A Critique of U.S. Insider Trading Regulation Theory

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Ⅰ. INTRODUCTION

Economists define insider trading as a transaction in which one party has informational advantage about the subject matter that the other party does not have. Such asymmetric information may occur in a wide variety of transactions. Generally, the seller has no duty to disclose to the buyer anything about the subject matter before they enter into the contract and vice versa. It is up to each party to negotiate the terms they want in the contract. Unless there was a fraudulent misrepresentation by one party, the other party may not be entitled to damages because it lacked information that was known to the counterparty.

According to jurists, insider trading is unlawful trading in securities by persons who possesses material nonpublic information about the company whose shares they are trading. Any person who possesses inside information can trade lawfully only if he discloses the inside information to the investing public before he trades in the stock. Otherwise, the person in possession of material nonpublic information should refrain from trading. The interesting questions are: Why should securities be singled out for special treatment by jurists? What is wrong with insider trading? Why should insider trading be regulated?

On one hand, prohibition of insider trading can be justified generally by fairness-related arguments. On the other hand, many law and economics scholars argue that fairness is simply not sufficient for a legal prohibition. Instead, they argue, the legality of insider trading should be based upon argument for efficiency. Some of these commentators argue insider trading is inefficient, and support government regulation. Others, however, believe insider trading is efficient, and that the prohibition of insider trading does not make sense. This article explores the rationale as to why insider trading should or should not be prohibited and reviews the development of insider trading theory.

The article proceeds as follows. The first part begins with the policy debate over insider trading regulation. I describe two arguments supporting insider trading: insider trading as an optimal compensation for insiders and as an enhancement of the efficient stock price change. Then I offer four

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arguments in support of prohibition of insider trading: (1) insider trading is an inefficient compensation device, (2) insider trading diminishes market efficiency, (3) insider trading is not fair, and (4) insider trading violates the property rights of corporation. In the second part of this chapter, I analyze the development of insider trading theory in the United States from possession theory, traditional theory, and misappropriation theory to property rights in information theory. I argue that any theory that relies on a breach of fiduciary duty and the property rights in information theory is problematic. Finally, I propose that the possession theory is the most effective theory to curb insider trading now and in the future.

Ⅱ .WHAT IS WRONG WITH INSIDER TRADING?

Are we certain that inside trading is detrimental to our society? Should people really consider themselves harmed by insider trading? Before law and economics theories emerged, the prohibition on insider trading was usually justified on fairness grounds or for the protection of investor confidence among lawyers, judges, and law professors. According to law and economics scholars who favor deregulation, however, insider trading is efficient because it enables the market price to more quickly reflect the non-public information and the true value of the affected stocks. Moreover, insider trading is efficient because it reduces the manager-shareholder conflict of interest and benefits the firm and society. On the other hand, those who favor regulation of insider trading contend insider trading and its prohibition are inefficient. The following analysis will review the policy debate as to why insider trading should or should not be prohibited. The debate is important in providing perspectives on how each country can respond to this issue in globalizing securities markets.

A. The Argument for Deregulation

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1.Insider Trading as an Efficient Compensation

Henry Manne argued that trading by insiders using material nonpublic information is an economically efficient way of compensating entrepreneurs for their innovational activities in the modern enterprise.[1] According to Manne, an entrepreneur does not receive sufficient reward for his invaluable contributions in the wage market. Therefore, insider trading profits represent the most efficient means of compensating entrepreneurs and give them incentives to produce more innovations.[2]

Professors Carlton and Fischel have argued a further refinement of Manne's compensation argument.3 To deal with the agency cost problem, they contend that compensation arrangements in contracts that are tied to managers' output can give managers incentives to behave efficiently.4 Compensation arrangements, however, are subject to high bargaining costs and the difficulty of evaluating managerial output.[5] Thus, in seeking to minimize these costs, firms limit the number of renegotiations to as few as possible.[6] The problem is that such a reduction in the number of renegotiations will again result in the rise of agency costs because managers are then less likely to have the proper amount of incentive at any given time.[7]

Carlton and Fischel suggest insider trading as a solution to this renegotiations dilemma because "the unique advantage of insider trading is that it allows a manager to alter his compensation package in light of new knowledge, thereby avoiding continual renegotiations."[8] According to this theory, the manager can tailor his compensation at his will for the

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[1] *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 131- 45 (1966).
[2] *See id*
[3] *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).
[4] *See id.* at 870.
[5] *See id.*
[6] *See id*.
[7] *See id*
[8] *Id.*

information he produces, increasing his incentives to acquire and develop valuable information.[9]

Carlton and Fischel further believe that permitting managers to profit from good and bad news, in fact, may induce them to be less risk-averse because "insider trading may induce managers to take on projects with a high expected return even if they are riskier."[10] Managers would not be concerned that future projects that fail will diminish their gain, since selling short when possessing bad inside information will compensate them well.

2.The Efficient Stock Price Change

Manne argues that insider trading enables the stock price to move smoothly to the real price.[11] He hypothesizes a stock trading at fifty dollars per share when managers have discovered new information that, if publicly disclosed, would skyrocket the stock price to sixty dollars. If insiders trade on this information, the price of the stock will gradually rise to the true price. In contrast, if insider trading were illegal, the stock's price would remain at fifty dollars until the information is publicly disclosed and then would rapidly rise to the true price of sixty dollars. Thus, the result is that insider trading can replace the traditional forms of public disclosure of the information, and the price of stock would more fully reflect all information about a company at any given time.[12]

Similarly, professors Carlton and Fischel contend that allowing insiders to trade on nonpublic material information enhances the overall efficiency of securities markets.[13] Their reasoning is that "if insiders trade, the share price will move closer to what it would have been had the

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[9] *See* Calton and Fischel, *supra note* 3, at 871.
[10] *Id.* at 865.
[11] *See id.* at 79-90.
[12] *See id.*
[13] *See* Calton and Fischel, *supra note* 3, at 866-68.

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information been disclosed" because the investors would observe the orders and price movement resulted from insider trading.[14] Consequently, investors would follow insiders and bid the prices of stocks up or down before the inside information is actually released.

B.The Argument for Regulation

The basic argument against insider trading is that it undermines public confidence in the fairness and integrity of securities markets. If investors fear to invest their money in securities markets, stock market liquidity and stock market efficiency suffer.

1.Insider Trading as an Inefficient Compensation Device

There is much literature criticizing on several grounds Mann's thesis that profits from insider trading constitute the only effective compensation scheme for entrepreneurial services in large corporations.[15] First, there are many forms of performance-related or stock-price-based compensation schemes that tie managerial compensation to annual increases in corporate profits.[16] In comparison to insider trading profits compensation scheme, this alternative mechanism would not only avoid conflict of interest with the company and its shareholders, but would also encourage managerial staff to maximize the corporate value as best as they can.

The thesis that a license to trade on bad and good inside news, if adopted as a means of managerial compensation, could cause managers to give up their commitment to maximize the firm's value and encourage

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[14] *Id.* at 868.

[15] *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3460-62 (1991); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* 1981 SUP. CT. REV. 309, 332 (1981); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?* 55 L. & CONTEMP. PROBS. 263, 288-90 (1992); Kenneth E. Scott, *Insider Trading, Rule 10b-5, Disclosure, and Corporate Privacy,* 9 J. LEGAL STUD. 801, 808-09 (1980).

[16] *See* Scott, *supra* note 15, at 808-09; ROBERT CLARK, CORPORATE LAW 278 (1986).

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them to make riskier business decisions because either way they would be rewarded.[17] Judge Easterbrook suggests that insider trading may seduce managers to "select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading, and, if the project flops, the shareholders bear the loss."[18] Besides, to exploit inside information, insider trading invites managers to devote themselves to identifying stock trading profit instead of paying attention to the running of business.[19] As a result, permitting insider trading rather than harmonizing the interests between managers and shareholders, harms the firms and shareholders.

Another reason to doubt the utility of insider trading as an optimal compensation scheme is that Manne overlooks the problem of tippee. According to professors Wang and Steinberg, "if managers are permitted to trade on inside information, presumably they will be permitted to tip as well. These tippees may in turn pass the information along to sub-tippees."[20] The crucial inquiry then is how to develop a regulatory regime to monitor whether all insider traders and their recent contributions are qualified to be rewarded through insider trading profits.

2.Insider Trading Diminishes Market Efficiency

Since insiders will always have an asymmetric information advantage, if investors know that insider trading is permitted, they will lose confidence in the stock markets and then pay a discount price for a

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[17] *See* CLARK, *supra* note 15, at 278; Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?* 55 L. & CONTEMP. PROBS. 263, 289 (1992).
[18] Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* 1981 SUP. CT. REV. 309, 332 (1981).
[19] *See* DONALD C. LANGEVOORT, INSIDER TRADING REGULATION 11 (1991).
[20] WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 17 (1996).

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share of a given company or refuse to trade in that stock market.[21] Consequently, stock market liquidity would be diminished because the final sale price of a share of stock would not be set at the appropriate level. The reason is lack of a willing buyer under such circumstances. Thus, public investors will pay less for shares traded in illiquid or inefficient stock markets, which makes it harder for firms to raise capital, compared to a situation without legal insider trading. A higher cost of capital curtails investment and thus weakens the growth of the economy. Therefore, governments and firms should prohibit insider trading to promote investors' confidence in the stock markets. When investors believe that stock markets are fair and honest, they invest more of their funds in the market. This, in turn, lowers the cost of capital to firms and increases the growth of the economy.[22]

Professor Macey contends, however, that in several countries public investors continue to invest even when they know that the insider trading laws are not enforced.[23] In other words, public investors are not bothered by insider trading. The best answer to refute Macey's argument is that "the issue is not whether outsiders continue to invest when insider trading is freely permitted, but whether they continue to invest at the same level when insider trading is freely permitted, ceteris paribus."[24]

Moreover, if a manager discovers or obtains information, he may delay disclosure of that information to the other members of the firm after he has traded on the basis of that information and before the corporation

[21] *See* LOSS & SELIGMAN, *supra* note 15, at 3451-54; LAURA N. BENY, A COMPARATIVE EMPIRICAL INVESTIGATION OF AGENCY AND MARKET THEORIES OF INSIDER TRADING 14-16 (Harvard Law School Discussion Paper No. 264, 1999); WANG & STEINBERG, *supra* note 20, at 29-33.

[22] *See* Mark Klock, *Mainstream Economics and the Case for Prohibiting Inside Trading*, 10 GA. ST. U. L. REV. 297, 331 (1994).

[23] *See* JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 43-44 (1991).

[24] *See* Klock, *supra* note 22, at 331.

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acts upon it.[25] In other words, timely and rapid disclosure of information by a manager to the superior would jeopardize his opportunity to reap the rewards of insider trading.

3.Unfairness

Traditionally, the most common policy justification for the prohibition of insider trading has been that insider trading is unfair.[26] It is true that each investor is afraid of being treated unfairly and of suffering informational disadvantages in the stock markets. In SEC v. Texas Gulf Sulphur, [27] the court delivered the opinion that "the rule [against insider trading] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." [28] The key of this rationale is the equality of access to inside information, but not equality of possession.[29] It is unfair if public investors cannot independently and lawfully acquire the same information that insiders can; insiders may have access to information that public investors can never obtain through

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[25] *See* Robert Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1053-55 (1982). *But see* MACEY, *supra* note 23, at 36-37.
[26] *See* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 148-49 (1999); Stephen M. Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma,* 38 U. FLA. L. REV. 35, 55 (1986). In Bainbridge's opinion, "fairness can be defined in three prncipal ways: fairness requires that no trader breach of fiduciary duty by trading; fairness requires that no trader possess an informational advantage; and, fairness requires that the trader not harm those with whom he trades."
[27] 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).
[28] 401 F.2d 833 , at 848.
[29] *See* BERNHARD BERGMANS, INSIDE INFORMATION AND SECURITIES TRADING – A LEGAL AND ECONOMIC ANALYSIS OF THE FOUNDATIONS OF LIABILITY IN THE U.S.A. AND THE EUROPEAN COMMUNITY 111 (1991).

their diligence and effort.[30] This is the main reason why, unlike in the case of most other property, unfair informational advantage is not allowed in securities transaction. If, however, one party is better informed because of personal capital, knowledge, or experience, there is no unfairness in the securities transaction.

Another argument that insider trading is unfair is that the informed traders (agents) violate a relationship of trust and confidence when they use confidential information for personal benefit without disclosing that fact to the corporation and its shareholders (principals).[31] The idea is that a fiduciary should be prohibited from acting in hisself-interest by trading on inside information that he acquired in his official positions. The heart of this rule is that a fiduciary shall not abuse his position for his personal benefit, and if there is a conflict of interest, the fiduciary has to sacrifice his self-interest for the benefit of one to whom he owes a fiduciary obligation.

4.Protecting Property Rights of Corporation

Some commentators argue that the material nonpublic information is an intangible property of a corporation.[32] To protect property rights in information, insider trading prohibition is justified if the corporation does not allow others to utilize price-sensitive information for their own benefit. According to professor Dooley, the rationale of property rights in

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[30] *See* Bainbridge, *supra* note 26, at 58; Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 332-46 (1979).

[31] *See* Bainbridge, *supra* note 26, at 56. *But see* Easterbrook, *supra* note 18, at 321-22.

[32] *See* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644-51 (1999); MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 774-76 (1995); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1252-57 (1995); Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 21-23 (1993); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 28 (1984).

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inside information duplicates the rationale of protection of trade secrets of a corporation.[33] Thus, "as the insider is forbidden to trade on confidential information, so is the employee forbidden to use his employer's secrets in competition against him."[34]

Professors Loss and Seligman have suggested that "[i]nformation, particularly about such matters as a new corporate product or a mineral discovery, can be viewed as corporate business property. The corporation has devoted resources to developing the property."[35] Producing an adequate amount of valuable information is costly for a corporation. If there were no recognition of property rights in information, the corporation that spent time and money developing socially valuable information would not earn a return on its invention cost. The reason is that the producer of the information must bear all of the costs for developing the information, while its trading partner can share in the information without having the burden of the invention costs since the producers of valuable information are not entitled to exclude others from using it. Therefore, according to Professor Bainbridge, "the rationale for prohibiting insider trading is precisely the same as the rationale for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce socially valuable information."[36]

C. Summary

In summary, the essence of the debate is whether insider trading regulation should be controlled by private ordering or by public ordering. From the view of private ordering, permitting insider trading not only

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[33] *See* DOOLEY, *supra* note 33, at 774-75.
[34] *Id.* at 775.
[35] LOSS & SELIGMAN, *supra* note 15, at 3458-59.
[36] Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1253 (1995).

ameliorates agency costs, but also contributes to market efficiency. The proponents of public ordering, however, argue that insider trading worsens agency costs and affects the stock market liquidity. Hence, insider trading regulation is necessary.

The author does support the argument favoring prohibition of insider trading because insider trading regulation by private ordering is not convincing. First, I am skeptical about the likelihood that insiders and shareholders can optimally contract about deployment of corporate inside information given the gross inequality in bargaining power and knowledge of insiders and shareholders. The advocates of deregulation suggest a dangerous proposition since shareholders are not able to protect their own self interests in securities markets. Moreover, considering the structure of a modern public corporation, the course of negotiations would be costly because insiders would need to negotiate with each shareholder term by term. After all, how can shareholders ensure that insiders are trading according to the contract terms? Shareholders may not even have strong incentives to contract with insiders under such circumstances.

Another problem with insider trading regulation through private ordering is the third party effect.[37] It is not surprising that there are affected parties who did not have the opportunity to attend the course of negotiations between the insiders and shareholders. The proponents of deregulation, therefore, need to consider what effect deregulation may have on other companies and the investing public in the securities markets. This, in itself, may provide a basis for establishing insider trading regulation in the public interest.[38]

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[37] *See* Klock, *supra* note 22, at 316-17.
[38] *See* J. WILLIAM HICKS, INTERNATIONAL SECURITIES REGULATION 4-1 (2000). Professor Hicks has pointed out that:

> Securities regulation, like other forms of regulation, takes many forms. In general and in the aggregate, it is the product of an endless number of compromises between the private and public interests in the securities markets.

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Also, if efficient market theory stands for the proposition that "stock prices accurately reflect the value of the underlying shares conditional upon the amount of information about the stock that is available in the marketplace," [39] then material nonpublic information should not be characterized as part of the information that is available about the fundamental value of the stocks. If the price of a stock can adjust quickly to reflect all current publicly available information, without doubt the market operates with efficiency. Some commentators overlook the fact that nonpublic material information does not qualify as the current public available information unless it becomes available to public. Therefore, I do agree that the rule of disclose-or-abstain induces disclosure, or at least eliminates delayed or inaccurate disclosures that would result from private ordering theory.

Finally, it is true that insiders will always have an asymmetric information advantage. Therefore, it is important that government

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> In the United States and in other countries that are committed to a market economy, the private interest flows naturally from the basic tenets of a capitalistic society. The private interest reflects the fundamental belief that individuals or groups of individuals are entitled to maximum freedom in the ownership and use of their rivate property in an economy where market forces intermediaries, and investors to a regulatory climate where all unnecessary impediments to efficient markets are eliminated.
>
> For governmental regulation in the area of securities to withstand challenge the public interest in the securities markets must be sufficiently strong to justify imposing restraints on the private interest in those markets. In theory, securities regulation is optimal where at any given moment a proper balance is struck between the private interest, which stresses freedom and efficiency, and the public interest, which allows for limitations and proscriptions.

Id.

[39] *Id.* at 299.

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provides an environment for investors in which they will not feel that insiders will take advantage them in the securities markets. The best ex ante solution for controlling asymmetric information is the disclose-or-abstain rule rather than permitting insider trading.[40]

Ⅲ.THEORIES FOR REGULATING INSIDER TRADING

The purpose of this section is to discuss the development of theories for regulating insider trading. The discussion will revolve around Section 10(b) of the U.S. Securities Exchange Act of 1934 and Rule 10b-5 promulgated under the Act.[41] Why U.S. laws? Unlike most other regulatory bodies around the world, the U.S. Congress and the Securities Exchange Commission have consistently resisted providing a definition of insider trading. Moreover, U.S. insider trading laws were the first set of insider trading laws in the world. The U.S. insider trading regime has

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[40] *Id.* at 329.

[41] 15 U.S.C. §78j(b) (1993).

The Section 10(b) provides, in relevant parts:

> It shall be unlawful for any person, directly or indirectly…to use or employ, in connection with the purchase or sale of any security…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 investor.

17 C.F.R. §240.10b-5 (1993).

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 any national securities exchange,
> (1) to employ any device, scheme, or artifice to defraud,
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.

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been developed through judicial interpretations that were based on various rationales to clarify the purpose of the inside trading laws.

The courts' efforts have yielded at least three legal theories, namely (1) the "possession" or "equal access" theory, (2) "traditional or classical" theory, and (3) "misappropriation" theories. As it will be seen, these theories are closely related and interconnected. Violation of section 10(b) and Rule 10b-5 is premised on the concept of fraud and fiduciary duty. Anyone whose trading activity breaches a fiduciary duty owed either to the investors with whom he trades or to the source of the information would be in violation of insider trading regulation. The one who is in possession of material nonpublic information must disclose such information before trading or, if disclosure is impossible, abstain from trading.[42] It should be pointed out from the outset that the arguments and reasoning advanced here may not include the theories of liability of Rule 14e-3 and Section 16(b). The simple reason is that those two theories have nothing to do with the disclose or abstain rule.

Finally, this section will also examine the property rights in information theory of insider trading.

A. Possession Theory

In In re Cady, Roberts & Co.,[43] the SEC for the first time extended the regulation of insider trading to an impersonal stock exchange setting. This case involved what is known as tippee liability of insider trading. J. Cheever Cowdin was a director of Curtiss-Wright Corporation and was also a partner at Cady, Roberts. After the Curtiss-Wright Corporation board of directors meeting, Cowdin informed Robert Gintel, a broker and partner at Cady, Roberts, that the board of directors decided to reduce the

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[42] SEC Rule 14e-3, 17 C.F.R. §240.14e-3 (1993) is an exception because it does not require a breach of fiduciary duty for violation.
[43] 40 S.E.C. 907 (1961).

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company's quarterly dividend. Before the news was publicly announced, Gintel moved quickly to sell 2,000 shares of Curtis-Wright stock for ten of his accounts while also selling 5,000 shares short of eleven accounts. After the dividend announcement, Curtis-Wright's stock price fell by a few dollars. Gintel was found to be in violation of insider trading regulations by the SEC. The SEC held that:

We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[44]

This obligation articulated what became known as the "disclose or abstain" rule. Moreover, the SEC extended the duty to disclose to any person who was outside the definition of a traditional corporate insider as long as the following two elements were met: "First, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[45] Thus, the disclose or abstain rule was based on the policy of fairness toward public investors.

The "inherent unfairness" principle was validated by the influential Court of Appeals of the Second Circuit in the landmark case of SEC v. Texas Gulf Sulphur.[46] This case involved various shades of insider trading using information about mineral exploration activities near Timmons, Ontario by Texas Gulf Sulphur (TGS). In October 1963, TGS conducted a ground survey on one particular area, known as Kidd 55, and

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[44] *Id*. at 911.
[45] *Id*. at 912.
[46] 401 F.2d 833 (2d Cir 1968), *cert denied*, 394 U.S. 936 (1969).

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confirmed that the area had the strongest reading for minerals. In November 8, 1963, there was a test drilling of the site, which indicated the presence of zinc and copper content in the rock. TGS's president ordered that more land be acquired and that the results of the drilling be kept confidential. After TGS acquired more land, the drilling was continued on March 31, 1964.

Between November 12, 1963 and March 26, 1964, various insiders of TGS purchased stock and call options, tipped outsiders, and accepted stock options issued by the company's board of directors without informing the directors of the discovery. The stock price was around $18 per share to $25 per share during that time. TGS finally announced its discovery in a press conference on April 16, 1964. The stock price quickly jumped to $37 per share. By May 15, 1964, TGS's stock was trading for more than $58 per share. The SEC initiated an action against all of the insiders who traded during the period in question for violation of Section 10(b) and Rule 10b-5.

The Second Circuit followed the SEC's fairness approach of Cady, Roberts, holding that simple possession of material nonpublic information was sufficient to evoke the "disclose or abstain" rule. The possession theory adopted by the appellate court stated 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…. Thus, anyone in possession of material inside information must either disclose it to the investing public, or if disabled from disclosing it in order to protect corporate confidence, or if he chooses not to do so, must

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abstain form trading in or recommending the securities concerned while such inside information remains undisclosed.[47]

The policy foundation on which the Second Circuit based its opinion was equality of access to information. The court contended that the purpose of Section 10(b) and Rule 10b-5 is "to prevent inequality and unfair practice and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges."[48] Therefore, the court held that "all investors trading on impersonal exchanges [should] have relatively equal access to material information."[49] It is apparent that the possession theory of liability is a founded upon unequal legal access to inside information but not upon fiduciary relationship requirement.

The advantage of the equal access theory is that it provides all participants in securities markets with clear and simple guidelines that forbid any person who possesses material non-public information from trading unless he has a legitimate reason. The equal access theory opposes all information disparity in securities markets. The present theory, however, does not seek to prevent anyone who is in possession of material information because of his skill or diligence from engaging in securities transactions. On the contrary, the possession theory allows the stock brokers, investments analysts, and other market professionals to enjoy informational advantages derived from their exercise of diligence.

B. Fiduciary Duty Theory

1.Overview

In the 1980s, the United States Supreme Court decided two decisions — Chiarella v. United States[50] and Dirks v. SEC[51] that substantially changed the scope of Texas Gulf Sulphur's disclose or

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[47] *Id*. at 848.
[48] *Id*. at 848.
[49] *Id*. at 833.
[50] 445 U.S. 222 (1980).
[51] 463 U.S. 646 (1983).

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abstain rule. In Chiarella, the Court decided that the liability of Section 10(b) and Rule 10b-5 for trading on material nonpublic information can be imposed only if the defendant owed a fiduciary duty to those with whom he trades. In Dirks, the Court held that the duty of tippers-tippees to disclose or abstain from trading under Section 10(b) and Rule 10b-5 depends on whether the tipper breaches a fiduciary duty by passing on the information, and the tippee knows or has reason to know that the tipper would benefit personally from the tip.

There are two types of nonpublic information upon which insider trading may be carried out. The first which is known as "issuer information" relates to events or developments affecting the firm's expected earnings or assets. It typically emanates from corporate sources. In Dirks, the nonpublic information was a type of issuer information. The other is "market information" which may have significant implications for the price of the firm's securities without affecting its earning power or assets and originate from sources other than the firm. The nonpublic information at issue in Chiarella thus was a type of market information. It is clearly apparent that insider trading liability can be imposed on those who trade while knowingly possessing either issuer information or market information.

2. Chiarella v. United States

In Chiarella v. United States,[52] the U.S. Supreme Court rejected the notion that Section 10(b) and Rule 10b-5 were intended to ensure all investors equal access to information. Without the relationship of fiduciary obligations between the trading parties, the insider trading liability would not exist by mere possession of nonpublic market information.

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[52] 445 U.S. 222 (1980).

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Vincent Chiarella, employed as a markup man by a financial printing press, Pandic Press, was able to crack the secret codes devised by his employer. Those codes encrypted the names of prospective tender offer targets. On five occasions, Chiarella purchased the target stocks prior to the bid being announced and sold thereafter. Chiarella was convicted of violating Rule 10b-5 by trading on the basis of material nonpublic information. The lower court found Chiarella criminally liabile under the rule in Cady and Texas Gulf Sulphur because Chiarella had greater access to information than public investors, which triggered the disclose or abstain duty upon him. The Supreme Court reversed and held that "neither the Congress nor the Commission ever has adopted a parity-of-information rule."[53] The equal access theory failed for two reasons:

First not every instance of financial unfairness constitutes fraudulent activity under § 10(b)…. Second, the element required to make silence fraudulent – a duty to disclose – is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner's had no prior dealings with them. He was not their agent, he was not a fiduciary, and he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.[54]

To summarize, when a Rule 10b-5 action was based on nondisclosure, there would be no fraud if the trader had no duty to disclose to the other party in the transaction. Such duty would have to arise in a fiduciary or similar relation of trust and confidence between the parties. Accordingly, Chiarella could not be held liable because he did not have any pre-existing relationship of trust and confidence with the uninformed traders.

3. Dirks v. SEC

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[53] *Id.* at 233.
[54] *Id.* at 232.

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Raymond Dirks was an investment analyst specializing in insurance company securities. Ronald Secrist was a former vice president of the Equity Funding Corporation of America who was fired because of the company's budget cuts. Secrist told Dirks that Equity Funding was engaging in the fraudulent activities and requested Dirks to investigate Equity Funding. While investigating, Dirks openly discussed his findings with his clients and investors; some of them sold their Equity Funding stocks for more than $16 million before the fact of fraud was made public. Dirks was charged by the SEC and found guilty of insider trading because he received material nonpublic information from an insider; thus, he had to disclose that information or refrain from trading as if he were a fiduciary.

In Dirks v. SEC, [55] the Supreme Court reversed the lower court's finding of guilt and supported the requirement of a breach of fiduciary duty in order for insider trading to attach:

We were explicit in Chiarella in saying that there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, * * * was not a fiduciary, [or] was not a person in whom the sellers [of the securities] have placed their trust and confidence.' Not to require such a fiduciary relationship, we recognized, would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties' and would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material , nonpublic information.'[56]

The fiduciary principle made it very difficult to hold a tippee liable if the he was not a fiduciary who had a duty to disclose or abstain. The Court reasoned that "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to

[55] 463 U.S. 646 (1983).
[56] *Id.* at 654-55.

their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[57] Thus, tippees' duty to disclose or abstain was derivative from the tippers' duty to disclose or abstain. The Court then developed its own tippee liability rule:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[58]

The Court also added a second requirement for finding of tippee liability in order to clarify the nature of tippees' liability:

[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach…This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputational benefit that will translate into future earnings. There are objective facts a circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[59]

Thus, a tippee can be held liable only when the tipper breached his fiduciary duty by disclosing material nonpublic information to the tippee,

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[57] *Id*. at 659.
[58] *Id*. at 660.
[59] *Id*. at 662-64 (citations omitted).

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and the tippee must know or have reason to know that the information was given to him for the personal benefit of the insider.

In footnote fourteen in Dirks, the Court observed that some tippees may be "temporary insiders" that would be held liable for insider trading even if the tipper did not breach his fiduciary duty in disclosing information to them.

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the enterprise and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a relationship to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship must at least imply such a duty.[60]

The status of a constructive fiduciary arises from confidential relationships between these professionals and the corporations. In order to fulfill the corporation's purposes for which the professionals were hired, they need to have access to inside information. Since they obtain access to confidential information, they are properly defined as fiduciaries who are prohibited from tipping or trading on such that confidential information.

4. A Critique of Fiduciary Duty Theory

Under the fiduciary duty theory, liability for insider trading can be imposed only on traders who owe fiduciary duties to those with whom

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[60] *Id*. at 655 n.14.

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they trade. In other words, a fiduciary relationship of trust and confidence between insiders and shareholders gives rise to a duty to disclose or abstain. The big concern under the fiduciary duty theory is that it cannot reach trading by outsiders who trade in the securities of an unrelated company based upon the inside information generated by their employers. Furthermore, the tippee can avoid liability for insider trading if the tipper did not breach his fiduciary duty for his personal benefit.[61] The misappropriation theory, discussed in the next section, was developed to fill this loophole.

Furthermore, the fiduciary duty theory is questionable when a corporate insider is the seller and a stranger is the buyer of the stock.[62] After all, the fiduciary duty should be imposed on the corporate insider only with respect to the current shareholders and not to those who do not own the stock.

Finally, if an insider buys or sells bonds rather than stocks pursuant to material nonpublic information, the fiduciary duty theory cannot cover this type of a transaction.[63] The reason is that the bondholder is a corporate creditor who lacks any fiduciary relationship with the corporation. It is unfair that the bondholder is without the protection of insider trading law just because the insider does not owe any fiduciary duty to bondholders.

C. Misappropriation Theory

1. Overview

Rule 10b-5 is violated under the misappropriation theory 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

[61] *See* Steven R. Salbu, *Tipper Credibility, Noninformational Tippee Trading, and Abstention from Trading: An Analysis of Gaps in the Insider Trading Law*, 68 WASH. L. REV. 307, 317-18 (1993).
[62] *See* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 392 (1999).
[63] *See id*.

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whether he owed any duties to the shareholders of the traded stock.[64] Under this theory, the wrongdoer is in breach of a fiduciary duty to the source of information, not to the persons with whom he trades.

On June 25, 1997, the Supreme Court reached the decision in United States v. O'Hagan that "a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating Section 10(b) and Rule 10b-5."[65] In so doing, the Supreme Court overturned the holding of the Court of Appeals for the Eighth Circuit.[66] Thus, the Supreme Court ruled on the misappropriation theory's viability and ended a split among the circuits that had developed over the application of the misappropriation theory to insider trading. This theory, however, has been extensively critcized.[67]

According to Section 10(b) and Rule 10b-5, "deception" is the key to regulating insider trading. In Sante Fe Industries, Inc. v. Green, the Supreme Court defined deception as one's material misrepresentation or nondisclosure of information, to induce another's action or inaction in

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[64] *See* SEC v. Clark, 915 F.2d 439, 443 (9 th Cir. 1990).
[65] *Id.*
[66] 92 F.3d 612 (8th Cir. 1996), *cert. granted*, 521 U.S. 642, at 653 (1997).
[67] *See generally* Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491 (1999); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998); Roberta S. Karmel, *Outsider Trading on Confidential Information – A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83 (1998); Victor Brudney, *O'Hagan's Problem*, 1997 SUP. CT. REV. 249 (1997); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV.1157 (1997). *But see* Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1 (1998); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395 (1998).

violation of a duty to disclose.[68] In addition, the Court stated that "thus the claim of fraud and fiduciary breach …states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as manipulative or deceptive within the meaning of the statute."[69] In other words, the Court ruled that even a breach of fiduciary duty can not trigger the § 10(b) liability without the deceptive conduct.[70]

In Chiarella, the Court delivered held that one who fails to disclose material nonpublic information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose.[71] The Court also found that a duty to disclose could arise only from the relationship between the parties to transaction.[72] The relationship is the "fiduciary relationship," i.e., the insider's duty to disclose to the other party is due to a fiduciary or similar relation of trust and confidence between them.[73]

The words "manipulative" and "deceptive" in Section 10(b) suggest that Section 10(b) was intended to regulate knowing and intentional wrongdoer in securities market. The other element of a cause under Section 10(b) and Rule 10b-5 is the "connection with the purchase or sale of securities." The Court held that the "in connection with" condition was satisfied when someone suffered an injury as a result of deceptive practices touching his sale or purchase of securities as an investor.[74] Thus, the Court found that the deception would not have to be directly related to the purchases or sales of securities between the parties.

2. Pre-O'Hagan: Background of Misappropriation Theory

a. Introduction

[68] 430 U.S. 462, 471- 76 (1977).
[69] *Id.* at 473- 74.
[70] *See* BAINBRIDGE, *supra* note 26, at 63.
[71] Chiarella v. U.S., 445 U.S. 222 (1980).
[72] *Id*. at 230, 232.
[73] *Id*. at 228.
[74] Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971).

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Since the classical theory has been premised on the existence of a fiduciary relationship between the insider and the shareholders of the corporation whose stocks are traded, it cannot effectively deal with situations involving an "outsider" of the corporation who uses the material nonpublic information for personal benefit. To fill this gap, the SEC developed the "misappropriation theory."

In Chiarella, Chief Justice Burger, in his dissenting opinion, stated that Section 10(b) and Rule 10b-5 should be interpreted "to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.[75] Burger's response in Chiarella was to abandon the fiduciary duty requirement, so that if a person traded on the basis of misappropriated material nonpublic information, he would commit a securities fraud because he would violate a general duty not to trade on misappropriated material nonpublic information. The majority rejected this reasoning solely on the ground that the theory had not been presented to the jury.

b. Carpenter v. United States

The Carpenter case[76] concerned a former columnist for the Wall Street Journal, R. Foster Winans, and two codefendants, Kenneth P. Felis and David Carpenter, who had misappropriated information from Winan's employer for use in transactions involving the purchase and sale of securities.[77] The trial court and the Court of Appeals for the Second Circuit applied the misappropriation theory and held that Winans was in breach of confidentiality owed to his employer and that he violated Section 10(b) and Rule 10b-5 even though his employer was not a buyer or seller in the securities transaction.[78]

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[75] Chiarella, 445 U.S. at 245.
[76] Carpenter v. United States, 484 U.S. 19 (1987).
[77] *Id*. at 20-22.
[78] *Id*. at 23-24.

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Since the Supreme Court was evenly divided (four to four) on this issue, it affirmed the Second Circuit without any opinion on the misappropriation theory.[79] The Court unanimously upheld the journalist's conviction under the federal mail and wire fraud statutes.[80]

c. United States v. Newman

In United States v. Newman,[81] the facts were analogous to those in Chiarella. The two defendants were employees of different investment banking firms. They joined Newman, a securities broker, to trade in subject company stock based on the material, nonpublic information about proposed mergers involving clients of the firm. Newman sold the stock for a large profit before the information became public.[82] The Court of Appeals for the Second Circuit found that the two insiders violated the duty they owed to their employer corporations to maintain confidentiality.[83] This, in turn, caused the employer to breach the duty of confidentiality it owed to the corporation whose securities were traded, resulting in a violation of Section 10(b) and Rule 10b-5.[84]

The fiduciary relationship required in Newman is different from the fiduciary relationship required in Chiarella. Under misappropriation theory, it does not matter whether the insider trader owes a fiduciary duty to the persons with whom he trades. Instead, the theory requires a showing that some sort of a fiduciary relationship existed between the insider trader and the source of the information. The misappropriation theory is justified under § 10(b) because the insider trader deceives the source of confidential information by secretly using the information for personal benefit in securities markets.[85]

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[79] *Id*. at 24.
[80] *See id*. at 25-28.
[81] 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).
[82] *Id*. at 15-16.
[83] *Id*. at 17.
[84] *Id*. at 16.
[85] *Id.* at 18.

In Dirks, however, in 1983, the Supreme Court found that "temporary" insiders, persons who work for a company that have access to a corporation's material, nonpublic information, might be treated as insiders.[86] Therefore, under the Dirks' temporary insider theory, the classical theory would still be applicable to the situation in the Newman case. Thus, there is no need to apply the misappropriation theory at all if the defendant is a "temporary insider."

d. United States v. Chestman

In Chestman, Robert Chestman was a broker and financial advisor to Keith Loeb.[87] Keith Loeb received material nonpublic information from his wife. His wife received the nonpublic information from her mother.[88] Loeb phoned Chestman and told him that he "had some definite, some accurate information" that Wauldbaum, Inc. was in the process of being sold.[89] Chestman then used the information to engage in several trading activities. Chestman was tried as a misappropriation tippee of Loeb. Under the misappropriation theory, Loeb must have violated the fiduciary duty to his wife or the Wauldbaum family; otherwise, Chestman could not be held liable as his tippee.

The court held that "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information,"[90] and that "more than the gratuitous reposal of a secret to another who happens to be a family member is required to establish a fiduciary or similar relationship of trust and confidence."[91] Since the court did not find a "similar relationship of trust and confidence" between the Loeb and the

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[86] Dirks v. SEC, 463 U.S. 646, 655, n.14 (1983).
[87] United States v. Chestman, 947 F.2d 551, 555 (2d Cir. 1991).
[88] *Id*.
[89] *Id*.
[90] *Id*. at 567.
[91] *Id*. at 568.

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Wauldbaum family, and because there was no indication of a fiduciary-like relationship between the spouses, therefore, the court held that the conviction of Chestman under Section 10(b) and Rule 10b-5 should be reversed.[92]

e. United States v. Bryan

In Bryan,[93] Bryan was the director of the West Virginia Lottery.[94] He was convicted of securities fraud for profiting by trading in companies that were about to be awarded contracts to provide goods and services to the lottery.[95] The trial court convicted him of Section 10(b) securities fraud under the misappropriation theory.[96]

The Court of Appeals for the Fourth Circuit rejected the misappropriation theory and concluded that "neither the language of Section 10(b), Rule 10b-5, the Supreme Court authority interpreting these provisions, nor the purposes of the securities fraud prohibitions will support convictions resting on the particular theory of misappropriation adopted by our sister circuits."[97]

The court was of the opinion that the misappropriation theory failed to satisfy two elements of Section 10(b).[98] Since Section 10(b) prohibits only deceptions in the form of material misrepresentations or omissions, the misappropriation theory, conversely, authorizes criminal conviction for simple breaches of fiduciary duty, whether or not the breaches entail a deception within the meaning of Section 10(b).[99] Thus, a fiduciary duty alone is insufficient to constitute a section 10(b) violation.

In addition, the misappropriation theory does not even require deception, but allows the imposition of liability upon the mere breach of a

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[92] *Id*. at 571.
[93] United States v. Bryan, 58 F.3d 933 (1995).
[94] *Id*. at 937.
[95] *Id*. at 938-39.
[96] *Id*. at 943.
[97] *Id*. at 944.
[98] *See id*.
[99] *See id*.

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fiduciary relationship or similar relationship of trust and confidence.[100] Under Section 10(b), deception is necessary for such a violation.

According to the Fourth Cirtuit, the misappropriation theory also does not satisfy the "in connection with" element of Section 10(b) and Rule 10b-5 because the theory authorizes criminal convictions whether or not the parties wronged by the fiduciary breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities.[101] The purpose of "connection" requirement in Rule 10b-5 is linking the fiduciary breach with a duty to a participant in a securities transaction. The Bryan court concluded:

[We] hold that criminal liability under §10(b) cannot be predicated upon the mere misappropriation of information in breach of a fiduciary duty owed to one who is neither a purchaser nor seller of securities, or in any other way connected with, or financially interested in, an actual or proposed purchase or sale of securities, even when such a breach is followed by the purchase or sale of securities. Such conduct simply does not constitute fraud in connection with the purchase or sale of securities, within the meaning of §10(b).[102]

3. United States v. O'Hagan

In United States v. O'Hagan,[103] the Court of Appeals for the Eighth Circuit also rejected the misappropriation theory. The case involved a Minneapolis law firm, Dorsey & Whitney, that represented Grand Metropolitan in an acquisition of the Pillsbury Company.[104] In July 1988, when James O'Hagan, a Dorsey & Whitney partner, learned that Grand Metropolitan was contemplating making a tender offer for Pillsbury

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[100] *See id*. at 946.
[101] *See id*. at 944.
[102] *Id*. at 952.
[103] 92 F.3d 612, 612 (8th Cir. 1996).
[104] *Id*. at 614 (8th Cir. 1996).

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Company's common stock, he engaged in purchasing 5,000 shares of Pillsbury common stock and 2,500 call options before the proposed tender offer became public.[105] When Grand Met publicly announced its tender offer in October 1988, O'Hagan exercised his options, earning more than $4 million.[106]

The government subsequently brought fifty-seven charges against O'Hagan, and the jury found O'Hagan guilty on all fifty-seven counts.[107] O'Hagan appealed and the Eighth Circuit reversed the conviction, holding that Section 10(b) and Rule 10b-5 liability may not be grounded on the "misappropriation theory" of securities fraud on which prosecution relied below.[108]

The Eighth Circuit rejected the misappropriation theory for two primary reasons. First, the misappropriation theory "permits the imposition of Section 10(b) liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation, nondisclosure, or other form of deception."[109] According to the principles of Santa Fe [110] and Central Bank,[111] the mere breach of a fiduciary obligation without misrepresentation or nondisclosure is not deception within the meaning of Section 10(b). Therefore, the misappropriation theory contradicts the principles of Santa Fe and Central Bank, since it doesn't require a material misrepresentation or a nondisclosure to the trading counterpart.

Second, the misappropriation theory "permits liability for a breach of duty owed to individuals who are unconnected with and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in

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[105] *Id*.
[106] *Id*.
[107] *Id*. at 612.
[108] *Id*. at 628.
[109] *Id*. at 618.
[110] Sante Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).
[111] Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A., 511 U.S. 164 (1994).

connection with' statutory language." [112] The court found that "the misappropriation theory cannot be defended because it allows the imposition of Section 10(b) liability even though no market participant was deceived or defrauded." [113] The Court concluded:

By evading the statutorily required nexus that the fraud be 'in connection with the purchase or sale of any security,' the misappropriation theory essentially turns §10(b) on its head, 'transforming it from a rule intended to govern and protect relations among market participants' into an expansive 'general fraud-on-the-source theory' which seemingly would apply to an infinite number of trust relationships…. Such a wide-ranging application of §10(b) liability simply cannot be reconciled with the Central Bank holding that the text of §10(b) governs the scope of conduct, which may be regulated under that provision, coupled with the focus in Chiarella, Dirks, and Central Bank on parties to the securities transaction or, at most, other market participants.[114]

On June 25, 1997, the U.S. Supreme Court held that the Eighth Circuit erred in rejecting the misappropriation theory in United States v. O'Hagan. 115 Compared to the appellate opinions in O'Hagan and Bryan, the Supreme Court reached different conclusions regarding the issues of fiduciary duty breach, deception, and "in connection with" under the misappropriation theory. The Supreme Court concluded that:

Misappropriation, as just defined, is the proper subject of a § 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" a securities transaction. First, misappropriators deal in deception: A fiduciary who [pretends] loyalty to

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[112] *Id*.

[113] *Id*. at 619.

[114] *Id*. at 619-20.

[115] United States v. O'Hagan, 521 U.S. 642 (1997).

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the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal. A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement… Second, § 10(b)'s requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of a security" is satisfied by the misappropriation theory because the fiduciary's fraud is consummated, not when he obtains the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities. The transaction and the breach of duty coincide, even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. Because undisclosed trading on the basis of misappropriated, nonpublic information both deceives the source of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence.[116]

The Supreme Court ruled that the traditional theory and the misappropriation theory are complementary. The traditional theory targets a corporate insider's breach of a fiduciary duty to shareholders with whom he trades; the misappropriation theory outlaws trading on the basis of material nonpublic information by a corporate outsider in breach of a fiduciary duty owed to the source of the information.[117]

4. A Critique of Misappropriation Theory

According to the Eighth Circuit in O'Hagan, the misappropriation theory does not require "deception" as mandated by Section 10(b).[118]

[116] *Id*. at 653-54.
[117] *See id*. at 652-53.
[118] *See* O'Hagan, 92 F.3d at 617.

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Consequently, the court rejected the misappropriation theory because it permits § 10(b) liability based on a mere breach of a fiduciary duty.[119]

The Eighth Circuit also determined that the misappropriation theory must be rejected because it permits liability for a breach of duty owed to persons who are unconnected to a securities transaction, rendering meaningless the "in connection with" language of Section 10(b).[120]

The Author ism in complete agreement with the Eighth Circuit's judgment. Moreover, the Supreme Court's reasoning in O'Hagan that misappropriation theory meets the statutory requirement is not very convincing. The idea of fraudulent non-disclosure between transacting fiduciaries is easy to understand. It is, however, unpersuasive that fraudulent requirement of §10(b) can be met while the fiduciary relationship exists outside the parties of securities transactions. The Supreme Court in O'Hagan majority accepted that:

Misappropriators deal in deception: A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal. A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement. Deception through nondisclosure is central to liability under the misappropriation theory.[121]

The misappropriation theory does not require a material misrepresentation or nondisclosure of material information in violation of a duty to disclose to the traders with whom a violator trades. The misappropriation theory seems to focus on misappropriation and a breach of duty of loyalty to his principal. Misappropriation generally occurs

[119] *Id*. at 618.
[120] *Id*.
[121] United States v. O'Hagan, 521 U.S. 642, 653 (1997).

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when an employee steals his employer's material information. The fraud will happen only if the misappropriator uses that material information for his personal benefit without disclosing to the principal. However, this does not seem to match the "deception" requirement of Section 10(b) for several reasons. First, it is not clear whether every breach of a fiduciary duty of loyalty will be considered fraud and deception if the principal did not enter into any securities transaction with the misappropriator. In Chiarella, the Supreme Court held that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[122] However, under the misappropriation theory, the breach of duty is to the source of the information and not to the party on the other side of the trade. Therefore, it is obvious that the misappropriation theory abandoned the interpretation of common law fraud.

Second, is there any difference between stealing money and stealing information under the misappropriation theory? Suppose someone steals money from his employer and buys securities. Would he still need to disclose to his employer that he wants to trade securities using his employer's money to avoid being liable for securities fraud?

Third, the beneficiary of the fiduciary relationship has the right to allow or disallow that the fiduciary to use information for personal benefit. The question is how does the misappropriation theory apply when the fiduciary has the beneficiary's consent to trade? The misappropriation theory of liability would not work in this type of situation because there would be no fraud and no breach of duty of loyalty.[123] Thus, if O'Hagan had the consent from the source of nonpublic information to trade, he could have traded in the securities market since he would not have breached his fiduciary duty to his law firm.

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[122] Chiarella v. United States, 445 U.S. 222, 230 (1980).

[123] *See* John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory,* 144 U. PA. L. REV. 1077, 1136 (1996).

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Fourth, the Supreme Court's finding that the Section 10(b) requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of a security" was satisfied under the misappropriation theory does not make very much sense. To understand the underlying the principle of Section 10(b) and Rule 10b-5, the "in connection with" requirement and the "deception" requirement should be evaluated together. Thus, O'Hagan could not deceive another unless he owed a duty to disclose to another. The "in connection with" requirement supports the integrity of this duty. O'Hagan was in breach of duty owed to the source of information, rather than to the persons with whom he trades. Since one was the source of information and the other was the person with whom he traded, how could the breach of duty could be "in connection with" the securities transactions?

Fifth, Professor Alder contends "[d]amages is an element of common law fraud."[124] Rule 10b-5 fraud cannot exist if there was no injury to the source of inside information under the misappropriation theory.[125] As a matter of fact, the beneficiary of a fiduciary relationship generally does not suffer any "securities injury" Thus, if there was no securities violation between the misappropriator and his principal, then the misappropriation theory should not call for liability. The Supreme Court's conclusion that the misapropriator's deception the source of the information simultaneously harms the members of the investing public is troublesome. It views the misappropriator's trade from an ex post, rather than the more appropriate ex ante, perspective. Indeed, what the misappropriator did in O'Hagan was mere misappropriation ex ante and as such could not trigger the Rule 10b-5 liability because it lacked a

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[124] Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 119 (1984).
[125] *See* Steven A. Ramirez & Christopher M. Gilbert, *The Misappropriation Theory of Insider Trading Under United States v. O'Hagan: Why its Bark is Worse than its Bite*, 26 SEC. REGULATION L.J. 162, 205 (1998).

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securities injury that generally results from fraud. If this sort of liability is allowed, other liabilities may also arise, depending on the manner in which the misappropriator used the information. He could possibly use it in the securities markets. He could tip it to his family or friends or could even disclose it to the public. Thus, no matter what he does after his mere misappropriation, it could be inappropriate to mix all the distinct acts into one violation.

D. The Property Rights in Information Theory

1. Overview

Some commentators have suggested that material nonpublic information is a corporation's intangible "property" and that the corporation is free to decide whether to exclude others from knowing and using it or to transfer it to insiders or others.[126] Professor Jonathan R. Macey contended that:

The regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity. As the Supreme Court recognized in Chiarella and Dirks, the only conceivable justification for banning insider trading is that such trading involves the theft of valuable corporate property from its rightful owner. The attempts to justify insider trading regulation on other grounds simply reflect efforts by a farrago of special interest groups to obtain private advantage through the regulatory and legislative process.[127]

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[126] *See generally* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644-51 (1999); MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 774-76 (1995); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1252-57 (1995); Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 21-23 (1993); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 28 (1984).

[127] JONATHAN R. MACEY, INSIDER TRADING: ECONOMIC, POLITICS, AND POLICY 67 (1991).

According to this view, insider trading is a theft of corporate property if the firm does not allow its insiders to use the inside information for personal benefit. “Insider trading does not constitute a theft of corporate property, however, if such trading is conducted with the firm’s permission.”[128] Given this view, Professor Macey has argued that the best legal regime is allowing the firms to freely contract with insiders to assign the property rights to them if permitting such insider trading would be beneficial not only to the firms but also to their shareholders.[129]

The property rights in information theory originated from the idea of the Coase theorem.[130] In general, the Coase theorem states that contracting parties will allocate resources to their most valuable use of in the absence of transaction cost.[131] The Coasian argument assumes that firms and shareholders can privately negotiate allocation of the property rights in information to the party that values it the most.[132] According to Professors Easterbrook and Fischel, whether insider trading is beneficial or detrimental to firms and shareholders “varies from firm to firm and industry to industry. Even within firms, the effects of trading depend on the context and positions of the employees involved.”[133] Without a uniform consensus among the parties interested in inside information, the “Coase Theorem implies that firms and insiders have strong incentives to allocate the property right in valuable information to the highest valuing user.”[134]

2. The Rationale

[128] *Id.* at 44.
[129] *See id.* at 4-5.
[130] *See* Ronald H. Coase, *The Problem of Social Cost*, 3. J. L. & ECON. 1 (1960).
[131] *See* Ronald H. Coase, *The Nature of the Firm*, 4 J. L. ECON. 1, 10 (1960).
[132] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 263 (1991); MACEY, *supra* note127, 4-5.
[133] EASTERBROOK & FISCHEL, *supra* note 132, at 263.
[134] *Id.*

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The rationale of the property theory in prohibiting insider trading is similar to the rationale of the modern patent system of regulation.[135] To protect the economic incentive to produce socially valuable information, the producers of economically valuable information should be granted a property right to exclude others from using it.[136] Indeed, the production of such information calls for investing of a lot of time, money and effort. Because of those production costs, it is important that the creators have the property rights in information that they developed. Unless the information is copyrighted or patented, any competitor can copy or use that information. As a result, it is possible that the developer will not continue to engage in costly research to develop socially beneficial information because it is unlikely that he will recoup his costs incurred in developing it. This is exactly why our society provides inventors with property rights through the patent system.[137] Although corporate inside information is unlikely to meet the requirements of petentability, the principles of the patent system could serve as guidelines in forming the law of insider trading.

Under this rationale, the inside information would be treated as a firm's asset. Once the property rights in inside information are recognized, any inside information generated in the course of business at the firm's expense would belong to the firm and no one could legally appropriate it.[138] The firm would be entitled to the exclusive use and would have the protection against infringement. Consequently, corporate insiders would not be free to use it for personal benefit unless the firm authorized them to do so.[139] In summary, the property rights in information belong to those who created it under property rights theory.

It is obvious that the rationale of the property rights in information has nothing to do with the disclose or abstain rule or Rule 10b-5. Instead,

[135] STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 165-66 (1999).
[136] *See id.*
[137] *See id.* at 166.
[138] *See* BERGMANS, *supra* note 29, at 137.
[139] *See id*. at 139.

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liability for insider trading would be imposed only on persons who used corporate inside information for their personal benefit.[140] Therefore, the prohibition of insider trading would no longer be concerned with traders who owe fiduciary duty to those with whom they trade or to the source of information. The property rights in information theory places the focus on thief of information rather than on various forms of a fiduciary duty.

3. A Critique of Property Rights in Information Theory

If we accept the protection of property rights as the appropriate rationale for regulating insider trading, some questions still remain open. First, can the corporation use the inside information to trade in its own securities for its own profit? As the property rights allow their owner to freely use the inside information or keep it secret, the answer may be yes. Consequently, it would be difficult to justify the prohibition of such trading under this theory because the inside information belongs to the corporation. The owner of the would be entitle to transfer or tip it to other persons, gratuitously or for consideration. In other words, the insider trading rules under this theory would simply be antitheft laws under this theory. A person would not be considered a thief if he obtained a consent from the owner to appropriate the information for his personal benefit. Without a doubt, the disclosure regime would be destroyed if this theory were accepted. On close examination, the justification offered by the property rights theory, that the insider information is similar to other property rights that are freely alienable, does not seem to fully accomplish the underlying purpose of regulating insider trading, which is to preserve a fair public securities markets. Professor Karmel argued that "the view that inside information is a property right that insiders should be permitted to exploit is morally obnoxious and legally unsound. Simply

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[140] *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1257 (1995).

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put, it is an attempt to transform the dark side of capitalism into a public good but it wholly ignores the public interest and public opinion."[141]

The second question under the property rights in information theory is: will a corporation truly suffer any damages when an insider wrongfully uses the corporate information for his personal gain? The rationale of the property rights in information is based on the rationale of the intellectual property system. The property right in valuable information is given to the developer to recoup his costs incurred in developing it. When someone infringes on that property right, the owner of information can ask to be awarded damages. Accordingly, the liability for such infringement is premised on the existence of an owner. Copyrights, patents, and trade secrets regulations results in the actual damages. The same may not necessarily be true for inside information, because it is possible that insider trading would not interfere with the corporation's use of the same information and probably would not diminish its value to the corporation.[142] Suppose, for example, that an insider X knows that his hardware company successfully obtained a contract with IBM that is expected to double the company earnings over the next year. If X uses this information to purchase additional shares of his company before the company announces the good news, the subsequent profits most likely will not diminish the value of that inside information. Furthermore, the implications of the property rights in information theory become troubling when we start dealing with the attenuated circumstances, especially with respect to "market information," because such information typically comes from outside the firm and may be entirely unknown to that firm's insiders.

E. Comment

1. A Critique of the Fiduciary-Oriented Theories

[141] *See* Roberta S. Karmel, *The Relationship between Mandatory Disclosure and Prohibitions against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable?* 59 BROOK. L. REV. 149, 168 (1993).
[142] *See* BAINBRIDGE, *supra* note 135, at 166-67.

It is true that the classical theory cannot resolve all of the problems associated with insider trading. The misappropriation theory cannot do it well either. Generally speaking, there seems to be no easy way to resolve the problem of the unfair use of material nonpublic corporate information by outsiders under the strategies of the traditional insider trading analysis. In other words, the goal of protecting investors' expectations of fairness, honesty, and integrity of the public securities markets can not be achieved if we continue insisting the liability of insider trading be based on fiduciary duty that one may owe to the person with whom they trade or to the source of the inside information.

The fiduciary duty approach makes a lot of sense under the classical insider trading analysis. The true insider should not be allowed to get an unjust profit in trading with the shareholders because the insider owes the fiduciary duty to the shareholders. The rule requiring disclosure can prevent the insiders from using inside information to their benefit at the expense of uninformed shareholders. Hence, an insider has a fiduciary obligation to either disclose the inside information to the shareholders or to abstain from trading with them.

The same, however, is not true under the misappropriation theory. First, the insider's relationship to the corporation's shareholders is very different from the misappropriator's relationship to the corporation's shareholders. More specifically, a corporate insider owes a fiduciary duty to the corporation's shareholders, whereas a misappropriator owes no such duty at all to the corporation's shareholders; the misappropriator owes the fiduciary duty only to the source of inside information. Without a fiduciary duty owed to the shareholders, the disclose or abstain rule cannot be applied. The Supreme Court in O'Hagan held that the misappropriator was obligated to disclose the misappropriated information to his source or not to trade on it for his personal benefit. This, however, does not accomplish the main purpose of the disclosure rules, which is to protect the trading counter parties. Moreover, in most

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misappropriation situation, early disclosure of the misappropriated information to the public would have only further harmed the person or entity to whom the duty was owed.[143]

Accordingly, the insider trading problem is mainly a fiduciary duty issue under the Supreme Court's Rule 10b-5 jurisprudence. The elements of the disclose or abstain analysis include the following: (1) there must be a relationship of trust and confidence between the insiders and the shareholders or the source of inside information; (2) if the relationship meets the requirement of fiduciary relationship, then it gives rise to a duty to disclose or abstain; and (3) one who fails to disclose material information given the existence of the prior two elements commits fraud. Although these elements seem to be clear, a certain amount of vagueness and uncertainty regarding the source of fiduciary duty remains.

The first question is what law defines the source and nature of the fiduciary duty? It is the federal common law or the state corporate law? If the answer is federal common law, we have to face the circular reasoning problem in finding the source of fiduciary duty. According to the disclose or abstain rule, on one hand, nondisclosure of inside information before trading will not violate Rule 10b-5 if the trader owes no fiduciary duty to his counter parties. On the other hand, Rule 10b-5 liability arises only when one party has a fiduciary duty to disclose before trading. Then, this approach begs the question - how do we know whether the defendant is a fiduciary? In fact, Rule 10b-5 is only concerned with fraud, not with the fiduciary duty at all. Thus, it is impossible to rely on Rule 10b-5 to decide if there is a breach of fiduciary duty by the defendant. The finding of the requisite fiduciary relationship, therefore, appears to be outside the scope of the federal law.

In Santa Fe Industries, Inc. v. Green,[144] the court held that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize

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[143] David M. Brodsky & Daniel J. Kramer & Schulte Roth & Zabel LLP, *A Critique of the Misappropriation Theory of Insider Trading,* SB93 ALI-ABA 105, 131 (1997).

[144] 430 U.S. 462 (1977).

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the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[145] Thus, with respect to the source of fiduciary duty, the Court seems to direct us toward the state law because the federal fiduciary duty analysis would override the well-established state policies of corporate regulation.[146] This, in turn, suggests further inquiry. Have states uniformly adopted the duty to disclose or abstain from trading rule when a fiduciary relationship is involved? If not, which state law should govern?

Finally, in Chiarella, the Supreme Court had quoted Restatement (Second) of Torts section 551(2)(a)[147] to support its classical theory and then held that "[the] duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[148] The Court seemed to fail to realize that section 551(2)(e) could provide another avenue for compelling disclosure aside from the fiduciary duty analysis.[149] According to section 551(2)(e), the duty to disclose arises to any person who has "facts basic to the transaction, if he

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[145] Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 471-72 (1977).

[146] *See* BAINBRIDGE, *supra* note 135, at 63-67.

[147] *See* Restatement (Second) of Torts § 551(2)(a) (1976). Section 551 (2)(a) states:

> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.

[148] Chiarella v. United States 445 U.S. 222, 228 (1980).

[149] *See* Micah A. Acoba, Note, *Insider Trading Jurisprudence after United States v. O'Hagan: A Restatement (Second) of Torts § 551(2) Perspective*, 84 CORNELL L. REV. 1356, 1407-16 (1999).

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knows that the other party is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the custom of the trade or other objective circumstances, would reasonably expect a disclosure of those facts."[150] Thus, the duty to disclose does not necessarily have to arise from the fiduciary relationship. It would have been reasonable for the Court to apply section 551(2)(e) to insider trading transaction in creating the fairness-based disclose or abstain rule. The undisclosed material nonpublic information would satisfy the "basic fact" requirement. Also, the insider would know that his counter parties are trading under a mistake resulting from the nondisclosure of the basic information and that they are relying on the concept of fair and honest securities markets when trading. Each investor would reasonably expect the disclosure of a basic fact concerning the stock in a fair and honest securities market. Section 551(2)(e) would reach all transacting parties who own material nonpublic information that the investing public could not discover through diligence.

2. Rethinking the Insider Trading Theory

The fiduciary-duty based insider trading rules are confusing and raise many questions, as indicated in the previous discussion. The insider trading prohibition rules ought to be viewed as means of protecting the integrity of securities markets, rather than as means of protecting property rights in information or preventing the fiduciaries' secret profits. The possession theory seems to be the most effective theory for protecting the integrity of the securities markets.

The advantage of the possession theory is that it provides a simple bright-line rule that prohibits anyone from trading while in possession of material nonpublic information. The basis for the possession theory liability is not rooted only in the information advantage but rather is founded upon unequal legal access. In other words, the right of anyone who can legally accesses the material nonpublic information should be protected. Thus, all trading by any person possessing the material

[150] Restatement (Second) of Torts § 551(2)(e) (1976).

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nonpublic information should be prohibited, except by those one who legally possess and can legally use that information. Professor Seligman endorsed this approach and suggested some exceptions to the possession theory.[151]

[151] *See* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L. J. 1083, 1138 (1985). Dean Seligman suggested:

> In order to harmonize the new standard with other parts of the securities law, there would have to be several exceptions to a prohibition on trading while in possession of material nonpublic information. First, the new statute would need to parallel the Williams Act and exempt potential takeover bidders who possess less than five percent of a target from the disclose or abstain rule. Second, the new statutory section should legitimate the 'Chinese Wall' defense, by which securities broker-dealer firms that receive nonpublic information from firms for underwriting or other purposes will not be held liable if their brokers simultaneously make recommendations concerning the firms, as long as the broker-dealer firms have implemented procedures to prevent the brokers from knowing the information provided to their underwriting or other departments. The 'Chinese Wall' defense has been recognized in both rule 14e-3 and rule 10b-5 case law. Third, the new statutory provision, either in its text or in the accompanying legislative report, should affirm that securities analysts may discover immaterial nonpublic information and may form opinions or make recommendations based on such data without risk of liability. Fourth, the new provision should permit stock or options exchange specialists, market-markers or floor traders to trade while in possession of material nonpublic information about trading activity on the floor of an exchange to the extent that such trading is permitted by section 11 of the Securities Exchange Act or Stock Exchange rules (which are adopted after SEC approval). Congress, no doubt, would also consider other exceptions to the general prohibition on trading while in possession of material nonpublic information.

Id.

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In summary, the possession theory does not seek to prevent anyone who is in possession of material information due to his lawful skill or diligence from engaging in securities transactions. On contrary, the possession theory protects the interests of stockbrokers, investments analysts and other market professionals in enjoying the informational advantages derived from their exercise of effort and diligence.

Having discussed a number of justifications for insider trading law presented in various Supreme Court and Appellate opinions and by various learned commentator, the consensus is a person in possession of material nonpublic information should be prevented from wrongfully benefiting from such information when trading in securities.. As such, the insider trading liability is imposed on the insider who fails to refrain from trading, rather than on the one who fails to disclose. The possession theory has already directly provided us with a shortcut to the destination of protecting the integrity of the securities markets. We just need to realize the true meaning of the possession theory. We do not need to detour around it to get what we want. The misappropriation theory, however, seems to be a detour to the destination of protecting the integrity of securities markets.

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Ⅳ. CONCLUSION

What is wrong with insider trading? It is wrong because it allows insiders to always have an information advantage over outsiders, which is unfair to the uninformed outsiders. Meaningful private contracting between investors and insiders over the use of nonpublic information is impossible under the current corporate regime. After all, it is true that most investing individuals are unsophisticated and unable to fend for themselves. Professor Manne and scholars building on his work overlook the fact that there is a public interest in the securities marketplace and that the insider trading regulations should ensure that investing public has

confidence that insiders will not take advantage of them.[152] Without the prohibition of insider trading, the efficient, sound, and fair securities markets would be difficult to achieve.

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[152] *See* J. WILLIAM HICKS, INTERNATIONAL SECURITIES REGULATION 4-11 to 4-12 (2000). Professor Hicks argued:

> At least three reasons have been advanced in the United States for believing that the public has a legitimate interest in the securities market. These reasons arguably support regulation of some form in the area of investment decision-making.
>
> *National Property Resource*. Securities are an important form of private property, but they also represent an integral part of the resources of a large segment of this country's population. Arguably, the public has a legitimate interest in the long-term financial security of its important resources.
>
> *Availability of Capital*. The safety, soundness, and efficiency of the trading markets have a direct bearing on the flow of new capital into private enterprise. This relationship in turn has a bearing on the country's rate of economic growth. These same points can made with respect of the flow of new capital into public issuers – including the National Government, states and municipalities, and government-sponsored entities, such as Fannie Mase and Freddie Mac.
>
> *Economic Health*. The securities markets can affect the nation's general economy and well-being. The stock market crash in 1929 and the market break in 1987 are events that demonstrated the close interrelationship between the securities marke6ts and the nation as a whole. Imperfections and fraud in the capital markets inflict harm on many more persons than the investors who are directly effected. In 1934, the U.S. Congress passed the Securities Exchange Act of 1934. In that statute, the Congress expressed its belief that the public had an interest in the domestic securities markets, stating that "national emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of

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Having a legal informational advantage due to one's wealth, diligence, knowledge, and experience, is allowed and even encouraged in order to maximize one's profits in the securities markets.[153] Neither law nor the possession theory suggests that any person possessing this type of informational advantage should be prohibited from using it to his advantage. However, if the position of informational advantage was acquired by theft or any other illicit act, it is reasonable to expect that public policy would prohibit this kind of unfair informational advantage in the securities markets.[154] The possession theory of insider trading is justified on this principle.

The possession theory is superior to the other fiduciary-duty based theories and to the property rights in information theory because it provides a simple bright-line rule that prevents a person while in possession of material nonpublic information from trading unless the person has the legitimate right of access to that information.

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security prices and by excessive speculation on such exchanges and markets" (footnote omission)
Id.

[153] *See id*. at 4-9.
[154] *Id*.

國證券內線交易規範法理論之批判與檢討

莊永丞*

摘　要

本文主要在批判探討美國證券內線交易 (Insider Trading) 規範之法理論。藉由美國當代規範內線交易法理論之發展，了解內線交易違法性之源由及其規範之必要，而現今美國規範內線交易之法理論，不論是忠實義務理論 (Fiduciary Duty Theory) 抑或不正私取理論 (Misappropriation Theory)，皆是以受任人忠實義務之違反為理論基礎；前者係以內部人違反對於公司之忠實義務，後者則以內部人違反對於內線消息來源保密之忠實義務，本文對於美國以忠實義務違反之有無，作為內線交易責任有無之依據，難表贊同。此外，對於法與經濟學派所採之財產權理論 (The Property Rights in Information Theory)，本文亦提出不同的見解。

總之，為了確保一般投資人對於證券市場公正性之信賴，本文以為正本清源之道在於應給予內線消息持有理論 (The Possession Theory) 正面的評價，並應釐清部份學者與實務界對於該理論之誤解，如此，對於內線交易之規範，定可收事半功倍之效。

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