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FROM JUDICIAL SOLUTIONS TO POLITICAL SOLUTIONS:  
THE NEW, NEW DIRECTION OF THE RULES AGAINST  
INSIDER TRADING  

Jonathan R. Macey*  

INTRODUCTION  

Although the ethical1 and economic aspects2 of insider trading regulation have been discussed at length, only recently have commentators begun to examine the political components of insider trading regulation.3 This virtual neglect of the political side of the story is particularly curious in light of the fact that regulation of insiders' trading practices recently has become a highly politicized issue, resulting in numerous bills4 and hearings5 in Congress.  

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4. The following bills were introduced before Congress in 1987:  

(1) S. 230, 100th Cong., 1st Sess. (1987), introduced by Senator D'Amato on January 6, 1987, entails proposed legislation that, inter alia, provides a definition of insider trading and holds companies civilly liable for money damages if the companies knew or should have known that their employees were engaging in illegal insider trading. For comment, see D'Amato Proposes Insider Trading Bill with Definition of Insider Trading, 19 Sec. Reg. & L. Rep. (BNA) 86 (Jan. 16, 1987); Boesky, Other Insider Issues, Debated at Annual Securities Institute, 19 Sec. Reg. & L. Rep. (BNA) 171 (Jan. 30, 1987).
At present, a battle for the right to regulate insider trading is being fought among Congress, the regulators at the Securities and 

(2) S. 231, 100th Cong., 1st Sess. (1987), also introduced by Senator D'Amato, is an alternative to S. 230 and provides a broader approach to the insider trading problem. For comment, see D'Amato Proposes Insider Trading Bill with Definition of Insider Trading, supra.

(3) S. 657, 100th Cong., 1st Sess., 133 CONG. REC. S2821 (daily ed. Mar. 6, 1987), introduced by Senator Metzenbaum on March 6, 1987, mandates treble damages for insider trading and provides a substantial increase to the civil liability penalties for insider trading (i.e., up to $500,000 and up to 5 years in prison, or both). For comment, see Metzenbaum to Propose Mandating Treble Damages for Insider Trading, 19 Sec. Reg. & L. Rep. (BNA) 330 (Mar. 6, 1987).


(7) S. 1323, 100th Cong., 1st Sess., 133 CONG. REC. S7601 (daily ed. June 4, 1987) (Tender Offer Disclosure and Fairness Act of 1987), introduced by Senator Riegle, along with Senator Proxmire, on June 4, 1987, reforms the regulation of tender offer. The bill increases the maximum imprisonment for insider trading from 5 years to 10 years and the maximum fine from $100,000 to $1 million. It also requires a minimum sentence of 1 year for perjury or obstruction of justice in connection with an insider trading investigation. See Definition of Insider Trading (Part I): Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 2 (June 17 & 19, 1987) (statement of Senator Donald W. Riegle) [hereinafter June Senate Hearings].

In addition to the above introduced bills, the following special interest groups are also active in this area of reform: (1) The Securities Industry Association (SIA) and their ad hoc group of industry officials formed to explore insider trading issues, see SIA Forms Ad Hoc Group To Study Insider Trading Issues, 19 Sec. Reg. & L. Rep. (BNA) 132 (Jan. 23, 1987), SIA Urges Insider Trading Definition, Seeks More Surveillance by SRO's, Firms, 19 Sec. Reg. & L. Rep. (BNA) 438 (Mar. 27, 1987); (2) the American Bar Association (ABA), see ABA Members Call for Changes in Short Swing Profit, Reporting Rules, 19 Sec. Reg. & L. Rep. (BNA) 544 (Apr. 17, 1987); (3) the North American Securities Administrators Association (NASAA), see Speakers Offer Variety of Solutions for Insider Trading at NASAA Meeting, 19 Sec. Reg. & L. Rep. (BNA) 555 (Apr. 17, 1987); and (4) the Securities and Exchange Commission (SEC), see June Senate Hearings, supra, at 109-41 (testimony of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission).
Exchange Commission ("SEC"), and the federal judiciary. Each organization has an institutional and, in some cases, political interest in regulating the trading practices of insiders, and their proposed regulations reflect these interests.

Not surprisingly, the federal judiciary, insulated from political pressures by the relative independence afforded it by article III of the Constitution, has promulgated the most sensible rules on insider trading.\(^6\) Political dissatisfaction with this judicial intervention among powerful political constituencies has led Congress and the SEC to attempt to abrogate the rules developed by the Supreme Court and the lower federal courts over the last several years.

Focusing on the politically controversial aspects of insider trading, this Article initially examines the political implications of the rules on this subject that were generated by the Supreme Court’s decisions in \textit{Chiarella v. United States}\(^7\) and \textit{Dirks v. SEC}\(^8\) and clarified in a series of lower court decisions.\(^9\) Both \textit{Chiarella} and \textit{Dirks} brought clarity and coherence to the law of insider trading, a much-needed shift from its earlier state of confusion. These decisions also represented major defeats to the SEC’s concerted attempts to manipulate the insider trading rules to enhance its bureaucratic powers.

I will explain why these holdings dissatisfied powerful, special interest constituencies of Congress and the SEC. I believe that this discontent with the Supreme Court’s rulings led the SEC to pro-

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An additional hearing was conducted before the Securities Subcommittee on December 15, 1987. However, due to the backlog at the United States Government Printing Office, the December hearing was unavailable at the time of this writing.


mulgate the recently proposed compromise statute, which purports to define the crime of insider trading for the first time. 10

Additionally, I will argue that the insider trading laws currently being considered reflect only the narrow, “special” interests of these constituencies, rather than the public’s interest in protecting the “fairness, efficiency and integrity of the Nation’s securities markets.” 11 In a previous article, I traced the evolution of the judge-made law of insider trading from the enactment of SEC rule 10b-5 12 to the Supreme Court’s decisions in *Chiarella* and *Dirks*. 13 I argued that the courts gradually have shifted from vague, incoherent “fairness” principles within insider trading law to precise, intellectually defensible justifications based on contract law and on contractarian ideas about the modern publicly held corporation. Since I completed that article, the locus of lawmaking on the subject of insider trading has moved from the federal courts to Congress. The consequence has been the triumph of politics over principle.

I. THE RAMIFICATIONS OF *Chiarella* AND *Dirks*

Prior to the Reagan Administration, elected officials deferred the regulation of insider trading to the SEC and the federal courts. During the 1980s, the Supreme Court, philosophically opposed to the SEC’s position on insider trading, rejected the notion that those possessing material nonpublic corporate information owe a general duty to the marketplace that requires them to disclose that information. In its place, the Supreme Court established a theory of insider trading liability defined by property law. The Court’s shift in focus was profoundly threatening to the SEC and led to pleas for congressional action to alter the way in which insider trading practices are regulated.

A. The Supreme Court's Insider Trading Rules

Prior to the Supreme Court’s decision in Chiarella, the law of insider trading was a morass. The law not only was devoid of clarity, but also lacked a unifying theory of liability upon which enforcement could be based. The SEC professed a rule that came perilously close to penalizing any trader who dared to consummate a securities transaction of any kind on the basis of an informational advantage over his trading partner. If fully implemented, this theory would have brought the capital markets to ruin.

In deciding Chiarella, the Supreme Court temporarily rescued the financial marketplace. The defendant in the case, Vincent Chiarella, was accused in criminal court of trading stock on the basis of information acquired in the course of his employment at Pandick Press, a financial printer. Mr. Chiarella had deduced the identity of companies that were about to become targets of public tender offers by decoding the disclosure documents that he was helping to prepare. Significantly, while making it clear that Chiarella could be found guilty under these facts, Justice Powell, writing for the Court, rejected the SEC’s contention that all traders owe a general duty of disclosure to all participants in market transactions, regardless of how the traders have obtained the information upon which they are trading.

By squarely rejecting the possibility, left open by the Second Circuit’s flawed (but highly influential) opinion in SEC v. Texas Gulf Sulphur Co., that the law required total equality of information among traders, the Supreme Court ushered in a new era of certainty and rationality in the realm of insider trading regulation. The Court not only dismissed the idea that the law should attempt to achieve a generalized parity of information among traders, but also refused to accept the additional theory in Texas Gulf Sulphur that a purchaser or seller of stock automatically acquires

14. See id. at 13-24 (describing the state of the insider trading law at the time of the Chiarella decision).
17. See Macey, supra note 6, at 26.
a duty to disclose whenever he enters into a transaction on an organized stock exchange. 18

Reception of either theory of liability would have had disastrous consequences on the financial marketplace. The capital markets are driven by the quest for information. Without an opportunity to profit from an informational advantage, traders would have no incentive to expend the resources necessary to obtain and assimilate firm-specific information about companies. Without such information, the capital markets would behave in an irrational manner, unable to serve as an adequate guide for the allocation of society’s investment resources. Thus, by rejecting these earlier theories of liability, the Supreme Court performed an important service to the capital markets and the national economy.

In place of the dangerous incoherence in the law that preceded Chiarella, the Court offered a new theory, based on notions of property rights, to define the trading activities of insiders. That is, the Court clarified the definition of insider trading. Specifically, the Court held that a specific contractual relationship, fiduciary in nature, is a necessary prerequisite to liability under the SEC’s notorious rule 10b-5. 19

In Chiarella the Court clearly established that there is no obligation to disclose “where the person who has traded on the inside information was not the corporation’s agent[,] . . . was not a fiduciary, was not a person in whom the sellers had placed their trust and confidence.” 20 Moreover, because Chiarella had been criminally prosecuted and the new “fiduciary duty” theory of liability had not been articulated to the jury, the Court ruled that Chiarella’s conviction could not be upheld. In cases decided subsequent to Chiarella, particularly United States v. Newman 21 and SEC v. Materia, 22 however, the Second Circuit Court of Appeals expressly held that future fact patterns similar to the one that gave rise to Chiarella’s prosecution will support a criminal prosecution under rule 10b-5. In both Newman and Materia, investment

18. Chiarella, 445 U.S. at 232-33 (finding that Chiarella owed no duty to his trading partners to disclose or refrain from trading because he “dealt with the sellers through only impersonal market transactions”).
19. Id. at 233.
20. Id.
bankers and financial printers held positions of trust and confidence in connection with the roles they played on behalf of bidders seeking control of publicly traded corporations. The individuals betrayed those confidential relationships by trading for their own accounts on the information they acquired. The trading occurred at the expense of the firms that initiated the relevant control contests and gave rise to a cause of action under rule 10b-5.

Subsequently, the Supreme Court, in Dirks v. SEC,23 further clarified insider trading law by formulating a rule to handle the problem of tippee liability.24 In that case, the defendant, Raymond Dirks, was a financial analyst who had acquired confidential information about Equity Funding, a large insurance firm, from former officers and directors of that company. The acquired information revealed that the assets of Equity Funding were vastly overstated as a result of internal fraud of epic proportions. Dirks, after verifying the tips at great personal peril and expense, advised several of his clients to liquidate their holdings in Equity Funding. Several of his clients took his advice and thereby avoided windfall losses when the fraud ultimately was exposed.

Confirming the old adage that no good deed goes unpunished (at least by the SEC), the SEC pursued Dirks to the full extent of the law. In absolving Dirks of liability, the Supreme Court handed the SEC its second straight major defeat in insider trading litigation. In doing so the Court developed what is essentially a three-part test for determining tippee liability. First, for a tippee to be liable, the person from whom he has acquired his information (the tipper) himself must have breached a fiduciary duty of some kind.25 Second, tippees are liable only if they inherit the fiduciary duty of their tipper. Tippees inherit such a duty only in cases in which “they knew or should have known that the tipper has breached” a fiduciary duty in passing along the information.26 Finally, a tippee is liable for trading on such information only where the tipper passes along the information in order to receive a “di-

24. A “tippee,” of course, is someone who acquires material nonpublic information from somebody who enjoys a fiduciary relationship with the firm to which such information pertains.
25. Dirks, 463 U.S. at 663.
26. Id.
rect or indirect personal benefit . . . such as a pecuniary gain or reputational benefit that will translate into future earnings.\footnote{27}

Although significant problems exist with the test devised by the Court in \textit{Dirks},\footnote{28} the fact remains that in that case the Court reaffirmed the basic principle of \textit{Chiarella} that the SEC's theory of liability in insider trading cases will not withstand judicial scrutiny simply because the theory is "rooted in the idea that the antifraud provisions [of the securities laws] require equal information among all traders."\footnote{29}

The Court based its affirmand of \textit{Chiarella} on economic principles that evinced a solid respect for property rights. Specifically, the Court recognized the value to the capital markets of encouraging the activities of financial analysts such as Dirks and declined to permit the SEC to regulate those vital activities in the ways in which they were attempting to do so.\footnote{30} As the Court noted:

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 . . . . The analyst's judgment . . . is made available [in various ways] to clients of [the analyst's] 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.\footnote{31}

\textbf{B. The Political Fallout from \textit{Chiarella} and \textit{Dirks}}

One lesson can be drawn from the above analysis that transcends all others. It is that the rules regarding insider trading have become more, rather than less, coherent over time.\footnote{32} The nature of the constraints on insiders' trading activities that were promul-
gated by the Supreme Court in *Dirks* and *Chiarella* were as concise, coherent, and economically rational as judge-made law can be. Critics wishing to redirect this correct trend towards clarity therefore cannot justify their wish on the basis that a need exists for clearer law.

Thus, we must look for another explanation for the current legislative initiatives by the critics on the subject of insider trading. In this section, I argue that the Supreme Court's interpretation of rule 10b-5 posed some severe problems for special interest groups, who stood to lose from the Court's interpretations.

From the SEC's perspective, the Court's decisions were problematic because they severely diminished the agency's power over its most important constituency, the investment banking community. It was the investment banks that benefitted most from the Court's decisions. The agency responded to pressures from this constituency by dramatically increasing its enforcement activities; however, by doing so, it suffered a loss of control over its own agenda.

Meanwhile, Congress faced its own angered constituency. Specifically, by protecting property rights in information, the Supreme Court's decisions on insider trading had enhanced the market climate for corporate takeovers. In turn, this pressured incumbent management teams of large corporations by increasing the probability that those teams would have to contend with hostile takeovers. The managers wanted a set of rules that would eliminate existing incentives for engaging in costly searches for poorly managed or undervalued firms. From these groups erupted a nigh-hysterical demand for alteration of the Supreme Court's decisions on the subject of insider trading.

As mentioned above, the SEC long had taken the position that trading on the basis of material nonpublic information, regardless

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insider trading prohibitions to permit treble damage recoveries, it declined to include a definition of insider trading on the theory that the existing substantive law was adequate.

Senator Alfonse D'Amato had proposed a draft bill containing a definition of insider trading, but officials of the SEC, including John Shad (then-Chairman of the SEC), Daniel J. Goelzer (General Counsel to the SEC), and John Fedders (then-Director of the SEC's Enforcement Division), all testified against it. See Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 33-39 (1984).

33. See Haddock & Macey, Regulation on Demand, supra note 3, at 338-39.
34. Id. at 334.
of the means by which the trader obtained such information, con­
stituted a violation of rule 10b-5. It is tempting to infer from this
that the SEC's policy on insider trading is driven by a well-inten­
tioned, albeit misguided, belief that securities traders should
compete on a completely level playing field. As Professor Michael
Dooley pointed out in his careful study of SEC enforcement activi­
ties against insiders, however, until the Court's decision in
Chiarella, the SEC rarely prosecuted anybody for violating the
rule against insider trading.35

What inferences can be drawn from the odd combination of an
incredibly broad conception of what constitutes illegal insider trad­
ing and an almost complete dearth of enforcement activity prior to
Chiarella? It seems that the SEC has adopted an expansive view
of the meaning of rule 10b-5 and the scope of insider liability in an
effort to enhance its own power. The agency has exercised this
power by agreeing to refrain from regulating insider trading in ex­
change for support from political supplicants.36

As David Haddock and I have observed elsewhere, the Court’s
decision in Chiarella was an exogenous shock to this preexisting
political equilibrium.37 For the first time, at least one interested
group, market professionals, had an incentive to replace their re­
quest for regulatory forbearance with a demand for a greatly
enhanced enforcement effort. This incentive developed because the
Supreme Court for the first time made it clear that, while true ins­
siders would be barred from trading on the basis of information
acquired in the course of their official duties, those who acquired
nonpublic information through the traditional financial investiga­
tions of investment bankers would not be subject to liability for
violating the rules against insider trading. Investment bankers and
other professional information processors began to demand greater
enforcement efforts by the SEC—and they got it.38

Meanwhile, however, the SEC's administrative control over
these supplicants has diminished since the law is now on their side.
The SEC would prefer a return to the days when the vagueness

36. For an excellent theoretical explanation of how regulators can extract political
support from forbearing to regulate, see McChesney, Rent Extraction and Rent Creation in
37. See Haddock & Macey, Regulation on Demand, supra note 3, at 327-30.
38. Id. at 332-33.
and incoherence of insider trading law provided the agency with a considerable source of power. Consistent with this explanation was the SEC's prolonged and indefensible refusal to promulgate a definition of insider trading; to do so would provide clarity to the law and consequently limit the SEC's power. To the extent that the law remains vague, the SEC's services and regulatory forbearance are in demand.

II. THE CURRENT LEGISLATIVE PROPOSAL

Not surprisingly in light of this analysis, the definition the SEC ultimately promulgated is a model of vagueness and obfuscation. In fact, the SEC has taken the remarkable position that if a definition of insider trading is to be enacted, it not only must be so broad as to include all activities currently prohibited by case law, but also must be flexible enough to apply to unspecified sorts of investment activities that the SEC has yet to define.39

It was not until the summer of 1987, after the enactment of a statutory definition of insider trading had become a virtual certainty, that the SEC proposed legislation that would define the crime of insider trading. Senators Donald Riegle and Alfonse D'Amato made a specific request that the SEC assist their Securities Subcommittee in developing a universally acceptable definition. Finally, on November 18, 1987, the SEC issued a press release containing a proposed statute that it finds acceptable and which it believes also will be acceptable to the Ad Hoc Legislative Committee on Insider Trading, chaired by Harvey L. Pitt.40

The SEC's Proposed Insider Trading Bill41 contains some subtle, yet significant, differences from the current law as articulated by the Supreme Court. These changes, if implemented, not only would broaden the current scope of the law, but also would make its applicability more vague than it currently is.

40. See Letter from David S. Ruder, Chairman of the Securities and Exchange Commission, to Donald W. Riegle, Chairman of the Securities Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs, and Alfonse M. D'Amato, Ranking Minority Member of the Securities Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs (Nov. 18, 1987) [hereinafter Ruder Letter].
41. See SEC Proposed Bill, supra note 10.
For example, current case law makes it illegal to trade "on the basis of" material nonpublic information. By contrast, the SEC's proposed statute makes it illegal to trade "while in possession of" such information. Under current law, in other words, defendants may assert in their own defense that, while they may have been in possession of inside information when they traded, their trades were made on the basis of other factors besides this information. This subtle change in language will make life much easier for plaintiffs in insider trading cases, particularly where the defendant has made a career of studying the company in whose shares he was trading.

This change of language not only enhances the SEC's power, but also is likely to make the securities markets less efficient. The only people who are able to drive share prices to their correct levels are those in possession of material information about a firm's stock. By banning anyone possessing inside information from trading, regardless of the source of his motivation for trading, the SEC would deprive the market of its principal source of rationality. To the extent that the proposed statute seeks to establish a conclusive presumption that possession, rather than use, of insider information is illegal, it stands to do an enormous disservice to the capital markets.

In one sense, the SEC's proposed statute ironically appears to make things easier on defendant-tippees than current law. Under current law, a tippee is liable if, inter alia, he "knows or should have known" that the information he received was wrongfully obtained. Under the SEC's proposed statute, however, the defendant is liable only if he "knows or recklessly disregards" the fact that the information was wrongfully obtained by the tipper. Under

42. Id. sec. 2, § 16A(b)(1).
43. The concept of market efficiency refers to the standard conception of the term as used by financial economists. In this context, a capital market is said to be more or less efficient depending on how quickly share prices in that market reflect information. The more quickly share prices come to reflect information about underlying firms, the more efficient the market is thought to be. Efficient markets serve as better guides of a society's capital resources and, hence, are socially desirable.
45. SEC Proposed Bill, supra note 10, sec. 2, § 16A(b)(1).
the existing judge-made law, it is easier for plaintiffs to establish the mental state ("scienter") necessary to obtain a conviction, because they need only meet an objective standard, i.e., they must establish that a reasonable person in the same circumstances would have realized that the information had been wrongfully obtained. By contrast, under the SEC's proposal, it appears that a plaintiff must establish that the individual defendant in the case actually traded on nonpublic information after disregarding available signals that the information had been wrongfully obtained. It is a proposed shift from the objective to the subjective. This rule change will be a benefit to market analysts and other market professionals who acquire corporate information in the course of their work and might be barred from trading under present law.46

The SEC's proposed statute also overrules a significant aspect of the Supreme Court's opinion in Dirks on tipper-tippee liability. In Dirks the Court held that tippees who obtained nonpublic information from corporate fiduciaries would not be liable for trading on the basis of that information unless the tippers obtained a "personal benefit" of some sort in exchange for releasing the information to the tippees.47 The statute proposed by the SEC removes this personal benefit requirement, making it illegal to communicate information that has been wrongfully obtained when subsequent trading is "reasonably foreseeable."48

Again, this change from existing case law is likely to decrease the efficiency of the capital markets. The personal benefit test, though crude, did delineate liability and enabled the courts to distinguish certain cases, such as Dirks, in which insider trading provided benefits to the capital markets, from those in which the individual traders involved in the transactions were the only beneficiaries of the trading.

The Dirks Court held that because Ronald Secrist, the defendant's tipper, received no personal benefit from passing along the inside information, Dirks was not subject to liability, regardless of whether Secrist foresaw that Dirks would trade on the information received. This conclusion benefitted the capital markets by provid-

46. For a theory of why the SEC might adjust insider trading law to benefit market professionals, see Haddock & Macey, Regulation on Demand, supra note 3, at 319-24.
47. Dirks v. SEC, 463 U.S. 646, 663 (1983); see also supra text accompanying notes 23-31.
48. SEC Proposed Bill, supra note 10, sec. 2, § 16A(c).
ing analysts, such as Dirks, with incentives to ferret out all sorts of socially useful information, including the financial fraud that brought Equity Funding to its knees. Under the SEC's approach, analysts are deprived of such incentives. In contrast to the Supreme Court's Dirks decision, if a tipper gives information to tippees in order to benefit not himself, but his firm or his shareholders (e.g., in the context of a takeover battle), he would be subject to insider trading liability.

The SEC's proposed statute also overrules the famous case of SEC v. Switzer, a case which caused the Commission considerable embarrassment. In the case, Coach Barry Switzer, the defendant, while a spectator at an University of Oklahoma track meet, overheard a man, whom he knew to be a director of a publicly held corporation, discuss with his wife the impending liquidation of one of the corporation's subsidiaries. Switzer traded on the basis of the overheard conversation and, subsequently, the SEC brought suit. The United States District Court for the Western District of Oklahoma, relying on Dirks, found that because the director did not personally benefit from passing along the confidential information, Switzer, as tippee, could not be held liable. Had the SEC's proposal governed the outcome of the case, Coach Switzer might have ended up in jail as a result of his trading activity. The proposal would require courts to determine whether the tipper—in this case, the director—breached a duty to the corporation, and then whether the tippee—in this case, Switzer—recklessly disregarded that the information had been wrongfully obtained. Liability would hinge on affirmative findings on both inquiries.

The SEC's proposal also marks a significant change from existing law in its description of the sort of contractual relationships that constitute relationships of trust for the purpose of regulating stock trading. Most significantly, the proposal makes it illegal for one to trade on the basis of the "breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship" and thus codifies the controversial

50. Switzer, 590 F. Supp. at 766.
51. SEC Proposed Bill, supra note 10, sec. 2, § 16A(c).
misappropriation theory upon which the SEC based its recent prosecution of R. Foster Winans in **Carpenter v. United States**.52

In **Carpenter**, Mr. Winans, an employee of the *Wall Street Journal*, was an author of a daily column published for securities investors called “Heard on the Street.” Despite the fact that the *Wall Street Journal* considered the contents of the column to be confidential, Winans entered into an agreement with brokers at the investment firm of Kidder, Peabody under which he gave the brokers advance warning regarding the timing and contents of his column. The brokers made large trading profits by purchasing and selling stock on the basis of the information.

Winans was indicted for violating section 10(b) of the Securities Exchange Act of 1934. The Court of Appeals ruled that Winans fraudulently had misappropriated information from the *Wall Street Journal* and that the misappropriation could support a conviction under section 10(b) of the Act.53 The Supreme Court recently upheld the Court of Appeals holding, dividing equally on the propriety of Winans’s securities fraud conviction.54 Considering **Chiarella** and **Dirks**, a decision stating that a breach of fiduciary duty can give rise to a prosecution for violation of the rules against insider trading should not be surprising. The supposed wrinkle in **Carpenter**, however, was that the actual trading did not occur in the stocks of companies to whom the defendants owed a fiduciary duty. Yet, in **Chiarella** the defendant did not purchase shares in firms with whom he had a contractual or quasi-contractual relationship.

In essence, then, the misappropriation theory adds nothing of substance to the rules of insider trading developed in **Chiarella** and **Dirks**. Rather, to the extent that it represents a change in the law of insider trading, the theory affects the important procedural question of standing, as opposed to any substantive issue. Specifically, the interesting question posed by the misappropriation theory is whether purchasers and sellers of stock who traded at the same time as Winans and his confederates have standing to sue for violations of rule 10b-5. Here, the judge-made law indicates that

52. 108 S. Ct. 316 (1987), aff’g on securities fraud counts by an equally divided Court 791 F.2d 1024 (2d Cir. 1986).
54. Carpenter v. United States, 108 S. Ct. 316 (1987), aff’g on securities fraud counts by an equally divided Court 791 F.2d 1024 (2d Cir. 1986).
the answer is "no" since, under the Supreme Court's theory of the law of insider trading, liability flows from the breach of a fiduciary duty by the defendant-trader (i.e., liability originates in the trader's activities). An implication of this theory is that only those market participants to whom the defendant owed a fiduciary duty at the time of their trading have standing to bring suit.\(^{56}\)

The SEC's proposal attempts to alter this state of affairs. It grants standing to sue

in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that forms the basis of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.\(^{57}\)

Thus, the proposal greatly expands the scope of defendant liability by providing standing to sue to a whole class of plaintiffs to whom no fiduciary duty was owed.

Aside from being devoid of any theoretical or practical justification, the SEC's exceedingly expansive concept of standing in insider trading cases undermines the basic theory of insider trading liability derived by the lower federal courts from the Supreme Court's holdings in \textit{Chiarella} and \textit{Dirks}.\(^{58}\) Again, it trades clarity and accuracy for political prominence and confusion.

The expansive rule of standing proposed by the SEC would produce bizarre results. Under the proposed law, the violation of any express or implied intra-firm employment agreement would give rise to a federal cause of action under the Securities Exchange Act of 1934 so long as securities trading somehow is involved in the transaction. Additionally, not only may the SEC or the United States Attorney General bring suit, but anybody involved in contemporaneous trading of the relevant securities is empowered to bring suit, despite the fact that, in most cases, no fiduciary duty was owed by the defendant to contemporaneous purchasers and sellers.


\(^{56}\) Moss, 719 F.2d at 12; see also Macey, \textit{supra} note 6, at 48-53 (discussing standing under current insider trading law).

\(^{57}\) SEC Proposed Bill, \textit{supra} note 10, sec. 2, § 16A(g)(1)(A).

\(^{58}\) See Macey, \textit{supra} note 6, at 48-53.
The statute also grants standing to "[a]ny person . . . injured by a violation of this section in connection with such person's purchase or sale of securities." By expanding standing to nonpurchasers, the SEC proposal overrules the 1975 Supreme Court decision in Blue Chip Stamps v. Manor Drug Stores, which required that plaintiffs in insider trading cases be actual purchasers or sellers of stock. There is no public interest justification for this bizarre constellation of legal rules. It effectively allows a host of unrelated parties with absolutely no stake in the matter to bring suit. At the same time, the real party in interest, the employer, is empowered to translate a violation of a minor provision in an intra-firm employment agreement into a federal cause of action. It is anybody's guess how courts will grapple with the issue of determining damages in such cases.

The SEC's proposed statute contains a number of exemptions that are worth noting. First, brokerage firms that implement procedures deemed "reasonable under the circumstances" and designed to prevent decisionmakers from possessing material nonpublic information are exempted from liability. Because the SEC ascertains whether the firms involved have taken these reasonable steps, the proposed section will create a strong demand among the brokerage community for the advice of the SEC about how their firms should organize in order to avoid liability.

Additionally, by hiring a market professional who is not aware of or influenced by the material nonpublic information, an insider may exempt himself from liability. Needless to say, this provision benefits the market professionals who comprise the SEC's natural constituency.

Finally, lest there be any lingering doubt about the Commission's desire to use the legislative process to gather power for itself, the proposal gives the Commission the power to exempt by rule or by order "any person, security or transaction, or any class thereof, from any or all of the provisions of this section." In essence, the proposed statute is exceedingly complex, remarkably broad, and shameless in its attempt to consolidate authority. By making mere
possession of nonpublic information a crime in certain circumstances, the Act stands to restrict the flow of corporate information that is vital to the efficient operation of the market.

The foregoing analysis suggests that the SEC stands to gain not only by promulgating overly broad legal rules, but also by creating a sense of confusion among market participants. Indefinite rules create a demand for the SEC's ability to engage in regulatory forbearance. Similarly, creating confusion about the state of the law fosters a demand for the SEC's administrative guidance. The insider trading law the SEC has proposed is consistent with these models of SEC behavior.

Thus far this essay has focused almost exclusively on the effects of the SEC's interest in the compromise proposal that it generated. There is one substantive area in which the SEC was unable to find common ground with the views of the Senate's Ad Hoc Committee: regulation of the market for corporate control under the guise of insider trading law.

The SEC's compromise bill essentially codifies SEC rule 14e-3. The SEC proposes to make it a crime for anyone to trade while in possession of material nonpublic information relating to a tender offer after "any person has taken a substantial step or steps to commence, or has commenced, a tender offer" if the trader knows or recklessly disregards that the information has been acquired directly or indirectly from the offering person, the target, or their agents. In addition to making trading on such information illegal, the SEC also purports to make it illegal for offerors, targets, or their agents to disclose information about an impending tender offer.

In its proposed bill, labeled S. 1380, the Ad Hoc Committee goes even further than the SEC to bar trading in takeover stocks by those who enjoy an informational advantage. The bill seeks to prevent

any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person . . . for the purpose of influencing

or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities.68

The Ad Hoc Committee extends its definition of liability beyond that of the SEC by regulating communications pertaining to transactions other than tender offers. The goal of both statutory approaches is clear: it is to retard the operation of the market for corporate control by impeding the ability of "corporate raiders" to use nonpublic information about target firms in their quests for the control.

Until recently, arbitrageurs and other market professionals played an invaluable role in the market for corporate control by amassing large blocks of shares in anticipation of a shift in corporate management following a tender offer. These arbitrageurs, of course, ultimately profited by selling the shares to the tender offeror. But the arbitrageurs do not capture all of the gains in such transactions. Shareholders of the firms that are targeted for the tender offers also stand to profit by garnering a large capital gain on the sale of their shares when they sell to the arbitrageurs.

By their purchases, arbitrageurs also reduce the bidders' acquisition costs in several ways. First, arbitrageurs often have specialized expertise in locating and ferreting out share blocks, which is of incalculable value to bidders. Additionally, successful purchases by arbitrageurs of the stock sought by bidders often result in favorable financing for the bidders. Finally, arbitrage facilitates bidders' activities by enabling bidders to conceal their identities and intentions until the final moments of the takeover process.

The use of nonpublic information is critical to the takeover process. Bidders who are forced to disclose their plans regarding purchases of target firm stock will lose their incentive to engage in the costly search necessary to uncover undervalued companies and inefficient management teams. To the extent that bidders are deprived of the ability to keep their plans and information confidential, there will be fewer corporate control transactions, and

68. Id. sec. 2, § 16A(c)(2).
capital markets will be less efficient than they would be otherwise.\textsuperscript{69}

At present, the Williams Act\textsuperscript{70} forces bidders to disclose their identity and plans upon launching a tender offer or within ten days of acquiring five percent of another firm's stock via purchases that do not constitute a tender offer. This requirement severely impedes the proper operation of the market for corporate control.\textsuperscript{71} To the extent that bidders legally or otherwise could circumvent the requirements of the Williams Act by taking advantage of the services of arbitrageurs, shareholders, not to mention the economy as a whole, were better off.

Those entrenched incumbent management teams of the corporations whose shares are likely targets for acquisition are the only group harmed by the activities of arbitrageurs. Such management teams stand to lose their jobs if their firms are taken over. Thus, to the extent that incumbent management teams can mold themselves into an effective political coalition, they are likely to seek restrictive legislation, despite the public benefits associated with arbitrage activities.\textsuperscript{72}

The legislation promulgated by the SEC and Congress reflects the effectiveness of incumbent management as a political coalition. Predictably, insiders have had more success influencing Congress than they have had influencing the SEC. This is because the takeover activities of such market professionals as arbitrageurs provide direct economic benefits to the investment banks that constitute the SEC's most loyal constituent group. Indeed, the benefits granted to incumbent management that are seemingly contained in the SEC's version of the statute may be illusory given that the SEC has proposed to retain for itself broad authority to exempt particular groups from the coverage of the Act. In contrast, the perspective of incumbent management is well-represented in Congress, since incumbent management teams are spread throughout the country, while investment banks are concentrated on the


\textsuperscript{71} See Fischel, supra note 69, at 9-18.

\textsuperscript{72} See Haddock & Macey, \textit{Regulation on Demand}, supra note 3, at 314-17.
coasts. Accordingly, in Congress investment banks are likely to be at a distinct disadvantage vis-à-vis the incumbent management group. This disparity of political power will be felt most strongly in the Senate, of course, since representation there is strictly geographic—but it will be felt in the House as well.

III. IMPLICATIONS OF THE CURRENT POLITICAL EQUILIBRIUM

To summarize, perhaps the most startling aspect of the SEC's compromise statute is its incoherence. The incoherence should not be surprising, since the SEC lacks a coherent theory for regulating activities described in the statute. Most notably, the statute does not provide a clear, cohesive theory for protecting those who are harmed by insider trading. At one point, the statute invokes such concepts as "misappropriation" and "conversion." The clear implication of this language is that insider trading is being proscribed because it involves theft of a property interest (information) that rightfully belongs to somebody other than the trader. But the fact that those who purchase and sell stock contemporaneously with the insider are given standing to bring suit indicates that the statute seeks to do something more than simply protect the property interests of those rightfully in possession of nonpublic firm-specific information. 73 Similarly, the provisions in the statute that seek to punish traders in possession of material nonpublic information, regardless of whether their trades were consummated on the basis of such information, cannot be reconciled with a property rights approach to the problem of insider trading. 74

Indeed, the SEC's property rights justifications for the rules against insider trading are inherently suspect. To be convincing,

73. On the other hand, the statute's treatment of trading in anticipation of tender offers by those who enjoy an informational advantage appears to be more or less consistent with a property rights/efficiency explanation of the legislation. As has been developed elsewhere, a property rights analysis would allocate the rights to information about an impending takeover to the firm or individual that initiates the transaction. See Macey, supra note 6, at 28; Fischel, supra note 69, at 13-15. This is usually the tender offeror. Consistent with this reality, the SEC's proposed insider trading law permits offerors through contractual arrangement or otherwise to empower other entities to purchase stock on behalf of the offering person. SEC Proposed Bill, supra note 10, sec. 2, § 16A(d)(1). But, as discussed above, the rights afforded by one law may be restricted by another. The Williams Act places severe restrictions on the ability of offerors to amass purchasing groups to acquire stock on their behalf. See 15 U.S.C. § 78n (1982).

74. See SEC Proposed Bill, supra note 10, sec. 2, § 16A(b)(1).
such justifications must explain why the control of insider trading cannot be left to the plethora of private enforcement mechanisms that are available to contracting parties. The SEC's proposal offers no such explanation. Even more perplexing from a property rights perspective is the question why those who enjoy a rightful ownership interest in nonpublic information are forbidden by the statute from selling the information. A statute outlawing such contracts and forbidding the relevant parties from waiving the statute's provisions in a consensual agreement cannot be defended on the basis of a property rights theory.

It is also not possible to defend the proposed statute on the grounds that it promotes a concept of "fairness" in the marketplace. The fairness justification for the laws barring insider trading embody the thoroughly discredited concept that no trade should be consummated unless both traders enjoy "parity of information." Although this justification for insider trading regulation long was embraced by the SEC, the Commission specifically rejected it when it issued its compromise regulation.

Having rejected both the fairness and the property rights theories as coherent explanations for the law, we are left with the argument that the law is needed to protect the "integrity of the nation's capital markets." This argument is hard to refute because nobody ever has bothered to explain what is meant by capital market "integrity." Moreover, nobody ever has explained why we should restrict the efficient allocation of property rights in information in order to achieve such an ethereal goal.

One view of the concept of market integrity (often proffered by the SEC when it lacks a coherent justification for its actions) is that insider trading rules are needed because investors will lose confidence in the capital market unless they believe that they are competing on a level playing field. At least four distinct arguments refute this contention.

75. See Carlton & Fischel, supra note 2, at 861-72; Haddock & Macey, supra note 2, at 1452-56.
76. See Macey, supra note 6, at 14-17.
77. See Ruder Letter, supra note 40, at 4 ("The legislative history should state that the bill is intended to reaffirm the existing law concerning 'market' information and 'corporate' information, and regarding what constitutes 'material nonpublic information,' including the Supreme Court's disavowal in Chiarella . . . that a 'parity of information' theory is intended." (citation omitted)).
78. See SEC Proposed Bill, supra note 10, sec. 2, § 16A(a)(1).
First, the insider trading rules proffered by the SEC do not attempt to establish a level playing field. Most obviously, tender offerors who have an unambiguous informational advantage over their trading partners are free to purchase shares on the basis of their advantage within the limits prescribed by the Williams Act.

Perhaps more importantly, when insiders are barred from trading, a level playing field is not created because one group of market professionals, often called quasi-insiders, still has an advantage over all other traders. These market professionals “devote their careers to acquiring information and honing evaluative skills” about a firm, an industry, or a group of firms or industries.\textsuperscript{79} Even though true insiders are barred from trading by the SEC’s proposal, these market professionals, who owe no legal or fiduciary duty to refrain from trading on the basis of their lawfully acquired informational advantage, are permitted, indeed encouraged, to trade.\textsuperscript{80} It is this group of market professionals, rather than the trading public, that benefits from the general proscription on insider trading. A level playing field does not exist.

Stated another way, the level playing field vision of the market integrity argument rests on the bizarre premise that if insiders are barred from trading, the resulting gains will be spread randomly throughout the economy. This premise is absurd. The competition to capture profits based on information not currently reflected in a firm’s share price is one that is won by the swiftest. The swiftest invariably turn out to be the cadre of market professionals who have devoted their lifetimes to acquiring, decoding, and acting upon the corporate information upon which trading profits are based. If insider trading is banned, the playing field does not automatically become level; it simply tilts in a different direction.

A second reason why the market integrity argument cannot be maintained is based on the fact that traders do not believe that the market represents a level playing field anyway. Traders can be divided into two distinct groups. One group consists of investors who do not harbor the illusion that they can garner returns on their investments that are greater than those earned by a market index.

\textsuperscript{79} Gilson & Kraakman, \textit{The Mechanisms of Market Efficiency}, 70 VA. L. REV. 549, 571 (1984); see Haddock & Macey, \textit{Regulation on Demand}, supra note 3, at 318.

\textsuperscript{80} See Haddock & Macey, \textit{Regulation on Demand}, supra note 3, at 318.
These investors typically own a diversified portfolio of securities and adopt a buy-and-hold strategy. Such investors are immune to the effects of insider trading of any sort because they purchase shares when insiders are purchasing just as often as they purchase shares when insiders are selling. Consequently, such investors are indifferent to whether insider trading is taking place.\footnote{To the extent that insider trading by managers lowers the demand of such managers for fixed salaries from their firms, shareholders will prefer that insiders be permitted to engage in such trading. See Haddock & Macey, supra note 2, at 1454, 1463-64.} In contrast, some investors, the market professionals, can garner profits by strategic (i.e., nondiversified) trading. As David Haddock and I have argued elsewhere, it is these investors who prefer that insiders be banned. They do not want the playing field \textit{level}, but want to make it irregular by tilting it in their favor.\footnote{Haddock & Macey, \textit{Regulation on Demand}, supra note 3, at 330-32.} Of course, there may be some traders who are not market professionals who believe that they can beat the market (i.e., beat the market professionals) if insiders are barred from trading. The efficient capital market hypothesis has shown this investment strategy to be extremely dubious. In any case, such investors do not want a level playing field any more than the market professionals do. Rather, they want the insiders removed from the competition so that they will have a greater advantage over those whom they believe are less well-informed.

The third response to the level playing field argument was formulated by Professor Ken Scott of Stanford Law School. He has observed that, so long as the possibility of insider trading is known to all traders, outsiders cannot be disadvantaged because the price the outsiders pay for their shares will be reduced by the amount necessary to compensate them for any excess risk they assume in purchasing the shares.\footnote{Scott, supra note 1, at 808-09.} In other words, the stock price absorbs the risk. As Dennis Carlton and Dan Fischel have pointed out, this is virtually "a complete response to the claim that investors are exploited by insider trading."\footnote{Carlton & Fischel, supra note 2, at 881.}

Finally, the best response to the market integrity argument rests in the fact that the securities markets of several countries in which capital formation techniques have reached very high levels of sophistication and in which secondary trading markets provide
investors with great liquidity do not enforce bans on insider trading regulation at all. Of particular interest in this regard is the complete lack of enforcement of the laws that are on the books in Japan and the absence of laws affecting the Hong Kong Stock Exchange. In Japan, the Tokyo Stock Exchange is roughly the same size as the New York Stock Exchange. Trading on the Tokyo Exchange is highly automated, and investors enjoy unparalleled liquidity for their shares. In recent years, corporate stock traded on the Tokyo exchange has traded at a far higher price-to-earnings ratio than corporate stock traded on the New York Stock Exchange. In other words, there is absolutely no evidence of any crisis of confidence in the Japanese capital markets despite the fact that “[t]he Japanese stock market is an insider’s paradise. There is no clear rule of law prohibiting insider trading and no public record of efforts to prevent the practice.”

Similarly, in Hong Kong, the regulation promulgated in 1974 to control insider trading was repealed without any discernible effects on that robust marketplace. Indeed, the recent trend towards insider trading regulation in Common Market countries appears to be due largely to pressure from the United States.

CONCLUSION

In summary, the SEC’s regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity. This exhausts the public interest rationales for the proffered regulation. Instead, the regulation offered reflects a hodgepodge of special interest concerns. It thus is no surprise that the proposed statute appears needlessly complex and lacks any coherent theoretical framework.

It seems that the best explanation for the statute is that it reflects the unrelated private concerns of three powerful special in-

85. See Haddock & Macey, Controlling Insider Trading, supra note 3, at 149-51.
86. Repeta, Declining Public Ownership of Japanese Industry: A Case of Regulatory Failure? 17 L. JAPAN 153, 184 (1984); see also Carlton & Fischel, supra note 2, at 860 n.16 (“In Japan . . . insider trading is considered proper, and there has never been a reported case under the limited insider trading prohibition currently in effect.”) (quoting B. RIDER & H. FRENCH, THE REGULATION OF INSIDER TRADING (1979)).
87. Carlton & Fischel, supra note 2, at 860 n.16 (citing B. RIDER & H. FRENCH, supra note 86).
88. See Haddock & Macey, Controlling Insider Trading, supra note 3, at 150.
terest groups. The SEC itself is interested in keeping the law as vague as possible in order to maximize the demand for its own services as an administrative agency. The recent enthusiasm in Congress for increasing the budget of the SEC in an era of fiscal belt-tightening reflects the SEC's success in this regard. Most of the publicity and concomitant increases in congressional support for the SEC's activities come from the Commission's investigations of insider trading activity.\(^{89}\)

In addition to the SEC, the community of investment bankers and related market professionals who stand to gain if true insiders are barred from trading, are a major source of demand for the new statute. Securities professionals and their lawyers have spent millions of dollars lobbying for a statute that deals with insider trading. It is impossible to imagine that those professionals have provided this sort of support for a statute that does not favor their interests.

The final group that stands to gain from the new statute is the incumbent management teams of companies that are likely to confront hostile takeover bids. By supplementing the existing provisions of the Williams Act and related rules, the SEC's proposed statute further impedes the operation of arbitrageurs, who facilitate corporate control contests.

The point of this essay has not been to suggest that it is impossible to come up with an internally coherent set of rules to regulate insiders' trading activities. In fact, I have made it clear that the Supreme Court moved quite decidedly in this direction in its enormously valuable decisions in \textit{Chiarella} and \textit{Dirks}.\(^{90}\) Although the law promulgated in these cases was by no means perfect, contrasting that law with the SEC's new proposed statute reveals that the SEC's proposal is an inferior product from the perspective of serving the interests of the American public. As usual, the special interests have triumphed in the legislative process.

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89. Of particular note, of course, is the publicity surrounding the recent prosecutions of Dennis Levine and Ivan Boesky.

90. \textit{See supra} text accompanying notes 14-31 (discussing \textit{Chiarella} and \textit{Dirks}).