Insider Trading and the Dual Role of Information


I

James H. O’Hagan—accused of insider trading—is escaping conviction with over $4 million of questionable trading profits. In United States v. O’Hagan,1 the Eighth Circuit rejected the misappropriation theory of insider trading and, in doing so, removed the legal foundation on which O’Hagan was convicted of securities fraud.2 Besides enriching O’Hagan, the decision aggravated a growing circuit split over the misappropriation theory: Accepted by four circuits, the theory has now been rejected by two.3 The government has petitioned for a rehearing en banc.4 Whatever the outcome of that petition—and any rehearing that may follow—it is likely that one of the parties will appeal to the Supreme Court, which deadlocked four to four in its only previous consideration of the misappropriation theory.5 Thus, O’Hagan presents an opportunity to resolve two splits: one among the circuits and another among the Justices.

1. 92 F.3d 612 (8th Cir. 1996).

2. See id. The Eighth Circuit’s decision requires that the government return to O’Hagan his disgorged profits. See SEC v. O’Hagan, 901 F. Supp. 1461, 1466, 1475 (D. Minn. 1995) The Eighth Circuit also invalidated Rule 14a-3 and reversed O’Hagan’s conviction thereunder See O’Hagan, 92 F.3d at 622; 17 C.F.R. § 240.14a-3 (1996). Despite its significance, the Eighth Circuit’s invalidation of Rule 14a-3 is beyond the scope of this Case Note.

3. The Fourth Circuit has also rejected the misappropriation theory. See United States v. Bryan, 58 F.3d 933, 949 (4th Cir. 1995). The Second, Third, Seventh, and Ninth Circuits have accepted it See SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 449-50 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985); United States v. Newman, 664 F.2d 12, 16-17 (2d Cir. 1981).


5. See Carpenter v. United States, 484 U.S. 19, 24 (1987) (decided after Justice Powell retired but before Justice Kennedy took his seat); see also Chiarella v. United States, 445 U.S. 222, 235-37 (1980) (refusing to consider misappropriation theory because it was not properly presented to jury)
No matter what the courts decide in *O'Hagan*, final resolution of the controversy surrounding insider trading awaits a coherent policy rationale that would simultaneously support and limit insider trading liability. Several commentators have offered promising analyses that treat insider trading cases as information cases. I argue in this Case Note that these “information analyses” suffer from a serious deficiency: They fail to account for the dual role of information in our economy.

II

The *O'Hagan* litigation grew out of Grand Met PLC’s takeover of Pillsbury Company. In July 1988, Grand Met retained the law firm of Dorsey & Whitney, of which O’Hagan was a partner. O’Hagan learned of the impending takeover and purchased call options for Pillsbury stock. When Grand Met publicly announced its tender offer in October 1988, O’Hagan exercised his options, earning over $4 million. He was subsequently convicted on fifty-seven counts of securities fraud, mail fraud, and money laundering.  

On the basis of his criminal convictions, the SEC ordered O’Hagan to disgorge his profits. The Eighth Circuit’s rejection of the misappropriation theory relieved O’Hagan of criminal liability and reimbursed his profits.

The vitality of the misappropriation theory depends upon whether it is supported by section 10(b) of the Securities Exchange Act. Section 10(b) prohibits manipulation and deception in the securities market. However, neither section 10(b) nor Rule 10b-5—promulgated by the SEC under section 10(b)—provides significant guidance as to what constitutes “deception.” Traditionally, courts have described “deception” in the context of insider trading as a violation of the fiduciary duty owed by corporate management to shareholders. The SEC developed the misappropriation theory as a means of reaching section 10(b) violators not covered by the conventional analysis. Under this theory, section 10(b) “is violated when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.”

The *O'Hagan* court found that the misappropriation theory required too
broad an interpretation of "deception." Specifically, the court held: (1) that "deception" under section 10(b) requires either misrepresentation or nondisclosure in violation of a duty to disclose; and (2) that if liability is premised on nondisclosure, the underlying duty to disclose must be owed to the purchasers or sellers of the securities in question. For the first proposition, the court relied upon *Santa Fe Industries, Inc. v. Green*. In *Santa Fe*, the Supreme Court stated that the language of section 10(b) "gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception," and therefore a claim of fraud and fiduciary breach is actionable under Rule 10b-5 "only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." For the second proposition, the court relied upon *Chiarella v. United States*. In *Chiarella*, the Supreme Court held that section 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." The Eighth Circuit rejected the misappropriation theory because: (1) it permits the imposition of liability without a particularized showing of misrepresentation or nondisclosure; and (2) it permits liability for a breach of duty owed to parties who are unconnected to the disputed securities transaction.

Circuits that have adopted the misappropriation theory do not engage these aspects of *Santa Fe* and *Chiarella*. Instead, they rely on *United States v. Newman*, in which the Second Circuit concluded that Rule 10b-5—and therefore section 10(b)—"contains no specific requirement that fraud be perpetrated upon the seller or buyer of securities." The Second Circuit based its decision on a series of circuit court opinions predating *Chiarella*, and did not cite *Chiarella* in this context despite its citation by the district court.

The Eighth Circuit resisted the temptation to adopt the misappropriation theory, but at a price: O'Hagan is getting away. To many, this result seems plainly unfair. Yet, "[i]f arguments about fairness are to be more than discussion stoppers, they must have some content." This is precisely the
point at which the jurisprudence fails: The case law lacks a coherent policy rationale that would otherwise serve to demarcate section 10(b) liability and order our normative expectations. Some commentators have attempted to remedy this problem by treating insider trading cases as information cases. However, because these commentators fail to acknowledge the dual role of information in our economy, their analyses fail to maximize market efficiency, systematize section 10(b) liability, or disambiguate our moral intuitions.

III

Information plays a dual role in our economy. First, it drives the pricing mechanism essential to economic efficiency. When market prices incorporate all relevant information, the market allocates resources optimally and corporate managers make efficient production decisions. Second, information is a commodity, produced and bargained for within the market structure. Information is gathered only when it is cost effective to do so, i.e., when its market value exceeds its cost of production. To capture this value, the producer of information must restrict its availability.

The challenge lies in the tension between these two roles of information. Because more information means greater economic efficiency, we would all be better off if information were "free, complete, instantaneous, and universally available." However, market participants have no incentive to produce information unless they are allowed to profit from its production. This profit is a transaction cost, undermining economic efficiency. Thus, as one commentator has remarked, "[t]o postulate efficiency in the production of information, we must assume away the incentive necessary to produce. To postulate the incentive is to make efficiency impossible."
If this discussion makes the situation seem hopeless, it need not. This tension is not peculiar to the securities market; analogous concerns exist in the context of intellectual property. Copyright law, for example, "trades off the costs of limiting access to a work against the benefits of providing incentives to create the work in the first place."35 Adopting an analogous posture in the securities context, Congress should weigh the efficiency gains of free information against the efficiency losses of either: (1) paying for information, by allowing information producers to profit by trading without disclosure; or (2) failing to motivate production. This dual information approach would accord with and rationalize section 10(b) jurisprudence as it now applies to corporate insiders (liable for insider trading) and market analysts (not liable). It would also resolve the controversy presented by O'Hagan, providing a principled means of extending insider trading liability to outsiders now covered only by the misappropriation theory.

We begin by partitioning investors into two classes: (1) those who are motivated by potential trading profits to gather new information; and (2) those whose production of new information is insensitive to the availability of trading profits. We shall refer to the first class as diligent searchers.36 The second class is residual. Diligent searchers gather information until the marginal cost of doing so is equal to their marginal trading profits. Residual class members gather the same amount of information regardless of trading opportunities. This class includes at least two kinds of people: (a) corporate insiders, who gather new information in the course of fulfilling their management duties; and (b) certain outsiders—tippees and eavesdroppers—who do not produce new information but instead intercept the information of others.

By definition, imposing on the residual class a duty to disclose all material nonpublic information would have no deleterious effect on the amount of information available to the market.37 Although it would disseminate much information, there are two problems with such an uncompromising duty. First, corporate insiders may have legitimate business reasons for delaying disclosure.38 Second, such a rule would impose on an unsuspecting public liability for the mere possession of inside information.39 Consequently, a

36. The term "diligent searcher" is borrowed from Clark, see CLARK, supra note 27, § 8 12,2, who makes a distinction similar to that drawn here, but fails to consider the cost to market efficiency of allowing searchers to capture the value of their work.
37. Investors owning more than five percent of the stock of a public company are already required to make certain disclosures, see 15 U.S.C. § 78m(d) (1994); 17 C.F.R. § 240.13d-1 (1996), as is anyone making a tender offer for a public company, see 15 U.S.C. 78n(d); 17 C.F.R. § 240.14d-3.
38. See, e.g., Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (sanctioning use of "no comment" to protect confidentiality of pending merger negotiations in case emphasizing importance of disclosure).
39. Such a result is clearly unjust in the context of a criminal prosecution. See, e.g., Lambert v. California, 355 U.S. 225, 229–30 (1957) ("Where a person did not know of a duty and where there was no proof of the probability of such knowledge, he may not be convicted consistently with due process.")
The disclose-or-abstain rule may be the best alternative.\textsuperscript{40} This rule already applies to corporate insiders;\textsuperscript{41} we need only extend it to the other members of the residual class. Extending the rule permits residual class members in possession of inside information to keep it in confidence, provided they do not trade on it. If they want to trade, they must disclose.

If the amount of information disseminated by the residual class is suboptimal, i.e., the positive contribution to market efficiency of additional information outweighs the negative effect of paying for its production, then we should permit diligent searchers to trade without disclosure.\textsuperscript{42} The information they produce will be disseminated, through the medium of market prices, in two ways. First, their buying and selling will move market prices toward their informed values.\textsuperscript{43} Second, other investors will mimic their trades, accelerating the rate at which information is impounded in market prices.\textsuperscript{44}

There are three advantages to this approach. First, it deliberately and selfconsciously maximizes efficiency, taking into account the dual role of information.\textsuperscript{45} Second, it provides a principled means of both imposing and limiting insider trading liability. Finally, it orders our expectations concerning the behavior of market participants and—once familiar—will cause our moral intuitions about insider trading to track section 10(b) liability.

Returning to United States v. O'Hagan, the dual information approach would, if implemented by Congress, provide a principled means of imposing section 10(b) liability. Since denying trading privileges to O'Hagan would have no effect on his production of information, O'Hagan would be a member of the residual class and therefore subject to the disclose-or-abstain rule. As a result, his possession of material nonpublic information would trigger a duty to disclose or abstain. Because O'Hagan traded without disclosure, his silence would constitute "deception" under section 10(b). Thus, once we account for the dual role of information, O'Hagan is guilty of insider trading. As for his $4 million: Easy come, easy go.

\textit{—Jonathan E.A. ten Oever}

\textsuperscript{40} The disclose-or-abstain rule will cause the disclosure of material nonpublic information if persons disclosing it have an opportunity to trade before the market fully impounds the information disclosed. However, this information forcing effect has been challenged. See, e.g., Easterbrook, supra note 26, at 327.
If persons disclosing material nonpublic information could not earn trading profits exceeding the costs of disclosure, it may be advantageous to grant the residual class limited trading privileges. See infra note 44.

\textsuperscript{41} See, e.g., Chiarella v. United States, 445 U.S. 222, 227 (1980).

\textsuperscript{42} Market analysts—the paradigmatic diligent searchers—already enjoy a safe harbor from section 10(b) liability. See Dirks v. SEC, 463 U.S. 646, 658 (1983).

\textsuperscript{43} See Gilson & Kraakman, supra note 28, at 574-76 (explaining "price decoding").

\textsuperscript{44} See id. at 572-79 (explaining "trade decoding"). It might be advantageous to formalize the diligent searchers' trading privileges in a manner analogous to copyright protection. The government could then manipulate the amount of available information by adjusting the extent or temporal duration of the trading privilege. Cf. 17 U.S.C. §§ 106, 302 (1994) (establishing copyright protection and duration thereof).

\textsuperscript{45} Contrast the conventional judicial analysis, which focuses on the fiduciary duty of corporate insiders to shareholders. See supra note 12 and accompanying text.