

April 1998

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Paula J. Dalley

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### Repository Citation

Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 Wm. & Mary L. Rev. 1289 (1998), <https://scholarship.law.wm.edu/wmlr/vol39/iss4/6>

# FROM HORSE TRADING TO INSIDER TRADING: THE HISTORICAL ANTECEDENTS OF THE INSIDER TRADING DEBATE

PAULA J. DALLEY\*

## INTRODUCTION

Generally speaking, a corporate insider<sup>1</sup> may not buy or sell a corporation's securities while that insider is in possession of material, nonpublic information relating to that corporation's securities. This is the so-called "disclose or abstain" rule, embodied in Rule 10b-5<sup>2</sup> promulgated under Section 10(b)<sup>3</sup> of the Se-

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\* Assistant Professor of Law, Oklahoma City University School of Law.

1. The term "insider" is used to refer to an officer, a director, or a controlling stockholder because those are the persons generally held to have fiduciary duties to the corporation. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 913-16 (1961). The term "insider trading" is used to mean trading in stock while in possession of material, nonpublic information, whether by insiders or not.

2. Rule 10b-5 provides:

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,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1951). The "disclose or abstain" rule is usually held to derive from clause (c) of the Rule.

3. Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

curities Exchange Act of 1934 (the "1934 Act").<sup>4</sup> The law is a great deal more complex than this simple statement implies; nevertheless, the courts have not had significant difficulty applying the basic disclose-or-abstain rule in its simplest form.

The case generally credited with creating the disclose-or-abstain rule is *SEC v. Texas Gulf Sulphur Co.*,<sup>5</sup> in which executives of Texas Gulf Sulphur, among others, who were aware that the company had made a rich mineral strike, purchased shares of the company's stock.<sup>6</sup> The company had not publicized the strike for a number of reasons, not the least of which was that it had not yet acquired the land surrounding the area where the strike had been made,<sup>7</sup> and it wanted to complete the acquisition before the public—and the owners of the land—learned of the strike. The insiders were found to have committed securities fraud by purchasing stock from sellers who were unaware of the "real" value of the stock.<sup>8</sup> No one thought, however, that the company had entered into a contract fraudulently by purchasing the land from sellers who were unaware of the "real" value of the land.<sup>9</sup> In fact, the common law of fraud seems to be quite clear that the company's purchase of the land was *not* fraud.<sup>10</sup>

At first glance, there might be a number of reasons for this difference between contract and securities law, the most obvious of which is that the securities market is different from the real property market.<sup>11</sup> Well-functioning capital markets are an es-

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15 U.S.C. § 78j(b) (1988).

4. The language of Rule 10b-5 comes from section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1994)). The Rule was adopted without discussion in 1943. See 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3485-88 (3d ed. 1991); *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-23 (1967).

5. 401 F.2d 833 (2d Cir. 1968).

6. See *id.* at 844.

7. See *id.* at 843.

8. See *id.* at 852.

9. The expression "real value" is used here to mean the price based on the best information currently available, whether public or not.

10. See Paula J. Dalley, *The Law of Deceit, 1790-1860: Continuity Amidst Change*, 39 AM. J. LEGAL HIST. 405, 427, n.117 (1995); CHARLES FRIED, *CONTRACT AS PROMISE* 77-85 (1981).

11. See *In Re Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961) ("[T]he purchase and sale of securities is a field in special need of regulation for the protection of investors."). The Supreme Court has also recognized this fact on at least one occa-

sential feature of an advanced economy;<sup>12</sup> thus, the securities acts, for policy reasons, might require disclosure beyond what was required at common law. Furthermore, given that the oft-cited, but not undisputed, philosophy of the securities laws is to mandate full disclosure of corporate information,<sup>13</sup> it makes sense that mandatory disclosure rules exist in securities transactions. There is a popular belief that to be healthy a securities market must be perceived to be "fair"; securities regulators around the world have adopted antifraud provisions modeled on Rule 10b-5 in an effort to attract investors to their exchanges.<sup>14</sup> A credible account of the disclose-or-abstain rule, therefore, is that it is a deliberate alteration of the common law intended to banish the rule of caveat emptor in the stock market, to encourage wider participation, to reduce the cost of capital, and, thus, to increase the competitiveness of American companies.<sup>15</sup> There is, however, a problem with that account.<sup>16</sup> In 1980, the Supreme Court, in-

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sion. See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194, 201 (1963); see also Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 326-28 (1979) (describing the stock market as exceptional because of the extensive information constantly becoming available).

12. Cf. *Veazie v. Williams*, 49 U.S. 134, 154 (1850) (considering the importance of public faith in the auction process).

13. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477 (1977); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963); cf. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 390-92 nn.25-31 (1990) (stating that the 1934 Act is concerned mainly with market regulation and "has little to do with disclosure").

14. See, e.g., Eugenio Ruggiero, *Regulation of Insider Trading in Italy*, 22 BROOK. J. INT'L L. 157, 160-61 (1996); Lynda M. Ruiz, Note, *European Community Directive on Insider Dealing: A Model for Effective Enforcement of Prohibitions on Insider Trading in International Securities Markets*, 33 COLUM. J. TRANSNAT'L L. 217, 218-19 n.10-13 (1995); Rupert Bruce, *U.S., Britain Spur Asia Toward Reform*, INT'L HERALD TRIB., Oct. 1 1994; Matt Marshall, *Germany's Law on Insider Trading Brings a Conviction*, WALL ST. J., Aug. 21, 1995, at A5.

15. For a list of sources on this point, see 7 LOSS & SELIGMAN, *supra* note 4, at 3451-58, nn.3, 6, 11.

16. Actually, there are several problems with that account. For example, there is a large body of law and economics literature devoted to the proposition that prohibitions on insider trading have no effect whatsoever on encouraging investors to participate in the market; rather, investors simply adjust their investing behavior based on their assessment of the risks that other market participants may have "inside information," just as they adjust for other risks (by diversifying their portfolios, for example). See, e.g., Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary*

interpreting Rule 10b-5 in *Chiarella v. United States*,<sup>17</sup> held that the Rule only prohibited "fraud."<sup>18</sup> Although the definition of fraud under Rule 10b-5 was not limited strictly to common law fraud, the Court was quite clear in its rejection of the argument that Rule 10b-5 required full disclosure in every case.<sup>19</sup> Whatever the securities laws may have done otherwise, they did *not* abrogate the rule of caveat emptor, if, in fact, such was the common law rule before the securities laws were enacted.

What, then, becomes of the disclose-or-abstain rule? The Court preserved the disclose-or-abstain rule as it applies to corporate insiders because such insiders owe fiduciary duties to their shareholders and, therefore, have a duty to disclose material facts.<sup>20</sup> That holding did not comport with the common law, however, because before 1934, not only were insiders generally

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*Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 325-26.

17. 445 U.S. 222 (1980).

18. *See id.* at 234-35.

19. *See id.* at 233.

20. *See id.* at 230. This theory works for insiders who are buying stock because the sellers will necessarily be stockholders at the time of the transaction. It would not apply to insiders selling stock to nonstockholders. The Court solved this problem by adopting prior authority that an insider seller acquires a duty to a buyer (a prospective shareholder) by virtue of the transaction. *See id.* at 227 n.8; *see also* Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123, 127 n.21 (discussing *Chiarella's* analysis of an insider seller's obligation to a nonstockholder buyer). Such a proposition was disputed, to put it mildly, at common law. *Compare* *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206, 212-17 (1908) (holding that a corporation does not have a claim against a promoter because all current shareholders at the time of the promoter's acts consented to those acts) *with* *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 89 N.E. 193 (Mass. 1909) (rejecting the Supreme Court's reasoning and ruling that the corporation does have a claim because additional, future subscribers were contemplated at time of the promoter's acts). Under the fiduciary duty theory, Rule 10b-5 also would not apply to insiders trading options or other derivative securities, but that particular problem was solved by Congress when it added section 20(d) to the 1934 Act, 15 U.S.C. § 78t(d) (1988), which generally provides that trades of options are to be treated as trades of the underlying securities for insider trading purposes. *See generally* Steve Thel, *Section 20(d) of the Securities Exchange Act: Congress, the Supreme Court, the SEC and the Process of Defining Insider Trading*, 69 N.C. L. REV. 1261 (1991) (discussing the implications of Congress's belief that insider trading in stock options is essentially the same as insider trading in stock). The theory continues to be inappropriate for bondholders, to whom insiders owe no fiduciary duty. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH & LEE L. REV. 1189, 1213 *et seq.* (1995).

permitted to trade stock based on nonpublic information,<sup>21</sup> it was doubtful whether insiders owed any fiduciary duties to their shareholders, as opposed to the corporation as an entity.<sup>22</sup> Since 1980, however, it has been the law that it is fraud, under the 1934 Act, for a corporate insider to trade the stock of her corporation while in possession of material, nonpublic information. Such a transaction, unlike the purchase of land with a mine on it, is fraud because, in theory, the trader owes a fiduciary duty to the opposite party in the transaction—the corporation's current and future stockholders—and the remedy, therefore, should be disgorgement of the insider's profits.<sup>23</sup>

The *Chiarella* decision spawned what seems to be a new academic discipline. Hardly a month goes by without an article on insider trading appearing in one legal journal or another.<sup>24</sup> Some of the debate has revolved around whether it is even desirable to regulate insider trading at all. Few contemporary commentators advocate permitting *all* insider trading, but there is a great deal of debate on just what kinds of insider trading to prohibit.<sup>25</sup> Almost everyone agrees, for example, that true cor-

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21. See, e.g., *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933).

22. See Bainbridge, *supra* note 20, at 1218-22.

23. In fact, the theory holds as far as the remedy goes. In the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988), Congress amended the 1934 Act to provide that contemporaneous traders may recover their losses from insider traders; however, insider traders may not be required to pay more in damages than the amount of their profits.

24. See 7 LOSS & SELIGMAN, *supra* note 4, at 3448-51, n.1 (listing academic works on the subject). See, e.g., Edward A. Fallone, *Section 10(B) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 97 U. ILL. L. REV. 71 (1997); Robert A. Prentice, *Locating that "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691 (1997); Shawn J. Lindquist, Note, *United States v. O'Hagan: The Eighth Circuit Throws the Second Strike to the Misappropriation Theory of Rule 10B-5 Liability*, 1997 B.Y.U. L. REV. 197; Michael J. Voves, Comment, *United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into § 14(E) of the Securities Exchange Act*, 81 MINN. L. REV. 1015 (1997).

25. For a lucid summary of the debate, see 7 LOSS & SELIGMAN, *supra* note 4, at 3448-66; WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 13-39 (1996); cf. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 329 (1932). Berle and Means noted:

Debate as to the desirability of the rule [against insider trading] is perhaps profitless. Opinion seems to be divided among business men them-

porate insiders should not be permitted to trade with inside information, but that market and company analysts should be allowed to do so. Where the line between those cases should be drawn, however, remains problematic, as does the legal support for the rules drawing such lines.<sup>26</sup>

Meanwhile, since *Chiarella*, the federal courts have been left to determine what exactly is common law fraud in the securities context. The SEC has tried occasionally to enforce a level playing field by prosecuting *anyone* with superior, nonpublic information. Defendants have included a corporate psychiatrist of an executive's wife<sup>27</sup> and a popular football coach in an advantageous spot at a track meet.<sup>28</sup> The courts have attempted to produce a theory capable of determining when such trading is fraud. Recently, the Supreme Court approved a version of the "misappropriation theory" developed by several federal courts of appeal as a definition of insider trading.<sup>29</sup> That theory answers some questions but raises others. The scholarly commentators and the courts have thus united in an effort to articulate a standard for insider trading. In so doing, they take their places in the ranks of jurists through the centuries who have wrestled

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selves, some holding that the making of incidental profits from trading in the stock of his corporation is one of the ways by which a director gets paid; others, that it should not be permitted save under extraordinary circumstances.

*Id.* Part of the debate has revolved around the question whether anyone is actually harmed by insider trading. See WANG & STEINBERG, *supra*, at 41-117; *infra* notes 316-23 and accompanying text.

26. See, e.g., GULIAN C. VERPLANCK, AN ESSAY ON THE DOCTRINE OF CONTRACTS 57 (1825) ("If there is a distinction in these and thousands of other similar cases where the law applies widely different rules, where is the line to be drawn?"); Brudney, *supra* note 11, at 342-43 (addressing the cost-benefit analysis of denial of informational advantages); 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, 169, 174 (1993) (addressing the need for a line defining insider trading).

27. See *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990); Jeff Cole, *Therapist Pleads Guilty to Fraud in Trading of Lockheed Stock*, WALL ST. J., Dec. 14, 1995, at B5.

28. See *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984). Switzer's location at the track meet enabled him to overhear information about a proposed merger. See *id.* at 762. The court ruled in favor of the defendants. See *id.* at 767.

29. See *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

with the question: "When is it unlawful to buy or sell a thing when you know something the other party doesn't?"<sup>30</sup>

This Article is intended to place the insider trading debate in its historical context by examining the arguments made in recent cases and commentary and comparing them to arguments made in analogous contexts in the past two centuries.<sup>31</sup> Remarkably, the arguments made through the decades hardly have changed at all. Virtually every approach proposed in the Rule 10b-5 literature has direct nineteenth century precursors and remains subject to the same objections that rendered it unacceptable in its earlier appearances. Similarly, Rule 10b-5 cases are just as inconsistent, and the reasoning of the cases just as unsatisfactory, as the common law insider trading cases of a century ago or the general fraud cases of 150 years ago. In short, legal minds and the law itself have been unable to solve one of the most basic questions of commercial behavior: "When must I tell my trading partner what I know?" Faced with the inadequacies of legal solutions, courts and commentators have fallen back on nonlegal standards of ethical behavior, perhaps in tacit acknowledgment of the limitations of legal method.

This Article begins with an attempt to summarize the current law and its legal development. Part I addresses the Supreme Court's fiduciary trading rule, including common law precursors to the rule; the Court's decision; the treatment of *Chiarella* in lower federal courts since 1980; and the recent decision in *United States v. O'Hagan*.<sup>32</sup> Part II examines the various considerations courts and commentators have used in attempting to define the ideal trading rule and traces the use of those considerations in various contexts over the past two centuries. Finally, Part III considers the extent to which stock market transactions

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30. The earliest legal treatment of the issue located, appears in CICERO, DE OFFICIIS [ON DUTIES] Book III, §§ 50-72 (Harry G. Edinger trans., 1974) (44 B.C.). I have limited the scope of this paper to American cases and commentary appearing after 1815.

31. This analysis is confined primarily to liability for fraud, although the doctrine of unilateral mistake would also be applicable in many of the cases discussed. This Article attempts to include representative examples from the insider trading literature instead of providing exhaustive or comprehensive references to the voluminous materials available.

32. 117 S. Ct. 2199 (1997).



differ from other transactions and what the implications of those differences might be. In conclusion, this Article returns to the implacability of the problems presented and the law's reliance on other standards of behavior.

### I. INSIDER TRADING, THE FIDUCIARY TRADING RULE, AND THE MISAPPROPRIATION THEORY

The general rule at common law was that there was no fraud liability for "mere silence"; in other words, a knowledgeable party could buy from or sell to an ignorant party unless there was a "duty to disclose" the nonpublic fact.<sup>33</sup> The problem with that rule was that no one was quite sure what would give rise to a duty to disclose. Some commentators claimed that any superior information gave rise to a duty to disclose.<sup>34</sup> If this were true, however, the exception would completely swallow the rule.<sup>35</sup> Nevertheless, the common law recognized a duty to disclose based solely on superior knowledge in two situations: When the knowledgeable party was an expert, such as an art dealer, and the ignorant party relied on the other's expertise,<sup>36</sup> and when the nonpublic fact was a latent defect that the ignorant party could not discover for himself.<sup>37</sup> There was also a duty to disclose when the nonpublic "fact" was hidden by a false impression produced by the knowledgeable party.<sup>38</sup> The clearest

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33. See, e.g., *Peek v. Gurney*, [1861-73] All E.R. 116 (H.L. 1873) (appeal taken from M.R.); RESTATEMENT (SECOND) OF TORTS § 551(1) (1977); 1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE §§ 204-08, 213-18 (1836).

34. See 2 JAMES KENT, COMMENTARIES ON AMERICAN LAW 378 (1827) (describing the duty to disclose any information not available to the other party); cf. *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (discussing why the obligation to disclose is not limited to corporate insiders).

35. See, e.g., FRIED, *supra* note 10, at 80; STORY, *supra* note 33, § 205, at 214-15.

36. See STORY, *supra* note 33, § 198, at 208; cf. RESTATEMENT (SECOND) OF TORTS § 551 illus. 6-8 (1977) (illustrating the rule that there is no obligation to provide information when the facts are patent or both parties have equal opportunity to obtain the information).

37. Originally, this rule was limited to defects in manufactured goods that could cause bodily injury. See W. Page Keeton, *Fraud-Concealment & Non-disclosure*, 15 TEX. L. REV. 1, 17 (1936).

38. See Keeton, *supra* note 37, at 2-7. This is actually more properly a case of concealment than of failure to disclose or mere silence, but it is included here because of its relevance to the insider trading cases. See *infra* notes 294-95 and accompanying text.

duty to disclose was that which arose between fiduciary and beneficiary.

Clearly, it is unlawful for a knowledgeable party to buy from or sell to an ignorant party when the knowledgeable party owes a fiduciary duty to the ignorant party.<sup>39</sup> This rule (the "fiduciary trading rule") can be traced at least to Joseph Story's early nineteenth century treatises and probably earlier.<sup>40</sup> Given that some fiduciaries are prohibited completely from transacting business with their beneficiaries without consent,<sup>41</sup> the prohibition on transactions where information is unequal is not particularly startling. This rule is such a basic part of fiduciary law that it rarely receives more than a cross-reference in discussions of the general law of sales or fraud.<sup>42</sup> Nevertheless, the fiduciary trading rule developed significance in the second half of the nineteenth century when stockholders tried to use it to support a claim for insider trading against corporate officers and directors. The courts generally rejected their claims, not because the rule was suspect, but because corporate insiders did not owe fiduciary duties to their stockholders. Nevertheless, plaintiffs continued to sue insider traders on the fiduciary trading theory, and a minority rule allowing such suits to go forward developed. At the time the securities acts were enacted, both the majority and minority rules had ample support in the law.

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39. See RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977). There is always a prior issue involved here: Who owes a fiduciary duty to whom? Much of the case law on the misappropriation theory described below can be criticized for misapplying basic fiduciary concepts. A discussion of those issues is beyond the scope of this Article. For an introduction to the problems of fiduciary duties, see Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983).

40. See STORY, *supra* note 33, § 218, at 224; VERPLANCK, *supra* note 26, at 52-53, 188-89.

41. See 2A AUSTIN W. SCOTT, TRUSTS §§ 170-170.23 (1987) (determining that once it is shown that the trustee traded with the beneficiary with respect to the trust corpus, "no further inquiry" will be made).

42. See, e.g., STORY, *supra* note 33, § 218, at 224.

*A. The Majority Rule: Corporate Insiders Owe No Duty to Shareholders*

One of the first cases to consider what we know as insider trading was *Carpenter v. Danforth*.<sup>43</sup> The lower court in that case stated that, "[t]hough probably the relation of trustee and *cestui que* trust did not strictly exist" between the plaintiff stockholder and the defendant director, "considering their situation and relations to the stock in question," the defendant "was bound to disclose to the plaintiff all the material facts within his knowledge, which tended to enhance the value of the stock."<sup>44</sup> The Appellate Division reversed.<sup>45</sup>

[T]he trust put in the directors usually extends . . . only to the management of the general affairs of the corporation . . . . The plaintiff's *stock* was not the subject of trust between them, . . . except so far as the good or bad management of the general affairs of the corporation by its directors, indirectly affects the value of its stock.<sup>46</sup>

The court also reasoned that stock traded in the market is bought and sold at a market price without any reference to the "real value" of the shares. It would therefore not make sense to place a duty on a director, trading in the market, to disclose facts bearing on the real value of the stock.<sup>47</sup> Because the rule affecting directors should be the same regardless of the manner in which the stock is traded, there also could be no duty to disclose even in a face-to-face transaction.<sup>48</sup>

The court's holding in *Carpenter* that the director's admitted duty to the corporation did not extend to the shareholder with

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43. 19 Abb. Pr. 225 (N.Y. Sup. Ct. 1865), *rev'd*, 52 Barb. 581 (N.Y. App. Div. 1868). There was at least one prior case, *Spence v. Whitaker*, 3 Port. 297 (Ala. 1836), in which the court held for the plaintiff because *only* the defendant had the ability to know the actual value of the stock. *See id.* at 324-26.

44. *Carpenter*, 19 Abb. Pr. at 227.

45. *See Carpenter*, 52 Barb. at 581.

46. *Id.* at 584.

47. For a rejection of this argument, see BERLE & MEANS, *supra* note 25, at 328. For a discussion of the role of an impersonal trading market in insider trading analysis, see *infra* notes 305-327 and accompanying text.

48. *See Carpenter*, 52 Barb. at 586.

respect to his shares<sup>49</sup> was adopted quickly by other courts. In 1873 the Indiana Supreme Court,<sup>50</sup> and in 1874 the Tennessee Supreme Court,<sup>51</sup> rendered decisions closely following *Carpenter*. The *Carpenter* holding thus became the majority rule.<sup>52</sup>

Cases following *Carpenter* often relied on the earlier case of *Smith v. Hurd*,<sup>53</sup> which involved an action by stockholders against the directors for, essentially, waste and mismanagement. Chief Justice Shaw wrote that the action belonged to the corporation and not to the individual shareholders because the injury was to the corporation and its creditors and only indirectly to the stockholders.<sup>54</sup> *Smith v. Hurd* is, therefore, part of the foundation of the derivative suit.<sup>55</sup> Needless to say, perhaps, the reasoning in *Smith v. Hurd* does not necessarily require a holding that directors do not owe a duty to stockholders with respect to the purchase of their individual shares,<sup>56</sup> although in

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49. The court in *Carpenter* discussed that the information that the plaintiff alleged had been withheld (a favorable government contract) was in fact unknown to the insider, or at most speculative, at the time of the stock purchase. Also, the court framed the ultimate question as "Did [the defendant] intentionally do or say anything, to divert or prevent . . . the plaintiff from looking into, or making inquiry, . . . as to the affairs or condition of the company." *Id.* at 589. This formula derives from the general law of fraud, which required that a party remain strictly silent—neither actively lying nor taking steps to prevent inquiry. See Dalley, *supra* note 10, at 426-27.

50. See *Tipppecanoe County Comm'rs v. Reynolds*, 44 Ind. 509, 513 (1873).

51. See *Deaderick v. Wilson*, 67 Tenn. 108 (1874).

52. See, e.g., *Stout v. Cunningham*, 196 P. 208 (Idaho 1921); *Walsh v. Goulden*, 90 N.W. 406 (Mich. 1902); *Crowell v. Jackson*, 23 A. 426 (N.J. 1891); *Krumbhaar v. Griffiths*, 25 A. 64 (Penn. 1892); *Haarstick v. Fox*, 33 P. 251 (Utah 1893); see also A.A. Berle, Jr., *Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827, 828-29 (1927) (stating majority rule); Clarence D. Laylin, *The Duty of a Director Purchasing Shares of Stock*, 27 YALE L.J. 731, 731-32 (1918) (stating majority rule); H. L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267 (1910) (stating majority rule); R.E. Heinselman, Annotation, *Duty of Officer or Director of Corporation toward One from whom he Purchases Stock*, 84 A.L.R. 615, 630 *et seq.* (1933) (stating majority rule).

53. 53 Mass. (12 Met.) 371 (1847). The court in *Carpenter* did not cite *Smith v. Hurd*.

54. See *id.* at 384-86.

55. The equitable remedy for shareholders' derivative claims was recognized in *Massachusetts in Peabody v. Flint*, 88 Mass. (6 Allen) 52 (1863). See also *Dodge v. Woolsey*, 59 U.S. 331, 342 (1855) (stating that "where the legal remedy against a corporation is inadequate, a court of equity will interfere").

56. The law today, of course, requires that shareholders sue derivatively for gener-

many nineteenth century cases it is difficult to tell whether the gist of the plaintiff's claim is waste or insider trading. Many stockholders alleged that the insiders managed the company and controlled the flow of information so as to depress the stock price—by not paying dividends, taking out large loans, painting a gloomy picture of business prospects, etc.—and then, knowing that the stockholders were under a misapprehension, the insiders purchased the stock for less than they knew it was worth.<sup>57</sup> The company then would experience a miraculous turnaround and proceed to pay large dividends. It is perhaps not surprising to see *Smith v. Hurd* cited in such cases.

*Smith v. Hurd* is also important because it established a precedent recognizing the corporation as an entity and denying privity between shareholders and directors.<sup>58</sup> The question of whether directors owed fiduciary duties directly to their stockholders, rather than to the corporate entity as a whole, had implications beyond the insider trading cases. The legal conception of the corporation—as an artificial entity, as an “aggregate” akin to a partnership, or as a “natural” entity—was in flux from the 1870s to the 1920s,<sup>59</sup> and the insider trading cases were doubtless influenced by those theoretical concerns. The controversy over the entity theory of the corporation may explain why in many late nineteenth and early twentieth century cases, the courts ex-

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alized harm to the corporation from mismanagement, see *infra* text accompanying notes 109-11, but also allows trading shareholders to sue insiders directly for insider trading under the 1934 Act. See *SEC v. Texas Sulphur Co.*, 401 F.2d 833, 847-52 (2d Cir. 1968).

57. See, e.g., *Ritchie v. McMullen*, 79 F. 522 (6th Cir. 1897) (discussing the defendants' mismanagement of all aspects of the corporation in order to depreciate stock values); *Stewart v. Harris*, 77 P. 277 (Kan. 1904) (addressing the turnaround in financial condition of troubled bank not reflected in books); *Woodruff v. Cole*, 269 S.W. 599 (Mo. 1925) (discussing a defendant who caused the company to enter into debt and fail to pay dividends); *Wann v. Scullin*, 109 S.W. 688 (Mo. 1908) (discussing the defendants who allegedly depressed the railroad's value by reducing fares and then bought the company); *Von Au v. Magenheimer*, 110 N.Y.S. 629 (App. Div. 1908) (addressing the case in which the defendant stated it was unlikely the company would ever pay dividends).

58. See *Smith*, 53 Mass. at 384.

59. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870-1960* 65-108 (1992). For an earlier discussion of fiduciary duties, the entity theory of the corporation, and insider trading, see BERLE & MEANS, *supra* note 25, at 221-26; Laylin, *supra* note 52, at 733 *et seq.*

pounded unnecessarily on the existence of a fiduciary relationship between insiders and their stockholders in cases involving unrelated issues or factual settings.<sup>60</sup> In other cases, the courts expressly refused to consider the fiduciary duty question.<sup>61</sup>

There are explanations for the majority rule other than that it accorded with the understanding of the corporation as a separate entity. There may be an instrumentalist explanation—that courts were concerned that people would not be willing to serve as directors if they were not able to profit from their positions.<sup>62</sup> Additionally, some courts attributed the plaintiff's loss and the insider's gain simply to luck, business acumen, and willingness to take risks.<sup>63</sup> The majority rule, in those courts' view, simply reflected the realities of the business world.<sup>64</sup> Additionally, some courts based their decisions on the fact that the corporate books were available by statute to any shareholder. If a shareholder imprudently neglected to examine the books prior to agreeing to a sale, then he or she should not be allowed later to complain that

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60. See, e.g., *Steinfeld v. Nielson*, 100 P. 1094, 1101-02 (Ariz. 1909) (discussing an insider's fiduciary duty in a case in which the seller was also an insider and in which the price was not inadequate); *Stout v. Cunningham*, 196 P. 208, 209 (Idaho 1921) (stating in dictum that an insider owes no duty in a case not involving a corporate officer and not involving insider trading); *Mulvane v. O'Brien*, 49 P. 607, 612 (Kan. 1897) (stating in dictum that an insider owes a duty in a case in which insider was also seller's agent); *Walsh v. Goulden*, 90 N.W. 406, 409 (Mich. 1902) (stating in dictum that an insider does not owe a duty in a case not involving a failure to disclose); *Von Au*, 110 N.Y.S. at 629 (stating in dictum that an insider owes a duty in a case involving actual fraud); *Haarstick v. Fox*, 33 P. 251, 253 (Utah 1893) (stating in dictum that an insider has no duty in a case not involving inside information).

61. See, e.g., *Woodruff*, 269 S.W. at 604; *Baird v. Granniss*, 106 S.W. 980, 982 (Mo. 1907).

62. See *infra* note 187 and accompanying text.

63. See, e.g., *Grant v. Attrill*, 11 F. 469, 470 (C.C.S.D.N.Y. 1882) (rejecting a claim of duty); *Oliver v. Oliver*, 45 S.E. 232, 233, (Ga. 1903) (finding a fiduciary duty); *Stewart v. Harris*, 77 P. 277, 281 (Kan. 1904) (noting the advantages of skill and judgment but also finding a fiduciary duty); *Boulden v. Stilwell*, 60 A. 609, 612 (Md. 1905) ("it must be held his own lack of business prudence and business courage which caused him to cancel his contract and sell his stock under the circumstances stated"); *Woodruff*, 269 S.W. at 601, 604 (discussing the fact that the plaintiff advocated a policy that was rejected by the board; therefore, the board's policy ultimately paid off); *infra* notes 163-65 and accompanying text.

64. For a vehement argument in favor of the majority rule on these grounds, see *Roberts Walker, The Duty of Disclosure of a Director Purchasing Stock from His Stockholders*, 32 YALE L.J. 637 (1923).

the purchase price was too low.<sup>65</sup> Courts often neglected to offer any justification for the rule. Sometimes, however, they acknowledged the immorality of the defendant's acts but noted that the dictates of law and morality do not always coincide.<sup>66</sup>

*B. The Minority View: Corporate Insiders Owe Duties to Shareholders*

The sense that the defendant behaved immorally or unfairly seems to underlie the minority rule, which developed more or less concurrently with the majority view. One of the earlier cases allowing a plaintiff to recover from an insider who bought the plaintiff's shares at an artificially low price was *Fisher v. Budlong*.<sup>67</sup> The court in *Fisher* noted that, although the usual rule in sales was that neither party had a duty to disclose material information, the rule differed where there was a "peculiar relation implying confidence or leading to confidence" between the parties.<sup>68</sup> The equities in *Fisher* were in favor of the plaintiff: the defendant professed to be aiding the plaintiff in finding a buyer for the stock; the defendant then purchased the stock surreptitiously through a straw man.<sup>69</sup> The court stated:

although any single officer cannot perhaps be considered as standing in the relation of trustee to each stockholder, yet . . . it would be considered as a reason for confidence, and more especially when this officer is practically the sole manager of the corporation, and the stockholder has a right to

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65. See *Oliver*, 45 S.E. at 234; *Walsh*, 90 N.W. at 410; *Woodruff*, 269 S.W. at 604, 601; . This, too, was simply a recognized doctrine in the law of fraud, arising from the requirement that the plaintiff's reliance on the defendant's representations be reasonable. See *Dalley*, *supra* note 10, at 419-24.

66. See, e.g., *Grant*, 11 F. at 470; *Boulden*, 60 A. at 610.

67. 10 R.I. 525 (1873). An earlier case was *Walsham v. Stainton*, 46 Eng. Rep. 268 (Ch. 1863). That case was often cited by later cases finding a fiduciary duty, but in *Walsham*, the nature of the company was unclear. The justices referred to the members of the company sometimes as "partners" and sometimes as "shareholders," and the organization, which may have been a joint-stock company, had certain partnershiplike features, such as monthly meetings of members. The case was often cited, however, for the language that "[a]gents are, in a sense, trustees." *Id.* at 272.

68. *Fisher*, 10 R.I. at 528.

69. This might have created a cause of action for misrepresentation, if the defendant actually lied to the plaintiff. The court did not discuss such a claim, however.

call on him for this very information [about the value of the stock].<sup>70</sup>

The plaintiff had a legal right to rely on the defendant's statements, and the defendant should have known that his statements would be so relied on by the plaintiff.<sup>71</sup> The plaintiff, therefore, was able to recover his damages.

Despite this early start, the minority rule did not attract many judicial adherents until *Oliver v. Oliver*<sup>72</sup> in 1903. The court in *Oliver* discussed at length the relationship between the shareholders and the directors and concluded that insiders are "quasi-trustees."<sup>73</sup> An insider may not be able to disclose certain corporate secrets, but "it does not follow that he may use [such information] to his own advantage, and to the disadvantage of one whom he also represents."<sup>74</sup> The director, according to the court, "occupies a fiduciary position and is essentially within the rule which requires agents . . . or other fiduciaries, to exercise the highest degree of good faith as to all matters connected with the property committed to their care."<sup>75</sup> The court reasoned that a rule that the insider did not owe a duty to the shareholders would lead to the conclusion that "while a director is bound to serve stockholders en masse, he may antagonize them one by one; that he is an officer of the company, but may

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70. *Id.* at 529.

71. *See id.* This reasoning focuses on the reliance element of fraud. Admitted lies by a defendant will not support a cause of action if the plaintiff's reliance on the lies was not reasonable. Some insider-buyers therefore sought to avoid liability even when they actually lied about the value of the company (as was the case in *Fisher*). *See also Voellmeck v. Harding*, 6 P.2d 373, 375 (Wash. 1931) (discussing the right to rely).

72. 45 S.E. 232 (Ga. 1903).

73. *See id.* at 233-35.

74. *Id.* at 234. The court propounded a "disclose or abstain" rule much like that created by *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968). *See supra* notes 5-10 and accompanying text. "The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known." *Oliver*, 45 S.E. at 234.

75. *Oliver*, 45 S.E. at 234. The court treated corporate secrets as assets of the corporation, which a fiduciary (which an insider certainly is with respect to the corporation) may not use to his personal advantage under basic agency principles. *See id.*; *infra* notes 249-65 and accompanying text.



be the foe of each private in the ranks."<sup>76</sup>

After *Oliver*, courts became increasingly willing to allow plaintiffs' claims against insider traders to go forward.<sup>77</sup> The majority rule cases were criticized as old and outdated and as leaving shareholders to the mercy of managers.<sup>78</sup> The courts argued that the law "cannot give its approval to a course of dealing that will permit those occupying a trust relation to be unmindful of the trust, betray the confidence reposed, and profit by such betrayal."<sup>79</sup>

The U.S. Supreme Court gave further impetus to the trend allowing plaintiffs to recover when it enunciated the "special facts" doctrine in *Strong v. Repide*.<sup>80</sup> *Strong* involved a shareholder who sold out to an insider while an advantageous sale of the entire company was pending, but not public knowledge.<sup>81</sup> The Court ruled that, even if directors do not have a general duty to their shareholders, there may be a duty where "special facts" exist.<sup>82</sup> In this case, the defendant was conducting the negotiations for the sale of a company that he had almost complete control over when the sale occurred.<sup>83</sup> As negotiator, he

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76. *Oliver*, 45 S.E. at 235.

77. Several cases adopted the *Oliver* holding. See, e.g., *Strong v. Repide*, 213 U.S. 419, 431 (1909); *Steinfeld v. Nielsen*, 100 P. 1094, 1102 (Ariz. 1909), *rev'd*, 139 P. 879 (1913); *Hotchkiss v. Fischer*, 16 P.2d 531, 533 (Kan. 1932); *Stewart v. Harris*, 77 P. 277 (Kan. 1904); *Jacquith v. Mason*, 156 N.W. 1041, 1043 (Neb. 1916).

78. See, e.g., *Stewart*, 77 P. at 280-81.

79. *Id.* at 281.

80. 213 U.S. 419, 431 (1909).

81. See *id.* This was a common fact pattern. See, e.g., *Oliver*, 45 S.E. at 232; *Tippecanoe County Comm'rs v. Reynolds*, 44 Ind. 509 (1873); *Walsh v. Goulden*, 90 N.W. 406 (Mich. 1902); *Krumbhaar v. Griffiths*, 15 A. 64 (Pa. 1892); *Voellmeck v. Harding*, 6 P.2d 373 (Wash. 1931); see also *Stout v. Cunningham*, 196 P. 208 (Idaho 1921) (addressing a tender offer); *Jacquith v. Mason*, 156 N.W. 1041 (Neb. 1916) (addressing the same).

82. *Strong*, 213 U.S. at 431. Most commentators treat the special facts cases as distinct from the minority view because the inquiry in the special facts cases focused not on the fiduciary status of the defendant, but on the nature of the information. See 7 LOSS & SELIGMAN, *supra* note 4, at 3475. But see *Chiarella v. United States*, 445 U.S. 222, 228 n.10 (1980) ("The decision in *Strong v. Repide* was premised upon the fiduciary duty between the corporate insider and the shareholder."); *Berle*, *supra* note 52, at 834 (noting that the special circumstances rule implies a fiduciary relationship, contrary to the majority rule). The discussion is included here for the sake of economy.

83. See *Strong*, 213 U.S. at 421.

was "acting substantially as the agent of the shareholders of his company."<sup>84</sup> His information about the sale therefore came to him because of his position as the shareholders' agent.<sup>85</sup> Under these circumstances, he had a duty to disclose the information to the seller.<sup>86</sup> Although the facts in *Strong* were at least somewhat unusual, in that the sale of the company was completely in the control of the director, the case was cited widely as supporting decisions for plaintiffs in a variety of circumstances.<sup>87</sup>

Courts and commentators described the justification for the minority rule in various ways. One commentator hostile to the rule noted that "[s]ince the earlier [majority rule] decisions, judicial thought, particularly at a distance from salt water, seems to have beclouded rather than clarified the state of the law."<sup>88</sup>

Courts, in the Mississippi basin especially, seem to cherish a mental picture of shrewd, sharp, scheming directors craftily trading with inexperienced, female, infant, defective stockholders. In a word, the kind of stockholders for whom the law should guarantee bank deposits, prohibit cigarettes, or control reading matter.<sup>89</sup>

The commentators supporting the rule proposed a moral justification:

That the director may take advantage of his position to secure the profits that all have won, offends the moral sense; no shareholder expects to be so treated by the director he selects; no director would urge his friends to select him for that reason; that the law yet allows him to do this, does more to discourage legitimate investment in corporate shares than almost anything else, and allows the fiction of the corporate entity to obstruct instead of advance justice.<sup>90</sup>

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84. *Id.* at 432.

85. *See id.*

86. This applies the same basic principle of agency law discussed in *Oliver*. *See supra* note 75 and accompanying text.

87. *See* cases cited in Heinselman, *supra* note 52, at 630 *et seq.*

88. Walker, *supra* note 64, at 639.

89. *Id.* at 640.

90. Wilgus, *supra* note 52, at 297; *see* Laylin, *supra* note 52, at 732 n.6.

On a more practical level, many of the minority rule decisions involved cases in which the insider deliberately concealed his identity in the purchase of the stock.<sup>91</sup> Although none of the courts were willing to base a legal rule on that fact, such circumstances would prevent the plaintiff from being put on guard by the fact that insiders were buying.

The results in these cases are inconsistent enough to have caused one commentator to remark that the minority or majority position "has been assumed on practical grounds, and rejected on like grounds; and that the supporting reasons have been props rather than foundations."<sup>92</sup> By the time of the securities acts, the legal rule seemed to be up for grabs. In 1932, the Kansas Supreme Court imposed a seemingly absurd duty on directors in *Hotchkiss v. Fischer*.<sup>93</sup> In *Hotchkiss*, the director showed and explained the company's financial statements to the plaintiff. Such action was not enough as the court held that financial statements do not reflect the true financial condition of the company unless they are interpreted by an expert in light of market and other conditions.<sup>94</sup> The following year, the Supreme Judicial Court of Massachusetts rejected the fiduciary trading theory and supported a director's right to trade the stock of his company at will.<sup>95</sup> When the Supreme Court in 1980 implied that purchase or sale transactions between shareholders and insiders were fraudulent at common law, and therefore prohibited under Rule 10b-5, because of the fiduciary relationship between the parties,<sup>96</sup> it therefore was supported by some, but not unanimous, precedent.

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91. The Court paid considerable attention to this fact in *Strong*. See *Strong v. Repide*, 213 U.S. 419, 432-33 (1909); *Stewart v. Harris*, 77 P. 277 (Kan 1904); *Jacquith v. Mason*, 156 N.W. 1041 (Neb. 1916); *Fisher v. Budlong*, 10 R.I. 525 (1873).

92. Laylin, *supra* note 52, at 732.

93. 16 P.2d 531 (Kan. 1932).

94. See *id.* at 534.

95. See *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933).

96. See *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980).

*C. Chiarella and the Fiduciary Trading Rule Under Federal Law*

In a 1961 decision,<sup>97</sup> the SEC opined that the duty to disclose material information in a stock trade rested on two elements: the existence of a relationship giving access to information and the "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."<sup>98</sup> The duty was not limited to those owing a fiduciary duty to shareholders; instead, "insiders" are defined as those with access to superior information.<sup>99</sup> The SEC noted the debate over the fiduciary trading rule under state law but stated that under federal law, an insider's failure to disclose material information constituted a violation of the antifraud provisions of the 1934 Act.<sup>100</sup> The *Cady, Roberts* decision represented the SEC's position on insider trading until the Supreme Court rejected that approach in *Chiarella*.<sup>101</sup>

*Chiarella v. United States*<sup>102</sup> involved proposed corporate acquisitions in which Chiarella, an employee of the bidders' financial printer, was able to discover the identity of the targets and purchased stock in anticipation of the announcement of the bids.<sup>103</sup> The Court reversed his conviction.<sup>104</sup> According to the Court, the rule prohibiting insider trading under federal law was premised upon the fiduciary duty of the insider and not her access to information.<sup>105</sup> An outsider, therefore, would not violate Rule 10b-5 even if she had special access to nonpublic infor-

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97. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

98. *Id.* at 912.

99. See *id.*

100. See *id.* at 911 & n.13.

101. Prior to *Chiarella*, the Court considered whether Rule 10b-5 applied to a failure to disclose in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). In that case, the Court held that the rule applied where the defendants purchased shares and effectuated others' purchases without disclosing material information to the sellers. The Court based the defendants' duty to disclose on the special relationship they had with the sellers: the defendants were acting on behalf of the sellers in making a market in the shares. See *id.* at 152-53.

102. 445 U.S. 222 (1980).

103. See *id.* at 224.

104. See *id.* at 236-37.

105. See *id.* at 230.

mation. Section 10(b) was directed at fraud, and silence does not constitute fraud unless there is a duty to speak.<sup>106</sup> The SEC's reasoning in *Cady, Roberts* was flawed because possession of information alone does not give rise to a duty to disclose.<sup>107</sup>

There are a number of problems with the fiduciary trading approach of *Chiarella* in addition to its tenuous support at common law.<sup>108</sup> For example, the fiduciary approach conflicts with the concept of the modern corporation as an entity. The question may have been open to debate in 1900, but in 1980, there was little question that the corporation is an entity independent of its shareholders, and that the directors' duty is to the corporation and only derivatively to the shareholders.<sup>109</sup> Following the

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106. See *id.* at 234-35.

107. See *id.* at 235; *supra* note 35 and accompanying text. Rule 14e-3, 17 C.F.R. § 240.14e-3 (1996), which prohibits anyone other than a bidder from purchasing stock in anticipation of a tender offer, was promulgated after the facts giving rise to *Chiarella* occurred. Rule 10b-5 is therefore no longer necessary to reach traders in *Chiarella*'s position. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2215 (1997).

108. Justice Blackmun criticized the majority opinion on this ground, among others. See *Chiarella* 445 U.S. at 247-48 (Blackmun, J., dissenting). One defense of *Chiarella* notes that most of the common law cases deal with face-to-face transactions, and so are arguably inapposite to market transactions. See William T. Allen, *Professor Scheppele's Middle Way: On Minimizing Normativity and Economics in Securities Laws*, LAW AND CONTEMP. PROBS., Summer 1993, at 175, 177-79. Because the Court invoked common law concepts of fraud, however, it seems fair to examine what those concepts were. Also, *Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933), dealt with a transaction occurring on an exchange, and the court expressly stated that, in such circumstances, the fiduciary trading rule did not apply.

109. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990) ("[T]he question of 'long-term' versus 'short-term' values [to the shareholders] is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests . . .") (emphasis added). But see FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 12 (1991) (arguing that the entity concept is only a matter of convenience and appearance); *id.* at 16-17 (arguing that managers are shareholders' agents under corporate contract). Since 1980, some states have recognized by statute that directors may have duties to "constituencies" other than shareholders. See, e.g., FLA. STAT. § 607.0830(3) (1993); 805 ILL. COMP. STAT. 5/8.85 (1993); MASS GEN. LAWS ch. 156B, § 65 (Supp. 1997); N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1997); 15 PA. CONS. STAT. § 1715 (1995). That raises the interesting question of whether a Rule 10b-5 claim might be brought on the basis of the trader's duty to customers or employees who might have traded in the stock. For a persuasive argument that the "other constituency" statutes do not create duties to nonshareholders, see Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163 (1991).

triumph of the entity theory of the corporation between the wars<sup>110</sup> and the formalization of the mechanism of the derivative suit, the only direct claims a shareholder has against the officers and directors are for denial of the shareholder's fundamental participation rights such as voting or receipt of dividends.<sup>111</sup> All claims related to management, including damage to the stock price, are derivative. Thus, if a director deliberately manages the company so as to depress the stock price and thereby facilitate her own purchases, the shareholders, including those who sold to her at the depressed price, have only a derivative claim against her. If, however, the director *discovers* that the stock price is depressed, for example, because a new development has not yet been made public, and buys stock in the expectation that the price will rise, the selling shareholders' claim, under *Chiarella*, is direct.

One might argue that if insiders are fiduciaries for their shareholders, then *Chiarella's* restriction of Rule 10b-5 liability to insiders makes some sense: the purpose of the fiduciary trading rule is acknowledged generally to be a fear that the fiduciary will use her position to overreach the beneficiary, who is dependent upon the fiduciary in some way.<sup>112</sup> Even if a stock purchase occurs on an impersonal exchange, the shareholder is dependent on the insider: the insider, or a group of insiders, controls the flow of information to the market generally and thus to the shareholder. But unlike other market participants, the shareholder, in a sense, has placed the fiduciary in this position of power over the shareholder by delegating management responsibilities to the fiduciary. Under basic fiduciary law, therefore, the fiduciary should be prohibited from making a secret profit in a transaction with the beneficiary involving the subject of the trust—here, the insider's control of the corporation.<sup>113</sup> If one rejects the argument that insiders are fiduciaries

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110. See HORWITZ, *supra* note 59, at 68, 86, 106.

111. See, e.g., *Eisenberg v. Flying Tiger Line, Inc.*, 451 F.2d 267, 270 (2d Cir. 1971); HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 360 (3d ed. 1983).

112. See Frankel, *supra* note 39, at 800-01.

113. One problem with this rationale is that the power of the board of directors to manage the corporation, from which the power of the managers is derived, is *not*

for shareholders, however, then this support for *Chiarella's* imposition of insider Rule 10b-5 liability collapses.<sup>114</sup>

In practice, the real problem with the fiduciary trading rule has been that it seems too narrow. The SEC, the lower federal courts, and many commentators have taken the view that Rule 10b-5 liability should extend to others beyond insiders.<sup>115</sup> If the purpose of the rule prohibiting insider trading is to encourage broad participation in the equity markets by providing a fair trading environment,<sup>116</sup> then the prohibition must apply to everyone whose trading is unfair.<sup>117</sup> *Chiarella* leaves undressed, for example, the problem of "scalping"—trading by those with advance, nonpublic information about the content of influential recommendations by analysts, columnists, and other advisors.<sup>118</sup> The intuition that such trades should be prohibited

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delegated by the shareholders. Rather, it arises "naturally" from incorporation. See *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918).

114. Another problem with the fiduciary rule of *Chiarella* is that the language of both Section 10(b), *supra* note 3, and Rule 10b-5, *supra* note 2, is not limited to fiduciaries. Nor does the use of the term "deception" necessarily so limit the application of the prohibition: the common law recognized a duty to disclose in a variety of situations other than fiduciary relationships. See Dalley, *supra* note 10, at 424-28; *supra* notes 36-38 and accompanying text; Scheppele, *supra* note 20, at 132-43.

115. Commentators have noted, for example, that the fiduciary rule draws an arbitrary line between persons performing the same functions based on whether they are employees or outside contractors. See *EASTERBROOK & FISHEL*, *supra* note 109, at 269-70; Scheppele, *supra* note 20, at 134-35. This problem has been addressed to some degree by *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983), which held that some contractors, such as lawyers and accountants, will be "temporary insiders" for purposes of Rule 10b-5.

116. See *supra* note 15 and accompanying text.

117. See HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 159-62, 171 *passim* (1966) (discussing the problem of knowledgeable outsiders and governmental employees).

118. The most well-known example of this appeared in *Carpenter v. United States*, 484 U.S. 19 (1987), in which a reporter for the *Wall Street Journal* made use of his position to trade in stocks about to be profiled in the influential "Heard on the Street" column. The Supreme Court split four to four on the misappropriation theory described below, see *id.* at 24; see *infra* notes 121-57 and accompanying text, although it upheld his wire fraud conviction. See *Carpenter*, 484 U.S. at 28. Recently, even thornier issues arose when mutual fund employees traded based on the nonpublic activities of the fund. See Charles Gasparino & Laura Jereski, *Can Fidelity Brokers Spy on Jeff Vink? Not in Scottsdale*, WALL ST. J., May 15, 1996, at A1 (discussing brokers fired for "piggybacking" trades on activity by fund manager); Roger Lowenstein, *Intrinsic Value: Fund Industry's Real Conflict of Interest*, WALL ST. J., Apr. 25, 1996, at C1 (addressing the problem of managers trading personally

is evidenced by publishers' internal policies against scalping.<sup>119</sup> Noninsiders can also gain access to nonpublic information in other ways.<sup>120</sup> The problem has been to determine when such noninsiders should be prohibited from trading and to provide a legal support in the securities laws for such a prohibition.

#### *D. O'Hagan and the Misappropriation Theory*

One means of expanding Rule 10b-5 liability beyond traditional insiders is provided by the so-called misappropriation theory. In *Chiarella*, the United States discussed an alternative basis for 10b-5 liability: because Chiarella had breached a duty to his employer, the printer, and to the acquiring company, the printer's client, there had been fraud sufficient to implicate Section 10(b).<sup>121</sup> The Court refused to consider this theory because it had not been submitted to the jury,<sup>122</sup> but it was adopted by Chief Justice Burger in his dissent.<sup>123</sup> Thereafter, many courts of appeal adopted the misappropriation theory,<sup>124</sup>

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ahead of fund trades and Fidelity Investment's policies prohibiting such trades); Robert McGough, *Few Mutual Funds Ban Personal Shorting*, WALL ST. J., June 24, 1996, at C21 (describing the industry's proposed rules against personal trading).

119. See *Carpenter*, 484 U.S. at 23; see also Laura Johannes, *Newsletter Writer Sturza is Told to Turn Over Trading Records*, WALL ST. J., Apr. 19, 1996 at C1 (reporting the SEC's investigation of an analyst following unusual trading patterns in a stock he both owned and analyzed); William Power, *Heard on the Street: Some Analysts Own the Stocks They Tout*, WALL ST. J., June 15, 1995, at C1 (discussing investment and disclosure by analysts).

120. In a recent case, law enforcement officials interviewed employees of Cadence Design Systems as part of an investigation into theft charges against Cadence's competitor, Avant! Corp. The Cadence employees sold Avant! stock short, and the SEC subsequently investigated them. See Michael Schroeder, *SEC Probes Some Cadence Employees Concerning Trading of Avant! Shares*, WALL ST. J., June 9, 1997, at B12.

121. See *Chiarella v. United States*, 445 U.S. 222, 236 (1980). This argument is based on the language in Rule 10b-5 that prohibits fraud "upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1997).

122. See *Chiarella*, 445 U.S. at 236-37.

123. See *id.* at 239-45 (Burger, C.J., dissenting).

124. See, e.g., *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991) (en banc); *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990). But see *United States v. O'Hagan*, 92 F.3d 612, 618-19 (8th Cir. 1996) (rejecting the misappropriation theory), *rev'd*, 117 S. Ct. 2199 (1997); *United States v. Bryan*, 58 F.3d 933, 943-59 (4th Cir. 1995) (same), *questioned in*



and the Supreme Court finally approved the theory in *United States v. O'Hagan*.<sup>125</sup>

The original articulation of the theory by Chief Justice Burger would have prohibited trading based on nonpublic information whenever the trader obtained the information by unlawful means, in other words, by misappropriation.<sup>126</sup> The theory rested on the assumption that obtaining information unlawfully serves no useful societal function and does not involve the foresight and skill that the law of fraud seeks to protect.<sup>127</sup> Misappropriation thus provides an "undue" advantage that should not be available in a "fair" securities market.<sup>128</sup> In the lower federal courts, the misappropriation theory underwent some change. The theory was applied generally only to information obtained in breach of a fiduciary duty; ordinary theft might not count.<sup>129</sup> This limitation was based on the requirement, under *Chiarella*, that conduct prohibited under Rule 10b-5 must be "fraudulent."<sup>130</sup> Additionally, the breach of fiduciary duty must have been committed for personal gain; violating a confidence for altruistic purposes would not give rise to Rule 10b-5 liability.<sup>131</sup>

The Supreme Court, in *O'Hagan*, recently adopted a version of the misappropriation theory that reflects this evolution. The Court stated that a trader "commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."<sup>132</sup> The theory is premised on the trader's "deception" of the owner of the information and the trader's defrauding the owner of the exclusive use of the information.<sup>133</sup>

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*O'Hagan*, 117 S. Ct. at 2199.

125. 117 S. Ct. at 2199, 2213-14.

126. See *Chiarella*, 445 U.S. at 242 (Burger, C.J., dissenting).

127. See *id.* at 241.

128. See *id.*

129. See *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984); *Cherif*, 933 F.2d at 412 & n.6.

130. *Materia*, 745 F.2d at 201-02.

131. See *Dirks v. SEC*, 463 U.S. 646, 662 (1983).

132. *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997).

133. See *id.*

The Court in *O'Hagan* had to deal with several problems inherent in the misappropriation theory. First, the theory's reliance on the broad "in connection with" language in Rule 10b-5 raises questions about the limits of the theory's application. Why would a lawyer who embezzled from her client's trust account to buy stock not be just as guilty of "fraud . . . in connection with the purchase or sale of any security"<sup>134</sup> as one who, like Mr. O'Hagan, made use of a client's takeover plans?<sup>135</sup> The Court addressed this problem by limiting the scope of the "in connection with" language to acts of fraud that "ordinarily" derive their value from securities trading.<sup>136</sup> Money has many uses, but information about a takeover is "ordinarily" only useful on the stock market.<sup>137</sup> The Court rejected the dissent's argument that takeover information might have other value,<sup>138</sup> but did not consider that information other than takeover information might be involved in a misappropriation case. The news of the mineral strike in *SEC v. Texas Gulf Sulphur Co.*,<sup>139</sup> for example, would have been of enormous value to the owner of the surrounding land or to anyone in a position to purchase that land before the company did. It is hard to say that such information ordinarily would have value only in the stock market.<sup>140</sup> It will,

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134. 17 C.F.R. § 240.10b-5 (1997).

135. O'Hagan's firm represented Grand Metropolitan PLC in its effort to acquire Pillsbury Company. See *O'Hagan*, 117 S. Ct. at 2205. O'Hagan, who, by virtue of his partnership in the firm, owed a duty to Grand Met, purchased Pillsbury stock and options. See *id.* Although he did not owe a duty to Pillsbury, his use of the firm's information allegedly violated a duty to the firm and to Grand Met. See *id.* at 2208. Interestingly, O'Hagan also was convicted of theft and disbarred for misusing clients' funds in a separate incident prior to the Grand Met matter. See *In re Disciplinary Action Against O'Hagan*, 450 N.W.2d 571 (Minn. 1990); *State v. O'Hagan*, 474 N.W.2d 613 (Minn. Ct. App. 1991).

136. See *O'Hagan*, 117 S. Ct. at 2210.

137. See *id.*; see also *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984) (recognizing a similar limitation).

138. See *O'Hagan*, 117 S. Ct. at 2209. The dissent argued that a newspaper might be willing to pay for the information. See *id.* at 2223 (Thomas, J., dissenting).

139. 401 F.2d 833 (2d Cir. 1968). This case is discussed *supra* in notes 5-10 and accompanying text.

140. A real-life example of this concerns the trade secrets investigation of Avant! See *supra* note 120. The Cadence employees who learned of the investigation might have used the information to tip off the targets of the investigation and help them avoid prosecution. They might also, and allegedly did, conduct their own business so

presumably, be left for the lower courts to determine the scope of the misappropriation theory.

Another problem with the misappropriation theory is its reliance, like *Chiarella's*, on underlying, poorly defined, state law fraud. The Court in *O'Hagan* assumed that O'Hagan had committed fraud by using client information to trade securities, even though the client was not damaged by that use.<sup>141</sup> Under the American Bar Association's Model Rules of Professional Conduct, however, the use of confidential client information is prohibited only if such use is "to the disadvantage of the client."<sup>142</sup> The older Model Code does not have such a limitation.<sup>143</sup> A lawyer who practices in a Model Code state, such as New York, and buys securities based on a client's intentions may misappropriate information, although a lawyer in a Model Rules state, such as Texas or Florida, may not.<sup>144</sup> None of this would appear to have anything to do with the integrity of the securities markets. Additionally, there is no reason why fraud, to use *Chiarella's* term, should be limited to breach of fiduciary duty. A material misrepresentation, for example, is fraud even where there is no fiduciary relationship between the parties. Certain breaches of fiduciary duties, however, are not generally thought

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as to take advantage of their competitor's troubles. See Schroeder, *supra* note 120 (describing the civil suit by Avant! against Cadence for libel and unfair competition). Similarly, in *United States v. Bryan*, 58 F.3d 933, 938-39 (4th Cir. 1995), *questioned* in *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), the defendant's acts involved bid-rigging for the West Virginia video lottery machine contract. Bryan also bought stock in the company whose bid he supported prior to the public announcement of the contract award. See *id.* at 939. Bid-rigging is not a fraud ordinarily of value only in the stock market. The SEC described his fraud, however, as trading on the basis of confidential information, the identity of the "winning" bid, entrusted to him in his capacity as lottery director. See *id.*

141. See *O'Hagan*, 117 S. Ct. at 2208-09. It is not hard to imagine a scenario in which the trades would harm the client—where the trading starts rumors or otherwise results in an increase in the price of the target's stock—but there was no suggestion that *O'Hagan* involved such a turn of events. See *infra* notes 251-53 and accompanying text.

142. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(b) (1995).

143. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(B)(3) (1983).

144. At the time of O'Hagan's trading, Minnesota was a Model Rules state. See 52 MINN. STAT. ANN. Rule of Professional Conduct 1.8(b) (West 1993) (effective 1985). O'Hagan's use of the information may have violated a duty to his partners regardless of whether it violated a duty to the client.

of as fraud: a breach of the fiduciary's duty of care, for example, or disclosure of confidential information that does not result in gain to the fiduciary.<sup>145</sup> The SEC's and the federal courts' continuing focus on breaches of fiduciary duty seems a bit unwarranted and perhaps results from the lingering effect of *Chiarella's* fiduciary trading rule.

The Court also noted that if a fiduciary discloses her intentions to use the information, there is no breach of duty.<sup>146</sup> If O'Hagan had notified his partners and his client of his trading plans, then he would not have violated the securities laws.<sup>147</sup> If, as the Court frequently stated in *O'Hagan*, the purpose of Rule 10b-5 is to protect the integrity of the securities markets,<sup>148</sup> then it is difficult to see why O'Hagan's disclosure to nonmarket participants should matter. Additionally, this facet of the misappropriation theory puts the SEC in the interesting position of protecting not buyers and sellers of securities or even the market generally, but attorneys' clients and other beneficiaries of fiduciary relationships.<sup>149</sup>

Commentators have raised objections to the misappropriation theory since it began to gain currency in the 1980s;<sup>150</sup> it is not

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145. The Court in *O'Hagan* recognized this when it referred to *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, a former employee disclosed corporate wrongdoing to an analyst, and the Court held that, because the employee had not "acted for personal profit," there was no 10b-5 violation. See *O'Hagan*, 117 S. Ct. at 2213. The Court also stated, however, that "[n]o showing had been made in *Dirks* that the tippers had violated any duty . . . ." *Id.* It is at least arguable that the employees did, in fact, violate a duty by disclosing the wrongdoing as they did. What the Court appears to have meant is that Rule 10b-5 is limited to breaches of a fiduciary's duty of loyalty.

146. See *O'Hagan*, 117 S. Ct. at 2209.

147. See *id.* This part of the rule is relevant to the practice of "warehousing," in which a soon-to-be-bidder notifies friendly parties of its intentions so that they may purchase the target's stock at prebid prices. Under the misappropriation theory, warehousing is permitted because it is fully disclosed to the "owner" of the information, the bidder. The SEC takes the position that warehousing violates Rule 14e-3, which does not require a breach of a disclosure duty. See *id.* at 2215-16. The Court in *O'Hagan* left that question open. See *id.* at 2217 n.17.

148. See *id.* at 2207, 2210.

149. See *id.* at 2208, 2211. The misappropriation theory will raise further questions if it is used to provide a basis for private causes of action by "defrauded" traders. See *infra* notes 222-24 and accompanying text. The Court carefully limited its approval of the misappropriation theory to criminal cases. See *O'Hagan*, 117 S. Ct. at 2214.

150. See, e.g., David Cowan Bayne, S.J., *Insider Trading: The Demise of the Mis-*

to be expected that those objections will disappear now that the Supreme Court has given the theory its imprimatur. The theory has one huge advantage, however, that probably explains its popularity better than the carefully justified reasoning of the courts: It eliminates one of the absurdities of the old fiduciary trading rule, which treats those, like *Chiarella*, with takeover information derived from a bidder, differently from those with information derived from a target.<sup>151</sup> In other words, *O'Hagan* was necessary to repair the damage done by *Chiarella*, but it unfortunately is almost as unsatisfactory.<sup>152</sup>

The federal courts and the academic community will have to continue their struggle to find an acceptable definition for insider trading that will include the appropriate noninsiders.<sup>153</sup> At one extreme is the position supported by language in *Cady, Roberts* that anyone with superior information has a duty to disclose or abstain—the “parity-of-information” rule.<sup>154</sup> That rule is believed generally to be unworkable because with per-

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*appropriation Theory—and Thereafter*, 41 ST. LOUIS U. L.J. 625 (1997); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 204-08 (1991); Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(B)*, 59 ALB. L. REV. 139 (1995); Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 90-93 (1984); Steven R. Salbu, *The Misappropriations Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223, 233-53 (1992).

151. The Court in *O'Hagan* summed up with that observation. See *O'Hagan*, 117 S. Ct. at 2210-11. Although insiders at the target are not likely to have advance information about hostile bids, they will often have knowledge of pending negotiated transactions.

152. One interesting feature of the Court's opinion in *O'Hagan* is its repeated references to the need for “fair” securities markets and to the public's interest in prohibiting the unfair, “no-risk” profits *O'Hagan* made because of his inside information. See *O'Hagan*, 117 S. Ct. at 2207-08, 2209-10, & 2210-11. This emphasis might be read to call into question the Court's position in *Chiarella*, in which the Court expressly rejected the lower court's argument that “[t]he use by anyone of material information not generally available is fraudulent because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.” *Chiarella v. United States*, 445 U.S. 222, 222 (1980).

153. I have omitted a discussion of “tippee” liability as outside the scope of this Article. The Supreme Court has recognized that a trader who trades on information from a tipper, who has breached a duty by making the tip, has violated Rule 10b-5. See *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

154. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

fectly equal information, no trades would ever occur. At the other extreme is the old regime of caveat emptor, under which only outright lies are prohibited.<sup>155</sup> That rule generally is believed to be undesirable because it would reduce public confidence in, and willingness to participate in, the securities markets, and because it is "unfair."<sup>156</sup> I turn now to a discussion of the wide variety of concepts jurists have considered in attempting to formulate a workable rule.<sup>157</sup>

## II. THE CHARACTERISTICS OF AN IDEAL TRADING RULE

The search for a legal definition of prohibited trading by those with special knowledge ("fraud by silence") covers the ground between two end positions. At one extreme is the parity-of-information approach, which some have accused the SEC of advocat-

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155. See *infra* notes 168-71 and accompanying text.

156. *O'Hagan*, 117 S. Ct. at 2209 (quoting 15 U.S.C. § 78b (1934)); *id.* at 2210 (describing the need for fair securities markets); H.R. Rep. No. 98-355, at 5 (1983) ("The abuse of informational advantages that other investors cannot hope to overcome through their own efforts is unfair and inconsistent with the investing public's legitimate expectation of honest and fair securities markets where all participants play by the same rules."); see also 7 LOSS & SELIGMAN, *supra* note 4, at 3451-54 (describing the "integrity of the market theory"). Other sources advocating fair insider trading rules include Parker M. Nielson, *So What Else is New in the Law?* Texas Gulf Sulphur *Restates* Peek v. Gurney, 1971 UTAH L. REV. 327, 343; Scheppele, *supra* note 20, at 125; Ellen Virginia Hines, Comment, *New Concept of Fraud on the Securities Exchange—a Comment on In Re Cady, Roberts & Co.*, 15 S.C. L. REV. 557, 560 (1963). For a criticism of "fairness" as a legal concept, see Easterbrook, *supra* note 16, at 323-30.

157. It is worth noting here that the state common law has not stood still since 1934. Several states have recognized a cause of action by the corporation, or by shareholders derivatively, against insider traders based on the secret profit doctrine of agency law. See, e.g., *Brophy v. Cities Service Co.*, 70 A.2d 5, 8 (Del. Ch. 1949); *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969); 7 LOSS & SELIGMAN, *supra* note 4, at 3477-84; Bainbridge, *supra* note 20, at 1223-27. But see *Freeman v. Decio*, 584 F.2d 186, 196 (7th Cir. 1978). If the insider (an agent) profits from knowledge she received in the course of employment, then her profits belong to the company (the principal) and can be recovered in an accounting. In most states, the corporation need not prove damage. If agency law can effectively discourage insider trading, then it may make Rule 10b-5 liability unnecessary. Because the recovery in such an action goes to the corporation, however, there is no incentive for private litigants and their lawyers to bring such actions, which may explain the scarcity of secret profit insider trading cases. In any event, because the secret profit rule has a separate doctrinal and theoretical basis from Rule 10b-5 liability, it is not relevant to the analysis in this Article.

ing.<sup>158</sup> That approach would prohibit any transaction in which the parties have unequal information, thus placing a duty to disclose on all the world.<sup>159</sup> The problem with such a rule is obvious: Trades of any good occur only because the parties have different views of the value of the good. If the parties are rational, then their different views must be based on the information each has, and requiring each party to disclose all relevant information would eliminate the incentive to trade.<sup>160</sup> This fact of economic life perhaps needs no citation, but it is worth noting that it is neither new nor confined to the stock market.<sup>161</sup>

Furthermore, public policy favors rewarding diligence, sagacity, and foresight. As an early nineteenth century commentator put it:

My knowledge of the articles in which I traffic, and of the circumstances which influence the fluctuations of their market price, forms the most valuable and perhaps the most costly part of my capital. Why then are not the profits which I may make by using them as much my own, as the interest of my money or the rents of my houses? . . . Moreover, does not public policy agree with common sense, in allowing the skillful and industrious the full enjoyment of that necessary superiority over their competitors, which well directed industry must always give?<sup>162</sup>

Courts and commentators alike have recognized the law's concern for rewarding effort and skill. The common law insider trading cases recognized that "[i]t is not the intent of the law to place a restraint on the affairs of business, when conducted fairly, honestly and openly, nor to deprive one party to a con-

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158. See *Chiarella v. United States*, 445 U.S. 222, 252 n.2 (Blackmun, J., dissenting).

159. See VERPLANCK, *supra* note 26, at 8.

160. This analysis treats things such as each party's aversion to risk and other personal preferences and characteristics as "information."

161. See, e.g., FRIED, *supra* note 10, at 80; 1 STORY, *supra* note 33, at 215 ("the rule must be drawn, so as not to affect the general transactions of mankind"); Easterbrook, *supra* note 16, at 327-28; *Caveat Emptor—The Rule of the Common Law—Not of the Civil Law*, 12 AM. JURIST & L. MAG. 94, 97 (1834) [hereinafter *Caveat Emptor*].

162. VERPLANCK, *supra* note 26, at 9; see 1 STORY, *supra* note 33, at 215.

tract of the advantage which superior judgment, greater skill, or better information may give."<sup>163</sup> Additionally, the law has always had little patience with plaintiffs who are foolish or over-cautious and later seek to recover from wiser parties.<sup>164</sup> The *Restatement (Second) of Contracts* states: "If the other [party] is indolent, inexperienced or ignorant, or if his judgment is bad or he lacks access to adequate information, his adversary is not generally expected to compensate for these deficiencies."<sup>165</sup> As a matter of fraud law generally, the law does not relieve one from an "unwise, careless or improvident bargain."<sup>166</sup> To the extent that insider trading prohibitions rely on the assumption that insiders are more sophisticated and perhaps less honest than their trading opposites, they fail to recognize that "trading is full of human nature, a stock trade no less than a horse trade. Buyers and sellers alike may be crafty, and more than one seller has been known to be a welsher."<sup>167</sup>

If the parity-of-information approach is not acceptable, then neither, it seems, is the other extreme, a rule that would permit all trading based on secret information, except, presumably, for cases involving traditional fiduciary relationships, such as trustees, guardians, etc. Unlike the parity-of-information approach, this caveat emptor position has had adherents over the years.<sup>168</sup> The most frequently cited judicial pronouncement of caveat emptor occurred in *Laidlaw v. Organ*.<sup>169</sup> *Laidlaw* involved a pur-

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163. *Stewart v. Harris*, 77 P. 277, 281 (Kan. 1904); see also *Oliver v. Oliver*, 45 S.E. 232, 233 (Ga. 1903) (stating that courts "cannot put parties upon an equality which does not in fact exist. They cannot deprive one of the advantage which superior judgment, greater skill, or wider information may give.").

164. See *Woodruff v. Cole*, 269 S.W. 599, 604 (Mo. 1925) ("Appellant could judge of what might happen as well as others"); *Grant v. Attrill*, 11 F. 469, 470 (C.C.S.D.N.Y. 1882) ("The [plaintiff] seems to have preferred to sell rather than risk the management promised; and he sold out"); *Dalley*, *supra* note 10, at 419-21.

165. RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. d (1979); see *FRIED*, *supra* note 10, at 82-83.

166. *Caveat Emptor*, *supra* note 161, at 100.

167. *Walker*, *supra* note 64, at 637, 640.

168. See, e.g., *MANNE*, *supra* note 117. Manne does not specifically oppose insider trading regulation; rather, he proposes an alternative mode of analysis that others have interpreted as rejecting regulation of most insider trading. See generally *Caveat Emptor*, *supra* note 161, *passim*; *Walker*, *supra* note 64, *passim*.

169. 15 U.S. (2 Wheat.) 178 (1817).



chase of tobacco by a buyer who knew about the Treaty of Ghent<sup>170</sup> from a seller who did not. Chief Justice Marshall's brief opinion, holding that the buyer "was not bound to communicate [the news]," stirred up considerable controversy.<sup>171</sup>

The basis for much of the criticism of *Laidlaw* was its failure to recognize common standards of morality.

However correct this judicial decision may have been in point of law, and however strongly the expediency of the law, as laid down, may seem to be recommended by considerations of public policy and the necessities of trade, yet I believe, most of those who, without much speculation or deliberate reasoning, form their moral judgments from their unstudied impressions of right and wrong, will find it somewhat revolting to their notions of sound morality.<sup>172</sup>

Others have argued, however, that although ordinary people might criticize the buyer in *Laidlaw* as unethical, they would do the same themselves given the opportunity.<sup>173</sup> More fundamentally, the problem with morality as a guiding principle is that there is no *necessary* connection between law and morality. Some have argued that law, where practicable, should mirror morality because a perceived divergence between law and morality causes law to lose its legitimacy with the public.<sup>174</sup> Yet, where established law clearly is opposed to common notions of morality, or where policy dictates that it be so opposed, morality loses.<sup>175</sup>

Moral arguments have also been raised in the context of insider trading.<sup>176</sup> Pre-1934 courts finding in favor of plaintiffs

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170. The Treaty of Ghent ended the War of 1812 and caused tobacco prices to rise sharply. *See id.* at 181.

171. *See Laidlaw*, 15 U.S. at 195. The opinion actually did not espouse a true caveat emptor position because it was limited to cases in which "each party . . . take[s] care not to say or do any thing tending to impose upon the other." *Id.* The case was remanded to the trial court. For an analysis of *Laidlaw* based on modern economic concepts, see 7 LOSS & SELIGMAN, *supra* note 4, at 3467-69.

172. VERPLANCK, *supra* note 26, at 5; cf. 1 STORY, *supra* note 33, § 194, at 20304 (noting the divergence between law and morality).

173. *See* Bainbridge, *supra* note 20, at 1241-42; Keeton, *supra* note 37, at 32.

174. *See* VERPLANCK, *supra* note 26, at 155-74; Allen, *supra* note 108, at 176.

175. *See* VERPLANCK, *supra* note 26, at 147-48, 159.

176. *See* BERLE & MEANS, *supra* note 25, at 226.

sometimes cited morality as a basis for their decisions,<sup>177</sup> but more often courts noted the immorality of the defendants' acts, but nevertheless rejected the plaintiffs' claims.<sup>178</sup> Although moral concerns are mentioned rarely by post-1934 commentators, the morality of insider trading is probably still open to question.<sup>179</sup> At least one court of appeals has argued that the securities acts were intended to achieve high standards of business ethics in the securities industry.<sup>180</sup>

Another support for a full disclosure rule, at least in the nineteenth century, was the authority of the civil law. According to some sources, the civil law recognized fraud by silence and thus required parties to disclose all relevant information.<sup>181</sup> Most

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There is no great disagreement about the ethics of the [insider trading] transaction. Managements engaged in this kind of business do not enjoy having it divulged. And when business men dislike to have their methods disclosed, even after the fact, it is usually sound to conclude that their ethical judgment is against it.

*Id.* See MANNE, *supra* note 117, at 15 (admitting that moral standards "play an important role" in the business community); Hines, *supra* note 156, at 558-60 (discussing ethics and fairness); Laylin, *supra* note 52, at 732 n.6; Wilgus, *supra* note 52, at 297; see also *infra* notes 266-85 and accompanying text, for a discussion of arguments related to "fairness."

177. See, e.g., *Morrison v. Snow*, 72 P. 924, 928 (Utah 1903).

178. See, e.g., *Boulden v. Stilwell*, 60 A. 609, 610 (Md. 1905); *Grant v. Attrill*, 11 F. 469, 470 (C.C.S.D.N.Y. 1882); cf. *Crowell v. Jackson*, 23 A. 426, 427 (N.J. 1891) ("there can be no fraud without moral delinquency"). The increasing influence of progressive legal thought during this period presumably accounts for jurists' changing attitudes toward morality and law. See generally AMERICAN LEGAL REALISM 4-8 (William W. Fisher, III et al. eds. 1993) (discussing forerunners to Realists such as Justice Oliver Wendell Holmes); HORWITZ, *supra* note 59, at 113-16 (discussing views of the role of morality in tort law).

179. See WANG & STEINBERG, *supra* note 25, at 105-17, for a discussion of the moral arguments for and against insider trading. Morality is not completely absent from contemporary legal analysis. See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 238-40 (3d ed. 1986) (arguing that there is no fundamental inconsistency between morality and economic efficiency).

180. See *United States v. Newman*, 664 F.2d 12, 18-19 (2d Cir. 1981).

181. See, e.g., *Laidlaw v. Organ*, 15 U.S. (2 Wheat) 178, 185 *et seq.* (1817) (citing Pothier); 1 STORY, *supra* note 33, § 204, at 213-14 (citing Cicero); VERPLANCK, *supra* note 26, at 60-63 (discussing, at length, the beauty of Roman law); Keeton, *supra* note 37, at 23 n.55 (citing Cicero and others). The citation of civil law sources by commentators in the nineteenth century may represent a general fondness for the civil law among American jurists at that time. See M.H. Hoeflich, *Law & Geometry: Legal Science from Leibniz to Langdell*, 30 AM. J. LEGAL HIST. 95, 112 *et seq.* (1986).

commentators noted, however, that the civil law rule in its purest form—the parity-of-information rule—was inappropriate for a commercial society,<sup>182</sup> but was “suited to the less complicated dealings of a people without much trade, and, as in fact it was, to a people who despised commerce.”<sup>183</sup>

A third argument against a strict caveat emptor regime is its effect on the integrity of markets. Commentators often express fears that an “every man for himself” approach would discourage people from participating in commerce.<sup>184</sup> Additionally, in the stock market context, the early disclosure of information, which a disclose-or-abstain rule would encourage, is a positive good because it facilitates rational investment decisions.<sup>185</sup> The investor confidence argument has been rejected vehemently by law and economics scholars, among others, who note that there is no empirical evidence that insider trading affects the rate of market participation.<sup>186</sup>

It is worth noting one other argument in favor of the caveat emptor approach to insider trading: insider trading provides compensation for corporate officers and, especially, directors who would not undertake the risks of service without such an incentive.<sup>187</sup> Several objections to that argument have been identified, including the haphazard nature of such compensation and the incentives it gives managers to delay disclosure and adopt

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182. See 1 STORY, *supra* note 33, § 205, at 214-15; VERPLANCK, *supra* note 26, at 71-75; see also *Caveat Emptor*, *supra* note 161, at 101, 103, 104 (criticizing sharply the civil law).

183. *Caveat Emptor*, *supra* note 161, at 95.

184. See, e.g., FRIED, *supra* note 10, at 83; MANNE, *supra* note 117, at 15 (“[U]nless there is broad-based agreement on various standards of ethical conduct, free markets do not seem to function very effectively.”); WANG & STEINBERG, *supra* note 25, at 29-32; Berle, *supra* note 52, at 830; Wilgus, *supra* note 52, at 287; Nielson, *supra* note 156, at 350. But see EASTERBROOK & FISCHEL, *supra* note 109, at 296-97.

185. See, e.g., Brudney *supra* note 11, at 334. But see EASTERBROOK & FISCHEL, *supra* note 109, at 299 (arguing that more information is only good if it is worth more than it costs to produce).

186. See Easterbrook, *supra* note 16, at 325-26.

187. The most cited source for this argument is MANNE, *supra* note 117, at 131-45, although there are other sources. See, e.g., BERLE & MEANS, *supra* note 25, at 225 n.6; cf. *Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933) (“Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office.”); Wilgus, *supra* note 52, at 297 (criticizing the argument).

policies fostering volatility in stock price.<sup>188</sup>

Because most commentators have rejected both the parity-of-information and the caveat emptor positions, they have been forced to search for a principled means of distinguishing between fraud by silence and acceptable market behavior. Those distinctions are discussed below.

### A. *Types of Information*

Through the years, commentators, although oddly not courts, have drawn distinctions based on the type of information withheld. To the extent generalization is possible, the rules proposed would treat the withholding of intrinsic or company information as fraud by silence, but the withholding of extrinsic, market, or personal information as acceptable market behavior. As explained below, these categories are quite fluid and contain numerous exceptions; therefore, it is surprising to find them perennially featured in the literature.

#### 1. *Intrinsic v. Extrinsic Information.*

Nineteenth century commentators often discussed the difference between intrinsic information, which directly pertains to the item in question, and extrinsic information, which pertains to the environment in which the sale occurs.<sup>189</sup> The news of the Treaty of Ghent in *Laidlaw v. Organ* was thus extrinsic information, and Justice Marshall so described it, albeit without discussion.<sup>190</sup> The intrinsic/extrinsic distinction seems to have come from the Roman law, but Roman law, according to American commentators, applied the same rule to both types of information.<sup>191</sup> Similarly, the commentators' description of the law relating to intrinsic information, on the one hand, and extrinsic

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188. See, e.g., Brudney, *supra* note 11, at 345 n.78 (citing sources advocating this position); Easterbrook, *supra* note 16, at 332-33.

189. See 1 STORY, *supra* note 33, §§ 210-13, at 219-21; WILLIAM W. STORY, A TREATISE ON THE LAW OF SALES OF PERSONAL PROPERTY § 179, 167-68 (4th ed. 1871); Keeton, *supra* note 37, at 20, 35.

190. See 15 U.S. (2 Wheat.) 178, 195 (1817).

191. See 1 STORY, *supra* note 33, § 211, at 220-21; VERPLANCK, *supra* note 26, at 63-68.

information, on the other, often did not sound any different. Joseph Story thus noted that under the common law, the rule of caveat emptor applied to extrinsic facts, whereas for intrinsic facts, the rule is caveat emptor unless there are special circumstances or a special relationship between the parties.<sup>192</sup> Similarly, William W. Story wrote:

In respect to extrinsic circumstances, the rule is . . . that no mere concealment in respect thereto constitutes such a fraud as to nullify the contract [unless the defendant's acts amount to active concealment or prevention of discovery of the facts] . . . . But in respect to intrinsic qualities, the rule is different; and in such cases, mere concealment will, under certain circumstances, constitute a fraud . . . , although, ordinarily, the maxim of *caveat emptor* also applies.<sup>193</sup>

Story then described those "certain circumstances" in terms rather similar to the exceptions applicable to extrinsic facts.<sup>194</sup> Gulian Verplanck, who wrote a long essay on fraud by silence in 1825, carefully described the difference between intrinsic and extrinsic facts, but stated that they should be treated the same as long as they are material.<sup>195</sup>

To the extent that there was a difference in the law between extrinsic and intrinsic information, it probably related to a general view that extrinsic information about the trading environment—market forces, wars, political events, tariffs—is theoretically available to any person, whereas information specific to an item is usually available only to its owner.<sup>196</sup> As discussed below, this rationale would apply somewhat differently in the securities markets, because of the unusual position of existing shareholders as owners of the company in question and because of the required disclosure of company information.

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192. See 1 STORY, *supra* note 33, §§ 212-13, at 221; see also 2 KENT, *supra* note 34, at 377 ("There may be some difference in the facility with which the rule applies between facts and circumstances that are intrinsic . . . and those that are extrinsic . . . .").

193. 1 STORY, *supra* note 33, § 179, at 167-68.

194. *Id.*

195. See VERPLANCK, *supra* note 26, at 227-28.

196. See *infra* notes 230-32 and accompanying text.

## 2. *Market v. Company Information.*

In the insider trading context, the vocabulary of the intrinsic/extrinsic distinction is changed to that of company information, which relates directly to the issuer of the stock in question (such as a drop in earnings or a research breakthrough), and market information, which relates to market forces generally (such as a change in Federal Reserve policy or "bullish" sentiment among traders).<sup>197</sup> Again, however, the distinction is only helpful up to a point. It seems clear that a corporation would not have an obligation to disclose advance notice of a war in Europe,<sup>198</sup> but other market information is more problematic. The Supreme Court in *Chiarella*, for example, noted that the information upon which Chiarella traded was market information because it concerned market demand for the stock rather than the business prospects of the target company.<sup>199</sup> Other commentators have argued persuasively that a distinction between company and market information has no basis in the language or intent of the securities laws.<sup>200</sup>

Presumably, the legal distinction between market and company information is intended to produce some policy-based difference in the cases. One proposed rationale for the distinction notes that company information generally is produced for a business purpose and has usefulness beyond predicting fluctuations in stock price. Company information therefore generally will be produced even if its producers are not permitted to profit from the information by stock transactions.<sup>201</sup> Much market information, however, is also produced for nonstock purposes. Information about a takeover bid is produced because the bidder

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197. Cf. VERPLANCK, *supra* note 26, at 112-13 (discussing how external circumstances and the common and ordinary quality of the thing being sold affects the price of the thing being sold).

198. See BERLE & MEANS, *supra* note 25, at 323.

199. See *Chiarella v. United States*, 445 U.S. 222, 231 (1980).

200. See, e.g., Brudney, *supra* note 11, at 329-33 (noting that some of the specific abuses, such as pools generating artificial demand for stocks, that the securities acts were intended to correct involved market information), cited in *Chiarella*, 445 U.S. at 341 (Burger, C.J., dissenting).

201. See Brudney, *supra* note 11, at 356. Many commentators are concerned that, without the incentive of profit on the stock market, market participants will not produce information. See Easterbrook, *supra* note 16, at 313-14, 338-39.

must effectuate its bid. Chiarella had access to information because the bidder had to print offering materials, not because he conducted careful research in the industry.

The real reason why the market/company distinction seems relevant is that analysts' information is vital to the functioning of the stock market, and any acceptable insider trading rule must continue to provide incentives for analysts to generate information. Analysts' information will not necessarily be market information, however, and it often will not be nonpublic. An analyst who examines publicly available information about an industry, who talks to executives and visits facilities and who then produces a report based on that research has not generated inside information. All the information the analyst used is publicly available, and the interpretation that a market participant places upon publicly-available information is not inside information by any reasonable definition.<sup>202</sup> But if the analyst trades on the information, then he or she has done nothing more than profit by his or her research and analytical skills. The analyst's clients have done nothing more than hire an agent to do their research and analysis for them. Additionally, if an executive gives an analyst preferential access to information,<sup>203</sup> the executive or the company may have violated the disclosure provisions of the securities acts or stock exchange rules,<sup>204</sup> or the access may, in extreme cases, amount to "tipping," placing the analyst in the same position with respect to the information as the insider who "tipped."<sup>205</sup> There is no reason to tailor insider trading regulation to specially deal with the analyst problem.

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202. It may be proprietary, and the analyst may be able to restrict access to the information. See *infra* notes 258-61, 264, and accompanying text. It is not "nonpublic" because anyone who bothered could produce the information just as the analyst had done.

203. See Vanessa O'Connell & Dave Kansas, *Shut Out: Bank of New York Scrutinized Over Delay in Announcing Big Reserve*, WALL ST. J., June 21, 1996, at C1; Randall Smith, *Conference Calls to Big Investors Often Leave Little Guys Hung Up*, WALL ST. J., June 21, 1995, at C1.

204. See generally Safe Harbor for Forward-Looking Statements, Securities Act Release No. 7101, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,436, at 85,787-88 (Oct. 13, 1994) (discussing "Entanglement and Endorsement" in the analyst-corporation relationship).

205. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 230, n.12 (1980).

A company/market distinction also leaves unaddressed the problem of "scalpers" because it always involves market information.<sup>206</sup> If a scalper trades because she is aware of the content of the recommendation, then she is trading on nonpublic market information, and a market/company distinction would allow her to trade.<sup>207</sup> If, however, the scalper writes the column because she owns the stock and wishes to cause the price to rise, then she may be guilty of market manipulation, but cannot be said to have engaged in insider trading.<sup>208</sup>

Finally, unlike the common law intrinsic/extrinsic distinction, the company/market distinction does not make sense based on insiders' access to information. Company information may relate to more than one company. A research breakthrough by Company A, for example, may affect the business prospects of Company B, one of Company A's competitors. The information will be company information in both cases, but there is no reason to assume that Company B's managers will have access to the information earlier than anyone else. Market information, however, will often be accessible only to those planning the event, such as the bidder in a takeover attempt or governmental employees in the case of regulatory activity.

### 3. *General v. Personal Information.*

One other distinction that, although useful, receives little attention in the commentaries is the distinction between general

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206. See discussion *supra* note 118.

207. It may be that scalping is an acceptable market practice that should be permitted under the securities laws. See generally Brudney, *supra* note 11, at 368-71 (discussing scalping and its legal implications). Professor Brudney noted that, to the extent scalping acts as a fraud on the readers of the advice in question, it is addressed by fiduciary law. See *id.* at 369. A related question concerns whether mutual fund managers should be permitted to trade based on their knowledge of fund activity. Some, but not all, fund companies prohibit such practices. See *supra* note 118. When managers trade *against* their funds (i.e., selling when the fund is buying or vice versa), different issues are present. See Jeffrey Taylor, *SEC Action is Unlikely on Vinik*, WALL ST. J., May 9, 1996, at C1.

208. Generally, publications either require their columnists to disclose their positions in any securities mentioned in the column or publish blanket disclaimers warning readers that columnists may hold such positions. See *supra* notes 118-19 and accompanying text.



and personal information.<sup>209</sup> Personal information consists only of information that relates to one's own attitudes, expectations, or intentions. All other information, including information about others' attitudes, is general. In the paradigmatic horse trade, therefore, the fact that the horse has a disease is intrinsic information, the fact that the Union Army's advance has created an increase in the demand for horses is extrinsic market information, but the fact that the seller is planning to leave town and will sell at any price is the seller's personal information. However fraud by silence is defined, it cannot include a duty to disclose personal information, absent a close fiduciary relationship of some kind.<sup>210</sup>

A rule that excludes personal information from insider trading or fraud by silence solves several problems. It explains, for example, why analysts or other sophisticated parties are permitted to trade based on the results of their analysis and research,<sup>211</sup> and it explains why a bidder planning to launch a takeover may acquire shares of the target prior to the announcement of the bid.<sup>212</sup> This rule might be construed to allow scalping, because it involves the columnist's personal decision to print, and advance trading by mutual fund managers, because it is based on their intentions for the fund. Yet, because scalpers and fund managers have duties to their clients—their readers or the fund's investors—their trading may be prohibited on other grounds. A personal information rule would have to consider whether, or when, to allow those with personal information to delegate their trading activity to agents. As Verplanck writes, when the seller of a horse who will take any price sends an agent to make the sale, the agent is under no more duty to disclose the seller's intention than the seller would be.<sup>213</sup> Similarly, before the adoption of Rule 14e-3 under the 1934 Act, tender offerors regularly employed warehousemen to acquire stock before

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209. For a rare discussion of such information, see VERPLANCK, *supra* note 26, at 113, 119-20; Brudney, *supra* note 11, at 361-62.

210. See VERPLANCK, *supra* note 26, at 113, 119-20; Brudney, *supra* note 11, at 361-62.

211. See Brudney, *supra* note 11, at 361-62.

212. See *id.* at 371-76 (discussing tender offers).

213. See VERPLANCK, *supra* note 26, at 78.

the announcement of the bid.<sup>214</sup> There would appear to be no reason to forbid the use of agents in transactions based on personal information; if the information is "personal" to a party, then it will also be "personal" to her agent.<sup>215</sup>

### *B. Means of Discovery*

Commentators searching for a definition of fraud by silence have long focused on the means by which the trader acquired the information. Distinctions based on the means of discovery have an apparent advantage in that they address the policy concerns inherent in any fraud-by-silence rule.

#### *1. Effort v. Theft or Accident*

Because one of the goals of the law is to encourage and reward both diligence and the production of information, a rule that distinguishes between information acquired by lawful effort and information acquired by theft or accident makes a great deal of sense. This is one of the main advantages of the so-called misappropriation theory discussed above, which precludes the use of information acquired by theft.<sup>216</sup> Were it not so difficult to administer, a rule might be drawn that specifically defines fraud by silence as the withholding of all information acquired "casually" or accidentally rather than "deliberately."<sup>217</sup> As Professor Keeton wrote in 1936, "any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information, irrespective of the nature of the remedy."<sup>218</sup> Keeton also included information gained through merely tortious actions, such as trespass to land, and information acquired by "mere chance" in this category.<sup>219</sup>

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214. For a discussion of this practice and the rule, see *Chiarella v. United States*, 445 U.S. 222, 234 (1980); Brudney, *supra* note 11, at 371-76.

215. This simply follows general agency principles. Cf. *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (treating some agents, such as the issuer's lawyers and accountants, as temporary insiders for Rule 10b-5 purposes).

216. See *supra* notes 121-52 and accompanying text.

217. See Brudney, *supra* note 11, at 342 n.69; Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 16-17 (1978).

218. Keeton, *supra* note 37, at 25-26; see *id.* at 35.

219. See *id.* at 26. It often seems to be the case, however, that distinctions drawn

## 2. *The Misappropriation Theory and its Relatives*

The "misappropriation theory" has been popular with courts and commentators alike as a way of expanding Rule 10b-5 liability beyond corporate insiders and, because it recently received the approval of the Supreme Court, it is likely to be the leading theory of 10b-5 liability for the foreseeable future. Needless to say, perhaps, the misappropriation theory rests on the means of discovery distinction. As discussed above, however, there are problems with the misappropriation theory. For one thing, the remedy does not match the wrong: the civil penalty for violating Rule 10b-5 is based on the trader's profits, or losses avoided,<sup>220</sup> and persons who traded in the market during the same time period as the insider trader may recover the trader's profits.<sup>221</sup> The "defrauded" party—the party whose information was misappropriated—does not have a private cause of action under the securities laws, and that party's damages are not considered in the civil penalties under the 1934 Act.<sup>222</sup> In fact, the owner of the information may have a state law cause of action against the trader,<sup>223</sup> but such an action would not implicate the securities laws because only buyers and sellers have the right to sue for securities act violations.<sup>224</sup>

Additionally, the misappropriation theory seems overly broad. As discussed above,<sup>225</sup> to the extent the misappropriation theory rests on the language of the 1934 Act and Rule that refers to deceptive practices, no statutory basis exists for limiting the theory

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on the basis of the means by which the trader acquired her information are motivated primarily by another fact, that the other party to the transaction *could not* have discovered the information himself. In the case Keeton cited for his proposition, the holding rested not only on the fact that the information was acquired by theft, but also on the fact that the information was unavailable to the plaintiffs. See Phillips v. Homfray, 6 L.R.-Ch. 770 (1871), cited in Keeton, *supra* note 37, at 25.

220. See Securities Exchange Act of 1934 § 21A(a)(2), 15 U.S.C. § 78u-1(a)(2) (1994).

221. See § 20A(b), 15 U.S.C. § 78t-1(b). The Supreme Court has limited its approval of the misappropriation theory to criminal cases. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2214 (1997).

222. See EASTERBROOK & FISCHER, *supra* note 109, at 270-71.

223. See *infra* note 255 and accompanying text (discussing cause of action for secret profits).

224. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

225. See *supra* notes 121-52 and accompanying text.

to misuse of information on the stock market.<sup>226</sup> Why would a trustee who embezzles from his trust and uses the proceeds to invest in the stock market not be just as guilty of having engaged in a "deceptive device . . . in connection with the purchase and sale of securities" as the former employee who breaks into his old office to obtain information about a pending merger?<sup>227</sup>

The misappropriation theory, like the effort/theft distinction generally, has an advantage over other approaches on policy grounds. One policy concern is that regulation of fraud by silence should not discourage the production of useful information.<sup>228</sup> An insider trading prohibition based on the misappropriation theory would not implicate this concern because those who misappropriate information do not serve any useful societal function. The misappropriation theory's purported basis in the language of Rule 10b-5, therefore, is probably no more than a linguistic sleight-of-hand to create the favored rule. Outside of the context of the 1934 Act, a definition of fraud by silence based on misappropriation would run into the apparently intractable remedy problem. To give the ignorant trader a cause of action based on the knowledgeable trader's commission of a tort against a complete stranger to the plaintiff is unthinkable in a world that still recognizes concepts of privity. The misappropriation theory's utility is therefore probably limited to cases involving stock transactions.

### 3. *Monopoly v. Equal Access to Information*

The recent popularity of the misappropriation theory notwithstanding, the most enduring distinction made by jurists considering fraud by silence is the distinction between information available to all parties who bother to look and information available only to certain persons. The arguments appear as early as

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226. Burger recognized this. See *Chiarella v. United States* 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

227. The latter example is drawn from *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991). But see *U.S. v. O'Hagan*, 117 S. Ct. 2199, 2209 (1997) (rejecting the argument that embezzlement could be a basis for a Rule 10b-5 claim under the misappropriation theory).

228. See EASTERBROOK & FISCHER, *supra* note 109, at 259-60.

*Laidlaw v. Organ*,<sup>229</sup> in which both sides relied on the distinction. The plaintiff's lawyer argued that those who first received the news of the treaty deliberately "monopolized" the information and withheld it until after the completion of the tobacco purchase.<sup>230</sup> The defendant's lawyer argued that "[t]here was . . . no circumvention or manoeuvre practised by the vendee, unless rising earlier in the morning, and obtaining by superior diligence and alertness that intelligence by which the price of commodities was regulated, be such."<sup>231</sup> Chief Justice Marshall treated the case as one in which "the intelligence . . . was exclusively within the knowledge of the vendee," but found for the defendant nevertheless because "[i]t would be difficult to circumscribe the contrary doctrine within proper limits, where the means of intelligence are equally accessible to both parties."<sup>232</sup>

Despite the rather unequivocal language in *Laidlaw*, commentators continued to argue for a rule requiring disclosure where the parties did not have equal access to the information in question. Chancellor Kent, writing ten years later, cited *Laidlaw* for the proposition that disclosure is not required "[w]hen . . . the means of information . . . be equally accessible to both parties."<sup>233</sup> Other sources argued for a related doctrine that, where inspection was available, defects that an inspection would have disclosed could not give rise to a fraud claim, even when the buyer failed to inspect.<sup>234</sup> As Professor Keeton pointed out and as *Laidlaw* illustrated, however, the equal access rule was of limited usefulness.<sup>235</sup> Although there was never a duty to disclose information available to all, there was not *always* a duty to disclose information not available to all.<sup>236</sup>

The equal access rule also appeared in the common law insid-

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229. 15 U.S. (2 Wheat) 178 (1817).

230. *See id.* at 194.

231. *Id.* at 193.

232. *Id.* at 195.

233. 2 KENT, *supra* note 34, at 380.

234. *See* 3 WILLIAM BLACKSTONE, COMMENTARIES 165 (1768) (explaining that there is no duty to disclose things plain to the eyes of all); Brudney, *supra* note 11, at 355 n.110; *Caveat Emptor*, *supra* note 161, at 99; Dalley, *supra* note 10, at 419-24.

235. *See supra* notes 218-19 and accompanying text; *supra* notes 229-32 and accompanying text.

236. *See* Keeton, *supra* note 37, at 30.

er trading cases. In the very early case of *Spence v. Whitaker*,<sup>237</sup> the court based liability on the fact that the defendant's "situation must have given him an intimate knowledge of the state and condition of the affairs of the company[;] that no other could have any satisfactory knowledge concerning them, unless derived through him."<sup>238</sup> Additionally, the concern for equal access probably led to the turn-of-the-century rule that there was no duty to disclose information reflected in the company's books, but that information not so available, such as merger negotiations, must be disclosed.<sup>239</sup>

The equal access theory also has played a significant role in the post-1934 insider-trading debate. One leading commentator has proposed a rule that would permit trading only on the basis of informational advantages that other traders were able to erode.<sup>240</sup> In other words, if the public does not have lawful access to information, then a trader who does have such access violates Rule 10b-5 if she trades on the basis of the information.<sup>241</sup> Justice Blackmun, in his dissent in *Chiarella*, made a similar proposal.<sup>242</sup> Justice Blackmun thought that it was the trader's special access to information, rather than the existence of a breach of duty, that gave rise to the 10b-5 violation.<sup>243</sup> Even if the print shop and its client, the bidder, had

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237. 3 Port. 297 (Ala. 1836).

238. *Id.* at 324. In addition, in that case the plaintiff's lack of knowledge was due to the defendant's failure to keep accurate records. *See id.*; *see also* *Jacquith v. Mason*, 156 N.W. 1041 (Neb. 1916) (noting that the plaintiff "was not familiar with public transactions, was wholly unacquainted with the condition of the corporation, the value of the stock, or the opportunity to sell the same."); *Morrison v. Snow*, 72 P. 924, 928 (Utah 1903) (determining that the plaintiff did not have equal access because his job kept him tied to a distant city).

239. *See, e.g.*, *Oliver v. Oliver*, 45 S.E. 232, 234 (Ga. 1903); *Walsh v. Goulden*, 90 N.W. 406, 410 (Mich. 1902); *Heinselman, supra* note 52, at 629-30; *see also* *Steinfeld v. Nielsen*, 139 P. 879, 888 (Ariz. 1913) (discussing a situation in which the plaintiff was also a director); *Boulden v. Stilwell*, 60 A. 609, 612 (Md. 1905) (same). *But see* *Stewart v. Harris*, 77 P. 277, 281 (Kan. 1904) (holding that the fact that the plaintiff could have examined the books is irrelevant); *Woodruff v. Cole*, 269 S.W. 599, 601, 604 (Mo. 1925) (same).

240. *See* *Brudney, supra* note 11 at 346-47, 354-56 *passim*; *see also* *Scheppele, supra* note 20, at 125, 162 *et seq.* (making a similar argument).

241. *See supra* notes 97-100 and accompanying text.

242. *See Chiarella v. United States*, 445 U.S. 222, 247 *et seq.* (1980) (Blackmun, J., dissenting).

243. *See id.* at 251 (Blackmun, J., dissenting); *see also* *Brudney, supra* note 11,

permitted its employees to use the information, Chiarella would still have committed securities fraud.<sup>244</sup> The equal access approach has not attracted the judicial attention that the misappropriation theory has; nevertheless, it has been subject to some academic criticism. Law and economics scholars have argued that access can always be purchased in some way; one could, for example, devote one's life to becoming a corporate director and thus have the same legal access to corporate information.<sup>245</sup> Additionally, the equal access rule would seem to prohibit a bidder and its accomplices from purchasing stock prior to announcement of the bid, while the price was still low, unless the bidder's purchases were exempt because the bidder's information is "personal."<sup>246</sup> The equal access theory avoids the remedy problem presented by the misappropriation theory; nevertheless, it is related to the misappropriation theory. To the extent that the only people who have unequal access are people who receive information that is protected legally (and so cannot be acquired by others at any price), the access theory will cover the same cases covered by the misappropriation theory, except to the extent that a trader with permission from her employer is covered by the equal access rule but not the misappropriation theory.<sup>247</sup> Additionally, because the equal access rule is based on the public's *lawful* access to the information in question, it is

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*passim*.

244. See *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting). For a contrary view, that permission by the "owner" of the information removes the case from regulation, see *United States v. O'Hagan*, 117 S. Ct. 2199, 2208 (1997); EASTERBROOK & FISCHEL, *supra* note 109, at 270. The unequal access theory does not rest, as the SEC's *Cady, Roberts* position did, on an imbalance of information between buyer and seller. See *supra* note 98 and accompanying text. Rather, it rests on the unequal access to information between the two parties. See *Chiarella*, 445 U.S. at 252, n.2 (Blackmun, J., dissenting). Blackmun limits his theory to information to which one has unequal *legal* access. See *id.* at 247, 251. To say that the opposite trader might have broken into the print shop to get the same information *Chiarella* had is not a rebuttal to Justice Blackmun's argument.

245. See EASTERBROOK AND FISCHEL, *supra* note 109, at 254. Easterbrook and Fischel also give as an example that anyone can gain access to an analyst's report by hiring the analyst. See *id.* This treats an analyst's admittedly valuable opinion as nonpublic information.

246. See *supra* note 215 and accompanying text.

247. See Easterbrook, *supra* note 16, at 330.

closely related to property-based rules discussed below.<sup>248</sup>

### C. *Information as Property*

Another popular fraud-by-silence rule is based on the characterization of information as the property of some person or entity.<sup>249</sup> Under this theory, news about corporate prospects is corporate property and an employee of the company is prohibited from using the information to her own advantage just as she is prohibited from using other corporate property.<sup>250</sup> Similarly, the news of the pending takeover in *Chiarella* was the property of the bidder, and neither the printing company nor the printer's employees could benefit from the use of their client's property without permission. Needless to say, perhaps, the misappropriation theory derives from a property analysis.

Merely describing information as property does not determine the extent to which the use of information should be prohibited. Some commentators argue that the use of information should be prohibited only when the use causes damage to the owner of the property—by forestalling the owner's opportunity to profit, for example, or by causing the information to be disclosed to the owner's detriment.<sup>251</sup> To the extent that *Chiarella's* or *O'Hagan's* trading caused an increase in the price of the target's stock, it should be prohibited because the bidder who owned the information would be damaged by having to pay a higher price to acquire the target's stock. Conversely, the property theory eliminates liability in those situations where damage cannot be shown. Proponents of insider trading prohibitions have been

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248. See *id.*; *infra* notes 249-65 and accompanying text.

249. See, e.g., *Carpenter v. United States*, 484 U.S. 19, 25-26 (1987) (holding that information is property for purposes of mail fraud statute).

250. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2208 (1997); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981) ("In other areas of the law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful.").

251. See Easterbrook, *supra* note 16, at 331. It is not clear who would have the burden of proof on the damage issue. Would the SEC, or a private plaintiff in a civil damages action, have to show damage to the owner of the information, who normally will not be a party to the suit, in order to claim that a stock trade violated Rule 10b-5? Would speculative harms, such as the loss of credibility that a financial publication suffers as a result of scalping, be sufficient?



unable to identify a victim of insider trading because losses in the stock market are rarely, if ever, caused by other traders.<sup>252</sup> The property theory solves that problem by requiring an identifiable victim, that is, someone who has been harmed, for the insider trade to be wrongful. However, showing harm under the property theory will be extremely difficult, because individual trades rarely affect the market for a stock or result in disclosure of the information.<sup>253</sup> Even true insider trading by corporate executives in their own company's stock would often be permitted under this rule.

An alternative formulation of the property theory would prohibit use of information even when there is no damage to the owner of the information.<sup>254</sup> Such a rule is consistent with the "secret profit" rule of agency law, which requires that an agent disgorge to his principal all profits derived by the agent from the agency relationship, regardless of whether there has been a loss to the principal.<sup>255</sup> Additionally, this rule is consistent with the principle that an owner of property generally has a right to compensation for another's use of the property, even if the owner is not damaged by the use.<sup>256</sup> If Rule 10b-5 liability is to be dependent on a showing of damage to the owner of the information, then the liability cannot be said to derive from traditional property law principles.<sup>257</sup>

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252. See *infra* notes 305-27 and accompanying text.

253. Insider trades that are disclosed publicly under SEC regulations may have an effect on the market—the *Wall Street Journal* and other financial publications regularly report such trades, presumably because readers find them relevant—but because such trades rarely involve nonpublic information, they are not at issue here.

254. See, e.g., *United States v. Willis*, 737 F. Supp. 269, 274 (S.D.N.Y. 1990).

255. See RESTATEMENT (SECOND) OF AGENCY § 388, cmt. c (1957) (stating that an agent has a duty not to profit from a principal's confidential information even if there is no harm to principal); *Reading v. Attorney-General*, 1951 App. Cas. 507 (appeal taken from C.A.).

256. See *Olwell v. Nye & Nissen Co.*, 173 P.2d 652, 654 (Wash. 1946) (determining that a user of the plaintiff's machine must pay the plaintiff for the user's profits even when the plaintiff put machine in storage). The court noted that "[t]he very essence of the nature of property is the right to its exclusive use." *Id.*

257. It is not, of course, necessary for 10b-5 liability to be based on any existing principles at all. But because the Supreme Court has precluded an interpretation of Rule 10b-5 not based on common law fraud principles, a property-based liability rule created out of whole cloth is unlikely to win the Court's favor. See *supra* note 18 and accompanying text.

Like the other analyses described above, the property-based approach to fraud by silence was not invented by the 10b-5 commentators. Verplanck considered the role of property interests in his 1825 commentary, in which he noted that traders often justly regard information, especially information acquired through considerable effort, as private property, which one is not required to transfer gratuitously.<sup>258</sup> The common law insider trading cases also considered property principles, albeit in a different light. There, the argument went as follows:

The information as to the corporate affairs belongs to the corporation and can be used only for its benefit or for the benefit of each and all of its stockholders alike; and the attempt by one director to gain advantage by it is a breach of his obligation in the premises.<sup>259</sup>

An additional problem with the property theory is that it depends upon a workable theory of how rights in information are created. In most cases, the property rights protected under the property theory will derive from some idea akin to the labor theory of property.<sup>260</sup> This would allow a trader to create property rights in things not owned by anyone, such as publicly disclosed corporate data or even news of world events.<sup>261</sup> The

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258. See VERPLANCK, *supra* note 26, at 9, 77; *supra* note 162 and accompanying text.

259. Berle, *supra* note 52, at 836; see, e.g., *Oliver v. Oliver*, 45 S.E. 232, 234 (Ga. 1903) ("In a certain sense the information is a quasi asset of the company, and the shareholder is as much entitled to the advantage of that sort of asset as to any other regularly entered on the list of the company's holding."); BERLE & MEANS, *supra* note 25, at 225 n.6 (arguing that the director acquires information "only in his capacity as a manager of the corporation. Ethically it would seem plain that the information and any advantage from it belonged to the shareholders rather than to the director personally.").

260. Although the courts have rejected the idea that effort alone can create a property right in information, see, e.g., *International News Serv. v. Associated Press*, 248 U.S. 215, 240 (1918), they have espoused the view that the right to protect information derives from the fact that the information would not be produced without that protection. See *National Basketball Ass'n v. Motorola, Inc.*, Nos. 96-7975, 96-7983 (CON), 96-9123 (XAP), 1997 LEXIS 1527, at \*38 (2d Cir. Jan. 30, 1997). The cost of producing the information, in terms of effort and expense, is an essential feature creating the right to protect the information.

261. The reasoning of *International News Service v. Associated Press* would be ap-

news of the treaty in *Laidlaw* presents an interesting situation.<sup>262</sup> The news may have been the property of the two governments who were parties to the treaty, but they had no interest in preventing its disclosure. One might treat the news as the property of the captain of the ship carrying the message, but that rule might be offensive if the ship was carrying the news as a public function. Nathan Rothschild's sailing across the English Channel in bad weather to trade on the news of Waterloo would perhaps be a different matter.<sup>263</sup> Similarly, an analyst who "crunched" industry numbers presumably would have a property right in the result, even though she could not have a property right in publicly available raw data.<sup>264</sup> By incorporating an existing set of complex rules determining when information becomes property, the property theory would address the policy concerns served by those rules. Alternatively, the property theory would subject fraud-by-silence law to the uncertainty and controversy present in the underlying property law, just as the fiduciary trading rule subjects fraud-by-silence law to the continuing debate over fiduciary duties.<sup>265</sup>

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plicable here. See *International News Serv.*, 248 U.S. at 215. A court would not, presumably, protect an analyst's early knowledge of a change in Federal Reserve interest rate policy, see *id.* at 234 (declaring that news reports are *publici juris*), but it might protect the analyst's report describing how the change would affect a given company or market sector.

262. See *Laidlaw v. Organ*, 15 U.S. (2 Wheat) 178 (1817).

263. This story is apparently apocryphal. The Rothschild messenger, not Nathan himself, did arrive in London before Wellington's official envoy, but the rest of the story, including the Rothchilds' stock market profits as a result of the early news, was invented. See COUNT EGON CAESAR CORTI, *THE RISE OF THE HOUSE OF ROTHSCHILD* 156-57 (Brian & Beatrix Lunn, trans., Western Islands 1972) (1927).

264. Cf. JOHN LOCKE, *TWO TREATISES OF GOVERNMENT* 288 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690) ("Whatsoever, then, he removes out of the State that Nature hath provided, and left it in, he hath mixed his *Labour* with and joyned to it something that is his own, and thereby makes it his *Property*."). But see *Feist Publications Inc. v. Rural Tel. Serv. Co.*, 499 U.S. 340, 359-61 (1991) (determining that there is no property right in telephone listings even if the gathering involved labor).

265. The property theory would have to address the problem presented by those who acquire information accidentally. Traditional property analysis would ask whether the owner had "abandoned" her rights in the property, which in the information context might approximate the expectation of privacy analysis used in the context of the Fourth Amendment and attorney-client privilege.

*D. Fairness and the Standards of the Business Community*

Another characteristic of fraud by silence that commentators raise with considerable regularity is "fairness." The concept of fairness has been criticized as being "messy" and lacking content,<sup>266</sup> and in fact, courts rarely cite fairness as a basis for their decisions, even in the strongest proplaintiff cases.<sup>267</sup> Nevertheless, the idea that trading on the basis of nonpublic information is "just not right" is an enduring one.<sup>268</sup> Commentators usually have defined fairness in this context according to standards generally accepted in the business community. Some commentators have argued that trading on nonpublic information is fair, and should be permitted, whenever the risk of the existence of nonpublic information is one of the assumptions of the transaction.<sup>269</sup> If the existence of the information is foreseeable, if "[a]ll know that a wide difference exists among men in these points,"<sup>270</sup> then the information may be used. In *Laidlaw*, each merchant would know that the other might have a different view of the outcome of the war, and each was free to trade based on that view. Neither would suspect, however, that the other had actual knowledge of the war's end.<sup>271</sup> In other words, if the

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266. See, e.g., Easterbrook, *supra* note 16, at 323-24 *et seq.*; see also EASTERBROOK & FISCHER, *supra* note 109, at 261-62 (refuting arguments for the position that managers' trading is unfair).

267. Courts sometimes raise fairness as an element of the duty of "utmost fairness" traditionally imposed on fiduciaries. See, e.g., *Hotchkiss v. Fischer*, 16 P.2d 531, 535 (Kan. 1932). But see Allen, *supra* note 108, at 183 (arguing that the "vague, empty or meaningless" concept of fairness is a legitimate concern for the courts).

268. Scheppele, *supra* note 20, at 123 (quoting Henry Manne's anecdote about a law student who stamped her foot and declared "I don't care; it's just not right."). But see MANNE, *supra* note 117, at 93 ("It is not enough simply to say that insider trading is unfair. If it is unfair, it must be unfair to somebody.").

269. See FRIED, *supra* note 10, at 82 ("these risks are part of the assumptions of the deal"); cf. VERPLANCK, *supra* note 26, at 119 ("It is always fraudulent in contracts, to take advantage in any respect whatever, wherein it is of course presumed by the one side, and understood by the other to be so presumed, that no advantage will be taken.").

270. VERPLANCK, *supra* note 26, at 119.

271. See *id.* at 122; see also *id.* at 1-3 (noting that news of the end of the war was unexpected completely in New Orleans when the tobacco purchase occurred); cf. 2 KENT, *supra* note 34, at 383 n.a (criticizing Verplanck for finding fraud in the "ten thousand cases in which . . . men deal with each other at arm's length, and with an entire and exclusive reliance upon their own judgment, knowledge, and examination").

transaction involves deep secrets, that is, "secrets whose existence one does not even suspect,"<sup>272</sup> then the transaction is unfair and should be prohibited.<sup>273</sup>

The general "assumption of the deal" rule has been used to create more specific rules. For example, the rule that fiduciaries have a duty of full disclosure before they trade may be explained by the fact that one of the assumptions of the fiduciary relationship is precisely that the fiduciary will not take advantage of superior knowledge, among other things.<sup>274</sup> Similarly, a horse trader does not have a duty to disclose superior information about the horse precisely because everyone knows that horse trading is subject to sharp practices, and everyone is therefore on his or her guard.<sup>275</sup> In a stock transaction, the rule would permit an insider to sell stock based on his knowledge of business generally, and of his business, in particular. This is permitted because "[t]he buyer knows that there is a great difference among men in their management of their money concerns, and their knowledge of all that relates to it, and this[] he has no reason to suppose may not also exist between him and [the insider]."<sup>276</sup> For example, an insurance company executive may sell his company's stock if he believes insurance premiums do not compensate adequately for risks. If the executive has "intelligence of distant losses, which have sunk half of [the company's]

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272. Scheppele, *supra* note 20, at 158.

273. *See id.* at 157-60. Both Scheppele and Verplanck use games of chance as an example of this rule. Scheppele compares the usual lottery situation, in which the odds of winning are calculable by anyone, to one in which, unbeknownst to the players, the lottery commission periodically removes some numbers from play. In the latter situation, the commission's action would be a deep secret and would make the game unfair. *See id.* Verplanck also uses the example of "contracts of hazard," including lotteries and horse races, that are considered unfair if one party has private information. VERPLANCK, *supra* note 26, at 139.

274. *See* VERPLANCK, *supra* note 26, at 189.

275. *See id.* at 209-10.

276. *Id.* at 122. Another feature of such information is that it is theoretically available to anyone with the sagacity or other resources to acquire it. Whether some traders have a monopoly on information may also be a factor in determining when a trade is "fair," although most commentators treat the two considerations separately. *See, e.g.,* Keeton, *supra* note 37, at 32-33 ("the opportunity which the uninformed person might have to ascertain the fact not disclosed is a factor of importance" in determining the fairness of the transaction); Scheppele, *supra* note 20, at 157-60 (discussing assumption of the deal); *id.* at 160-62 (addressing the monopoly on information).

capital, and [the executive and his] brother directors conceal it until [they] have disposed of [their] own stock at the current rate, this is no longer a fair use of superior knowledge."<sup>277</sup>

An alternative formulation of the assumption of the deal rule focuses on the prevailing standards in this business community. Needless to say, perhaps, this is a linguistic rather than a substantive difference because the prevailing standards in the business community will determine what information is assumed to be within the deal and what information is instead a deep secret. The *Restatement (Second) of Contracts* includes as one of the few instances in which nondisclosure of a fact will amount to misrepresentation when "non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing."<sup>278</sup> Similarly, the *Restatement (Second) of Torts* discusses this concept at length:

The continuing development of modern business ethics has . . . limited to some extent [the] privilege to take advantage of ignorance. In general, the cases in which the rule [requiring disclosure] has been applied have been those in which the advantage taken of the plaintiff's ignorance is so shocking to the ethical sense of the community, and is so extreme and unfair, as to amount to a form of swindling, in which the plaintiff is led by appearances into a bargain that is a trap, of whose essence and substance he is unaware. In such a case, even in a tort action for deceit, the plaintiff is entitled to be compensated for the loss that he has sustained . . . There are indications, also, that with changing ethical attitudes in many fields of modern business, the concept of facts basic to the transaction may be expanding and the duty to use reasonable care to disclose the facts may be increasing somewhat.<sup>279</sup>

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277. VERPLANCK, *supra* note 26, at 121-22. Professor Scheppele has a somewhat different take on the insider trading context. She argues that insider trading involves inherently "deep secrets," even when other participants know that insider trading may be taking place, because the existence of an impersonal market in which traders do not have any information other than price and do not know the identity of the opposite party makes it impossible for a participant to judge accurately the risk that she is trading in the face of nonpublic information. Scheppele, *supra* note 20, at 159-60.

278. RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1979).

279. RESTATEMENT (SECOND) OF TORTS § 551 cmt. 1 (1977).

Professor Keeton argued in 1936 that whether nondisclosure should amount to fraud is a question "of fair conduct, just as negligence is a question of fair conduct,"<sup>280</sup> and therefore the standard to be applied could be determined by consulting the reasonable man. Keeton proposed that the law determine what "the man of ordinary moral sensibilities would have done; would he have disclosed the information or would he have remained silent?"<sup>281</sup> The ordinary man also makes an appearance in Verplanck's commentary on *Laidlaw*:

[T]he virtuous and benevolent man will find in his own common sense, and in his determination to do unto his neighbours as he would that they should do unto him, much surer guides for his conduct in every situation of life, than any logical or technical rule can afford. Yet the decisions of such a man . . . must involve some uniform principle.<sup>282</sup>

Verplanck then attempted in the rest of his book to explain that uniform principle. The law, according to Verplanck, should comport with common sense, which the extreme rule of *caveat emptor* does not. "[W]henever in a law report," he wrote, "I meet with one of these moldy scraps of bad Latin, I always prepare to find some argument or decision startling to common sense."<sup>283</sup>

Interestingly, the Rule 10b-5 literature has not made much use of the concept of fair conduct, perhaps because the *Chiarella* decision seems to reject such a flexible standard, perhaps because the law and economics movement has driven such concepts underground.<sup>284</sup> One of the few recent commentators to make a fairness argument dressed it in a contractarian analysis

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280. Keeton, *supra* note 37, at 32.

281. *Id.* Keeton then listed a number of factors that could be used to determine what the "ordinary ethical person" would do. *Id.* at 34-37. Among the factors Keeton discussed are the relation the parties bear to one another, the manner in which the information is acquired, the nature of the fact not disclosed (e.g., intrinsic or extrinsic), whether the party with the knowledge was a buyer or seller, the nature of the contract, and the materiality of the fact. *See id.*

282. VERPLANCK, *supra* note 26, at 10-11.

283. *Id.* at 219.

284. Manne, one of the founding fathers of the law and economics approach to insider trading, acknowledged the role of fairness in a rarely cited passage. *See supra* note 268.

to make it more palatable.<sup>285</sup> Nevertheless, the concept of fairness is alive and well in the common law of fraud, as the excerpts presented above indicate. Additionally, fairness concerns may underlie many of the judicial decisions on insider trading, perhaps producing the seemingly inconsistent, in theoretical terms, results of the cases.

### *E. Buyers v. Sellers*

Finally, it is worth mentioning one distinction recognized by the common law in sales that has never been advocated as a meaningful distinction between stock traders: the distinction between buyers and sellers. At common law, a seller's failure to disclose a defect not readily discoverable by inspection was actionable as deceit.<sup>286</sup> A buyer, however, was under no obligation to disclose facts to a seller, provided that the buyer did not mislead the seller in any way.<sup>287</sup> This distinction may have reflected the fact that sellers generally have intimate knowledge of the items in question, whereas buyers do not.<sup>288</sup> In commercial transactions, however, that generalization would not hold true. An end-user buyer might have more knowledge about an item than a middleman-seller, and in a transaction between two middlemen, both parties might be ignorant of the goods' defects and characteristics. This may explain the courts' failure to apply the buyer-seller distinction consistently.<sup>289</sup>

In stock transactions under the mandatory disclosure system established by the 1934 Act, there is no reason to suppose that sellers (existing shareholders) will have better knowledge of the company or the market than buyers who may, in fact, also be shareholders. Alternatively, if one applies a strict fiduciary test to identify fraud, then only seller-shareholders would have a

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285. See Scheppele, *supra* note 20.

286. See KIM LANE SCHEPPELE, LEGAL SECRETS: EQUALITY AND EFFICIENCY IN THE COMMON LAW 270-282 (1988); Dalley, *supra* note 10, at 424-28.

287. See *id.*

288. See Keeton, *supra* note 37, at 21; cf. SCHEPPELE, *supra* note 286, at 270 (arguing that "caveat emptor was not stacked against ignorant buyers in favor of crafty and devious sellers").

289. See Dalley, *supra* note 10, at 426-28; see also VERPLANCK, *supra* note 26, at 70 (noting that Roman law did not recognize a difference between buyers and sellers).



cause of action, and only against insider-buyers. In the words of Judge Learned Hand, "it would be a sorry distinction to allow [an insider] to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one."<sup>290</sup> The distinction has never been important in the insider trading context.

### III. SPECIAL CONSIDERATIONS IN THE INSIDER TRADING CONTEXT

Two features distinguish late twentieth century insider trading from garden variety common law fraud. One of those features is the existence of a trading environment full of information about all publicly traded stocks, and the other is the existence of an impersonal market for those stocks.<sup>291</sup> Oddly, the federal courts have not considered these features in their Rule 10b-5 jurisprudence. Nevertheless, both features have figured prominently in the insider trading debate, and both have common law roots.

#### A. *The Environment of Existing Information*

As discussed above, the common law recognizes a duty to disclose between a fiduciary and beneficiary.<sup>292</sup> The common law also imposes a duty to disclose information on a party who is responsible for her trading opposite's incorrect information.<sup>293</sup> There are generally three ways in which one party can cause another's ignorance. First, a party who takes steps to disguise facts that would otherwise be obvious, who, in other

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290. *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951), *quoted in* *Chiarella v. United States*, 445 U.S. 222, 227 n.8 (1980) and *In re Cady, Roberts and Co.*, 40 S.E.C. 907, 914 n.23 (1961). This point is reflected in fiduciary law outside the corporate context by the existence of preresult duties between principals and agents. *See* RESTATEMENT (SECOND) OF AGENCY § 23 (1958).

291. There are two other features unique to insider trading under Rule 10b-5 that are beyond the scope of this Article. One is the fact that a violation of Rule 10b-5 can carry criminal penalties; the other is that regulation is by the federal government, rather than by the states. *See* Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff(a) (1994).

292. *See supra* notes 33-42 and accompanying text.

293. *See* FRIED, *supra* note 10, at 78-81.

words, engages in "active concealment," for example by painting over termite damage, is under a duty to disclose full information.<sup>294</sup> Second, a party who makes statements that, although technically accurate, contain misleading omissions, in other words, half-truths, is also under a duty to disclose the true facts.<sup>295</sup> Third, a party who makes true statements that later become inaccurate is under a duty to disclose the change in circumstances.<sup>296</sup> This last rule is particularly relevant in the insider trading context.

Today's stock transactions take place in an environment in which a vast amount of information is available to all traders.<sup>297</sup> Most of this information either comes directly from the issuer of the stock or is derived from such issuer information.<sup>298</sup> The issuer and those individuals who are in control of

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294. See, e.g., RESTATEMENT (SECOND) OF TORTS § 550 (1977); 2 WILLIAM BLACKSTONE, COMMENTARIES \*452 (1766); FRIED, *supra* note 10, at 78; Keeton, *supra* note 37, at 3. The termite example is from *Obde v. Schlemeyer*, 353 P.2d 672 (Wash. 1960), discussed in FRIED, *supra* note 10, at 78 *et seq.* and Kronman, *supra* note 217, at 24-25. See also RESTATEMENT (SECOND) OF CONTRACTS § 160 (1979) (stating that action preventing another from learning a fact is equivalent to a misrepresentation and may make a contract voidable).

295. See, e.g., *Buckley v. Buckley*, 202 N.W. 955 (Mich. 1925), cited in Heinselman, *supra* note 52, at 627; RESTATEMENT (SECOND) OF TORTS § 551(2)(b); Dalley, *supra* note 10, at 438; see also RESTATEMENT (SECOND) OF CONTRACTS § 159 cmt. b (1979) (stating that a half-truth is equivalent to a misrepresentation).

296. See, e.g., RESTATEMENT (SECOND) OF TORTS § 551(2)(c); Keeton, *supra* note 37, at 6-7 (describing what he calls "continuing misrepresentations"); see also RESTATEMENT (SECOND) OF CONTRACTS § 161(a) (stating that failure to correct prior statements that have become inaccurate is equivalent to a misrepresentation).

297. This fact has been used to support an argument that imposing liability on insiders is unnecessary in publicly held companies, unlike close corporations, because the public traders are not dependent on the insiders for information. See Walker, *supra* note 64, at 641.

298. See Brudney, *supra* note 11, at 326.

The continuous description of their businesses and prospects by publicly held corporations to their investors—and to the public—is evidenced not merely by mandated information and periodic financial reports, but by regular reports to stockholders, by extensive and frequent press releases, by meetings with securities analysts (both formal in assembly and informal in individual meetings), and by advertisements in the media. . . . [I]t can fairly be said that anybody considering an investment decision . . . with respect to the stock of a publicly held company will be acting on the basis of extensive information proffered by the corporation up until the moment of his decision. . . . [H]e can be said to have been given a certain impression of the enterprise and its prospects from its

the issuer, in other words, insiders, are directly or indirectly responsible for the information available to the marketplace.<sup>299</sup> At least in theory, all of this information is reflected in the price of a security, so that even a trader who bases his or her decision solely on price will in fact be acting in reliance on all of the available information.<sup>300</sup> Under common law fraud principles, when a change in circumstances occurs that makes the existing information misleading, in other words, when not-yet-public news develops, those responsible for the existing information—the issuer and its insiders—should be under a duty to disclose the new information before entering into a transaction on that basis.<sup>301</sup>

The duty-to-correct rule is in fact reflected in the language of Rule 10b-5 and in other rules and regulations applicable to issuers.<sup>302</sup> Rule 10b-5 makes it unlawful “to omit to state a materi-

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own published utterances, both mandated and not mandated.

*Id.*

299. See *id.* When considering the adequacy of corporate disclosure, courts look to the “total mix” of available information, not only to individual disclosure documents. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). This too reflects legal recognition of the amount of information available to the market in general.

300. This is the efficient capital markets hypothesis. For a general discussion, see ROBERT W. HAMILTON, *MONEY MANAGEMENT FOR LAWYERS AND CLIENTS* 296-98 (1993); for a scholarly discussion, see Burton G. Malkiel, *Efficient Market Hypothesis*, in *FINANCE* 127 (John Eatwell et al. eds., 1989); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). This is also not a particularly recent phenomenon. See VERPLANCK, *supra* note 26, at 108-12 (stating that the market price of an item reflects the sum of information relating to the item); cf. Nielson, *supra* note 156, at 350 (asserting that false or inaccurate information causes harm to whole market).

301. See Brudney, *supra* note 11, at 327.

In the light of the continuous creation of a particular impression of corporate affairs by the corporation, if events occur that make that previously created impression materially misleading, failure to communicate the occurrence of those events may plausibly be taken to be a representation—or at least may fairly permit investors to infer—that all previous disclosures remain accurate and complete and furnish an adequate basis for the investment decision of the outsider. In the language of the statutes, the failure to disclose those events constitutes an omission to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

*Id.*

302. See 17 C.F.R. § 240.10b-5 (1951). It is not clear, however, that issuers have a general duty under the securities acts to disclose new information. See generally Safe

al fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."<sup>303</sup> The rule does not, obviously, extend to noninsiders or even, presumably, to low-level corporate employees who are not in a position to control corporate disclosure. The rule would, however, apply to both market and company information,<sup>304</sup> to the extent that that information made the existing mix of information misleading. The fact that the duty to correct would apply only to insiders who are already covered by Rule 10b-5 under the fiduciary trading rule probably explains the courts' lack of interest in this theory.

### *B. The Impersonal Stock Market*

Most stock transactions today take place in an organized, impersonal market in which buyers and sellers never meet.<sup>305</sup> In fact, buyers and sellers do not know, and probably cannot learn, each other's identity.<sup>306</sup> This fact has a number of consequences for the definition of fraud by silence. For example, the integrity of the market argument discussed above, which is based on the existence and importance of national stock markets, has been used to justify a broad insider trading prohibition.<sup>307</sup> Furthermore, the efficient functioning of a stock market requires

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Harbor for Forward-Looking Statements, Securities Act Release No. 7101, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,436, at 85,787 (Oct. 13, 1994) (discussing the uncertainty in law regarding the duty to update); 7 LOSS & SELIGMAN, *supra* note 4, at 3517-19 *et seq.* (discussing SEC regulations requiring issuers to correct and update information); *id.* at 3510-14 (describing stock exchange rules requiring prompt disclosure of new information).

303. 17 C.F.R. § 240.10b-5(b).

304. See *supra* notes 197-201 and accompanying text.

305. This is by no means a recent development. Even early cases noted the existence of stock markets. In *Carpenter v. Danforth*, 52 Barb. 581, 586 (N.Y. App. Div. 1868), the court rather quaintly argued in dicta that the market price of a security does not reflect the "real" value of the company, and, therefore, an insider's information about the company would not be an advantage in a transaction for a market-traded stock. Other cases noting the existence of markets include *Smock v. Henderson*, 1 Wils. 241 (Ind. 1872), and *Deck v. Feld*, 38 Mo. App. 674 (1890). Impersonal transactions occur not only on the exchanges, but also in the over-the-counter market and electronic trading systems.

306. For a comprehensive explanation of this phenomenon, see WANG & STEINBERG, *supra* note 25, at 48-61.

307. See *supra* notes 184-86 and accompanying text.

dissemination of material information, and any insider trading prohibition should foster, or at least, not impede, that goal.<sup>308</sup> Similarly, the structure of the market gives corporate managers the power to affect, and manipulate, the price of the corporation's securities,<sup>309</sup> and insider trading rules may affect managers' incentives to manipulate stock prices and create market volatility.<sup>310</sup>

Commentators on insider trading law have debated the significance of impersonal markets for decades. Some pre-1934 courts argued that the duty to disclose should be stricter in an impersonal market in which the trader's identity cannot serve a signaling function to other traders.<sup>311</sup> The fact that a buyer and seller are in a fiduciary relationship, however, loses much of its significance in a transaction on an exchange.<sup>312</sup> Courts and commentators have long argued that where there is no negotiation, no discussion, and no reliance on the information given, in other words, where there is no face-to-face transaction, the common law fraud rules should not apply.<sup>313</sup> This fact is evidenced allegedly by the fact that every common law insider trading case that found insider liability concerned a face-to-face transaction.<sup>314</sup>

308. See *supra* note 228 and accompanying text; see also BERLE & MEANS, *supra* note 25, at 293-94 (describing the market's mechanisms for collecting and disseminating facts). This goal is especially important if the original purpose of the 1934 Act was to ensure the "integrity" of security prices. See Thel, *supra* note 13, at 391-92.

309. See *Oliver v. Oliver*, 45 S.E. 232, 234-45 (Ga. 1903).

310. See *supra* text accompanying notes 187-88.

311. See, e.g., *Boulden v. Stilwell*, 60 A. 609, 612 (Md. 1905); see also *Strong v. Repide*, 213 U.S. 419 (1909) (declaring that the defendant's use of a straw man to purchase the plaintiffs stock was strong evidence of fraud); *Keeton*, *supra* note 37, at 26 (describing situations where a buyer has been held liable for failing to disclose identity).

312. See *Oliver*, 45 S.E. at 235.

313. See, e.g., *Goodwin v. Agassiz*, 186 N.E. 659, 661 (Mass. 1933); *Allen*, *supra* note 108, at 177-79; *Scheppele*, *supra* note 20, at 137-38. But see BERLE & MEANS, *supra* note 25, at 226 n.9 (noting that insider traders in impersonal markets are no happier to have their trades publicized than are traders in face-to-face transactions); *Berle*, *supra* note 52, at 835 (rejecting the argument that there is no contact between an insider trader and her opposite in an impersonal market because the corporation's public disclosures create such contact).

314. See, e.g., 7 LOSS & SELIGMAN, *supra* note 4, at 3476 (ascribing the lack of market-based cases to a privity requirement); *Walker*, *supra* note 64, at 641.

Nevertheless, the securities laws would seem to apply particularly to market transactions, and if Rule 10b-5 liability does not extend to market transactions, it will have almost no force at all.<sup>315</sup>

The fact that insider trading occurs primarily in an impersonal market is probably most significant in that it makes the ignorant trader's loss difficult to identify.<sup>316</sup> Because traders in the market do not know the identity of their opposite traders, the fact that any given trader has traded with an insider trader will be completely fortuitous. The insider trader's opposite is completely indistinguishable from all of the other traders in the market. Why then should that trader have a cause of action while other traders do not? Congress has solved this problem by giving a cause of action to all contemporaneous opposite traders, whether they were in fact the ones who traded with the insider.<sup>317</sup> Another problem arises from the fact that the other traders in the market would have traded even if the insider had abstained from trading, as required by the disclose-or-abstain rule.<sup>318</sup> The insider cannot be said to have caused the other traders' losses because their decision to trade or not to trade was made completely independent of the insider.<sup>319</sup> The response to this is that the harm has been caused by the insider's failure to disclose, not by her trade.<sup>320</sup> As discussed above, the other traders' decisions are based primarily on the price of the securi-

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315. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 914-15 (1961); see also Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 BOSTON UNIV. L. REV. 389, 403 n.58 (1993) (describing common law fraud as appropriate for face-to-face transactions and Rule 10b-5 as appropriate for transactions in impersonal markets).

316. For a comprehensive discussion of the debate over who is harmed by insider trading, see WANG & STEINBERG, *supra* note 25, at 41-115. See also EASTERBROOK & FISCHEL, *supra* note 109, at 345-48; MANNE, *supra* note 117, at 99-110.

317. In other words, if an insider buys stock, all contemporaneous sellers have a cause of action against the insider. This rule solves the practical problem that it is often impossible to match an insider's trades with those of other traders. See *supra* note 306 and accompanying text.

318. See MANNE, *supra* note 117, at 94-96; WANG & STEINBERG, *supra* note 25, at 99-104.

319. See WANG & STEINBERG, *supra* note 25, at 44; Allen, *supra* note 108, at 178; Walker, *supra* note 64, at 640-41.

320. See BERLE & MEANS, *supra* note 25, at 321-25; WANG & STEINBERG, *supra* note 25, at 42-47; Bainbridge, *supra* note 20, at 1239.

ty, and the price of the security reflects the current state of information.<sup>321</sup> If material, nonpublic information exists, which will necessarily be the case if there is an insider trader, then the market price of the security is, in a sense, "wrong." That means, of course, that not only those who actually traded opposite the insider, but also those who decided to refrain from trading the security, and, in fact, everyone who acted or refrained from acting based on the market price, are damaged.<sup>322</sup> The harm, in effect, is to the market in general.<sup>323</sup> If that is the case, however, why do only contemporaneous opposite traders have a cause of action against insider traders?<sup>324</sup>

The existence of an impersonal market has thus created some complications for fraud-by-silence law, and insider trading law is unique in fraud law in being dependent upon stock market mechanics and potentially variable patterns of market behavior.<sup>325</sup> It is not clear, however, whether such issues should affect the fraud-by-silence rule itself or only the application of the rule. Because the difficulty of identifying harm arises with any knowledgeable trader in a stock market transaction, even true insiders, that difficulty can only support a rule allowing *all* insider trading or giving only the SEC, not individual traders, the right to sue knowledgeable traders. That rule would approximate the common law of fraud, when, in the absence of causation and harm, the law does not apply unless a crime was involved. Because Congress<sup>326</sup> and the Supreme Court<sup>327</sup> have both rejected

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321. See *supra* note 300 and accompanying text; see also BERLE & MEANS, *supra* note 25, at 281-87, 314-15 (noting that traders make trading decisions in reliance on the market price).

322. This is true for other forms of securities fraud as well. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749-54 (1975), the Supreme Court held that those who refrained from trading because of inaccurately gloomy corporate disclosure did not have a cause of action because section 10(b) protects only buyers and sellers.

323. See BERLE & MEANS, *supra* note 25, at 327; Nielson, *supra* note 156, at 346.

324. This problem could be solved by doing away with a private right of action under Rule 10b-5 for insider trading and leaving enforcement to the SEC.

325. Even market mechanics are changing, as electronic trading becomes more common. See generally Division of Market Regulation, SEC, *Market 2000: An Examination of Current Equity Market Developments*, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,311, at 85,029-36 (Jan. 27, 1994) (studying the future composition of participants in the U.S. equity market, the growth of alternative market systems, and the role of technology in the future market).

326. See 15 U.S.C. § 78t-1(b) (1994) (giving a cause of action to those who did not

that rule, however, the relevance of the lack of harm argument is unclear.

## V. CONCLUSION

This Article's concern has been to identify concepts in the insider trading literature that have appeared repeatedly over the past two centuries.<sup>328</sup> The inability of the law and of American legal scholars to make any progress on the fraud-by-silence question is startling. In areas in which legislation has derogated from the common law rules, as with the securities acts and consumer protection acts, the law now often requires disclosure by knowledgeable traders in circumstances where the common law did not do so. The common law concept of fraud by silence, however, continues to be poorly defined, as does insider trading, which, because of the nonspecific language of Section 10(b) of the 1934 Act and Rule 10b-5, combined with the Supreme Court's interpretation of that language, also continues to be essentially a common law concept. Not only has the common law been unable in 160 years to resolve the issues raised by *Laidlaw v. Organ*, but legal commentators have also been unable to make any progress on the policy concerns, legal arguments, and theoretical foundations of the analysis. Despite the parade of intellectual movements during this period, from classicism to realism to economic analysis, the actual analysis, that is, the identity of the arguments considered, has remained the same.

What conclusion can we draw from this essential stagnation? It may reflect the basic intractability of the problem, but it may also reflect the limited utility of the legal method of handling certain nonlegal concepts. When the jurists' multitudinous legal distinctions and theories failed, they often returned to nonlegal concepts, such as fairness or common sense, or to legal surrogates for those concepts, such as the reasonably ethical person standard or the

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trade with the insider trader).

327. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2209 (1997) (describing harm to "members of the investing public").

328. It is no doubt the case that the repetition of concepts is the result of borrowing, regardless of whether attributed by later writers, but I have not tried to track connections between specific authors.



standards of the business community, as presenting a solution to the problem. Even those most hostile to such ambiguous concepts proposed legal rules that will ultimately result in a similar analysis. A market-based approach, for example, that would allow companies and insiders to determine their own rules and then allow investors to vote with their wallets for the rules they prefer, would not be particularly different in practice than a standards-of-the-community rule that allows only such behavior as the business community agrees should be permitted.<sup>329</sup>

Perhaps, then, the recurring references to fairness and business standards, on the one hand, and the continual but always unsatisfactory rearranging of the other arguments described above, on the other, reflect the common law's inability, at least in this area, to define what is right and what is wrong. If this is the case, then the fraud-by-silence problem may never be "solved" except by legislation. In this respect, the common law insider trading cases are illustrative. The minority and majority views arose at about the same time and coexisted for fifty years or more, with neither rule making much headway. The rules rarely were supported by satisfactory reasoning; rather, the courts relied instead on invective about morality, trust, sound business practice, and the relative positions of the parties. In short, the courts seem to have been driven by their own senses of right and wrong but were unable to provide a consistent "legal" justification for the rules they were announcing. The cases applying Rule 10b-5 are not very different. The misappropriation theory has allowed some courts, most notably the Second Circuit, to reach a favored result without a coherent basis for liability, but other courts have rejected nonlegislative attempts to limit the hurly-burly of the stock market.<sup>330</sup> One solution is simply for the legislature to step in

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329. See Easterbrook, *supra* note 16, at 335.

330. This sort of ad hoc decision making is also not new; the struggle between allowing judicial discretion to reach correct results and limiting judicial arbitrariness by requiring courts to follow doctrine has been a continuing theme of jurisprudence. The search for a definition of fraud by silence may be simply another example of judges doing what they believe is best and lawyers and appellate courts trying to restrict their ability to do so with rules, definitions, and theories. See, e.g., ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW 48-71 (1922); Karl N. Llewellyn, *On Reading and Using the New Jurisprudence*, 40 COL. L. REV. 581 (1940).

once again, as it has from time to time considered in the insider trading context.<sup>331</sup> But is the common law itself powerless to provide a consistent fraud-by-silence rule? Unless the courts are willing to rule that generally held ethical standards exist and are a legitimate basis for legal rulemaking,<sup>332</sup> fraud by silence may never be more than a concept without parameters.

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331. Cf. JEREMY BENTHAM, OF LAWS IN GENERAL 241 (H.L.A. Hart ed., Athlone Press 1970) (1782) (describing the role of a legislator in curbing judicial discretion).

332. There is some precedent for a legal regime based on common ethics. Until the eighteenth century, commercial law was generally governed by the law merchant, rather than the common law. The law merchant was an international body of law based on the practices of, and enforced by, the commercial community. See 1 WILLIAM BLACKSTONE, COMMENTARIES 264 (1765); Thomas Edward Scrutton, *General Survey of the History of the Law Merchant*, in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY 7, 8-9 (Assoc. of Am. Law Sch. ed., 1909). Even today, commercial communities sharing general moral and ethical values continue to provide their own legal systems. See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUDS. 115, 140-48 (1992) (discussing the historical importance of "reputation bonds" and ethnic and cultural homogeneity in the diamond industry).