstanding that limitation on Rule 14e-3’s application, the authority of the SEC to adopt this rule and the rule’s validity remain very questionable.\textsuperscript{88}

\textsuperscript{74.} Id. at 233.
\textsuperscript{75.} Id. at 232–33.
\textsuperscript{76.} Id. at 232.
\textsuperscript{77.} Id.
\textsuperscript{78.} Id.
\textsuperscript{79.} Id. at 227–28.
\textsuperscript{80.} Id. at 235–36.
\textsuperscript{81.} Id.
\textsuperscript{82.} See R. Jennings and H. Marsh, supra note 42, at 919.
\textsuperscript{83.} See Release No. 17120, supra note 11.
\textsuperscript{84.} 17 C.F.R. § 240.14e–3 (1986).
\textsuperscript{85.} 15 U.S.C. § 78n(e) (1982), provides as follows:
It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request, or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.
\textsuperscript{86.} See infra notes 230–36 and accompanying text.
\textsuperscript{87.} See supra note 63.
particularly in light of recent Supreme Court pronouncements regarding the purpose and application of Section 14e.\textsuperscript{89} Enforcement by the SEC of the rule as written has not been deterred, however, by doubts about the rule’s validity or wisdom.\textsuperscript{90}

In addition to promulgating Rule 14e-3, the SEC responded to the \textit{Chiarella} decision by noting the narrowness of the Supreme Court’s holding in \textit{Chiarella} and by promptly addressing the issue left open by the Supreme Court—whether the breach of a duty to someone else in connection with the defendant’s use of undisclosed, material information can support a finding of “fraud” and the conclusion that Rule 10b-5 has thus been violated.\textsuperscript{91} The government argued this position successfully before the Second Circuit in \textit{United States v. Newman},\textsuperscript{92} in which the court sustained criminal indictments against defendants who, like Mr. \textit{Chiarella}, had used confidential information stolen from their employers to trade in securities of corporations to which the defendants had no relationship.\textsuperscript{93} The Second Circuit concluded that this sort of insider trading was actionable under Rule 10b-5, even though there was no relationship between the defendants and the corporation in whose securities they traded, because the use by the defendants of confidential information breached a duty to their employer (and to the employer’s clients) and therefore constituted a fraud for purposes of Rule 10b-5.\textsuperscript{94} Even though the Second Circuit has refused to extend this approach to cases initiated by private litigants,\textsuperscript{95} the \textit{Newman} case illustrates the desire of the lower courts to broadly read and apply Rule 10b-5 in insider trading cases, and to read narrowly the Supreme Court’s analysis in \textit{Chiarella}.

Perhaps because it recognized such a disposition on the part of some or all of the lower courts, the Supreme Court took great pains in the recent case of \textit{Dirks v. SEC}\textsuperscript{96} to reiterate the views announced in \textit{Chiarella}: that Section 10b and Rule 10b-5 can only apply to fraudulent conduct; that silently trading on an informational advantage is not fraudulent absent a duty to disclose; that a duty to disclose arises only from a relationship of trust and confidence between the defendant and the corporation; and that absent such a duty, the defendant’s trading is not actionable under Rule 10b-5.\textsuperscript{97} The Court’s opinion in \textit{Dirks} also contains language,\textsuperscript{98} however, that has been construed by the SEC and some commentators to indicate that the Court does not really mean that a duty to disclose arises only from such a relationship.\textsuperscript{99} Such language, it is argued, indicates that the Court has not rejected the notion that trading

\textsuperscript{91} Release No. 17120, supra note 11.
\textsuperscript{92} 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983).
\textsuperscript{93} Id. at 19.
\textsuperscript{94} Id.
\textsuperscript{96} 463 U.S. 646 (1983).
\textsuperscript{97} Id. at 654–55.
\textsuperscript{98} Id. at 665.
\textsuperscript{99} See, e.g., Aldave, supra note 71, at 102 n.6.
on misappropriated or stolen information, in breach of a duty to someone other than
the corporation, constitutes fraudulent conduct that is actionable under Rule 10b-5.\textsuperscript{100}

Though the Court's opinion in \textit{Dirks} went to some length to reaffirm the
principles announced in \textit{Chiarella}, \textit{Dirks} and \textit{Chiarella} are factually dissimilar cases. As indicated earlier,\textsuperscript{101} \textit{Chiarella} involved insider trading by a defendant who had
stolen information from his employer who, in turn, had no relationship to the
corporation in whose securities the trading occurred.\textsuperscript{102} \textit{Dirks} involved a securities
analyst who concluded, after a lengthy investigation of a company (which included
interviews with present and former officials of that company), that the company was
engaged in a massive fraud.\textsuperscript{103} The analyst then precipitated the revelation of that
fraud by recommending that his clients dispose of the company's securities, which
led to a market decline, which led the SEC and the exchange to stop trading and
investigate the company's circumstances.\textsuperscript{104} In \textit{Chiarella}, therefore, there was no
relationship between the defendant and the corporation in whose securities he traded.
In \textit{Dirks}, there was an indirect relationship; the defendant, \textit{Dirks}, was a tippee of a
corporate insider who had a relationship with the corporation, which the tippee
allegedly inherited when he received the tip from the insider.\textsuperscript{105}

While the lower courts, prior to \textit{Dirks}, had fairly well established that tippees
and tippers could be equally liable under Rule 10b-5,\textsuperscript{106} the Supreme Court in \textit{Dirks}
was not willing to impose this liability on the securities analyst who had revealed this
massive fraud. Because of its regard for the important role that securities analysts
play in bringing information to the marketplace and the important role that \textit{Dirks}
played in revealing this fraud, the court rejected the view that a tippee (such as \textit{Dirks})
should always be liable for trading on inside information received from a person (such
as a present or former officer of the company) who has a relationship with the
corporation.\textsuperscript{107} Rather, the Court structured a two-part test for tippee liability,
designed to permit the continued methods of investment analysts, under which
liability for insider trading under Rule 10b-5 will be imposed only if 1) the
insider/tipper violated a fiduciary duty in disclosing the information to the tippee, and
2) the tippee knew or had reason to know that the disclosure of the information to him
or her was in violation of such a duty.\textsuperscript{108}

Because \textit{Dirks}' tipper had disclosed the fraud to \textit{Dirks} for altruistic reasons—to
end the company's misconduct—rather than for personal gain or benefit, the Court
concluded that he had not violated a duty in making this disclosure to \textit{Dirks}.\textsuperscript{109} Since

\begin{thebibliography}{99}
\bibitem{100} Id.
\bibitem{101} See infra notes 62–82 and accompanying text.
\bibitem{102} 445 U.S. 222, 224 (1980).
\bibitem{104} Id. at 649.
\bibitem{105} Id.
\bibitem{106} See, e.g., Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir.
\bibitem{108} Id. at 657–58.
\bibitem{109} Id. at 667.
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the tipper was in violation of no duty, the tippee, Dirks, did not violate Rule 10b-5 when he received and acted on the information. 

While Chiarella and Dirks are factually dissimilar cases, there are of course some similarities in the Court’s resolution of the cases. In neither case did the Court consider the wisdom, under economic theory or otherwise, of regulating insider trading. Rather, in both cases the Court, relying heavily on lower court precedent, concluded that Rule 10b-5 had been firmly established as a regulator of insider trading. In both cases the Court emphasized the “fraud” language of Section 10b and Rule 10b-5 and looked to the common law of fraud in defining the parameters of insider trading regulation under Rule 10b-5. In both cases the Court reached a just and equitable result in letting the defendants off. (Chiarella, who was the first person ever prosecuted for insider trading, had already been sanctioned by his employer and by the SEC; Dirks’ activity resulted in the discovery and termination of a major fraud.)

However, in reaching these just results, the Court’s statutory and common law fraud analysis did little to advance the understanding of the principles underlying insider trading regulation or to improve the coherence and workability of the insider trading regulations. By focusing on common law fraud, on fiduciary duties to ill-defined persons or entities, and on the motives of tippers and knowledge of tippees, the Court contributed to the continuing uncertainty concerning the justification and the application of the insider trading rules.

B. Problems with the Present Restrictions on Insider Trading

That the Supreme Court did not consider the wisdom of insider trading regulation and that it did consider fraud and fiduciary duty principles is, of course, not necessarily its fault. The Supreme Court, like the lower courts before it, felt constrained to follow the language of a statute and rule that were assumed to apply to insider trading. This judicial attitude—of accepting the applicability of Section 10b and Rule 10b-5 and then limiting analysis to the language of those provisions—has led to a major problem in the insider trading area. Even if one accepts the notion that insider trading should be regulated, it is very hard to tell which transactions will be subject to that regulation, since under Rule 10b-5 that depends on the existence of fiduciary (and other ill-defined) duties that run to persons who are not very clearly defined and on motivations, states of mind and knowledge that are very subjective and not easy to identify in the planning stage.

But this is not the only problem with the present use of Section 10b and Rule 10b-5 as a regulator of insider trading. Because of the Court’s view that insider trading liability under that Rule depends on the existence and breach of a fiduciary duty to the corporation, Rule 10b-5 regulates insider trading by some but fails to

110. See Fischel, supra note 2.
regulate insider trading by others whose conduct is equally reprehensible (or at least no more morally justified). For example, an employee of Company A who trades in securities of Company B, which is about to receive a yet undisclosed lucrative contract with Company A, is not necessarily subject to insider trading liability under Rule 10b-5, since he or she has no relationship to the company in whose securities he or she traded. On the other hand, the Company B officer who trades in securities of that company on the basis of that undisclosed information concerning the contract will have liability under the Rule, since he or she clearly has the requisite relationship.

Yet, the conduct of these persons appears equally justified or unjustified. In both cases the person used inside information for his or her benefit. In both cases the person took that information from an enterprise for whose benefit the information was intended. In neither case did the person create the information or receive permission to trade from the information’s creator. Thus, if one is to be sanctioned for insider trading (or allowed to insider trade), so should the other. However, because of the fraud language of the statute and rule and the Supreme Court’s common law/fiduciary duty approach to the implementation of that language, one defendant may be able to trade while the other clearly may not.

Other problems also exist with the use of Section 10b and Rule 10b-5 as the primary federal regulator of insider trading. These provisions, like most of the provisions of the federal securities laws, may be enforced by the SEC. The SEC, having been authorized to enforce these provisions and having determined that insider trading is a very bad thing, has committed substantial resources to this enforcement effort. However, because of the extent of the insider trading “problem” and because of the relatively limited resources of the SEC, there is a serious question as to whether the SEC’s resources should be employed in this way. An insider trading regulatory scheme (either under or outside of Rule 10b-5) that freed the SEC from this enforcement role would allow the SEC to reallocate its resources to other, perhaps more productive, purposes. Such a scheme would rely for its enforcement on private enterprise, rather than on the SEC.

115. Of course, Rule 14e-3 may cover tender offer related conduct that is outside the ambit of Section 10b and Rule 10b-5. See supra notes 82–90 and accompanying text, and infra notes 230–36. See also infra note 236.

116. Such an employee might, however, have Rule 10b-5 liability under the theory of United States v. Newman, 664 F.2d 12 (2d Cir. 1981), which is discussed in the text accompanying notes 90–96 supra. The Supreme Court has yet to rule on this theory.

117. Actually, § 10b says nothing about fraud, and Rule 10b–5 is not by its terms limited to fraudulent conduct. However, the Supreme Court has interpreted the statute to proscribe only fraudulent conduct. Aaron v. SEC, 446 U.S. 680, 701–02 (1980); Chiarella v. United States, 445 U.S. 222, 235 (1980); Santa Fe Industries Inc. v. Green, 430 U.S. 462, 478–79 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 215 (1976). Because the Rule cannot exceed the bounds of the statute under which it was created, Rule 10b–5 is also limited to fraudulent conduct. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 215 (1976).


119. See supra note 4.

120. See supra note 5.

121. For an argument that the cost of enforcement of the insider trading restrictions should not be borne by the taxpayers, see Macey, supra note 4, at 58–61.
Of course, the courts and the SEC already depend to considerable extent on private litigation for help in enforcing the federal securities laws.122 Even where Congress provided no private right of action under those statutes, the courts have often implied such a right,123 to enable private plaintiffs to supplement the SEC’s enforcement efforts, on the theory (among others) that such a supplement was necessary to support the meager, beleaguered SEC staff.124 Such a private right of action has been implied by the lower courts and recognized by the Supreme Court under Rule 10b-5.125

A private right of action under Rule 10b-5 causes other analytical and practical problems with the use of this Rule as a regulator of insider trading. Because Section 10b and Rule 10b-5 prohibit manipulative and deceptive conduct “in connection with the purchase and sale of any security,”126 the Supreme Court has held that plaintiffs in a private lawsuit under Rule 10b-5 must be purchasers or sellers of securities.127 This means that in many cases the person or enterprise from which inside information has been taken, for the personal trading benefit of the defendant, will be unable to bring a cause of action against the defendant under Rule 10b-5,128 since that person or enterprise will not necessarily be a purchaser or seller of securities.129

While limiting private plaintiffs under Rule 10b-5 to purchasers and sellers of securities was intended to reasonably curtail the scope of a potentially enormous plaintiff class,130 in the insider trading area (as opposed to other applications of Rule 10b-5) this curtailment does not necessarily operate reasonably. Because it is very difficult in market transactions to determine the actual purchasers and sellers whose securities changed hands,131 many lower courts have granted standing to sue under Rule 10b-5 to all market participants who engaged in transactions opposite to those of the defendant between the time of the defendant’s trade and the time of the effective dissemination of the inside information.132 Since the number of such traders

126. See supra notes 16 and 17.
128. Of course, such a person might proceed on other theories, such as state law breach of fiduciary duty, conversion or theft. See infra notes 211-28 and accompanying text.
129. See supra notes 16 and 17; Dooley, supra note 1, at 21.
132. See, e.g., Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Shapiro v. Merrill, Lynch, Pierce,
and the volume of their transactions during that period is potentially huge, an insider trader who is liable to all of them faces potentially “draconian” damages, disproportionate to the profits that he or she made and to the effect that his or her transactions had on the market.\textsuperscript{133}

Because of this problem of potentially draconian damages against insider trading defendants, some courts have refused to find any causal connection between the defendant’s trading and the plaintiff’s alleged loss.\textsuperscript{134} Other lower courts, however, have said that the materiality of the omitted, inside information is sufficient to presumptively establish the required causal link between the defendant’s insider trading and whatever harm the plaintiffs allegedly suffered.\textsuperscript{135} For these courts, there remains the problem of how to deal with the potential for draconian damages, which they do by artificially limiting the total damage award to the amount of profit realized by the defendant.\textsuperscript{136}

As applied to plaintiffs who were market participants, this limitation on damages makes little sense.\textsuperscript{137} If those participants have been damaged by the defendant’s insider trading, they should receive their actual damages,\textsuperscript{138} which might be measured in a variety of ways.\textsuperscript{139} If they have not been injured, they should not receive damages.\textsuperscript{140} Awarding them the defendant’s insider trading profits, which are not the same as the losses suffered by the plaintiff/market participants,\textsuperscript{141} accomplishes nothing other than forcing the defendant to disgorge his or her profit.

Even if profit disgorgement is the goal, it is not at all clear that the disgorged profits should wind up in the hands of the plaintiff/market participants.\textsuperscript{142} To the extent that the disgorged profits do not recompense those market participants for damage suffered by them, they have no logical claim to those profits. If profit disgorgement is the goal, it would be better to have the insider trader return his or her profits to the corporation, as is the case under Section 16b.
Analytically serious as these standing, causation and damage limitation problems are, there is an even more serious problem with the current use of Rule 10b-5 to regulate insider trading. As discussed in Part III, under Rule 10b-5 the plaintiffs in private insider trading litigation are usually market participants who have not been harmed by the insider trading¹⁴³ (since they would have traded even if the insider had stayed out of the market) and who may have benefitted from that insider trading (since purchases by an insider often move the market price up and sales by an insider often move the market price down). Plaintiffs who sell in a market in which insider buying has increased the market price, or who buy in a market in which insider selling has decreased the market price, have little to complain about.¹⁴⁴ Accordingly, a fundamental problem with the present use of Section 10b and Rule 10b-5 as the regulator of insider trading is that the wrong people are allowed to bring claims under this regulation.

For the reasons indicated, insider trading regulation under Rule 10b-5 has thus far been an analytical failure. Perhaps because of the unpredictability and sometime irrationality of the present doctrine, insider trading regulation has also been a practical failure. A proposal to provide a coherent, rational, and predictable doctrine in this area follows in the next part.

II. INSIDER TRADING AND PROPERTY

Because many of the difficulties with our present regulation of insider trading arise from the courts' inability or reluctance to move beyond the language of the statute and rule to a consideration of the overall wisdom of this regulation, this part sets forth a model of insider trading regulation that may or may not be consistent with the language of Section 10b and Rule 10b-5. After demonstrating that the proposed model solves the analytical problems previously identified and is consistent with economic theory regarding insider trading regulation, the article returns in Part IV to the question of whether the proposal can be implemented under that section and rule without new legislative authority.

A. Information as an Asset

Information can be an asset.¹⁴⁵ Like other assets, it can be developed by the work of its creator, who may have engaged in an analysis of publicly available information and in an investigation to reach conclusions or gather facts that are not generally known, or who may have participated in the discovery or development of new products, procedures, or projects that are as yet generally unknown. Like other assets, information can sometimes be transferred by its owner to other persons, either by purchase, by gift, as compensation for services rendered, through a temporary use

¹⁴³. See infra notes 192–205 and accompanying text; Dooley, supra note 1, at 21; Fischel, supra note 2, at 889; Macey, supra note 4, at 47–48.

¹⁴⁴. For an interesting, theoretical argument that many (often unidentifiable) persons are injured by insider trading in market transactions, see Wang, supra note 71, and Karjala, supra note 131.

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(i.e., licensing) arrangement or otherwise. So long as the information remains generally unknown, the information has potential value in the hands of the person who possesses it and who has the potential ability to benefit from the informational advantage that he or she possesses. It is this potential value that provides the incentive for the owner of the information to develop it and to keep it undisclosed, where nondisclosure will maximize the best interest of the information’s owner.

It is no big surprise that information can be an asset of potentially enormous value to its owner. Business enterprises and their employees and agents routinely recognize and deal with this fact in their dealings with ownership and use rights in trade secrets, copyrights, patents, and other forms of what is called “intellectual property” (which is simply information developed by or for a person whose rights in that “property” will be respected). In those dealings, it is not uncommon for the enterprise and its agents to agree on the allocation of ownership rights of the agent’s creations while in the employ of the enterprise; on the agent’s rights to compensation for those creations; on the agent’s right to disclose or make use of information regarding that creation, both during and after the termination of his or her employment; and on other matters. Thus, dealing with information as an asset and allocating its ownership and the uses to which it may be put is not necessarily novel to many businesses.

If information can be an asset whose ownership can be determined and transferred and whose uses can be allocated and restricted by agreement with the owner, it is possible to approach the regulation of insider trading as a matter of determining and protecting the ownership and use rights in the inside information on which that trading is based. If such an approach proves analytically sound, as a matter of property law, while protecting investors and overcoming the analytical problems with the present regulatory system identified in Part I and Part III, it will have much to commend it. Let us see if this approach can fill that large bill.

B. Ownership and Use of Corporate Information

One type of inside information on which people trade concerns the enterprise itself. New assets are discovered, developed, or acquired in favorable ways that benefit the company. Existing assets are lost or disposed of in ways unfavorable to the company. The company proposes to acquire another enterprise in a friendly or unfriendly acquisition. Key personnel decide to join, to stay with, or to leave the company. The company is about to enter into a favorable contract with another enterprise. The results of the company’s operations for a given period are computed and show a loss, rather than the expected profit, or a profit, rather than the expected loss. Because of a change in accounting policy, the company plans to revalue some of its assets and/or restate earnings for prior periods. New claims against the company are investigated. In all of these situations, the information arises from and concerns the company’s activities.

146. See supra note 18.
However, because companies are nothing more than aggregations of people and assets, the matters described in the preceding paragraph will necessarily have been accomplished for the company by individuals acting on its behalf. Those individuals will, of course, know about those matters and accomplishments concerning the company and may wish to trade in securities of the company based on that knowledge. The question in this situation is whether they should be able to so trade.

If the activity of the person in developing new assets, making acquisition plans, and handling other business matters was undertaken on behalf of the corporation, it seems clear that the information regarding the matter is not that of the corporate agent. That information belongs to the corporation, for which the activity was undertaken. If this is the case, whether the corporate agent (or anybody else) can trade on the information depends on whether the corporation, which owns the information, consents in some way for that information to be used by the other person.147

The corporation’s consent to the use by others of corporate information could be given by contract, as in the case of an agreement between the corporation and an employee, entered into at the time of his or her employment, permitting the use in trading of certain types of information developed by (or known to) the employee; by company policy, which might permit all officers above a certain rank to trade in company securities (on information known to them) as part of their compensation arrangements;148 or on a case-by-case basis, where it appears that the corporation’s best interests would be served by, for example, letting an arbitrageur know of (and trade on) the company’s planned takeover of another enterprise so that the arbitrageur’s “warehousing” activities could assist the company in that takeover effort.149 No matter what form the corporation’s consent takes, however, it is clear that that consent must be given by the person or body that is authorized to exercise the corporation’s consent on such matters.

Normally, that body will be the board of directors, which under state corporation law is usually authorized to manage the business, affairs, and assets of the corporation.150 Since such assets can include information, the use and management of that asset should be under the direction of the board, unless the board decides to delegate the authority to deal with such asset to a specific officer or committee of the corporation.151

In directing the business, affairs, and assets of the corporation, the board of directors, committees thereof, and corporate officers have a state law fiduciary duty to the corporation and all of the shareholders to act in the best interests of the enterprise.152 Thus, in deciding how to deal with undisclosed information that the corporation possesses and owns, the board (or its delegate, if any) must determine

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147. See Fischel, supra note 2, at 136.
148. See infra notes 206–10 and accompanying text.
149. For a discussion of “warehousing,” see Dooley, supra note 1, at 53; Fleischer, Mundheim and Murphy, supra note 61, at 811–12.
151. Id., §§ 8.41, 8.25.
152. Id., § 8.30.
that the contemplated action with respect to that information will serve the corporation's best interests.

This requirement of promoting the best interests of the corporation in any decision respecting the use (or nonuse) of corporate inside information differs radically from practice under the present doctrine. Because it is impossible under present doctrine for a director or other corporate officer to legitimize by consent an otherwise illegitimate use of inside information, directors, committees, or authorized officers are rarely asked to determine if the corporate best interest would be served by a proposed use of inside information concerning the corporation. Rather, users of inside information employ that information (either legitimately or illegitimately, depending on relational and other factors) for their own benefit and without regard to the corporation's best interests. Those who complain about that use of inside information are typically the SEC or other market participants, who often have not been harmed directly by the insider trading and whose enforcement activities are not necessarily undertaken with a view to the best interests of the corporation in whose securities the insider trading occurred.

Since the corporation whose information has been taken has a larger interest in the use of that information than does a market participant, who would have traded even in the absence of insider trading and probably at a worse price, it makes sense to adopt a system of insider trading regulation that at some stage focuses on the interests of the corporation. By treating inside information as corporate property to be managed by or under the direction of the board, that focus is implemented.

In considering the question of how the use of inside information might further the best interests of the corporation, the board or its delegate might conclude that no person should use that information, because such use would make more difficult a transaction that the corporation has in mind (e.g., insider buying might drive up the market price of the corporation's securities, thereby making more difficult the corporation's acquisition in a transaction that is tied to the market price of the corporation's securities), or because such use by individuals of undisclosed corporate information may taint the corporation's reputation for fairness and integrity, or because the corporation wishes to use the inside information itself in its own activities for the benefit of all of the corporation's shareholders. Indeed, as discussed below, in cases in which the board or its delegate has not affirmatively approved a person's use of corporate inside information, such use should be improper.

It would be possible, however, for the board or its delegate to determine in certain circumstances that authorizing others to use corporate inside information

154. See infra notes 193-205 and accompanying text.
155. See Dooley, supra note 1, at 21.
159. See infra notes 211-16 and accompanying text.
would be in the best interests of the corporation. As discussed in Part III, insider trading points the market in the proper direction—the one that it will take when full disclosure is made. Thus, if disclosure is presently impossible, for example, because of the preliminary nature of the information or because of a corporate need for secrecy, authorizing certain persons to trade will move the market in the proper direction, thereby indirectly informing the market of the corporate development and reducing the difference between the current value of the securities and their post-disclosure value. Thus, since insider trading may be beneficial to the corporation’s shareholders, the board may choose to authorize it.

The board or its delegate might also decide that allowing specific employees to trade on inside information, such as that relating to corporate developments generated by them, would be good compensation for their efforts on behalf of the corporation. Such a decision that this form of “compensation” is in the best interests of the corporation could only be made by the directors, obviously, where those developments were positive; where the inside information is that the managers have run the corporation into the ground, the directors could not decide (consistent with their duty to the corporation) to reward those managers by letting them trade on that inside information.

A decision by the board or its delegate to “tip” inside corporate information to certain outsiders, to facilitate trading by them, could also be in the best interests of the corporation. For example, where the corporation has received valuable services from an outsider, one way of providing indirect compensation for those services is by providing the outsider with the authorized use of inside information owned by the corporation. Thus, if one accepts the notion that inside information is property of the corporation, even the tipping of that information to others ought not be regarded as improper, if the board of directors or other authorized corporate decision maker has determined that such tipping is in the best interests of the corporation.

Where, however, that board or decision maker has not determined that the use of inside information by an insider or outsider is in the corporation’s best interests, the use of such corporate information should be prohibited. As discussed in Part IV, with respect to employees and agents of the corporation, in these circumstances their duty of loyalty to the corporation should prevent the usurpation and use (whether as traders or tippers) of corporate information, under the corporate opportunity doctrine or under the theory of theft or conversion of corporate assets. With respect to persons who are not employees or agents of the corporation, where no authorization to use the information has been given by the corporation, such persons either will have stolen the information from the corporation or have been given the

160. See infra notes 192–205 and accompanying text.
161. See Dooley, supra note 1, at 4, 33, 36, 55, 68; Fischel, supra note 2, at 129; Macey, supra note 4, at 15.
162. See Carlton and Fischel, supra note 1, at 858, 876; Easterbrook, supra note 2, at 332; Scott, supra note 1, at 808. See infra notes 206–10 and accompanying text.
164. See infra notes 211–16 and accompanying text.
165. A burglar or industrial spy who overcomes the corporation’s effort to keep its information secret would fall in
information by an insider who was not authorized to use it for that purpose.\textsuperscript{166} In either case, the person should not be permitted to trade on the information, for the retention and use of stolen property is inconsistent with the criminal law, and, under property law, the receipt of property from an unauthorized, untitled person conveys to the recipient no title to, or authority to use, the property so received.

Since the key to the analysis of when and by whom corporate information can be used is the corporation’s consent, based upon the decision of the board of directors or other authorized decision maker that such use is in the corporation’s best interest, the role of the board can not be over-emphasized. In making this decision, or delegating to others the authority to make it, the board must act in the best interests of the enterprise and of all of its shareholders.\textsuperscript{167} If the board does not do that, or if it acts unreasonably, it can be held accountable to the corporation and its shareholders for breach of duty to the corporation.

C. Ownership and Use of Analytical Information

While the foregoing discussion deals with the common situation in which the inside information arises from and concerns activities and developments of the corporation itself, not all inside information arises in that way. Some inside information is created by outsiders, people who have no employee or agency relationship to the corporation to which the information relates. For example, analysts study the performance of selected companies in a variety of ways—by reviewing all of the publicly available financial and other reports on the company, by observing the market performance of the company’s securities, by observing company operations and facilities, by talking to company employees and contractors—and use these studies to draw conclusions as to the desirability of investing in the company’s securities. Even though much of that analysis will be based on publicly available information, some of the information (such as interviews with company officials, which are consistent with fiduciary duties if authorized by the company),\textsuperscript{168} the

\textsuperscript{166} An eavesdropper who overhears a private, corporate conversation would fall into this category, as would a person who is tipped to a new corporate product by his brother-in-law, who is a machinist down at the plant. An analyst who interviews company employees would not fall into this category, so long as those employees were authorized, actually or apparently, to provide information to analysts.

\textsuperscript{167} \textit{Model Business Corporation Act} § 8.30 (1984).

\textsuperscript{168} See Fischel, supra note 2; Comment, \textit{An Examination of Investment Analyst Liability Under Rule 10b-5}, 1984 ARIZ. Sr. L. J. 129.

\textsuperscript{169} Where an analyst gains information about the company from people who have been authorized (expressly or by past practice) to give it, neither the analyst nor the provider of the information has done anything wrong. Similarly, where the analyst obtains information regarding the company from people whose use of that information is not restricted (by employment, contractual or other duties to the company), neither the analyst nor the provider of the information has engaged in any misconduct. Disclosure of criminal conduct on the part of the company or others can never be restricted. In these cases, the analyst should be free to use the information so received.

However, where the analyst knows that his or her corporate source of information is not authorized in any way to provide that information, the analyst’s use of that information is improper. Similarly, where the analyst receives information about the corporation from an outsider, but knows that the outsider has received the information without the corporation’s authority, the analyst should not use that information.

In dealing with corporate information, analysts (and others) should respect the corporation’s ownership rights.
analysis itself and the conclusions drawn from that analysis will not be publicly available. This is yet another form of inside information—information that is created by an outsider.

The purpose of the analyst in creating this information is, of course, to profit from it. Such a profit can be accomplished in many ways. The analyst can sell the information to other investors through a newsletter or other investment advisory service. The analyst can give the information to his or her clients in the hope that the client's trading activity on that information will generate brokerage or other fees (or general goodwill) for the analyst. The analyst can use the information for his or her own trading benefit, by buying or selling securities of the target company for his or her own account or, perhaps, by deciding to mount a takeover bid for the target company. In all of these situations, the ability of the analyst to profit from the analysis and conclusions that he or she has produced will depend on the ability of the analyst to use the information while it is still secret, for once the information becomes widely known whatever trading advantage it would have provided (and whatever value it once had) is lost.

Because an analyst creates information by his or her work, he or she ought to have rights in that information. When a corporation publicly discloses information, that information becomes part of the public domain and can no longer be regarded as a corporate asset. When a corporation, acting through its board or other authorizing person, authorizes employees or agents to provide information to analysts for their use in an investment analysis of the corporation, that information is no longer secret information owned by the company. Thus, the analyst who combines public information and company interviews to set forth an analysis and reach conclusions has not usurped or stolen anything; he or she has created new information—the analysis and conclusions—based on other information that he or she was given or that was already in the public domain. As the creator of this information, the analyst ought to be regarded as its owner, just as the scientist who develops a new product or the law professor who types out some gibberish (in the form of a law review article, of course) ought to be regarded as the owner of that creation (or monstrosity, as the case may be).

If the analyst owns the analysis and conclusions that he or she has produced, the analyst ought to be free to exploit them for his or her benefit. Whether the analyst chooses to invest directly or to sell or give the information to others who will invest, as owner and creator of the information the analyst should have the choice of how to exploit the information. This, of course, is not always the case under present insider trading doctrine. It would be the case were a property rights approach to insider trading to be implemented.

However, since most corporations are eager to cooperate with analysts, by authorizing their people to talk to them, such respect need not materially adversely affect the flow of corporate information to analysts.

170. See Fleischer, Mundheim and Murphy, supra note 61.
171. See supra notes 165, 166 and 169.
172. Rule 14e-3, 17 C.F.R. § 240.14e-3 (1986), for example prevents tender offer warehousing, a practice in which tender offerors share their analyses and conclusions with selected arbitrageurs. See infra notes 230–33 and accompanying text. For a discussion of warehousing, see Dooley, supra note 1, at 53; Fleischer, Mundheim and Murphy, supra note 61, at 811–12.
Also, under the property rights approach, unauthorized use of the analyst’s information would not be permitted. Thus, a thief who stole an analyst’s working papers or an eavesdropper who overheard an analyst’s telephone conversation would be precluded from retaining and using the benefits of that information, just as thieves and receivers of stolen goods are precluded from retaining and benefitting from those goods.\(^{173}\)

D. The Responsiveness of the Proposed Property Rights Approach to the Problems with Present Insider Trading Doctrine

Before leaving the part of this paper that describes generally the proposed property rights approach to insider trading, note that this approach seems to resolve the many difficulties (described above) with the insider trading doctrine that have developed under Rule 10b-5. Unlike the Rule 10b-5 approach, where misappropriators of inside information are sometimes sanctioned and sometimes not, depending on “relationships,” under the property rights approach anyone who, without authority, usurps inside information will be subject to sanction. Unlike the Rule 10b-5 approach, in which enforcement is up to the SEC and to market traders (who have not necessarily been harmed by the defendant’s insider trading), under the property rights approach enforcement will be left to the owner of the information that has been stolen or infringed.

By placing the plaintiff’s role with the person whose property rights have been infringed, the property rights approach also eliminates the difficult problems of causation and limitations on damages that have flowed from the use of Rule 10b-5 (and its purchaser/seller rule) in the insider trading area. Where the plaintiff is the owner of information that has been infringed upon by the defendant, there is no need to establish a causal connection between the defendant’s conduct and harm allegedly suffered by anonymous market participants, nor is there any need to worry about “draconian” damages. All that the plaintiff must establish is that he or she owned (or had rights in) the information, that those ownership or other rights were infringed by the defendant, and that the plaintiff suffered damage.

Also, when the plaintiff in an insider trading case is the owner of the inside information, rather than a market participant, it may be appropriate to base the plaintiff’s recovery for the defendant’s insider trading on the amount of the defendant’s profit. While those profits have no logical connection with the harm (if any) suffered by market participants, disgorgement of those profits may in fact provide an appropriate remedy when the plaintiff is the owner of the misappropriated inside information. Because the plaintiff/information-owner could have initiated and profited from such an insider trade, had the defendant not usurped the opportunity and done it first, it may be appropriate to compensate the plaintiff by awarding him or her the profits that the defendant usurped. Such a remedy would be analogous to the constructive trusts that are imposed in corporate opportunity cases, in which the fruits

\(^{173}\) See Easterbrook, supra note 2, at 331; Fischel, supra note 2, at 136; Scott, supra note 1, at 814.
of opportunities wrongly taken from the corporation are, by judicial order, held for the benefit of the corporation.174

E. The Responsiveness of the Proposed Property Rights Approach to the Concern of the Securities Exchange Act for the Protection of Investors

While the property rights approach to insider trading solves these analytical difficulties under the present doctrine, it does not ignore the need, articulated in the Securities Exchange Act,175 to protect investors. Not only do corporate and other owners of information have substantial incentives to sue those who usurp and benefit from that information,176 where the owner is a corporation the shareholders of that corporation can sue derivatively to enforce that corporation’s rights.177 Because attorneys’ fees are often recoverable by such derivative plaintiffs,178 and because there generally is no dearth of shareholder plaintiffs to represent the corporate interest when a breach of fiduciary duty or misuse of corporate property is involved,179 the threat of litigation by the owner of the property (or the shareholders of the owner) ought to provide some deterrence and protection of investors from the alleged evils of insider trading. To the extent that investors are insufficiently protected by this approach from those evils, the SEC could remain involved in insider trading enforcement, at least to the extent of terrorizing insider traders with the threat of treble “damages” under the Insider Trading Sanctions Act of 1984.180

More importantly, however, as previously indicated181 and as discussed in Part III of this Article, it is not at all clear that insider trading is an evil from which investors need to be protected. If insider trading is in fact beneficial (or at least not harmful) to investors, then it is irrelevant whether the property rights approach deters or fails to deter insider trading. Either way, investors are not harmed; they need no protection from things that are not harmful.

176. If inside information is regarded as an asset to be owned by the corporation or analyst, then the trading on that information by an unauthorized person denies the owner of the information the opportunity to authorize others to make that trade or, perhaps, to trade on the information itself. Thus, in these circumstances, the use of the information by the unauthorized user is like the taking of a corporate opportunity or the conversion of a person’s assets. Since it is appropriate for the owner to reclaim converted assets (or usurped opportunities), plus the profits made by the wrongdoer from them, the owner will have a substantial incentive to sue. Under the property rights approach it will have a legitimate claim to the profits (perhaps substantial profits) made by the wrongdoer. Where that owner is a business enterprise, its managers will have to consider their fiduciary duties to the enterprise and its owners before declining to assert that claim.
179. Id. at 888.
180. 15 U.S.C. § 78u(d)(2)(A) provides that an insider trading defendant can be liable to the United States Treasury for an amount equal to three times the amount of his or her illegal insider trading profits.
181. See supra notes 143–45 and accompanying text.
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III. THE CONSISTENCY OF THE PROPERTY RIGHTS APPROACH WITH THE ECONOMIC ARGUMENTS CONCERNING THE PRESENT INSIDER TRADING DOCTRINE

As is well known, there have been numerous articles, both in the law reviews and the economics journals, that employ economic theory to analyze and criticize insider trading doctrine. While this modest article does not and could not purport to provide such analysis (since the author has little training in, and probably even less understanding of, economic theory), it would be inappropriate in an article such as this to ignore that important body of work. Therefore, in this part the Article attempts to identify some of the major economic criticisms of insider trading doctrine and to demonstrate that the property rights approach satisfactorily responds to those criticisms.

A. The Need to Provide Incentives and Rewards for Investment Analysis

Beyond the common law fraud and other rhetoric of the Chiarella and Dirks opinions, the Supreme Court’s fundamental messages in those cases appear to be a) there should be no blanket prohibition on the use of informational advantages in securities trading, and b) the development and use of at least some informational advantages, such as occurred in Dirks, is socially useful. Thus, the task of the policy makers is to distinguish between socially useful and socially harmful informational advantages, so that the former can be encouraged and the latter prohibited.

But this is not a new message. For years, commentators have argued that insider trading regulation should not stifle the flow of information to the securities markets by impeding the work of professional and non-professional analysts of all kinds. As Dirks recognizes, professional securities analysts play a very useful role in evaluating companies and their securities and bringing information and recommendations about them to their clients, investors in the marketplace. Important as professional securities analysts are to the information flow of the marketplace, others contribute to the efficient operation of the market as well. The potential tender offeror, the potential insurgent in a proxy fight, the arbitrageur looking for a short term purchase and resale of a presently undervalued security, and the ordinary

183. See supra notes 69–81 and accompanying text.
184. See supra notes 143–45 and accompanying text.
185. See, e.g., Dooley, supra note 1, at 72; Fischel, supra note 2, at 130; Fleischer, Mundheim and Murphy, supra note 61, at 830. The Supreme Court has also recognized that investment analysis is important to the marketplace, Dirks v. SEC, 463 U.S. 646, 658 (1983), and that the tender offers that sometimes result from the analysis of the offeror are beneficial to the economy. See, e.g., Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 26-36 (1977); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 591–95 (1973).
investor (if there is such a thing) who is looking for the best buy for his or her dollar—all of these persons contribute to the efficiency of the market when, through their study of the information available to them, they conclude to buy undervalued securities (or sell overvalued ones), thus moving the price of the misvalued securities towards the value that the investor thinks proper.

To the extent that a revaluation of securities occurs through the buying and selling of persons (or authorized tippees of persons) who have concluded from their analysis that those securities are currently improperly valued, the market and, indeed, society benefit because resources are now better allocated to their appropriate uses. Thus, as the economists (and the economics-friendly law professors) have been telling us for years, our insider trading doctrine must encourage rather than discourage the development and use of investment analysis and the resulting conclusions.

The property rights approach to insider trading, outlined above, provides incentives to analysis by permitting the owner of the information to trade on (and profit from) that information or authorize others to do so. Thus, the corporation that develops new information about itself (e.g., that a new product has been developed or that a significant new asset has been acquired) ought to be able to use that information for the best interests of the corporation and its shareholders, just as the analyst ought to be able to use for his or her best interest the analysis and conclusions that he or she creates based on legitimate sources of information (such as publicly available reports and interviews with company officers who have been authorized to disclose information). While the desirability of analysis was of course recognized in Dirks, the reasoning there employed and the test there created by the Court to absolve the analyst from insider trading liability were both far more complex than the simple property rights approach here proposed.

The property rights approach encourages analysis and the development of new ideas and conclusions by permitting the owner of that information to use it as he or she sees fit, and by prohibiting anyone but the owner (and users authorized by the owner) from using that information. Thus, a person such as Chiarella, who had done nothing to create the information that he used, who had not been authorized to use that information by its owner, and who had, therefore, simply stolen that information, would violate the property rights version of the insider trading doctrine were he to trade in the circumstances of that case. Similarly, the property rights approach would preclude employees, such as those in Texas Gulf Sulphur, from trading on corporate information where, as there, they had not been authorized to do so by the corporation that owned that information. This prohibition on the use of informational advantages by all persons other than the owner (and the owner’s authorized users)


188. As used here, this term includes more than the professional investment analyst. It includes anyone who, by his or her own efforts, develops information and conclusions regarding the desirability of investing in particular securities.

189. See supra notes 106–10 and accompanying text.

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also promotes the development of information by recognizing and protecting the rights of the owner in the information created.

Thus, the property rights approach distinguishes between socially useful and harmful informational advantages, permitting the former and proscribing the latter. By basing this distinction on the notion of ownership of the information, the property rights approach also deals with the concern—expressed in Section 2 of the Securities Exchange Act—that the securities markets be fair.\textsuperscript{191} Because the users of informational advantages under this approach are those who have created the information and who may trade on the information directly or authorize others to do so, there should be much less concern for the fairness of the markets under this approach than under present insider trading doctrine. While present doctrine permits trading by some usurpers of information—people such as Mr. Chiarella who have done nothing to create the information that they use—the property rights approach proscribes such trading, thereby eliminating the substantial fairness concern with people profiting from information that they did not create and were not authorized to use.

B. Insider Trading Provides Information to the Market and Points the Market in the Right Direction

Sometimes the securities markets do not properly value securities simply because relevant information concerning the securities is not known to the marketplace. Such information could be corporate information—for example, that the corporation has acquired significant new assets or is about to be sued for billions of dollars—or market information—for example, that an investor, having concluded from his or her analysis that a company's securities are undervalued, is about to start buying (and recommending that his or her friends and clients buy) significant amounts of securities. In either case, there may be no obligation (nor should there be an obligation) that the corporation or the investor disclose the information to the market.\textsuperscript{192}

With respect to corporate information, the decision of the board of directors or authorized corporate officer not to disclose that information obviously indicates a determination by that body or person that the best interests of the corporation and the shareholders would be better served by concealment than by disclosure. That


\textsuperscript{192} The federal securities laws do not require disclosure of material information in all circumstances. Under Section 7 of the Securities Act of 1933, 15 U.S.C. § 77q (1982), a company's registration statement for a public offering of securities must contain all material information required to prevent the information presented from being misleading. Similarly, under Section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78m (1982), reports that the company is required to file with the SEC must be complete and not misleading. However, when a company is not in the process of registering securities or filing reports with the SEC it has no duty under the federal securities laws to disclose information—even important information—to the public. If the company is in possession of such undisclosed information, its insiders are precluded from trading in its securities under the so called "disclose or abstain rule" announced in the Texas Gulf Sulphur case and discussed infra in notes 193-95 and accompanying text.

However, companies that have listed their securities on stock exchanges are subject to the requirements of the exchange. Such requirements may include an undertaking on the part of the corporation to promptly disclose material information concerning the enterprise.
determination having been made, no individual corporate agent would then be authorized to make disclosure of the information to the market.

Existing insider trading doctrine recognizes the ability of the corporation to serve its and its shareholders best interests by withholding even material information, at least so long as the failure to reveal the information does not render misleading any report, press release or registration statement that the company might make. However, while material information remains undisclosed by the company, insiders are prohibited by existing doctrine from trading in the company’s securities. This is the so called “disclose or abstain” rule, which does not mandate disclosure; in fact, because most corporate agents are not authorized to disclose the inside information, the typical means of complying with this rule is by abstention rather than by disclosure.

Thus, companies routinely possess information, including significant information, which is not known to the marketplace and which, if known, could have a significant effect on the valuation of the company’s securities. Not only is this permitted by existing doctrine, it is also desirable under the proposed property rights approach, since the company, as owner of the information in question, ought to be able to decide that corporate and shareholder interests would be served best (if that is the case) by withholding the information or, alternatively, to decide that those interests would be served best (if that is the case) by the disclosure of the information to the public.

Similarly, analysts routinely possess information about companies that is not publicly known which, if it were publicly known, would affect the value of the company’s securities. Here again, existing doctrine does not coerce the revelation of this information. As Dirks recognized, there is a need to provide incentives to analysts to provide the useful, analytical services that they bring to the market. If their analyses and conclusions had to be made public before the analyst could profit from them, there would be no incentive for analysis.

Recognizing, therefore, that the market does not immediately receive all of the information that it needs to “properly” value securities, should insider trading in the undisclosed information be permitted? One response is that insider trading should not be permitted because it is unfair to permit some to have and use informational advantages over others. However, because the Supreme Court has clearly rejected a blanket prohibition on informational advantages, and because present insider trading doctrine permits insider trading in situations (like Chiarella) where the use of inside information is clearly unfair, this response is not adequate. Furthermore, as earlier indicated, if the proposed property rights approach were to be adopted, it would go a long way toward eliminating unfairness as a concern in insider trading.

194. Id.
195. See Carlton and Fischel, supra note 1, at 885.
196. See supra note 60.
198. For analyses of this response, see Easterbrook, supra note 2, at 323; Scott, supra note 1, at 805.
199. See supra notes 115-17 and accompanying text.
A better response would be to permit insider trading if it is beneficial to the market or to prohibit it if it is not. When a corporation decides to authorize employees or others to buy its securities, because it has favorable, undisclosed information which indicates that the securities are undervalued, those purchase orders by insiders will result in an increased demand for the securities, thereby increasing their market value. Similarly, when an analyst tells his or her clients to sell securities, because the analyst has developed information indicating that they are overvalued, those sell orders will result in an increased supply of those securities, thus decreasing their market value. In both cases, the trading by the insider moves the market value in the direction that it would have moved, had disclosure of the inside information been made. Thus, unlike misrepresentations or misleading statements (which move the market in the direction opposite to the true information), trading on undisclosed, accurate information moves the market in the proper direction.

This effect of insider trading is beneficial to the market and to investors who may be buying or selling the company’s securities. Because the company and/or the analyst have the right not to disclose inside information (within the limits previously discussed) when that is in their best interests, the alternative to insider trading is not public disclosure; it is abstention by insiders from trading. However, were insiders to so abstain, the market would be denied the partial information that it receives from the market activity of the insiders—activity that at least moves the market in the direction that it will take when full disclosure is made. In short, a half a loaf (provided by insider trading) is better than nothing at all.

The proposed property rights approach to insider trading allows this half loaf to be provided to the securities markets. Because that approach permits owners of the inside information to use it in any way they choose, those owners can trade themselves or permit others to do so. Thus, where trading or tipping serves the best interest of the owner, presumably insider trading will take place, either by the owner or his or her tippee, with the effect that the market will be moved in the direction consistent with the nature of the information.

C. The Plaintiff Would Have Traded Anyway

Closely related to the economic argument that insider trading is beneficial to the market is the argument that present insider trading doctrine is illogical in allowing persons who have not been injured to litigate and recover as plaintiffs. Because these persons would have traded anyway, even absent insider trading in the marketplace, it makes no sense to allow them to sue the insider trader who did them no harm and who may, in fact, have helped them get a better price for their securities.

The observation that market participants who bought or sold (while lacking the inside information on which the defendant was engaging in transactions of the opposite character) would have done so anyway logically follows from the nature of

200. See Carlton and Fischel, supra note 1, at 883; Easterbrook, supra note 2, at 318.
201. Id.
202. See supra note 192 and accompanying text.
the present insider trading proscription, which is that the insider must disclose or refrain from trading. Given the disjunctive nature of this proscription, it is perfectly possible (and, as earlier indicated, in most cases quite certain) that compliance with this rule will not result in disclosure.\textsuperscript{203} Since the insider's abstention from the market will satisfy the rule and since most insiders are not authorized or disposed to disclose the information that they have, in most cases abstention rather than disclosure is the means of compliance with the present doctrine. Because compliance does not require or, as a practical matter, result in disclosure, the insider trading has not harmed those market participants generally (or even those who specifically allege that they would not have traded had they known the inside information), for those participants would have traded even if the insiders had complied with the law by staying out of the market.\textsuperscript{204}

In fact, as earlier indicated, it is very likely that the insider trading of which these plaintiffs complain actually benefitted them. Because an insider's purchases of securities increase the market value of the securities,\textsuperscript{205} the shareholder who sells in the market while insider buying is going on should receive more on the sale than he or she otherwise would receive. Similarly, because an insider's sales of securities decrease the market value of those securities, the investor who buys in the market while insider selling is going on should buy at a lower price than he or she would otherwise have to pay.

The proposed property rights approach to insider trading is consistent with the view that market participants should not be plaintiffs in insider trading litigation. Under the proposed approach, the owner of the information should be the sole private plaintiff. If that owner has not authorized the use by the defendant of the information in question, that owner—the one whose property has been stolen and who therefore has clearly been harmed—is the proper person to bring the lawsuit. Thus, the property rights approach avoids the use of inappropriate, unharmed plaintiffs in insider trading litigation.

D. Insider Trading as a Means of Compensation

One legitimate use of insider trading, it has been argued,\textsuperscript{206} is to compensate corporate managers for their contributions to the company. When an employee has developed a new product or discovered new minerals, one way to reward him or her is to allow that person to buy corporate securities at their present price, in anticipation of the price increase that will follow the subsequent corporate announcement of the development. Of course, using insider trading as a means of compensation is appropriate only where developments are favorable; where the managers have run the enterprise into the ground they ought not be "compensated" by being allowed to bail

\textsuperscript{203} See supra notes 192-200 and accompanying text.

\textsuperscript{204} See Carlton and Fischel, supra note 1, at 889; Dooley, supra note 1, at 21; Macey, supra note 4, at 47-48.

\textsuperscript{205} See Carlton and Fischel, supra note 1, at 868; Easterbrook, supra note 2, at 335.

\textsuperscript{206} For discussions of this argument, see Carlton and Fischel, supra note 1, at 858, 876; Easterbrook, supra note 2, at 332; Scott, supra note 1, at 908.
out of their company securities before the market gets the news that the company is in trouble.\textsuperscript{207}

As with all compensation matters, the decision to use insider trading to compensate a particular person ought to be within the discretion of the board of directors or of the officer or committee, if any, to whom or to which the board has delegated authority over corporate compensation matters.\textsuperscript{208} In exercising that discretion, the authorized body obviously must act in the best interests of the enterprise and its owners.\textsuperscript{209} Thus, while it might be appropriate to permit a creative employee to trade on the undisclosed information of his or her new invention for the company since compensation for such inventions may serve the company's best interest, it would not be appropriate to permit poorly performing managers to bail out before news of the company's misfortune is known since extraordinary compensation for malperformance is not in the company's best interest.

While there are, of course, many other (and better) ways to compensate employees than insider trading,\textsuperscript{210} the use of insider trading as a compensation mechanism is allowed under the proposed property rights approach. Under that approach, the corporate owner of the inside information may authorize others, including employees or agents of the corporation, to use such information when that is in the corporation's best interests. Thus, if those interests would be served by using insider trading to compensate a particular employee, the corporation could do that consistent with the proposed property rights approach.

The proposed property rights approach to insider trading regulation seems to respond well to the economic criticisms and concerns identified above. Because of its consistency with economic theory and its ability to overcome many of the difficulties with our present, problematic insider trading doctrine, the property rights approach has much to commend it. The final question, to be addressed in the next part of this Article, is how and under what authority to implement this proposed approach.

IV. THE IMPLEMENTATION OF THE PROPOSED APPROACH

A. Implementing the Proposed Approach Under State Corporation Law

As is obvious from the earlier discussion, one way to at least partially implement the proposed property rights approach is through state corporation law. Under those state laws, directors, officers, controlling shareholders, and certain other employees and agents have fiduciary responsibilities to the enterprise.\textsuperscript{211} Among those fiduciary duties is the duty of loyalty—the duty to put the best interests of the enterprise ahead

\textsuperscript{207} For an example of this type of situation, see Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

\textsuperscript{208} See H. HENN AND J. ALEXANDER, LAWS OF CORPORATIONS 665-70 (3d ed. 1983).


\textsuperscript{210} See supra notes 206-08.

of one's personal interests.\textsuperscript{212} A variant of the duty of loyalty is the "corporate opportunity" doctrine, under which fiduciaries are not supposed to take for themselves business opportunities which are connected with the enterprise's business activities, unless the governing body of the enterprise has authorized the fiduciary's taking of that opportunity.\textsuperscript{213}

These general fiduciary duties obviously have relevance in the insider trading area, at least where the person who trades on inside information is a fiduciary to the corporation or enterprise in whose securities he or she trades. If one accepts the notion that inside information regarding the enterprise is owned by the enterprise and that the enterprise can do with it what it wishes, then the act of an officer, director, or other fiduciary in taking and trading on that information (without authority) for himself or herself violates the duty of loyalty; such a taking puts personal interest ahead of the interests of the enterprise.

Such a taking also arguably constitutes the usurpation of a corporate opportunity. If the information taken and traded on was in fact that of the enterprise, on which the enterprise itself could have traded (or otherwise profitably dealt), the taking of that opportunity by an officer, director, or other fiduciary seems a violation of the corporate opportunity doctrine.

Even if the corporate opportunity doctrine is somehow inapplicable, if one accepts the notion that undisclosed information regarding corporate developments and activities is an asset of the corporation, then the taking and use of such a corporate asset by an unauthorized fiduciary obviously raises serious fiduciary duty issues. Corporate assets are not supposed to be used for personal purposes; they are supposed to be used for the best interests of the corporation and its shareholders.

Of course, if the board of directors of the corporation (or governing body of a non-corporate enterprise) were to determine that an officer, director, or other fiduciary should be able to trade on inside information regarding the enterprise, under the proposed property rights approach such trading would raise no fiduciary duty problems. Such a determination indicates that the board or governing body believes that such trading is in the enterprise's best interest and that the enterprise consents to the use of its informational asset in that way. Thus, since the board controls the affairs of the corporation,\textsuperscript{214} when the corporation's consent has been given in this way there is no breach of the duty of loyalty,\textsuperscript{215} no usurpation of corporate opportunities\textsuperscript{216} and no improper personal use of corporate assets when the authorized insider trades.

The idea of using state corporate fiduciary duty concepts to regulate insider trading by those with a fiduciary duty to the enterprise is not new. In \textit{Diamond v.}
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Oreamuno, the New York Court of Appeals determined that shareholders suing derivatively on behalf of the corporation could state a cause of action for breach of fiduciary duty against officers who sold their corporate securities on the basis of undisclosed, adverse information regarding the corporation's earnings. In reaching the conclusion in 1969 that state fiduciary duty concepts should apply to insider trading by corporate officers and directors, that court was influenced by what it then perceived to be a paucity of effective federal regulation of insider trading.

During the early 1970s, of course, federal regulation of insider trading under Rule 10b-5 flourished, proving (at least for a while) that the Diamond court's concern about lack of federal regulation was misplaced. While the Supreme Court has, since the mid-1970s, attempted to restrict the lower courts' expansive use of Rule 10b-5 between 1969 and 1975 those courts put that rule to creative and ever expanding uses in a number of areas, including insider trading. It was after this expansion that the Diamond doctrine—that state corporate law fiduciary principles could be used to proscribe insider trading—was rejected by other courts.

Perhaps one reason for this rejection of the doctrine was the view by those courts that Diamond, which had been based in part on the court of appeal's concern about lack of federal regulation, was no longer an appropriate decision in light of the development of that regulation. If that is so, the courts might be less emphatic in their rejection of Diamond today since the use of Rule 10b-5 as a regulator of corporate conduct, including insider trading, is now contracting rather than expanding (as it was at the time of Diamond's rejection).

Whether or not the development of federal regulation contributed to Diamond's rejection by the courts, one clear reason for that rejection was the courts' inability to conclude that insider trading harms the corporation. Since a derivative plaintiff suing on behalf of the corporation must allege damage to the enterprise, absent damage to the corporation courts were unwilling to follow the Diamond rationale and let derivative suits proceed for breach of fiduciary duty through insider trading. While the Diamond court had found damage to the corporation through the reputational harm that the enterprise suffered from the disclosure that its officers were insider traders, other courts were unwilling to make this finding.

To the extent that damage to the enterprise has been a stumbling block to the use of fiduciary duty principles to regulate insider trading under state law, that should not

220. See generally R. JENKINS AND H. MARSH, supra note 42, at 912–22; Dooley, supra note 1; Scott, supra note 1.
222. See supra note 24.
223. See supra note 211. Although the Supreme Court has clearly sought to curtail the reach of Section 10b and Rule 10b–5, the lower courts often resist the Supreme Court's teachings in this area. See, e.g., R. JENKINS AND H. MARSH, supra note 42, at 951–52.
224. See W. Cary AND M. Eisenberg, supra note 178, at 897–98.
225. See supra note 24.
be the case if the proposed property rights approach is adopted. If the proposed property rights approach were adopted, there would be no question that the corporation, such as the one in *Diamond*, suffered damage when its officers traded on undisclosed, corporate information without authority; that information is an asset of the corporation, the unauthorized taking of which harms the corporation just as the unauthorized taking of a company car for personal use harms the corporation.

Thus, while state law fiduciary duty concepts have been used somewhat unsuccessfully in an effort to regulate insider trading under state law, it may be time to try those concepts again. Because of the change in the federal regulatory climate and because the proposed property rights approach is responsive to at least one of the major problems that courts previously found with *Diamond*, the time for regulation of insider trading through state corporate law, fiduciary duty principles may now have come.

Of course, state corporate fiduciary principles are useful in the regulation of insider trading only when the trading is being done by a person (or the tippee of a person) who is subject to such principles, such as an officer, director, or controlling shareholder. Where the defendant is an outsider, who has no fiduciary duty to the enterprise, those principles may not apply.

However, even assuming that an “outsider” is not subject to state law fiduciary duty concepts, he or she is still subject to state law conversion principles. Thus, the outsider who takes information developed and owned by another and uses it without authority for his own benefit can be liable in conversion to the owner of that information.

Also, it may be that such an “outsider” breaches a state law fiduciary duty when he or she trades or tips. Where the trading or tipping person has no relationship to the company in whose securities he or she trades, but has an agency or employment relationship with the analyst (or other person) from whom information about the company was taken, that person may violate a fiduciary duty to that analyst in taking information for his or her own use.

B. Implementing the Proposed Approach Under Federal Securities Law

While one way to implement the proposed property rights approach would be through the use of state law, in light of the historical reliance on federal law as a regulator of insider trading, it would be inappropriate to conclude this Article without considering whether the proposed approach could be accomplished under existing federal securities law. As the following analysis attempts to demonstrate, a portion of the proposed approach could be implemented, were the courts and the SEC so

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227. See supra note 211.
228. See, e.g., United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1983); O’Connor & Associates v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981); note 241, infra. The Supreme Court has yet to pass on the theory embraced in these cases—that breach of duty to a person other than the issuer of the securities can constitute a fraud for purposes of Rule 10b-5. There is language in *Dirks* which suggests that the Court will not embrace this theory, when and if it is presented. See *Dirks* v. SEC, 463 U.S. 646, 654-64 (1983).
229. State fiduciary duty principles are not the only possible means of implementation at the state level. Specific legislation dealing with this proposal is another possibility. See, e.g., *Cal. Corp. Code* § 25402 (West 1977).
inclined, under the authority of the existing statutory and administrative framework of the federal securities laws. However, because of Rule 10b-5's purchaser-seller standing limitation, and because not all of the proposed approach will fit within the "fraud" language of that Rule, it would be better to adopt the proposed approach through new federal legislation specifically designed for that purpose.

Insider trading is regulated under federal securities law by Section 16b of Securities Exchange Act, Section 10b of that statute and Rule 10b-5 thereunder, and Rule 14e-3 under Section 14e of the Securities Exchange Act. Rule 14e-3 is inconsistent with the proposed property rights approach. Among other things, this rule precludes a tender offeror (or authorized people connected with the tender offeror) from tipping information about the planned tender to others.

This rule, therefore, prevents "warehousing," a practice in which the tender offeror alerts arbitrageurs to the pendency of the tender, in advance of the public announcement of it, so that they can buy up target company securities with a view to reselling them in the tender. Warehousing is obviously beneficial to the tender offeror—if it were not beneficial, tender offerors would not help arbitrageurs to engage in it—since it places target company securities in the hands of persons (the arbitrageurs) who are eager to sell out in the tender offer.

Rule 14e-3's prohibition on warehousing and other forms of tipping of information by the tender offeror to others is obviously inconsistent with the proposed property rights approach to the regulation of insider trading. Under the property rights approach, the tender offeror, who has analyzed the target company, concluded that its securities are undervalued, and determined to make a tender offer for those securities, is regarded as the owner of that information. As such, he or she should be free to do with that information what he or she wishes, including giving it to others, such as arbitrageurs, for purposes that will benefit the tender offeror. To the extent that Rule 14e-3 prevents this, it is of course inconsistent with the proposed property rights approach.

However, Rule 14e-3 need not necessarily remain the law (assuming for the moment that it is the law). Were the SEC to subscribe to the proposed property rights approach, it could easily amend the rule to make it consistent with that approach. Furthermore, there have long been substantial doubts as to the validity of Rule 14e-3, due to the fact that it attempts to preclude under Section 14e conduct that the Supreme Court said could not be precluded under the similar (but not identical) language of Section 10b. The doubts about Rule 14e-3's validity are now even greater, after the Supreme Court's recent pronouncement that Section 14e can regulate only manipulative and deceptive conduct.

230. See supra note 172.

231. See supra note 85.


233. See supra note 172.

234. See supra notes 88–89.


236. In Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985), the Supreme Court interpreted Section 14e in light of the Court's Section 10b jurisprudence and held that the term 'manipulative' as used in § 14(e) requires...
While Rule 14e-3 in its present form is clearly inconsistent, at least to some extent, with the proposed property rights approach to the regulation of insider trading, Section 16b is clearly consistent with that approach. This is because Section 16b really has little to do with insider trading; it simply prevents short swing trading by officers, directors, and certain shareholders, whether or not they have any inside information. Therefore, since inside information is usually irrelevant to the application of the statute, the ownership of that information and the circumstances of its acquisition are also usually irrelevant.

That leaves Section 10b and Rule 10b-5, the provisions under which most federal regulation of insider trading has taken place. Can the proposed property rights approach be adopted under the authority of, and consistent with, the language of those provisions?

Because Section 10b proscribes manipulative and deceptive securities-connected conduct, the Supreme Court has said that the kind of conduct actionable under that section (and Rule 10b-5 thereunder) is fraud. The Supreme Court has already indicated that insider trading is fraudulent when it breaches a fiduciary duty that the trader owes to the company in whose securities he or she trades. Thus, there is no question that the usurpation of corporate information by an officer, director, or other fiduciary constitutes fraud. The property rights approach is therefore compatible with Section 10b and Rule 10b-5, at least to the extent that it proscribes the usurpation by corporate officers and directors of information owned by the corporation.

Where insider trading is based on inside information taken from an analyst, such as his or her conclusion that a particular security is misvalued by the market, that trading may or may not be fraudulent. Where the usurper has a fiduciary relationship to the analyst from which the information was taken, as Mr. Chiarella may have had to the tender offeror in that case, the misappropriation of that information is probably fraudulent. Where the usurper of the information has no relationship with the person from whom the information was taken or with the company to which the information relates (as would be the case, for example, where a thief, burglar, or eavesdropper simply stole information from an unrelated analyst or corporation), the question becomes whether that sort of thievery constitutes fraud within the meaning of Section 10b and Rule 10b-5.

misrepresentation or nondisclosure. It connotes 'conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.' Since conduct such as Chiarella’s was not fraudulent, manipulative or deceptive for Section 10b purposes, query whether it can now be so regarded for Section 14e purposes.

237. See Easterbrook, supra note 2, at 315; Phillips and Zutz, supra note 4, at 72.
Because there is authority for the proposition that stealing assets can constitute fraud for purposes of Section 10b and Rule 10b-5,242 it is at least arguable that any theft of information owned by another is fraudulent. If that is so, then any unauthorized insider trading on information owned by another (in violation of the proposed property rights approach to insider trading) always comes within Section 10b and Rule 10b-5.

However, the authority for that proposition is not unassailable.243 It includes the Supreme Court’s opinion in *Superintendent of Insurance v. Bankers Life and Casualty Co.*244 case (the continuing vitality of which has been questioned), in which the Court determined that a private plaintiff could state a cause of action under Rule 10b-5 against a person who, in connection with his misappropriation of corporate assets, caused the corporation to sell securities and lied to the corporation’s directors about the disposition of the proceeds of that sale.245

While the *Bankers Life* case has been cited for the proposition that “just plain stealing” amounts to fraud for purposes of Rule 10b-5,246 the case did not involve insider trading and did involve an affirmative misrepresentation—a fraud—in addition to the theft of corporate assets.247 Accordingly, it has been argued that the case does not support the proposition that a theft of information in connection with insider trading constitutes fraud for purposes of Rule 10b-5, and that something other than theft is required to bring that rule into play.248

The other authority that supports the proposition that misappropriation of information owned by another should constitute a fraud for purposes of Rule 10b-5 is Chief Justice Burger’s dissent in *Chiarella*.249 While the Court and commentators continue to discuss the notion that misappropriation of information might be fraudulent under Rule 10b-5, the Court has not yet accepted that idea.250

Thus, when an eavesdropper, burglar or thief steals and trades on information owned by another, he or she contravenes the proposed property rights approach to insider trading, by using information owned by another without permission. However, he or she may not violate Section 10b and Rule 10b-5, as presently construed, since the theft of that information may not constitute fraudulent conduct. That section and rule are violated though by a person, such as an officer or agent, who steals information from one with whom he has a fiduciary relationship.251 Therefore, Section 10b and Rule 10b-5 can subsume most, but not all, of the insider trading situations covered by the proposed property rights approach. To cover insider trading

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243. See Aldave, supra note 71, at 118–19.
244. 404 U.S. 6 (1971).
245. Id. at 10.
246. R. JENNINGS AND H. MARSH, supra note 42, at 949.
248. See Aldave, supra note 71, at 118–19.
by eavesdroppers, burglars, and thieves (an insignificant portion of the insider trading population, one would guess), it may be necessary to amend the statute and rule, or to rely on the state law principles discussed above.

A more important problem with the integration of the proposed property rights approach into the existing language of Section 10b and Rule 10b-5 arises because of the purchaser-seller standing limitation imposed by that Rule in private litigation. Under that Rule, private plaintiffs in Rule 10b-5 cases must have purchased or sold securities. However, in many cases, the owner of misappropriated inside information will not be such a purchaser or seller of securities, and so will not qualify as a private plaintiff under that existing statute and rule.

Since the proposed property rights approach is based on the idea that the owner of the information should be the one to complain of its misuse, this purchaser-seller is obviously a major impediment to the implementation of the proposed approach under Section 10b and Rule 10b-5. A legislative modification would therefore be appropriate, were the proposed property rights approach to become part of federal securities law.

CONCLUSION

The purpose of this Article has been to try to set forth a simplified framework for the analysis and enforcement of restrictions on insider trading. As the Article has demonstrated (at least the author hopes so), treating inside information as property, determining the owner of that property, and permitting the owner to exercise rights of ownership with respect to that property, eliminate many of the existing problems with, and criticisms of, our insider trading doctrine. Were this simple approach to be implemented, it could be accomplished under state law or, with revisions to Section 10b and to Rule 14e-3, under federal law.