NOTE

THE BATTLE AGAINST INSIDER TRADING: ARE WE PAYING TOO HIGH A PRICE FOR TOO LITTLE GAIN?

INTRODUCTION

The stock market[1] serves the critical function of providing a means for corporations to raise capital through sales of equity and debt.[2] This is accomplished by offering shares to the public on the stock market. The price obtained for these initial offerings[3] constitutes the capital-raising aspect of the stock market. After a corporation, or "issuer," sells its shares to the public, the public may then trade those shares among other public purchasers. Numerous factors indirectly affect the selling price[4] of these traded shares. However, the simple economic principle of supply and demand is the most significant and direct influence on the price of the traded shares. Typically, when there are more traders[5] willing to buy than there are traders willing to sell, the price of the stock will rise.

While many factors influence trading decisions, it is convenient to group them into two basic categories: intra-market factors and extra-market factors. Extra-market factors are generally not associated with price fluctuation, but include a trader's individual reason for selling, such as the need to liquidate her shares for debt, tax selling,[6] or settlement of an estate after death or divorce. Intra-

1. The stock market is a forum for trading the shares of publicly held corporations. Public investors trade these shares on registered exchanges, such as the New York Stock Exchange. *See generally* J. LITTLE & L. RHODES, UNDERSTANDING WALL STREET (1987).

2. *Id.* at 5.

3. Initial offerings, or new issues, are the shares of a corporation which has just begun to sell stock publicly. *Id.*

4. Once a corporation has offered shares of stock for public sale, public investors trade these shares. The number of shares offered for sale in relation to the public demand for these shares determines the selling price of the stock. This is capitalism in its simplest economic form. When there are more investors willing to purchase stock than there are shares offered for sale, the price rises. Many factors influence the decision to trade, including sales caused by a need to liquidate, purchases sparked by confidence in a new product, and the marketing methods of a corporation. *Id.*

5. Traders are investors who purchase and sell shares of corporate stock. They may be institutional traders who are market professionals, or lay traders. *See id.* at 23-42.

6. Traders may sell at a loss for two reasons. First, a trader may take a loss to avoid

market factors are more complex, involving a vast range of price-sensitive information. This information falls into three general categories: (1) firm-specific information,[7] (2) industry-specific information,[8] and (3) market-wide information. Within each of these intra-market categories, some of the information is available to the public while other information is not. Information which, if made public, is likely to have an impact on the price of stock, is considered "material."[9] When material information is nonpublic, it is called "inside information."[10]

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further loss. Second, a trader may sell at a loss if she has experienced a profit in other stock and wants to reduce her net income for tax purposes. This is referred to as "tax selling." *Id.* at 91-103.

7. Firm-specific information is that which uniquely pertains to a particular corporation. This includes information regarding the inner organization of a firm, such as dividend news, management restructuring, tender offers, and new products. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 48-57 (1966).

8. Industry-specific information is that which affects an entire industry, such as new tax provisions, prices for raw materials, large government contracts, safety regulations, and trade treaties or tariffs. J. LITTLE & L. RHODES, *supra* note 1, at 63-78. For example, if the price of steel goes up, there will be an impact on the entire automobile manufacturing industry. H. MANNE, *supra* note 7, at 48-57.

9. Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of the national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1988). *See also* Act of Aug. 10, 1984, Pub. L. No. 98-376, 1984 U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 2274, 2276. The United States Court of Appeals for the Second Circuit has applied a test for materiality which asks "whether a reasonable man would attach importance [to the information in question] in determining his choice of action in the transaction in question. . . . This, of course, encompasses any fact which in reasonable and objective contemplation might affect the value of the corporation's stock or securities." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) *cert. denied*, 394 U.S. 976 (1969).

10. The use of material, nonpublic information in securities transactions constitutes trading on inside information. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1979)(mark-up man for financial printer who decoded names of companies involved in mergers and traded on that information was found not to have violated securities laws); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) (financial columnist found guilty of violating securities laws after stealing publication schedule from his employer and trading prior to publication of articles about stocks); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (officers and directors of mining company found guilty of violating securities laws after trading on information concerning valuable ore discovery without disclosing the true value of the mineral

Commentators have both condemned and defended the act of trading on inside information.[11] Both positions are supported by a number of factors. The existence of fiduciary duties—to employers,[12] clients,[13] readers,[14] and customers[15]—forms the basis of most objections to insider trading. Proponents of inside trading, on the other hand, tout the benefits of that activity which include market efficiency[16] and incentive compensation promoting favorable corporate economics.[17]

It is worth noting that the law accords disparate treatment to different types of inside traders. One group of traders who face liability for using inside information are the true, or classic, insiders. These individuals are corporate directors and employees who owe a fiduciary obligation to shareholders.[18] When members of this group possess inside information, their fiduciary obligation may preclude them from trading in the shares of their companies. Another group of potential violators are not classic insiders; rather, the information they use is obtained from the classic insiders. The law recognizes a derivative liability in such "tippees" from their corporate insider "tippers."[19] The third group of individuals who use inside information is comprised of all other traders who do not fall into either of the other two groups. Accordingly, these traders are neither directors or employees of a corporation whose stock they are trading, nor do they receive their inside information directly from insiders or "quasi-insiders."[20] The current law does not pro-

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find).

11. For a discussion in favor of insider trading, see H. MANNE, *supra* note 7. For views opposing insider trading, see Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470 (1969).

12. *See, e.g.*, *Chiarella*, 445 U.S. at 224 (where a mark-up man for a financial printing company decoded names of companies involved in a merger and traded on such information despite his employer's rules and warnings not to do so).

13. *See, e.g.*, *id.* at 235-37.

14. *See, e.g.*, United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 454 U.S. 19 (1987) (where a writer of a financial column traded shares of corporations prior to publication of columns discussing the same corporations without disclosing his interest).

15. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983) (where a corporate insider tipped off an analyst that the insider's corporation was misrepresenting its financial position and the analyst advised his clients to sell).

16. *See generally* H. MANNE, *supra* note 7, at 93-110.

17. *Id.* at 131-45.

18. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

19. *See Dirks*, 463 U.S. at 659-61.

20. A "quasi-insider," or atypical insider, is one who is not recognized as a classic insider, but comes into possession of material non-public information by virtue of his or her

hibit this group from trading on inside information, and does not impose on this group a duty to anyone who may be trading on the opposite side of the transaction.[21]

The stock exchange is regulated in order to promote its primary function—to provide capital for corporations through sales of equity and debt. Such regulation, then, must instill in investors the confidence that they can participate in the stock exchange with an opportunity for profit. In order to draw from the widest pool of investors, the stock exchange is open to anyone who wants to invest and has the capital resources to do so. This pool includes a broad spectrum of investors, from the sophisticated professional market analyst to the lay person equipped with virtually no knowledge of the workings of the exchange. Regulation of the exchange, then, must encourage the efficient pricing of shares, the public dissemination of material information, and the opportunity for traders to obtain reliable, unbiased trading recommendations.

For the purposes of this Note, while fiduciary obligations will be considered, the discussion centers on the consequences of trading with inside information by both insiders and outsiders. This Note will expose inconsistencies in current securities regulations, and contrast the recognized problems of allowing trading on inside information with the cost of current law which inefficiently regulates such trading. The discussion also addresses the potential cost to the market in the event that the current proscriptions were to eliminate all insider-trading.

Part I provides a brief history of how the market began, and reviews the events and public sentiment that led to the present regulations. Such an investigation is necessary in order to understand what the Securities and Exchange Commission (SEC) regulations were reacting against. Moreover, an understanding of the concerns of the early market regulators will help show why today's prohibitions are misplaced—and even harmful—to the current operation of the market. Part II examines the costly attempt to eliminate insider trading. Part III then explores how the market might function if no illegal insider trading occurred. Part IV examines the alleged unfairness attributed to insider trading. Finally, the

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profession or position—as a lawyer or banker might in working on a corporate merger. H. Bloomenthal, Securities Law in Perspective 92 (1977). *See also Dirks*, 463 U.S. at 655 n.14.

21. Chiarella v. United States, 445 U.S. 222, 231-35 (1979).

Note concludes that proscriptions against insider trading should be eliminated, principally because insider trading causes no real injury, market pricing efficiency is improved by insider trading, and the costs of enforcement outweigh any benefits.

I. THE HISTORY OF INSIDER TRADING AND THE REGULATIONS PROMULGATED TO PREVENT IT

The Industrial Revolution at the end of the nineteenth century required extensive capital for growth, and corporations increasingly turned to stock sales as a means of raising that capital. These corporations offered shares of stock to those willing to invest. The public was generally enthusiastic to participate in the expanding industrial economy.[22] In an age in which stock brokers were free to make a strong sell and few regulations governed the disclosure of offerings, investors readily purchased stock in corporations they knew little or nothing about.[23] These investors naively hoped that the shares they purchased would rise in value. While there were many solid corporations which provided good investment opportunities,[24] there were an even greater number of shaky offerings, along with a healthy supply of unscrupulous brokers.[25] The lure of these risky offerings was usually a promise that share values would skyrocket.[26] Because the broker earned a commission on sales regardless of whether the customer reaped a profit, there was little reason for the broker to be concerned with the soundness or genuineness of the securities purchased.[27]

"Bucket shops,"[28] referred to on Wall Street as "funeral parlors," sprung up all over the country.[29] These were "mini-exchanges" where small-time speculators gathered to invest their money in stock.[30] While some bucket shops executed legitimate

22. C. COWING, POPULISTS, PLUNGERS, AND PROGRESSIVES 75 (1965).
23. *Id.* at 95-105.
24. *Id.* at 98-101.
25. *Id.* at 95-105.
26. *Id.* at 96.
27. *Id.* at 32.
28. The term "bucket shop" originated in England. It referred to meeting places of street urchins who drained beer kegs discarded by taverns. *Id.* at 28-29 n.5. In the sense that these urchins took what little value there was left from the beer kegs already discarded, the proprietors of bucket shops dealt in stock sales that were usually too small or too unreliable for legitimate brokers. *Id.*
29. *Id.* at 27.
30. *Id.* at 27-30.

trades, many only pretended to trade in real stocks. In order to gain credibility, the latter often peppered phony quotations with those of actual stocks.[31] Bucket shop owners relied on an uninformed public, and often merely simulated the risk of market fluctuations through fraudulent practices. Specifically, instead of actually purchasing shares of a corporation on a customer's order, the bucket shop owners would hold the customer's money. If the price of the stock fell and the customer then wanted to sell, the bucket shop owner could pocket not only his commission, but also the difference between the original stock price and the lower price at which the customer chose to sell.[32] If customers, who were overwhelmingly bullish,[33] turned out to be correct, the shops would simply close and the owners would move on to the next group of unwary traders.[34]

The New York Stock Exchange and the Chicago Board of Trade,[35] along with the media, exposed and criticized the practices of the bucket shops.[36] Wall Street brokerage houses entered into agreements with Western Union[37] which denied bucket shops access to the stock wire. Without quotations to lure customers, most bucket shops were forced to close. In response, the bucket shops charged that the brokerage houses of Wall Street were seeking to monopolize the stock industry.[38] The shops argued that a significant portion of their business involved trading in the small lots of legitimate stock which most Wall Street brokers disdained.[39] The bucket shops also claimed that their offenses were no worse than Wall Street's since Wall Street brokerage houses often dealt in

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31. *Id.* at 28.

32. *Id.*

33. "Bullish" traders are those who purchase stock anticipating an increase in the stock's price. "Bears" take a pessimistic view and usually sell in anticipation of the stock price's decline. *Id.* at 36.

34. *Id.* at 28. One commentator described the crudest bucket shops as those which "captivated their clients with simulated quotes on fictitious stocks, displayed on a revolving tape and a 'private wire' system that extended only to the edge of the rug." *Id.*

35. The Chicago Board of Trade is a "formal organization of futures trading in provisions and commodities." *Id.* at 3.

36. *Id.* at 29-30.

37. Western Union lines carried price information from organized exchanges to 'tickers' around the country. A ticker was a machine which printed a tape with stock prices on it. It was crucial for any broker (legitimate or bucket shop) to have current prices of stocks their customers wished to trade. *Id.* at 29.

38. *Id.* at 30.

39. *Id.* Bucket shops were geared to accommodate small investor transactions. Large Wall Street brokerage houses spurned small investor business because larger transactions required the same amount of paperwork but yielded higher commissions. *Id.*

worthless stock.[40] Moreover, bucket shops charged lower commissions.[41] Nevertheless, during the period from 1905 to 1907, most states passed laws which prohibited the operation of bucket shops.[42]

Apart from any of the vices which were unique to the bucket shops, these shops had one evil in common with the dominant Wall Street brokerage firms: long-term investments were neglected, while short-term speculation—more accurately, gambling—prevailed.[43] There were dangers in a market where short-term speculation eclipsed long-term investment: "As the gambling spirit gained dominance in the exchanges, prices were much more susceptible to sudden decline than to sudden advance. Wall Street, in fact, was a paying proposition only for the broker and the insider, not for the average customer."[44] This volatility was probably due to an artificial escalation in stock prices when misinformation concerning a corporation's potential for profitable growth triggered flurries of trading activity.

Besides having little concern for the solidity of their invest-

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40. *Id.* at 29.

41. *Id.* at 29-31.

42. *Id.* at 29-30.

43. *See generally id.* at 75-126. There are two basic approaches to securities trading: speculation and investment. Speculation is the practice of purchasing stock to profit from short term price volatility. Purchases and sales are induced primarily by momentary market conditions, world news, rumors of imminent disclosure of material information that will affect the stock price, or any feeling a trader may have that the stock price will change in the near future. Investment stands in contrast to speculation. Theoretically, an investor purchases shares of a corporation with the intention of keeping them for long-term gain. Solid corporate structure, strong management, and earnings and payment of dividends typically induce investment.

For both long-term investors and short-term speculators the inside trader offers the benefit of price correction. Insider trading accomplishes this by digesting information, both public and non-public, and trading on this information. If the insider knows of good news she will be willing to pay a higher price for shares than the market currently demands. Likewise, if the insider knows of bad news, her offer to sell will adjust the price of the stock down to reflect a more accurate value for the shares.

In the case of good news, the insider's trading adjusts the price upwards and allows investors and speculators alike to benefit from a more accurate reflection of share value. While it may be argued that an insider trading on bad news may depress the stock and potentially injure the corporation, it is of no societal value to allow a corporation to deceive public investors by withholding bad news (that which they are not technically required to report, or do not have to report immediately) and to allow the public to invest in a corporation whose value is not accurately reflected in the stock price. *See generally* H. MANNE, *supra* note 7.

44. C. COWING, *supra* note 22, at 31-32 (quoting Givens, *Does Wall Street Speculation Pay?*, 59 THE INDEPENDENT 494-96 (Aug. 31, 1905)).

ments, speculators used other people's money. The minimum margin[45] was often as low as ten percent,[46] and the broker made an additional one percent on relending.[47] With ninety-five percent of all stock traded on margin,[48] market stability was dubious at best. For the most part, lenders' money backed stock transactions. If the value of purchased stock did not continue to rise—as few ever did—the trader had to pay the margin call[49] on the spot. If the trader lacked cash, the investments usually were lost.[50]

The small "investor" was not the only culprit. While it was true that stock brokers preyed on the public's greed and encouraged the over-extension of credit, a more significant drain on bank funds came from another group. This group was comprised of only a very few wealthy investors, but some commentators thought it ran the country.[51] Perhaps it did. Local banks throughout the country funneled their funds into New York accounts to obtain higher returns on loans than they could get locally.[52] The Standard Oil Trust, led by William Rockefeller and Henry K. Rogers, was at the center of the "system" some felt was strangling the American economy.[53] The public's bank funds benefitted a few elite investors, such as Rockefeller and other market manipulators. Money was loaned to those wealthy investors so that they could cheaply buy up stocks after they had contrived the declines that shook out small investors.[54] In effect, the public was lending money to such investors, enabling them to buy the public out of the market at bargain prices.[55]

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45. Margin is credit advanced to the trader by his broker. *See* J. Little & L. Rhodes, *supra* note 1, at 88.

46. C. Cowing, *supra* note 22, at 39. The margin minimum set at 10% meant that a trader could, for example, purchase $10,000 worth of stock with $1,000 of his own money and borrow, or margin, the balance. J. Little & L. Rhodes, *supra* note 1, at 87-88.

47. C. Cowing, *supra* note 22, at 32. Relending was what the broker did to provide credit for his customer. The broker did not lend the customer his own money. Instead, the broker borrowed money from another source (usually a bank) and in turn loaned the money to his customer to buy stock. The broker charged 1% (of the loan) for this service. *Id.*

48. *Id.*

49. For example, if the stock price starts to decline, the bank will usually demand payment of the loan principal immediately. The bank's demand is termed a "margin call." J. Little & L. Rhodes, *supra* note 1, at 95.

50. That is, the investors often failed to pay the banks on their margin notes. C. Cowing, *supra* note 22, at 148-51.

51. L. Lowenstein, What's Wrong with Wall Street 13-21 (1988).

52. C. Cowing, *supra* note 22, at 138.

53. *Id.* at 33.

54. *Id.*

55. L. Lowenstein, *supra* note 51, at 14-17.

In 1907, the Bankers' Panic ended a three year cycle of prosperity after pressure on the money supply[56] increased.[57] In response, some observers proposed a new banking system while others recommended that the stock market be regulated.[58] Governor Charles Evans Hughes of New York appointed a committee to investigate stock market practices.[59] He hoped that the findings would temper any proposals for strict regulations that might arise in the Congress or the state legislature.[60]

Two members of the committee sent a letter to Governor Hughes that advised him "to take a strong stand in favor of regulation so that New York statutes might set a very high precedent for the nation."[61] These committee members believed that a gradual strengthening of public faith in the market would offset the otherwise inevitable initial decline in the market.[62] The other committee members refused to sign the letter out of fear that implementation of the letter's proposals would trigger an immediate adverse reaction in the market.[63]

In June of 1909, the committee sent its report to Governor Hughes. The Hughes Report called for raising the margin minimum to twenty percent[64] from the ten percent that had been established by common practice.[65] The Committee did not regard short sales[66] as inherently more detrimental to the economy than long sales.[67] Moreover, the Committee did not find that speculation, as opposed to long-term investment, would have a deleterious effect on the market.[68] In fact, the Committee suggested that any

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56. The money supply here refers to money available for loans to the public.

57. C. Cowing, *supra* note 22, at 38. This pressure was augmented in the United States by repercussions from manipulative campaigns in the stock market. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 39.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at n.23.

66. A short sale of stock occurs when a trader anticipates a price decline in a stock and "sells" shares which he does not own, with the intention of purchasing, or covering, those shares when the price declines. J. Little & L. Rhodes, *supra* note 1, at 77, 99.

67. C. Cowing, *supra* note 22, at 39-40. A long sale refers to the typical purchase of stock in which a trader buys, anticipating that the price of the stock will increase. J. Little & L. Rhodes, *supra* note 1, at 77.

68. C. Cowing, *supra* note 22, at 40. *See generally id.* at 75-126; L. Lowenstein, *supra* note 51, at 21-30.

restrictions on speculation would effectively impair the market. Commentators interpreted the report as subscribing to the view that

> [s]peculation was not gambling but simply the legitimate exercise of acumen in the business field, and genuine reform could come only with the gradual growth of an enlightened commercial public and the consequent adoption of higher standards of social ethics. As the fiduciary relations of business to the public become more apparent, there would be a decline of sharp practices.[69]

By the early Spring of 1910, concrete responses to the Hughes Report had been made. For example, the New York Stock Exchange enacted rules "forbidding trading by messengers, clerks, and others acting in a fiduciary relationship to the brokers."[70] In addition, the Exchange tightened existing rules in order to curb manipulation.[71]

Market regulation was not merely a state concern. In 1913, a number of United States Senators argued about how Congress should respond to excessive speculation during debates over proposed legislation aimed at curbing speculation in cotton.[72] Supporting data in the argument for increased regulation of speculation included an analysis of railroad stocks which, as of 1913, comprised seventy-five percent of the stocks traded on the New York Stock Exchange.[73] While railroad industry earnings had fluctuated only five to ten percent for the year, railroad companies' stock prices had fluctuated from thirty to one hundred percent during the same period.[74] These figures, argued the supporters of increased regulation, revealed the manipulation of stock prices for profit.[75] Consequently, a company's stock prices did not necessarily reflect the actual economic conditions of the business.[76]

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69. C. COWING, *supra* note 22, at 41.

70. *Id.* Wisconsin had already enacted legislation barring trading by anyone acting in a fiduciary relationship to a broker. Soon afterwards, Wyoming, Kentucky, South Carolina, New Jersey, Rhode Island, and Mississippi passed laws making speculation by such persons a felony. *Id.* at 42.

71. *Id.* at 41.

72. *Id.* at 44-46.

73. *Id.* at 46.

74. *Id.*

75. *Id.*

76. *Id.*

Methods of manipulation included the "washing"[77] of stock. A broker or manager of a pool[78] washed stock by trading it in order to feign interest in the stock and thereby drive the price up.[79] In order to do this, traders bought and sold large blocks of stock at the same time. In reality, no stock changed hands. Rather, price action in the stock made outsiders think something was going on. Thus, the outsiders in turn purchased the stock and drove the price higher.[80] When the desired price level was reached, the pool operators "dumped the securities at the higher price on the unsuspecting public."[81]

Newspapers and trade publications warned of the public's dwindling faith in the stock market.[82] The common belief was that the more secure the public felt about the exchange, the more business Wall Street would do.[83] Periodicals uncovered fraudulent stock issues and exposed the investment bankers who floated[84] those issues. Newspaper articles attacked the watering of stock, especially that of the railroads.[85] Wall Street began to fear a loss of public confidence. While professional traders often lamented about the presence of amateurs, they understood that these amateurs brought much-needed liquidity to the market.[86] The solution, ac-

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77. "Washing" is the fictitious purchase and sale of stock to create market activity. J. LITTLE & L. RHODES, *supra* note 1, at 19.

78. A stock pool is a group of investors who "pool" their funds for investment. C. COWING, *supra* note 22, at 204-05.

79. J. SELIGMAN, THE TRANSFORMATION OF WALL STREET 17 (1982).

80. C. COWING, *supra* note 22, at 54. In 1909, James R. Keene, a leading Wall Street manipulator, acting as manager of a syndicate, bought and sold 124,000 shares of Hocking Coal and Iron Company in less than a year when only 70,000 shares were outstanding. This manipulation drove the price of the stock from $20 to $90 within a few months. *Id.* On January 19, 1910, however, the stock plummeted from $88.75 to $25. One of the traders, who was a part of the pool controlled by Keene's syndicate, had been leaking—selling short against the pool. *Id.* This is an example of an insider inadvertently helping to bring the price of the stock closer to its legitimate value.

81. H. BLACK, THE WATCHDOGS OF WALL STREET 5 (1962).

82. C. COWING, *supra* note 22, at 58. The *New York Journal of Commerce* chastised brokers for having been careless in selling new securities to the public. *Id.*

83. *Id.*

84. An issue is "floated" when the initial offering is made. For a discussion of public offerings and current regulation, see H. BLOOMENTHAL, SECURITIES LAW HANDBOOK 97-177 (1988-89).

85. C. COWING, *supra* note 22, at 58. Stock is "watered" when more shares are unofficially issued without changing the offering price of the stock. The extra shares dilute the value of all the company's stock. L. LOWENSTEIN, *supra* note 51, at 13-17.

86. A market is "liquid" when it is saturated with traders, whether investors or speculators. This occurs because there are more people willing to buy and sell, thus producing a greater market for all issues generally. *But see* H. MANNE, *supra* note 8, at 108-09 (arguing

cording to the wisdom on Wall Street, was for Congress to enact a law regulating the issuance of corporate securities.[87] In so regulating the market, the public would "be protected from spurious stocks and the exchange would remain free of the deadening hand of government supervision."[88]

The Crash of 1929 precipitated the federal government's taking a more active role in protecting the securities markets. Between September 1, 1929, and July 1, 1932, the value of stocks traded on the New York Stock Exchange shrunk by eighty-three percent.[89] However, the 1929 Crash was not the only reason for the loss of public confidence. During the post World War I period through 1932, approximately fifty billion dollars of new securities were sold to the public, and about half of them proved worthless.[90]

Ferdinand Pecora served as counsel for the Senate Banking and Currency Committee's 1932-1934 investigation into the decline of the value of securities.[91] Pecora intended to reduce any faith the public may have had left in the financial institutions of the day. He publicly exposed the salaries and tax records of the dominant financiers who appeared before the Committee.[92] These revelations helped to galvanize "broad public support for direct federal regulation of the stock markets."[93] There was political impetus for Pecora's actions. During the preceding twelve years, a majority of voters supported President Calvin Coolidge's laissez-faire attitude toward government regulation of business.[94] Following the Crash of 1929 and Pecora's hearings, the national political sentiment was transformed "to a regulatory-reform ideology associated with Roosevelt's New Deal."[95]

Franklin Roosevelt attempted to convince the American people that banking leaders had been responsible for the Crash of 1929, and had effectively ruined the economy in return for per-

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that short-term traders do not add as much liquidity to the market as they are often credited as providing).

87. C. Cowing, *supra* note 22, at 58-59.

88. *Id.* at 59.

89. J. Seligman, *supra* note 79, at 1.

90. *Id.* at 1-2.

91. *Id.* at 1; H. Black, *supra* note 81, at 10-13 (1962).

92. J. Seligman, *supra* note 79, at 2. It is critical to understand that Pecora's intent, at Roosevelt's beckoning, was to rally public support for federal securities regulation.

93. *Id.*

94. *Id.*

95. *Id.*

sonal gain.[96] He accused the bankers of dishonesty as well as incompetence in the handling of other people's money, charging that they had wasted that money in ill-advised speculations and loans.[97] Roosevelt then recommended that Pecora investigate J.P. Morgan and Company.[98]

Pecora's investigation revealed that the partners in the House of Morgan paid very little in income taxes during the early thirties.[99] Although sensationalized by the press, the diminution in taxes paid after 1929 actually reflected the shrinking value of the market in general and heavy losses incurred by the Morgan partners.[100] Indeed, five years later Pecora wrote that "[i]n truth, the investigation of the Morgan firm elicited no such glaring abuses [as were anticipated and found in other banking firms]."[101]

Second in notoriety only to the tax returns of the Morgan partners were the "preferred lists" which Pecora uncovered. These were lists of individuals to whom Morgan offered newly-issued shares of common stock at, or slightly above, cost.[102] Those on the preferred lists were given the opportunity to purchase stock below the market price, enabling them to make an immediate profit in the sale of such stock.[103] While Pecora could not find anything illegal in the maintenance of preferred lists, their existence reinforced the view that the average investor traded on the market at a significant disadvantage.[104]

The Banking Act of 1933,[105] which limited the services a private bank could offer,[106] directly resulted from the public impact of the Morgan hearings. The hearings also insured further funding for

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96. *Id.* at 29.

97. *Id.*

98. *Id.* at 30.

99. *Id.* at 33.

100. *Id.* In fact, the net worth of both Morgan and Company and Drexel and Company, Morgan's allied concern in Philadelphia, "fell 55 percent between 1929 and 1931, declining from $119 million dollars to $53 million dollars." *Id.*

101. F. PECORA, WALL STREET UNDER OATH 5 (1939).

102. J. SELIGMAN, *supra* note 79, at 34.

103. *Id.*

104. *Id.* at 35.

105. Glass-Steagall Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended at 12 U.S.C. § 378 (1982)).

106. J. SELIGMAN, *supra* note 79, at 38; The Banking Act "divorced commercial banks from their security affiliates and investment banks from their deposit business." H. BLACK, *supra* note 81, at 13.

Pecora's on-going investigations.[107] Another result of Pecora's work came with President Roosevelt's signing of the Securities Act of 1933.[108] At the signing, Roosevelt stated that the Act

> will safeguard against the abuses of high pressure salesmanship in security flotations. It will require full disclosure of all the private interests on the part of those who seek to sell securities to the public. The Act is thus intended to correct some of the evils which have been so glaringly revealed in the exploitation of the public's money.[109]

But Roosevelt approached securities regulation more as a politician than an economist.[110] He was generally unconcerned with the bigger issues of capital allocation and economic recovery.[111] Rather, Roosevelt felt that the moral indiscretions of the self-serving bankers would be curtailed through public exposure.[112] Consequently, he rallied public sentiment to forge securities regulation legislation. Following the Crash of 1929 and the revelation of financiers' personal gains, it was not very difficult to convince the public that a few insiders had gained enormous wealth, apparently at the expense of ordinary citizens.

As part of Roosevelt's New Deal, Congress passed the Securities Act of 1933 (1933 Act).[113] The main thrust of the 1933 Act, amid many questions of legislators over what the federal government's role should be in securities regulation,[114] was to protect public investors by imposing strict reporting and registration requirements on corporations wishing to issue stock to the public. Critics of the 1933 Act claimed that the public lacked the necessary expertise to read and understand the technical accounting papers required by the Act.[115]

107. J. SELIGMAN, *supra* note 79, at 38.

108. *Id.*

109. 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 213-14 (1933).

110. J. SELIGMAN, *supra* note 79, at 41.

111. *Id.*

112. *Id.*

113. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 87-92 (1988). *See* 15 U.S.C. § 77a (1988).

114. L. LOSS, *supra* note 113, at 28 (1988). More specifically, Congress faced the question of what "the standards of the limited federal licensing should be." *Id.* On the one hand there was a contingent opposed to any licensing. This contingent advocated only the stern enforcement of existing common law fraud. On the other extreme there stood William O. Douglas, later to be Chairman of the SEC, who criticized the 1933 Act for its lack of pervasiveness. *Id.* at 28-29.

115. *Id.* at 29. On this point William O. Douglas, *see supra* note 114, argued that

The Securities and Exchange Act of 1934 (1934 Act)[116] took up where the 1933 Act left off. In addressing the practice of post-distribution trading,[117] the 1934 Act extended added protection to the public investor. A 1934 House Report expressed the concerns of Congress that gave rise to the Act:

> The causes of dangerous speculation in the securities markets go far deeper than defects and abuses in stock-exchange machinery alone. They include inadequate central control of a national credit system, . . . inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment of the values of securities . . . [and] managements in possession of inside information.[118]

The report noted that "[s]peculation, manipulation, faulty credit control, investor's ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries are all a single seamless web."[119] Capitol Hill politicians with the support of Roosevelt attempted to persuade the public that securities regulations would rid the market of all previous abuses. Individuals, therefore, could theoretically participate in the market on an equal footing.

Whereas the 1933 Act required registration of all corporations which issued public shares, the 1934 Act regulated the trading of those shares among investors.[120] Yet both acts attempted to prevent fraud and market manipulation.[121] Prior to the 1933 Act, the only way to confront securities fraud was under the federal mail fraud statute,[122] or under an administrative "fraud order" entered

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> those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant.

Id.

116. 15 U.S.C. § 78(a) (1982).

117. L. Loss, *supra* note 113, at 36.

118. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3, 5-6 (1934).

119. *Id.* at 6. In fact, the report described the stock manipulator as "a shell-game artist who can live only by following the county fair of too easy credit and ignorance." *Id.*

120. L. Loss, *supra* note 113, at 36.

121. *Id.* at 36. Provisions of the 1934 Act provide for the formation of the Securities Exchange Commission (SEC). 15 U.S.C. § 78d (1988). The SEC is "an independent agency of five members appointed by the President and confirmed by the Senate for staggered five-year terms." L. Loss, *supra* note 113, at 35. It has executive and "quasi-legislative (rulemaking) and quasi-judicial powers." *Id.* at 35.

122. The relevant part of the federal mail fraud statute states:

by the Postmaster General.[123]

Section 17(a) of the 1933 Act is a general anti-fraud provision.[124] Its protections are arguably limited, however, to prohibiting unfair dealings by persons engaged in selling securities;[125] section 17(a) does not unequivocally prohibit the purchase of securities through fraudulent means. This deficiency was in part remedied by section 10(b) of the 1934 Act.[126] This section prohibits both the selling and buying of securities in contravention of prescribed rules. However, section 10(b) is only a general anti-fraud provision—it relies on specifically prescribed rules as a guide to determine what type of behavior is proscribed.[127]

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, . . . for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes it to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

18 U.S.C. § 1341 (1982) (originally enacted as Act of June 8, 1872, ch. 335, 301, 17 Stat. 323). *See also* Comment, Survey of the Law of Mail Fraud, 1975 U. ILL. L.F. 237.

123. 39 U.S.C. § 3005(a) (1982). *See generally* L. Loss, *supra* note 113, at 699.

124. Section 17(a) of the 1933 Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1988).

125. L. Loss, *supra* note 113, at 701.

126. Section 10(b) of the 1934 Act provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
> . . . .
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1988).

127. L. Loss, *supra* note 113, at 704.

Even when applying the provisions of the 1933 and 1934 Acts in combination with one another, there still existed a large gap in investor protection by virtue of which "an issuer itself, or an officer or director or principal stockholder could buy in its securities by fraudulent practices without being touched by federal authority except for criminal prosecution under the mail or wire fraud statute or the entry of a mail fraud order."[128] In May of 1942, the SEC came up with a solution to this problem.[129] Under section 10(b) of the 1934 Act, which contains a provision that enables the Commission to prescribe rules and regulations,[130] the Commission adopted what is now designated Rule 10b-5.[131] Rule 10b-5 borrows the general anti-fraud language of section 17(a) of the 1933 Act,[132] with the additional reference in clause (2) to *obtaining money or property by means of* an untrue statement or half-truth, yet applies it "in connection with the purchase and sale of any security."[133]

These anti-fraud regulations grew out of a belief that the public deserved special protection when trading securities.[134] Because one objective of securities regulation is to provide this special protection, several courts have acknowledged that the SEC provisions often give rise to charges of fraud which would ordinarily not fall within the common law notion of deceit.[135] This sort of expanded regulation—very likely the result of an overreaction to the abuses of manipulators early in the stock market's history—offers only

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128. *Id.* at 708-09.

129. *Id.* at 709.

130. *See* 15 U.S.C. § 77s(a) (1988) ("The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter . . . .").

131. 17 C.F.R. § 240.10b-5 (1988). For the full text of Rule 10b-5, see *supra* note 9.

132. *See supra* note 124.

133. 17 C.F.R. § 240.10b-5. *See also* L. Loss, *supra* note 113, at 709.

134. As pointed out by Professor Loss,

> The anti-fraud provisions are part of a statutory scheme that resulted from a finding that securities are 'intricate merchandise' and a congressional determination that the public interest demanded legislation that would recognize the gross inequality of bargaining power between the professional securities firm and the average investor. 'The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do.'

L. Loss, *supra* note 113, at 716 (quoting H.R. REP. No. 85, 73d Cong., 1st. Sess. 8 (1933), and Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944)).

135. *Id. See, e.g.*, Harris v. American Inv. Co., 523 F.2d 220, 224 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

limited protection to arbitrarily selected investors. Moreover, these very same regulations can work to inhibit severely the dissemination of valuable information concerning public corporations.[136] The most commonly employed weapon in the SEC's arsenal against trading on inside information is Rule 10b-5, which has grown from a narrowly applied rule to one of malleable form and apparently limitless scope.[137]

II. The Judicial Expansion of Rule 10b-5

Having created Rule 10b-5 out of a combination of two rules dealing, respectively, with fraudulent stock issues and deceptions

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136. For a discussion of the dissemination of market information, see *infra* text accompanying notes 270-79.

137. L. Loss, *supra* note 113, at 726. L. Loss recognizes the widening application of Rule 10b-5 and writes:

> The 10b-5 story tempts the pen. For it is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little. What is more remarkable is that the whole development was unplanned. Like the British Empire, which Eamon de Valera called 'A domain created in a moment of world absent-mindedness,' it just happened. One has his choice of figures of speech: Chief Justice Rehnquist's 'judicial oak which has grown from little more than a legislative acorn.'

Id. (footnotes omitted). Rule 10b-5 was promulgated out of a desire to curb the activity of a single corporate executive from Boston. The following account is provided by Milton V. Freeman, a member of the District of Columbia Bar who was present at the creation of the Rule:

> It was one day in the year [1942], I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, 'I have just been on the telephone with Paul Rowen,' who was then the S.E.C. Regional Administrator in Boston, 'and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?' So he came upstairs and I called in my secretary and I looked at section 10(b) and I looked at section 17, and I put them together, and the only discussion we had there was where 'in connection with the purchase and sale' should be, and we decided it should be at the end.
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> We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' That is how it happened.

Id. at 727 (quoting ABA, Section of Corporate, Banking & Business Law, *Conference on the Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 921-23 (1967)).

by brokers, the SEC used the rule only in broker-dealer disciplinary actions during the first five years of its existence.[138] The first important case to expand the scope of Rule 10b-5 was *Speed v. Transamerica Corp.*[139] The action in that case arose when Transamerica purchased its own stock from minority shareholders based on inside information concerning inventory values which had appreciated significantly over book value.[140] Because the stock price did not accurately reflect the true inventory values, Transamerica realized that its stock was selling below its actual value. In repurchasing its stock from the minority shareholders, Transamerica did not disclose the reasons underlying the purchase.[141] In deciding the case, Judge Leahy of the District Court for the District of Delaware wrote that Rule 10b-5 was "an attempt to provide some degree of equalization of bargaining positions in order that the minority may exercise an informed judgment in any such transaction."[142] The Court also noted that the defendant corporation, at the request of the majority shareholders, had personally solicited the shares of minority shareholders with an offer.[143] In finding for the plaintiffs, Judge Leahy held that

> [t]he rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock from minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.[144]

Following *Transamerica*, Rule 10b-5 actions arose with more frequency. However, courts were unable to clarify the scope of the rule.[145] Because the courts had expanded securities regulations beyond common law fraud theory,[146] it was difficult to define with precision the elements necessary to prove a Rule 10b-5 violation.[147]

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138. H. MANNE, *supra* note 7, at 34-35.
139. 99 F. Supp. 808 (D. Del. 1951).
140. *Id.* at 819.
141. *Id.* at 826.
142. *Id.* at 829.
143. *Id.* at 826.
144. *Id.* at 828-29.
145. H. MANNE, *supra* note 7, at 36.
146. *See, e.g.*, Harris v. American Inv. Co., 523 F.2d 220, 224 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). *See generally* L. Loss, *supra* note 113, at 699-723.
147. H. MANNE, *supra* note 7, at 36-37.

The difficulties faced by courts in applying the rule probably stemmed from the impersonal-transaction nature of the stock market. Specifically, buyers and sellers seldom meet, and they rarely disclose their reasons for buying or selling.[148] Accordingly, courts differed over whether "scienter,"[149] normally an essential element of common law fraud actions, was requisite to a Rule 10b-5 action.[150] Questions also arose over the degree of reliance necessary on the plaintiff's part, and whether the 10b-5 action required underlying privity between buyer and seller.[151]

The current law treats users of inside information differently, depending on the duty to disclose arising from the fiduciary obligations owed to the trading shareholders. One group of traders who use inside information may be characterized as the "true" or "classic" insiders. These are the directors and employees of the corporations in whose securities they are trading. In *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*,[152] the Second Circuit recognized the fiduciary obligation owed by directors and employees of a corporation to its shareholders. On that theory, the court held that under Rule 10b-5 the directors and employees were liable for trading while in possession of inside information.[153] The court ruled that

> anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," *i.e.*, the investing public.[154]

Accordingly, the *Texas Gulf Sulphur* court asserted that *anyone*

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148. *See infra* text accompanying notes 306-12 (discussion of impersonal markets).

149. "Scienter" is the knowledge by the defendant that a misrepresentation is being made. BLACK'S LAW DICTIONARY 1207 (5th ed. 1979).

150. H. MANNE, *supra* note 7, at 36. In 1976, the United States Supreme Court resolved the question regarding the necessity of scienter in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In that case a brokerage firm fraudulently induced their customers to invest in an investment scheme. The Supreme Court held that "a private cause of action for damages will [not] lie under Section 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' —intent to deceive, manipulate, or defraud." *Id.* at 193.

151. H. MANNE, *supra* note 7, at 36.

152. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

153. *Texas Gulf Sulphur*, 401 F.2d at 848.

154. *Id.* at 848 (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)). In dicta, the *Texas Gulf Sulphur* court broadly included as liable for securities fraud anyone who might be in possession of inside information, regardless of any duty owed to disclose.

trading with the advantage of inside information would be liable under Rule 10b-5. In doing so, the court expanded the duty to abstain or disclose to include anyone who possesses inside information. The court thus attempted to eliminate trading by any investor who had acquired inside information by imposing a fiduciary duty on that investor.

In 1980, the United States Supreme Court narrowed the application of Rule 10b-5 in *Chiarella v. United States.*[155] In *Chiarella,* the defendant was a financial printer who deciphered codes in a printing job; in so doing he was able to determine target takeover companies, and he then traded on this information to his benefit.[156] The United States District Court for the Southern District of New York convicted the defendant for violating section 10(b) of the Securities Exchange Act.[157] The Court of Appeals for the Second Circuit affirmed.[158] On appeal, the United States Supreme Court reversed, holding that there was no duty to disclose inside information to an opposing trader (or abstain from trading).[159] In so holding, the Court noted that the defendant had no fiduciary obligation as a result of directorship or employment with either corporation, and the information he discovered was not disclosed to him by anyone who had violated a fiduciary obligation.[160] The Court reasoned that "the element required to make silence fraudulent—a duty to disclose—is absent in this case."[161] Absent a fiduciary relationship giving rise to a duty to disclose, the defendant had no obligation *not* to use the inside information he had gathered; therefore, he violated no fraud provision in doing so.

In 1982, the United States Supreme Court clarified the liability of a "tippee"[162] in *Dirks v. Securities and Exchange Commission.*[163] Dirks was a market analyst who received information from a corporate employee that the latter's employer was misrepresenting the health of the corporation to its shareholders.[164] The analyst

155. 445 U.S. 222 (1980).
156. *Id.* at 224.
157. 450 F. Supp. 95 (S.D.N.Y. 1978).
158. 588 F.2d 1358 (2d Cir. 1978).
159. 445 U.S. at 231-35.
160. *Id.* at 232-33.
161. *Id.* at 232.
162. A "tippee" is one who receives inside information from a "tipper," and subsequently may incur liability from trading on that information.
163. 463 U.S. 646 (1983).
164. *Id.* at 649.

contacted the *Wall Street Journal*, and subsequently notified his clients and other investors who liquidated their holdings in the corporation.[165] After the fraud was exposed to the public, the SEC investigated and ultimately censured the defendant analyst.[166] Dirks then sought review in the United States Court of Appeals for the District of Columbia.[167] That court entered judgment against Dirks, resting its decision on the position that "obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large."[168]

The United States Supreme Court granted certiorari and reversed. The Court noted that "[w]hether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure,"[169] and held that absent some personal gain to the tipper, such disclosure constitutes no breach of duty to the stockholders and hence does not violate Rule 10b-5.[170] The Court also held that a tippee was liable only if he knowingly received information from somebody who was breaching her fiduciary duty.[171] In such a case, the tippee inherits the tipper's duty to disclose and is thus liable: "[S]ome tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."[172] In order to be convicted in a Rule 10b-5 action, the tippee must have known that "the information was given to him in breach of a duty having a special relationship to the issuer not to disclose the information."[173] If the tipper breached a fiduciary obligation by tipping and the tipper is aware of this, the tippee has then violated Rule 10b-5 and is also liable for the breach.

The goals underlying the law on insider trading are unclear. Among the most recent cases that have further muddled the picture is *United States v. Carpenter*.[174] In *Carpenter*, the Second

165. *Id.*
166. *Id.* at 650-52.
167. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982).
168. *Id.* at 839.
169. *Dirks*, 463 U.S. at 662.
170. *Id.*
171. *Id.*
172. *Id.* at 660 (emphasis added).
173. *Id.* at 661.
174. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987). The United States Supreme Court affirmed, by an evenly divided court, the convictions under the securities laws. By

Circuit upheld the convictions of a *Wall Street Journal* reporter and two associates under the "misappropriation theory."[175] This theory applies when information is stolen, or "misappropriated." The court held "that a journalist who trades securities on the basis of non-public information gathered in the course of employment is guilty of insider trading if the journalist's newspaper has a policy prohibiting such trading."[176] While it is undisputed that the journalist in question violated his company's policy against insider trading, it is not conclusive that he violated federal securities regulations. The Second Circuit broadly interpreted Rule 10b-5 liability to include any person who misappropriates material non-public information in connection with the purchase or sale of securities,[177] regardless of the defendant's position as an insider or quasi-insider.[178] *Carpenter* extended the misappropriation theory further than any previous cases.[179]

The convictions upheld in *Carpenter* represent a considerable expansion of the earlier fraud cases involving personal solicitation and misrepresentation, and stray even further from the goals underlying securities regulations. Rule 10b-5 arose out of an era of extensive manipulation by a handful of powerful market makers, and was intended to protect securities investors from fraudulent trading practices involving personal solicitation and manipulation.[180] As discussed above,[181] the tactics of the early market manipulators involved personal solicitation and the deliberate withholding of material information in face-to-face transactions. After artificially driving down prices, the market professionals were able to buy out the public investors. The drafters of Rule 10b-5 probably never dreamed it would be used to enforce a private corporation's house rules.

Although the liability imposed by Rule 10b-5 should logically be related to the deceived person's decision to trade, the approach taken by the Second Circuit in *Carpenter* ignored the injured in-

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unanimous decision, the Court also affirmed the judgment with respect to mail and wire fraud convictions.

175. Recent Developments, 10 HARV. J.L. & PUB. POL'Y 265, 265-66 (1987).

176. *Id.*

177. *Carpenter*, 791 F.2d at 1028-29.

178. See *supra* note 20 and accompanying text.

179. Recent Developments, *supra* note 175, at 270.

180. For a discussion of the genesis and intended application of Rule 10b-5, see *supra* note 137.

181. *See supra* text accompanying notes 138-50.

vestor and instead focused on the "harm caused by the informational source."[182] At the same time, however, the trading in *Carpenter* would not have violated securities laws had the *Wall Street Journal* lacked a formal policy prohibiting such trading.[183] The court circumvented this apparent inconsistency by holding that "although the employer may perhaps lawfully destroy its own reputation, its employees should be and are barred from destroying their employer's reputation by misappropriating their employer's informational property."[184] Such an interpretation expands Rule 10b-5 beyond its reasonable limits and beyond its basic goal of protecting investors from fraud.[185] Indeed, this signiticant expansion of securities regulation prompted Chief Justice Rehnquist to describe Rule 10b-5 as the "judicial oak" coming from the "legislative acorn."[186]

At least one judge from the Second Circuit believes that the court may have gone too far in its application of Rule 10b-5. In his dissenting opinion in *Carpenter*, Judge Miner wrote that "[k]nowledge of publication dates simply is not in the special securities-related knowledge implicated in the misappropriation theory."[187] In this context, it is crucial to reflect on the original purpose behind market regulation. Without public confidence in the stock exchange, public corporations would have difficulty raising capital. It was the combined evils of face-to-face misrepresentation, personal solicitation without disclosure, and the conspiracy of powerful market makers to manipulate prices that drove away some public investors.

Various regulations, together with tremendous trading volume and the market competition of the exchanges, have eradicated many of these evils. The restrictions on trading with inside information, however, in reality promotes trading based on ignorance.[188] Ignorant trading in turn hinders efficient market pricing, and may ultimately lead to more public suspicion than the kind of trading done by the defendants in *Carpenter*. The image of any market as

182. Recent Developments, *supra* note 175, at 269-70.

183. *Carpenter*, 791 F.2d at 1033. Furthermore, the *Wall Street Journal* itself was under no obligation to abstain from trading. *Id.*

184. *Id.*

185. Recent Developments, *supra* note 175, at 271.

186. *See supra* note 137 and accompanying text.

187. *Carpenter*, 791 F.2d at 1037 (Miner, J., dissenting).

188. *See infra* text accompanying notes 271-79 (discussion of dissemination of market information).

equally fair to all players is an illusion. The stock exchange, as any other market, will always remain most beneficial to those most informed. Ultimately, convictions such as those in *Carpenter* may be as useless and vengeful as Pecora's publication of the Morgan brokers' salaries and tax returns.[189] The campaign appears to be one against wealth, not fraud.

A. *Who Is Injured by Insider Trading?*

The untamed growth of Rule 10b-5 application must have some impetus. Undoubtedly, the most popular rationale for sharpening the sword of securities regulation is the hard-to-attack moral claim that such regulations protect the public.[190] That rationale implies that unregulated insider trading would injure the public. The following discussion explores the resulting "damage" of insider trading.

After accepting the somewhat vague parameters of the insider trading definition discussed above, it is necessary to identify those who the practice injures. The potential harm is always ultimately to investors. Two major categories of harm result from insider trading, direct or indirect. In short, direct harm is the most immediate, personal intrusion to profitable investing. This intrusion causes a loss of money to an investor's account. "It is difficult, however, to draw a convincing, or even plausible, causal connection between the insider trading and the market losses experienced by outside investors."[191] This is true because outside investors typically trade on share price and public information. Trading on inside information simply changes the timing of dissemination of information, but not the effect. Because investors do not anticipate material non-public information, trading on inside information will, at worst, shift dissemination from one arbitrary time to another arbitrary time. At best, trading on inside information will correct the share price more slowly than would an official announcement. This section discusses direct harm in greater detail.

Indirect harm is that which is damaging to the market as a whole, or to corporations individually. The derivative injury to investors from indirect harm is the loss of an efficient market[192] in

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189. *See supra* text accompanying notes 99-101.
190. *See supra* notes 89-123 and accompanying text.
191. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 31 (1980).
192. *See infra* text accompanying notes 271-79 (discussion of dissemination of market

which to invest, and the damage to corporations in which they hold shares. A corporation may suffer damage if bad news prohibits a corporation from borrowing. Bad news is information which tends to lower the price of shares. A corporation may also suffer if the public considers it too volatile in which to invest. The conclusion of this section demonstrates that the public, in fact, has not lost confidence in the stock exchange, even following the most notorious revelations about certain market players. Moreover, the value of increased information flow to the public generally is greater than the cost arising out of some initial inequalities of information.

Direct harm may come from failing to disclose inside information to other traders, causing a delay in the publication of crucial information in order that insiders may trade first, and misleading outside investors.[193] If an inside trader induces trading by misrepresenting information to an opposing trader, the insider has committed fraud,[194] "which is covered adequately by existing law."[195] Short of such misrepresentation, there is no cause of action. There are no property rights in information obtained by insiders or outsiders because "[t]he corporate principal owns the information and may withhold it so long as withholding serves a valid corporate purpose."[196] "The corporation may choose to keep information confidential either to exploit it for commercial reasons . . . or because it is deemed too uncertain to be released safely to the public."[197] Assuming that no insiders wish to trade, there exists no duty to disclose material information concerning the corporation. The corporation may either conceal or disclose information that may affect share price or outside investor trading.[198] Nevertheless, the free-market competition for capital may encourage corporations to publish all relevant information and boast of their integrity in so doing. Yet,

> [o]nce one concedes that insiders have no independent duty to disclose, it is hard to escape the conclusion reached in *Fridrich*[199] that there is no causal connection between insider

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information).

193. Dooley, *supra* note 191, at 32.

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. This, of course, is information other than that which state corporation statutes may require in periodic reporting, such as annual reports.

199. Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053

> trading and outsiders' losses. Insider trading does not induce the outsiders' trades, nor does it mislead them or affect their expectations in any way.[200]

Insiders may also have an incentive to delay publication of information in order to exploit such information themselves.[201] While there is an argument that a delay in publication of certain information may harm some outside traders, the delay will also help other outside traders on the insider's side of the transaction.[202] Insider trading does not, however, usually delay the publication of information.[203] "In fact, the reported cases illustrate, with one possible exception, that insider trading had no effect on the timing of publication."[204]

The last argument that insider trading causes direct harm is that price movements that insider trading produces may mislead outside investors.[205] Outside investors may misread an upward price movement as "overpricing and sell or, worse, misperceive a decrease as evidence of a bargain and board a sinking ship."[206] Even though these possibilities exist, "[i]t is clearly unreasonable to suppose that all persons who sell after an insider's purchase are motivated by the price rise attributable to the insider's trading. Many would have sold anyway and they have benefitted from the price increase."[207] There is only a weak argument that some investors would have acted differently if they had had the same information as the trading insiders.[208]

The second general category of harm caused by insider trading is indirect harm. Indirect harm can cause damage by detracting from market integrity or investor confidence in the market.[209] These harms are not always market-wide. If certain stocks became

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(1977).

200. Dooley, *supra* note 191, at 33. *See also*, Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863, 863 (1987).

201. Dooley, *supra* note 191, at 33.

202. *See id.*

203. *See id.*

204. *Id.* at 34. The noted exception is SEC v. Shattuck Denn Mining Corp., 297 F. Supp. 470 (S.D.N.Y. 1968).

205. Dooley, *supra* note 191, at 34.

206. *Id.* at 35.

207. *Id.* Thus, expanding the application of Rule 10b-5 serves only to provide a cause of action to plaintiffs who would not have acted differently even with disclosure.

208. *Id.* at 36.

209. *Id.* at 37. *See supra* notes 1-3 and accompanying text.

wildly unpredictable, and in turn investors can validly attribute this unpredictability to insider trading, they may lose faith in that particular issue. It is therefore in the best interest of corporations to police insider trading themselves. The fact remains, however, that investors have failed to regard insider trading as a fatal flaw in the market.[210] "[I]nvestors do not regard insider trading as sufficiently injurious to their interests to alter their investment behavior in any discernible way."[211] Even after the Ivan Boesky and Dennis Levine cases, "widely interpreted as evidence of pervasive insider trading,"[212] there was no substantial impact on securities investments, "which continued to increase."[213] In addition, few prominent commentators have mentioned "disillusionment over insider trading"[214] as a contributing factor to the New York Stock Exchange Crash of October, 1987. Consequently, the loss of public confidence in the securities market, which is the most frequently invoked economic argument against insider trading, is largely unproved.[215] In fact, "stock markets functioned successfully . . . long before insider trading prosecutions became as common as they have in the last twenty-five years."[216] "When and if investors desert the market, it will be likely for reasons having little to do with insider trading."[217]

If public investors generally feel that they trade from an inferior position to insiders, public investors "may demand a risk discount for shares they purchase."[218] In turn, this discount may affect the capital a corporation can raise when it issues shares.[219] If

210. Dooley, *supra* note 191, at 44.

211. *Id. But see* Mendelson, Book Review, 117 U. PA. L. REV. 470, 471-72 (1969) (arguing that there is little economic justification for insider trading and that it is harmful to the normal operation of the securities markets in allocating resources). This note argues that trading on insider information indeed adds to the efficiency of market pricing and the ultimate dissemination of more material information. Such a result can only increase the informed trading that occurs.

212. Cox & Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 354 (1988).

213. *Id.* at 354. "The Dow Jones Industrial Average stood at 1873.59 before the Boesky case was announced, closed at 1860.52 the next business day, at 1893.56 after a week, at 1922.81 after a month, and at 2325.49 after six months." *Id.* at n.5. "[I]f insider trading were regarded as legitimate, rather than prosecuted and publicized as scandal, it is possible that, for a given amount of insider trading, the damage to public confidence would be less." *Id.*

214. *Id.* at 354.

215. *Id.*

216. *Id.* "From 1981 through 1986, the SEC brought 129 insider trading cases, compared to 77 in the preceding 47 years." *Id.*

217. *Id.*

218. *Id.* at 356.

219. *Id.* There may be a correlation between insider trading and the bid/ask spreads of

corporate employees trade on inside information as part of their compensation, and therefore account for this risk discount, any resulting loss to a corporation is no more alarming to the public than high corporate salaries or perquisites.[220] Employee contracts forbidding certain trading or limiting insider trading may eliminate the danger of abuse.[221]

Insider trading may also yield a negative impact on a corporation if insiders disseminate financial information that they should keep confidential in the best interest of the corporation. Such damage may occur in two ways. First, competitors may get information which compromises the position of a corporation. The type of financial information valuable to insider traders, however, is usually of little use to competitors.[222] Second, a corporation may wish to keep negative financial information confidential. The leaking of such information could damage the position of a corporation with respect to its "creditors, investors or financiers of some type."[223] Accordingly, "it is not clear why there should be less social utility in informing them than in protecting the corporation."[224]

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market makers or specialists.

> To the extent market makers' inventories are larger because they purchased from insiders who knew nonpublic bad news, or smaller because they sold to insiders who knew nonpublic good news, market makers will lose money, and, according to this theory, increase their spreads to recoup it, since they can never know when they are dealing with an insider. The risk premium thus charged on all transactions renders shares less valuable and may ultimately affect the original price available to the issuing corporation.

Id. at n.11. A market maker is an individual or institution, usually a broker/dealer, who maintains an inventory of an issue and is prepared to purchase and sell such shares. J. LITTLE & L. RHODES, *supra* note 1, at 39. The bid/ask spread represents the difference between a share's purchase price and its sale price. This difference, or spread, is the mark-up or profit that a market-maker takes for wholesaling the issue. *Id.* at 37. A specialist's function is to "insure a fair and orderly market" for each issue assigned to it. *Id.*

220. *Id.* at 356. *See also infra* text accompanying notes 227-45 (discussion of insider trading as compensation). *But see* Cox & Fogarty, *supra* note 212, at 356 n.13 (allowing corporate insiders to trade on nonpublic information may be more dangerous than other compensation methods widely used).

221. *See infra* text accompanying notes 252-64 (discussion of insider information as compensation).

222. Cox & Fogarty, *supra* note 212, at 357. For example, the cash position of a corporation may be valuable to an insider wishing to trade, but such information will have less utility for a competitor.

223. *Id.*

224. *Id.*

B. *Who Benefits from Insider Trading?*

As insider trading may harm investors directly and indirectly, so may it benefit investors directly and indirectly. The most obvious beneficiaries are the corporate insiders trading for their own self-interest. Such insiders have the advantage of corporate information which generally elevates their trading position.[225] However, the corporate insider's trading advantage is not one totally devoid of risk. While a corporate insider may know the plans and condition of her particular corporation, she may have no more knowledge than outsiders about timing strategies of rival corporations. For example, banking on the anticipated announcement of a potentially valuable innovation by her company, an insider might purchase what she considers undervalued stock. However, if a rival corporation makes an earlier announcement which neutralizes, or even reduces, the value of the news of her corporation, she will have no gain and may even suffer a loss.[226]

There are other beneficiaries of insider trading. Corporations may allow corporate officers and directors to trade on inside information as a form of compensation for developing valuable information. Professor Manne[227] regarded commensurate compensation for corporate entrepreneurs[228] invaluable.[229] Corporate entrepreneurs, here, refers to employees who add to their normal performance an element of ingenuity which the corporation cannot otherwise accu-

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225. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 581.

226. *Id.* at 582 n.41.

227. Professor Henry G. Manne, of The George Washington University, Washington, D.C., wrote the seminal work in favor of allowing insider trading. H. MANNE, *supra* note 7.

228. Professor Manne distinguishes corporate entrepreneurs from managers.

> Although the technical skills required for successful management may be very great and its market value very high, the fact remains that, within a fairly wide range, we know in advance what a manager is to do. To the extent he is acting purely as a manager, his is not an innovating function. Because we know in advance what the task entails, the service can be purchased like any commodity in the marketplace.

Id. at 115. The price of this commodity can be easily determined by the laws of supply and demand. *Id.* The entrepreneur, on the other hand, does not perform functions which are predictable. *Id.* Indeed, it is the very nature of unpredicted innovation which defines the entrepreneur. Professor Manne described the entrepreneur's function as one making "new combinations of productive factors, that is, to bring them together in a new way." *Id.* at 116 (construing J. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1934)). Manne points out that "[b]eing an entrepreneur is a functional condition relating to innovational activity and does not connote a status or class of persons. . . . Furthermore, entrepreneurial activity itself is not always easy to identify or distinguish in advance." *Id.* at 116-17.

229. *See* H. MANNE, *supra* note 7, at 133.

rately reward nor encourage. "Undoubtedly, if no way to reward the entrepreneur within a corporation exists, he will tend to disappear from the corporate scene."[230] Professor Manne points out that the theory of a corporation which allows a "separation of ownership and control kill[s] the incentive to profit that the sole proprietorship promoted."[231] A corporate employee receives her salary and regular increases for executing the job she is assigned. Therefore, she has little incentive to innovate improvements concerning her work. While this separation may be permissible for certain industries such as banking, insurance, and public utility enterprises, it is damaging to aggressive creativity which is crucial to "many branches of manufacture and of speculative commerce."[232]

It is essential that corporate directors foster an entrepreneurial spirit which evinces their most creative and productive actions. Corporate managers can easily handle competition of prices and product differentiation, but only entrepreneurs can handle competition of new products, new methods, and innovative organization.[233] This service requires different compensation than the interest the capitalist receives for risk taking or the salary to a manager for providing a service for which the labor market can determine a price.[234] The capitalist and the manager offer items for which the free-market can determine a value. There must be a special device for compensating a corporate entrepreneur in order that she has a vehicle through which to market her services to corporations.[235] Such a device must enable compensation for anyone who is competent to offer entrepreneurial value. Lacking such a device, only those with sufficient capital to start their own business and exploit their entrepreneurial talents will be rewarded.[236] The resulting cost to business will be an unreachable source of creative entrepreneurial talent.

Fixed salary is not sufficient compensation for employees who might contribute entrepreneurial skills.[237] Bonuses, profit sharing, and stock options at first appear to be more suitable for entrepreneurial compensation. Bonuses, however, are nearly always

230. *Id.* at 129.
231. *Id.* at 111.
232. *Id.* at 111-12.
233. *Id.* at 131.
234. *Id.* at 115-18.
235. *Id.* at 133.
236. *Id.*
237. *Id.* at 134.

determined by parties other than the recipient.[238] Also, bonuses must be settled yearly, and certain entrepreneurial contributions have more far-reaching effects.[239] Profit-sharing is not satisfactory after the initial offering.[240] The initial offering of profit-sharing may accurately reflect entrepreneurial contribution. But then, the "effect of such a plan is to give the recipient a proprietary stake in the business. He is then an investor and a risk-taker, and his annual return will be that of a capitalist."[241] Stock options offer a specific, limited reward for innovation.[242] However, the value of a contribution may far exceed the gain realized on the optioned shares.[243]

Insider trading, on the other hand, allows a more accurate correlation between entrepreneurial contributions and compensation for such contributions. Permitting corporate entrepreneurs to trade on the information resulting from their contributions "allow[s] recovery for their ideas by permitting them to exploit information about the existence of the ideas in a market primarily based on information."[244] Corporations may limit accumulation of shares by such an entrepreneur so as to prevent excessive windfalls. The corporation may also limit eligibility in such trading. Regardless of the annual profit or loss of the company, the entrepreneur can derive his compensation from the information attributable to his efforts.[245]

In turn, trading on inside information benefits both the corporation and its shareholders. Rather than taking the form of a corporate disbursement, the entrepreneur's compensation results from his trading corporate shares with other investors.[246] Thus, allowing insider trading by corporate entrepreneurs to replace other forms of compensation, such as bonuses, saves the corporation

238. *Id.* at 135.

239. *Id.* "Bonuses are not apt to be forthcoming in years when the company has actually lost money, even though the value of the innovation was substantial and without it the company might have shown greater losses." *Id.*

240. *Id.* at 134.

241. *Id.* While the initial returns from a corporate entrepreneur's participation in such a plan would resemble entrepreneurial profits, "subsequent withdrawals will constitute interest on his investment." *Id.*

242. *Id.* at 138.

243. *Id.*

244. *Id.*

245. *Id.*

246. *See id.* at 111-45.

expenditure.[247]

In addition, shareholders generally benefit from owning shares in a company that fosters entrepreneurial creativity[248] by offering economical compensation for such services. Shareholders also benefit when insider trading is allowed because the stock price will more accurately reflect the value of shares.[249] Beneficiaries of trading on inside information include short-term speculators as well as long-term investors. Shareholders who retain their stock over the long-term will enjoy an incidental gain because insider trading and information dissemination has created a new value for the stock.[250] "The insider gains part of the new value that has been created, and his gain is not made at the expense of anyone."[251] Therefore, trading on inside information is an economical approach to compensating entrepreneurs that will also benefit shareholders.

C. *Benefits to Corporations and Professional Firms*

In a merger transaction a purchasing corporation generally hires investment bankers and securities lawyers to consummate a deal. These professional firms are hired for their expertise in business and law, as well as for the value of the knowledge and information they have gained from handling mergers.[252] A purchasing company may prefer either that the firms handling its merger trade in the target company stock, or abstain from such trading. In order to preserve these expectations such trading may be permitted or proscribed by contract with the professional firms.[253] Al-

247. Even if the corporation is slightly restricted in its capital raising capability by the potential demand by investors to discount shares, it is likely that bonuses or profit-sharing plans would cost the corporation more. *See supra* text accompanying notes 218-19.

248. Perhaps the appeal to shareholders will be sufficient to counter the public investors' potential demand for discounted shares. *But see supra* text accompanying notes 218-19.

249. *See generally* H. MANNE, *supra* note 7; Cox & Fogarty, *supra* note 212, at 355. "[I]nsider transactions . . . have moved the price in the right direction and helped to satisfy the expectations of those traders relying neither on inside information nor fake bargains, but on the general efficiency of the market in gauging value." *Id.* See *supra* note 43 for discussion of price correction due to dissemination of information.

250. Mendelson, *supra* note 211, at 481 (citing H. MANNE, *supra* note 7, at 61).

251. *Id.* Mendelson's view, however, is based on the reasoning that "[i]nsider purchasing is an attempt to capture unrecognized value, not a creation of value." *Id.* at 482.

252. Garten, *supra* note 225, at 601-03.

253. *Id.* at 603. Newspapers and financial publications may elect to demonstrate their integrity by private enforcement of insider trading. Note, *United States v. Carpenter: Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 DEL. J. CORP. L. 605, 642-43 (1987) [hereinafter Note, *Carpenter*]. "At some publi-

lowing such trading has at least two benefits. First, profits reaped by this trading can be used to satisfy legal and investment banking fees.[254] Second, such trading or tipping[255] could facilitate the bankers and lawyers' understanding of a particular industry because such information can be exchanged for other valuable information available to the firms handling the merger.[256] As a result of this exchange, the efficiency and quality of the firms' professional services could increase. "[I]t is not inconceivable that in some circumstances clients may be more tolerant of disclosure of their own information if they benefit generally from the free exchange of client information by professionals."[257]

The liberal exchange of information was once common practice.[258] Investment bankers passed information to their trust account managers who used the information in purchasing securities on behalf of their accounts. Similarly, investment advisors made inside information available to their clients.[259] "In both these cases, legal developments expanding the prohibition against insider trading, not the demands of corporate clients, resulted in modified practices."[260] In certain situations it may be in the purchasing firm's best interest to benefit only from the textbook expertise of professional firms and pay for such service directly.[261] When this occurs the purchasing company could contract to prohibit all use and dissemination of information regarding its merger and acquisi-

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cations, such as *The Washington Post*, business writers are required to file an annual report listing all their personal investments." *Id.* at 642.

254. *See supra* text accompanying notes 189-98 for a discussion of potential injury to third parties from trading on inside information. It should be noted, however, that this innovation raises ethical conflict of interest problems. Corporate attorneys often serve as directors and/or have developed a vested interest in corporate operations. Such interest creates a dilemma with the attorney's ability to render unbiased legal counsel. Corporations and firms may mitigate these problems with contracts representing full disclosure of each party's intent to trade on inside information.

255. Tipping occurs when an insider conveys inside information to an outsider. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852-53 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

256. *See generally* Garten, *supra* note 225, at 601-03.

257. *Id.* at 604.

258. *Id.*

259. *Id.*

260. *Id. See In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (holding that the use of insider information for the benefit of brokerage clients violated Rule 10b-5).

261. Garten, *supra* note 225, at 603. For example, a company may be hesitant to disclose "specific details concerning its plans or special corporate structures developed expressly for its use." *Id.*

tion activities[262] and a violation could be remedied by an action for breach. Moreover, the public would scrutinize the reputation of the firm once such a breach became known.[263] When a client seeks to preserve confidential information it is in the best interest of clients and firms to contract for the use of confidential information. "If insider trading operated as a fraud on corporate clients, corporations would not need to depend on SEC enforcement of the insider trading restrictions to redress their injuries, but would alter their relationships with professional firms, no longer entrusting them with sensitive information."[264]

In mergers, inside traders can help the target and the purchaser, as well as themselves. Although "warehousing"[265] shares may violate Rule 14e-3,[266] insider trading may serve the same function to the benefit of the purchasing company. Because inside traders are generally interested in a quick return on their investments, they will be equally willing to turn a quick profit on their shares.[267] Having no loyalty to existing target company management, inside traders will not resist purchase of their shares by the purchasing company.[268] In so far as insider trading raises the price of the target company's stock, thus deterring competing bidders, such trading "must be beneficial to target companies that want to resist

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262. *Id.*

263. *Id.* at 636-37. Garten, however, states:

> In recent years, however, the traditional relationship between professional firms and their clients has changed significantly, affecting both parties' expectations with respect to the functions and expertise of the professional firm. Longstanding client relationships have been severed as companies shop around for the professional firm that can best serve their immediate needs on individual deals. Thus, a corporation will go to the investment banker who can place its securities most cheaply or who can match it with the best merger partner. Professional relationships are formed and severed so quickly that there is little opportunity for competing bankers to demonstrate their reputation for keeping confidences.

Id. at 606.

264. *Id.* at 636-37.

265. "Warehousing" is the practice of holding shares of a target corporation in the hands of a third party purchaser in order to avoid disclosure of the intentions of the takeover company. Without formal disclosure of the intentions of the takeover company, the price of the target company stock will not rise drastically. *See* Fleischer, Mundhein & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 811-12 (1973).

266. 17 C.F.R. § 240.14e-3(c)(1) (1989). This rule prohibits any securities purchases made on the basis of nonpublic information about a tender offer except for those made by actual brokers or agents on behalf of the bidder. *Id.*

267. *See* Garten, *supra* note 225, at 631.

268. *See id.*

takeovers."[269]

D. *Efficiency of Market for Dissemination of Information*

It is generally considered efficient market theory that stock prices accurately reflect the value of the underlying shares.[270] Generally, in a merger situation, insider trading may move stock prices in the "correct" direction.[271] This occurs because prime targets for takeovers are companies with undervalued stock.[272] Correcting the price of any stock adds efficiency to the market system in terms of a better correlation between the price of the stock and the underlying value of those shares. Trading on nonpublic information correctly moves the stock more efficiently than corporate publication of information for at least two reasons.[273] First, corporations may purposely delay publication of detrimental information. This delay, however, yields no valuable service to the shareholder and indeed may damage his position if a corporation is withholding information that will initiate a fury of fast selling and thus lead to a sharp price drop.[274] Insider trading allows slower dissemination of bad news and causes a more gradual price drop that provides an escape for shareholders.[275] "[P]rice continuity, ordinarily considered desirable, is less likely when the impact of information is concentrated at the point of its official release, whenever made."[276]

Second, corporations may not publicize less significant, or subtle corporate developments and industry situations. Insiders, including analysts, may trade on this nonpublic information and push the price of the stock in the correct direction. This trading adds to market efficiency.[277] "The Supreme Court has acknowl-

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269. *Id.* at 632.

270. *See generally* H. MANNE, *supra* note 7, at 77-91.

271. *See infra* text accompanying notes 275-79 on correct price movement caused by insider trading.

272. Garten, *supra* note 225, at 631.

273. For a discussion about stock price correction, see *supra* note 41 and accompanying text.

274. *See generally* H. MANNE, *supra* note 7, at 77-91.

275. *Id.* at 93-110.

276. Cox & Fogarty, *supra* note 212, at 356. *See also* H. MANNE, *supra* note 7, at 93-110.

277. *See* Mendelson, *supra* note 211, at 473.

> If the capital markets are to allocate resources efficiently, the prices of the securities must reflect, as accurately as possible, the prospects of corporate issuers. If information bearing on those prospects is withheld, the implications of that information cannot be reflected in market prices, and the alloca-

edged that the use of nonpublic information by analysts has beneficial market effects."[278] It follows that if insider trading by analysts "serves the beneficial function of helping the market price of a security to reflect valuable nonpublic information, then presumably other tipping and insider trading has exactly the same beneficial market effect."[279]

III. THE COST OF FIGHTING INSIDER TRADING

There are several costs associated with proscribing insider trading. This section will discuss three major costs. First, fighting insider trading involves significant SEC resources. The already overworked SEC spends part of its annual one hundred thirty-five million dollar budget enforcing prohibitions against such trading.[280] Due to the SEC's limited resources, there is a significant opportunity cost incurred when SEC personnel are redirected away from other SEC functions such as reviewing registration applications for new issues.[281] The SEC's shift to insider trading enforcement followed the scandals that surfaced in 1986.[282] Aside from litigating "some splashy securities-fraud cases,"[283] the SEC has had trouble keeping up with its other less glamorous duties. In the last ten years, the SEC has been unable to thoroughly examine registration statements, thus compromising the purpose of the 1933 and 1934 Acts.[284] As long as the SEC concentrates on policing insider trading there will be a question whether it can determine "when its enforcement efforts are costing more than they are worth."[285]

Second, market efficiency suffers in the absence of insider trading. As discussed in the previous section, insider trading corrects the stock price to reflect the underlying value of the corpo-

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tive function of the capital markets is impaired.

Id.

278. Garten, *supra* note 225, at 612-13 (citing Dirks v. SEC, 463 U.S. 646, 658 (1983)). It is not clear, however, whether the Supreme Court has made an exemption for insider trading by analysts. *Id.* at 613 n.64.

279. *Id.* at 613. *But see* Note, *Carpenter*, *supra* note 253, at 627-28. Justice Blackmun dissented in *Dirks* that the majority's personal benefit test rested upon the policy that the ends justify the means. Dirks v. SEC, 463 U.S. 646, 677 (1983) (Blackmun, J., dissenting).

280. *Watchdog Woes: Up Against It At The SEC*, BUS. WK., Oct. 10, 1988 at 120.

281. *Id.*

282. *Id.* at 120-21.

283. *Id.* at 120.

284. *Id.*

285. Cox & Fogarty, *supra* note 212, at 357.

rate shares.[286] The most accurate pricing of listed stock issues[287] occurs when the greatest amount of information is available to all traders and potential traders.[288] Analysts and researchers make an industry of evaluating securities by gathering "as much information as they can glean as soon as they can glean it."[289] Any "prohibition that discourages use of information other than that already discovered necessarily discourages the discovery of new information and inhibits the use of information whose public or nonpublic status is uncertain."[290] Thus, the ambiguity of the definition of inside information[291] and the prohibition on "tipping"[292] can inhibit valuable information gathering by analysts. Corporate issuers may be reluctant to discuss with the analysts matters which are important to investors for fear that such information may be characterized as material, nonpublic information.[293] Moreover, Rule 10b-5[294] does not lead to more candid disclosure. Most insiders apparently abstain from trading rather than disclose.[295] Corporations, therefore, are withholding from shareholders and potential shareholders information that may be material to trading decisions. To the extent that the prohibition against insider trading discourages the discovery and use of information, the efficiency of market pricing suffers.

Third, there are costs to society. Directly, there are investigatory, apprehension, and prosecution costs. Indirectly, society pays the cost of inconsistent penalties for violations of ambiguous trading laws. Absent a statutory definition of insider trading, courts

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286. *See generally* H. MANNE, *supra* note 7.

287. Listed stock issues are those traded on exchanges such as the New York Stock Exchange. J. LITTLE & L. RHODES, *supra* note 1, at 33.

288. *See* Cox & Fogarty, *supra* note 212, at 355.

289. *Id.*

290. *Id.*

291. *See infra* text accompanying notes 296-99.

292. Cox & Fogarty, *supra* note 212, at 355. A "tipper" is an insider who conveys her inside information to an outsider or "tippee." *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852-53 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

293. *See* Cox & Fogarty, *supra* note 212, at 355.

294. 17 C.F.R. § 240.10b-5 (1989). For text of Rule 10b-5 see *supra* note 9. Rule 10b-5 proscribes trading on material inside information unless that information is disclosed.

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.

Texas Gulf Sulphur, 401 F.2d at 848.

295. *See* Cox & Fogarty, *supra* note 212, at 355.

exercise broad discretion "to formulate theories of liability based upon public policy considerations."[296] Although some latitude is legitimate, "the absence of statutory guidelines has turned the law of insider trading into a playground[,]"[297] leaving investors unable to predict the legal consequences of their stock market participation.

Ambiguous codes[298] and ambiguous case law[299] have led to inconsistent prosecution of traders using inside information. Such inconsistency deters market participants from acting because they may find themselves violating a novel interpretation of the fraud provisions of Rule 10b-5. To the extent that there are inconsistent penalties for violating ambiguous insider trading laws, there is a potential loss of innovation due to the lack of incentive to exploit entrepreneurial skills.[300]

Fighting insider trading results in at least the misallocation of SEC resources, market pricing inefficiency, and disincentives caused by inconsistent administration of insider trading laws.[301] "Overall, it cannot conclusively be said that the economic benefits outweigh the costs of prohibiting insider trading."[302]

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296. Note, *Carpenter*, *supra* note 253, at 639.

297. *Id.*

298. Rule 10b-5 is a general anti-fraud provision, but it does not expressly prohibit insider trading. Indeed, the rule does not mention trading on inside information and does not define the exact activity it proscribes. *See* 17 C.F.R. § 240.10b-5 (1989).

The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984), does not clarify the permissive actions of an insider investor. The Act stipulates fines and civil actions for activity proscribed by the Securities Exchange Act of 1934.

The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988), is an attempt to strengthen the general fraud provisions of earlier acts but it uses similar language. It does not narrow definitions of prohibited activities. The Act as drafted called for an analysis of "the extent of improper trading while in possession of insider information, such as trading with advance knowledge of tender offers or forthcoming announcements of material financial information." The Insider Trading and Securities Fraud Enforcement Act, 15 U.S.C. § 78(b)(2)(A) (1988).

299. *See supra* text accompanying notes 162-87.

300. *See supra* notes 227-45 and accompanying text (insider trading as compensation for corporate entrepreneurs).

301. *See* Cox & Fogarty, *supra* note 212, at 357.

> What we pay for enforcing public prohibitions against insider trading, for surveillance, litigation, private compliance efforts, as well as what we pay in pricing efficiency or other economic costs, are the price we pay for justice.

Id.

302. *Id.*

IV. The Alleged Unfairness of Securities Trading With Insider Trading

There are several situations in which trading on inside information, and trading with similar advantages, is not proscribed. Therefore, the eradication of all occurrences of proscribed trading while possessing material nonpublic information would still not create a level playing field for every individual who wishes to invest in corporate shares. Consider the situation in *Chiarella v. United States*[303] where a financial printer deciphered merger codes and traded in the shares of takeover targets. Because Chiarella had not inherited a fiduciary duty to abstain or disclose, his trading was not proscribed. Nevertheless, a trader opposite Chiarella would have suffered the same disadvantage if Chiarella had such a duty. The resulting imbalance of information is not cured by allowing one group of traders to use inside information and proscribing such use of the same information by another group.

Trading by specialists on inside information is also not proscribed. Specialists are permitted to trade for themselves in order to maintain an orderly market.[304] They may profit whether their trading is ultimately healthy or detrimental to the market. Moreover, any harm done to traders on the other side of their transactions is no less painful simply because it is done in the interest of keeping an orderly market. Analysts are an anomaly as well. They gather, evaluate, and are permitted to sell industry, market, and firm-specific information.[305] Permitting the sale of such informa-

303. 445 U.S. 222 (1980).

304. A specialist handles the trading for a particular corporation on the floor of the securities exchange. For a detailed discussion of a specialist's role, see L. Loss, *supra* note 113, at 595-96.

305. The Supreme Court has acknowledged the value of market analysts in *Dirks*.

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

Dirks v. SEC, 463 U.S. 646, 658-59 (1983)(footnote omitted)(citation omitted).

tion does not promote the objective of a more level playing field, because it is only available to those who can afford to pay the price. In effect, the system encourages market professionals to use their informational advantage.

While eradicating all occurrences of proscribed trading would not result in a level playing field, it does not follow that insider trading is unfair. The argument that insider trading is unfair requires an examination of one's notions of fairness.[306] One view of fairness requires consensual parties.[307] A transaction is consensual if it lacks duress and deceit.[308] Neither duress nor deceit is typically present in situations involving trading on inside information.[309] Due to the nature of the impersonal market there is little opportunity for duress.[310] Buyers and sellers do not meet or even know who is on the other side of a trade. Rule 10b-5 was originally intended to proscribe misrepresentation or omission of material fact in the context of a personal solicitation or face-to-face transaction.[311] In an impersonal transaction, there is no inducement to purchase or sell for other than the posted price of the shares. In the rare and unusual case where duress is present, the injured party has an action at common law.[312]

Failure to disclose nonpublic information that may affect a trader's decision to buy or sell may appear unfair because of the informational imbalance. This failure to disclose, however, does not constitute "what is commonly understood as deceit."[313] Full disclosure of facts is not typically expected in other transactions.[314] Some traders may use nonpublic information which no one expects to be disclosed, such as their own intentions to make further

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306. *See* Cox & Fogarty, *supra* note 212, at 357.

307. *Id.* at 358.

308. *Id.*

309. *See id.*

310. The nature of the securities exchange is an impersonal market. That is, buyers and sellers typically do not meet or discuss reasons for buying and selling. The actual trading is done by brokers (agents of the investors) through specialists. *See id.*

311. *See supra* note 137, discussing the original reason for implementing Rule 10b-5.

312. Perhaps the greatest opportunity for overreaching, and thus duress, comes from the lay investor's link to the market: his or her broker. Since the broker will always profit from the customer's trade by taking a commission, it is the broker who may cause damage by using duress or deceit on clients to buy or sell shares. Brokers may also inflict damage on clients' accounts by simple ignorance of sound financial advice.

313. Cox & Fogarty, *supra* note 212, at 358.

314. *See id.* Indeed, agency law permits agents to complete transactions without disclosing the identity of a principal, or even the fact that the agent is not himself the principal. *See* H. HENN, CORPORATIONS, 1170-86 (2d ed. 1986).

purchases which could materially affect the share price.[315] Given the possibility that an opposing trader could not afford the advice of an analyst, it then becomes a question whether trading with an informational advantage of any kind is fair. The reality remains that some traders can afford more legally available information than other traders.

However, this does not lead to the conclusion that the market is unfair to public investors who lack access to insider information or professional analysts. Recognizing that other investors may have certain information has not dissuaded the public from making investments and speculating on limited information.[316] Because "the general efficiency of the market in gauging the value" makes beating the market difficult,[317] a nonpublic informational advantage may typically be of negligible concern to public investors.[318] Despite the different information investors rely on, lacking misrepresentation of facts, every investor has a fair opportunity to interpret that information. It is likely that the same information will lead one investor to sell and another investor to buy. While many conservative investors would never gamble on weak issues regardless of price, "there seems to be no shortage of people willing to take a flier on the next computer or genetic engineering company."[319]

Not all instances of trading in inside information or with an informational advantage are proscribed. Consequently, eradicating instances of proscribed conduct does not result in a level playing field. One cannot then jump to the conclusion that insider trading is unfair. In particular, the inherent informational advantage typically does not involve duress or deceit. Given the reality that not all parties have access to or can afford the same information, the informational advantage will remain a fixture of the securities markets. A nonpublic informational advantage does not seem to have deterred investors' participation.

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315. Cox & Fogarty, *supra* note 212, at 359. There are, however, SEC reporting requirements for purchases exceeding five percent of the outstanding shares of certain issuers, including those whose shares are registered on a national securities exchange. *See* 15 U.S.C. §§ 78l, 78m(d) (1988).

316. *See supra* text accompanying notes 211-13 (exposure of Boesky scandal led to no appreciable loss of public investing despite awareness that public investors were less informed than insiders).

317. Cox & Fogarty, *supra* note 212, at 355.

318. *See id.* at 354.

319. L. LOWENSTEIN, *supra* note 51, at 39.

CONCLUSION

The desire to maintain a solvent, efficient, capital-raising securities market is currently competing with, and losing to, the desire to protect the investing public. There has been a futile attempt to equate the opportunities for all individuals who wish to invest. Even absent insider trading, people with special education, training, and access to or control of sophisticated information gathering systems enjoy informational advantages. Because the costs of legally gathering and evaluating information is prohibitive to most lay investors, parity with professional investors is unattainable.

As discussed above, share pricing is inefficient and inaccurate without insider trading. In addition, it is difficult to point to specific injuries to investors in any instance of insider trading prosecution. Thus, the SEC exacts a costly vengeance when the public pays for pursuing innocuous, and potentially helpful, market players who trade on material non-public information. Indeed, in certain cases the harm has been identical and the liability has been inconsistent.[320] If insider trading were permitted, lay-investors would enter the market aware of the potential informational advantage insiders may have, but they could be more certain that the prices they were paying for securities accurately reflected the underlying value of those shares.

Insider trading adds more efficiency and accuracy than detriment to the securities markets. The cost of ineffectively battling these practices which cause minimal, if any real, harms far outweighs what benefit the market would enjoy in the absence of insider trading. There is little reliable evidence to suggest that our securities markets have lost public support because of the existence of insider trading. At the same time, due to the impersonal nature of the securities markets, there is little opportunity to damage investors by deceit that is not adequately proscribed without expanding Rule 10b-5 as far as the courts have. Besides the paucity of significant harm caused by insider trading, insider traders perform a valuable service in dissemination of information and stock price correction. It is in the best interest of the securities

320. Traders opposite defendants in *Carpenter* and *Chiarella* suffered similar harms from trading with informational disadvantages. As previously discussed, however, the defendants in *Carpenter* were convicted while the defendant in *Chiarella* did not violate any securities laws.

markets and the investing public to eliminate proscriptions against insider trading.

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