Why Now is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory

Bruce W. Klaw

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WHY NOW IS THE TIME TO STATUTORILY BAN INSIDER TRADING UNDER THE EQUALITY OF ACCESS THEORY

Bruce W. Klaw*

Abstract

This Article makes the case for a new U.S. statutory provision that defines and prohibits insider trading under an “equality of access” theory. It supports this claim, and contributes to the important public dialogue concerning this prevalent practice, by highlighting the moral and legal gaps in existing U.S. law that result from understanding the harms of trading on the basis of material nonpublic information solely with reference to fiduciary breach or misappropriation, as evidenced by the recent cases of United States v. Newman and United States v. Salman. It weaves legal analysis together with current literature in business ethics, moral philosophy, finance, and accounting to consolidate and offer new arguments in the long-standing debate over insider trading based on Rawlsian social contract theory, applied deontology, and empirically informed utilitarianism. It then draws on lessons learned from empirical analysis of European states’ adoption of the equality of access theory under the Market Abuse Directive. Finally, it analyzes three insider trading bills currently pending in Congress and makes the case for a statute, like S. 702, that will prohibit the use, by anyone, of material information concerning a financial instrument that is not, at least in principle, available to others through independent and otherwise lawful due diligence.

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# TABLE OF CONTENTS

## INTRODUCTION

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. BACKGROUND ON U.S. INSIDER TRADING LAW</td>
<td>286</td>
</tr>
<tr>
<td>A. Insider Trading as Fraud</td>
<td>287</td>
</tr>
<tr>
<td>B. Fiduciary Duty Breach, The Personal Benefit Requirement</td>
<td>288</td>
</tr>
<tr>
<td>and the Misappropriation Theory</td>
<td></td>
</tr>
<tr>
<td>C. Tipper-Tippee Liability</td>
<td>290</td>
</tr>
<tr>
<td>D. The Implications of Newman and The Limits</td>
<td>292</td>
</tr>
<tr>
<td>of Salman</td>
<td></td>
</tr>
<tr>
<td>E. The Extent of Insider Trading</td>
<td>297</td>
</tr>
<tr>
<td>II. WHY TRADING ON THE BASIS OF NON-PUBLICLY AVAILABLE INFORMATION</td>
<td>298</td>
</tr>
<tr>
<td>SHOULD BE BANNED, REGARDLESS OF FIDUCIARY BREACH OR MISAPPROPRIATION</td>
<td></td>
</tr>
<tr>
<td>A. Insider Trading Violates the Social Contract</td>
<td>298</td>
</tr>
<tr>
<td>1. Insider Trading Denies Equality of Opportunity</td>
<td>298</td>
</tr>
<tr>
<td>2. Insider Trading Constitutes “Cheating”</td>
<td>308</td>
</tr>
<tr>
<td>B. Insider Trading Violates the Categorical Imperative</td>
<td>312</td>
</tr>
<tr>
<td>1. Insider Trading Violates the Formula of Universal Law</td>
<td>313</td>
</tr>
<tr>
<td>2. Insider Trading Treats Counterparties As Mere Means to an End</td>
<td>314</td>
</tr>
<tr>
<td>C. Insider Trading Undermines Social Utility</td>
<td>314</td>
</tr>
<tr>
<td>1. The Alleged Benefits of Insider Trading and the Harms of Prohibition</td>
<td>315</td>
</tr>
<tr>
<td>2. The Ostensible Harms of Insider Trading</td>
<td>319</td>
</tr>
<tr>
<td>a. Harms to Selling Shareholders</td>
<td>320</td>
</tr>
<tr>
<td>b. Harms to Buyers</td>
<td>323</td>
</tr>
<tr>
<td>c. Harms to Issuers</td>
<td>324</td>
</tr>
<tr>
<td>d. Harms to Employers</td>
<td>327</td>
</tr>
<tr>
<td>e. Harms to the Capital Markets and Economy as</td>
<td>328</td>
</tr>
<tr>
<td>a Whole</td>
<td></td>
</tr>
<tr>
<td>i. Insider Trading Undermines Investor Trust and Deters Retail Investment</td>
<td>329</td>
</tr>
<tr>
<td>ii. Insider Trading Reduces Market Liquidity</td>
<td>331</td>
</tr>
<tr>
<td>iii. Insider Trading Increases Firms’ Cost of Equity</td>
<td>331</td>
</tr>
<tr>
<td>iv. Insider Trading May Increase Cost of Debt</td>
<td>331</td>
</tr>
</tbody>
</table>
III. EQUITY OF ACCESS LAWS: LESSONS FROM THE E.U.
MARTET ABUSE DIRECTIVE .......................................................... 332

A. Increased Liquidity and Decreases in Cost of
   Equity Capital ........................................................................ 333
B. Greater Ease of Enforcement ............................................. 336

IV. CURRENT U.S. LEGISLATIVE PROPOSALS ......................... 337

A. The Ban Insider Trading Act of 2015 .............................. 338
B. The Insider Trading Prohibition Act ................................. 340
C. The Stop Illegal Insider Trading Act ............................... 342

CONCLUSION ............................................................................ 345
INTRODUCTION

As it turns out, cheaters do win. This was the lesson implicitly taught by the United States Supreme Court when it declined to review the Second Circuit Court of Appeals’ landmark decision in *United States v. Newman*, which effectively legalized in that Circuit certain forms of insider trading by those who receive non-public corporate information through clandestine tips so long as the insider from whom the tips originated did not receive a sufficiently valuable “personal benefit” in exchange for them, or so long as the ultimate tippee remains plausibly ignorant of who the original tipper was and what he received in exchange.¹ And while the Supreme Court now appears poised through its grant of review in *United States v. Salman* to either expressly extend *Newman* throughout the United States, or curtail it in some respects by once again barring tippees from willfully using nonpublic information provided as mere gifts, the underlying dysfunction of U.S. insider trading law cannot be cured by judicial decisions alone. To ensure the transparency and health of U.S. securities markets, it is time to finally enact a dedicated insider trading statute that comports with the fundamental dictates of ethics by recognizing the independent wrongfulness of trading on information that the trader knows or should know cannot be accessed by others through their own lawful and independent diligence.

Although U.S. insider trading law has been troublingly disconnected from ethical norms for decades, the implications of this disjunction came to a head in December of 2014 when the Second Circuit in *Newman* vacated the convictions of two hedge fund portfolio managers who undeniably traded on the basis of tips of material nonpublic information to reap more than $72 million in profits.² According to the U.S. Department of Justice, the precedent set in *Newman* “arguably represents one of the most significant developments in insider trading law in a generation.”³

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Dismissing the defendants' indictments with prejudice, the Newman court held that the remote hedge fund tippees in that case could not be liable for insider trading, and that prosecutors failed to show that the corporate insiders from whom advanced earnings tips emanated had violated their fiduciary duties to their corporate principals by receiving personal benefits in exchange for their tips that were “objective, consequential, and represent[ed] at least a potential gain of a pecuniary or similarly valuable nature.” This holding seemingly tightened the personal benefit requirement previously announced in the 1983 Supreme Court case Dirks v. SEC, which held that the intangible reputational benefits gained by gifting tips were sufficient to constitute a breach of the insider-tipper’s fiduciary duty. Prosecutors in Newman also failed to satisfy a new knowledge requirement in the Second Circuit, which now requires prosecutors to show not only that the tippee knew or should have known of the tipper’s fiduciary breach (an inference that could arguably arise from the availability of confidential information itself), but more specifically that “the tippee knew that an insider disclosed confidential information and [knew] that he did so in exchange for a personal benefit.”

Taken together, the holdings in the Newman case further narrowed the already anemic definition of unlawful trading under Section 10(b) and Rule 10b-5, as interpreted by a majority of the Supreme Court in Dirks, and they effectively immunize certain forms of market cheating from prosecution.

As the government has recognized, the precedent set by the Newman case “unjustifiably impedes the government’s ability to restrain and punish tippers and tippees engaging in culpable

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4 Id. at 452.
5 463 U.S. 646, 663 (1983) (explaining that the tippee’s liability depends on “whether there has been a breach of duty by the insider” and that such breach of duty depends upon “whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or a reputational benefit that will translate into future earnings.”) (emphasis added); see also Victor Brudney, Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws, 93 HARV. L. REV. 322, 348 (1979) (“The theory ... is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself ....”).
6 Newman, 773 F.3d at 442 (emphasis added).
7 See id. at 442, 452.
behavior.” It “licenses trading by insiders’ favored tippees, thereby shifting losses to investors who lack access to confidential corporate information and eroding public confidence in the integrity of securities markets.” It “disadvantages legitimate analysts who pursue research and modeling based on authorized information.” And it “increases the chances that such conduct will proliferate.”

Indeed, since its issuance, the *Newman* precedent has prompted the vacatur of numerous guilty pleas and various potentially successful appeals by convicted inside traders. For these reasons, on July 30, 2015, the Solicitor General petitioned the Supreme Court for a writ of certiorari, seeking to overturn *Newman*. Despite the government’s warnings, however, the Supreme Court denied review without comment on October 5, 2015.

Perhaps cognizant of the public confusion and outrage over *Newman*, the Supreme Court less than four months later made a surprise move on January 19, 2016 to grant review of another tipper-tippee insider trading case, *United States v. Salman*, which seemingly contradicts *Newman* on the type of improper personal benefit necessary to constitute a fiduciary breach by an insider under *Dirks*.

In *United States v. Salman*, the Ninth Circuit Court of Appeals affirmed the conviction of Bassam Salman, who received and traded on advance tips concerning Citigroup takeover deals that emanated from a former Citigroup investment banker who, apparently without asking for anything in return, gave them to...

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9 *Id.* at 26.
10 *Id.*
11 *Id.*
12 *Id.* at 33.
14 *See* Petition for Writ of Certiorari, *supra* note 8, at 32–34.
his brother, who in turn freely gave them to their brother-in-law, Salman. Finding that “[p]roof that the insider disclosed material nonpublic information with intent to benefit a trading relative or friend is sufficient to establish the breach of fiduciary duty element,” the Ninth Circuit expressly declined to follow Newman.\(^\text{17}\) It relied instead on language in Dirks, which stated that a breach of fiduciary duty is met where an “insider makes a gift of confidential information to a trading relative or friend.”\(^\text{18}\)

Accordingly, the Supreme Court is now slated to address the question of whether the personal benefit to the insider that is necessary to establish a tippee’s liability for insider trading requires proof of “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature,” as the Second Circuit held in Newman, or whether it is enough to constitute a fiduciary breach that the insider intended to gift a tip to his close family member, as the Ninth Circuit held in Salman.

While it is not possible to know at the time of this writing whether the Court will limit Newman and once again allow certain tippee prosecutions for trading on gifted tips, it seems highly dubious that the Court will or can singlehandedly correct the path of U.S. insider law. Regardless of whether the personal benefit requirement is ultimately interpreted once again to include gift tips and not just tips in exchange for some potential pecuniary benefit, the Court is unlikely to, *sua sponte*, revisit its long-standing holdings that (1) insider trading must resemble fraud by involving some fiduciary breach or misappropriation; (2) a tippee’s liability for trading on nonpublic information necessarily depends upon the tipper’s breach of his fiduciary duty; (3) a tipper does not breach his fiduciary duty merely by disclosing confidential information but rather only receiving some “personal benefit” in exchange for the disclosure; and (4) that the tippee knows or should know that the tipper violated his fiduciary duty or that the tipper received a personal benefit. Now more than ever, U.S. insider trading law remains in need of serious reconsideration. But judicial action is not a panacea. Indeed,

\(^{17}\) United States v. Salman, 792 F.3d 1087, 1093–94 (9th Cir. 2015) (declining to follow Newman).

by virtue of the above listed holdings that predate Newman, numerous forms of unethical and harmful market behavior will continue to go unpunished and undeterred, regardless of whether Newman is limited or revised in the forthcoming Salman decision.

Despite being a moral leader and first mover in the fight to secure the integrity of the securities markets by regulating insider trading more than thirty years before any other country, the United States has now fallen significantly behind other developed market economies in Europe that have adopted the “equal access to information” theory pursuant to the E.U. Market Abuse Directive (M.A.D.). Under the broader M.A.D. standard, trading by anyone “who possesses inside information while that person knows, or ought to have known, that it is inside information” is illegal. So too is “disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties.” Under the M.A.D., there is no requirement of fiduciary breach, personal benefit or misappropriation. And by continuing to impose such requirements, federal law in the United States has become pigeonholed in outdated, analytically off-base, and overly narrow theories of what makes trading on the basis of nonpublic information morally wrongful.

The resultant enforcement gaps that follow from these narrow American theories—and that allow blatant cheating to go unpunished—dangerously unmoor federal securities law from its

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19 See, e.g., Utpal Bhattacharya & Hazem Daouk, The World Price of Insider Trading, 57 J. Fin. 75, 88 (Feb. 2002) (“Until 1967, when France established these laws, the United States was the only country that had insider trading laws.”).

20 See Marco Ventoruzzo, Comparing Insider Trading in the United States and in the European Union: History and Recent Developments abstract (European Corp. Governance Inst., Working Paper No. 257/2014, 2014) (noting that pursuant to the E.U. Market Abuse Directives, numerous European countries have adopted the “equal access to information” theory, which is “more clear, easy to apply and broad”).


22 Id. art. 3.

23 See id. art. 4.
expressly intended ethical foundations.\textsuperscript{24} The 1934 Act was “purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges.”\textsuperscript{25} That Act, adopted shortly after the 1933 Securities Act in the wake of the frauds that preceded the Great Depression, was intended to “substitute a philosophy of full disclosure for the philosophy of \textit{caveat emptor} and thus to achieve a high standard of business ethics in the securities industry.”\textsuperscript{26}

The solution to this problem is not simply to overturn or limit \textit{Newman},\textsuperscript{27} and this Article is not intended as a mere indictment of that Second Circuit decision. Rather, \textit{Newman} and the concern it has wrought is largely the result of the failure of the United States to have a dedicated and comprehensive statute defining insider trading\textsuperscript{28} and, in particular, a statute that adopts the equality of access theory.

This statutory vacuum has required the Supreme Court (and the SEC) to use securities fraud statutes to define the contours of unlawful insider trading.\textsuperscript{29} Accordingly, even if \textit{Newman} were to be limited by \textit{Salman}, existing Supreme Court precedent like \textit{Chiarella v. United States} (which held “that a duty to [abstain}


\textsuperscript{25} Id. at 848.


\textsuperscript{27} See Andrew C. Whitman, \textit{The Supreme Court Should Overturn U.S. v. Newman and Recognize a New Type of Insider Trading Liability}, AMERICAN CRIM. L. REV. (Jan. 1, 2015), http://www.americancriminallawreview.com/aclr-online/supreme-court-should-overturn-us-v-newman-and-recognize-new-type-insider-trading-liability/ [https://perma.cc/6KB2-K9QL] (arguing, inter alia, for the theory of “enterprise liability,” where liability would turn on (1) the tipper’s release of information in order for tippee to trade, and (2) the tippee’s knowledge that “such a scheme had been set up so that he may trade on some insider information”). \textit{But see} Petition for Writ of Certiorari, \textit{supra} note 8, at 34 (urging the Supreme Court to simply overturn \textit{Newman} and return to the \textit{Dirks} standard).

\textsuperscript{28} See Robert W. McGee, \textit{Applying Ethics to Insider Trading}, 77 J. BUS. ETHICS 205, 214 (2008) (noting that U.S. insider trading legislation has not defined the term “insider trading”).

\textsuperscript{29} \textit{See infra} note 42 (crafting liability for insider trading when a breach of fiduciary duty for personal gain (deceptive self-dealing) or misappropriation is found).
from trading or] disclose under § 10(b) does not arise from the mere possession of nonpublic material information")30 and *Dirks v. SEC* (which rendered tippee liability derivative of the tipper’s breach of fiduciary duty and imposed an ill-conceived personal benefit requirement in the first place)31 would still continue to pose substantial concerns.

The solution lies in the creation of a new statutory provision defining insider trading as distinct from other forms of securities fraud appropriately governed by the 1933 Securities Act and 1934 Securities Exchange Act. Such a provision would make it unlawful to trade where one is in possession of material nonpublic information that is not, at least in principle, available to others through independent and otherwise lawful due diligence.

Fortunately, the widespread public reaction to *Newman*32 has prompted renewed interest in a legislative fix to U.S. insider trading law.33 Three new bills are currently pending in Congress

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31 The notion that a tippee's liability depends upon the tipper's breach of fiduciary duty and the tippee's knowledge of such fiduciary breach was set forth by the Supreme Court in *Dirks*:

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

*Dirks v. SEC*, 463 U.S. 646, 660 (1983). The requirement that a fiduciary duty breach, for the purposes of Section 10(b), only occurs if the tipper was improperly motivated by personal gain was also set forth in *Dirks*, even though it arguably contravened then-existing law. See *id.* at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders."). *But see, e.g.*, Mosser *v. Darrow*, 341 U.S. 267, 275 (1951) (trustee liable to estate for authorizing employees to take adverse interest to trust, notwithstanding his selfless motives); RESTATEMENT (SECOND) OF TRUSTS § 205 cmts. c, d (1959) (trustee liable for acts causing diminution of value regardless of personal benefit).


that would finally statutorily define insider trading.\footnote{See Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015); Stop Illegal Insider Trading Act, S. 702, 114th Cong. (2015); Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015).} One such bill in the Senate would adopt the “equality of access” theory by making it unlawful “to purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available” unless it is “information that the person has independently developed from publicly available sources.”\footnote{S. 702.}

This Article aims to contribute to the long-standing academic debate over insider trading by adding to the voices of those who have argued that trading on the basis of information that is inaccessible to the public is ethically repugnant,\footnote{See generally Patricia H. Werhane, The Ethics of Insider Trading, 8 J. BUS. ETHICS, 841 (1989); Kim Lane Scheppelle, “It’s Just Not Right”: The Ethics of Insider Trading, 56 LAW AND CONTEMP. PROBS., 123 (1993); Daniel Osts, When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint, 44 AM. BUS. L.J. 571 (2007).} as well as those from both sides of the debate who have recognized that a dedicated and comprehensive U.S. statutory provision that defines insider trading should finally be enacted.\footnote{McGee, supra note 28, at 214 (“To charge Congress with irresponsibility for this omission is an understatement. Insider trading is now officially a crime, yet nobody knows how to define the crime.”).} It argues that any effort to define when insider trading is illegal must more squarely overlap with all of the fundamental reasons why it is morally wrongful, instead of continuing to moor the law solely to principles of fraud and its attendant mechanisms of fiduciary duty breach or misappropriation.

Part I of this Article will provide a brief background on U.S. insider trading law. It explains that, in the absence of a dedicated statute, insider trading is and will continue to be conceived merely as a species of fraud, which requires proof of a fiduciary breach or misappropriation. It further explains why affirming Salman’s conviction and/or limiting \textit{Newman} would have only a limited impact upon the government’s effort to promote healthy, transparent markets and safeguard investors.

Part II of this Article explains why trading on the basis of non-publicly available information is ethically wrongful and ought
to be statutorily prohibited, regardless of fiduciary breach or mis-appropriation. Weaving together previously disconnected threads of research from the literature in moral philosophy, business ethics, law, accounting, and finance, it argues that the wrongfulness of insider trading derives not only from the fact that it offends the sanctity of fiduciary, familial, agency, or employment relationships—or that it arguably steals value from issuers and trading counterparties—but also because (1) it violates the basic requirement of equality of opportunity that we expect in our social contract and constitutes cheating (see Part II.A); (2) it violates categorical imperatives to act only on maxims that can be universalized and that treat individuals as more than mere means to our profit-driven ends (see Part II.B); and (3) it demonstrably harms the capital markets by undermining trust, deterring investment, raising the cost of equity capital, and decreasing market liquidity according to empirical finance and accounting research.\textsuperscript{38}

Part III brings forth lessons learned from E.U. member states’ adoption of the Market Abuse Directive, highlighting the advantages to adopting the “equal access” theory in terms of its empirically demonstrated beneficial effects upon the capital markets as well as its relative ease of enforcement compared to current U.S. law.

Part IV analyzes three legislative proposals currently pending in Congress that aim to fix U.S. insider trading law after \textit{Newman}. It argues for the adoption, with minor modifications, of S. 702, which embodies the “equal access” theory.

The Conclusion includes remarks in support of the argument that the United States should adopt an insider trading statute that expressly prohibits all trades made on the basis of material information that is not, at least in principle, accessible to all other investors through independent and otherwise lawful diligence.

I. BACKGROUND ON U.S. INSIDER TRADING LAW

Commonly and colloquially termed “insider trading,” all questionable forms of the practice generally involve trading in financial instruments on the basis of “material, nonpublic information.”\textsuperscript{39}
Despite the misnomer, however, such trading is not limited to corporate insiders, but also encompasses those working as temporary insiders (e.g., consultants) and outsiders with no allegiance to an issuer (e.g., hedge fund traders). Accordingly, for the purposes of this Article, the term “insider trading” refers to the buying or selling of any financial instrument on the basis of material, non-publicly available information concerning such traded financial instruments regardless of whether the trading is done by (1) an insider (a corporate officer, director, employee, controlling shareholder); (2) a “temporary insider,” such as a lawyer, accountant, or consultant working as an independent contractor of the issuer; or (3) an outsider, including any person or entity unaffiliated with the issuer of the traded instrument who receives material, nonpublic information through intentional or inadvertent tips, selective disclosure, eavesdropping, or misappropriation from corporate personnel.

A. Insider Trading as Fraud

Outside of very limited circumstances, insider trading is generally only punishable if it constitutes a form of fraud by virtue of being accompanied by the breach of a fiduciary duty for personal gain (deceptive self-dealing) or misappropriation (deceptive theft). This is largely because insider trading in the United States


42 See, e.g., O’Hagan, 521 U.S. at 650 (holding that “criminal liability under § 10(b) may be predicated on the misappropriation theory”); Dirks, 463 U.S. at 654 (“duty arises ... from the existence of a fiduciary relationship.”); Chiarella v. United States, 445 U.S. 222, 233, 235 (1980) (“We hold that a duty to disclose under § 10(b) does not arise from the mere possession of non-public material information” but instead “arises from a specific relationship between two parties.”).
is not currently defined by any dedicated statute, but is instead mainly governed by general “catch-all” securities fraud provisions like Section 10(b) of the 1934 Securities Exchange Act (“1934 Act”), which prohibits “any manipulative or deceptive device or contrivance” in connection with securities, and the corresponding SEC Rule 10b-5, which bars the use of “any device, scheme, or artifice to defraud.” The Supreme Court has made clear, however, that even though these are “catch-all” provisions, what they catch “must be fraud” and “not every instance of financial unfairness constitutes fraudulent activity.”

To constitute fraud, there must typically be an affirmative false statement. If there is merely silence—as is the case with virtually all modern securities transactions conducted anonymously over an exchange—it is only fraudulent if there is a “duty to disclose” material facts in one’s possession.

B. Fiduciary Duty Breach, The Personal Benefit Requirement and the Misappropriation Theory

Pursuant to the two dominant theories of insider trading, the classical theory (governing corporate insiders and temporary insiders) and the misappropriation theory (governing all traders who steal information entrusted to them), the Supreme Court has held that the duty to “disclose or abstain” from trading until the information is public generally only applies to (1) people who are recognized fiduciaries (corporate officers, directors, trustees, or agents) or who are otherwise involved in relationship of trust and confidence that are breached for personal gain (deceptive self-dealing); and (2) people who otherwise “feign[ ] fidelity to the source of information” but then misappropriate such information

43 McGee, supra note 28, at 214.
46 Chiarella, 445 U.S. at 234–35.
47 Id. at 232.
49 See Chiarella, 445 U.S. at 232.
50 Id. at 230.
for personal gain (deceptive stealing). With regard to the latter category, the SEC has adopted Rule 10b5-2, which explains that a duty of trust or confidentiality exists whenever (1) a person "agrees to maintain information in confidence;" (2) the tipper and tippee "have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality;" or (3) a person "receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling" unless it is otherwise clear that no expectation of trust and confidence exists.

Under either theory, and because insider trading law currently is grounded in antifraud statutes, the obligation to "disclose or abstain" from trading requires the existence of a special duty of trust and confidence that does not exist between trading counterparties generally. Codifying the illegality of trading in violation of these relationships, the SEC adopted Rule 10b5-1 in August 2000, which generally bars the

purchase or sale of a security of any issuer, on the basis of

material nonpublic information about that security or issuer,

in breach of a duty of trust or confidence that is owed directly,

indirectly, or derivatively, to the issuer of that security or the

shareholders of that issuer, or to any other person who is the

source of the material nonpublic information.

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53 O'Hagan, 521 U.S. at 652–53.

54 Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,737 (Aug. 24, 2000) (codified at 17 C.F.R. § 240.10b5-1(a)) (emphasis added). That rule explains that trading "on the basis of" material, nonpublic information simply means trading while being "aware" of nonpublic information. 17 C.F.R. § 240.10b5-1(b). The rule also provides for affirmative defenses if, before becoming aware of the information, the person had (1) "entered into a binding contract to purchase or sell the security;" (2) "instructed another person to purchase or sell the security for the instructing person's account;" or (3) "adopted a written plan for trading securities." Id. § 240.10b5-1(c)(A)(1)–(3).
C. Tipper-Tippee Liability

Because U.S. law only bars insider trading where it constitutes a form of securities fraud involving proof of a fiduciary breach for personal benefit or feigned loyalty coupled with misappropriation, significant questions arise regarding the liability of insiders who tip out such information as well as those who trade on the basis of such tips.

Clearly, the liability of tippers and tippees does not fit well into the insider-trading-as-fraud regime. After all, tippers are not necessarily trading for themselves and thus directly profiting at the expense of those to whom they owe fiduciary duties. And certain outside tippees (like the defendants in Newman and Salman) are neither corporate fiduciaries nor misappropriators. So, are insiders always allowed to provide tips? And are tippees always free to trade on material non-public information? The seminal case to address these questions was the 1983 Supreme Court case Dirks v. SEC.

In Dirks, the Supreme Court largely resolved the issue of tipper liability by explaining that “[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.”55 However, corporate insiders who provide material, nonpublic information to a third party that trades upon that information (“tippers”) are generally not subject to prosecution unless they receive a personal benefit in exchange,56 although they could be laid off or penalized by the SEC under Regulation FD.57

The Dirks court also recognized “[t]he need for a ban on some tippee trading.”58 Yet, because of concerns about inhibiting the role of market analysts, the Court expressly rejected “imposing a duty to disclose or abstain solely because a person knowingly

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58 Dirks, 463 U.S. at 659.
receives material nonpublic from an insider and trades on it.” Accordingly, the *Dirks* court held that “a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breaches his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.” Tippee liability is thus understood to be derivative of (and dependent upon) the tipper’s breach.

So when does a tipper breach his fiduciary duty? The *Dirks* majority explained that “all disclosures of confidential information are not inconsistent with the duty insiders owe to shareholders.” It took the position that whether disclosure is a breach of fiduciary duty “depends in large part on the purpose of the disclosure” and “the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.” It thus stated that “[a]bsent some personal gain, there has been no breach of duty to stockholders.” Accordingly, the court directed other courts to focus on “whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.”

Because direct evidence of such a personal benefit may be difficult to obtain, the *Dirks* court noted that there are often facts and circumstances that will justify an inference concerning the existence of a personal benefit. For example, the Court stated “there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient.” It added that “the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend,” because “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”

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59 Id. at 658.
60 Id. at 660.
61 Id. at 661–62.
62 Id. at 662.
63 Id.
64 Id. at 663.
65 Id. at 664.
66 Id.
D. The Implications of Newman and The Limits of Salman

As noted above, the Second Circuit’s opinion in Newman made it more difficult to prosecute tippees in two ways. First, the court made it harder to prove that the tipper breached his fiduciary duty by receiving a “personal benefit.” Second, the court made it harder to satisfy Dirks’ requirement that the tippee “knew or should have known that there has been a breach” of the tipper’s fiduciary duty. While the Supreme Court has an opportunity in its review of Salman to revisit and clarify the definition of “personal benefit” (so as to once again allow prosecutor to punish recipients of gifted tips, not just those who receive a quid pro quo) it is unlikely to modify the knowledge requirement announced in Newman. Moreover, because the Court is constrained to conceive of insider trading only as a species of fraud,67 the Court is also unlikely to revisit several other fundamental requirements of U.S. insider trading law that allow certain market cheaters to go unpunished.

In Newman, the Second Circuit seemingly limited the definition of the “personal benefit” required to constitute fiduciary breach by the inside tipper and increased the quantum of evidence necessary for the jury to infer that the tipper received an improper personal benefit based on the tipper’s close relationship with the tippee. Rejecting the government’s proffer of evidence that one insider gave information to his business school friend in exchange for career advice and that another insider gave information to his friend from church, the Newman court stated that “the personal benefit received in exchange for confidential information must be of some consequence.”68 It added that the government may not prove “the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature”69 and held that a personal benefit inference “is impermissible in

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67 There are express indications in both Chiarella and Dirks that the Supreme Court felt constrained by congressional intent (or the absence thereof). See, e.g., Chiarella v. United States, 445 U.S. 222, 233–34 (1980) (stating that the formulation of different duty from current law “should not be undertaken absent some explicit evidence of congressional intent”); Dirks, 463 U.S. at 656 (arguing that the SEC’s position “differs little from the view that we rejected as inconsistent with congressional intent in Chiarella.”).
69 Id.
the absence of proof of a meaningfully close relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.” Based on this holding, the government has raised substantial concerns regarding the ability to prosecute those who provide tips as gifts.71

By contrast, in Salman, the Ninth Circuit took a more traditional view of the Dirks precedent. Noting that the Second Circuit’s Newman opinion was not binding upon it, the Ninth Circuit held that the personal benefit requirement was satisfied where one provides a “gift of confidential information to a trading relative.” 72 Accordingly, because the government presented direct evidence that the Citigroup tipper intended to provide a gift of market-sensitive information to his brother, the personal benefit requirement was satisfied.

With its grant of certiorari in Salman, the Supreme Court has an opportunity to clarify that the definition of “personal benefit” includes the intangible benefits one obtains by gifting tips to outsiders. Doing so would merely require the Court to emphasize its lesson from Dirks that “the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend,” because “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.” By affirming Salman’s conviction, the Court could also once again permit the jury to infer the existence of (and the tippee’s awareness of) the tipper’s personal benefit based on the existence of a close personal relationship between the tipper and his immediate tippee.

Nevertheless, it is important not to expect from the Court more than it is able to give in Salman. Indeed, due to the fact

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70 Id.

71 See Petition For Writ of Certiorari, supra note 8, at 32 (arguing that “a case in which an insider gifts inside information to a trading friend or relative will not meet the Second Circuit’s new standard absent evidence that the relationship was ‘meaningfully close’ and that the insider stood to obtain money (or something of ‘similar’ value) via an ‘exchange’ and noting that “[s]uch evidence will not always exist”).

72 United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015) (quoting Dirks, 463 U.S. at 664 (1983)).
that, with limited exception, U.S. statutory law only prohibits insider trading when it falls within the ambit of “fraud,” there are several fundamental interpretations that the Court will likely feel constrained or inclined to follow.

First, since the Court is constrained to fit insider trading into “anti-fraud” provisions, it is unlikely that the Court will dispense with the requirement that trading be accompanied by the breach of a relationship of trust and confidence for personal benefit. As noted above, fraud requires either an affirmative misstatement or an omission coupled with a duty to disclose. Accordingly, even if Newman were to be curtailed in Salman, persons who trade on material, nonpublic information after eavesdropping on the conversation of a person to whom they do not otherwise owe any duty of trust and confidence may continue to do so, even if they know that such person is an insider who just inadvertently divulged material, nonpublic information.73

Second, the Court’s forthcoming decision in Salman will likely not fundamentally depart from the understanding that a tippee’s liability for trading on nonpublic information necessarily depends upon the tipper’s breach of his fiduciary duty. Apart from the fact that this understanding from Dirks has persisted for more than thirty years and neither party has requested the Court to overturn that case, the Court will likely find itself constrained to continue to ground the tippee’s obligation to “abstain or disclose” in the tippee’s participation in the tipper’s breach, lest it impose duties upon everyone in the absence of Congressional authorization to do so.

Third, regardless of how the “personal benefit” requirement is ultimately defined, the Court in Salman will likely leave undisturbed its holding from Dirks that a tipper does not breach his fiduciary duty merely by disclosing confidential information,

73 See, e.g., SEC v. Switzer, 590 F. Supp. 756, 762, 766 (W.D. Okla. 1984) (dismissing insider trading charges against former football coach who traded on information concerning an upcoming corporate liquidation that he inadvertently overheard during a track meet from a man he knew was on the liquidating company’s board); see also Dirks, 463 U.S. at 659–60 (“[S]ome tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly.” (emphasis added)).
but rather only by having an improper motive (such as receiving some “personal benefit” in exchange for the disclosure). There are several good reasons for the Court to reconsider this interpretation. Notably, shareholders can be harmed by unauthorized disclosures regardless of whether the tipper personally benefits, and there is established corporate law providing that corporate fiduciaries in other contexts can breach their duties of care or good faith without a personal benefit or self-dealing. Nevertheless, it is doubtful that the Court will alter a determination that has stood for decades. Accordingly, even if Newman were to be limited under Salman, where an issuer’s authorized senior management receives no individual personal benefit, they are unlikely to be punished for intentionally and selectively disclosing information to a controlling shareholder or outside trader. While the SEC might bring a civil or administrative enforcement action in respect of such conduct and impose a monetary penalty, “[n]o failure to make a public disclosure required solely by [Regulation FD] shall be deemed to be a violation of Rule 10b-5 (17 C.F.R. § 240.10b-5) under the Securities Exchange Act.”

74 See, e.g., Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985) (holding director liable for shareholder losses occasioned by breach of fiduciary duty of care, notwithstanding the absence of any claims of self-dealing or bad faith).


76 See, e.g., Cooke et al., supra note 75 (explaining that, without admitting or denying liability for Regulation FD violations, Home Depot paid a $1 million civil penalty and its executives paid $50,000 each).

77 See 17 C.F.R. § 243.102; see also Baker & Kanjorski, SEC Written Statement (May 17, 2001), https://www.sec.gov/news/testimony/051701wssec.htm #P97_22392 [https://perma.cc/6BX3-A86P] (noting that “the prospect of private liability under Regulation FD could contribute to a ‘chilling effect’ on issuer communications. Accordingly, the regulation expressly provides that a failure to make a disclosure required solely by Regulation FD will not violate the
Fourth, the Court is unlikely to modify the Newman court’s holding that, in order to satisfy Dirks’ requirement that the “tippee knows or should know that there has been a breach,” prosecutors must show that the defendant-traders knew (or consciously avoided knowing) that “the tippee knew that an insider disclosed confidential information and that he did so in exchange for a personal benefit.” As a matter of due process and established substantive principles of criminal law regarding mens rea, the Court will likely uphold this interpretation. The reason for this is as follows: if a fiduciary breach continues to be a necessary element of insider trading liability, and (under Dirks), only the tipper’s receipt of a personal benefit can transform an otherwise unauthorized and damaging disclosure of nonpublic information into a fiduciary breach, then the defendant-tippee’s due process rights to not to be convicted without proof of all the elements of the crime (including criminal intent) should require the tippee’s awareness that the tipper received a personal benefit. Without knowledge that the tipper received a personal benefit, it would be impossible for the defendants to have fair notice that they would be committing a crime if they traded on the information. In effect, this means that traders savvy enough to remain plausibly ignorant of the source of the tip they receive will remain untouchable. And indeed, it will be nearly impossible to prosecute remote tippees, like the hedge fund defendants in Newman, who are several levels removed from the original source.

In sum, because current U.S. insider trading law remains moored to the notions of fraud, fiduciary duty breach, and misappropriation and does not currently ban insider trading when

general antifraud rule, Rule 10b-5. Thus, private plaintiffs cannot rely on a Regulation FD violation as a basis for a private securities fraud lawsuit. The regulation is enforceable only by the Commission.”)

78 Dirks, 463 U.S. at 660 (emphasis added).
80 Cf. Staples v. United States, 511 U.S. 600, 624–25 (1994) (requiring the government to prove that the defendant knew that his gun had prohibited features of an automatic weapon before convicting him of possessing an unregistered machine gun); Turner v. United States, 396 U.S. 398, 420 (1970) (Black, J., dissenting) (“[C]onstitutional due process requires the Government to prove each element beyond a reasonable doubt before it can convict the accused of the crime it deliberately and clearly defined.”).
81 See Newman, 773 F.3d at 438.
a person is merely in possession of information that they know is not accessible to others, merely overturning or clarifying Newman in its upcoming Salman decision will likely fall short of prohibiting unethical trading. Only a statute that recognizes insider trading as cheating and not just fraud can accomplish that goal. Only a statute that unmoors a tippee-trader’s liability for insider trading from the tipper’s breach of fiduciary duty will allow prosecutors to hold tippees liable for exploiting their positions of access to the disadvantage of other traders. Only a statute that recognizes the independent wrongfulness of trading on material corporate information that the trader knows or should know that others do not have access to through their own independent and lawful diligence can truly facilitate an honest, transparent and healthy market.

E. The Extent of Insider Trading

Although exact figures on the prevalence of insider trading remain elusive due to the secrecy with which such practitioners operate to avoid detection by the exchanges and the SEC, a recent study by McGill University Professor Augustin and New York University Professors Brenner and Subrahmanyam found empirical evidence suggesting that nearly one quarter of all mergers or acquisitions involving publicly traded companies may involve some kind of insider trading.\(^{82}\) The prevalence of such trading has led some to conclude, as Professor McGee has, that “[t]here are just too many individuals who are violating the law to find and prosecute them all.”\(^{83}\) Yet the magnitude of the problem of rampant cheating ought not lead us to conclude that society is entirely powerless to minimize it. Something can be done, but it must be done by statute. And statutory changes require political will. The

\(^{82}\) Patrick Augustin, M. Brenner, et al., Informed Options Trading Prior to M&A Announcements: Insider Trading? 2 (May 2014) (unpublished manuscript), http://irrcinstitute.org/reports/informed-options-trading-prior-to-ma-announcements-insider-trading/ [https://perma.cc/Z3KN-45P9] ("Approximately 25% of all the cases in our sample have abnormal volumes [in equity options written on the target firms in the U.S. over the 30 days preceding M&A announcements] that are significant at the 5% level, and for 15% the significance is at a 1% level.").

\(^{83}\) McGee, supra note 28, at 212–13.
first step to foment such political will is to appreciate why the status quo is wrong from both moral and economic perspectives.

II. WHY TRADING ON THE BASIS OF NON-PUBLICLY AVAILABLE INFORMATION SHOULD BE BANNED, REGARDLESS OF FIDUCIARY BREACH OR MISAPPROPRIATION

To understand why a statutory prohibition against trading on the basis of information that is not, at least in theory, accessible to others is needed, it is helpful to start with the foundation of such law: ethics. As Professor Thomas Dunfee has eloquently explained, the domains of ethics and law are “synergistically and intimately related. They are so much so, that neither can be fully meaningful or realized without the other. Law without reference to ethics and community moral values is in danger of becoming disconnected from the public will.”

I submit that the ethical imperative to curtail cheating by legally prohibiting trading on the basis of material information that is not, in principle, available to all other investors through independent and otherwise lawful diligence is evident under social contractarian, deontological, and consequentialist theories of justice.

A. Insider Trading Violates the Social Contract

This Section will make the ethical argument based on Rawlsian social contract theory. I shall first endeavor to lend content and specificity to the oft-maligned notion of “fairness” by explaining why it requires equality of access to information, but not equality of information, skill, sophistication, financial resources, or luck. I shall then try to explain, in concrete terms, why trading on the basis of information that is not, in principle, available to others through independent and otherwise lawful diligence constitutes the moral wrong of “cheating,” irrespective of any fiduciary breach or misappropriation.

1. Insider Trading Denies Equality of Opportunity

So, what exactly is meant by “fairness”? Professor Scheppele has aptly recognized that “[d]iscussions of the ‘fairness’ of insider

trading have been plagued by charges that fairness is a fuzzy idea that needs to be clarified with the pure logic of economic theory” and “have been criticized for failing to provide any clearly defined sense of what would be prohibited.”85 Too often, it seems, straw man arguments are set up simply so that they can easily be knocked down. Professor McGee’s argument in Applying Ethics to Insider Trading is an example of this.86 In oversimplified terms, McGee defines the so-called “fairness” argument as one asserting that “[t]he market should be fair to all participants,” which he seemingly interprets as requiring symmetry of information and skill.87 After setting up the straw man, he then knocks it down, noting “it is not possible or desirable to ever have a level playing field in the realm of economics.”88 He contends that the true unfairness lies in forcing “experts who work 60 hours a week to gather information as part of their job ... to disclose such information to people who have done nothing to earn it.”89 Those of us without inside information, asserts McGee, are like “Alaskan banana farmers” seeking to impose “punitive regulations or higher tax burdens” to compensate for the fact that “some individuals or groups are naturally better at some things than others.”90

So, to be clear: perfect fairness—i.e., equality of skill, sophistication, financial resources, information, luck, or outcome—is not, has never been, and probably never will be a fundamental feature of the securities markets. And few of us, if offered a Rawlsian ex ante opportunity to devise securities laws from behind a veil of ignorance in the Original Position,91 would probably want it to be. While we likely would seek to maximize our minimums in the probable event that we did not become Wall Street tycoons once the veil lifts, we probably would not demand absolute equality on most fronts.

85 Scheppel, supra note 36, at 125 (citing Easterbrook & Fischel’s comment at page 251 of The Economic Structure of Corporate Law that they “suspect that few people who invoke arguments on fairness have in mind any particular content for the term.”)
86 McGee, supra note 28, at 210–11.
87 Id. at 210.
88 Id. at 211.
89 Id.
90 Id.
The ability to accumulate wealth and achieve economic development—which, in principle, benefits us all and is "to the greatest benefit of the least-advantaged members of society"—is often realized through the buying and selling of securities precisely because there are differences in the sophistication and skill possessed by traders of the same security. In large measure, such differences are inevitable; some spend their lives mastering the markets, while others simply dabble. These differences allow certain securities traders to make money in a transaction—and cause others to lose money—precisely because they lead to differing judgments as to the value (future cash flow) of a given security relative to its current price. Yet this type of arguable unfairness is something that most of us living in a capitalist society would probably accept as largely inevitable and indeed morally permissible. Part of our acceptance of such a system lies in the fact that it seemingly encourages hard work, due diligence, and thorough analysis. It provides most of us with the belief that, if we too become educated—or at least if we hire somebody educated and experienced to manage our money—we can also eventually succeed in the market.

Most of us are probably also willing to accept that trading gains and losses are morally permissible—and should continue to be legally permissible—even if they are just the result of dumb luck. Although some have defended insider trading, in part, as a means to minimize chance in the allocation of trading gains and losses in the market, most of us probably perceive no problem with the influence of luck so long as the allocation of luck is truly random. The ubiquity of state lotteries suggests that most of us would probably not want Congress to force us to disgorge profits based on pure luck, even if it were possible to do so. After all, in the stock market—like in any casino—we, too might eventually choose a winner, get lucky, and become rich.

As to differences in financial resources amongst traders, many of us probably recognize that a blanket rule denying the market

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92 Id. at 43 (explaining the "Difference Principle"). Notably, this Article does not intend to suggest that the least advantaged amongst us are always, in practice, served by inequalities of wealth.

93 See Werhane, supra note 36, at 842–44 (challenging Henry Manne's assertion of such an argument); see also generally HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).
advantages that money brings would also be undesirable. Apart from the perverse incentives for free-riding that such a rule would produce due to the removal of the profit motive, it would also be difficult to maintain for long if we are to maintain a free and capitalist society.94 Even if some might occasionally want to eliminate certain market advantages occasioned by differences in wealth—for example, by barring well-financed high-speed traders from purchasing closer server proximity to the Exchanges95 or gaining access to the University of Michigan’s Consumer Sentiment Index from Thomson Reuters 300 or 302 seconds earlier than everyone else96—such instances are best dealt with on a case-by-case basis, and with rules that limit the definition of “inside information” to specific information related to a particular issuer, rather than general market information, which can be independently gathered in lieu of purchase.

But the fact that American society tolerates these deviations from what might be deemed “perfect fairness” (i.e., perfect equality) in the securities markets should not be taken to mean that other, more fundamental aspects of trading fairness ought not be expected, demanded, and ultimately ensured in our securities markets.

I submit, with substantial credit to John Rawls, that apart from equal basic liberties (which would not include the liberty to harm others or society), the most fundamental guarantee of “fairness” that most of us would probably want if we did not otherwise have entrenched privilege is equality of opportunity.97 Appearing seventeen times in the Republican Party platform and

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95 MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT 10 (2014).
96 Peter Lattman, Thomson Reuters to Suspend Early Peeks at Key Index, N.Y. TIMES (July 7, 2013), http://dealbook.nytimes.com/2013/07/07/thomson-reuters-to-suspend-early-peeks-at-key-index/?_r=0 [https://perma.cc/8S3H-C6L2].
97 RAWLS, supra note 91, at 42–43 (“Social and economic inequalities are to satisfy two conditions: first, they are to be attached to offices and positions open to all under conditions of fair equality of opportunity; and second, they are to be to the greatest benefit of the least-advantaged members of society (the difference principle).”).
twenty-one times in the Democratic Party platform, the concept of “opportunity” forms a cornerstone of our national identity and pervades many of our public policy decisions, from education to employment to healthcare. It is also a hallmark of the ethical codes adopted by international organizations and multi-national corporations alike, and serves as the basis for many contemporary business-related initiatives like microfinance.

While we might not all agree as to how best to facilitate such opportunity in numerous social contexts or always practice what is preached, this Article submits that, in the context of the securities markets, the ethical mandate of equal opportunity translates into the need for a legal requirement of equality of access to corporate information. Without the opportunity to access meaningful information, it is scarcely possible to make informed judgments about one’s investments. And without informed judgment, many of us would probably prefer to refrain from investing at all.

Here, though, it is critical not to conflate the claim that fairness requires equality of access to information with “impossibly utopian” calls for equality of information. Yet this is the error made by certain academics and by a majority of the Supreme Court in both Chiarella v. United States and Dirks v. SEC.

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99 Dinah Payne et al., A Global Code of Business Ethics, 16 J. BUS. ETHICS 1727, 1729 (1997) (citing the United Nations International Labor Organization’s declaration of “equality of opportunity and treatment” as one of the key issues concerning foreign direct investment in developing countries, and citing the Johnson & Johnson Credo, which states that “[t]here must be equal opportunity for employment, development and advancement for those qualified”). Id. at 1731.

100 See Roland Bardy, et al., Foreign Investment and Ethics: How to Contribute to Social Responsibility by Doing Business in Less-Developed Countries, 106 J. BUS. ETHICS 267, 271, 276 (“Micro-financing has evolved in response to the inability of traditional financial institutions” to ensure “fair equality of opportunity.”).

101 Scheppele, supra note 36, at 125.

102 See McGee, supra note 28, at 210–11.

Chiarella was a case involving a “mark-up man” at a financial printing company who traded in the securities of a takeover target company after learning its identity from confidential and redacted dealbooks given to his employer by the acquiring company.\textsuperscript{104} Although the government prosecuted and convicted Chiarella of insider trading, a majority of the Supreme Court reversed, holding that because Chiarella was not an insider, he owed no affirmative duty to disclose the nonpublic information he obtained.\textsuperscript{105} With the fledgling misappropriation theory not yet properly before the Court,\textsuperscript{106} the majority believed that they could not affirm the conviction without recognizing “a general duty between all participants in market transactions to forgo actions based on material, nonpublic information”\textsuperscript{107} or adopting a “parity of information” rule, requiring perfect informational symmetry amongst all market participants.\textsuperscript{108}

In actuality, there were other viable options to decide Chiarella, as presented by the dissenting justices, which did not require perfect equality of information. Most notably, Justice Blackmun—joined by Justice Marshall—explained that he would hold that “persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantages through trading in affected securities.”\textsuperscript{109} Indeed, it was Chiarella’s access to the dealbooks that was the proximate and structural cause of his informational advantage, rather than any true financial acumen or diligence on his part that could not now be accomplished with a quick Google search.\textsuperscript{110} Thus, as pointed out by dissenting Justices Blackmun and Marshall, a rule barring Chiarella from exploiting his position

\begin{footnotes}
\item[104] Chiarella, 445 U.S. at 224.
\item[105] Id. at 231.
\item[106] See id. at 235–36 (declining to decide whether the misappropriation theory presented by the government had merit because it was not submitted to the jury). But see id. at 240 (Berger, C.J., dissenting) (expressing willingness to hold that “a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading”).
\item[107] Chiarella, 445 U.S. at 233.
\item[108] Id.
\item[109] Id. at 251 (Blackmun, J., dissenting).
\item[110] Id. at 247 (Blackmun, J., dissenting).
\end{footnotes}
of access against his counterparts, whom he knew could not possibly lawfully access the same information, could have formed the basis for a limited rule about why, under the circumstances, he should have been under a unique obligation to abstain from trading.\footnote{Id. at 251 (Blackmun, J., dissenting).} In fact, a similar rule was adopted nearly twenty years earlier by the SEC in the groundbreaking matter of Cady, Roberts.\footnote{Cady, Roberts, & Co., Exchange Act Release No. 34-6668, 40 SEC Docket 907, 912 (1961) (noting that certain people were subject to the disclose-or-abstain obligation where there is “[1] the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and ... [2] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”). Notably, the Commission’s interpretation of the Cady, Roberts rule would have imposed the disclose-or-abstain obligations on certain “insiders,” while the rule for which this Article advocates would impose it on everyone when they have \textit{inside access}. Id. at 911 (internal quotations omitted).} Yet, the majority in Chiarella took pains to reject a needlessly broad “parity-of-information” theory, even though the dissent by Justices Blackmun and Marshall explained, as this Article has attempted to explain, that “there is a significant conceptual distinction between parity of information and parity of \textit{access} to material information.”\footnote{Chiarella, 445 U.S. at 233 & 252 n.2 (1980) (Blackmun, J., dissenting).}

\textit{Dirks} involved a securities analyst who was censured by the SEC because he received and then passed on to his institutional clients a former insider’s tip concerning corporate fraud at the issuer, and the clients traded on the information before it was disclosed to the public or the SEC.\footnote{Dirks v. SEC, 463 U.S. 646, 648–49 (1983).} After appeal of his censure, the majority of the Supreme Court determined that Dirks could not be held liable for insider trading.\footnote{Id. at 666.} The majority reasoned that Dirks did not fit into the classical theory of insider trading because Dirks was neither an insider nor a temporary insider under an obligation to disclose or abstain from trading.\footnote{Id. at 665 (“It is undisputed that Dirks himself was a stranger to [the issuer whose shares were traded] with no pre-existing fiduciary duty to its shareholders.”).} Moreover, the still nascent misappropriation theory would not have

\footnote{Id. at 251 (Blackmun, J., dissenting).}
\footnote{Cady, Roberts, & Co., Exchange Act Release No. 34-6668, 40 SEC Docket 907, 912 (1961) (noting that certain people were subject to the disclose-or-abstain obligation where there is “[1] the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and ... [2] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”). Notably, the Commission’s interpretation of the Cady, Roberts rule would have imposed the disclose-or-abstain obligations on certain “insiders,” while the rule for which this Article advocates would impose it on everyone when they have \textit{inside access}. Id. at 911 (internal quotations omitted).}
\footnote{Chiarella, 445 U.S. at 233 & 252 n.2 (1980) (Blackmun, J., dissenting).}
\footnote{Dirks v. SEC, 463 U.S. 646, 648–49 (1983).}
\footnote{Id. at 666.}
\footnote{Id. at 665 (“It is undisputed that Dirks himself was a stranger to [the issuer whose shares were traded] with no pre-existing fiduciary duty to its shareholders.”).}
applied to Dirks because the information he received and shared was not stolen in breach of confidence to the source, but rather was given to him by the insider with no expectation of privacy. The majority therefore crafted a new tipper-tippee theory of liability, under which “some tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly.”

It thus held:

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

The majority added that “[w]hether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure .... The test is whether the insider personally will benefit, directly or indirectly, from his disclosure.”

The Dirks majority’s decision not to hold that a tippee assumes a duty to disclose or abstain from trading by virtue of the mere fact that (s)he receives nonpublic information (a position advocated by the SEC) was prompted, in large part, by its erroneous belief that holding otherwise would require “equal information among all traders.” Yet, this is not the case. A much narrower rule, based on the equality of access theory, could have recognized any wrongfulness in the former insider’s and Dirks’s behavior (i.e., sharing the information with likely traders without first notifying the SEC or the public) while at the same time preserving incentives for analysts to “ferret out and analyze information” and ensuring fundamental market fairness. Based

117 See United States v. O’Hagan, 521 U.S. 642, 652 (1997) (“The ‘misappropriation theory’ holds that a person 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.”).
118 Dirks, 463 U.S. at 660 (emphasis added).
119 Id. at 647.
120 Id. at 662.
121 Id. at 657.
122 Id. at 658 (internal quotations omitted).
on the facts of the case, it was clear that the information concerning the fraud derived not primarily from Dirks’s independent diligence, but rather from the access offered by the tipper’s position as former employee of the issuer.\textsuperscript{123} While the majority of the Supreme Court, writing in the pre-Internet age, believed that “such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally,”\textsuperscript{124} technological advances since that 1983 decision have done just that (e.g., EDGAR, corporate websites, etc.).\textsuperscript{125} Indeed, Regulation FD (adopted in 2000) now even requires it.\textsuperscript{126}

The difference between “equal information” and “equal access” is that the former is neither required by fairness nor tenable,\textsuperscript{127} while the latter “rewards investment in the production of information in markets and also protects structurally disadvantaged parties in securities transactions.”\textsuperscript{128} Requiring equality of access to corporate information or disclosure prior to trading incentivizes the production of information because it would give “free rein to certain kinds of informational advantages that result in differences in diligence and acumen.”\textsuperscript{129} Yet, it safeguards the structurally disadvantaged “by limiting opportunities for profit from manipulation of confidential connections or resort to stealth.”\textsuperscript{130}

\textsuperscript{123} Id. at 660.
\textsuperscript{124} Id. at 659.
\textsuperscript{126} See 17 C.F.R. § 243.100 (2011) (“Whenever an issuer, or person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any [broker-dealer, investment advisor, institutional management advisor, investment company, or shareholder under circumstances in which it is reasonably foreseeable that the shareholder will buy or sell the issuer’s securities] .... the issuer shall make public disclosure of that information .... (1) [s]imultaneously, in the case of an intentional disclosure; and (2) [p]romptly, in the case of a non-intentional disclosure.”).
\textsuperscript{127} Scheppele, supra note 36, at 125 (“Fairness does not require equality to extend so far” as to require informational symmetry.).
\textsuperscript{128} Id. at 125.
\textsuperscript{130} Id.
Even supporters of legalized insider trading have noted that insider traders often obtain this “secret” information through “the good old boy network.” But most Americans are not current or former senior corporate officials with access to advance information on price-moving matters such as earnings, dividends, mergers, or undisclosed frauds like the tipping insiders in Cady, Roberts and Dirks. Most Americans are not analysts able to command meetings with corporate insiders like the tippee in Dirks. Most Americans do not socialize with corporate insiders who are capable of providing meaningful tips like the two analysts in Newman, one of whom knew an individual in the investor relations department at Dell from business school, and the other of whom was tipped about NVIDIA’s earnings because he knew an individual in the finance department from church. Most Americans do not have a close family relative that works as an investment banker, as in the Salman case. Most Americans do not even work in positions that would grant access to insider information without tipping, like the white-collar lawyer in O’Hagan who noticed his partners working to facilitate Grand Met’s acquisition of Pillsbury before he bought options in the latter company, or even the “mark-up man” in Chiarella who worked nightly with confidential dealbooks.

Because of these issues of structural access, such unfairness would not be remedied by simply allowing everyone to trade on the nonpublic information in their possession. For while such a rule could conceivably be fair with respect to those whose positions of access allow them to be in the know at least some of the time, it would not provide equality of opportunity to most retail investors.

For these reasons, if we were in the Original Position deciding ex ante on rules to govern the securities industry, we would probably decide that “fairness” does not require perfect equality

\[131\] McGee, supra note 28, at 212 (internal quotations omitted).


of information, money, skill, sophistication, or luck. It merely requires an equal ability to obtain meaningful investment information through independent and otherwise lawful diligence. That is, fairness under the social contract requires equality of access to information.

2. Insider Trading Constitutes “Cheating”

Concomitant with the need to define “fairness” in the securities markets, it is also critical at the outset of any effort to legislate against certain forms of impermissible trading to define precisely what “cheating” means.

However tempting it may be to fall back upon Justice Stewart’s famous statement on obscenity—“I know it when I see it”—both business and society as a whole deserve more precision. Yet “the concept of cheating, despite its apparent importance in our everyday lives, has been mostly ignored in the literature of moral philosophy.” Although the concept of insider trading is a recurring topic in the legal literature, seldom is it identified or analyzed as a mode of cheating as opposed to a form of lying or stealing. For example, in accordance with the theoretical focus of current law on fiduciary duty and misappropriation, Professor Ostas describes insider trading as a crime that “combine[s] the sin of theft with the sins of betrayal and deceit.” Even Black’s Law Dictionary conflates cheating with lying and stealing (fraud), as it defines cheating as “the fraudulent obtaining of another’s property by means of a false symbol or token or by other illegal practices.” But as anyone who has ever administered or taken an exam knows, cheating does not necessarily require lying or stealing another’s information. Cheating can also occur when the “right” answers are given to the test-taker, or when the test-taker secretly views the answer key on the professor’s desk.

It is, in part, the failure to adequately define “cheating”—or consistently recognizing insider trading as a grave form of cheating

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139 Ostas, supra note 36, at 582.
140 BLACK’S LAW DICTIONARY 287 (10th ed. 2014).
independent of fiduciary breach or misappropriation—\textsuperscript{141}—that has resulted in the dismal state of U.S. insider trading law and the prevalence of this destructive practice.

In his book \textit{Lying, Cheating, and Stealing: A Moral Theory of White Collar Crime}, Rutgers Law Professor Stuart Green offers that, “in order for us to say that X has cheated, X must (1) violate a fair and fairly enforced rule, (2) with the intent to obtain an advantage over a party with whom she is in a cooperative, rule-bound relationship.”\textsuperscript{142}

As to the first requirement, Green explains with considerable reference to the pioneering work of H.L.A. Hart, Dworkin, and Rawls that cheating, insofar as it obtains moral condemnation, generally involves the violation of a mandatory, proscriptive rule that regulates conduct in a particular endeavor.\textsuperscript{143} However, Green rightly does not indicate that such a rule must be codified in order for its violation to constitute cheating because codification is a necessary function of law, not morality.\textsuperscript{144} The function of Green’s first requirement is simply to indicate that there must be some degree of rule specificity before one’s violation of such a rule can

\textsuperscript{141} Although it is not expressly recognized as cheating, one notable exception to the general rule that insider trading is not punishable unless it is accompanied by fiduciary breach or misappropriation is SEC Rule 14e-3, which prohibits trading on the basis of material nonpublic information concerning a tender offer that:

- [the trader] knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.


\textsuperscript{142} GREEN, \textit{supra} note 138, at 57.

\textsuperscript{143} \textit{Id.} at 58–62.

\textsuperscript{144} See \textit{id.} at 75.
be deemed cheating.\textsuperscript{145} Thus, it would seem that only if we are willing to accept that there are no mandatory prescriptive rules governing appropriate behavior in the markets can the moniker of cheating, in the moral sense, be necessarily inapplicable or absent from our insider trading lexicon.

Only the most callous Gordon Gekkos\textsuperscript{146} amongst us, however, would claim today that “anything goes” in the securities markets. This author is aware of no issuer, financial institution, or fund that makes this claim. Thus, certain rules do exist in the securities markets—both express and implied—and their violation can, under certain circumstances, be condemned as cheating. This Article would submit that the “rule” violated by insider trading is the implied rule that “thou shalt not trade in securities on the basis of information concerning that issuer unless such information could also be available to others through their independent and otherwise lawful diligence.”

Green’s second condition for cheating—that it is a rule violation “\textit{with the intent to obtain an advantage over a party with whom she is in a cooperative rule-bound relationship}”\textsuperscript{147}—is also met by insider trading. Green explains that “although all instances of cheating involve rule-breaking, there are many cases of rule-breaking that do not involve cheating.”\textsuperscript{148} He thus offers four additional conditions necessary to turn rule-breaking into immoral cheating: (1) “the rule broken must be fair and enforced in an even-handed manner and not subject to a justified exception;” (2) “the rule-breaking must be intentional;” (3) “the rule-breaker must be part of a cooperative rule-governed activity that involves another party;” and (4) “the rule-breaker must intend to gain an advantage through her rule-breaking.”\textsuperscript{149}

The first two requirements are meant to indicate that, to constitute cheating deserving of moral condemnation (if not also legal prohibition), the violation of a rule must be unjustified and not accidental.\textsuperscript{150} To those versed in criminal law, these two requirements

\textsuperscript{145} \textit{Id.} at 61–62.
\textsuperscript{146} \textit{WALL STREET} (20th Century Fox 1987).
\textsuperscript{147} \textsc{Green, supra} note 138, at 57 (emphasis added).
\textsuperscript{148} \textit{Id.} at 63.
\textsuperscript{149} \textit{Id.}
\textsuperscript{150} \textit{Id.} at 63–64.
are familiar and easily understood, for they are reflected in the requirements of *mens rea* (criminal intent)\(^{151}\) and in the availability of affirmative defenses.\(^{152}\)

The third requirement, however, is worthy of substantially more explanation. Are securities traders “part of a cooperative rule-governed activity that involves another party”\(^{153}\) such that they may be capable of cheating? Certain people may be tempted, at first glance, to deny that there is any “cooperative” activity in the securities markets because there are undoubtedly zero-sum aspects to trading. In many securities transactions, there must be a buyer and seller: a “winner” (who underpays, sells above fair market value, or places the correct bet as to the future value of the security) and a “loser” (who overpays, sells below fair market value, or places the wrong bet as to the future value of the security). However, this would be a fundamental misunderstanding of both Green’s requirement of cooperative activity and the securities markets themselves. The requirement of cooperative activity does not mean that the parties must cooperate, but rather that they are “engaged in a mutually beneficial cooperative enterprise, such as a game, a market or a political contest.”\(^{154}\) Without a counterparty to purchase what is being sold or sell what one wishes to purchase, there can be no securities market. Without a securities market, there can be scant capital accumulation for people or enterprises. Thus, all issuers and traders are involved in a mutually beneficial endeavor to raise capital, grow wealth, and develop economies.

The fourth requirement is perhaps the *sine qua non* of cheating: “the rule breaker must intend to gain an advantage through her rule-breaking.”\(^{155}\) We have already established that “fairness” in the context of the securities markets, under the principle of equality of opportunity, requires equality of access to material information.\(^{156}\) It thus follows that “unfairness” means inequality

\(^{151}\) BLACK’S LAW DICTIONARY 1134–35 (10th ed. 2014); see also id. at 930–31.

\(^{152}\) Id.

\(^{153}\) GREEN, supra note 138, at 63.

\(^{154}\) Id. at 64.

\(^{155}\) Id. at 63.

\(^{156}\) Scheppele, supra note 36, at 125.
of access to information. And “gaining an unfair advantage” means exploiting this inequality of access to information. Indeed, this was the SEC’s original recognition in Cady, Roberts back in 1961, when it explained that a duty to disclose or abstain ought to arise as a function of two factors: “the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone,” and “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”

For these reasons, trading on the basis of information that is not theoretically accessible to others through independent diligence constitutes cheating in violation of our basic social contract applicable to business. And it should be recognized as such, irrespective of whether it is accompanied with lying or violating a confidence (the breach of fiduciary duty) or stealing (misappropriation).

B. Insider Trading Violates the Categorical Imperative

Trading on the basis of information known to be inaccessible to others through diligence is also wrong because it violates deontological duties of morality. Immanuel Kant explained that the morality of an act depends upon the intent of its author to adhere, as a matter of duty, to the “categorical imperative.” Under his first formulation, known as the Formula of the Universal Law, Kant explains that one must “act only on that maxim whereby you can at the same time will that it should become a universal law.” In his second formulation, the Formula of Humanity, he defines the imperative as “[s]o act that you treat humanity, whether in your own person or in the person of any other, always at the same time as an end, never merely as a means.” Since these two formulations effectively boil down to the same thing, the question concerning the morality of insider trading becomes: would we want the principle of cheating to become something that

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158 SANDEL, supra note 94, at 122.
159 Id. at 120.
160 Id. at 122.
161 Id. at 120.
everyone should do all the time, or are traders who exploit information they know to be structurally inaccessible to others simply “put[ting] [their] interests and special circumstances ahead of everyone else’s”? The answer appears clear under either formulation: it violates the categorical imperative.

1. Insider Trading Violates the Formula of Universal Law

Insider trading violates the Formula of Universal Law because traders operate in a market system that depends on the existence of somebody willing to buy what they are selling and sell what they are buying. If everyone were to use their own non-publicly available information, and could be expected to do so, then the market for trading would likely cease to function effectively. Much like Kant’s famous explanation of why rampant promise-breaking would destroy the reliability and value of promises altogether, this Article argues that if everyone traded on their own privately accessible information, the markets themselves would cease to function effectively, as few people would willingly purchase stocks. Why relinquish your money if the odds are that your counterparty knows something that you don’t—and can’t—know, and that your investment will promptly devalue?

Rampant insider trading would undermine trust, deter investing, and potentially destroy the ability to accumulate capital. Indeed, even staunch defenders of certain forms of insider trading note that there is some evidence of this occurring insofar as liquidity providers, who anticipate some degree of insider trading, adjust their bid-ask spread in order to self-insure and thereby pass along an “insider trading tax” upon all other investors. If

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162 Id. at 121.
164 Cf. United States v. O’Hagan, 521 U.S. 658 (1997) (“Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on mis-appropriated nonpublic information is unchecked by law.”).
165 Henry G. Manne, Hayek, Virtual Markets, and the Dog that Did Not Bark, 31 IOWA J. CORP. L. 167, 168 (Fall 2005) (finding “feasible merit” in the “adverse selection” argument against insider trading, which holds that because market makers systematically lose money when insiders are trading, they will expand
the practice of insider trading were to become universal, this
liquidity problem likely would only intensify.

2. Insider Trading Treats Counterparties As Mere Means to
an End

Insider trading also violates the Formula of Humanity, which
commands that we never treat people as mere means to an end,
but rather always as inherently valuable ends in themselves. To understand why it does so, it is critical to understand what is
meant by treating people as “mere means.” Cambridge philoso-
pher Baroness Onora O’Neil, has aptly explained that there is a
difference between occasionally using people as means—for ex-
ample, using a teller to cash our checks at the bank—and using
them as “mere means,” or as “a prop to be manipulated.” The
difference lies in respecting the other’s ability to consent to our
treatment, at least in principle. In the case of securities transactions that depend upon counterparties being
unaware that we possess information that they could never pos-
sess through their independent diligence, we deny them the op-
portunity to make such choices on their own.

In sum, because the value of insider trading depends on the
insider trader’s ability to obtain exceptions to the rules they expect
others generally to follow, and necessarily requires the trader to
deny others the opportunity to make fully informed choices as
rational humans, it violates deontological duties of justice.

C. Insider Trading Undermines Social Utility

This Section shall argue that insider trading is unethical be-
cause it undermines social utility by bringing more harm than

166 Sandel, supra note 94, at 122.
167 O’Neill, supra note 163, at 48.
168 Id.
169 Id. at 48–49.
good. The vast majority of the arguments concerning the ethics of insider trading are consequentialist along these lines—perhaps, in part, to speak the language of economists like Henry Manne and adherents of the law and economics movement who have engaged heavily in this debate and tend to dismiss “fairness” arguments as “puerile.”

Since the academy has already long debated the ethics of insider trading on these lines, this Section shall only briefly recap the major arguments before offering my contribution: based on new empirical evidence from recent finance and accounting literature, insider trading harms the economy by undermining trust, which deters retail investment and correlates with increases in the cost of equity capital and decreases in liquidity.

1. The Alleged Benefits of Insider Trading and the Harms of Prohibition

Proponents of insider trading argue that it provides a number of benefits. In his famous 1966 book, *Insider Trading and the Stock Market*, Manne argued that insider trading served as a relatively low-cost form of corporate compensation for the insider-entrepreneur for creating the valuable information in the first place. This argument, which he has subsequently all but abandoned, was shown to be fallacious because such a regime would allow many individuals to reap “compensation” they have not earned and potentially even profit off information that actually harms the company.

Manne also argued that insider trading “contribute[s] importantly to the efficiency of stock market pricing,” insofar as the increased flow of information occasioned by insider trading allows the price of stocks to better reflect their true value. McGee

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171 Id. at 171 (noting that the argument is “perhaps less robust than I and other proponents had originally assumed”).

172 Id. at 171 (noting that the argument is “perhaps less robust than I and other proponents had originally assumed”).


similarly argues that “insider trading serves as a means of communicating market information, which makes markets more efficient” because “it acts as a signal to others that a stock’s price will likely move in a certain direction.”175 It thus has been contended that “restricting insider trading may have long-term adverse effects on the economy” as it “decreases market efficiency” by arguably stifling information flow.176 This argument, while persuasive to an extent if true (at least insofar as more accurate pricing benefits outsiders choosing whether to invest initially), has been criticized as logically inconsistent. While it champions market efficiency, it seemingly ignores the fact that market efficiency also requires self-restrained competition, which is thwarted by insider trading.177 In my view, the pricing efficiency argument would only have potential merit insofar as it pertains to trading by true insiders (i.e., corporate officers and directors) because those are the only people whose trades might be perceived as reliable signals. Trading by outsider-tippees would likely offer no such signaling benefit.

Nearly forty years after his first salvo, Manne subsequently argued that insider trading could improve internal corporate efficiency by generating price swings, which would signal to upper management that corporate problems are afoot.178 This signaling argument, however, was effectively rebutted by Prentice and Donelson, who pointed out that it rests on faulty assumptions. First, it assumes that senior management needs such signals generated by insider trades, even though senior management is already in the best position to know about corporate problems.179 Second, it assumes that management has the ability to discern meaningful information from insider trades that may be too small, anonymous, intentionally slow-played, or otherwise shielded by market noise to be detectable or provide actionable information.180

175 McGee, supra note 28, at 209.
176 Id. at 210.
177 Werhane, supra note 36, at 842–44.
179 Prentice & Donelson, supra note 173, at 18–22.
180 Id.
Yale Professor Jonathan Macey also advanced an argument about the beneficial signaling effects of insider trading, although under more limited circumstances involving whistleblowing.181 Macey argued, as some before him similarly suggested,182 that “[p]ermitting insider trading on the basis of [information about ongoing corporate misconduct] would ... provide the strongest incentives for people to seek out and expose such corporate wrongdoing.”183 While interesting, this argument was also rebutted by Prentice and Donelson, who note that insider trading occasioned by undisclosed news of corporate fraud would send only a vague signal to the markets unless it was coupled with explanatory disclosures, which would immediately destroy the “value” of the secret information, and thus prompt would-be whistleblowers to delay or forego disclosure altogether.184

In the context of takeovers, McGee argues that “[t]he potential acquirer in a takeover attempt may also benefit by insider trading” because if arbitrageurs acquire shares in advance on the basis of a tip of the pending acquisition, they presumably intend to subsequently tender them, thereby increasing the likelihood that the takeover will succeed.185 He adds that insider trading regulations (like the Williams Act) that require would-be tender-offerors to announce their intentions well in advance actually harm the shareholders of the target issuer because they make it easier for management to adopt defensive tactics to thwart the takeover.186 These arguments, however, are based on the assumption that

183 Macey, supra note 181, at 1939.
184 Prentice & Donelson, supra note 173, at 52.
185 McGee, supra note 28, at 209.
186 Id. at 210.
takeovers are always good—an assumption he fails to support—and that appears belied in many circumstances by the anti-competitive consequences that such consolidations may bring.\textsuperscript{187}

In that same takeover context, and under the premise that “insider trading has a tendency to increase the stock’s price,” some have argued that such price increases will benefit (1) “the shareholders who sell at the time the [tipped] arbitrageurs are buying” whom they speculate “would probably have sold anyway”; (2) the shareholders who do not sell, since the price of their shares will have increased; and (3) the target corporation itself.\textsuperscript{188} They also argue that insider trading by intentionally tipped traders might even benefit the acquiring corporation, to the extent it serves as “indirect compensation” for various services rendered.\textsuperscript{189}

These arguments, too, seem flawed. First, the assumption that existing shareholders would have sold anyway is uselessly speculative. Second, as Prentice and Donelson have noted, inside information certain can be negative information that harms the value of the issuer,\textsuperscript{190} such as the information about corporate fraud in \textit{Dirks}.\textsuperscript{191}

Some proponents of legalized trading on nonpublic information also argue that if insider trading were banned, various harms may ensue. First, intentional tippers and tippees would allegedly be harmed because corporate information is a property right, which should be disposable at will, either for profit or for free.\textsuperscript{192} Second, forcing the analyst to give this information to the world would eliminate the incentive to obtain it, harm the market by reducing available information, and be unjust to the analyst because others would be free riding on his efforts.\textsuperscript{193} These arguments are also suspect because the inside information allegedly

\textsuperscript{187} See FTC, STATEMENT ON MERGER REVIEW, https://www.ftc.gov/enforcement/merger-review [https://perma.cc/MYQ9-ZX73] (explaining that the purpose of FTC merger review under Hart-Scott-Rodino and the Clayton Act are directed at “preventing mergers and acquisitions that are likely to reduce competition and lead to higher prices, lower quality goods or services, or less innovation.”).

\textsuperscript{188} McGee, supra note 28, at 209.

\textsuperscript{189} Id. at 209–10.

\textsuperscript{190} Prentice & Donelson, supra note 173, at 5.

\textsuperscript{191} Id. at 23–24.

\textsuperscript{192} McGee, supra note 28, at 212.

\textsuperscript{193} Id.
being tipped out belongs not to the insider-tipper, but rather to his corporation and all of its shareholders.194

Finally, as a last refuge, some have argued that insider trading regulations are problematic because they increase taxpayer costs by requiring public compliance monitors like the SEC.195 Such an argument could only hold water, however, if indeed it “does not result in any harm to any identifiable group”196 or if the costs of regulation were not outweighed by the benefits of prohibition and the harms associated with insider trading. The next Section shall now turn to those questions.

2. The Ostensible Harms of Insider Trading

Opponents of insider trading focus on the harms caused by insider trading. Historically, these arguments have focused largely on shareholders whose value is stolen by insider traders and the harms done to the sanctity of fiduciary relationships, like that of a director to his corporation or an employee to his employer, when confidential corporate information is misappropriated for the personal benefit of a director or employee.197 The gradual legal recognition of these harms has given rise to the body of U.S. insider trading law.198 They appear to be the main reasons that “practically all the articles that have been written on insider trading in recent years have treated it as something evil”199 and why insider

194 Id. at 210.
195 Id.
196 Id. at 208.
197 See, e.g., Robert S. Rubin and Myer Feldman, Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders, 95(4) U. PA. L. REV. 468, 469, 471–72 (1947) (noting that early common law “did not adequately reach the subtleties of harm in connection with manipulation on the impersonal securities markets” and recognizing that a “guiding light” of the 1934 Securities Exchange Act was to “curb abuses by insiders who normally have access to confidential information not available to small stockholders and to the general public”).
198 See infra Part II.C.2.a–d (explaining the gradual evolution of insider trading case law to protect through disclosure requirements (1) existing shareholders from trades with a non-disclosing holder of material nonpublic information under special circumstances; (2) all existing shareholders regardless of special circumstances; (3) soon-to-be shareholders buying stock from non-disclosing insiders; and ultimately (4) issuers and employers through the misappropriation theory).
199 McGee, supra note 28, at 217.
trading currently commands “a strong sense of moral disapproval.” However, as set forth below, the harms arising from insider trading go far beyond these harms to shareholders and employers. Now, insider trading is also associated with empirically demonstrable harm to capital markets themselves.

a. Harms to Selling Shareholders

It should be noted at the outset of any discussion regarding harms caused by trading on the basis of material nonpublic information that such insider trading was not always perceived as wrongful in the United States, at least insofar as the practice did not involve public officials. Up until the early part of the twentieth century, states were split on the question of whether it was appropriate for corporate insiders to use material nonpublic information to obtain a trading advantage in the market—even over one’s own shareholders. Although outright fraud through affirmative factual misrepresentation was generally prohibited under the common law of contracts of all states, the majority of states held that there was no obligation on the part of a corporate insider when buying shares from existing shareholders to proactively disclose information known only to him. Rather, the ability to capitalize on corporate inside information through silence while trading was deemed by many to be “a normal emolument of corporate office.”

200 Ostas, supra note 36, at 582.
202 Prentice & Donelson, supra note 173, at 28.
203 The first known case of insider trading in the United States traces back to 1792, when William Duer was convicted of using knowledge obtained by virtue of his position as Assistant Secretary of the Treasury to guide his speculation in federal bonds. See Steve Fraser, The Genealogy of Wall Street Crime, L.A. TIMES (Jan. 30, 2005), http://articles.latimes.com/2005/jan/30/opinion/oe-fraser30 [https://perma.cc/6USD-9R57].
204 MANNE, supra note 93, at 18.
205 Id.
206 Id.
Only a small minority of states prior to 1909 had established a different rule, by court decision or Blue Sky statute, which created a fiduciary relationship between corporate insiders and selling shareholders, and required full disclosure of all relevant facts. Since that time, however, the ostensible harms from insider trading have received gradual legal recognition.

The main argument offered by opponents of insider trading is that it harms existing shareholders who sell their stock to an inside trader because such sellers lose the value they would have received had they not sold, or at least not sold at the price at which they sold, to an insider who possesses information that indicates the shares are worth more. This type of harm gave rise to the first United States Supreme Court case to address insider trading: *Strong v. Repide*. In *Strong*, the Court held that a corporate insider with knowledge of an impending sale of corporate land assets to the U.S. government that would affect the price of the corporate landowner’s securities was barred from effectuating an in-person stock purchase from a minority shareholder where he had concealed the fact of the land sale and used an intermediary to keep his identity secret. Without squarely deciding whether corporate insiders necessarily had a duty to disclose all material facts, the Court based its decision to bar the sale upon the so-called “special facts rule.” Under that doctrine, it was legally noteworthy that the defendant-insider was not only a director, but also that (1) he owned three-fourths of the shares of its stock; (2) he was acting as chief negotiator regarding the corporate asset sale with the government on behalf of the other shareholders and therefore was privy to the probability of the sale; and (3) that the sale was for the whole of the property of

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208 MANNE, supra note 93, at 18–19.


210 See generally 213 U.S. 419 (1909).

211 Id. at 434.

212 Id. at 431; see also MANNE, supra note 93, at 21 (After *Strong*, the “special facts” doctrine became the prevailing approach in the states at least insofar as securities transactions were conducted in person, rather than anonymously over an exchange, as most are today.).
the company—its only valuable asset. Accordingly, under the “special facts” of that case, the court held “there was a legal obligation on the part of the defendant to make these disclosures.”

Harms to selling shareholders involving no affirmative misrepresentation (only silence) because they were conducted over an anonymous exchange only became truly recognized in 1961, when the SEC decided *Cady, Roberts*, holding that “[i]t would be anomalous indeed if the protection afforded by the antifraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions.” Until that time, state courts like the Massachusetts Supreme Court in *Goodwin v. Agassiz* (in 1933) often regretfully reasoned: “Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill, and shrewdness.”

By the time of the *Cady, Roberts* decision in 1961, of course, the 1933 Securities Act and 1934 Securities Exchange Act had

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213 *Strong*, 213 U.S. at 431–32.
214 *Id.* at 434.
215 *Cady, Roberts* involved the question of whether a selling broker and his firm committed fraud by trading on the basis of not-yet-public information that Curtis Wright Corporation would soon reduce its quarterly dividend, which had been tipped to them by an associate of the brokerage firm who was also a director of that issuer. Finding that cognizable harm had been committed by the trader, notwithstanding the lack of any affirmative false statement, SEC Chairman and former Columbia Law Professor William Cary also noted that silence may also constitute fraud in cases of “corporate ‘insiders,’ particularly officers, directors or controlling stockholders” because such individuals “must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal, and which, if known, would affect their investment judgment ....” or, abstain from trading. He explained that

> the obligation [to disclose or abstain] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

been enacted upon a recognition that a “staggering portion of the securities issued in the bubble economy of the 1920s had been tainted with fraud.”

“A significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.” The SEC had also, by then, promulgated Rule 10b-5 in 1942, even though when the SEC adopted it, it apparently did not consider its possible application to insider trading.

While some dismiss the harms to these selling shareholders, assuming they “would have sold anyway” and arguably received a better price than they would have had insider-trader demand not existed, even Henry Manne appears to have recognized the tremendous assumption imbedded here, and thus simply has argued of late that “the practice of insider trading [does] no significant harm to long-term investors.”

b. Harms to Buyers

Insider trading also ostensibly harms people who buy stock from insiders. The main problem here is that these people may be buying junk from an insider with the secret knowledge that the security is worth less than the current price, which does not reflect the insider’s potentially negative information. This harm was also recognized in 1961 when the SEC in Cady, Roberts held

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218 *Cady, Roberts*, 40 S.E.C. at 912 n.15.


(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 ....).


222 Manne, *supra* note 165, at 168 (emphasis added).
that Rule 10b-5 was “also applicable to a defrauded buyer.” To find otherwise, according to the Commission, “ignores the plight of the buying public—wholly unprotected from the misuse of special information.” The Commissioner noted that “there is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an ‘insider’ should not have the same protection afforded by disclosure of special information as persons who sell stock to them[,]” adding:

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 [owed fiduciary duties by corporate insiders to corporate shareholders] although he was forbidden to do so once the buyer had become one.

c. Harms to Issuers

Opponents of insider trading also focus on harms that it may cause to issuers. The harm can take several forms, depending upon whether the underlying information is good or bad for the issuer, whether the insider or her tippee is buying or selling, or whether the transaction involves shares in the insider’s own company or another company.

On the most fundamental and legally recognized level, when an insider trades on or tips out information she gleaned by virtue of her position, she may be personally benefitting from information that belongs to the issuer and that was entrusted to the insider for the benefit of the issuer and its shareholders. The harm consists of misappropriation of the issuer’s property right and the breach of the fiduciary relationship.

223 Cady, Roberts, 40 S.E.C. at 913.
224 Id.
225 Id. at 914 n.23 (emphasis in original).
227 Cf. United States v. Carpenter, 484 U.S. 19, 27–28 (1987) (finding that the Wall Street Journal reporter who tipped out advance copies of his market-moving column to certain traders violated the mail and wire fraud statutes because the pre-publication column “was its property” and involved the violation of “[t]he general proposition, that a person who acquires special knowledge and information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit[,]”).
However, as the dissenting Justices recognized in *Dirks*, issuer harm can also occur regardless of whether the insider-tipper receives a personal benefit in exchange, let alone one that is “objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature” as is now required in the Second Circuit under *Newman*.  

Justices Blackmun, Brennan, and Marshall all knew that “[t]he fact that the insider himself does not benefit from the breach does not eradicate the shareholder’s injury” and “it makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider’s misuse of nonpublic information.”

To see why this is so, imagine that an insider or a temporary insider learns of his company’s plans to conduct a takeover of another company. Imagine further that the insider then purchases stock in the target (as in *O’Hagan*), or tips the information to a hedge fund analyst (as in *Newman*) or his relative (as in *Salman*), who then purchases the target’s stock. Such trading on the basis of this information may harm the insider’s own issuer (the acquiring company) because it may drive up the price of the target company’s shares, causing the acquiring company to pay more than they otherwise would have had to in order to complete the takeover. This could be the case if (1) the insider’s or tippee’s trade is large enough to increase the share price based on increased demand, or (2) if the trade results in a leak of the acquiring company’s intentions, which could cause selling shareholders of the target to become “holdouts” for more money. Accordingly, the practice of trading on the basis of material nonpublic information regarding a tender offer has long been banned.

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228 *Dirks*, 463 U.S. at 646 (Blackmun, J., dissenting).
229 *Id.* at 676–77 (recognizing that “[t]he improper-purpose requirement ... has no basis in law” but merely rests on the policy that “the end justifie[s] the means,” which is unique).
In the case of bad corporate news (e.g., Steve Jobs’s cancer for Apple), issuers might also be harmed by trading before the company chooses to make the information public. If a trade on this negative information causes a substantive “leak” as to the reason why the insider is selling (i.e., uncertainty in senior management), it could prompt a panicked market sell-off before the issuer has time to put reassuring contingency plans in place. Thus, as Professor Werhane has noted, insider trading harms issuers because it “does not protect the privacy of information it is supposed to protect.”

Finally, one other way in which issuers may be harmed by tipping out and/or trading on material nonpublic information concerns the apparent effect of such conduct on investors’ trust and confidence in the management of the issuer. Consider the case of Rajat Gupta, who learned material nonpublic information concerning Goldman Sachs and Procter & Gamble by virtue of his position on their boards, and then reportedly gave such then-secret information to his friend, Raj Rajaratnam, a principal at the now-defunct Galleon hedge fund. When the public learned about Gupta’s tipping in early March 2011 from articles entitled “Feds Accuse P&G Director” as a result of the government’s decision to charge Gupta with insider trading, many were left wondering “what else might he have leaked?” Ultimately, the

234 Werhane, supra note 36, at 844.
235 Id.
236 Id.
238 Indictment, United States v. Rajat Gupta, No. 11-Crim-907, (S.D.N.Y. Oct. 25, 2011) (“Gupta obtained the Inside Information in his capacity as a member of the Goldman Sachs Board and the P&G Board…[he] disclosed the Inside Information to Rajaratnam, with the understanding that Rajaratnam would use the Inside Information to purchase and sell securities.”).
market punished Procter & Gamble, effectively forcing Gupta to resign from the company the same day.

Reinforcing these reasons why insider trading harms issuers, a number of empirical studies have also concluded that robust insider trading regulations actually help issuers. For example, University of Michigan Professor Laura Beny concluded that “stringent insider trading laws and enforcement are associated with greater corporate valuation[,]” at least in common law countries. Likewise, Durnev and Nain found empirical evidence indicating that “insider trading restrictions are on average associated with higher firm value.” This appears to be related to the tendency of insider trading to “distort the incentives of controlling shareholders in a manner detrimental to firm value.” That is, in the absence of insider trading restrictions, controlling shareholders may be tempted by the prospect of receiving inside tips from management to “refrain from monitoring the firm sufficiently .”

\[d.\] Harms to Employers

Even if no issuer is harmed in the process of insider trading, it may also harm other stakeholders like employers who often depend upon their employees’ discretion in order to maintain the confidences of their clients, lest they lose business.

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241 According to the results of a financial event study, P&G stock experienced a statistically significant decline of approximately 2 percent in its stock price relative to its expected returns (cumulative abnormal return) over the course of the four days following the revelations of its director’s involvement in insider trading. See Bruce W. Klaw & Tricia D. Olsen, \textit{Do Investors Care About Corporate Wrongdoing? An Empirical Study Into The Materiality of Revelations of Corporate Malfeasance} (Presented to International Association for Business and Society 2014 Annual Meeting, Working Paper, June 2014).


244 Durnev & Nain, \textit{supra} note 75, at 411.

245 Id.

246 Id.

In the case of a misappropriating employee who seeks to capitalize off of material nonpublic information belonging to his employer’s client, like the mark-up man in *Chiarella* or the lawyer in *O’Hagan*, it seems probable that such an employee will cause his employer to lose a client or potentially get sued. Indeed, after Rajat Gupta (then managing director of consulting firm McKinsey & Co.) was charged with tipping Rajaratnam, the media justifiably questioned “[w]ill Rajat Gupta [d]estroy McKinsey?” because “proximity to misdeeds of this sort could be fatal” for a company whose “clients are attracted by its reputation for excellence and discretion ....”

*e. Harms to the Capital Markets and Economy as a Whole*

Finally, this Article shall turn to a more recently recognized harm from insider trading: the harm that it causes to the capital markets and the economy as a whole by raising the cost of capital, deterring retail investment, and reducing liquidity. Largely absent from the legal and business ethics literature until recently, the harms caused by insider trading to the capital markets and economy as a whole have only recently begun to garner the attention of law and ethics scholars through articles like Prentice and Donelson’s important piece in the American Business Law Journal on *Insider Trading as a Signaling Device*. For years, economists had dominated this part of the consequentialist debate by assuming that insider trading actually benefits the economy because it may improve information flow and allow prices to better reflect the true value of stock.

Based on a growing body of empirical evidence in finance and accounting literature, this Article joins Prentice and Donelson by submitting that the opposite is actually true. In essence, the failure to effectively prevent insider trading—including the tendency of current U.S. law to allow certain forms of cheating to go unpunished because they do not fit neatly into theories of fiduciary duty or misappropriation—may have seriously negative economic

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effects. Through several different mechanisms, which may compound upon each other, insider trading is associated with statistically and economically significant increases in the cost of capital and decreases in market liquidity.

i. Insider Trading Undermines Investor Trust and Deters Retail Investment

First, insider trading erodes the public’s confidence in the financial and legal institutions that support capital markets. The loss of investor trust through perceived cheating has an empirically proven and significant effect upon retail participation in the stock market by reducing household demand for equity and raising the return required before many retail investors choose to participate in a seemingly rigged game. Recent empirical research has found “unambiguous evidence that household stock market participation decreases ... following corporate scandals in the state where the household resides.” Such participatory declines do not just affect the wrongdoing issuer. Rather, “households decrease their stock holdings in fraudulent as well as non-fraudulent firms.”

Misconduct perpetrated by some may thus “create a negative externality for non-fraudulent firms by increasing their cost of capital and impairing their ability to raise equity.” Moreover, “[e]ven households that did not hold the stocks of fraudulent firms decrease their equity holdings.” Thus, the decrease in household stock market participation is not driven by financial

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251 Bhattacharya & Daouk, supra note 19, at 102 (noting that the assumption that insider trading enforcement affects the cost of equity through only one mechanism, such as lowered credit ratings, is a “conservative assumption”).
252 See Prentice & Donelson, supra note 173, at 69–70.
253 Luigi Guiso, Paola Sapienza & Luigi Zingales, Trusting the Stock Market, 63 J. Fin. 2557, 2557 (2008).
255 Id. (emphasis in original).
256 Id. at 32.
257 Id. at 2.
losses associated with the holdings in fraudulent stocks."\(^{258}\) It appears instead to be "due to a loss of trust in the stock market."\(^{259}\)

The relationship between trust and stock market participation has been studied by academics for a number of years. Guiso, Sapienza, and Zingales have defined trust as "the subjective probability individuals attribute to the possibility of being cheated,"\(^{260}\) and they have recognized that "a low level of trust can explain why a large fraction of individuals do not invest in the stock market."\(^{261}\) This is because "[t]he decision to invest in stocks requires not only an assessment of the risk-return trade-off given the existing data, but also an act of faith (trust) that the data in our possession are reliable and that the overall system is fair."\(^{262}\) Olisi and Paulson have recognized that "[i]nvesting in stock ... requires a great deal of confidence in many institutions" as "[t]he investor must be convinced that the stockbroker will not abscond with her investment and that the institutional and legal framework is sufficient" to ensure that their money will not effectively be stolen or squandered.\(^{263}\) "Stock market participation can be discouraged ... by a mistrust in the institutions that should facilitate stock market participation (brokerage houses, etc.)."\(^{264}\)

Lack of trust reduces stock market participation in a number of ways, including reducing expected return,\(^{265}\) and by increasing the amount of funds necessary in a nest egg before an individual is willing to risk funds in the market casino.\(^{266}\) By contrast,

\(^{258}\) Id.
\(^{259}\) Id. at Abstract.
\(^{260}\) Guiso et al., supra note 253, at 2557.
\(^{261}\) Id. at 2558.
\(^{262}\) Id. at 2557.
\(^{264}\) Guiso et al., supra note 253, at 2559.
\(^{266}\) Id. at 2567–68.


If outside investors have doubts whether firms will return their money, they are unlikely to provide funds in the first place (leading to low market liquidity) or, if they provide capital to
“implementation of specific insider trading prohibitions on stock exchanges tend[s] to increase investor confidence.”

ii. Insider Trading Reduces Market Liquidity

Second, the prevalence of insider trading increases the bid-ask spread demanded by liquidity providers, like financial institutions, before they are willing to purchase and sell equities, thus imposing an “inside trading tax” on “all outside investors with whom they deal,” and reducing liquidity. This is because, in a world dominated by insider trading, liquidity providers like financial institutions will “protect themselves by increasing their sell price and decreasing their buy price,” which “increase[s] the transaction cost” in connection with trades, and “induces a stock trader to require an even higher return on equity.”

iii. Insider Trading Increases Firms’ Cost of Equity

Third, insider trading appears to increase firms’ cost of equity by discouraging proper corporate governance and thereby increasing risk to minority shareholders. In a world dominated by insider trading, minority shareholders would likely demand higher returns on their equity because “controlling large shareholders could easily be tempted by management to make profits from stock tips rather than profits from hard-to-do monitoring.”

iv. Insider Trading May Increase Cost of Debt

Fourth, ineffectively policed insider trading is correlated with lower country credit ratings, according to Institutional Investor’s semiannual banker survey. Although the underlying theory as to

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267 Prentice & Donelson, supra note 173, at 71; see also Douglas Cumming et al., Exchange Trading Rules and Stock Market Liquidity, 99 J. FIN. ECON. 651, 652 (2011) (finding “strong evidence” that detailed rules “that specifically recognize and prohibit certain acts in the marketplace enhance investor confidence”).

268 Manne, supra note 165, at 168.

269 Bhattacharya & Daouk, supra note 19, at 76.

270 Id.

271 Id. at 101–02.
why this is the case has not been well explained (and causality has
not been established), one possible explanation for this phenomenon
is that because country credit ratings reflect perceptions of ex ante
risk exposure, the perceived failure of a country to effectively
police insider trading may also give the impression that it is
similarly institutionally deficient to take other responsible actions,
such as repaying its own debts. In this way, insider trading may
not only affect the cost of capital in terms of issuer equity, but
also the cost of capital raised through debt (e.g., bond yields).

The economic effects of failing to properly police insider trad-
ing are significant. In their highly influential empirical study on
whether the existence and enforcement of insider trading laws
affects the cost of equity (The World Price of Insider Trading),
Bhattacharya and Daouk surveyed each of the 103 countries
that had a stock exchange at the time of writing to determine
whether they had any insider trading laws on their domestic
books—and, if so, whether such laws had been enforced against
a violator at least once in actual practice. Using regression
analysis on four different analytical models, they concluded that
meaningful “insider trading enforcement is associated with a
significant decrease in the cost of equity” up to approximately 7
percent, and also has a “positive and significant effect on coun-
try credit ratings” by .3 percent, which is significant given that
credit ratings tend not to move much.

III. EQUALITY OF ACCESS LAWS: LESSONS FROM THE
E.U. MARKET ABUSE DIRECTIVE

It is not the case, however, that having just any insider trading
law matters; empirical research also makes clear that the type

272 Claude B. Erb et al., Country Risk and Global Equity Selection, 21 J.
PORTFOLIO MGMT. 74, 75 (1995) (noting that country credit risks reflect
perceived risk as a function of many factors, including political and other ex-
propriation risks).
273 Bhattacharya & Daouk, supra note 19, at 79.
274 Id. at 78, 97, 202.
275 Bhattacharya and Daouk concluded that “the mere existence of insider
trading regulations does not affect the cost of equity,” and that actual enforce-
ment matters greatly, but they made no attempt—as finance professors—to
ascertain whether there were any qualitative differences in the law, and if so,
whether such differences had any effect. Id. at 78.
of law on the books matters too. Wharton Professor Luzzi Hail and Chicago Professor Christian Leuz, for example, have concluded after an empirical study that “countries’ legal institutions are significantly related to international differences in the cost of equity capital.”\textsuperscript{276} They have found that “firms in countries with more extensive disclosure requirements and stronger securities regulation ... display a lower cost of capital, even after traditional controls for firm and country risk.”\textsuperscript{277}

\textbf{A. Increased Liquidity and Decreases in Cost of Equity Capital}

More specifically, recent empirical evidence suggests that the adoption of insider trading laws like those in the European Union that require “equality of access” have a statistically significant correlation with economically significant increases in liquidity and decreases in the cost of equity capital.\textsuperscript{278}

Here, it is notable that in early 2003, the European Parliament adopted the Market Abuse Directive (M.A.D.) 2003/6/EC, which “introduced a comprehensive framework to tackle insider dealing and market manipulation practices” and, among other things, was aimed specifically at “increas[ing] investor confidence and market integrity by prohibiting those who possess inside information from trading in related financial instruments.”\textsuperscript{279} Article II of the M.A.D. requires member states to:

prohibit any person ... who possesses inside information [“(a) by virtue of his membership of the administrative, management or supervisory bodies of the issuer; or (b) by virtue of his holding in the capital of the issuer; or (c) by virtue of his having access to the information through the exercise of his employment, profession or duties; or (d) by virtue of his criminal activities”] from

\textsuperscript{277} Id.
\textsuperscript{278} Christensen et al., \textit{supra} note 266, at 13, 35.
using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates.\[^{260}\]

Article III of the M.A.D. addresses tipping, as it requires member states to prohibit any insider, temporary insider, shareholder or misappropriator from “(a) disclosing inside information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties; [or] (b) recommending or inducing another person, on the basis of inside information, to acquire or dispose of financial instruments to which that information relates.”\[^{281}\] Critically (unlike U.S. law, which, under Chiarella, Dirks, and Newman, only prohibits outside traders from using inside information where it is accompanied by a fiduciary breach or misappropriation\[^{282}\]), Article IV of the M.A.D. also expressly bars outsiders from trading on material nonpublic information regardless of how they received it, as it requires member states to also ban trading by anyone “who possesses inside information while that person knows, or ought to have known, that it is inside information.”\[^{283}\]

As implementation of the M.A.D. by European countries has been staggered, Christensen, Hail, and Leuz were able to exploit this timing differential to empirically study the effects of its implementation (and, separately, that of the E.U. Transparency Directive) upon market liquidity and firms’ cost of equity capital across different countries while accounting for general market movements and other potentially confounding effects.\[^{284}\] They concluded that “market liquidity increases and firms’ cost of capital decreases as the two E.U. directives become effective in the member states.”\[^{285}\] Following implementation of the M.A.D., increased liquidity was evident under both of the established liquidity proxies of bid-ask spreads and percentage of zero-return


\[^{281}\] Id. art. III.


\[^{284}\] Christensen et al., supra note 266, at 1–2, 20.

\[^{285}\] Id. at 35.
days (the proportion of trading days with zero daily stock returns out of all potential trading days in a given quarter). Likewise, decreases in the cost of capital following implementation of the M.A.D. were evident from both the dividend yields and implied cost of capital models commonly used in the finance literature.

These positive market effects are particularly pronounced where countries have an otherwise strong history of prior securities regulation and exhibit a true willingness to implement and enforce such new regulations. And while the United States has a lengthy history of securities regulation as a first-mover in the area, its political will to effectively implement and enforce meaningful changes to insider trading law akin to those in Europe remains to be seen.

Given the balance of alleged benefits (largely speculative and few) and harms (to shareholders, issuers, employers, and the capital markets as a whole) that are associated with insider trading, now is the time for legislators to develop such will. Moreover, based on the foregoing arguments, their campaign contributors in the securities and financial services industries should also

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286 Id. at 3, 17–18.
287 Id. at 22.
288 Id. at 6.
289 See, e.g., Bhattacharya & Daouk, supra note 19, at 88; McGee, supra note 28, at 207 (recognizing that the United States was the first major country to enact an insider trading law).
290 Contributions by the financial and securities industry have tended to dominate the campaign war chests of the leadership of the two key Congressional committees responsible for financial services legislation, and before whom insider trading bills currently are pending: the House Financial Services Committee (chaired by Jeb Hensarling, and before which the Ban Insider Trading Act of 2015 and the Insider Trading Prohibition Act are pending) and the Senate Committee on Banking, Housing & Urban Development (chaired by Richard Shelby, and before which the Stop Illegal Insider Trading Act is pending). See Rep. Jeb Hensarling, OPENSECRETS.ORG, https://www.opensecrets.org/politicians/summary.php?cid=N00024922 [https://perma.cc/SQU4-6WM2] (listing Rep. Jeb Hensarling’s top five campaign committee contributors for 2013–2014, with JPMorgan Chase & Co. and Goldman Sachs as #1 and #2 respectively; and top five industries from which campaign committee contributors were drawn in 2013–2014, with Securities & Investment at #3); see also Sen. Richard C Shelby, OPENSECRETS.ORG, https://www.opensecrets.org/politicians/summary.php?cid=N00009920 [https://perma.cc/A2HM-T5LE] (listing Sen. Richard Shelby’s top five campaign committee contributors for 2009–2014, with BNY Mellon
support a new legislative effort to better define and curtail insider trading to the extent they wish to maintain a vibrant, effective, and ethical capital market.

B. Greater Ease of Enforcement

If designed properly, according to the equal access theory, such an insider trading law would also be easier to enforce than current law.291 As Penn State Law Professor Marco Ventoruzzo has explained, an approach based on equality of access, like that adopted in Europe under the M.A.D.,292 “is broader and enforcement actions do not need to jump through the same legal loopholes to successfully argue a violation of insider trading prohibitions.”293 To establish liability, regulators would only need to prove that the defendant traded on material nonpublic information concerning an issuer or financial instrument that could not, in principle, have been available to others through independent and otherwise lawful due diligence.294 The government

291 Ventoruzzo, supra note 20, at 3 (explaining that the European approach is a “more simple, elegant, and effective regulation” that is “more straightforward and easily enforceable”).

292 Id. at 19–20 (recognizing that the European approach under the M.A.D. is based on the “equal access to information,” under which “the tippee does not need to have received the information from an insider that has breached a fiduciary duty”).

293 Id. at 25.

294 The M.A.D. accomplishes this basic goal through a slightly different statutory regime that turns largely on the definition of “inside information” and then, pursuant to Articles II, III, and IV, prohibits virtually all people—insiders, temporary insiders, misappropriators, and outsiders—from trading on such information to the extent they “know[ ] or ought to have known, that it is inside information.” Council Directive 2003/6/EC, supra note 21, art. II–IV. Article I of the M.A.D. defines “inside information” as information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.
would not need to show that a defendant-tippee received insider information through a breach of a fiduciary duty for personal benefit, or satisfy the nearly impossible task of showing that a remote tippee (like the hedge fund portfolio managers in *Newman*) was aware of any personal benefit received by the tipper. Tippers would be liable under a straightforward aiding and abetting theory, provided they knowingly or recklessly provided material nonpublic information to a person who was reasonably likely to trade or further tip the information to a trader who did, in fact, trade.

IV. CURRENT U.S. LEGISLATIVE PROPOSALS

This Article has endeavored to establish the reasons why overturning or limiting *Newman* under the forthcoming *Salman* case is insufficient to effectively police market misconduct, and to make the case for a statute that adopts the “equality of access” theory of insider trading. This Section will briefly examine the current legislative proposals that are pending in Congress to reform U.S. insider trading law. To date, three such bills exist.

It also provides that

[i]n relation to derivatives on commodities, ‘inside information’ shall mean information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets.

Finally, it provides that

[i]f persons charged with the execution of orders concerning financial instruments, ‘inside information’ shall also mean information conveyed by a client and related to the client’s pending orders, which is of a precise nature, which relates directly or indirectly to one or more issuers of financial instruments or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

*Id.*, art. I.

296 *Id.* at 18–19; see United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).
After analyzing each below, this Article shall argue that, with minor modification, the United States should adopt S. 702.

A. The Ban Insider Trading Act of 2015

H.R. 1173, the “Ban Insider Trading Act of 2015,” was introduced in the House by Massachusetts Representative Stephen F. Lynch on February 27, 2015, and referred to the House Committee on Financial Services, where it remains at the time of this writing.\(^{298}\) The bill would amend section 10 of the 1934 Securities Exchange Act (15 U.S.C. § 78j), making it unlawful under a new subparagraph (d)(1):

To purchase or sell any security, or any securities-based swap agreement, based on information that the person knows or, considering factors including financial sophistication, knowledge of and experience in financial matters, position in a company, and amount of assets under management, should know is material information and inside information.\(^{299}\)

Addressing *Newman*, in a newly proposed subsection (d)(2), the bill purports to require that “nothing in this subsection may be construed ... (B) to require for an action under paragraph [d](1) a personal benefit to any party.”\(^{300}\) Although the bill expressly declines “to affect liability” under existing Section 10(b),\(^{301}\) this provision would, by creating a new type of Section (d)(2) violation, seemingly overturn *Dirks*’s holding that the prosecutor must show that the tipper received a “personal benefit.”\(^{302}\) It would also affect *Newman*’s holding that the prosecutor must show that the tippee-defendant knew (or consciously avoided knowing) that the insider received a personal benefit in exchange for the tip.\(^{303}\)


[^299]: Id. § 2(d)(1).

[^300]: Id. § 2(d)(2)(B).

[^301]: Id. § 2(d)(2)(A).


However, in newly proposed section (d)(3)(A), the bill goes on to define “inside information” as information that is “(i) nonpublic” and “(ii) obtained ... (I) illegally; (II) directly or indirectly from an issuer with an expectation of confidentiality or that such information will only be used for a legitimate purpose,” or “(III) in violation of a fiduciary duty.” Clearly, portions of the bill that reference obtaining the information “illegally” and “from an issuer with an expectation of confidentiality” are attempts to codify the misappropriation theory. Yet the bill continues to refer to the “violation of a fiduciary duty.” It is therefore unclear whether the provision that purports to eliminate the “personal benefit” requirement will have the intended effect, unless the bill is intended to redefine what constitutes a breach of a fiduciary duty in a way that overrides the Dirks majority’s decision requiring an ill motive of personal gain for a breach of fiduciary duty.

Additionally, the bill proposes a modification to section (e) of 15 U.S.C. § 78t, which would subject to aiding and abetting liability any “person” who

intentionally disclose[s] without a legitimate business purpose to another person information that the discloser knows or, considering factors including financial sophistication, knowledge of and experience in financial matters, position in a company, and amount of assets under management, should know is material information and inside information ....

While this provision may be an attempt to add teeth to Regulation FD (which generally requires that issuer material information be disclosed simultaneously but does not currently constitute a securities fraud violation under Rule 10b-5), its key caveat to liability—that is, disclosures “without a legitimate business purpose”—remains undefined. Moreover, while selective disclosure for a personal benefit would presumably not be a “legitimate business purpose,” it is unclear whether selective disclosure to a

305 Id.
306 Id. § 2(e)(2).
308 H.R. 1173 § 2(e)(2) (emphasis added).
large shareholder for purposes of managing quarterly earnings expectations or permitting front-running as a reward for shareholder behavior that assists the company would be deemed illegitimate. While such disclosures may be beneficial to a company, they may nonetheless harm persons not privy to the advance information.

B. The Insider Trading Prohibition Act

H.R. 1625, the “Insider Trading Prohibition Act,” was introduced in the House of Representatives by Connecticut Representative James Himes on March 25, 2015, and subsequently referred to the House Committee on Financial Services.\(^{309}\) It would add a new section 16A to the 1934 Securities Exchange Act.\(^{310}\)

Section (a) of that new provision, entitled “Prohibition Against Trading Securities While In Possession Of Material, Nonpublic Information,” provides in pertinent part that

\[
\text{[it] shall be unlawful for any person, directly or indirectly, to purchase, sell, or enter into, cause the purchase or sale of or entry into, any security ... while in possession of material, nonpublic information relating to such security ... or relating to the market for such security ... if such person knows, or recklessly disregards, that such information has been obtained wrongfully, or that such purchase, sale, or entry would constitute a wrongful use of such information.}^{311}\]

Section (b) of that new provision, entitled “Prohibition Against the Wrongful Communication of Certain Material, Nonpublic Information,” further provides that

\[
\text{[it] shall be unlawful for any person whose own purchase or sale of a security ... would violate subsection (a) (referred to in this subsection as the 'communicating person'), wrongfully to communicate material, nonpublic information relating to such security ... to any other person if—}

(1) the other person—

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\(^{310}\) Id.

\(^{311}\) Id. § 16A(a).
(A) purchases, sells, or causes the purchase or sale of, any security or security-based swap or enters into or causes the entry into any security-based swap agreement, to which such communication relates; or
(B) communicates the information to another person who makes or causes such a purchase, sale, or entry while in possession of such information; and
(2) such a purchase, sale, or entry while in possession of such information is reasonably foreseeable. 312

Each of these provisions turns on the meaning of the word “wrongful.” Proposed section 16A(a) prohibits trading if the trader knows or recklessly disregards that the information has been “obtained wrongfully,” or that such a trade “would constitute a wrongful use of such information.” 313 Proposed section 16A(b), covering tipping by insiders or people who receive tips from insiders like Dirks, makes it unlawful for such persons “wrongfully to communicate” the tip. 314 Accordingly, a newly proposed section 16A(c) explains that such trading or tipping

is wrongful only if the information has been obtained by, or its communication or use would constitute, directly or indirectly—
(A) theft, bribery, misrepresentation, or espionage (through electronic or other means);
(B) a violation of any Federal law protecting computer data or the intellectual property or privacy of computer users; or
(C) conversion, misappropriation, or other unauthorized and deceptive taking of such information, or a breach of any fiduciary duty or any other personal or other relationship of trust and confidence. 315

In my view, this definition of “wrongful” trading or tipping is narrow. While it would codify much of what is covered by the current case law (e.g., misappropriation), and seemingly bolster the consequences of certain types of selective disclosures that might currently be deemed relatively minor Regulation FD violations, this definition would apparently exclude selectively disclosed tips that are authorized by the issuer. The definition of “wrongful”

312 Id. § 16A(b).
313 Id. § 16( A) (a).
314 Id. § 16( A) (b).
315 Id. § 16A(c)(1).
continues to adhere to the “fiduciary duty” standard, thus seem-
ingly excluding from prosecution trading or tipping information
that does not involve misappropriation or a breach of an existing
fiduciary duty for personal benefit, like that in Dirks.\footnote{Dirks v. SEC, 463 U.S. 646, 665 (1983).}

Finally, section 16A(c)(2) provides that

\[
[i]t \text{ shall not be necessary [for prosecution] that the person}
\text{ trading while in possession of such information ... or making}
\text{ the communication ... know the specific means by which the}
\text{ information was obtained or communicated, or whether any}
\text{ personal benefit was paid or promised by or to any person in}
\text{ the chain of communication, so long as the person trading while}
\text{ in possession of such information or making the communica-
\text{ tion ... was aware, or recklessly disregarded that such informa-
\text{ tion was wrongfully obtained or communicated.}\footnote{H.R. 1625 § 16(A)(c)(2).}}
\]

This provision—apparently intended to lower the knowledge
threshold that the Second Circuit announced in \textit{Newman}—
would go a long way toward ensuring that remote but savvy
tippees, like the defendants in that case, could once again realistically be prosecuted. It would remove the \textit{Newman} court’s re-
quirement that tippees be \textit{aware} that “any personal benefit was
paid.”\footnote{\textit{Id.}; see \textit{United States v. Newman}, 773 F.3d 438, 450 (2d Cir. 2014).} However, as the provision fails to define “personal benef-
it,” it would seemingly not address what constitutes a personal
benefit.\footnote{H.R. 1625 § 16(A)(c)(2).} Nor would it address the fundamental requirement announced in \textit{Dirks} that the prosecutor prove that, in fact, the
tipper received a personal benefit.\footnote{\textit{Dirks}, 463 U.S. at 662.} Accordingly, as the dissent-
ing Justices in \textit{Dirks} explained, tips and subsequent trades that
harm non-privy shareholders would presumably continue to be
lawful if H.R. 1625 were adopted, so long as they do not involve
the receipt of a personal benefit by the tipper.

\section*{C. The Stop Illegal Insider Trading Act}

To a large extent, the statutory regime for which this Article
has argued could be effectuated by adopting S. 702, the “Stop
Illegal Insider Act,” which was introduced by Senator Jack Reed
of Rhode Island and Senator Bob Menendez of New Jersey on March 11, 2015. At the time of writing, this bill is pending in the Senate Committee on Banking, Housing, and Urban Affairs. This concisely written bill would add a new subsection (d)(1) to section 10 of the 1934 Securities Exchange Act, making it unlawful

(d)(1)(A) [to] purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available.  
(B) To knowingly or recklessly communicate material information that the person knows or has reason to know is not publicly available to any other person under circumstances in which it is foreseeable that such communication is likely to result in a violation of subparagraph (A).

In support of the bill, Senator Reed issued a statement roundly condemning the Second Circuit’s Newman opinion, which he argued “defies common sense.” Implicitly also criticizing the Dirks opinion and siding with the dissenting Justices in that case, Senator Reed argued that “[i]t should not matter whether someone, who traded on material information that was not publicly available, knew whether the source of such information breached a fiduciary duty and additionally received a personal benefit in return for sharing this inside information.” Accordingly, Senator Reed explained his bill as follows:

Simply put, if a person trades a security on the basis of material information that the person knows or has reason to know is not publicly available, then they have engaged in unlawful insider trading. Under our legislation, it is irrelevant whether the trader knew of the source’s fiduciary duty or whether the source derived any personal benefit. What matters is whether the trader knew or has reason to know that such trader had an unfair advantage in being given material information that was not shared with the broader public.

322 Id.
323 Id. § 2(d)(1)(A)–(B).
325 Id.
326 Id.
The bill further provides in proposed section (D)(2) that, for purposes of the new subsection, “the term ‘not publicly available’ shall not include information that the person has independently developed from publicly available sources.” According to Senator Reed, this provision is intended “to ensure that those who take the time to independently develop their own information from publicly available sources can trade on this independently developed information so that publicly available information can be analyzed and interpreted without fear of liability.”

Consistent with the “equal access theory” for which this Article has argued, S. 702 would improve existing U. S. insider trading law by better aligning it with the fundamental requirements of public morality, eliminating the fiduciary duty requirements that currently allow certain forms of harmful market cheating to go unpunished, and likely improving capital market conditions. To those ends, Senator Reed explained:

In short, by making it an offense for those who contribute to a securities market rigged in favor of the well connected, our legislation focuses on providing everyday investors with a fair shot at seeing some returns after investing their hard-earned savings. Incidents of insider trading, and the perceived perverseness of the practice, have for years served to validate the public’s worst assumptions about Wall Street culture. It is time we clearly define what is appropriate under the law and take this meaningful step towards improving the integrity of our securities markets for professional traders and amateur investors alike.

Moreover, by virtue of subsection (D)(2) above, which clearly eschews utopian parity-of-information ideals in lieu of more viable equality of access requirements, S. 702 would accomplish these ends while also providing incentives to independently and lawfully develop information.

While the bill authorizes the SEC to provide certain exemptions to liability, I would simply clarify (d)(1)(A) above by indicating

328 See 161 Cong. Rec. 41, S1440–S1441.
329 Id.
330 Id.
331 Id.
that such material information does not include “general market information” (e.g., the University of Michigan Consumer Sentiment Index), from which data can be independently gathered in lieu of purchase, but rather covers only specific information concerning an issuer or their financial products. I would also extend its prohibition on insider trading not only to securities, but also to other financial instruments as the Europeans have done under the M.A.D.\textsuperscript{333}

\textbf{Conclusion}

This Article has endeavored to make the case for a new statutory provision in the United States that will define insider trading under an “equality of access” theory. It has supported this claim by highlighting the moral and legal gaps in existing U.S. law. Instead of continuing to define unlawful trading solely with reference to fiduciary breach or misappropriation, trading on the basis of material nonpublic information must be understood as a fundamentally unfair form of market cheating that undermines the equality of opportunity required by the social contract, violates deontological duties, and demonstrably produces more societal harm than good to investors, issuers, employers, and capital markets as a whole.

Now is the time to adopt a new statutory provision that finally defines “insider trading.” As Senate Bill S.702 purports to do, a newly enacted statute should prohibit the use, by anyone, of material information concerning a financial instrument that is not, at least in principle, available to others through independent and otherwise lawful diligence.
