

A Policy Based Definition - Insider Trading

By

Michael J. Trevelline  
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## A POLICY BASED DEFINITION OF INSIDER TRADING

### I. Introduction

Insider trading has recently come to the fore of public consciousness for three reasons. First, the U.S. Supreme Court addressed the issue of a proper definition for insider trading several times in recent years. Second, the Securities and Exchange Commission (SEC) and the Department of Justice brought several highly publicized cases in recent years against some who made quite large profits from trading on inside information. Third, the large number of takeovers in the eighties increased insider trading opportunities and so increased the amount (at least perceived) of insider trading. The U.S. Congress and many scholarly commentators have simultaneously taken a very circumspect look at insider trading from legal, policy, and economic standpoints.<sup>1</sup> In addition, several nations, in an effort to develop their own securities markets have followed the

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<sup>1</sup>Insider trading has especially been studied since SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

U.S. lead and prohibited insider trading.<sup>2</sup>

Even with all this effort to understand and develop the law of insider trading, several gaps in the present law exist.<sup>3</sup> No clear policy statement, neither judicial nor Congressional, of why insider trading is illegal in the United States exists. So the judiciary has no basic goal to reference; nor do those trying to determine whether their conduct is legal. Congress has considered remedying this problem with a definition of insider trading. These Congressional considerations took place from 1983 to 1991.<sup>4</sup> The attempts have failed; no proposal ever

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<sup>2</sup>E.g., Council Directive 89/592, 1989 O.J. (L 334) 30 (requiring each member state of the European Community to prohibit insider trading by June 1, 1992);

<sup>3</sup>See infra note 51.

<sup>4</sup>House Comm. on Agriculture, Commodity Futures Improvements Act of 1991, H.R. Rept. No. 6, 102d Cong., 1st Sess. (1991); Senate Comm. on Agriculture, Nutrition, and Forestry, Futures Trading Practices Act of 1991, S. Rept. No. 22, 102d Cong., 1st Sess. (1991); Insider Trading Before the House Comm. on Energy and Commerce, 100th Cong., 2d Sess. (1988); RICO Reform Act of 1989, Hearings Before the House Comm. on the Judiciary, 101st Cong., 1st Sess. (1989); Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 100th Cong., 2d Sess. (1988); Senate Comm. on Agriculture, Nutrition, and Forestry, Futures Trading Practices Act of 1989, S. Rep. No. 191, 101st Cong., 1st Sess. (1989); Overview of the Agencies and Programs Under the Jurisdiction of the Subcomm. on Conservation, Credit, and Rural Development, Hearings Before the House Comm. on Agriculture, 100 Cong., 1st Sess. (1987); House Comm. on Agriculture, 100th Cong., 1st Sess. (1987); Securities

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Regulation Issues, Hearings Before the House Comm. on Energy and Commerce, 100th Cong., 1st Sess. (1987); Tender Offer Reform (Part 1), Hearings Before the House Comm. on Energy and Commerce 100th Cong., 1st Sess. (1987); House Comm. on Energy and Commerce, Insider Trading and Securities Fraud Enforcement Act of 1988 H. Rep. No. 910, 100th Cong., 2d Sess. (1988); Problems with the Sec's Enforcement of U.S. Securities Laws in Cases Involving Suspicious Trades Originating from Abroad, Hearings Before the House Comm. on Government Operations, 100th Cong., 2d Sess. (1988); Oversight Hearing on the Commodity Futures Trading Commission, Hearings Before the Senate Committee on Agriculture, Nutrition, and Forestry, 100th Cong., 1st Sess. (1987); Reauthorizations for the Securities and Exchange Commission, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 99 (1987); Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. (1986); SEC and Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. (1986); Improper Activities in the Securities Industry, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Oversight of the Securities and Exchange Commission and the Securities Industry, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Definition of Insider Trading, Part 1, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Regulating Hostile Corporate Takeovers, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. (1987); Senate Comm. on Banking, Housing, and Urban Affairs, Tender Offer Disclosure and Fairness Act of 1987, S. Rep. 265, 100th Cong., 1st Sess. (1987); Insider trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. (1983); Insider Trading Sanctions and SEC Enforcement Legislation, Hearings Before the House Comm. on Energy and Commerce, 98th Cong., 1st Sess. (1983); House Comm. on Energy and Commerce, Insider Trading Sanctions Act of 1983, H. Rpt. No. 355, 98th Cong., 1st Sess. (1983).

left committee. The law of insider trading remains a fraud concept except when the information relates to a tender offer. It does so by necessity since section 10(b) is an anti-fraud provision.<sup>5</sup> Most of the contemplated definitions have held to the concept that insider trading be defined in terms of fraud.<sup>6</sup> Indeed almost all proposed definitions

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<sup>5</sup>The Securities Exchange Act of 1934 §10(b), 15 U.S.C. §78j (1988).

<sup>6</sup>E.g., Fed. Sec. Code §1603 (1980); S. 1380, 100th Cong., 1st Sess. (1987), reprinted in, 39 Ala. L. Rev. 531 app. at 531-34 (1988) [hereinafter S. 1380]; Securities and Exchange Commission Proposed Insider Trading Bill of Aug. 3, 1987, 39 Ala. L. Rev. 531 app. at 535-42 (1988) [hereinafter SEC 1st Proposal]; New York Stock Exchange Legal Advisory Committee Proposed Statutory Definition of Insider Trading, Id. at 543-44 (proposing a non-fraud based definition) [hereinafter NYSE Proposal]; Securities and Exchange Commission Proposed Insider Trading Bill of Nov. 18, 1987, Id. at 545-51 [hereinafter SEC 2d Proposal]; Reconciliation Draft of S. 1380, 100th Cong., 1st Sess. (1987), reprinted in, 39 Ala. L. Rev. 531 app. at 552-58 (1988) (proposing a non-fraud based definition) [hereinafter Reconciliation Draft S. 1380].

do little more than codify the present law.<sup>7</sup> Discussions of a statutory definition have been accompanied by a preoccupation with writing a definition which leaves no loopholes. Recently more serious attention is being given to a prohibition not predicated on fraud. Other nations have recently adopted definitions not predicated on fraud.<sup>8</sup> Such definitions take better account of the policy reasons behind prohibiting insider trading. It is the thesis of this paper that clear policy reasons for prohibiting insider trading should be stated and that a comprehensive non-fraud based definition consistent with those policy reasons should be enacted. A modern complex securities market calls for such a definition. In addition, such a definition will better integrate the U.S. market into the international market.

## **II. Need to Prohibit Insider Trading**

### **A. Policy Goal of Prohibiting**

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<sup>7</sup>E.g., Fed. Sec. Code. §1603 (1980); S. 1380 supra note 6; SEC 1st Proposal supra note 6; SEC 2d Proposal supra note 6; Reconciliation Draft S. 1380 supra note 6.

A dispute exists whether insider trading should be prohibited at all.<sup>9</sup> Even among those who support prohibiting insider trading, they differ on exactly why it should be prohibited. A clear policy statement would give all involved something to reference to. Court decisions would become more predictable. Therefore, any definition of insider trading should be accompanied by a precise policy statement of the harm sought to be avoided and the reason why.

A logical and appropriate policy statement can be discerned from current understanding of insider trading. This policy statement is arrived at by focusing on the major function of securities markets. The major function of securities markets is to allocate capital to the enterprises which can make the best use of the capital. In doing so, the economy is served best

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<sup>8</sup>E.q., Council Directive 89/592, 1989 O.J. (L 334) 30.

<sup>9</sup>E.q., Kenneth E. Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. of Legal Stud. 801 (1980); Dennis W. Carlton & Daniel R. Fishel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857 (1983); Donald C. 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 (1988); Henry G. Manne, Insider Trading and the Stock Market, (1966); Lewis D. Solomon, Donald E. Schwartz & Jeffrey D. Bauman, Corporations Law and

when capital is appropriately allocated, that is, the more productive enterprises have proportionally more capital.<sup>10</sup> For the capital to flow from the investors to the appropriate enterprises, information must flow to the investors. The mechanism by which investors allocate capital is the pricing of securities. Investors analyze this information and price securities based on their analysis in the context of a free-enterprise system. A necessary part of a free-enterprise system is competition. In pricing securities, the competition is between the investors. Each investor strives to outdo the other by finding securities which are inaccurately priced.

Securities markets are divided into two types, primary and secondary. So the pricing must be done in both markets. Accurate pricing in the primary market is critical since it is then that the capital is actually flowing to the enterprise. Since capital is not flowing to the enterprise in the secondary markets, pricing is not as critical. Nevertheless, accurate pricing in the secondary markets is important. The secondary markets are an integral part of the system allocating capital

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Policy: Materials and Problems, (2d Ed. 1988).

<sup>10</sup>Economies of scale also play a part in the allocation of resources by limiting the amount of capital that an enterprise can use efficiently.

for two reasons. First, pricing in the secondary market provides information critical to accurate pricing in the primary markets. Even with an initial public offering, underwriters deciding the appropriate offering price look to pricing in the secondary market -- both security prices in the secondary market as a whole and prices of securities with the same characteristics as the securities being offered.<sup>11</sup> Second, pricing in the secondary market provides valuable information to corporate managers about the corporations ability to raise capital in the future.

This analysis of securities markets points to three major underlying policy goals which insider trading regulations should strive to met. That buyers have and understand all available information is the key to pricing securities. Therefore, the first policy goal must be to encourage the flow of information to investors.<sup>12</sup> The second basic policy goal of regulating insider trading is also apparent: The information flow must be available to as many investors as possible. For the more widely

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<sup>11</sup>It is well recognized that underwriters rely heavily on the secondary market when pricing an issuance. Thomas Lee Hazen, The Law of Securities Regulation §3.1, at p. 91 (2d ed. 1990).

dispersed the information is the more accurate the price will be.<sup>13</sup>

The third policy goal is a little more general in nature: Market participants should be encouraged to perform their function. The nature of this goal is developed throughout this paper but is worth summarizing here. The first participants, the investors, should be encouraged to invest.<sup>14</sup> For example, if any group of investors is excluded from the flow of market information, they will have little incentive to invest. The second participants are the analysts. For example, their product, analysis, will not be valued by investors if investors can make even larger profits by purchasing inside information. The third participants, market makers incur losses when insider trading occurs and so increase the cost of their services.

## **B. Arguments For and Against Insider Trading**

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<sup>12</sup>Scott, supra note 9, at 804.

<sup>13</sup>Ronald J. Gilson and Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 567 (1984).

<sup>14</sup>The analysis of this paper assumes that securities markets are one of the most efficient means of allocating capital. Therefore, the comparative allocative efficiency of other

This analysis focuses on the primary purpose of securities markets, the allocation of capital.<sup>15</sup> Therefore, this paper proceeds on the basic assumption that society is benefited the most from an accurate allocation of capital. This paper analyzes how insider trading inhibits the accurate allocation of

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markets, such as bank deposits, is not discussed.

<sup>15</sup>This role of the securities markets is well recognized in economics:

The type of social organization which allows for this coordination of activities among individuals is essentially a **market** or **price system**. In such a system, resources tend to flow where they yield the highest rate of return, or highest profit. Prices generate the signals for such resource movements; they provide information cheaply and quickly; and they affect incentives. These prices are determined in the myriad markets for the myriad goods and services bought and sold every day.

A market system is only one type of social organization for production and distribution. A political social organization would be another. Within this very broad category of political systems, there are a large number of variants - majority rule, dictatorship, plurality, and so on. Actually, within most countries a combination of market and political systems is used: a hybrid social organization which determines production and distribution.

Roger LeRoy Miller, Intermediate Micro-Economics: Theory, Issues, and Applications, 2 (1978).

capital. However, benefits of insider trading, largely external to the securities markets themselves, may well exist. Many of the arguments for allowing insider trading focus on one of these external benefits without recognizing the harm done to the accurate allocation of capital. The three policy goals of insider trading regulation clarify the harm done to the accurate allocation of capital thus placing the arguments for insider trading in perspective. To the extent that a particular external benefit from insider trading outweighs any benefit from accurately allocating capital, one may decide to allow insider trading. However, the analysis of this paper finds no such benefit to be so large.

What follows is a brief discussion of each of the major arguments analyzed with the three policy goals in mind. Then, with the reasoning behind these three goals as a framework, the paper looks at possible definition of insider trading.

Essential to developing an appropriate definition of insider trading is a clear understanding of the harms of insider trading. Therefore, it is appropriate to place the major arguments for and against insider trading in perspective. Yet another need for a detailed analysis of the various insider

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trading arguments exists. A particular judge administering the law, or a legislator, may be presented with one of many arguments for allowing insider trading. If he were not able to place that argument in perspective, he may well create an ill-advised exception to an insider trading prohibition. Four general harms exist.

### **1. Investor Confidence Harmed**

Insider trading harms investor confidence in the market. "[I]nvestor confidence in the securities markets . . . is arguably the principal purpose of all securities laws.<sup>16</sup> Virtually every group called to comment before Congress on insider trading believed it damaged the integrity of the market.<sup>17</sup> The question remains, however: How is market

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<sup>16</sup>Jeffrey D. Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose, 67 Geo. L. J. 935, 948 (1970) (footnote omitted).

<sup>17</sup>For example, the New York State Bar Association said that insider trading "undermine[s] the integrity of our securities markets . . . ." Insider Trading Sanctions Act of 1983, Hearings before the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 106 (1983). Sam Scott Miller representing the Securities Industry Association said that it undermines confidence in the securities markets. Id. at 124. John Shad, Chairman of the SEC said that "[i]t victimizes not

efficiency harmed by this mere perception? This perception says nothing about the policy goals not being met other than some investors believe the goals are not being met. That investors will not invest in the market is the harm, the third policy goal. Society is harmed by capital being channeled to investments which would not be made if the securities market were a viable alternative. This analysis refutes a prominent argument in favor of insider trading which centers around the apparent lack of harm from insider trading.

However, many argue that even if insider trading is occurring, investors will be indifferent since the harm cannot be traced to a particular investor. When looking for a specific person harmed from a specific trade, often no one can be pinpointed.<sup>18</sup> This argument misses the point that the trades carry great external costs. Others have raised compelling criticisms of such an argument.<sup>19</sup> Precisely why investors will

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only individual and institutional investors, but also securities firms, corporations, and others." Id. at 11.

<sup>18</sup>E.g., Manne, supra note 9, at 352.

<sup>19</sup>See infra note 47. This argument has been very well thought out. Professor Painter recognizes Professor Manne' argues that long-term traders are indifferent to insider trading since they hold stock through the ups and downs of the insider's trades anyhow. He, then, criticizes this argument. William H. Painter, Federal Regulation of Insider Trading 352-55.

not invest in an unfair securities market can be seen in even greater clarity by again focusing on the securities market. Our entire free-enterprise system is based on competition. As in most aspects of our economy, securities investors perceive themselves as competing against each other. They are competing to make the smartest investments, to have the portfolio with the highest returns. Certainly most investors understand that other larger investors with access to advisors and research departments have an advantage. But such an advantage is being paid for. The fact that a large portfolio with expensive analytical support did better than a particular individual is not very discouraging. But to be bettered by the person down the street who just happens to have a brother-in-law who is a financial printer is a different story. Investing becomes more

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Professor O'Connor has stated that investors do not know which firms are susceptible to insider trading so they discount the value of their entire portfolio. Therefore all corporations are harmed since recourses are not allocated efficiently. Marleen A. O'Connor, Toward A More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b), 58 Fordham L. Review 309, 316-17. Professor Wang has developed a "law of conservation of securities" argument. He claims that someone must be harmed because only so many securities are issued by any one issuer so that an inside trader must be either forcing other buyers out or allowing other buyers who would not normally buy. William K.S. Wang, Recent Developments in the Federal Law Regulating Stock Market Inside Trading, in Contemporary Issues in Securities Regulation 59, 73 (Marc I. Steinberg ed., 1988). One text summarizes the various arguments. Solomon, Schwartz & Bauman,

of a lottery, a game of "dumb luck" than an exercise in intelligence. Presumably those with the most ability to compete in an endeavor of skill will pick up and go elsewhere where their skill might actually mean something. Are not these the very people necessary to the running of an efficient market.<sup>20</sup>

Finally, some empirical evidence exists arguably supporting the conclusion that small investors react to insider trading by withdrawing from direct investment in the securities markets. Coinciding to some extent with the well-publicized insider trading scandals of the eighties, U.S. small investors transferred investments from direct ownership in securities to investments in mutual funds.<sup>21</sup> Similarly, foreign securities markets with traditional weak insider trading prohibitions have

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supra note 9, at 1177-84.

<sup>20</sup>Yet another external cost of loss of small investors may exist. Owning stock and receiving financial reports, securities investors may feel more apart of the U.S. financial system. News of the financial markets and macroeconomic decisions of the government will hold more significance. Generally, then, the investing public will be supportive of government endeavors and so participate in the political system.

<sup>21</sup>It has been reported that "there has been an explosive worldwide growth in mutual funds as a preferred investment medium. In the past decade, mutual funds have become firmly established as an investment of choice by the rapidly growing middle class around the world." David Silver, Meeting The Demand For Pooled Investments In A World Market 1 (Draft of Sept. 20, 1991) (unpublished paper prepared by the president of

had a low amount of small investor participation.<sup>22</sup>

## 2. Stock Analysts Harmed

Similar reasoning applies to the effect of insider trading on analysts. Analysts are similar to other investors in that they exist in a competitive environment. If anything, the competition is even keener for analysts who are making their living from the securities markets. Analysts serve directly the first policy goal, enhancing the flow of information. Analysts increase the flow of information to the market in two ways. First, they sift through volumes of publicly available information and interpret its relevance to the market. One aspect of this process is often referred to as the mosaic theory.<sup>23</sup> Second, they go beyond the commonly available

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the Investment Company Institute).

<sup>22</sup>Barry A. K. Rider & H. Leigh French, The Regulation of Insider Trading 232 (1979).

<sup>23</sup>The Financial Analysts Association's written presentation to Congress contains a fine description of the mosaic theory of analysts. Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 113 (1987). Basically the theory states that a single piece of information in itself may not be helpful but when viewed in the confines of an analytical framework with many other small pieces. The analysts has a significant insight

information and produce additional information by searching for it: interviewing managers, physically observing production facilities and products. Since these activities increase the flow of information to the market, they should be encouraged.

Therefore, the effect of insider trading on analysts is quite relevant. The question is whether insider trading encourages or discourages investors to accurately value analysis. On one hand, insider trading discourages analysts from performing their functions.<sup>24</sup> Insider trading will make their predictions less accurate. For example, an analysts may correctly interpret information concerning a security and buy the security for the portfolios he is managing. He and the owners of the portfolios will be surprised to learn that other portfolios sold the same security short and made a large profit. The other portfolios had access to inside information concerning negative news. After similar incidents are repeated, the portfolio owners will discount the value of analysis appropriately. So less analysis will end up being done. Both functions of analysts will be undervalued by the market.

On the other hand, prohibiting insider trading will also

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into a security's value.

<sup>24</sup>Note, Toward A Definition on Insider Trading, 14 Stan. L.

slow the flow of information to analysts.<sup>25</sup> But only the second, searching for information, function of analysts will be affected. If a corporate manager is potentially liable for tipping inside information by saying too much to an analysts, their relationship is bound to be cooled.<sup>26</sup> And this second function of analysts is not only valuable simply because it brings information to the market but also because it brings information to the market which falls through the cracks of

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Rev. 377, 398(1989).

<sup>25</sup>This affect is well recognized. E.g., Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 219 (1986); Daniel L. Goelzer & Max Berueffy, Insider Trading: The Search for a Definition, 39 Ala. L. Rev. 491, 506 (1988); Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 99 (1987) (statement of Theodore A. Levine); Daniel R. Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra L. Rev. 127, 144-45 (1984).

<sup>26</sup>A statement of the Financial Analyst Federation before Congress describes the situation: The Supreme Court in Dirks v. SEC, 463 U.S. 646 (1983), recognized that sometimes insiders

act consistently with their fiduciary duty in communicating [material nonpublic] information to managers and analysts . . . . These include instances where corporate officials may mistakenly think the information has already been disclosed or that it is not material enough to affect the market, or where there is an inadvertent or accidental disclosure.

Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th

disclosure rules. For example, the demeanor of the corporate managers when discussing already public information with analysts, may reveal how confident the managers are in the accuracy of the public information. Or the inability of management to discuss coherently the significance of the public information, may reveal how competent the management team is. Also this second function of analysts aids in the detection of fraud.<sup>27</sup> On the other hand, no reason exists to allow analysts to find information Congress has decided corporations need not disclose.<sup>28</sup> The fact that prohibiting inside information in this one area inhibits a desirable flow of information does not call for an across the board legalization of insider trading, but only that any prohibition be tempered in this area.<sup>29</sup>

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Cong., 1st Sess. 108 (1987).

<sup>27</sup>Fischel, supra note 25, at 142.

<sup>28</sup>Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L. J. 1083, 1121-23 (1985). Professor Seligman goes on to argue that much of this analyst problem can be solved, then, by increasing the corporate duty to disclose especially earnings projections.

<sup>29</sup>Professor Langevort summarizes the considerations for lessening insider trading liability for analysts and their sources:

Each explanation assumed a good faith desire on the part of the issuer's officials to inform the marketplace (or enhance the credibility of disclosure) through

### 3. Market Makers Harmed

Another external cost of insider trading is the effect on market makers and so the liquidity of the market. A number of commentators have detailed the cost to market makers of insider trading. Market makers normally incur disproportionate losses when insider trading occurs.<sup>30</sup>

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dissemination of information to one or a small group of analysts. However . . . pure insider trading will not have the capacity to make the market price of the issuer's securities more efficient unless somehow other traders are able to identify the insider as having an informational advantage and react accordingly . . . . Under the current market structure, such decoding is often difficult, if not impossible . . . . [However, the Dirks] safe-harbor is substantially overbroad: even taking the argument on its own terms, protection is appropriate only where the insider has a reasonable expectation that selective disclosure is indeed a means of informing the marketplace, an expectation that at best holds only under limited circumstances . . . .

. . . .

[A better rule may be that] the Dirks safe-harbor is available only with respect to unintentional disclosures, such as slips of the tongue or good faith misappreciations of materiality, not conscious tips.

Donald C. Langevoort, Investment Analysts and the Law of Insider Trading, 76 Va. L. Rev. 1023, 1028-53 (1990).

<sup>30</sup>E.g., Practising Law Institute, Trading on Inside Information: Problems of defining, detecting, prosecuting, and defending insider trading cases, 18 (1984) ("Insider trading can

The greater the proportion of [inside] traders to liquidity traders that [market makers] perceive they face, the wider their bid-ask spreads become in order to compensate themselves for their losses to insiders. . . . The result for firms is that the cost of using the market for financing rises, thereby altering the proportion of the funds they choose to derive from debt and equity.<sup>31</sup>

Options markets are especially vulnerable to this costs.<sup>32</sup>

#### 4. Management Incentives Harmed

A final well recognized cost and benefit of insider trading

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also have severely adverse effects on market-makers and specialists who cannot make rational pricing decisions about the securities they handle when trading with persons who possess insider information."); "Market makers and specialists, so necessary to the liquidity of the market, have suffered extreme financial losses in such situations." House Comm. on Energy and Commerce, Insider Trading Sanctions Act of 1983, H. Rpt. No. 355, 98th Cong., 1st Sess. 5 (1983). For example, in one instance \$430,000 of profits were made in 48 hours by buying \$3,000 worth of options. Id. at 5; Insider Trading Sanctions Act of 1983, hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 98th Cong., 2nd Sess. 16 (1987) (statement of SEC Commissioner John Shad) ("Market makers and specialists . . . cannot make rational pricing decisions."); Practicing Law Institute, supra at 18 ("Insider trading can also have severely adverse effects on market-makers and specialists who cannot make rational pricing decisions about the securities they handle when trading with persons who possess insider information.").

<sup>31</sup>Note, supra note 24, at 397.

<sup>32</sup>SEC Chairman John Shad has stated before Congress that options market makers have gone bankrupt or lost millions in takeover situations when insiders traded. Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 99th

is its effect on management incentives. The cost is that instead of concentrating on running a corporation as well as they can, managers will have an incentive to modify the flow of information in various ways in order to create greater profit opportunities. Most notably, management will delay disclosure in order to take advantage of the information before disclosure.<sup>33</sup>

However, several commentators have argued that insider trading in various ways provides incentives for corporate managers to be more productive<sup>34</sup> or to take risks which benefit investors.<sup>35</sup> For example, managers' incentives to increase the stock price and so benefit shareholders are strengthened most

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Cong., 2d Sess. 38 (1986).

<sup>33</sup>Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 60 (1987) (statement of Professor Donald Longevoort); Note, supra note 24, at 385 (summarizing both sides of this argument very well). An important consideration is that "[t]he advantages of encouraging full disclosure to maintain investor confidence are most obvious when one focuses on insider possession of material information. If insiders are forbidden to trade until disclosure occurs there will be no financial incentive to delay disclosure of material information." Seligman, supra note 14, at 1119 (citation omitted).

<sup>34</sup>Manne, supra note 9, at 78-104; Carlton & Fischel, supra note 9, at 869-72.

<sup>35</sup>Solomon, Schwartz & Bauman, supra note 9, at 1182 ("[I]t compensates managers and provides them with an additional

effectively by allowing insider trading. The managers have internal incentives to increase the stock price because they could profit greatly from it themselves.<sup>36</sup> The niceties of these arguments have been well thought out in the literature.

However, it is not within the scope of this paper to discuss them. Rather it is for this paper to put the costs and benefits of management incentives within the perspective of the three policy goals. Increasing management incentives has little or nothing to do with increasing the efficiency of the securities markets through the three policy goals. Devising means of increasing management incentives is a noble and worthwhile goal. However, insider trading is a securities market issue. As a securities market issue, the proper focus is on the securities market, not the most efficient means of increasing management incentives. The insider trading means of increasing management incentives is inconsistent with the three goals of insider trading regulation. It would only be otherwise were efficiency of the shareholder-manager relationship more important than the

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incentive to take risks that will benefit investors.").

<sup>36</sup>E.g., Manne, supra note 9, at chs. VIII & IX; Daniel R. Fischel, Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission, 13 Hofstra L. Rev. 127, 132-35; Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo.

efficiency of the securities markets.<sup>37</sup> Any benefits to management incentives are outweighed by the damage done to the securities markets by insider trading.<sup>38</sup> Certainly, management incentives considerations should be a factor, but only a secondary one.

## 5. Effect on Market Efficiency

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L. J. 1083, 1093-98 (1985).

<sup>37</sup>Generally, shareholders want managers to own shares in order to reduce agency costs because managers interests will then be more closely aligned with the shareholder's. However:

[m]anager's trading on material inside information widens the divergence between the shareholders' interests and the managers' interests, thus creating additional agency costs for the corporation. If a laissez-faire approach were taken toward insider trading, shareholders would be unable to control the amount of compensation that managers receive.

Similarly, if managers could freely engage in insider trading, they would have the incentive to concentrate more on their own trading agendas at the expense of the shareholders' long-term welfare. In concentrating on their own trading agendas, corporate officials would attempt to manipulate corporate events and the timing of information releases to induce price-swings in the firm's stock in order to create opportunities to engage in insider trading. O'Connor, supra note 19, at 318-19.

<sup>38</sup>Another external cost of insider trading is that corporate governance will become less efficient. Shareholders will have little control over the amount of compensation that managers receive.

A common argument in favor of insider trading is that such trading increases market efficiency. The core of the argument is that in an efficient securities market, the price of any one security reflects all available information about that security. When non-public information exists and is not being used to make trading decisions, the price does not reflect such information and so the market is not efficient. The argument follows that when insiders trade, the trades move the price toward the more accurate level.<sup>39</sup> So the first goal seems to be met: Insider trading moves information to the market. Commentators have pointed out a reason why the goal has not been met. The trades often do not move the price to the efficient level and when they do, the movement is done very inefficiently.<sup>40</sup> Stated in terms

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<sup>39</sup>E.g., Fischel, supra note 14, at 132-35; Solomon, Schwartz & Bauman, supra note 9, at 1182 ("[I]t will permit smoother changes in stock prices until the stock reaches its equilibrium price after the inside information has been publicly disclosed."); Note, Toward A Definition of Insider Trading, 14 Stan. L. Rev. 377, 385 (1989).

<sup>40</sup>Practicing Law Institute, Texas Gulf Sulphur: Disclosures & Insiders 629 (1968). Trades can move the price in three basic ways. Trades may cause demand to increase to such an extent that the price reflects this change in demand. Such a movement is unlikely since most securities are so widely distributed. Others may see the trades and by their volume and direction alone may guess or gamble that the traders have inside information and so follow their trades. The increased trades will drive the price toward the efficient level. Or others may

of the three policy goals of this paper, such trades simply do not meet the first goal since rarely can non-insiders even guess at the existence of such information.

The three policy goals place the effect on the efficiency of the market in perspective. Efficiency is the most necessary in securities markets when an issuer is actually issuing securities because it is then that capital is actually flowing to the user. When a corporation is issuing securities, it will possess very little inside information. To possess inside information during an issuance will usually be a fraudulent sale. Therefore, the market efficiently achieved by moving security prices quickly to the most accurate level has little value.

## **6. Property Right Theory**

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find out that insiders are trading and so follow their lead. Obviously others observing trades and guessing correctly or finding out that insiders are trading are fortuitous events. Id.; Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 631-32 (1984) ("[T]he greater the number of uninformed traders who are able to learn the identity of insider traders, the size of their trades, and other derivative information, the more effectively the derivatively informed trading mechanism will operate and the greater will be the market's relative efficiency with respect to the inside information."). By its very nature, then, insider trading is inefficient. Assuming that statutory insiders comply with a law requiring them to disclose their trades, market efficiency is increased. The Securities Exchange Act of 1934 §16, 15 U.S.C. §78 (1988).

Some argue that material nonpublic information is property and so the best analysis is to let the information be governed by property law principals.<sup>41</sup> The argument follows that the producer of the information, usually a corporation, owns the information. The corporation, then, should be allowed to use the information as it sees fit. The implicit assumption in this argument is that the market forces will allocate the information to the participants who are willing to pay the most for the information. The participant who is willing to pay the most for the information is the one who will derive the greatest benefit from it. Since he will derive the greatest benefit from it, society is better off from his use of the information than from another who values the information less. This assumption is consistent with economic theory.<sup>42</sup>

This assumption is fatally flawed. The use of this information by insiders has enormous external costs.<sup>43</sup> As made very clear below, the operation of the securities markets is

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<sup>41</sup>Scott, supra note 9, at 814; Carlton & Fischel, supra note 9, passim.

<sup>42</sup>Paul Wonnacott & Ronald Wonnacott, Economics 60-61 (1979).

<sup>43</sup>See, e.g., Id. at 61 & 84.

damaged to a great degree by such trading. When the external cost of an activity is significantly high, it is appropriate for the government to step in and through regulation allocate the external costs.<sup>44</sup> Congress has recognized this and passed the securities laws of the nineteen thirties for this very purpose. The key to the securities laws is disclosure of corporate information; Congress has recognized that efficient securities markets are so important that a comprehensive network of laws were needed to take the information from its rightful owners and disclose it to the public. Disclosure is needed to serve the first two policy goals of encouraging the flow of information to the securities markets and of encouraging the flow to a large number of investors. Congress allowed corporations to keep only a small amount of information without disclosing it. However, nothing indicates Congress meant for the information to be used by insider traders. So Congress has expropriated the information it allowed corporations to keep confidential, to a certain extent, as well by limiting the use corporations could put such information to. The information cannot be used to trade securities. Therefore, allowing insider trading is counter to the entire policy behind the securities laws.

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<sup>44</sup>Id. at 84-85.

Finally, corporations are not harmed by the loss of this property right. This information is a minor by-product of a business' main purpose, to provide a product or a service. Except for games of chance, such as lotteries, businesses do not undertake an endeavor to create information about the endeavor. That the information necessarily created such as plans and results has trading value does not mean the corporation provided the product or service with a view to trade on the information necessarily produced. The author is not aware of anyone arguing that more services or more products will be provided by allowing businesses to profit from this by-product.

## **7. Other Considerations**

Two additional significant arguments in favor of insider trading exist. One is that the expense of stopping insider trading is simply too great owing to the fluid nature of information.<sup>45</sup> The other is that if shareholders really were harmed, they would discount the value of corporations where insider trading has occurred. Therefore, firms will attempt to

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<sup>45</sup>E.g., Practicing Law Institute, supra note 30, at 19 ("Insider trading is widespread and difficult to stop").

signal the market that its securities are not susceptible to insider trading. Not being susceptible, their securities need not be discounted. Firms will conduct signalling through activities such as prohibiting it in the corporate charter or employment contracts.<sup>46</sup> The argument concludes that since corporations do not engage in signalling, investors must not be discounting securities. The response to each of these arguments does not involve the three policy goals of this paper and therefore beyond its scope. Strong counter-arguments have been authored by others.<sup>47</sup>

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<sup>46</sup>Carlton & Fischel, supra note 9, at 859.

<sup>47</sup>Manne, supra note 9, at 159.

The first of these arguments is perhaps the strongest argument in favor of legalizing insider trading: it is simply too expensive to stop. That insider trading is difficult to stop is a very commonly held view. The problem has been succinctly described:

Information is one of the most easily transmitted of all commodities. To prevent its rapid dissemination while it has exchange value is extremely difficult. Any attempt to regulate or police a market in information confronts two obstacles. The first is the extremely difficult one of knowing which transactions to prevent. The second is the actual job of policing once the undesired transactions are identified.

In fact Congress rejected a broader definition of inside trading when enacting the Securities Exchange Act of 1934 for precisely this reason.

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"When the first draft of the present [securities laws were] presented to Congress, Section 16 proscribed not only short-swing profits by insiders but disclosure to others and profiting by anyone to whom disclosure was made. Congress refused this broad coverage on the grounds that enforcement of such a provision was not feasible." Id. at 412 (citation omitted).

Although the strength of this argument cannot be ignored, considerations counsel against accepting it. The reluctance of Congress in 1934 to prohibit with a detailed definition what seemed complex and widespread is understandable especially with the recent failure of the Prohibition Act fresh in their minds. S. 2693 (H.R. 7852), Hearings Before the House Comm. on Interstate and Foreign Commerce and the Senate Committee on Banking and Commerce, 73rd Cong., 2nd Sess. 19-20 (1934), reprinted in Legislative History of The Securities Act of 1933 and Securities Exchange Act of 1934 (Compiled by J.S. Ellenberger & Ellen P. Mahar, 1973) (statement of Sidney Blumenthal) ("There are so many ways by which [a definition of insider trading] might cause damage to all business in general because of the impossibility of controlling honest observations by those who are genuinely square in interpreting it and because of the further possibility of circumvention of its purposes by those who are less scrupulous, that it seems a wholly undesirable section."). Much has happened since 1934 in the regulation of the securities markets. Most significantly commentators and the judiciary have accepted the SEC arguments that insider trading should be prohibited under rule 10b-5. In re Cady, Roberts, 40 S.E.C. 907 (1961), began the development of the theory that the federal securities laws prohibited insider trading. Not only that but many of the parameters and intricacies have been fleshed out by commentators and the judiciary. E.g., Chiarella v. U.S., 445 U.S. 222 (1980); Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 30 Hofstra L. Rev. 9 passim (1984). Not only have the intricacies been fleshed out but also insider trading has been actually prohibited for some time now. This is not to say that the present prohibition scheme is desirable. Rather the present scheme with its many gaps and inadequacies has provided a vehicle for the SEC, the judiciary and commentators to explore insider trading in the context of real cases. As will be made

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clear below, the present scheme needs to be replaced.

Although no one seems sure of the extent insider trading may actually exist, little evidence has been presented that it is so rampant that the present prohibitions are futile. As with most enforcement activities, the best that can be hoped for is to catch as many violators as possible; the change of being caught will deter further violations. See Generally, O'Connor, supra note 19, at 363-70. Congress was well aware of this consideration in 1934. The following exchange took place during the hearings:

Mr. Corcoran. The section [insider trader prohibition] is a deterrent, and you will in some cases actually catch violators.

Mr. Wolverton. Well, it seems to me you are just trying to scare them, in this particular, the same as we do children, if we say "Look out, or the bogey man will catch you."

S. 2963 (H.R. 7852), Hearings Before the House Comm. on Interstate and Foreign Commerce and the Senate Committee on Banking and Commerce, 73rd Cong., 2nd Sess. 137 (1934), reprinted in Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934 137 (Compiled by J. S. Ellenberger & Ellen P. Mahar, 1978).

In addition, the extensive harm caused to the securities markets by insider trading demands a good faith attempt at controlling it to the greatest degree possible

An additional reason exists to control insider trading. Many of the world's foreign securities markets prohibit insider trading. In a world of greater and greater market interactions, the harmonization of regulations is an important project of these nations, including the United States. Would not this particular aspect of harmonization be more readily attainable in the long-term if we passed legislation with this eventual goal in mind? See supra note 8 and accompanying text for a discussion of EC law.

### III. How to Prohibit

#### A. Introduction

The method of prohibiting can be approached from several general directions. Of course, the present rule 10b-5 fraud based method is the most well known. Under this method traditional fraud elements in some form or another must exist. The person trading on inside information must be breaking a duty owed to someone in order to be liable.<sup>48</sup> Since rule 10b-5 is a

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As for the second argument, the empirical argument that signalling has not occurred, the problem with it is twofold. First, corporations do impose duties upon their employees which include the duty not to trade on insider information. Corporations even emphasize to the investing public that they have high ethical standards of their employees. Second, why corporations do or do not engage in activities which apparently harm shareholders is the subject of much discussion. Why corporate managers engage in activity inimical to shareholders is a hotly debated corporate governance issue. E.g., Michael C. Jensen, Eclipse of the Public Corporation, 89 Harv. Bus. Rev. 61 (1988); Michael C. Jensen, Takeovers; Their Causes and Consequences, 2 J. of Economic Perspectives 21 (1988). One of the issues centers around the apparent lack of benefit to shareholders from "golden parachutes." Id. at 39-41. The issue only shows that no clear conclusions can be drawn from any apparent corporate inaction.

<sup>48</sup>Chiarella v. U.S., 445 U.S. 222 (1980); Dirks v. SEC, 463

general anti-fraud provision, the exact contours of its prohibition of insider trading were necessarily unclear at the outset. It has been the judiciary's and the SEC's task to explore these contours. Even with all the effort that has gone into this task, certain areas remain unclear.<sup>49</sup> Largely because of these uncertainties, proposals exist to clarify the law by

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U.S. 646 (1983).

<sup>49</sup>Several apparent gaps in §10b-5 insider trading prohibition exists: (1) the misappropriation theory of liability has an uncertain future. SEC Chairman David Ruder stated that after the recent decision of Carpenter v. U.S., 484 U.S. 19 (1987), if a new Supreme Court justice is appointed, the future of misappropriation is uncertain. Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs. 100th Cong., 1st Sess. 40 (1987). However, the Securities Industry Association stated that after Carpenter, a definition is no longer needed since the court accepted mail fraud liability. Id. at 54 & 56. (2) "It is doubtful that the Supreme Court intended the constructive insider concept to be used so broadly . . ." as it is being used in cases such as SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983). Richard M. Phillips & Robert Zutz, The Insider Trading Doctrine: A Need for Legislative Repair, 13 Hofstra L. Rev. 65, 93 (1984). (3) The personal gains test adopted by the Supreme Court in Dirk v. SEC, 463 U.S. 646 (1983), opens a large gap because often it cannot be proved that the insider disclosed for another purpose such as for a business purpose. Phillips & Zutz, supra at 84. (4) "Chiarella and Dirks may exonerate outsiders who trade on the basis of 'outside' information." Seligman, supra note 14, at 1090. (5) "Front-running" may not be prohibited. Carole B. Silver, Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984, 1985 Duke, L. J. 960, 980 & 987; see note 125 infra and accompanying text. (6) Trading in options on inside information is probably not prohibited. Hazen, supra note 11, at § 13.3, pp. 687-82.

essentially codifying the present law with changes only in perceived weak areas and vague areas. Another prohibition method exists: A general and simple knowing use type statute could be passed abandoning the traditional anti-fraud based method. Besides the method of prohibition issues, severity of punishment issues remain. Civil or criminal penalties are possible. If civil, the amount of liability and respondeat superior type issues are the main issues. If criminal, the mental intent and presumptions of intent are the main issues.<sup>50</sup> These severity of punishment issues are not within the scope of this paper.

## **B. Rule 10b-5 or a Definition**

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<sup>50</sup>Another consideration is the SEC's ability to go forward with one of these prohibition methods by rulemaking alone. Professor Kripke believes the SEC has the power to proceed by rulemaking. Homer Kripke, A Note on Insider Trading: An Example of How Not to Make Law, 39 Ala. L. Rev. 349, 350-51. Others disagree. Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 22 (1987) (statement of Daniel Gozler of the SEC) ("I think that obviously any rule that we adopt defining insider trading in a way contrary to the case law would undoubtedly be subject to challenge and we would have to litigate the validity of the rule."); Insider Trading, Hearings Before the House Comm. on Energy and Commerce, 99th Cong., 2d Sess. 216 (1986) (report of the Task Force on Regulation of Insider Trading) ("[I]t . . . would have an uncertain statutory basis to the extent that it departs from the fraud bases of

In the insider trading area, has rule 10b-5 reached the end of its useful life? That any statutory definition of insider trading must cover a wide spectrum of conduct is the chief argument against a definition.<sup>51</sup> To state the argument another way, "a definition . . . is not practicable . . . ."<sup>52</sup> The intricacies of insider trading are many and have been well spelled out by the cases. However, that such a wide spectrum of conduct is covered points to a need for a definition. Why should the many participants in the securities markets be left to conform their conduct to a standard which requires volumes of

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sections 10(b) and 14(e) of the 1934 Act.").

<sup>51</sup>See Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 280 (1987) (statement of Arnold S. Jacobs); Manne, supra note 9, at 163.

<sup>52</sup>Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 152 & 159-60 (1983) (statement of William D. Harrington). Arnold S. Jacobs stated the argument before Congress:

The law regarding the usual kind of inside trading practices is clear . . . . Hundreds of cases clarify Rule 10b-5's insider trading prohibitions. As with any broad anti-fraud remedy, the fringes of what constitutes the prohibited act are occasionally fuzzy. This, does not justify placing a definition in the bill; unscrupulous traders would skirt around any definition constructed.

reading to decipher? Such a method of regulation is especially inappropriate to govern a relatively technical market. The vast majority of market participants are accustomed to dealing with technical rules. So just because a definition may be more than a few sentences long is no reason to reject it.

Indeed, the very wide spectrum of situations presently covered by case law has put in doubt the Constitutionality of the present law.<sup>53</sup> "[A] defendant may lack notice of the illegality of his conduct. This lack of notice raises concerns about due process and the retroactive application of new rules of law.<sup>54</sup> Similar vagueness in Japanese insider trading laws along with other factors "combined to undermine effective regulation of Japanese insider trading."<sup>55</sup> This same concern must necessarily also exist in the United States.

A related line of criticism of a definition states that the present judge-made law composed of hundred of cases is as clear as can be expected. A new set of rules would simply create

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Id. at 99-100.

<sup>53</sup>Silver, supra note 49, at 979-1001.

<sup>54</sup>Id. at 964 (footnotes omitted).

<sup>55</sup>Note, Regulation of Insider Trading in Japan, 89 Colum. L. Rev. 1296, 1300 (1989) (footnote omitted).

uncertainty.<sup>56</sup> This argument fails to consider the many gaps and uncertainties of the present law. Certainly, a new system would take some getting used to. And to replace an old set of rules is not to say they were useless. Government enforcement officials and private litigators did a fine job of working out the parameters of insider trading with only a vague anti-fraud concept. Valuable in its time, judge-made law still is valuable; the insights obtained from the present law make a definition possible.<sup>57</sup> It has provided the SEC, the judiciary and commentators the means to explore insider trading in the context of real cases.

Perhaps more important than any theoretical legal argument for replacing the present rule 10b-5 prohibition, is the securities industry's belief itself. Overwhelmingly,

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<sup>56</sup>E.g., Kripke, supra note 50, at 363, Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 159-61 (1983) (statement of William D. Harrington); Silver, supra note 49, at 993.

<sup>57</sup>Some commentators call for even more study however. Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 221 (1983) (statement of the Committee on Securities Regulation of the New York State Bar Association Banking, Corporation and Business Law Section).

participants in the securities market want a definition.<sup>58</sup>

The main reason to prohibit insider trading through the use of a definition rather than rule 10b-5 has to do with the inadequacies of rule 10b-5 discussed in the next section.

### **C. Codify Rule 10b-5 Case Law**

The next question is what type of definition is needed. One option is a simple codification of the present law with changes only to the present weak points of the law. Such an approach has great benefits. No one would have to become accustomed to an entirely new set of rules. The workability of

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<sup>58</sup>Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st. 72, 74 & 85 (1987) (statement Richard M. Phillips representing New York Stock Exchange Legal Advisory Committee); Regulating Hostile Corporate Takeovers, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 192 & 194 (1987) (statement of the Securities Industry Association); Definition of Insider Trading, Part 1, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 95 (1987) (results of survey of market professionals prepared by Professor Gary L. Tidwell). Various commentators have strongly supported this request. E.G., O'Connor, supra note 19, at 367; Phillips & Zutz, supra note 49 at 70; Manne, supra note 9, at 163-64; William H. Painter, Federal Regulation of Insider Trading 394-97 (1968). Contra Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 108 (1983).

the present law in many areas of insider trading would be preserved;<sup>59</sup> since the theories of liability have already been approved in court, little concern for defendants finding loopholes should exist. In short many of the criticisms of a definition would be without merit because the present law would not be replaced. In fact, many of the proposals discussed by Congress in the hearings of the last several years have been this type of definition.<sup>60</sup>

Nevertheless, several reasons militate against retention of the present scheme; it should be abandoned completely. The failure of Congress to reach an agreement demonstrates the unworkability of the present system. One of the probable reasons for Congress' failure is that the general theory behind the present system is unworkable. The proposed definitions before Congress for over nine years now seem to get lost in listing and trying to define the types of fiduciary duties which

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<sup>59</sup>Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 18 (1987) (statement of SEC Chairman David Ruder) ("By making use of existing theories, the Commission's Proposal avoids the interpretational uncertainties that a definition based on more novel notions would inevitably entail.").

<sup>60</sup>39 Ala. L. Rev. 531 app. (1988) reproduces five major proposals.

need to be breached in order to have a violation. When experts in the area could come to no consensus on where to draw the line defining the various fiduciary relationships, how could Congress possibly come to a decision it felt confident about?

The main reason to regulate insider trading with a definition instead of rule 10b-5 is apparent from a look at the three policy goals of encouraging the flow of information to investors, encouraging the flow to a large number of investors and encouraging market participants to perform their function. As Part II of this paper discusses, all three of these goals are harmed when someone trades on inside information. All of the discussed harms occur whether or not a fiduciary duty existed. All occur whether or not a fiduciary duty existed. All occur whether or not that duty ran to the shareholders in some way. All occur whether or not any fraud elements exist. Why then should insider trading liability be tied to such considerations? These considerations do not bear on the three policy goals in any way.

Any definition adopted must abandon the fraud basis of the present system.<sup>61</sup> Fraud simply is not a workable mechanism for

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<sup>61</sup>Milton V. Freeman, The Insider Trading Sanctions Bill -- A Neglected Opportunity, 4 Pace L. Rev. 221, 221-22; Phillips &

encouraging the flow of information in an impersonal securities market. The inability of fraud concepts to adequately protect the securities markets was one of the main reasons for the passage of the securities laws in the first place.<sup>62</sup> "The Securities Exchange Act of 1934 and relevant amendments contain several provisions requiring a parity of information approach, regardless of traditional state law fiduciary duties."<sup>63</sup> Since insider trading harms the market without any direct harm to any one investor, requiring that the person trading have some fiduciary relationship with investors or someone else makes little sense.<sup>64</sup> Of course, the existence of a fiduciary duty goes a long way in proving mental culpability. But mental culpability can be proved in other ways than with a fiduciary duty. By increasing the flow of information, insider trading regulation is protecting the market as a whole not any one

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Zutz, supra note 49, at 71.

<sup>62</sup>Seligman, supra note 28, at 1107.

<sup>63</sup>Id. 1109-09 (citation omitted).

<sup>64</sup>Regulating Hostile Corporate Takeovers, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 213 (1987) (statement of Robert F. Greenhill) ("Enacting a special statute separate from the 'fraud' statutes will permit the law to focus on the proper issue: whether a trading advantage has been obtained by lawful means, such as through legitimate research and analysis, or whether it has been

investor; fraud concepts were just not designed to protect a market as a whole, just individual market participants. For example, the entire options market is presently without insider trading protection because of the inadequacies of the fraud scheme.<sup>65</sup>

The inadequacies of fraud is traceably to the intended purpose of the fraud concept. By its very nature, fraud can only exist when the two parties had some sort of relationship; they must have dealt with each other. Fraud is our legal system's means of imposing liability when one party took advantage of the other in some way when dealing with each other face to face. Thus, fraud is clearly out of place in an impersonal securities market.

The abandonment of fraud will also better integrate the primary insider trader regulation scheme with other insider trader regulation provisions. Yes, Congress and the SEC have already started on the inevitable abandonment of the regulation of insider trading with fraud. Congress is considering statutorily defining insider trading in the commodities futures

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obtained by illegal means, such as by bribing an insider.").

<sup>65</sup>Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 98th Cong., 2nd Sess. ??? (1987) (statement of SEC Chairman John Shad).

market without relying on fraud.<sup>66</sup> Fraud concepts just do not work in the commodities area, as in the options area, since no shareholders exist to be owed a duty. The SEC has by regulation prohibited insider trading on takeover information without relying on fraud.<sup>67</sup> In addition, the European Community (EC) is defining insider trading without relying on fraud.<sup>68</sup> Fraud based insider trading regulations are quickly becoming anachronistic.

#### **D. Knowing Use Approach**

The best means of prohibition is a general knowing use approach.<sup>69</sup> Not surprisingly, several commentators have come to

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<sup>66</sup>House Comm. on Agriculture, Commodity Futures Improvements Act of 1991, H.R. Rept. No. 6, 102d Cong., 1st Sess. 15, 56 & 72-73 (1991). No fiduciary duties running to shareholders exists in the futures markets, so insider trading must be prohibited in other ways. Overview of the Agencies and Programs Under the Jurisdiction of the Subcomm. on Conservation Credit, and Rural Development, Hearings Before the House Comm. on Agriculture, 100th Cong., 1st Sess. 422 (1987).

<sup>67</sup>17 C.F.R. §240. 14e-3 (1983).

<sup>68</sup>See, supra Note 2.

<sup>69</sup>"Knowing use" is used in this paper to describe the type of definition advocated for lack of a better name. Other possible names such as "wrongfulness" are not used because they

this same conclusion.<sup>70</sup> The most common criticism of the approach is that it is too vague and so unworkable.<sup>71</sup> This criticism is unfounded for two reasons. First, as has already been demonstrated, the present law is already quite vague in many areas. So even if such a definition were vague, it may well still be an improvement over the present law. Second, as the parameters of the definition are defined below, it should become clear that the definition is not vague. In fact, a knowing use approach is a bright line rule which will provide much guidance.<sup>72</sup> Several general forms of this approach exist. Generally speaking, the preferred approach "is to enact a statute specifically designed to achieve the underlying

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carry connotations not in line with what is sought to be prohibited.

<sup>70</sup>Langevoort, supra note 9, at 410-13; Seligman, supra note 14, at 1137-39; Phillips & Zutz, supra note 49, at 99-100; Barbara A. Ash, State Regulation of Insider Trading -- A timely Resurgence?, 49 Ohio St. L. Rev. 393 408 (1988); Wang, supra note 19, at 74; Regulating hostile Corporate Takeovers, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 213 (1987) (statement of Robert F. Greenhill).

<sup>71</sup>Note, Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence, 16 Hofstra L. Rev. 665, 1139 (1988).

<sup>72</sup>Seligman, supra note 28, at 1137.

objective of the insider trading doctrine."<sup>73</sup> The best one can only be found by looking at its effects upon the three policy goals.

### **1. Parity of Information**

Often a parity of information approach is discussed as an alternative. The approach would prohibit trading based on an informational advantage over the other party. The theory of the approach is that to have a fair stock transaction both parties must have at least access to the same information. Only if both parties have access to the information is the price the best reflection of information available so that the market is as efficient as possible. The parity of information approach is basically the approach being proposed in this paper. However, it should not be referred to as parity of information for semantic reasons alone. Even though parity of information actually refers to parity of access to information, the words alone do not imply this. The words imply equality in the dealings of market participants. This implication may cause misunderstanding and so the title parity of information should

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<sup>73</sup>Phillips & Zutz, supra note 49, at 99.

be rejected. When prohibiting insider trading, the proper emphasis should be on the source of the information.<sup>74</sup>

In an impersonal securities market, the parties do not know who was on the other end of the trade. So it makes little sense to put the emphasis on them being equal. As made clear in Part II, above, the harm from insider trading is to the market as a whole not to any individual trader. So no real reason exists to emphasize the position of individuals. The harm caused by insider trading derives from the fact that the information is nonpublic. So the proper focus must be on the nonpublic nature of the information not on the equality of the parties.

## **2. Duty Running to Market**

Another general approach is to say that all possessors of material nonpublic information have a duty to the market as a

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<sup>74</sup>At least one commentator does not recognize this distinction. He states: "The only significant difference between rule 14e-3 and the parity of information approach concerns the scope of application. It is possible that rule 14e-3's 'substantial steps . . . to commence . . . a tender offer' will be interpreted not to reach preliminary discussions or investigations . . . ." Seligman, supra note 28, at 1135.

whole not to trade on it.<sup>75</sup> This approach makes sense since again the harm being prevented is to the market as a whole. However, by stating the prohibition in terms of duty, fraud is implied. But again fraud is not an appropriate concept for regulating insider trading. Fraud is not involved, just unfairness and impropriety.<sup>76</sup>

### **3. Knowing Use Approach**

#### **a. Basic Definition**

The starting point to developing a general fairness definition must be to state the general proscription and then

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<sup>75</sup>Ash, supra note 70, at 408.

<sup>76</sup>The distinction has been described:

The problem is that this misconduct [insider trading by someone without a fiduciary duty] does not really involve deceit . . . . If the only basis of liability were the "special relationship" theory, however, a great deal of inside trading would escape section 10(b) and rule 10b-5.

The two conflicting principles are (1) the unfairness and impropriety of inside trading, and (2) the deceit requirement of section 10(b) and rule 10b-5. The stricter the adherence to the fraud requirement, the smaller the amount of unfair or improper inside trading forbidden.

limit its effect in appropriate areas. The general proscription can be stated as: No one shall trade in securities on the basis of<sup>77</sup> material nonpublic information. One element is needed to be added to this general rule, the scienter requirement. Several possibilities exist. First, the rule 14e-3 requirement could be adopted. Rule 14e-3 states:

information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer . . . .<sup>78</sup>

This is the model recommended by this paper (with certain modifications). Second, the Federal Securities Code requirement could be adopted. Section 1603 (a) states:

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Wang, supra note 19, at 74.

<sup>77</sup>A dispute exists whether the prohibition should require liability simply for trades "while in possession of nonpublic information" or whether it should be for trades made "on the basis of." This paper takes no position. The "on the basis of" language is used simply for convenience. E.g., O'Connor note 19, at 366; Kripke, supra note 50, at 366; Richard M. Phillips & Larry R. Lavoie, The SEC's Proposed Insider Trading Legislation: Insider Trading Controls Corporate Secrecy, and Full Disclosure, 39 Ala. L. Rev. 439, 460-76 (1988); Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 94-97 (1987).

It is unlawful for an insider to sell or buy a security of the issuer, if he knows a material fact with respect to the issuer or the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available, or (2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise.<sup>79</sup>

Third, S. 1380 is a comprehensive definition which was considered by the Senate Committee on Banking, Housing, and Urban Affairs for some time. It was drafted by a committee of securities practitioners formed at the Senate Committee's request. It states in part: "It shall be unlawful for any person . . . to purchase or sell any security . . . if such person knows or is reckless in not knowing that such information has been obtained wrongfully . . ." <sup>80</sup> Fourth, two SEC proposals exist. The first was prepared at the request of the Senate Committee. The second was an attempt to reconcile the SEC 1st Proposal with S. 1380. Both SEC proposals state: "It shall be unlawful for any person to purchase, sell or cause the

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<sup>78</sup>17 C.F.R. §240. 14e-3 (1980).

<sup>79</sup>Federal Securities Code §1603 (1980).

<sup>80</sup>S. 1380, supra note 6.

purchase or sale of, any security . . . if such person knows or recklessly disregards that such information has been obtained wrongfully or that such purchase or sale would constitute a wrongful use of such information."<sup>81</sup>

If the goal is to encourage the flow of information to many people and to encourage market participants to fulfill their duties, then the rule 14e-3 language is clearly the best model. There the focus is on the source of the information. Market investors or analysts are focused on gathering information and evaluating its value in determining security prices. A significant factor in evaluating information's value is whether it is nonpublic. So rule 14e-3 appropriately encourages them to continue their focus on the value of the information; if an investor determines the information has great value because it is nonpublic, he will also know that trading on the information is illegal.

The last two proposals, on the other hand, focus on the wrong facts. They focus on "has been obtained wrongfully" language. This wrongfulness language is undesirable for two reasons. First, wrongfulness may well mean that the information was obtained through the breach of a duty. Such a fraud concept

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<sup>81</sup>SEC Proposal & SEC 2d Proposal, supra note 6.

has already been rejected above. Second, investors and analysts are not encouraged to dig for information if they have a vague concept such as wrongfulness hanging over their heads. Under the 14e-3 approach, if they find nonpublic information, they will simply know not to trade on it. While under this wrongfulness approach, they will have to perform some sort of analysis to determine whether the means of obtaining was wrongful. In addition, a "reason to know" standard is much clearer than a reckless standard mentioned in the S. 1380.<sup>82</sup>

#### **b. Tender Offers**

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<sup>82</sup>Professor Silver has said:

Under Rule 14e-3, a violation of which also may give rise to treble damages under the Act, the issue of scienter is clearer. Rule 14e-3 specifies that the defendant must know or have reason to know the source of the material nonpublic information, and must know or have reason to know that the information is nonpublic. Although the Rule does not define "reason to know," this standard is well developed in the law generally. Moreover, the SEC suggested in its release announcing the adoption of the Rule that the "reason to know" standard implies a duty of inquiry by a person in possession of facts sufficient to raise the suspicion of a reasonable person.

Silver, supra note 49, at 986 (citations omitted). Accord Kripke, supra note 50, at 66-67. However, other commentators find ambiguity in rule 14e-3. Wang, supra note, at 292; Phillips & Lavoie, supra note 77, at 483-86.

Certain types of information because of special sensitivity merit special consideration. In narrowing this general definition, it is appropriate to first look at rule 14e-3 both because it is a model of the wrongfulness approach and because it governs insider trading in an area which perhaps should be excepted from the general rule. Rule 14e-3 governs insider trading in the tender offer context. It is given special consideration because such information is especially sensitive. Under the broad prohibition proposed by this paper, no special set of rules would have to be made for tender offer information since the proposed prohibition is strong enough to cover even such sensitive information. Several of the proposals before Congress contain special provisions for the tender offer context. These provisions are aimed more at stopping tender offers than regulating insider trading<sup>83</sup> and so do not fall within the subject matter of this paper.

### **c. Confusion of Proposals**

Another reason exists to error on the side of writing the

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<sup>83</sup>Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st sess. 77-78 (1987). See Wang, supra note 19, at 65; Kripke, supra note 50, at 372-74.

simplest definition wherever possible instead of treating each possible type of fact situation differently. The above quoted detailed definitions of the Federal Securities Code, S. 1380, and SEC proposals, all contain many provisions. Disagreements exist as to their interpretations.<sup>84</sup> The provisions seem to be written with unnecessary preoccupation to preventing a loophole. For example, the above quoted SEC proposals forbids not only trading on information but also "causing" someone else to do so. What reason exists to add the word causing? Perhaps such concern arises out of the problem of litigating insider trading issues with only an ill-suited fraud theory as the underlying law and no clear policy guidance as to why insider trading is prohibited. With the clear policy guides and an appropriate definition of insider trading set forth in this paper, fewer judicial setbacks should occur. So such overwriting is inappropriate.

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<sup>84</sup>E.g., Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 142-43 (1983) (statement of Sam Scott Miller) (pointing out a conflict in the Senate proposals); Definition of Insider Trading, Part 1, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 115 (1987) (statement of SEC Commissioner Charles C. Cox) (interpreting a provision of the S. 1380 to conflict with

#### 4. Tipper Liability

Now that a basic definition has been reached, modifications must be considered for special circumstances. One special circumstance worthy of a special provision concerns by what standard to hold someone liable who tips information. It is logical to start with tippers because one is in fact tracing the information as it flows from the corporation. The first people to have inside information are those who need the information to perform their duties. These people include both employees of the corporation and those performing services for the corporation on some type of contract basis such as outside legal counsel or printers.<sup>85</sup> On one hand, this group already has an incentive not to tip since usually they owe a duty to the corporation to not disclose confidences. On the other hand, two reasons exist indicating that they should not be held to a high standard. First, they often deal with large amounts of confidential information. Their daily lives are much more likely to be governed by the information they possess. For

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the explanatory note).

<sup>85</sup>Both types of people are grouped together since no real theoretical distinction exists between them as the Supreme Court did in footnote 14 of Chiarella v. U.S., 445 U.S. 222, 231

example, the confidential business of their employers may require them to take trips or work odd hours. Since they necessarily have to deal with outsiders on the many matters of their personal lives, they are likely to accidentally mention information in their contact with outsiders. Certainly it would be harsh to impose great liability on such unintentional tippers. (This situation will be referred to as the manager-friend and -acquaintance relationship.)

Second, corporate insiders are often called upon to discuss corporate matters with analysts. Analysts are performing their second function, described above, of additional information gathering. Most of the information they gather is not inside information but simply a first hand look at what was learned from reading reports. Again as in managing their personal lives, managers in this situation are likely to accidentally release bits of inside information. But this valued manager-executive contact will be chilled if managers are held liable for such slips.<sup>86</sup> The two goals which must be balanced in the analysts situation have been described as "the need to maintain investor confidence in the integrity of the securities markets,

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(1980).

<sup>86</sup>Insider Trading, Hearings Before the House Comm. on Energy

and the legitimate functioning of securities analysts and others who seek out and bring to the market the information that makes the market place uniquely vital."<sup>87</sup> The negligent communication of information goes more to the quality of the particular manager, better dealt with by state fiduciary duty laws.

At first glance, it might seem best to treat the above two situations, communications about personal affairs and communications to analysts, differently.<sup>88</sup> However, the better view is to cover both situations by the same rule. This is true even though the policy reasons for increasing the scienter requirement in the two situations differ. These reasons were discussed in the above two paragraphs. The strengths of the

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and Commerce, 99th Cong., 2d Sess. 219 (1986).

<sup>87</sup>Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 119 (1983) (statement of Faith Colish). This issue has already been described as follows:

The difficulty in developing rules for determining when communications of information by corporate insiders should be prohibited lies in the fact that information regarding corporate issuers is essential for the market's efficient evaluation of the issuer's securities. Too rigid of a prohibition on tipping could impede the flow of information to the market.

Goelzer & Berueffly, supra note 25, at 506.

<sup>88</sup>The SEC Proposals specifically impose a different rule on tipping analysts than on tipping others. SEC Proposal & SEC 2d

policies behind increasing scienter for both types of tips are roughly equal. So in the interest of simplicity, both should be covered by the same level of scienter.

Several options exist to balance these interests with an anti-tipping rule. Rule 14e-3(d) balances the goals in the tender offer area by saying in part, "it shall be unlawful for any person described [in another subsection] to communicate material, nonpublic information relating to a tender offer . . . under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section . . . ." The Federal Securities Code approach is to not prohibit tipping. However, Federal Securities Code would hold some tippers liable through the aider and abettor doctrine.<sup>89</sup> S. 1380 approaches the issue by saying in part, "[i]t shall be unlawful for any person . . . wrongfully to communicate material, nonpublic information . . . if the person making the communication knows (or is reckless in not knowing) that such information would be used for purchase or sale of a security that would violate . . ." the above insider trading prohibition. The 1st SEC proposal states:

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Proposal, supra note 6.

<sup>89</sup>Federal Securities Code Comment 6 to §1603 at p. 666.

It shall be unlawful for any person, whose purchase or sale of a security would violate subsection (a) of this Section, to communicate, directly or indirectly, information that such person knows or recklessly disregards is material and nonpublic to any other person who . . . purchases [or] sells . . . or who communicates the information to another [who purchases or sells] if such purchase or sale is reasonably foreseeable.

The second SEC proposal drops an exception for analysts and adds a wrongfulness element in its place.<sup>90</sup> The NYSE Proposal makes it unlawful "to communicate material, nonpublic information for the purpose of assisting another person to wrongfully use such information to purchase or sell any security in violation of this Section."<sup>91</sup> Finally, the Dirks personal benefit standard is another alternative.<sup>92</sup>

Three general approaches are discernible from these proposals.<sup>93</sup> The first approach is the Dirks personal benefit

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(1980).

<sup>90</sup>Langevoort, supra note 29, at 1036. The SEC 1st Proposal included a codification of the Dirks test. Supra not 6.

<sup>91</sup>Supra note 6.

<sup>92</sup>In Dirks v. SEC, 463 U.S. 646 (1983), the court held that for a tipper to be liable, he must have received a personal benefit from the tip.

<sup>93</sup>Of course, an option also exists to impose a breach of a fiduciary duty requirement. Such a fraud based alternative has

requirement followed in the first SEC proposal for analysts. This fraud based approach clearly needs to be replaced. A huge gap is left open when the tipper never receives any personal benefit or a benefit cannot be properly articulated in court.<sup>94</sup> No reason to allow altruistic tipping exists. The second approach is to follow the Federal Security Code model and put almost the total burden on the tippee not to trade. The advantage to this approach is that the manager-analyst relationship or the manager-friend or -acquaintance relationship is hardly chilled at all. The manager would only be liable if his tipping was with a high degree of scienter that is he is an aider and abettor. The third approach is to hold the tipper liable for tipping if some degree of scienter is found, the approach proposed here.

Rule 14e-3(d) and S. 1380 and both SEC proposals require some type of foreseeability of the trade. There are two drawbacks to these proposals. First, the foreseeability used is

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already been rejected by this paper and so will not be discussed.

<sup>94</sup>Criticism of the Dirks personal benefits test is wide spread. E.g. Definition of Insider Trading, Part I, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 28 & 31 (1987); Id. at 115 (statement of SEC Commissioner Charles C. Cox); Phillips & Lavoie, supra note 82, at 476-81; Kripke, supra note 50, at 406-407.

an objective one. So that if the tipper accidentally tips through an honest slip of the tongue he is still liable if it is foreseeable that the tippee would trade on the information.<sup>95</sup> Second, even if foreseeability were made a subjective element through a scienter requirement, it would may not properly balance the tension between the opposing policies. For foreseeability focuses unnecessarily on the tippee. Certainly facts about the tippee are relevant to the tipper's state of mind. But the focus should be on the intentions of the tipper.

The second SEC proposals also misses the point by requiring a wrongful communication.<sup>96</sup> Wrongfulness, as has been discussed,

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<sup>95</sup>Commissioner Charles C. Cox on the other hand believes that the foreseeability element is too restrictive because the tipper must actually know that a trade will occur. Definition of Insider Trading, Part I, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 109 (1987). This concern seems to be an overstatement. The real issue is the ubiquitous materiality issue. If the information were material, trading is foreseeable. If not material, trading is not foreseeable. Materiality is beyond the scope of this paper.

<sup>96</sup>For an SEC explanation of why wrongfulness was added, see Insider Trading Before the Comm. on Energy and Commerce, 100th Cong., 2d Sess. 72-73 (1988). In another hearing, SEC Chairman John Ruder explained that the "wrongfulness" element was added to protect analysts. It was added in response to criticism of the Securities Industry Association. Insider Trading Proscriptions Act of 1987, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 42 (1987).

is simply too ambiguous a term.

The NYSE proposed language of "for the purpose of assisting another person to wrongfully use" is much better.

Purposefulness is precisely the type of communication which should be prohibited by federal securities laws.<sup>97</sup> Of course, purposefulness will not always be easy to define, but the same holds for any other alternative. The advantage of purposefulness is that it focuses on the intent of the tipper, but it also allows facts concerning the tippee and the tippee-tipper relationship to be considered to the extent such facts are relevant.

For clarity's sake the "to wrongfully use" language should be substituted with "to use in violation of this rule." This standard will have a minimal chilling effect since the manager will be free to speak to analysts without fearing an accidental slip of the tongue. The elements of the tipping violation would also match nicely the elements of insider trading. The main difference is that "buying or selling" element of insider

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<sup>97</sup>A contrary view has been stated: "[T]he SEC's proposal defines 'wrongful communication in a manner that eliminates the existing safe harbor from good faith communications and subjects corporate officials to potential liability for recklessly communicating information in breach of a duty of care even if no improper purpose exists for its disclosure.'" Phillips & Lavoie,

trading would be substituted with a purposely communicate element of tipper liability.<sup>98</sup>

## 5. Tippee Liability

By what standard should a tippee be held liable? Two general considerations must be kept in mind. First, tippees harm the securities market just as much as any other form of insider trading. Under the fraud approach, however, tippees somehow seem not as culpable since they usually owe no fiduciary duties. So by concentrating on the harm done, any red herring concern caused by duty can be disregarded. Second, analysts are often tippees and so special consideration must again be given to how tippee liability affects their incentive to perform their duty. The answer here is different than for tipper liability. No reason exists to add an extra scienter requirement on for

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supra note 82, at 462.

<sup>98</sup>Another tipper issue will have to be considered: For what amount should the tipper be liable? Should he be liable for all tippee and sub-tippee trades? See generally, Practicing Law Institute, supra note 40 at 7; Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 42 (1987); Insider Trading Before the House Comm. on Energy and Commerce, 100th Cong., 2d Sess. 144 (1988). These issues are beyond the scope of this paper.

analysts' benefit. The primary policy of encouraging the flow of information has already been provided for by encouraging managers to talk to analysts. This was accomplished by restricting tipper liability. Holding analysts to a high tippee standard does not dissuade them from performing their function, the third policy goal. If an analyst receives inside information, he can simply not trade on it and so not be liable. If he tipped it to another, such as his clients, he would be potentially liable as a tipper. He will even have an incentive to pressure the managers to make a public disclosure and so increase the flow of information to the public.<sup>99</sup>

Several options exist for the standard of liability. One option is to make the tippee secondarily liable to the tipper as an aider and abettor, a participant after the fact.<sup>100</sup> Given the above tipper liability standard, such a tippee standard is a poor option. Tipper liability was limited to purposefulness so that the tipper will not be liable for negligently communicating insider information. No reason exists to allow the tippee to

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<sup>99</sup>For a discussion of the tippee's considerations when he knowingly receives inside information, see Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 114 (1987).

<sup>100</sup>Wang, supra note 19, at 65.

trade on inside information just because the communication was through negligence. Similarly proposals to condition tippee liability on knowledge of a breach of duty by the tipper<sup>101</sup> must be rejected; no place for looking for breached duties exist in a scheme not predicated on fraud.<sup>102</sup>

The best standard is the one that has already been described for insider trading liability, the simple knowing use standard described above. In fact, it already covers tippees by its very nature. The proposals before Congress for the most part do not follow this approach.<sup>103</sup> A version of this standard

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<sup>101</sup>E.g., Definition of Insider Trading, Part I, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 148 (1987); Definition of Insider Trading, Part II, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs 100th Cong., 1st Sess. 108 & 112 (1987).

<sup>102</sup>The Securities Industry Association also criticizes basing tippee liability on whether a duty has been breached. Insider Trading Proscriptions Act of 1989, Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 53. (1987).

<sup>103</sup>For an explanation of the tippee provisions, see Definition of Insider Trading, Part I, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 171-72 (1987); Kripke, supra note 50, at 368; William H. Painter, The Federal Securities Code and Corporate Disclosure §5.03.

is used in the Federal Security Code however.<sup>104</sup> Several commentators back this approach.<sup>105</sup> For example, Mr. Miller stated before Congress: "I think it's illogical and unfair for the Commission to have to plead some of the twisted and in some cases salacious facts that it does to get at the behavior."<sup>106</sup> One commentator describes how the standard would work: The "tippee violates the [standard] if he trades with specific material information which he knows (or should reasonably know) that the information is undisclosed. The standard of reasonableness is that of a person in similar circumstances and might differ for a broker, an individual investor, an institutional investor, a geologists, etc."<sup>107</sup>

Another issue is which sub-tippees should be held liable. Following the same analysis, any tippee who meets the elements of the general insider trading prohibition should be held liable. As with the first tippee, sub-tippees trading causes

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<sup>104</sup>Federal Securities Code §1603(b) & pp. 163-64.

<sup>105</sup>E.g. Insider Trading Sanctions Act of 1983, Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 146-47 (1983) (statements of Milton V. Freedman and Sam Scott Miller).

<sup>106</sup>Id. at 147 (statement of Sam Scott Miller).

<sup>107</sup>Brownberg, supra note 17, in Texas Gulf Sulphur:

just as much damage to the securities markets as any other insider trading. With the health of the securities markets in mind, no reason to draw a bright line rule and cut off liability at the first tippee (as Japan has done)<sup>108</sup> or at some other point exists. The following is an excellent explanation of how the point of liability would naturally be reached:

Where one tippee receives a tip from another tippee the same consideration should apply . . . except that, as the tippee chain lengthens, the recipient of the information is further from the original source and the likelihood that the information is reliable lessens. As this process continues one reaches a point where the information becomes mere rumor and those who act upon it are not held responsible if the rumor proves to be correct since they assume the risk that the information is untrustworthy.<sup>109</sup>

This method is much more just; it matches the sub-tippee's degree of culpability to whether he is liable much better than any other method.

The final issue of tippee liability concerns how specific the tippee's knowledge of the nonpublic nature of the information should be. The general prohibition proposed in this paper only requires him to know that the information is somehow

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Disclosures & Insiders 73, 79.

<sup>108</sup>Note, supra note 55, at 1314.

<sup>109</sup>Painter, supra note 103, at 162.

nonpublic. Other proposals require the tippee to also know the information came from certain inside sources. For example, the Federal Security Code, holds a tippee liable "who learns such a fact from a person within section 1603 (b) . . . with knowledge that the person from whom he learns the fact is such a person unless the Commission or a court finds that"<sup>110</sup> equitable principals require that liability not be imposed. Those referred to in section 1603(b) include "a director, officer, parent, subsidiary, etc., of an issuer, a person in an access relationship to one of these or any tippee of such person . . . ."<sup>111</sup> Great Britain has a quite similar requirement in its insider trading laws.<sup>112</sup> Such an explicit requirement is superfluous since as a practical matter proof of knowledge of the source of the information will almost always be required to prove knowledge that it is inside information. So no one is really being protected by adding this element. In addition, some guilty tippees will unnecessarily be held not liable. For example, a tippee may know from the form of the communication

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<sup>110</sup>Federal Securities Code §1603(b) (1980).

<sup>111</sup>Id. at 163.

<sup>112</sup>See Company Securities (Insider Dealing) Act, 1985, ch. 8.

that the information is highly trustworthy and so must be inside information; however, he may not know the exact source. But he does have a good reason to know that the information is inside information even though he does not know of the exact source.

#### **E. Narrow Exceptions**

Peculiar fact situations exist where insider trading may have to be permitted to a certain extent. Other considerations may sometimes override the considerations of this paper. For example, an underwriter may be making a market for one of its past offerings on a small exchange. The underwriter is too small to erect an effective Chinese wall and learns inside information from the client. Forcing the market maker to not trade would be disastrous to the stock's liquidity.<sup>113</sup> The SEC

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<sup>113</sup>Seligman, supra note 14, at 1138; The Twentieth Century Fund, Inc., Abuse on Wall Street: Conflicts of Interest in the Securities Markets 405-13 (1980); Phillips & Zutz, supra note 61, at 98. Or a bank trust department may receive inside information from a company that the bank is loaning money to. The trust department relies on the loan department for analysis of its debtors. A Chinese wall between the two department may from time to time not be able to distinguish research from all inside information. The trustee coming across the inside information has a conflict of interest. He has a duty to use all information for the investors behalf; he also has a duty to not trade on

should be permitted to except by rule such situations. Such exceptions should not be written into the statute because the needs for them are very technical and fact specific equity oriented needs. Such needs may change as the character of the securities markets change. A statute does not offer the flexibility to deal with such exceptions.

#### **F. Drawbacks to a Knowing Use Approach**

Drawbacks to a knowing use approach certainly exist. Since such a wide spectrum of conduct is covered, many people may violate the law without knowing of the proscription. For example, someone with no securities experience and no inclination to invest in securities may fortuitously overhear some valuable inside information. Not being aware of the workings of the securities markets and their regulations he may assume he is free to trade on the information. Under the knowing use approach he would be liable nonetheless. The general public may perceive such a result as unduly harsh. The press may point out extreme cases where the apparent mental culpability of the violator was minimal but the liability was

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inside information. Id. at 82-85.

great. For even where only civil, not criminal, sanctions are imposed, the effects of a finding that someone violated the securities laws may be harsh.<sup>114</sup> Concern about such harsh results may be why so many proposed definitions require a breach of a fiduciary duty or at least knowledge of such a breach for a violation to be found. If a trader has breached a duty himself or knows the information was derived through such a breach, then he is much more likely to be aware of the illegality of his action; he has a much greater mental culpability. So the breach of a fiduciary duty approach nicely culls out the mentally less culpable inside information traders.

Two main reasons militate against exculpating such traders. First, their trades do just as much damage to the securities markets as the trades of those with a much greater degree of culpability. The three policy goals are harmed just as much by both types of traders. Second, means exist to lessen the effects of liability in appropriate cases. For example, perhaps a provision could be added stating the normal legal consequences of a securities law violation will only be imposed if the finder of fact determines they should be.

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<sup>114</sup>E.g., Securities Exchange Act of 1933, Rule 252(c) under Regulation A.

### **G. Insider Trading from Third Party Sources**

Some types of insider trading may merit separate rules. Thus far, it has been assumed that all the information comes from the corporate source of the information. However, sometimes the sources of information comes not from the corporation at all but from some unrelated party. This information may have just as much effect on prices as that derived from the corporation. Such sources include an inventor negotiating to sell a revolutionary mechanism to a firm<sup>115</sup> or a speaker such as an economist about to make a momentous speech<sup>116</sup> or a journalist about to make a recommendation about a particular firm or industry, or a government agency about to grant a contract. Should such third parties be governed by an insider trading rule?

According to the analysis of this paper, the answer is generally yes. "If equal access to information is the purpose of the rule, then it would seem proper to extend it to any material nonpublic information, whether obtained from an

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<sup>115</sup>Seligman, supra note 14, at 1136.

'inside' source or any other source."<sup>117</sup> The threefold purpose of the rule as proposed in this paper is something akin to equal access. So the same logic may apply. However, a closer look at third party sources reveals that different policy considerations apply in some situations. Generally, as with corporate managers, little reason exists to encourage these third parties to produce information by allowing them to trade on inside information. Even with the inventor, he already has the incentives provided by the patent laws.<sup>118</sup> Usually trading on inside information from such sources will cause the same damage as when trading from corporate sources. Likewise, usually no benefit outweighing is the harm caused will exist.

However, many types of third party information exist. Some of these types may well provide sufficient reason to be exempted from insider trading rules. A careful study of each of these types analyzed in the context of the three policy goals will provide helpful guidance. By way of example, some merit discussion here.

In the above economist's speech example, economists may

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<sup>116</sup>Id. at 1136.

<sup>117</sup>Scott, supra note 9, at 806.

present evidence that allowing them to trade on their research before they make it public provides a needed incentive for them to undertake such research. Perhaps for whatever reason, the free-market system is undervaluing economic research; society could be greatly benefited by more such research. And a look at the three policy goals indicates that the goals are not harmed to as great an extent as with corporate sources: Stock analysts are not discouraged from performing their functions; Management disclosure incentives are not affected. To return to the property rights analysis of Part II, the government has less reason to expropriate the information. Such information is not a mere by-product as with corporate sources. It is the product. So the economist's incentives are harmed by the expropriation of such information. On the other hand, economists may be encouraged to produce information, not necessarily accurate, for the sake of affecting prices alone.

Another example is in the tender offer area. Should a corporation which plans to make a tender offer be permitted to buy large quantities of the target's stock without disclosing

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<sup>118</sup>Seligman, supra note 14, at 1137.

its plans?<sup>119</sup> According to the analysis of this paper, the answer is unclear. The three policy goals ensure that capital is allocated efficiently. Theoretically, the information which the market needs to allocate resources efficiently is information about the productivity of the corporation, that is, information about the corporation itself. Investment decisions of tender offer bidder then do not in theory aid the market in valuing a security accurately. Therefore, why should the government require disclosure of such information? One argument is that a tender offer involves an issuance of securities. Since the primary market is involved, the need for full disclosure is especially strong. (See Part II, above.) A corporate takeover usually means a totally new management team. This team may well use the corporate resources in a totally new way. For the market, then, to accurately price the securities, it should have this corporate takeover information. Which of these arguments is the strongest can only be answered with a detailed factual analysis beyond the scope of this paper.

One third party source of information issue of significance is the financial columnist trading in advance of information

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<sup>119</sup>Presently any investor must report a stock purchase of over five percent of a corporation's stock. Security Exchange

contained in his column. The issue is of real significance since the Supreme Court has at least twice addressed this problem.<sup>120</sup> Capital Gain's finding that a writer of a financial newsletter has a fiduciary duty to his subscribers to not "scalp" has since arguably been extended to anyone with a similar opportunity to scalp.<sup>121</sup> No such duty exists for newspapers. So according to the present state of insider trading law under Carpenter, a newspaper is free to trade itself or allow its employees to trade.<sup>122</sup> However, it may have to issue a notice that such trading may be occurring.<sup>123</sup> The issue, then, is whether the insider trading prohibition should be lifted in this situation. Generally, the arguments against

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Act of 1934, Sec. 13(d) & (e).

<sup>120</sup>SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963). In Capital Gains, a writer of a financial newsletter, not a newspaper, traded in advance of his recommendations. He was found to have a fiduciary duty to the subscribers and so to be liable. In Carpenter v. U.S., 484 U.S. 19 (1987), a Wall Street Journal columnist trading in advance of his column was found to be criminally liable because he had a duty imposed by the newspaper not to trade even though he had no duty to the readers.

<sup>121</sup>Hazen, supra note 11, at § 10.9.

<sup>122</sup>One commentator has argued that this lack of liability could be closed by SEC rulemaking. O'Connor, supra note 37, at 321.

<sup>123</sup>Note, The Inadequacy of Rule 10b-5 to Address Outsider

insider trading do not apply with as much force in this situation. The readers of the newspapers are free to not buy it or to discount its value by an appropriate amount to take into accounting the loss in value of the information caused by insider trading. Disclosure incentives of corporate managers is not a factor. Stock analysts are not discouraged from performing their function. However, such insider trading should still be prohibited. The securities markets are still harmed because of the effect on market makers and general investor confidence. It has been said:

[T]o encourage either registered advisers or nonregistered journalists to make recommendations for personal profit will detract from allocative efficiency. The market will receive inaccurate signals which will lead to some misallocation of capital and tend to subvert investor confidence. This can be avoided by a parity of information requirement.<sup>124</sup>

Another type of third party insider information is "frontrunning." This occurs where an investor knows that, what is usually, a large trade is about to go through. The trade will affect the price because of its volume alone or perhaps

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Trading by Reporters, 38 Stan. L. Rev. 1549, 1573 (1986).

<sup>124</sup>Seligman, supra note, at 1124. Others believe such a practice should be allowed. E.g., Note, supra note 123 at 1573.

because the fact of the trade possesses information about the value of the security. Perhaps the trader is a well respected analyst. Practically, frontrunning will be done most often by a broker-dealer trading in front of his client's orders. The analysis of this paper only partially answers whether such a practice should be prohibited. Other considerations concerning broker-dealer relationships with their client, the value of trade decoding, and other market regulation issues must be analyzed as well. Therefore, whether front-running should be prohibited cannot be answered by this paper.<sup>125</sup>

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<sup>125</sup>Painter, supra note 103, at §5.05; Carole B. Silver, Penalizing Sanctions Act of 1984, 1985 Duke L. J. 960, 987. In the government decision area, an interesting question is raised where the government decision is not publicly announced but known only by the company directly affected. The SEC settlement with Ivan Boesky illustrates this issue:

[Boesky was allowed to liquidate] up to \$1.4 billion of his investment fund's assets, with the imprimatur of the Commission in the weeks prior to the November 14 announcement.

. . . .

. . .critics protest that the SEC's acquiescence allowed Boesky to sell sensitive takeover-related stocks at their peak prices to investors who were unaware of the impending SEC announcement . . . .

Note, supra note 71, at 680. Under the analysis of this paper, the advisability of allowing Mr. Boesky to trade is unclear. On one hand the SEC should have announced the settlement with Boesky before allowing him to trade. The internal information

#### **IV. Conclusion**

By focusing on the purpose and efficiency of the securities alone, the costs and benefits of insider trading become apparent. Three general policy goals of prohibiting insider trading are discernible. These three goals directly affect the efficiency of the market. The three goals act as an excellent test of various prohibition schemes. The present fraud based scheme is clearly inappropriate. Fraud focuses on the insider trader-stockholder relationship or the insider trader-source relationship, relationships not suited to governing the flow of information in an impersonal securities market. Rather a blanket, knowing use, prohibition is needed using a "know or reasonably know" scienter standard. A standard only to be modified by a tipping prohibition based on purposefulness. The advisability of this approach is bolstered by its use in rule 14e-3, an EC Directive, and Great Britain law.<sup>126</sup>

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concerning his company is no different than the internal information of any corporation.

<sup>126</sup>Company Securities (Insider Dealing) Act, 1985, ch. 8.

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In Securities Regulation

Professors Phillip Parker and Thomas Riesenber

By

Michael J. Trevelline  
637 3rd Street, NE, Apt. 204  
Washington, DC 20002  
(202) 543-6248  
Exam Nos. 41815 & 41838