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A DYNAMIC DEFINITION OF AND PROHIBITION AGAINST INSIDER TRADING

Oliver Perry Colvin*

Insider trading—the unfair use of material, nonpublic information concerning an issue of securities—threatens to undermine the integrity of the national securities markets. The Securities and Exchange Commission (SEC), the guardian of America's securities markets, “has repeatedly declared that the eradication of trading on inside information is one of its top priority enforcement targets.”¹ Beyond doubt, the SEC's vigorous prosecution of insider trading cases will continue throughout the 1990s.² Unfortunately, the law governing insider trading presently consists of an incoherent maze of discordant administrative and judicial opinions built upon inappropriate fraud-based concepts. Lacking clearly articulated and consistently applied principles, the piecemeal development of the law of insider trading has driven the individual investor from the market and, at the same time, paralyzed securities professionals.³

Nevertheless, with the despised inside trader⁴ targeted as

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* B.A., 1985, University of California, Davis; J.D., 1988, Santa Clara University; LL.M., 1991, Georgetown University Law Center. I wish to thank Srila Colvin for her encouragement, and Basil Fthenakis, Robert Haft, and Daryl Miller for their helpful comments. Of course, all errors are my own.

1. T. HAZEN, *THE LAW OF SECURITIES REGULATION*, 13.9 at 137 (2d ed. practitioner's edition 1990); see also *Insider Trading Act of 1987*, Aug. 7, 1987, reprinted in 19 *Sec. Reg. & L. Rep. (BNA)* 1284-86 (Aug. 14, 1987).

2. See Mathews, Levine, Citera & Bracher, *The SEC's 1988-89 Enforcement Program: Part II*, 4 *Insights* 10, 11 (Feb. 1990).

3. See Day, *Small Investors Fold Their Hands*, *Wash. Post*, Nov. 18, 1990, § H, at 1 (reporting that in 1965, individuals owned 84% of publicly traded equities. In 1989, individual ownership of publicly traded equities dropped to just 56%).

4. Indeed, the terms “inside trader” and “insider trading” are misnomers. Under current administrative and judicial interpretations, liability for insider trading extends far beyond the classic, high-placed corporate officer and encompasses lawyers, doctors and housewives. See, e.g., *SEC v. Grossman*, No. 1287 Civ. 1031 (SWK) (S.D.N.Y. Feb. 17, 1987) Lit. Rel. No. 11359 (LEXIS, Bankers Library, Security Regulation) (alleged insider trading by lawyer); *United States v. Willis*, 737

the principal threat to the nation's capital markets, Congress has acted in recent years to increase the civil and criminal penalties for illegal insider trading.⁵ For example, in 1984 Congress amended section 21 of the Securities Exchange Act of 1934⁶ to provide the SEC with authority to seek a civil money penalty of up to three times the profit gained or the loss avoided by an inside trader.⁷ In addition, the 1984 Act increased the criminal fines for insider trading from \$10,000 to \$100,000.⁸ In 1988, Congress again moved to beef up the penalties for insider trading violations.⁹ The 1988 Act even authorized the SEC to award bounties to individuals who assisted in the apprehension and prosecution of inside traders.¹⁰

Paradoxically, the federal securities laws neither define, nor expressly prohibit, insider trading. Instead, liability for insider trading has grown out of a curious and inconsistent "hodgepodge" of administrative¹¹ and judicial¹² interpretations of section 10(b),¹³ the general antifraud provision of the

F. Supp. 269 (S.D.N.Y. 1990) (psychotherapist convicted of insider trading); *SEC v. Raab*, No. 90-3291 (DLJ) (N.D. Cal. Nov. 20, 1990) (alleged insider trading by housewife).

5. The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified at 15 U.S.C. §§ 78c, 78o, 78t, 78u and 78ff (1988)); and The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C.).

6. 15 U.S.C. §§ 78a-78ll (1988) [hereinafter the Exchange Act].

7. 15 U.S.C. § 78u-1(a)(2) (1988).

8. 15 U.S.C. § 78ff (1988).

9. The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. (1988)). In particular, the 1988 Act imposed harsh civil penalties on "controlling persons" of convicted inside traders. *See* 15 U.S.C. § 78u(a)(3) (1988).

10. 15 U.S.C. § 78u-1(e) (1988).

11. *See, e.g., In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

12. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. SEC*, 463 U.S. 646 (1983); *Carpenter v. United States*, 484 U.S. 19 (1987).

13. 15 U.S.C. § 78j(b) (1988). This section provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for

Exchange Act, and rule 10b-5¹⁴ promulgated thereunder, among other provisions. Not surprisingly, the judicially crafted parameters have resulted in an "intolerable degree of uncertainty."¹⁵ Although the results reached in the administrative and judicial proceedings are, for the most part, correct, the analysis and reasoning are flawed. Because of the vague and shifting standards concerning illegal insider trading, and because of the increasingly harsh civil and criminal penalties imposed for violating this undefined crime, calls for a definition of insider trading have recently reached a fevered pitch.¹⁶ This article sets forth a new, dynamic definition of

the protection of investors.

Id.

14. 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

15. Pitt & Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415, 416 (1988); see also Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies, and Other Curiosities in the Prevailing Law of Insider Trading*, 39 ALA. L. REV. 399, 401 (arguing that chaos currently engulfing law of insider trading due to different judges bringing "different perspectives" to each particular case). But see Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355, 357 (asserting that "the federal judiciary . . . has promulgated the most sensible rules on insider trading.").

16. See Crovitz, *The SEC Overstepped When It Made Insider Trading a Crime*, Wall St. J., Dec. 19, 1990, at A-17; Block & Hoff, *Renewed Interest in Defining Insider Trading*, N.Y.L.J. June 14, 1990, at 5, col. 1; Crovitz, *With "Insider Trading," It's Conviction First-Definition Later*, Wall St.J., May 9, 1990, at A15, col. 3; Norris, *A Big Loophole in Insider Cases*, N.Y. Times, May 4, 1990, at D8, col. 3; Pitt & Groskaufmanis, *Family Ties, Tippees and the Chestman Decision: Time for a Principled Definition of Insider Trading*, 4 Insights 7 (July 1990); *Roundup: Regulation*, Wash. Post, May 11, 1990, at F-2 (reporting that Representatives John Dingell and Edward Markey requested assistance from the SEC in drafting a legislative definition of insider trading); *Congress May Consider Definition of Insider Trading, Auditor Whistleblowing, Fair Trade Issues During 1991*, 6 Corp. Council Weekly 5, 8 (BNA) (Jan. 30, 1991) (explaining that "[t]he idea of legislatively defining insider insider

insider trading, one that seeks to protect the integrity of the securities markets while encouraging the free flow of legitimate information to the market.

Part I of this article briefly examines the chaotic law governing insider trading. Part II describes the economic and policy considerations that support the enactment of a clear and concise definition of insider trading. Part III examines the most recently proposed definition of insider trading, The Insider Trading Proscriptions Act of 1987.¹⁷ Finally, Part IV introduces a new, dynamic definition of insider trading (the "Act") and tests the Act against a series of hypothetical situations.

I. THE LAW GOVERNING INSIDER TRADING

The law governing insider trading is grounded on three distinct statutory provisions. Section 16 of the Exchange Act¹⁸ imposes trading restrictions on statutorily defined insiders—directors, officers and large shareholders.¹⁹ More specifically, section 16 requires the designated insiders to return short-swing trading profits to the corporation.²⁰ Significantly, liability under section 16 is strict; it does not turn on the insider's knowledge and intent.²¹

The second source regulating insider trading is rule 14e-3.²² Promulgated by the SEC in 1980, rule 14e-3 was specifically designed to deter insider trading in connection with tender offers.²³ In brief, rule 14e-3 prohibits any person other than a bidder or prospective bidder from trading a security subject to an actual or potential tender offer if such person possesses material, nonpublic information concerning the ten-

trading could resurface in 1991"). *But see* Sturc, *Where Insiders Trade, Law Reads Uncertainty*, *Legal Times*, Aug. 13, 1990, at 33, col. 1 (questioning whether legislative definition of insider trading is necessary).

17. Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. § 8247 (daily ed. June 17, 1987).

18. 15 U.S.C. § 78 (1988). An exhaustive analysis of section 16 is set forth in Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 BUS. LAW. 1087 (1987).

19. *Id.*

20. *Id.*

21. *Id.*

22. 17 C.F.R. § 240.14e-3 (1990).

23. Tender Offers, Exchange Act Release No. 34-17120, 45 Fed. Reg. 60, 410-13 (Sept. 12, 1980).

der offer and such person knows or has reason to know that the information is both nonpublic and originated from a person acting on behalf of the bidder or target.²⁴ Because of its broad "while in possession of" language and quasi-negligence standard, rule 14e-3 has significantly extended the reach of the prohibition against insider trading and, correspondingly, the influence and power of the SEC. In fact, the SEC has been accused of exceeding its authority in promulgating rule 14e-3.²⁵ Thus far, however, rule 14e-3 has survived the recent assaults and remains a viable enforcement tool for the SEC.²⁶

The final, and by far the most important,²⁷ source of regulation of insider trading is rule 10b-5,²⁸ promulgated by the SEC under section 10(b) of the Exchange Act.²⁹ Rule 10b-5 does not specifically prohibit, much less mention, insider trading. Rather, the prohibition against insider trading under rule 10b-5 is strictly the result of nearly thirty years³⁰ of ever-evolving administrative and judicial decisions.

Rule 10b-5 has been interpreted as imposing an alternative duty on "insiders" to either disclose the material, nonpublic information prior to trading or to abstain from trading on the

24. 17 C.F.R. § 240.14e-3 (1989).

25. See *United States v. Chestman*, 903 F.2d 75 (2d ¶ Cir. 1990), *reh'g en banc granted*, 1990 Transfer Binder, Fed. Sec. L. Rep. (CCH) 95,439, at 97,238 (Aug. 24, 1990); *United States v. Marcus Schloss & Co.*, 710 F. Supp. 944 (S.D.N.Y. 1989); *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981); see also, Raymond, *Validity Challenges to SEC Rule 14e-3*, 23 J. MARSHALL L. REV. 305 (1990).

26. *O'Connor & Assocs.*, 529 F. Supp. 1179 at 1191 ("The broad grant of authority to the SEC to define the particular practices banned by [section 14(e)] supports the proposition that the statute was not intended to be limited as defendants assert."). But see *Chestman*, 903 F.2d at 84 (Mahoney, J., concurring in part and dissenting in part) (concluding that the SEC "exceeded its statutorily granted authority by promulgating rule 14e-3 without including any requirement of a breach of fiduciary duty").

27. Shapiro, *Recent Developments Securities: Rule 10b-5 and Insider Trading*, 10 HARV. J.L. & PUB. POL'Y 265, 267 (1987) (observing that rule 10b-5 is the workhorse provision employed by the SEC in prosecuting insider trading cases).

28. 17 C.F.R. § 240.10b-5 (1989). For complete text of rule 10b-5, see *supra* note 14.

29. 15 U.S.C. § 78j(b) (1989). For complete text of section 10(b), see *supra* note 13.

30. Although rule 10b-5 and insider trading cases may trace their beginnings to as early as 1943 (see *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943)), Rule 10b-5's prohibition against insider trading gained prominence in 1961 (see *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)).

basis of such information.³¹ The duty to disclose or abstain from trading has its genesis in the seminal SEC decision *In re Cady, Roberts & Co.*³² In that case, the Commission imposed the disclose or abstain obligation on a corporate director because of:

[T]he existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and [because of] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.³³

The duty to disclose or to abstain from trading was given judicial life by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*³⁴ In *Texas Gulf Sulphur*, the court reasoned that fairness and, more specifically, the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information"³⁵ supported the *Cady, Roberts* disclose-or-abstain rule.

In 1980, in *Chiarella v. United States*,³⁶ the Supreme Court radically changed the law of insider trading. The Court specifically rejected the "parity of information" doctrine and held that mere possession of material, nonpublic information does not, by itself, trigger the disclose or abstain rule.³⁷ Rather, liability under Rule 10b-5 "is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."³⁸ Absent some fiduciary duty to disclose, the Court reasoned, no fraud had occurred.³⁹ The

31. *Carpenter v. United States*, 484 U.S. 19 (1987); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, *Kline v. SEC*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

32. 40 S.E.C. 907 (1961).

33. *Id.* at 912.

34. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* *Kline v. SEC*, 394 U.S. 976 (1969).

35. *Id.* at 848.

36. 445 U.S. 222 (1980).

37. *Id.* at 235.

38. *Id.* at 230. Indeed, the introduction of the fraud-based duty concept has raised significant problems in the area of the insider trading of junk bonds where the insiders do not traditionally owe duties to debt holders. See 23 Sec. Reg. & L. Rep. (BNA) 525 (Apr. 12, 1991).

39. *Chiarella*, 445 U.S. at 227-30 (the Court premised its holding on RESTATE-

Court's sudden introduction of the fraud concept of fiduciary duty sent the SEC reeling and, in turn, desperately searching for a theory to reach beyond the traditional fiduciary, the corporate insider.

Faced with the confusing and potentially limiting concept of a fiduciary duty standard, the SEC advanced the even more ambiguous misappropriation theory. Under that theory, any person who misappropriates—or, to put it more bluntly, steals⁴⁰—material, nonpublic information in breach of a fiduciary duty and later trades on the basis of such purloined information is liable under rule 10b-5.⁴¹ The Second Circuit has readily embraced and utilized the misappropriation theory on several occasions to find an investment banker⁴² and a financial printer⁴³ liable for insider trading. In both instances, the court stretched the common law definition of a fiduciary to find that the employees had violated their so-called fiduciary duties owed to their employers and their employers' clients.⁴⁴

In the first of two significant anomalies, however, the Second Circuit in *Moss v. Morgan Stanley Inc.*⁴⁵ held that, in the absence of some fiduciary duty owed to the particular private plaintiff by the alleged misappropriator, the misappropriation theory does not apply. On the other hand, when the plaintiff is the government, liability for insider trading under the misappropriation theory merely requires a showing that the misappropriator violated some fiduciary duty by disclosing or trading.⁴⁶ In *SEC v. Materia*, the court stated that the fiduciary duty "analysis bears only on the type of question raised in a private suit for damages; it is not relevant to an inquiry into whether [rule 10b-5] was or was not contravened."⁴⁷ Accord-

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MENT (SECOND) TORTS § 551(2)(a) (1976) regarding the common law fraud of misrepresentation and omission).

40. *Id.* at 245 (Burger, C.J., dissenting).

41. See *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983).

42. *Newman*, 664 F.2d 12.

43. *Materia*, 745 F.2d 197. The Ninth Circuit recently adopted the misappropriation theory in *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

44. *Newman*, 664 F.2d at 17; *Materia*, 745 F.2d at 202-03.

45. 719 F.2d 5, 11-16 (2d Cir. 1983).

46. *Newman*, 664 F.2d at 17; *Materia*, 745 F.2d at 202-03.

47. *Materia*, 745 F.2d at 203.

ingly, the reach of the misappropriation theory turns, in part, on the identity of the plaintiff.

The second anomaly under the misappropriation theory surfaced in *Carpenter v. United States*.⁴⁸ In *Carpenter*, Winnans, a reporter for *The Wall Street Journal*, secretly and selectively disclosed information concerning upcoming corporate profiles in his "Heard on the Street" columns.⁴⁹ The tenor and content of the column routinely and significantly affected the price of the subject corporation's securities. Employing the misappropriation theory, the court held that Winnans had breached his duty of confidentiality to his employer, *The Wall Street Journal*, by divulging proprietary and confidential information belonging to his employer.⁵⁰ Ironically, because *The Wall Street Journal* did not owe anyone any fiduciary-type duty, the newspaper could have traded on the basis of the confidential information without incurring Rule 10b-5 liability.⁵¹

In *Dirks v. SEC*,⁵² the Supreme Court addressed the duties and the liabilities of tippees, the recipients of inside information. The Court, clinging to the fiduciary duty concept articulated in *Chiarella*,⁵³ stated that, "[i]n determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty."⁵⁴ An insider breaches his or her fiduciary duty if, according to the Court, the tip was made for an improper purpose.⁵⁵ An improper purpose is found where "the insider personally will benefit, either directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach" by the tippee.⁵⁶ Accordingly, a tippee is apparently liable under Rule 10b-5 only when the tippee trades on the basis of material, nonpublic information that was revealed by a person in breach of a fiduciary duty, when such revelation was for an

48. 484 U.S. 19 (1987), *aff'g* securities issues, 791 F.2d 1024 (2d Cir. 1986).

49. *Id.* at 1026.

50. *Id.* at 1034.

51. *Id.* at 1033-34.

52. 463 U.S. 646 (1983).

53. 445 U.S. 222 (1980).

54. *Dirks*, 463 U.S. at 661.

55. *Id.* at 660.

56. *Id.* at 662.

improper purpose and when the tippee knows or has reason to know that the tipper has breached a duty of confidentiality by disclosing such information.⁵⁷ Just what exactly satisfies the "personal benefits" test is extremely uncertain.⁵⁸ Moreover, it is unsettled just how much a tippee must know about the tipper's breach before Rule 10b-5 liability arises. This last ambiguity was recently addressed by the Second Circuit.

In *United States v. Chestman*,⁵⁹ a fractured panel of the Second Circuit confronted the issue of when a remote tippee (Chestman) is liable under Rule 10b-5 for insider trading. Chestman argued that his trades in Waldbaum securities were based on preexisting research and were not based on confidential takeover information purportedly revealed by a Waldbaum family member, Keith Loeb.⁶⁰ Sidestepping Chestman's contention, the court held that, although Chestman knew that Loeb was a member of the Waldbaum family and that the takeover information was not "generally available," the prosecutor failed to produce evidence that Chestman knew that Loeb's disclosure constituted a breach of Loeb's fiduciary duty.⁶¹ Specifically, the court stated:

[T]here simply is no evidence that [Chestman] knew that Loeb was breaching a confidential relationship by imparting the information to him. The government can point to nothing in the record demonstrating actual or constructive knowledge on the part of Chestman that Keith Loeb was pledged to secrecy by [Loeb's wife], who was pledged to secrecy by [Loeb's mother-in-law], who was pledged to secrecy by Ira Waldbaum.⁶²

According to the court, the links of secrecy were too attenuated to impute Chestman with any constructive knowledge that the information was confidential and that Loeb's disclosure of

57. *Id.* at 659-63.

58. In *Dirks*, the Court commented that the personal benefits analysis should "focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 663.

59. *United States v. Chestman*, 903 F.2d 75 (2d Cir. 1990), *reh'g en banc granted*, 1990 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 95,439, at 97,238 (2d Cir. Aug. 24, 1990).

60. *Id.* at 77-78.

61. *Id.* at 79.

62. *Id.*

the information constituted a breach of a fiduciary duty.⁶³ Finally, the court quickly rejected the prosecutor's attempt to hang Chestman with rule 10b-5 liability under the misappropriation theory by stating that "[t]here can be no misappropriation of information by one who is unaware of the confidentiality of that information."⁶⁴ On August 24, 1990, the Second Circuit, sitting *en banc*, agreed to rehear the *Chestman* case.⁶⁵ This second guessing has fueled the uncertainty surrounding insider trading and underscores the need for precise legislative repair.

In sum, insider trading liability, particularly under rule 10b-5, is subject to the shifting analyses of the judiciary. The resulting court-created parameters of insider trading jurisprudence are ambiguous and unsettled. The "intolerable degree of uncertainty" surrounding insider trading warrants immediate legislative action.⁶⁶ However, before detailing and examining the most recent legislative attempt to define insider trading and describing and testing the Act, it is necessary to address the economic and policy considerations underlying insider trading.

II. THE ECONOMIC AND POLICY CONSIDERATIONS OF INSIDER TRADING: COMPLICATING THE PUZZLE

A. *Economic Considerations*

The puzzle of insider trading is complicated by conflicting and often polar opposite economic considerations. On the one hand, there is a wealth of literature arguing that insider trading purportedly promotes economic efficiency and, therefore, should not be prohibited.⁶⁷ On the other hand, numerous commentators assert that, on balance, trading by insiders may

63. *Id.*

64. *Id.* at 80.

65. Fed. Sec. L. Rep. (CCH) ¶ 95,439, at 97,238 (2d Cir. Aug. 24, 1990). The Second Circuit has not, as of the date of this article, issued its *en banc* decision in *Chestman*.

66. Pitt & Shapiro, *supra* note 15, at 416.

67. The economic efficiency camp gained its recognition, if not its start, with Dean Manne's seminal work, H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); see also, Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Haddock & Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1446 (1986); Carney, *Signaling & Causation*, 36 CATH. U.L. REV. 863 (1987).

actually result in economic inefficiencies.⁶⁸

Critics of insider trading regulation contend that trading by the most informed investors will quickly and accurately move the price of a security to its "true" level.⁶⁹ Those advocates assert that accurate pricing information is essential to the efficient allocation of capital resources. Accordingly, trading by insiders with their overwhelming informational advantages will ultimately result in the efficient allocation of capital because of the now accurate pricing of the affected securities.

Economic critics of a sweeping insider trading prohibition also assert that, absent transaction costs, the legislature should simply define, and courts should simply enforce, inside information as a property right and allow insiders and outside investors to allocate such a right.⁷⁰ This Coasian⁷¹ approach to insider trading will supposedly result in the parties allocating the inside information in such a way as to maximize wealth. Closely associated with the Coasian argument is the assertion that the allocation of inside information to insiders is an efficient method of compensating corporate insiders.⁷² Both of the Coasian-based arguments, as well as the efficient pricing argument, have been roundly criticized.

Proponents of insider trading regulation vehemently dispute the purported economic efficiency argument advanced by Manne and others.⁷³ The proponents attack the assertion that insider trading will result in the accurate pricing of securities.

68. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982); Goelzer, *Insider Trading: Introduction*, 13 HOFSTRA L. REV. 1 (1984).

69. H. MANNE, *supra* note 67, at 99-103. Acceptance of the proposition that a security has a "true" price necessarily means acceptance of the efficient market theory. The semi-strong form of the efficient market theory suggests that the price of a security reflects all publicly available information relating to that security. See generally Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANALYSTS J. 55 (1965); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 387 (1970). For a critique of the efficient market theory, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554-65 (1984).

70. Carlton & Fischel, *supra* note 67, at 863.

71. See Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

72. Carlton & Fischel, *supra* note 67, at 869-71.

73. Schotland, *supra* note 68, at 1438-39; see also Longstreth, *Halting Insider Trading*, N.Y. Times, Apr. 12, 1984, at A27, col. 1 (former SEC Commissioner ripped the economic efficiency proponents of insider trading and stated that "[t]he arguments in favor of insider trading are, in short, rubbish").

First, the proponents point out that insiders will benefit and profit from *either* good news or bad news.⁷⁴ As such, insiders faced with this "moral hazard" will be more likely to take abnormal risks on behalf of the corporation because the more significant the result, the larger the resulting price movement of the security. It simply does not matter whether the corporate action is successful; the only concern of the insider is the resulting price movement of the security. Second, the proponents argue that authorizing insider trading will decrease the efficient pricing mechanism of the market by increasing the incentive to delay the release of corporate information.⁷⁵ Specifically, insider trading will distort the market price for a period of time when corporate information is withheld so that the insiders may first make their trading profits.⁷⁶ Third, the proponents of a prohibition against insider trading argue that authorizing insider trading will grossly undermine the internal efficiency of the corporation.⁷⁷ Professor Haft has observed that "permitting insider trading would increase delay and distortion and thus impair decision-making that depends on timely and accurate information from" within the corporate hierarchy.⁷⁸ In addition, the proponents argue that the economic-efficiency critics have ignored the devastating effects of insider trading on widespread investor participation in the securities markets.⁷⁹ In fact, it is well established that the presence of insider trading destroys investors' confidence in the fairness and integrity of the securities markets and, at the same time, impedes the capital formation function of the securities markets.⁸⁰

The proponents of insider trading regulation also contest

74. See Warren, *A Foreward on Insider Trading Regulation*, 39 ALA. L. REV. 337, 346 (1988) (Professor Warren refers to this phenomenon as a "moral hazard").

75. Haft, *supra* note 68, at 1055-71.

76. Haft, *supra* note 68, at 1055-71.

77. Haft, *supra* note 68, at 1055-71.

78. Haft, *supra* note 68, at 1057.

79. See Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 225 (1985); Goelzer, *supra* note 68, at 2-3; see also Day, *supra* note 3.

80. Goelzer, *supra* note 68, at 2-3. See also 80 H.R. REP. NO. 355, 98th Cong., 2d Sess. (1983), reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2274, 2275, 2294.

the critics' Coasian-based arguments.⁸¹ The proponents correctly point out that transaction costs are indeed significant and that monitoring and enforcing contracts allocating the right to the insider information are costly.⁸² The proponents emphasize that the separation of ownership from control of a corporation leaves shareholders without an effective means for preventing management from misusing its broad discretion and that private contracts are ineffective tools in constraining the management abuses of insider trading.⁸³

Although not a strict economic efficiency argument, the strongest argument in favor of a clearly defined prohibition of insider trading is fairness. In his classic response to Manne, Professor Schotland noted that "[e]ven if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market . . . that satisf[ies] such noneconomic goals as fairness, just rewards and integrity."⁸⁴ Indeed, fairness is the cornerstone of the federal securities laws.⁸⁵ Courts have recognized that "[t]he fairness and integrity of conduct within the securities markets is a concern of utmost significance for the proper functioning of our securities laws."⁸⁶ The former General Counsel of the SEC, Daniel Goelzer, has emphasized that "[c]apital formation and our nation's economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets. Insider trading threatens these markets by undermining the public's expectations of honest and fair securities markets

81. See Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 390 (1989). For a discussion of transaction costs in corporate governance and agency-principal relationships, see Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1968).

82. Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 390 (1989).

83. Brudney, *supra* note 81, at 1409-11; Gordon, *supra* note 81, at 1595; A. BERLE & G. MEANS, *supra* note 81, at 119-25.

84. Schotland, *supra* note 68, at 1439.

85. See SENATE COMM. ON BANKING AND CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 1455, 73d Cong., 2d Sess. 55-68 (1934); SENATE COMM. ON BANKING AND CURRENCY, FEDERAL SECURITIES EXCHANGE ACT OF 1934, S. REP. NO. 792, 73d Cong., Sess. 21 (1934).

86. *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

where all participants play by the same rules."⁸⁷ Fairness, and the corresponding goals of investor confidence and market integrity, cannot be divorced from economic analysis. The efficient operation of a liquid and responsive securities market depends, in part, on widespread investor participation. In the long run, investors will participate only in fair markets, those markets that they are confident are not manipulated by insiders. To the extent that considerations of fairness conflict with pure economic analysis, equity should prevail over disputed economics.

In addition, it is inherently unfair to increase the civil and criminal penalties for an undefined and poorly articulated crime. Participants in the securities markets are entitled to legislative guidance as to what conduct is prohibited. Continued reliance on the judiciary to craft a predictable and consistent definition of insider trading will contribute to the growing uncertainty and malaise surrounding the securities markets.

B. *Policy Considerations*

A legislative solution to the current uncertainties engulfing insider trading is further exacerbated by political policy considerations. Despite the widely held belief that the undefined crime of insider trading "unfairly penalizes persons without [providing] reasonable guidance as to" what conduct is prohibited,⁸⁸ the SEC has long opposed a legislative definition of insider trading.⁸⁹ Indeed, the SEC did not propose its own definition of insider trading until a legislative definition, drafted by a group of private practitioners, appeared imminent.⁹⁰ Even then, however, the SEC's proposed definition was so imprecise that it was immediately attacked, and ultimately withdrawn.⁹¹

87. Goelzer, *supra* note 68, at 2-3.

88. Block & Hoff, *supra* note 16, at 5, col. 1; see also Crovitz, *supra* note 16 at A-17; Pitt & Shapiro, *supra* note 15, at 417; Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading*, 39 ALA. L. REV. 381, 381 (1988) (Professor Cox has stated that it is "imperative that Congress define insider trading.").

89. See, e.g., *The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 35-38 (1984) (testimony of SEC Enforcement Director John Fedders) [hereinafter *Hearings*].

90. See Warren, *supra* 74, at 338 (Professor Warren observed in early 1988 that a legislative definition of insider trading "appears on the horizon.").

91. Shortly after its submission, the SEC withdrew its proposed definition of

The SEC has put forth three general policy arguments in defense of its position that a legislative definition of insider trading is unwarranted. First, the SEC has asserted that a legislative definition will purportedly provide the unscrupulous with a blueprint for fraud.⁹² The SEC has argued that any legislative definition will necessarily be too narrow and inflexible, potentially permitting "new types of egregious conduct."⁹³ Representative John Dingell has reasoned that an inflexible, static definition of insider trading will allow "fertile legal minds [to] exploit [potential] loopholes."⁹⁴

The second reason advanced by the SEC in opposition to a concise legislative definition is purely political. Specifically, the SEC has asserted that it is politically impossible to gain a meaningful congressional consensus behind any legislative definition.⁹⁵ Consequently, the SEC did not want to derail legislation which provided for enhanced civil and criminal penalties, as well as expanding the influence and power of the turf-conscious regulator, by pushing for an almost unattainable legislative definition of insider trading.⁹⁶

Finally, the SEC has asserted, and the House Committee has blindly agreed, that a legislative definition is unnecessary because the courts have purportedly developed an adequate definition of insider trading.⁹⁷ As detailed above, however, the court-created parameters of insider trading are woefully inadequate and uncertain.⁹⁸ The enigma surrounding the law

insider trading.

92. *Hearings*, *supra* note 89, at 35-38 (testimony of Mr. Fedders).

93. *Hearings*, *supra* note 89, at 35-38 (testimony of Mr. Fedders).

94. See Statement of Representative John Dingell to Securities Industry Association, quoted in Crovitz, *supra* note 16, at A-15.

95. *Hearings*, *supra* note 89, at 35-38 (statement of Mr. Fedders).

96. *Hearings*, *supra* note 89, at 35-38; see also Statement of Senator Alfonse D'Amato that a legislative definition of insider trading was not included in the 1984 Act because "of the complexity of the undertaking, and the necessity for prompt action." 130 Cong. Rec. 8913 (daily ed. June 29, 1984) (statement of Senator D'Amato); Report of the Committee of Energy and Commerce, H.R. REP. 910, 100th Cong., 2d Sess. 11 (1988) [hereinafter Report] (Committee explained that 1988 Act's failure to include a legislative definition of insider trading was due, in part, to the "lack of consensus over the proper delineation of an insider trading definition" and to the belief that the "enforcement reforms encompassed within" the 1988 Act warranted immediate implementation).

97. Report, *supra* note 96, at 11. (Committee believed that "the court-drawn parameters of insider trading have established clear guidelines").

98. See *supra* notes 11-66 and accompanying text.

of insider trading is exemplified by the report accompanying the 1988 Act. On the one hand, the House Committee asserted in the report that the 1988 Act effectively overruled *Moss v. Morgan Stanley Inc.*⁹⁹ On the other hand, the House Committee claimed in the report that "the Committee does not intend to alter the substantive law with respect to insider trading with this legislation."¹⁰⁰ Those incongruous statements underscore the confusion surrounding insider trading and highlight the necessity of, and urgency for, a legislative definition of insider trading.

The SEC's reluctance to define insider trading cannot withstand scrutiny. It is patently unfair and possibly unconstitutional¹⁰¹ to impose draconian civil penalties and harsh criminal sanctions on investors for conduct that has never been defined. Although a narrow definition of insider trading may potentially provide the sophisticated criminals with legal loopholes, a carefully drafted definition, coupled with vigorous enforcement, will likely provide an effective and comprehensive prohibition against unfair insider trading. At the same time, a providently articulated legislative definition may, simultaneously, encourage the continued flow of information to the financial markets. It is also far from certain that a legislative definition is politically impracticable. In fact, former Commissioner Shad has opined that it would be possible to draft a politically acceptable definition of insider trading.¹⁰² Furthermore, avoidance of difficult political issues and reliance on judicial legislation offends our democratic system of government. Justice Powell recognized this evil in a slightly different context when he stated: "Rather than confronting the hard political choices involved, Congress is encouraged to shirk its constitutional obligation and leave the issue to the courts to

99. Report, *supra* note 96, at 38-39; see also *supra* notes 45-47 and accompanying text, discussing *Moss*, 719 F.2d 5 (2d Cir. 1983).

100. Report, *supra* note 96, at 11.

101. It has been suggested that the current chaotic state of the law governing insider trading may violate the ex post facto prohibition [U.S. Const. art. I, § 9, cl. 3] and fundamental due process rights of the criminally accused [*Id.* amend. V]. See, e.g., Warren, *supra* note 74, at 338.

102. See *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 599 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong. 1st Sess. 51 (statement of Mr. Shad).

decide. When this happens, the legislative process with its public scrutiny and participation has been bypassed, with attendant prejudice to everyone concerned."¹⁰³ In short, because the law of insider trading has developed in a piecemeal fashion ignoring significant economic and policy considerations, legislative action is necessary.

III. THE LEGISLATIVE RESPONSE: THE INSIDER TRADING PROSCRIPTIONS ACT OF 1987—MORE OF THE SAME

With the introduction of the Insider Trading Proscriptions Act of 1987,¹⁰⁴ Congress came extremely close to enacting a definition of insider trading. The Proposal and its definition, however, did not become law.¹⁰⁵ Nevertheless, because the Proposal represented the combined views of prominent practitioners and the SEC, and because the Proposal contained the most seriously considered definition of insider trading, the Proposal merits detailed examination.

Introduced by Senators Donald Riegle and Alfonse D'Amato¹⁰⁶ and drafted by an all-star committee of private securities practitioners,¹⁰⁷ the Proposal consisted of several significant components. The first key component of the Proposal, proposed section 16A(b)(1), was aimed at prohibiting "wrongful trading" of securities by persons in possession of

103. *Cannon v. University of Chicago*, 441 U.S. 677, 743 (1979) (Powell, J., dissenting) (footnote omitted).

104. The Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. 8247 (daily ed. June 17, 1987). Several months after S. 1380 was introduced, the SEC submitted its own proposed definition of insider trading. See *Definition of Insider Trading (Part II): Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 7-12 (Aug. 7, 1987). A reconciliation proposal of S. 1380 was submitted on November 19, 1987 [hereinafter Proposal]. See letter from Harvey L. Pitt, Chairman of the Ad Hoc Legislation Committee, to Senator Donald W. Riegle, Chairman of the Subcomm. on Securities of the Senate Banking, Housing, and Urban Affairs Comm. 1-2 (Nov. 19, 1987), reprinted in *SEC Compromise Proposal of Insider Trading Legislation: Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep. (BNA) 1817 (Nov. 27, 1987).

105. See Report, *supra* note 96, at 11.

106. See *supra* note 104 and accompanying text.

107. The Ad Hoc Legislation Committee consisted of Harvey Pitt, John Olson and Theodore Levine. For an exhaustive analysis of the Proposal, see Pitt & Shapiro, *supra* note 15; Pitt & Shapiro, *The Revised Insider Trading Proscriptions Act of 1988: A Legislative Remedy for a Problem that Persists*, 26 AM. CRIM. L. REV. 7 (1988).

material, nonpublic information.¹⁰⁸ In brief, proposed section 16A(b)(1) prohibited trading while in possession of material, nonpublic information¹⁰⁹ if the person engaged in the trading knew or recklessly disregarded that the information was either wrongfully obtained or that consummation of the trade would have constituted a wrongful use of the information.¹¹⁰ The thrust of that prohibition turned on the term "wrongful." The Proposal specifically defined "wrongful" as occurring:

[O]nly if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electric or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust or confidence, or breach of any contractual or employment relationship.¹¹¹

For the most part, proposed section 16A(b)(1) essentially codified the existing administrative and judicial law governing insider trading.

The second principal component of the Proposal concerned tipper-tippee liability. Proposed section 16A(c) prohibited, in general, any direct or indirect communication of material, nonpublic information when the tipper—the communicator of the information—could not have lawfully consummated the trade and when the tipper knew or recklessly disregarded that the "tip"—the communication—would lead to a trade in the subject securities.¹¹² Unlike proposed section 16A(b)(1), proposed section 16A(c) significantly alters the current legal landscape of tipper-tippee liability. Under proposed section 16A(c), "it is not necessary to prove a wrongful trade by the tippee or subtippee to sustain an action based on the wrongful communication against the original tipper."¹¹³ Moreover, proposed section 16A(c) would have eliminated the vague "personal benefits" analysis enunciated by the Supreme Court in *Dirks v.*

108. Proposal, *supra* note 104, at § 16A(b)(1).

109. The Proposal was not intended to displace the court-created definitions of material and nonpublic. See Pitt & Shapiro, *supra* note 107, at 16-17.

110. Proposal, *supra* note 104, at § 16A(b)(1).

111. Proposal, *supra* note 104, at § 16A(b)(1).

112. Proposal, *supra* note 104, at § 16A(c).

113. Pitt & Shapiro, *supra* note 15, at 422 n.23.

SEC.¹¹⁴ Tippee liability would have turned on proposed section 16A(b)(1)—whether the trading tippee knew or recklessly disregarded that the information was wrongfully obtained.

The Proposal included several other significant provisions. Proposed sections 16A(a)(1)-(5) set forth in detail the important policy considerations that justified the broad prohibitions. In particular, the Proposal recognized the nefarious impact that insider trading has on the fairness and efficiency of the nation's securities markets.¹¹⁵ In addition, the Proposal acknowledged the "important public interest in the prompt flow of information to the securities markets."¹¹⁶ In order to facilitate the creation and dissemination of information, the Proposal allowed multi-service investment firms to rebut the presumption of insider trading liability.¹¹⁷ The Proposal also included a specific prohibition relating to insider trading and tipping in the context of tender offers. Essentially, the Proposal codified rule 14e-3.¹¹⁸ Significantly, proposed section 16A(f)(1) authorized the SEC to "exempt any person, security or transaction" if the SEC determined that such exemptive action was not inconsistent with the Proposal.¹¹⁹ Finally, the Proposal provided an express private cause of action to contemporaneous traders but would have limited a violator's monetary liability to the violator's "actual profit obtained or loss avoided."¹²⁰

For the most part, the Proposal was a step in the right direction, a step towards substantive congressional action. For the first time, the Proposal clearly articulated the economic and policy considerations controlling the field of insider trading. The Proposal would have included broad prohibitions necessary to encompass harmful trading practices. At the same time, however, the Proposal was sufficiently specific to eliminate some of the uncertainties that currently plague the law of insider trading. If enacted, the Proposal would have synthesized in a reasonably coherent manner the various legal theo-

114. 463 U.S. 646, 664 (1983).

115. Proposal, *supra* note 104, at § 16A(a)(1).

116. Proposal, *supra* note 104, at § 16A(a)(4).

117. Proposal, *supra* note 104, at § 16A(b)(2).

118. Proposal, *supra* note 104, at § 16A(d). See 17 C.F.R. § 240.14e-3 (1989) and discussion of Rule 14e-3, *supra* notes 22-26 and accompanying text.

119. Proposal, *supra* note 104, at § 16A(f)(1).

120. Proposal, *supra* note 104, at §§ 16A(g)(1)(A), 16A(g)(1)(B)(2).

ries currently employed to punish inside traders. Another positive aspect of the Proposal was its proposed elimination of the "personal benefits" analysis, an awkward and inherently vague test concerning tipper-tippee liability. An additional beneficial aspect of the Proposal was its express creation of a private right of action. In view of the judicial trend against the implication of private causes of action,¹²¹ the Proposal would have eliminated any doubt that a private remedy was clearly intended.

The Proposal, however, had several significant drawbacks.¹²² First and foremost, the Proposal retained the ambiguous and inappropriate fiduciary duty standard espoused by the Supreme Court in *Chiarella v. United States*.¹²³ Professor Cox has correctly noted that "[t]he menace of *Chiarella* is its embrace of the empty standard of a fiduciary relationship as the litmus for regulation."¹²⁴ Indeed, the incongruous and baffling results in *Materia* and *Moss* epitomize "the deficiencies of the fiduciary principle."¹²⁵ The Proposal's retention of the "empty" fiduciary standard would have perpetuated the ambiguities and anomalies of the current court-created law.¹²⁶ Quite simply, the Proposal's adherence to a fiduciary standard ignores the "ethical precepts of fairness in the trading of securities" by permitting non-fiduciaries to trade on the basis of grossly unfair informational advantages.¹²⁷

Another significant flaw of the Proposal was its codifica-

121. See, e.g., *Cort v. Ash*, 422 U.S. 66 (1975) (announcing restrictive four-part test); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) (no private right of action under § 17(a) of the Exchange Act); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979) (no private right of action under the antifraud provisions of the Investment Advisers Act of 1940, but private cause of action for rescission). But see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982) (private right of action available under certain provisions of Commodity Exchange Act).

122. Professor Macey has opined that the Proposal was simply "a model of vagueness and obfuscation." Macey, *supra* note 15, at 365.

123. 445 U.S. 222 (1980).

124. Cox, *supra* note 88, at 397.

125. Note, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*, 73 CALIF. L. REV. 483, 506 (1985).

126. See generally Cox, *supra* note 88, at 386-97; Rosenbaum & Bainbridge, *The Corporate Takeover Game and Recent Legislative Attempts to Define Insider Trading*, 26 AM. CRIM. L. REV. 229 (1988).

127. Phillips & Zutz, *The Insider Trading Doctrine: A Need For Legislative Repair*, 13 HOFSTRA L. REV. 65, 97 (1984).

tion of the misappropriation theory, an expansive theory of liability premised on agency law.¹²⁸ Designed by the SEC in response to the Supreme Court's narrow reading of rule 10b-5,¹²⁹ the misappropriation theory has been roundly criticized by commentators.¹³⁰ In a vociferous attack, Professor Cox has opined that the misappropriation theory:

[D]evaluates all the jurisprudence that surrounds rule 10b-5. So cheapened is its application that one should question not only further developments under the antifraud rule, but also those that have become acceptable. In the realm of insider trading regulation, the misappropriation theory poses a serious threat of swallowing the entire field.¹³¹

Because the Proposal would have incorrectly and unjustifiably perpetuated the fundamentally flawed misappropriation theory, the Proposal was contrary to the policy goals of fairness and equal access to information underlying insider trading regulation.

Another lingering fraud-based remnant from the common law of insider trading was the Proposal's limit on who could initiate a private cause of action. Specifically, rather than allowing all persons injured by reason of the wrongful insider trading, the Proposal restricted the private remedy to a narrow group referred to as "contemporaneous traders."¹³² Under the Proposal, only those who traded while the violator was trading in the market would have standing to sue.¹³³ Understandably concerned with the threat of widespread vexatious litigation, the drafters of the Proposal sought to limit the private remedy to those who were indisputably and directly affected by the wrongful trading. The Proposal, however, went too far. The Proposal ignored the harm to honest investors who,

128. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting).

129. *Id.*

130. See, e.g., Cox, *supra* note 88, at 389; Phillips & Zutz, *supra* note 127, at 99 (attacking the misappropriation theory and concluding that "codification of the misappropriation theory would fall short of protecting investors from insider trading").

131. Cox, *supra* note 88, at 389.

132. Proposal, *supra* note 104, at § 16A(g)(1)(A). The "contemporaneous traders" provision was retained in section 20A of the Exchange Act [15 U.S.C. § 78t(A) (1988)], enacted as part of the 1988 Act.

133. Proposal, *supra* note 104, at § 16A(g)(1)(A).

while not trading contemporaneously with the violator, were nevertheless injured by the violator's conduct. For example, a bidder in a takeover contest who is not engaged in open-market purchases of the target's stock at the time the violator is trading in the market will likely be compelled to offer a higher premium in the tender offer because the violator's trading and disclosure drove up the price of the target company's shares. Certainly the bidder is injured by the violator's wrongful conduct. Under the Proposal, however, the bidder is left without a private remedy because the bidder could not squeeze itself under the title of "contemporaneous trader."¹³⁴ Professor Langevoort has concluded that the contemporaneous trader concept lacks "any justification except formalistic adherence to the notion of insider trading as fraud (i.e., a privity equivalent)."¹³⁵

Finally, the Proposal had too many special interest group provisions. For instance, the Proposal provided the powerful brokerage firms with a broad defense to insider trading claims brought under the Proposal. Pursuant to proposed sections 16A(b)(2)(A) and 16A(b)(2)(B), brokerage firms could escape liability by simply showing that the investment decision was not tainted by material, nonpublic information and that the brokerage firm had installed a "Chinese Wall."¹³⁶ Perhaps the most influential of the special interest groups, the SEC, forced proposed section 16A(f)(1) into the Proposal granting it broad exemptive powers.

Despite several significant drawbacks, the Proposal is an excellent starting point for future legislative action. It clearly articulates the goals underlying the federal securities laws in general and insider trading regulation in particular. It correctly modifies and eliminates troublesome areas of the current law

134. See, e.g., *Litton Indus. v. Lehman Bros. Kuhn Loeb, Inc.*, No. 86 Civ. 6447 (JMC) (S.D.N.Y. Aug. 4, 1989) (LEXIS, Genfed library, Dist. file) (no showing of damages because not trading contemporaneously with inside trader, Dennis Levine).

135. Langevoort, *supra* note 15, at 410-11 (footnote omitted).

136. Proposal, *supra* note 104, at §§ 16A(b)(2)(A), 16A(b)(2)(B). A "Chinese Wall" refers to systems and procedures implemented by multi-service investment firms to control the flow of material, nonpublic information within the firm. The Proposal's expansive exemption for trading by a target company's management has also been attacked as evidence of "the effectiveness of incumbent management as a political coalition." See Macey, *supra* note 15, at 374.

governing insider trading. The Proposal, however, is not perfect. It improperly retains inappropriate fraud-based theories at the expense of fundamental notions of fairness. Future legislation should, of course, incorporate the positive aspects of the Proposal while attempting to eliminate the its negative implications.

IV. A NEW DYNAMIC DEFINITION OF AND PROHIBITION AGAINST UNFAIR INSIDER TRADING

A. *The Underlying Policy Considerations*

At the outset, it is imperative to clearly articulate the goals of any proposed legislation. The Act, entitled "The Unfair Trading Act of 1991," is premised on fairness. In order to reestablish investor confidence in the integrity of the national securities markets, the Act will specifically aim at protecting and fostering investors' expectations of a fair marketplace. At the same time, however, the Act seeks to insulate from its proscriptions the legitimate and beneficial activities of market participants such as securities analysts. More particularly, by their skill, experience and diligence, securities analysts create and interpret information relating to specific securities and inject their analyses into the market.¹³⁷ The efforts of the securities analysts result in a more informed and, hence, more efficient market. Unlike the Proposal,¹³⁸ however, the Act does not provide securities analysts with a broad affirmative defense. Instead, the securities analyst may, like all other investors, counter charges of unfair insider trading with evidence that the subject trades were not unfair.¹³⁹

B. *The Act*

The substantive provisions of the Act provide as follows:

- (a) It shall be unlawful for any person, directly or indirectly, to trade a security on the basis of material, nonpublic information if such person knew or should have

137. *But see* Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023 (1990) (in which Professor Langevoort cautions against unquestioned acceptance that investment analysts merit special consideration under the law of insider trading).

138. Proposal, *supra* note 104, at § 16A(b)(2).

139. Proposal, *supra* note 104, at § 16A(b).

known that such material, nonpublic information was acquired unfairly.

(b) For the purposes of this section, material, nonpublic information is acquired unfairly if such information was used by, acquired from, or revealed by any person who has access to confidential information relating to the security.

(c) Any person injured by a violation of this section may initiate a private cause of action against any person who violates this section and such injured person may recover an amount of money damages consistent with such injury, in addition to such equitable relief as a court of competent jurisdiction shall deem necessary and appropriate.

The Act attempts to remove insider trading from the rubric of fraud. The Act reflects the commonsensical realization that unfair insider trading in an anonymous, impersonal market does not fit within a reasonable interpretation of fraud. The incoherent and confusing results reached under the current law governing insider trading are due in large part to the forced and often inappropriate application of common law fraud principles.¹⁴⁰ Professor Langevoort has noted that "insider trading may be many bad things, but it is unlikely that [fraudulent] deception is one of them."¹⁴¹ Accordingly, the Act is premised on fairness, not fraud. The Act focuses on the inherently unfair abuses by persons with access to confidential information. Thus, liability is based principally on the source of the material, nonpublic information; not some amorphous duty concept.

1. Subsection (a) of the Act

The opening language of subsection (a) of the Act, "[i]t shall be unlawful," signifies that a violation of the Act entails criminal, as well as civil, liability. That language would not alter the enforcement scheme under existing law.¹⁴²

140. See Langevoort, *supra* note 15, at 402; Note, *supra* note 125, at 494.

The current fraud-based law of insider trading does not promote the policies of fairness and equal access to information underlying the federal securities laws. The fiduciary principle narrows the scope of liability to such an extent that many traders, unfairly using their privileged access to information, are beyond the reach of Rule 10b-5.

Note, *supra* note 125, at 494.

141. Langevoort, *supra* note 15, at 402.

142. See § 32(a) of the Exchange Act, 15 U.S.C. § 78(c) (1989). See also crimi-

Because the gravest harm to investors occurs when a person trades in a market on the basis of an informational advantage gained in an unfair manner, subsection (a) imposes liability when a person trades, not simply when a person selectively discloses the confidential information. This is a significant departure from the current law governing insider trading¹⁴³ and from the Proposal.¹⁴⁴ Under the Proposal, the mere "tipping" of material, nonpublic information is enough to trigger liability, even in the absence of a subsequent trade by the "tippee."¹⁴⁵ While the selective disclosure of confidential information may violate agency, corporate or intellectual property laws, such conduct does not, by itself, affect the securities markets. As such, the mere "tipping" of information is beyond the scope of the federal securities laws and, therefore, is not prohibited by the Act. Instead, a violation of the Act turns on the unfair trading of securities.¹⁴⁶

Liability under subsection (a) attaches only when a trade is made "*on the basis of*" unfairly acquired material, nonpublic information. To a large extent, the "on the basis of" language does not modify the existing case law developed under rule 10b-5.¹⁴⁷ For instance, under both rule 10b-5 and the Act, the claimant must allege and prove that the unfair trade was made by a person "on the basis of" material, nonpublic information and not merely while in possession of such information.¹⁴⁸ While it is logical that a reasonable inference may arise that a trade was made on the basis of unfairly acquired material, nonpublic information by a showing that the trader was in pos-

nal prosecution for violation of rule 10b-5, *Chiarella v. United States*, 445 U.S. 222 (1980); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

143. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974) (non-trading tipper liable under rule 10b-5, at least where tippee trades).

144. See Proposal, *supra* note 104, at § 16A(c) and *supra* notes 112-14 and accompanying text.

145. Pitt and Shapiro, *supra* note 15, at 422 n.23.

146. Non-trading tippers are, admittedly, despicable characters. Nevertheless, because the integrity of the market is not undermined until an unfair trade is executed, non-trading tippers are not liable under the Act.

147. See, e.g., *Dirks v. United States*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

148. *Dirks*, 463 U.S. at 654; *Chiarella*, 445 U.S. at 235 ("We hold that a duty to disclose under 10(b) does not arise from the mere possession of nonpublic market information."); see also subsections (a) and (b) of the Act.

session of such information, the trader may rebut such an inference in a number of ways. For example, the trader may show that the trade was based on nonmaterial or public information. The trader may also put forth evidence that the material, nonpublic information was *not* acquired unfairly. Similarly, a multi-service investment firm in possession of unfairly acquired material, nonpublic information may refute the inference that a trade was made "on the basis of" such information by showing that the trading decision was driven by nonmaterial information or publicly available information. In addition, the investment firm may put forth evidence that the decision-maker behind the subject trade was not in possession of, nor did he or she have access to, material, nonpublic information. By emphasizing the "on the basis of" language, subsection (a) attempts to protect trading decisions that are the result of an investor's skill and expertise. Subsection (a) is a direct recognition of the substantial benefits that investors in general and securities analysts in particular bring to the marketplace through their honest and diligent efforts.¹⁴⁹ At the same time, attempting to avoid allegations that the Act is riddled with politically influenced, special-interest-group exemptions,¹⁵⁰ the Act applies a single set of rules for *all* market participants.

The Act incorporates existing general concepts in an attempt to avoid unnecessary litigation concerning the language of the Act. Similar to the Proposal,¹⁵¹ subsection (a) employs the well-developed phrase "material, nonpublic information." In *TSC Industries, Inc. v. Northway, Inc.*,¹⁵² the Supreme Court held that information is material if there is "a substantial likelihood that a reasonable shareholder would consider [the information] important" or, "[p]ut another way, there [is] a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

149. Some have argued for a bright-line rule premised solely on whether the trader was *in possession of* material, nonpublic information. See, e.g., Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083 (1985).

150. See *supra* note 136 and accompanying text.

151. Proposal, *supra* note 104, at §§ 16A(a)(I), 16A(b)(I), 16A(c) and 16(d)(I); see also Pitt & Shapiro, *supra* note 15, at 416-17.

152. 426 U.S. 438, 449 (1976) (footnote omitted).

The materiality test of *TSC Industries*, announced in the context of proxy disclosures, was subsequently adopted by the Supreme Court for rule 10b-5 actions in *Basic, Inc. v. Levinson*.¹⁵³ The Act retains the fact-specific objective test of materiality.

In addition to the requirement that the information is material, the Act also requires that the information is "nonpublic." Although not quite as developed as the term "material," information is generally considered "public" if it has been widely "disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution."¹⁵⁴ Similar to the materiality standard, the Act retains the administrative and judicial construction of "nonpublic."

Subsection (a) imposes liability on a trader if the trader "knew or should have known" that the material, nonpublic information was acquired unfairly. This objective standard differs from the current scienter requirement of rule 10b-5. In *Ernst & Ernst v. Hochfelder*,¹⁵⁵ the Supreme Court held that rule 10b-5 required proof of scienter¹⁵⁶ or, in the words of the Court, proof of a "mental state embracing intent to deceive, manipulate, or defraud."¹⁵⁷ Under rule 10b-5, it is uncertain whether scienter encompasses not only knowledge, but also recklessness.¹⁵⁸ By contrast, under the Act, liability is imposed when the trader knew or recklessly disregarded the fact that the confidential information was acquired unfairly. The Act goes further than existing rule 10b-5 law, however, and imposes liability if a reasonable person under the circumstances would have known that such information was acquired unfairly. The expansive standard of liability is admittedly harsh, but

153. 108 S. Ct. 978 (1988).

154. *In re Faberge, Inc.*, 45 S.E.C. 249, 255 (1973); see also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

155. 425 U.S. 185, 193 n.12 (1976).

156. *Id.* at 193; see also *Aaron v. SEC*, 446 U.S. 680 (1980).

157. *Hochfelder*, 425 U.S. at 193 n.12.

158. 446 U.S. at 690-91. The overwhelming majority of lower courts have held that recklessness is sufficient to state a claim under rule 10b-5. See, e.g., *Van Dyke v. Coburn Enterprises*, 873 F.2d 1094 (8th Cir. 1989); *Eisenberg v. Gagnon*, 766 F.2d 770 (3d Cir. 1985), cert. denied, 474 U.S. 946 (1985); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434 (9th Cir. 1984).

the seriousness and destructiveness of unfair insider trading supports such a broad standard. In the context of tipper-tippee liability, however, the Act's objective standard is consistent with current case law.¹⁵⁹ In *Investors Management Co., Inc.*,¹⁶⁰ the Commission stated that "[c]onsiderations of both fairness and effective enforcement demand that the standard as to the requisite knowledge be satisfied by proof that the recipient had reason to know of the non-public character of the information, and that it not be necessary to establish actual knowledge of that fact." Similarly, the objective standard is also consonant with the standard of liability under rule 14e-3.¹⁶¹

2. Subsection (b) of the Act

Subsection (b) of the Act details how material, nonpublic information is "acquired unfairly." Because the Act is both an acquisition and use statute, subsection (b), in conjunction with subsection (a), prohibits the unfair acquisition and use of material, nonpublic information in connection with a trade of securities. Under subsection (b), information is acquired unfairly "if such information was used by, acquired from, or revealed by" a person in a position with access to confidential information. If a person with access to confidential information concerning a security trades (*i.e.*, uses the information to trade) the security on the basis of such information, such person is liable under the Act. Likewise, if a person steals or otherwise acquires material, nonpublic information from a person with access to confidential information relating to a security and subsequently trades the security on the basis of such information, liability is imposed. In addition, under the expansive, but non-exhaustive,

159. See *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (where Court held that "a tippee assumes a fiduciary duty to shareholders of a corporation . . . only when the insider has breached his fiduciary duty to the shareholders . . . and the tippee knows or should know that there has been a breach") (emphasis added) (footnote omitted). But see *United States v. Chestman*, 903 F.2d 75, 79 (2d Cir. 1990), *reh'g granted*, [1990 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 95,439 at 97,238 (Aug. 24, 1990) (where court held that a tippee under rule 10b-5 must have knowledge that the tipper breached a fiduciary duty by selectively disclosing the material, nonpublic information).

160. 44 S.E.C. 633, 644 (1971).

161. 17 C.F.R. § 240.14e-3 (1989). Rule 14e-3 imposes liability on designated individuals and entities who know or have reason to know that the information is material, nonpublic information relating to a tender offer.

description of "acquired unfairly," a trader is liable if a person with access to confidential information reveals (*i.e.*, "tips") material, nonpublic information to a trader who subsequently trades on the basis of the material, nonpublic information.

The thrust of subsection (b) analysis is determining who has "access to confidential information relating to the security." While the concept of "access" is unique,¹⁶² its roots are deep and well established. The Commission in *In re Cady, Roberts & Co.* explained that the duty to disclose or abstain rested, in part, on "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone."¹⁶³ Similarly, in *SEC v. Texas Gulf Sulphur Co.*, the court emphasized that "[t]he only regulatory objective is that access to material information be enjoyed equally."¹⁶⁴ Justice Blackmun, in his eloquent dissent in *Chiarella v. United States*, opined that "persons having access to confidential material information that is not available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."¹⁶⁵

The Act intentionally leaves the precise meaning of "access" unspecified. Although that imprecision will likely spawn some litigation, a broad and flexible definition of the term is necessary in order to encompass new and sophisticated unfair trading schemes. At a minimum, however, persons with "access" should include officers, directors, certain employees and agents, influential controlling shareholders, and attorneys, accountants and investment bankers associated with the issuer.¹⁶⁶

162. The United Kingdom's prohibition against insider trading is also premised on the concept of access to confidential information. The United Kingdom's statute, however, uses the terms "connection" with and "connected" to an issuer of securities. Financial Services Act, 1986, ch. 60, Company Securities (Insider Dealing) Act, 1985, ch. 8, 1(1), (2), (3), (4), 9; see generally Note, *A New Look at the European Economic Community Directive on Insider Trading*, 23 VAND. J. TRANSNAT'L. L. 135 (1990).

163. 40 S.E.C. 907, 912 (1961) (emphasis added).

164. 401 F.2d 833, 849 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) (emphasis added).

165. 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting) (emphasis added).

166. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (describing "temporary insiders" as including an "underwriter, accountant, lawyer, or consultant").

The phrase "confidential information" used in subsection (b) is different from, and broader than, the phrase "material, nonpublic information."¹⁶⁷ Information is confidential if its disclosure, regardless of its materiality, would violate either agency, corporate or intellectual property laws. On the other hand, information is generally considered material only if it would substantially influence a reasonable investor.¹⁶⁸ Information is nonpublic if it has not been widely disseminated.¹⁶⁹ Thus, a person has "access to confidential information" even if such person does not have access to material, nonpublic information. The purpose of this textual difference is to enlarge the group of persons from whom liability under subsection (a) may attach. In practice, this textual difference will encompass people with access to information that is confidential but is not, by itself, material. It should be noted, however, that the information used by, acquired from, or revealed by the person with access must be material and nonpublic and not simply confidential in order for liability to arise under the Act.

Finally, the phrase "relating to the security" in subsection (b) signifies the intent to include both firm-specific information (i.e., dividends and earnings) and general market information (i.e., tender offers and mergers) within the conscriptions of the Act. Such an interpretation is consistent with current case law.¹⁷⁰

3. Subsection (c) of the Act

Subsection (c) of the Act creates an express private cause of action for persons "injured by a violation of" subsection (a). Establishing an express private remedy "augments SEC enforcement of the federal securities laws," and sharpens "the deterrent element so essential in securities transactions."¹⁷¹ Subsection (c) is broader than some proposals limiting recov-

167. See *supra* notes 151-54 and accompanying text.

168. See *supra* notes 151-54 and accompanying text.

169. See *supra* notes 151-54 and accompanying text.

170. Current case law under rule 10b-5 does not make a distinction between "inside" information—information created within the corporation—and "outside" information—information originating outside the corporation. See *Dirks v. SEC*, 463 U.S. 646, 656 n.15 (1983).

171. Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959, 1963 (1987) (footnote omitted).

ery to the corporate issuer¹⁷² and other legislative recommendations, namely the Proposal, limiting recovery to "contemporaneous traders."¹⁷³ The Act attempts to place a significant enforcement role on those investors who are injured because of the unfair trading. Limiting recovery to the corporate issuer may be an effective method of curbing spurious lawsuits, but such a limitation leaves those who were directly harmed by the egregious conduct without an effective remedy. Rather than enhancing investor confidence, such a restrictive recovery provision would likely buttress the injured investor's belief that the legal system cannot repair the inequities of the securities markets. Similarly, limiting recovery to "contemporaneous traders" is too restrictive and would ignore those investors injured by, although not trading contemporaneously with, an inside trader.¹⁷⁴

The express private remedy provided for in subsection (c) of the Act abrogates the "purchaser-seller" rule applicable to insider trading actions commenced under rule 10b-5. In general, the "purchaser-seller" rule, announced by the Second Circuit in *Birnbaum v. Newport Steel Corp.*¹⁷⁵ and adopted by the Supreme Court nearly twenty years later in *Blue Chips Stamps v. Manor Drug Stores*,¹⁷⁶ limits standing in rule 10b-5 actions to actual purchasers or sellers of the affected securities. According to the Court, the narrow "purchaser-seller" standing rule is warranted because of the "in connection with" language of rule 10b-5.¹⁷⁷

The Act does not include the limiting "in connection with" language of rule 10b-5. Instead, subsection (c) provides an express private cause of action for "[a]ny person *injured by*" a violation of subsection (a). The broad language in subsection (c) is specifically intended to provide private remedies for investors who are injured by unfair trading but who did not purchase or sell the subject security.

Subsection (c) is not, however, without limits. In order to fit within subsection (c), a private plaintiff must allege and

172. See Note, *supra* note 125, at 507-23.

173. See Proposal, *supra* note 104, at § 16A(g)(1)(A).

174. See *supra* notes 132-35 and accompanying text.

175. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

176. 421 U.S. 723 (1975), *reh'g denied*, 423 U.S. 884 (1976).

177. *Id.* at 728.

prove that he or she was *injured by* a defendant's violation of subsection (a). Accordingly, subsection (c) would require a showing of causation.¹⁷⁸

The amount of money damages recoverable pursuant to subsection (c) is subject to the broad, but reasonable, discretion of the trier-of-fact. The amount of damages is not without limitations. Specifically, the amount of damages must be compensatory. That is, the award must be consistent with the investor's injury. Therefore, the award should reflect the losses proximately sustained by the injured investor because of the unfair trading of the violator. This aspect of subsection (c) differs markedly from the Proposal. Rather than focusing on the profits obtained or the losses avoided by the wrongdoer, the Act aims at re-dressing the harm sustained by the injured investor.¹⁷⁹ Because the losses sustained by numerous investors as a result of the wrongdoer's conduct will likely exceed the benefits obtained by the wrongdoer, under the Proposal the injured investors' recovery is merely a fraction of their actual losses. Subsection (c) attempts to avoid the empty, pyrrhic victory provided for in the Proposal and seeks instead to fully compensate an investor injured by a violation of the Act.¹⁸⁰

Subsection (c) of the Act also provides that a court may, where necessary and appropriate, award equitable relief. For instance, a court may grant injunctive relief, order disgorgement or appoint a receiver, among other equitable measures, where circumstances warrant such action. It is the

178. See, e.g., *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). It should be noted, however, that simply because subsection (a) employs similar language as the antitrust laws, case law developed under the antitrust laws should not be grafted on to the Act. See, e.g., *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104, 113 (1986) (requiring antitrust injury). Instead, courts interpreting the Act should be guided by the Supreme Court's rejection of the proposition that a "RICO injury" is necessary in order to state a cause of action under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68 (1988). *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 500 (1985).

179. See Proposal, *supra* note 104, at § 16A(g)(1)(B)(2) ("No person shall be liable in any private action . . . for an amount in excess of such person's actual profit obtained or loss avoided"). See also *Insider Trading and Securities Fraud Enforcement Act of 1988*, § 20A(b)(1), 15 U.S.C. § 78t-1(b)(1) (1988).

180. The Act would not supplant the availability of treble damages as provided for in the 1984 Act. See *Insider Trading and Securities Fraud Enforcement Act of 1988*, § 21A(2), 15 U.S.C. § 78u-1(a)(2) (1988).

intent of the Act to allow a court significant leeway in fashioning equitable remedies that it deems both necessary in the furtherance of the Act's goals and appropriate under the circumstances.¹⁸¹

C. *Testing the Act*

1. *The Insider*

Suppose A, a director of XYZ, Inc., learns at a Board of Directors meeting that XYZ's quarterly earnings have increased fourfold. Suppose further that such information is material and, as of yet, nonpublic. Shortly after the meeting, A, capitalizing on his position as a director of XYZ, purchases 10,000 shares of XYZ common stock¹⁸² currently trading on the New York Stock Exchange (NYSE) at \$20 per share. Of course, A did not, and likely could not, disclose to the trading market the confidential earnings information before executing the above-described trade. Several days later, XYZ announces its tremendous quarterly earnings and, in response, the price of XYZ's common stock quickly jumps from \$20 per share to \$25 per share.¹⁸³ Certainly, any definition of unfair insider trading must prohibit such pernicious conduct.

Under the Act, A would be liable because he knew or should have known that the earnings information was acquired unfairly. Specifically, because A has access to confidential information, and because A "used" such information, A's trading clearly falls within the proscriptions of the Act. As such, under subsection (c), A is subject to liability to any person who proves a proximate injury because of A's unfair trading.¹⁸⁴ A

181. Finally, because the Act details only the substantive provisions of a definition of and prohibition against insider trading, the Act does not address peripheral, but nonetheless important, issues such as jurisdiction, venue and congressional findings. Such issues, of course, must be included in a comprehensive legislative definition of and prohibition against unfair insider trading.

182. Under the Act, the term "security" should be interpreted broadly to include derivative securities such as options and futures. For an examination of liability under rule 10b-5 for insider trading in connection with such derivative instruments, see Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056 (1988); Note, *supra* note 171.

183. For the purpose of this hypothetical, assume that the volume of A's trading does not, by itself, affect the market price of XYZ common stock.

184. A would also be subject to criminal prosecution pursuant to subsection (a) of the Act.

could, however, escape liability if he could somehow show that his trade was not made "on the basis of" the material and nonpublic earnings information.

2. *The Temporary Insider*¹⁸⁵

Assume the same facts as above but that B, an outside accountant hired by XYZ to assist in the preparation of the quarterly financial reports, purchases in an open market transactions on the NYSE several hundred shares of XYZ common stock, also at a price of \$20 per share. Again, hoping to exploit his temporary informational advantage, B does not disclose to the trading market the information concerning XYZ's phenomenal earnings for the most recent quarter. Similar to A, because of B's access to confidential information, B would be liable to any person injured by B's unfair trading if B traded on the basis of the material and nonpublic earnings information and if B knew or should have known that the information was acquired unfairly (that is, acquired from B's access to confidential information).

3. *Tippees*

Returning to the hypothetical situation involving A, suppose that A, in addition to unfairly trading in XYZ common stock, telephones his wife, C. A informs C that he just learned that XYZ's quarterly earnings have gone through the roof and that she should buy at least 1,000 shares of XYZ common stock as soon as possible. Within minutes of her telephone conversation with A, C dutifully calls her stockbroker. Moments later, C's order purchasing 1,000 shares of XYZ common stock is confirmed. C's conduct is patently unfair and, under the Act, prohibited. More particularly, C would be liable to any person injured by her unfair trading so long as it is shown that C purchased the XYZ stock on the basis of material, nonpublic information (the unannounced quarterly earnings) and that she knew or should have known that such information was acquired from a person with access to confidential information relating to XYZ. Significantly, it would not be

185. The concept of "temporary insiders" derives from footnote 14 of the *Dirks* opinion. *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

necessary to prove that A, by his disclosure, received some nebulous personal benefit.¹⁸⁶ However, because the Act is primarily concerned with the unfair trading of securities, A's self-interested and selective disclosure, by itself, is outside of the scope of the Act.

Now suppose that C told her friend, D, that XYZ's quarterly earnings have increased substantially and that it would be a good idea to buy XYZ common stock before the impending announcement. Assume further that D, without disclosing the earnings information prior to trading, purchases XYZ common stock on the NYSE, also at \$20 per share. Additionally, assume that D's purchase was based on the material and nonpublic earnings information. In order to impose liability on D under the Act, a prosecutor or injured investor must establish that the information was acquired from, or revealed by, a person with access to confidential information concerning XYZ. Regardless of whether C is determined to have access to confidential information concerning XYZ because of her marital relationship with A, D could be held liable under the Act if it is shown that D knew or should have known that the earnings information was initially revealed by a source with access to confidential information. Unlike the first three hypotheticals, D's liability is not so clear. Indeed, as the information is passed down the line, liability will ultimately turn on what the remote tippee knew or should have known concerning the source of the information. Admittedly, this is an imprecise aspect of the Act. Nevertheless, because the Act eliminates the vague personal benefits analysis, the Act is a significant improvement over the current chaotic law governing insider trading.

Perhaps another hypothetical will illuminate the inequities that can arise under the personal benefits test. Suppose that after learning of the earnings information, A telephones T, an aggressive analyst who follows XYZ. In addition, assume that A and T are not personally acquainted. Assume also that A's disclosure to T is not done in order to line A's pockets. Finally, assume that, on the basis of the material and nonpublic earnings information, T personally purchases on the NYSE a large block of XYZ common stock, also at \$20 per share. Under current case law, A's disclosure to T would not satisfy the

186. See *supra* notes 52-58 and accompanying text.

personal benefits test because A has not benefited from the disclosure.¹⁸⁷ By contrast, under the Act, T would be liable if it is established that T knew or should have known that the material, nonpublic information was acquired from or revealed by a person (A) with access to confidential information.

4. *Analysts*

As noted above, securities analysts are not afforded any special exemptions or defenses under the Act.¹⁸⁸ Instead, like all other investors, an analyst's liability under the Act will depend, in part, on whether the trade was made on the basis of material, nonpublic information acquired from, or revealed by, a person with access to confidential information relating to the subject security. For example, suppose that AN learns from A that XYZ's quarterly earnings have quadrupled. If AN then trades on the basis of such material, nonpublic information, AN, like C, would be liable under the Act to any person injured by AN's unfair trading. Similarly, if AN learns of the material and nonpublic information while assisting XYZ in some respect, AN, like B, would be liable because AN is a person with access to confidential information concerning XYZ. On the other hand, if AN examines material but public information concerning XYZ or acquires immaterial but nonpublic information relating to XYZ and, through AN's skill, experience and diligence, concludes that XYZ's quarterly earnings will increase substantially, AN has not traded on the basis of material, nonpublic information. In such a case, AN would not be liable under the Act.

5. *Creators of Information*

Similar to the securities analyst are other individuals or entities that, by their skill, experience and diligence, create material, nonpublic information relating to a security. For example, assume that BID, Inc. is planning on commencing a

187. It may be possible, however, to construct an argument that T was a "temporary insider" under the analysis of *Dirks* and, hence, should be prohibited from trading on the basis of the earnings information. A prosecutor or plaintiff would need to establish that T was given the information for a legitimate corporate purpose and that T knew that such information was confidential. See *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

188. See *supra* notes 137-39 and accompanying text.

tender offer for TAR, Inc. Assume further that information concerning this imminent tender offer is both material and nonpublic (not a very difficult assumption). Now suppose that BID purchases shares of TAR on the NYSE prior to announcing the tender offer. Has BID violated the Act? The short answer is no. BID has created the information concerning TAR and has *not* acquired the information from, nor was it revealed by, a person with access to confidential information concerning TAR. Accordingly, purchases of TAR shares made by or on behalf of BID would not violate subsection (a) of the Act. If, however, a person with access to confidential information concerning BID learns about the impending tender offer and then trades on the basis of such material, nonpublic information, the renegade trader would be liable under the Act. Such an interpretation of the Act would permit those who, through their own efforts and skill, create material, nonpublic information to benefit from their industriousness.¹⁸⁹

Similarly, suppose that a financial periodical, the WSJ, is so influential that its comments can significantly affect the price of a security. In addition, suppose that the contents of its upcoming articles are material, nonpublic information. Under the Act, the WSJ, as an entity, may benefit from an informational advantage that it has fairly created.¹⁹⁰ On the other hand, if a person with access to this material, nonpublic information trades on the basis of it, such a person would be liable under the Act. While it may appear that permitting the creators of information to exploit informational advantages is unfair, a contrary result would unjustifiably deny individuals and entities who, through their skill, experience and efforts, assemble and create information, from benefiting from their labors. It is important to emphasize that the Act does not attempt to require equal *possession* of information. Rather, the Act prohibits those with access to confidential information from unfairly exploiting their positions.

189. This result is consonant with the likely result under Rule 14e-3 [17 C.F.R. § 240-14e-3 (1989)].

190. This factual setting is lifted from the Winans/Wall Street Journal case. See *Carpenter v. United States*, 484 U.S. 19 (1987).

V. CONCLUSION

The current administrative and judicial interpretations of the various statutory provisions governing insider trading are inconsistent and incoherent. The discordant administrative and judicial decisions have contributed to the erosion of investors' confidence in the integrity and fairness of the securities markets. The courts have introduced inappropriate fraud-based principles while, at the same time, ignoring fundamental tenets of fairness. The confusing judicial opinions reached under the misappropriations theory and the troublesome personal benefit test underscore the necessity of a concise definition of and prohibition against insider trading.

The Proposal put forth in 1987 was a significant step toward reestablishing notions of fairness and accountability in the securities markets. The Proposal, however, fell victim to politics.

This article has introduced the Act, a variation of the Proposal. The Act is premised on fairness and would, in general, prohibit the unfair trading of securities. Unfair trading, in turn, depends on the source of the information which prompted the trade. The Act prohibits those with access to confidential information from trading on the basis of material, nonpublic information. Moreover, the Act prohibits those who acquire material, nonpublic information from a person with access to confidential information from trading on the basis of such information. In order to provide individual private investors with a sense of self-determination, the Act provides for broad legal and equitable relief.