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What's So Bad about Insider Trading Law

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By *Peter J. Henning**

The law of insider trading has been called everything from a "theoretical mess" to "astonishingly dysfunctional," with calls for change from Congress and the Securities and Exchange Commission to clarify the scope of the prohibition. But is the law really so bad? The elements are now well established, despite gray areas around the edges like other white collar crimes. Congress and the general public have embraced insider trading as something clearly wrongful. If the law needs to be changed, the most likely push would be to expand it by adopting the possession theory of liability used in Rule 14e-3 for tender offers and the European Union that makes trading on almost any confidential information subject to prosecution.

United States insider trading law seems to be about as popular as catching the flu, at least from the perspective of legal academics. It has been called a "theoretical mess,"[1] "seriously flawed,"[2] "extraordinarily vague and ill-formed,"[3] "arbitrary and incomplete,"[4] a "scandal,"[5] and even "astonishingly dysfunctional"[6]—as if it were a family. And like any good bout of the flu, there have been numerous prescriptions offered to treat its symptoms. Thus, scholars have suggested different theories to improve our understanding of the purportedly flawed insider trading legal framework, such as treating it as a form of "private corruption,"[7] looking at the nature of confidential information from the perspective

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1. Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 379 (1999).

2. Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 184 (1991).

3. Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 443 (2001).

4. John C. Coffee, Jr., *Introduction—Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 285 (2013).

5. Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159, 163 (2014) ("It is unfortunate, therefore, that Congress ducked this golden opportunity either to amend the '34 Act in order to define insider trading or, at least, to give the SEC authority to do so. Consequently, we are left with the jurisprudential scandal that insider trading is largely a federal common-law offense.").

6. Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).

7. Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 933 (2014).

of intellectual property,[8] de-emphasizing the role of fiduciary duty principles,[9] and viewing the prohibition as a means to protect the property rights of corporations whose information is so often misused for illicit gain.[10] There is even a dispute as to whether insider trading should be illegal at all,[11] much like how some swear by the annual flu shot while others abjure getting one.

Theoretical problems aside, the practice of trading on confidential information is not abating, nor is the government's determination to prosecute it—even if much of it appears to go undetected.[12] Of course, the fact that the prohibition has not deterred violators is no indictment of the criminalization of the conduct. So it is interesting to consider whether the law of insider trading should be viewed as working reasonably well; or put another way, what about insider trading law is so bad that it unleashes such sustained criticism—and even venom—from the academic community? One would think that such a deeply flawed legal prohibition would incite a broader public campaign against the law that might lead Congress at least to consider limiting, if not repealing, the government's authority to pursue violations. But there has been no great hue and cry for reforming the law of insider trading by the general public,[13] or even from the defense

8. Krawiec, *supra* note 3, at 446.

9. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 Iowa L. Rev. 1315, 1320 (2009) ("Numerous lower courts and the SEC have in effect concluded that the wrongful use of information constitutes the crux of the insider trading offense and that fiduciary principles are only relevant insofar as they establish such wrongful use.").

10. *See* Stephen M. Bainbridge, Insider Trading Law and Policy 192–201 (2014).

11. The most famous proponent of the position that insider trading should be legal is Dean Henry G. Manne, who expounded on it in his pioneering book, *Insider Trading and the Stock Market* (1966). One author described the response to this proposal as "vitriolic." Alexandre Padilla, *How Do We Think About Insider Trading? An Economist's Perspective on the Insider Trading Debate and Its Impact*, 4 J.L. Econ. & Pol'y 239, 243 (2008). What is interesting about the discussion of Dean Manne's seemingly heretical view is that when the book appeared, the SEC had not yet brought a significant insider trading case, which came two years later in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), and over a decade before the first criminal insider trading prosecution in *Chiarella v. United States*, 445 U.S. 222 (1980). To describe the federal law of insider trading as nascent in 1966 certainly would not be an exaggeration, yet the view in the scholarly literature seems to be that the elements of an insider trading violation were clearly established and well accepted at that time.

12. *See* Patrick Augustin, Menachem Brenner & Marti G. Subrahmanyam, Informed Options Trading Prior to M&A Announcements: Insider Trading? 40 (May 2014) (unpublished manuscript available at http://irrcinstitute.org/pdf/Informed-Options-Trading_June-12-2014.pdf) ("Our analysis of the trading volume and implied volatility over the 30 days preceding formal takeover announcements suggests that informed trading is more pervasive than would be expected based on the actual number of prosecuted cases."). Of course, any trading by an insider with superior information can be considered insider trading, but not all of which is illegal. *See* Dennis W. Carlton & Daniel W. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857, 860 (1983) ("[I]nsider trading in this country, despite the widespread perception to the contrary, is generally permitted. A fundamental difference exists between the legal and economic definitions of insider trading. Insider trading in an economic sense is trading by parties who are better informed than their trading partners. Thus, insider trading in an economic sense includes all trades where information is asymmetric . . . . Insider trading in an economic sense need not be illegal. The law never has attempted to prohibit all trading by knowledgeable insiders.").

13. *See* Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. Rev. 1105, 1122 (2011) ("[T]he fact remains that the SEC and the DOJ have been consistent, and for the most part successful, in advancing a strikingly broad view as to what it means to be entrusted with material nonpublic information for purposes of the Rule 10b-5 insider trading prohibition.").

bar—apart from occasional complaints about lengthy sentences that treat violators as being on par with some violent criminals.[14] Indeed, Congress almost fell over itself to adopt a statute in 2012 to explicitly subject its members and staff to the prohibition, with nary a complaint about how insider trading law works.[15]

This Article considers whether the law of insider trading should be changed to correct its perceived imperfections and, if so, what path Congress is likely to follow. The law developed through judicial decisions rather than from a more precise congressional enactment that would provide explicit guidance about what types of trading were intended to come within the scope of the prohibition. That does not distinguish insider trading from other federal white-collar crimes, however, and Part I discusses how the law, despite its murky origins, has arrived at a fairly well-settled meaning that is not difficult for judges and juries to apply. Like any crime, it is amorphous around the edges, and Part II looks at how the label "insider trading" can be attached to other types of transactions that appear to stretch the law beyond its intended scope. That does not mean the elements of the insider trading prohibition are flawed, but that the term should not become a handy moniker to assail every type of market abuse that involves confidential information related to securities trading. Despite the academic criticism of the prohibition, Part III reviews the acceptance of insider trading by Congress, the courts, and the executive branch, which suggests that calls for reform are likely to go unheeded. And if there were an effort to change the law of insider trading, Part IV posits that the most likely avenue would be to expand the prohibition by simplifying the law. The expansion could come along the lines of the European Union's prohibition on "insider dealing" that would make *any* use of confidential information in trading a violation. Ironically, that reform would subject even more trading to criminal and civil charges, the opposite of many academic proposals that seek to narrow insider trading law.

I. How We Got Here

At least part of the reason for the claimed incoherence of insider trading seems to be traceable to the origin of the prohibition: there is no real "law" setting forth the elements of a violation.[16] Most insider trading cases are pursued under the

14. *See* Dana R. Hermanson, *Corporate Governance and Internal Auditing: Corporate Governance Through Strict Criminal Prosecution*, Internal Auditing, Sept.–Oct. 2005, 2005 WL 3097493. ("Given the typical age of CEOs, lengthy prison sentences will, in many cases, consume a large part of the perpetrator's remaining years. It is reasonable to question whether such sentences go too far, especially relative to sentences for violent crimes.").

15. *See infra* notes 73–75 and accompanying text.

16. In 1988, here is how one author viewed the state of insider trading law:

> Although the federal securities laws are over fifty years old, recent Supreme Court and lower court decisions have raised various questions with respect to the scope of the antifraud provisions of the Securities Exchange Act of 1934. Consequently, the law concerning the trading of securities on the basis of material nonpublic information is unsettled because the applicable statutes and cases have failed to define clearly who is prohibited from trading on material nonpublic information.

general antifraud provisions of the federal securities law: section 10(b) of the Securities Exchange Act of 1934[17] and Rule 10b-5.[18] How these broad provisions prohibiting deceptive devices and schemes to defraud came to embody the prohibition on insider trading is a rather tortured tale, but suffice it to say that it is one that embodies the best and the worst of how a common law offense develops.[19] The parameters of the prohibition have been created through judicial interpretation intermingled with a few SEC rules, but certainly not through precise

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Carlos J. Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. Corp. L. 793, 794–95 (1988). Twenty-five years later, Professor Heminway noted, "Because the SEC has enforcement authority and because various aspects of U.S. insider trading law are susceptible of multiple interpretations, the SEC can (and does) assess the facts and circumstances of individual transactions and, after the fact, call some of those transactions into question by pursuing enforcement activities that explore and settle open doctrinal questions." Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 La. L. Rev. 999, 1001 (2012); *see also* Nagy, *supra* note 9, at 1322–23 ("In the United States, the law of insider trading is essentially judge-made. The critical role courts play is a function of the fact that no federal statute directly prohibits the offense of insider trading. Rather, insider trading may constitute a violation of Rule 10b-5, an SEC rule that broadly prohibits fraud in connection with the purchase or sale of any security. The lack of a specific statutory prohibition means that insider trading is generally unlawful only to the extent that it constitutes deceptive conduct.").

17. 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2014). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> > (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement [1] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

18. 17 C.F.R. § 240.10b-5. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

19. *See* Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 Colum. Bus. L. Rev. 369, 425 (2013) ("On a global scale, the United States is the 'odd one out' in the sense that it is one of the few countries that does not have specific and detailed legislation defining the offense of insider trading, relying instead on common law-like interpretations of a broad antifraud statute."); Schroeder, *supra* note 5, at 163 ("[W]e are left with the jurisprudential scandal that insider trading is largely a federal common-law offense."); David Cowan Bayne, *Insider Trading—The Misappropriation Theory Ignored: Ginsburg's* O'Hagan, 53 U. Miami L. Rev. 1, 4 (1998) ("The crime of Insider Trading is none other than the common-law tort of Deceit codified into Section 10(b) of the 1934 Act, and then criminalized by the addition of appropriate special penalties.").

legislative enactment by Congress.[20] Thus, there is no clear statement of the scope of the law, allowing for new applications, sometimes seemingly at the whim of the SEC and federal prosecutors.[21] The result, according to Professor Coffee, is that "[e]gregious cases of informational misuse are not covered, while less culpable instances of abuse are criminalized."[22]

It is unlikely that even a new statute defining insider trading would cure all of the problems related to the scope of the prohibition, but that does not make it unique in the federal criminal law. Instead, it is an issue that afflicts many white-collar offenses because they depend, for the most part, on proof of intent rather than a showing that a particular type of conduct resulted in an identifiable harm, like robbery or murder. For example, the mail[23] and wire[24] fraud statutes both prohibit schemes to defraud without delving much further into what constitutes a violation, leaving it up to the courts to explain the scope of the prohibition.[25] Indeed, Chief Justice Burger celebrated the flexibility of the fraud laws, noting that "[t]he criminal mail fraud statute must remain strong to be able to cope with the new varieties of fraud that the ever-inventive American 'con artist' is sure to develop."[26] One legislative effort to statutorily define what can be the object of a fraud, taken in response to a narrow reading of the provision by the U.S. Supreme Court, was the "intangible right of honest services" provision.[27] But Congress went no further in explaining the scope of this type of fraud, leaving it to the courts to further refine how broadly it could be applied. It took the Supreme Court over twenty years to finally establish what it means to deprive another of honest services, and even then all it did was limit the provision to

20. Congress is fully aware of the prohibition and has endorsed it in statutes, although without providing any clarification of what it means. For example, in 1988, Congress passed the Insider Trading and Securities Fraud Enforcement Act, which increased the maximum individual penalty to $1 million for a violation and a maximum jail term of ten years, and gave private parties who traded contemporaneously with the inside trader a private cause of action. Pub. L. No. 100-704, §§ 4, 5, 102 Stat. 4677, 4680–81 (1998) (codified as amended at 15 U.S.C. § 78t-1 (2012)). The preamble to the statute outlining the congressional findings supporting the law states that "the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possesssion of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors." *Id.* § 2, 102 Stat. at 4677. There was no effort to define the prohibition beyond simply repeating its primary elements.

21. That does not mean courts always accept efforts to push the boundaries of insider trading law. For example, in *SEC v. Bauer*, 723 F.3d 758 (7th Cir. 2012), the Seventh Circuit pointed out that an insider trading claim based on the sale of mutual fund shares was unique because it had never been brought before by the SEC, and the court overturned a grant of summary judgment so that the district court could consider whether the misappropriation theory applied to sales of such securities. *Id.* at 770–71. The district court subsequently dismissed the case because the SEC had not sought to establish a violation based on the misappropriation theory and therefore "any theory not raised before the district court is considered to be waived or forfeited." SEC v. Bauer, No. 03-C-1427, 2014 WL 4267412, at *5 (E.D. Wis. Aug. 29, 2014).

22. Coffee, Jr., *supra* note 4, at 285.

23. 18 U.S.C. § 1341 (2012).

24. *Id.* § 1343.

25. *See* McNally v. United States, 483 U.S. 350, 365 (1987) ("In considering the scope of the mail fraud statute it is essential to remember Congress' purpose in enacting it.").

26. United States v. Maze, 414 U.S. 395, 407 (1974) (Burger, C.J., dissenting).

27. 18 U.S.C. § 1346 (2012).

bribery or kickbacks, neither of which are mentioned explicitly in the statute nor clearly defined elsewhere.[28]

One could assail the insider trading prohibition as a judicially created offense and therefore somehow unworthy of such aggressive enforcement as compared to its brethren with a clear legislative basis. But it does not stand alone in regard to being the subject of expansive judicial interpretations to reach conduct that does not appear to come within the language of the statute, either. The Hobbs Act[29] prohibits extortion "under color of official right," which the Supreme Court interpreted as permitting the prosecution of a public official for bribery for receiving an improper campaign contribution—something far afield from a law originally enacted to deal with labor racketeering.[30] So that statute, along with the right of honest services law, contain nary a mention of bribery—yet they have become, through judicial interpretation, a means to police public corruption.[31] How much worse is insider trading being located within the broad prohibition on fraud contained in section 10(b) of the Securities Exchange Act of 1934?

Would a law purporting to define insider trading fare any better before the courts? Statutes often contain expansive terms that allow for application to new circumstances as they arise; thus, the issue of fair notice is frequently litigated. Insider trading is not unique among criminal offenses in having gray areas that can make certain conduct difficult to identify as clearly wrongful, and it does not appear to be an outlier compared to other types of crimes. There is nothing necessarily problematic when the determination of whether conduct is legal depends primarily on the knowledge and intent of the actors. For example, the act of handing an elected official a check may be a campaign contribution, which is perfectly legal, or it may be a bribe, which is clearly illegal.[32] The mere transfer of funds is not, in itself, proof of a violation, even though such acts can be powerful indicia of a crime if linked to a quid pro quo agreement. In much the same way, placing a well-timed order to buy or sell securities, generating significant profits, may involve insider trading, but

28. *See* Skilling v. United States, 561 U.S. 358, 408–09 (2010) ("To preserve the statute without transgressing constitutional limitations, we now hold that § 1346 criminalizes only the bribe-and-kickback core of the pre-*McNally* case law.").

29. 18 U.S.C. § 1951 (2012).

30. *See* McCormick v. United States, 500 U.S. 257, 274 (1991) ("We thus disagree with the Court of Appeals' holding in this case that a quid pro quo is not necessary for conviction under the Hobbs Act when an official receives a campaign contribution.").

31. *See* Peter J. Henning, The Prosecution and Defense of Public Corruption: The Law and Legal Strategies §§ 5.02, 6.04 (2d ed. 2014).

32. *See McCormick*, 500 U.S. at 273 ("This is not to say that it is impossible for an elected official to commit extortion in the course of financing an election campaign. Political contributions are of course vulnerable if induced by the use of force, violence, or fear. The receipt of such contributions is also vulnerable under the Act as having been taken under color of official right, but only if the payments are made in return for an explicit promise or undertaking by the official to perform or not to perform an official act. In such situations the official asserts that his official conduct will be controlled by the terms of the promise or undertaking. This is the receipt of money by an elected official under color of official right within the meaning of the Hobbs Act.").

like most campaign contributions, the vast majority of such transactions are probably legal. So insider trading is hardly alone in the pantheon of federal offenses, especially those considered white-collar crimes, that can be criticized as confused or a theoretical mess. Indeed, one scholar even noted that the Supreme Court applies an "anti-messiness" principle to its interpretation of statutes by pushing for simple construction, which tends toward being more inclusive of the conduct that can result in a conviction.[33]

Since the SEC first initiated an administrative proceeding over fifty years ago to sanction a broker for trading on confidential corporate information,[34] the federal law of insider trading has grown into a reasonably well-defined prohibition, even with questions about its scope around the periphery.[35] Some uncertainty in the law should not be surprising, given that the violation is not a creature of statute but instead more a common law offense developed through a series of judicial decisions.[36] Only in the last thirty years has insider trading become a priority for the SEC and federal prosecutors, which means its development has come through numerous judicial decisions.[37] The growth of the law has occurred largely in fits and starts, rather than through a clear progression reflecting a coherent conception of the many aspects that make up a violation.

The courts have identified the core of the prohibition (both in criminal prosecutions and civil enforcement actions) as requiring proof of trading on material, nonpublic information obtained and used in breach of a duty of trust and

33. *See* Anita S. Krishnakumar, *The Anti-Messiness Principle in Statutory Interpretation*, 87 NOTRE DAME L. REV. 1465, 1469 (2012) ("Anti-messiness refers to a background principle that favors the avoidance of inelegant, complex, indeterminate, impractical, confusing, or unworkable factual inquiries. More specifically, it is an interpretive principle that rejects statutory interpretations that will require implementing courts to engage in messy factual inquiries in the application.").

34. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961) (describing "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing").

35. *See* Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 429 (2013) ("To be sure, we now have a stable framework of three distinct legal theories—the classical theory, the misappropriation theory, and Rule 14e-3—each of which is well understood as to its basic elements. Most insider trading cases handed down in any given year say nothing particularly new about the state of the law, but rather simply apply familiar principles to sometimes challenging facts. However, every so often we do discover something new about the core conceptions of insider trading.").

36. *See* Steginsky v. Xcelera Inc., 741 F.3d 365, 371 (2d Cir. 2014) ("[W]e hold that the fiduciary-like duty against insider trading under section 10(b) is imposed and defined by federal common law, not the law of the Cayman Islands. While we have not previously made the source of this duty explicit, we agree with one district court in this Circuit which concluded that insider trading cases from this Court and the Supreme Court have implicitly assumed that the relevant duty springs from federal law, and that looking to idiosyncratic differences in state law would thwart the goal of promoting national uniformity in securities markets.").

37. Stephen J. Crimmins, *Insider Trading: Where Is the Line?*, 2013 COLUM. BUS. L. REV. 330, 349 (2013) ("From the SEC's founding in 1934 to Chairman Cary's groundbreaking 1961 decision in *Cady, Roberts*—a span of twenty-seven years—the SEC brought no insider trading cases at all. Over the subsequent twenty years, insider trading continued to be a relatively low prosecution priority in terms of the number of cases at the agency . . . .").

confidence.[38] Cases that involve tipping further require showing that the tipper received some benefit for disclosing the information that the tippee knew or should have known was disclosed in breach of a duty.[39] A recent decision by the Second Circuit clarified the law further by holding that a remote tippee who receives the information second- or even third-hand must know that the tipper received a benefit.[40]

Yet, even in those areas where the law is clear, it does not appear to be much of a deterrent. Although the amount of insider trading is always difficult to estimate, in at least the mergers and acquisitions sector, information appears to leak out with great regularity.[41] Most insider trading actions, many of which are resolved with a plea agreement and civil settlement, do not raise issues about the underlying legal definition of the violation. The SEC expanded the insider trading prohibition by adopting Rule 10b5-2 in 2000 to incorporate a wider range of relationships that can establish a duty of trust and confidence for liability.[42] Under the rule, the duty can be based on an agreement to maintain the confidentiality of information, or even more loosely, when "the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences" to create an expectation of confidentiality.[43] Thus, the SEC brought a case against a defendant who received confidential information from a fellow member of Alcoholics Anonymous, alleging that the relationship between them included main-

38. *See, e.g.*, United States v. Jiau, 734 F.3d 147, 152–53 (2d Cir. 2013) ("To hold Jiau criminally liable for insider trading, the government had to prove each of the following elements beyond a reasonable doubt: (1) the insider-tippers (Nguyen and Ng) were entrusted the duty to protect confidential information, which (2) they breached by disclosing to their tippee (Jiau), who (3) knew of their duty and (4) still used the information to trade a security or further tip the information for her benefit, and finally (5) the insider-tippers benefited in some way from their disclosure.").

39. *See, e.g.*, SEC v. Obus, 693 F.3d 276, 288 (2d Cir. 2012) ("A tipper will be liable if he tips material non-public information, in breach of a fiduciary duty, to someone he knows will likely (1) trade on the information or (2) disseminate the information further for the first tippee's own benefit. The first tippee must both know or have reason to know that the information was obtained and transmitted through a breach and intentionally or recklessly tip the information further for her own benefit. The final tippee must both know or have reason to know that the information was obtained through a breach and trade while in knowing possession of the information.").

40. United States v. Newman, 773 F.3d 438, 448 (2d Cir. 2014) ("[W]ithout establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the Government cannot meet its burden of showing that the tippee knew of a breach.").

41. *See* Augustin, Brenner & Subrahmanyam, *supra* note 21, at 40; Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Two Traders in Chile with Insider Trading (Dec. 22, 2014), *available at* http://www.sec.gov/news/pressrelease/2014-291.html#.VQ3it-EYFIY (civil insider trading charges filed against a former director of a company for trading on information in advance of a tender offer for its shares).

42. 17 C.F.R. § 240.10b5-2 (2014). In adopting the rule, the SEC explained that it was designed to overcome an "anomalous result" involving family members passing along confidential information, although the rule is broader than that situation. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881, 65 Fed. Reg. 51716 (to be codified at 17 C.F.R. pts. 240, 243 & 249).

43. 17 C.F.R. § 240.10b5-2(b)(1)–(2).

taining the confidentiality of any information they discussed.[44] Although that may be viewed as an extension of the law, it does not fall outside the traditional paradigm for insider trading or mark an unexpected extension of the law.

For those cases that do proceed to trial, the primary issues revolve around the strength of the government's factual proof—such as whether the evidence sufficiently demonstrates that the trader received confidential information from someone with a fiduciary duty to maintain its confidentiality—rather than determining the meaning of the elements of the offense. For example, a string of recent prosecutions involving hedge fund traders and expert network participants relied on wiretaps, which revealed the participants trading information, to prove the insider trading. They fit comfortably within the structure of the insider trading prohibition, so that more important questions concerned evidentiary decisions at trial about the propriety of the wiretap applications rather than whether there was trading on material nonpublic information.[45]

II. Everything Isn't Insider Trading

Some transactions that can resemble insider trading, in fact, do not violate the law because at least one of the essential requirements is missing. A person who obtains confidential information by sheer luck or happenstance would not be liable for trading on it.[46] A recent offer by Valeant Pharmaceuticals International for Allergan Inc. was preceded by the company's CEO recruiting activist hedge fund manager William Ackman to support the deal by buying up shares in the

44. SEC v. McGee, 895 F. Supp. 2d 669, 682 (E.D. Pa. 2012). The defendant's criminal conviction for trading on inside information was affirmed by the Third Circuit, which rejected a claim that Rule 10b5-2(b)(2) was not within the SEC's authority. The circuit court held that "the imposition of a duty to disclose under Rule 10b5-2(b)(2) when parties have a history, pattern or practice of sharing confidences does not conflict with Supreme Court precedent." United States v. McGee, 763 F.3d 304, 314 (3d Cir. 2014).

45. For example, the Second Circuit affirmed the conviction of Raj Rajaratnam on multiple counts of insider trading in an opinion that included an extensive discussion of the application of the wiretap laws to an investigation of insider trading. United States v. Rajaratnam, 719 F.3d 139 (2d Cir. 2013). The court's discussion of whether the trial court's jury instruction of the legal issue—how much use a defendant must make of the confidential information to violate the insider trading prohibition—came at the end of the opinion in seven paragraphs, in which the court noted the instruction was actually *more* favorable than the law of the circuit on that issue.

46. John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 Utah L. Rev. 1, 22 ("[C]ourts have found no section 10(b) liability where a noninsider acquires material nonpublic information by sheer luck or by eavesdropping on the conversation of insiders."). One of the few cases in which a claim that information came into the trader's possession by sheer luck was *SEC v. Switzer*, 590 F. Supp. 756, 761–62 (W.D. Okla. 1984), involving a well-known college football coach overhearing information about an impending merger. The district court found that the executive was speaking with his wife when the coach happened to hear their conversation. *Id.* at 761–62 ("G. Platt did not make any stock recommendations to Switzer, nor did he intentionally communicate material, non-public corporate information to Switzer about Phoenix during their conversations at the track meet. The information that Switzer heard at the track meet about Phoenix was overheard and was not the result of an intentional disclosure by G. Platt.").

target through his hedge fund, Pershing Square Capital, before public disclosure of the offer. Although this looks like insider trading, Valeant's CEO appears to have lawfully disclosed Valeant's intentions and identified the target for the very purpose of motivating Mr. Ackman to buy a large block of Allergan shares in support of the bid. So even though the trading was on the basis of material nonpublic information, there would not appear to be a violation of Rule 10b-5 because the disclosure did not violate any duty of trust and confidence. Thus, Mr. Ackman rather proudly proclaimed that his legal counsel—no less than the former head of the SEC's Enforcement Division—told him that the purchases were well within the law.[47]

On the other hand, there are cases that result in a violation that are difficult to square with the key elements of the insider trading prohibition, but it may simply be that they have been mislabeled as insider trading. For example, in *SEC v. Dorozhko*,[48] a district court denied an injunction when the SEC sued a foreign computer hacker who misrepresented his identity to gain access to a company's negative earnings report and then bet against its stock by buying put options before the announcement that quickly netted approximately $286,000 in profits. On appeal, the SEC argued the defendant acted deceptively in obtaining the information by hacking into the computer and therefore engaged in fraudulent trading in violation of section 10(b) and Rule 10b-5. The Second Circuit reversed the district court, holding that "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information, is plainly 'deceptive' within the ordinary meaning of the word."[49]

Dorozkho certainly sounds like insider trading, does it not? But resembling that type of violation doesn't necessarily mean the conduct should be understood in that way. It is not a stretch to find that misrepresenting one's identity to obtain valuable information that otherwise would not have been made available, and

47. *See* Peter J. Henning, *Is It Time to Broaden the Definition of Insider Trading?*, N.Y. Times DealBook (Apr. 28, 2014, 1:38 PM), http://dealbook.nytimes.com/2014/04/28/could-it-be-time-to-broaden-the-definition-of-illegal-insider-trading/. Shareholders of Allegan have sued Mr. Ackman and Valeant for violating Rule 14e-3, 17 C.F.R. § 240.14e-3 (2014), which prohibits trading on confidential information about a tender offer. *See* Complaint, Basile v. Valeant Pharms. Int'l, Inc., No. 8:14-cv-02004 (C.D. Cal. Dec. 16, 2014). Unlike a violation of Rule 10b-5, which requires a breach of duty in the disclosure, Rule 14e-3 is not based on a breach of duty but instead only receiving information from a party involved in the tender offer. *See infra* notes 106–07 and accompanying text (discussing Rule 14e-3).

48. 574 F.3d 42 (2d Cir. 2009).

49. *Id.* at 51. The circuit court noted that it was unclear whether "exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft. Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b–5." *Id.* Therefore, it remanded the case to the district court to determine whether the defendant's conduct rose to the level of a "deceptive device" in violation of section 10(b) to trigger liability. The defendant never appeared back in the district court and a default judgment was entered against him.

subsequently misusing it for personal profit, is fraudulent without necessarily qualifying as insider trading.[50] But rather than just being an ordinary fraud case, like other Rule 10b-5 actions targeting Ponzi schemes, market manipulations, and penny stock scams, when the label "insider trading" is attached, suddenly it becomes the subject of much scholarly commentary about whether there is a new—and perhaps misguided—expansion of the scope of the prohibition.[51] If this really was insider trading, then the circuit court dispensed with a key element of the offense that has been around since the dawn of the prohibition—or, more specifically, *Chiarella v. United States*[52] in 1980: a breach of a duty of trust and confidence. But maybe *Dorozkho* is not all that it is cracked up to be. The case may be a unique, or at least rare, occurrence in which a thief engaged in deceptive conduct that touched on trading with confidential information, but does not represent anything greater than that.

Not every case brought under section 10(b) and Rule 10b-5 involving the use of confidential information in profitable trades necessarily comes under the label of "insider trading." It is not a term with a fixed meaning, so it can be misused by

50. *But see* Bainbridge, *supra* note 10, at 172 ("At most, the hacker 'lies' to a computer network, not a person. Hacking is theft; it is not fraud."). Historically, the common law offense of larceny by trick, which is the basis for the modern fraud statutes, was a type of theft.

51. For just a sampling of the articles devoting considerable attention to *Dorozhko*'s implications, see Kim, *supra* note 7, at 932 ("[W]as the Second Circuit nonetheless justified in casting aside the fiduciary duty requirement in order to punish the hacker? How would one know?"); Greene & Schmid, *supra* note 19, at 418 ("*SEC v. Dorozhko* is a recent example illustrating the U.S. courts' frustration with the confines of the fiduciary duty framework, and their subsequent attempt to reach beyond it."); Mark F. DiGiovanni, Note, *Weeding Out a New Theory of Insider Trading Liability and Cultivating an Heirloom Variety: A Proposed Response to* SEC v. Dorozhko, 19 GEO. MASON L. REV. 593, 595 (2012) ("The Supreme Court should weed out the Second Circuit's holding from insider trading jurisprudence at the first available opportunity."); Sean F. Doyle, *Simplifying the Analysis: The Second Circuit Lays Out a Straightforward Theory of Fraud in* SEC v. Dorozhko, 89 N.C. L. REV. 357, 358 (2010) ("The United States Court of Appeals for the Second Circuit therefore struck a progressive and potentially expansive victory for section 10(b)'s fundamental antifraud purpose in SEC v. Dorozhko."); Matthew T.M. Feeks, *Turned Inside-Out: The Development of "Outsider Trading" and How* Dorozhko *May Expand the Scope of Insider Trading Liability*, 7 J.L. ECON. & POL'Y 61, 83 (2010) ("Thus, analyzing the case under all three elements for Rule 10b-5 liability, holding Dorozhko liable for insider trading, would entail expansion of the 'deceptive act or contrivance' and the 'in connection with' elements."); Brian A. Karol, *Deception Absent Duty: Computer Hackers & Section 10(b) Liability*, 19 U. MIAMI BUS. L. REV. 185, 211 (2011) ("Since the Supreme Court has held that conduct itself can be 'deceptive' under Section 10(b), it is entirely plausible that the hacker's illegal acquisition of inside information could amount to a misrepresentation in violation of Section 10(b)."); Adam R. Nelson, Note, *Extending Outsider Trading Liability to Thieves*, 80 FORDHAM L. REV. 2157, 2192 (2012) ("The extension of liability to thieves will require the Court to disclaim a fiduciary duty as a prerequisite in all insider and outsider trading cases, as the Second Circuit held in *Dorozhko*."); Elizabeth A. Odian, Note, SEC v. Dorozhko*'s Affirmative Misrepresentation Theory of Insider Trading: An Improper Means to a Proper End*, 94 MARQ. L. REV. 1313, 1331 (2011) ("The Second Circuit's unprecedented holding—that a fiduciary duty is not an element of an insider trading case where an affirmative misrepresentation is involved—effectively combines two distinct theories of securities fraud by substituting an insider trading case's fiduciary duty analysis with a common law affirmative misrepresentation analysis."). I admit that I, too, joined in the chorus proclaiming the importance of the *Dorozhko* decision for insider trading law. *See* Ashby Jones, *On the SEC, Mark Cuban, and a Man Named Dorozhko*, WALL ST. J. L. BLOG (July 28, 2009, 1:01 PM EST), http://blogs.wsj.com/law/2009/07/28/on-the-sec-mark-cuban-and-a-man-named-dorozhko/.

52. 445 U.S. 220 (1980).

those looking to exploit the hostile reaction it provokes among the general public—and perhaps generate a little positive publicity for an elected official. For example, New York Attorney General Eric T. Schneiderman argued for a crackdown on what he dubbed "Insider Trading 2.0," which apparently occurs when investors pay for advance access to potentially market-moving information not otherwise available to the general public. In an editorial published in October 2013, Mr. Schneiderman wrote:

> Small groups of privileged traders have created unfair advantages for themselves by combining early glimpses of critical data with high-frequency trading—superfast computers that flip tens of thousands of shares in the blink of an eye. This new generation of market manipulators has devised schemes that allow them to suck all the value out of market-moving information before it hits the rest of the street.[53]

Since then, the New York Attorney General has reached agreements with providers of information to cut back or stop giving advanced access to a limited number of subscribers before it is released to the market.[54]

What Mr. Schneiderman is targeting is not insider trading, at least in the United States, because there is no breach of a fiduciary duty in dispensing the information. Indeed, under the securities laws, there is nothing illegal about a firm selling access to information it generates properly, at least so long as it is within the control of the provider and offered to anyone willing to pay. There is one exception to this: publicly traded companies disclosing their own information must make it generally available under the requirements of Regulation FD.[55] The New York Attorney General's primary concern is with high-frequency traders gaining access to information just a few milliseconds in advance of others, which can result in highly profitable transactions.[56] There is no misuse of confidential information, only contractual agreements to permit access to information before others reap the benefit, all of which is available to a willing purchaser.

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53. Press Release, Attorney Gen. Eric T. Schneiderman, Cracking Down on Insider Trading 2.0 (Oct. 11, 2013) (op-ed published in *Albany Business Review*), *available at* http://www.ag.ny.gov/press-release/op-ed-cracking-down-insider-trading-20.

54. For example, on July 8, 2013, the New York Attorney General reached an agreement with Thomson Reuters under which the company agreed not to sell access to the University of Michigan's consumer sentiment survey ahead of other subscribers. *See* Press Release, Attorney Gen. Eric T. Schneiderman, A.G. Schneiderman Secures Agreement by Thomson Reuters to Stop Offering Early Access to Market-Moving Information (July 8, 2013), *available at* http://www.ag.ny.gov/press-release/ag-schneiderman-secures-agreement-thomson-reuters-stop-offering-early-access-market. It is interesting to note that the agreement only keeps a select few high-frequency traders from getting advanced notice, but continues to allow anyone willing to subscribe to the service to get the information before the rest of the market. So much for the level playing field.

55. 17 C.F.R. §§ 243.100–.103 (2014).

56. For an extensive, if somewhat overwrought, discussion of high-frequency trading, see MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (2014). And not everyone is quite as negative about these firms. See Bart Chilton, *No Need to Demonize High-Frequency Trading*, N.Y. TIMES DEALBOOK (July 7, 2014, 2:59 PM), http://dealbook.nytimes.com/2014/07/07/no-need-to-demonize-high-frequency-trading/ ("High-frequency trading—done for profit, for sure—moves supply and demand among long-term investors quickly and efficiently. This serves an important function, reduces volatility and helps make markets better.").

Just putting the "insider trading" moniker on it, even with "2.0" attached, does not make it wrongful, at least under the law as we know it now. Indeed, the notion of a "level playing field," sometimes trotted out as a justification for prohibiting insider trading, only goes so far because there are numerous informational disparities that are perfectly legal.[57] The fact that Warren Buffett has decided to buy or sell shares in a company will, in all likelihood, affect its stock price, but that cause-and-effect does not mean his decision to act is insider trading, even if every other investor would love to know in advance what he plans to do.[58]

III. WHERE WILL CHANGE COME FROM?

Criticism of insider trading law often revolves around the failure to identify an obvious victim of the offense, unlike other crimes in which there is a defrauded investor or at least an offense against the government.[59] Indeed, the conduct is viewed by some as beneficial—not harmful—to companies whose information is used for private gain. This leads to the conclusion that the law reaches too much trading that should be permissible as long as it is approved in advance by the company whose information is used and disclosed to other investors as a possibility, so that the profitable use of confidential information can be seen as a form of management compensation.[60] One benefit to having internal corporate infor-

57. *See* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 562 (2011) ("Economic exchange is full of perfectly acceptable information disparities. 'Disclose everything you know' would be a silly and disastrous rule for any market."); Stanislav Dolgopolov, *Insider Trading, Informed Trading, and Market Making: Liquidity of Securities Markets in the Zero-Sum Game*, 3 WM. & MARY BUS. L. REV. 1, 12–13 (2012) ("In the context of the link between insider trading and market liquidity, it is critical to make the distinction between true insider trading and other forms of informed trading, despite the blurry economic and legal boundaries of these types of transactions. The gamut of informational advantages in securities markets is rather broad, with different types of company-specific, including security-specific, and non-company-specific information that may be inherently concentrated or dispersed among different market participants.").

58. Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 331 (2002) ("[W]hen Warren Buffett announces that he has made a large investment in a particular company, the market may react positively to such information.").

59. *See* William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 898 (1987) ("Legal theories of investor harm from insider trading are confused at best and overbroad at worst. Investor choices in trading markets are not influenced by the presence or absence of insiders.").

60. *See, e.g.*, David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1468 (1986) ("Our analysis leads to the conclusion that the legal prohibition against insider trading prevents shareholders from reaching compensation agreements with the managers of their firms that would make both sides better off. Thus, while insider trading law might provide for centralized *monitoring* of insider activities, the per se prohibitions on insider trading reflected in the current law seem deleterious to ordinary shareholders."); M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 505, 544 (2011) ("The other typical objection to insider trading is that it will make markets less liquid and less efficient because individual shareholders will not trust the market to be fair, viewing it instead as a place for privileged individuals to extract wealth from less privileged ones. This argument is weaker, however, in a world where the possibility of trading is disclosed *ex ante*. If traders know about the potential for informed insiders to be on the other side of a transaction, this risk should be priced by the market, and the firm should internalize these costs. In addition, the unfairness is ameliorated by the fact that the insiders are paying for any insider-trading gains by reducing other forms of compensation in approximately equal amounts."); *but see*

mation leaked into the market is that investors will not be surprised—at least not too much—by company developments, so stock prices will not be whipsawed by every rumor that pops up.[61]

From another perspective, not all forms of trading on confidential information should be prosecuted because there is no moral blameworthiness involved when the person does not breach a promise to maintain its secrecy.[62] One author went so far as to answer the question "[b]ut what is wrong with insider trading?" by finding: "Nothing. In fact, insider trading is good for the economy. Insider trading results is an efficient allocation of capital and thus makes the world wealthier."[63]

The counterparty to the transaction has no meaningful interaction with the trader misusing confidential information for personal gain, so it is difficult to conclude that the person was defrauded.[64] Under the misappropriation theory, it appears that the source of the confidential information is the wronged party, even though that person or entity did not trade and usually suffers no direct monetary loss from the misuse. The SEC and federal prosecutors speak generally about protecting the integrity of the market, so that investors do not flee the stock exchanges because they are viewed as rigged. But there is a reasonable counterargument that trading on confidential information makes the markets *more* efficient, a benefit that should be encouraged rather than punished.[65]

George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 266 (2013) ("[A]lthough individual companies could forbid insider trading, this would not be as effective as a public ban. At the least, it would substitute thousands of company-specific rules against insider trading for the current uniform rule.").

61. This view of insider trading remains a minority position, and there is little prospect that the prohibition will be repealed in the name of increasing management compensation or heightening market efficiency. *See infra* notes 70–71 and accompanying text; *see also* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 648 ("The free marketers' position that insider trading corrects the stock's price proves too much. If accepted, this position justifies massive trading and tipping to ensure that sufficient trading occurs to propel the stock to the equilibrium price appropriate for the nondisclosed information. Such widespread trading, however, compromises the corporate interest that justified nondisclosure in the first place."); Dent, *supra* note 61, at 248 ("Although insider trading is illegal and widely condemned, a stubborn minority still defends it as an efficient method of compensating executives and spurring innovation.").

62. *See, e.g.*, Anderson, *supra* note 46, at 6 ("The analysis concludes that [consequentialism and deontology] cannot justify the criminalization of nonpromissory insider trading. And while the other forms of insider trading should be criminalized, given the nature of the wrongs committed, we should revisit the severity of the punishments currently imposed.").

63. Eric Engle, *Insider Trading: Incoherent in Theory, Inefficient in Practice*, 32 OKLA. CITY U. L. REV. 37, 38 (2007); *see also* Ralph K. Winter, *On "Protecting the Ordinary Investor,"* 63 WASH. L. REV. 881, 901 (1988) ("So far as performing the market function of the Speculator or Institutional Investor is concerned, therefore, insider trading is good rather than bad.").

64. *See* Dent, *supra* note 61, at 259 ("In most cases it is difficult, if not impossible, to identify specific victims of insider trading. It does not, however, follow that insider trading is benign.").

65. *See, e.g.*, Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045, 1048 (2006) ("[P]rice-decreasing insider trading provides an effective means—perhaps the only cost-effective means—of combating the problem of overvalued equity . . . .").

Some have even argued that the company whose securities are traded on the basis of its confidential information should get to decide whether to block these transactions, at least when it involves outsiders.[66] If there is no clear victim of the violation, or one that is as ephemeral as the "market," then it is fair to ask whether it should even be a crime—especially one that can result in a substantial prison sentence.[67]

The absence of a traditional victim, in the sense of an identifiable group of individuals or organizations, along with the differing effects of trading on nonpublic information by various market participants and corporate constituents, have led to proposals to restructure—and thereby limit—the insider trading prohibition. They range from having Congress adopt a new law to avoid chilling legitimate trading[68] to imploring the SEC to adopt rules to restrict its discretion by more clearly defining what constitutes material information so that a violation can more easily be avoided by investors and insiders seeking to take advantage of informational asymmetries.[69]

But the plethora of theories about how to change the law to align it with more easily identifiable victims or to encourage economic efficiency through executive compensation are unlikely to alter the basic political calculation that Congress and the executive branch—the U.S. Department of Justice and SEC—like insider trading law pretty much the way it is now.[70] There is little prospect that they would support, and can be expected to actively oppose, any effort to restrict or restructure the law to any significant degree, especially if it means showing even a hint of compassion toward Wall Street traders and hedge fund billionaires. Arguments to make it harder for the government to pursue white-collar

66. Ayres & Choi, *supra* note 58, at 322 ("[T]he thesis of this Article is that regulators should allow the traded firm to block informed trading in its securities. Unlike the current regime that grants outsiders laissez faire trading rights, our proposal reassigns the outsider trading rights to the traded firm itself.").

67. The issue of whether prison terms of ten years or more for insider trading are appropriate is different—although not completely divorced—from the discussion of how the law should be understood. I leave aside the issue of appropriate punishment for insider trading.

68. *See* Fisch, *supra* note 2, at 251 ("If regulation is to continue, Congress should replace the current regime with a statute that is clear and predictable. A statutory definition of insider trading would provide the requisite notice to traders of the potential illegality of their conduct and would not chill legitimate trading, thereby promoting market efficiency."); Joseph J. Humke, Comment, *The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 847 (1997) ("[A]s the incidences of insider trading continue to escalate, so too shall the confusion accompanying them. After all, there is no indication that unscrupulous investors will soon refrain from contriving innovative new methods of market exploitation. Hence, with recognition of the federal courts' already overburdened dockets, it is imperative that Congress intervene to define 'insider trading.'").

69. *See* Heminway, *supra* note 16, at 1012–13 ("An efficacious insider trading regime under current U.S. law should enable enforcement against those in positions of trust and confidence who desire to misuse significant, market-relevant information by appropriating it for personal benefit rather than releasing it to the market—no more, no less. When the breadth of enforcement discretion creates collateral damage (in terms of economic inefficiencies, deterrence failures, or otherwise) and that enforcement discretion can be constrained without compromising the efficacy of the scheme of regulation, then rule makers should consider placing appropriate limits on enforcement discretion.").

70. *See* Stephen Clark, *Insider Trading and Financial Economics: Where Do We Go from Here?*, 16 STAN. J.L. BUS. & FIN. 43, 65 (2010) ("[T]he practical reality seems to be that insider trading regulation is here to stay.").

criminals will not gain much traction in the current environment in which there are persistent complaints about the lack of criminal prosecutions arising from the financial crisis.[71]

Congress has embraced an expansive approach to insider trading as far back as 1988 when it enacted the Insider Trading and Securities Fraud Enforcement Act that gave private parties an express right of action to recover damages for insider trading.[72] More recently, in 2012, in response to a flood of negative publicity generated by a *Sixty Minutes* report,[73] Congress adopted the STOCK Act[74] to make it crystal clear that "Members of Congress and employees of Congress are not exempt from the insider trading prohibitions arising under the securities laws, including section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder."[75] There has never been any indication from Capitol Hill that the insider trading prohibition should be restricted, and indeed it has been embraced. There is almost no chance Congress will tinker with the law to authorize some types of trading on confidential information that could be seen as

71. *See* Joe Nocera, *The Hole in Holder's Legacy: He Didn't Go After Crooked Financiers After the Financial Collapse*, N.Y. Times, Oct. 1, 2014, at A21 ("Actually, Mr. Holder's Justice Department has been notoriously laggard in prosecuting crimes that stemmed from the financial crisis, and much of what it has done amounts to an exercise in public relations."); Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. Rev. Books (Jan. 9, 2014), http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/ ("If the Great Recession was in no part the handiwork of intentionally fraudulent practices by high-level executives, then to prosecute such executives criminally would be "scapegoating" of the most shallow and despicable kind. But if, by contrast, the Great Recession was in material part the product of intentional fraud, the failure to prosecute those responsible must be judged one of the more egregious failures of the criminal justice system in many years.").

72. Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680–81 (1988) (codified as amended at 15 U.S.C. § 78t-1 (2012)) ("Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class."). In 1984, Congress adopted the Insider Trading Sanctions Act to authorize the SEC to seek up to a triple penalty based on the gains or loss avoided from trading "while in possession of material nonpublic information in a transaction." Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264 (1984) (codified as amended at 15 U.S.C. § 78u(d)(3) (2012)). Indeed, this provision appears to go even further than the Supreme Court's duty-based analysis of insider trading liability under section 10(b) and Rule 10b-5 by allowing for a penalty based on trading while in possession of information.

73. *See Congress: Trading Stock on Inside Information?*, CBS News (June 11, 2012), http://www.cbsnews.com/news/congress-trading-stock-on-inside-information/ (*Sixty Minutes*).

74. Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012). Senator Collins explained the purpose of the legislation this way:

> The STOCK Act is intended to affirm that Members of Congress are not exempt from our laws prohibiting insider trading. There are disputes among the experts about whether this legislation is necessary, but we feel we should send a very strong message to the American public that we understand Members of Congress are not exempt from insider trading laws, and that is exactly what this bill does.

158 Cong. Rec. S299 (daily ed. Feb. 2, 2012) (statement of Sen. Collins).

75. *See* 15 U.S.C. § 78u-1(g)(1) (2012).

favoring Wall Street and large hedge funds, even if academics could show that it also somehow benefitted small investors. Indeed, the push is much more likely to be in the direction of a broader prohibition rather than a narrowly tailored approach that authorizes some use of confidential information.

A recent decision by the Second Circuit in *United States v. Newman*[76] reversing the convictions of two hedge fund managers because they were too far removed from the source of the information to show that they knew a benefit was provided by the initial tippees was viewed as hamstringing the government's effort to pursue insider trading and led to a call by James Stewart for Congress to act to expand the law with a simple plea: "We need an insider trading statute."[77] In response to *Newman*, bills were introduced in the House and Senate to expand insider trading liability to trading while in possession of almost all confidential information.[78] This broad approach to defining insider trading is no doubt music to the ears of the SEC, which has resisted efforts to clarify the prohibition that might have the effect of restricting the agency's power to bring enforcement actions.[79]

For the SEC, its approach has been to take a much more expansive view of what comes within the prohibition.[80] In 2000, the SEC adopted rules specifically addressing the scope of insider trading liability that took an expansive view of what constitutes a duty of trust and confidence triggering liability and the role of the confidential information in the transaction. In Rule 10b5-1, the SEC defined a "manipulative or deceptive device" to include trading "on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence" owed to the source of the information.[81] Note that the rule is

76. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

77. James B. Stewart, *Delving into Morass of Insider Trading*, N.Y. Times, Dec. 20, 2014, at B1, *available at* http://www.nytimes.com/2014/12/20/business/the-insider-trading-morass.html.

78. Insider Trading Prohibition Act, H.R. 1625, 114th Cong. § 2 (2015); Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. § 2 (2015); Stop Illegal Insider Trading Act of 2015, S. 702, 114th Cong. § 2 (2015).

79. *See* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 Cardozo L. Rev. 83, 127 (1998) ("[T]he SEC is a prosecutorial agency that has long articulated the view that detailed regulations will be a blueprint for fraud and therefore it is better to rely upon general antifraud concepts to police the securities markets."); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 Yale J. on Reg. 149, 156 (1990) ("The SEC *has*, at times, resorted to *ad hoc* enforcement of the federal securities laws in particular contexts, in the absence of meaningful advance guidance (or warning) to those subject to the agency's jurisdiction, in large measure because of the agency's institutional fear that any specific regulations it might promulgate could prove underinclusive or susceptible of easy evasion.").

80. One way in which the SEC may have inadvertently authorized trading that can appear to violate the prohibition is for transactions by corporate employees pursuant to a plan that meets the requirements of Rule 10b5-1(c). 17 C.F.R. § 240.10b5-1(c) (2014). These so-called 10b5-1 Plans allow the sale of securities if they are adopted before the person becomes aware of confidential corporate information and specifies the amount of the securities without permitting the person to influence when or how the transactions will take place. The *Wall Street Journal* raised questions in November 2012 regarding whether executives manipulated the plans to take advantage of advance notice of corporate information. *See* Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock*, Wall St. J. (Nov. 27, 2012, 11:17 PM), http://www.wsj.com/articles/SB1000087239 6390444100404577641463717344178.

81. 17 C.F.R. § 240.10b5-1 (2014).

phrased in the disjunctive, even though the Supreme Court in *Chiarella* stated that it was a violation of "a duty of trust *and* confidence" that was the prerequisite for insider trading liability.[82] In Rule 10b5-2, the SEC went a step further by providing that the duty could arise "whenever a person agrees to maintain information in confidence," where persons have a "history, pattern or practice of sharing confidences," and "whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling."[83] This provision dilutes, and arguably even ignores, the duty element first recognized in *Chiarella* to violate Rule 10b-5 for trading on material nonpublic information.[84] The lower courts have rejected challenges to the rule as exceeding the SEC's authority to define what constitutes a "deceptive" device under the law, finding that it can clarify the Supreme Court's analysis of the requisite duty.[85] The agency is unlikely to see any need to cut back on insider trading liability when its expansive approach has been endorsed by the judiciary and embraced by Congress.

The only viable remaining avenue for reshaping the law is the Supreme Court, which could substantially narrow the prohibition by reinterpreting the scope of section 10(b) and Rule 10b-5. Justice Scalia, joined by Justice Thomas, recently argued that the courts should not rely on the SEC's expansive interpretations of what constitutes insider trading in determining the scope of the law. He pointed out that administrative determinations do not deserve deference in a criminal prosecution because "[t]hey collide with the norm that legislatures, not executive

82. *See* Schroeder, *supra* note 5, at 198 ("This formulation noticeably does not say that this duty must be fiduciary or its equivalent in nature. Moreover, it makes the relationships of trust and confidence disjunctive, rather than conjunctive.").

83. 17 C.F.R. § 240.10b5-2 (2014). The Rule has been upheld as a permissible interpretation of the antifraud provision in section 10(b). *See* United States v. McGee, 763 F.3d 304, 316 (3d Cir. 2014) ("We believe that Rule 10b5-2(b)(2) is based on a permissible reading of "deceptive device[s]" under § 10(b). Although we are not without reservations concerning the breadth of misappropriation under Rule 105b-2(b)(2), it is for Congress to limit its delegation of authority to the SEC or to limit misappropriation by statute."); United States v. Corbin, 729 F. Supp. 2d 607, 619 (S.D.N.Y. 2010) ("[T]he Court finds that the SEC's exercise of its rulemaking authority to promulgate Rule 10b5-2 under § 10(b) is far from arbitrary, capricious, or contrary to § 10(b). Rather, it was buttressed by a thorough and careful consideration—one that far surpasses mere reasonableness—of the ends of § 10(b), the state of the current insider trading case law which included Supreme Court and Second Circuit decisions, and the need to protect investors and the market generally.").

84. *See* Nagy, *supra* note 9, at 1361 ("The SEC's expansion of liability under the misappropriation theory is most apparent in connection with Rule 10b5-2(b)(1), which encompasses situations in which 'a person agrees to maintain information in confidence.' This category dispenses entirely with the relational elements of trust and loyalty essential to *O'Hagan*'s reasoning. Thus, while Rule 10b5-1's second and third categories may substantially dilute fiduciary principles, the rule's first category simply dispenses with those principles altogether.").

85. *McGee*, 763 F.3d at 314 ("[T]he imposition of a duty to disclose under Rule 10b5-2(b)(2) when parties have a history, pattern or practice of sharing confidences does not conflict with Supreme Court precedent."). In *McGee*, the Third Circuit upheld a defendant's conviction based on a duty of trust and confidence derived from the confidentiality in the relationship between members of Alcoholics Anonymous. *See id.* at 317 ("Confidentiality was not just Maguire's unilateral hope; it was the parties' expectation. It was their understanding that information discussed would not be disclosed or used by either party. Maguire never repeated information that McGee revealed to him and McGee assured Maguire that their discussions were going to remain private.").

officers, define crimes."[86] Justice Scalia would apply the rule of lenity to take a more restrictive view of how the government should prove a violation. Yet, that understanding would not necessarily result in a significant narrowing of the law, even without the SEC's broader interpretation of what constitutes "use" of confidential information and a relationship of trust and confidence. The current approach taken by the lower courts that apply the law along the lines of the SEC's interpretation could still fit comfortably within the statutory prohibition on manipulative and deceptive devices. The Supreme Court has not been bashful about taking an expansive view of what constitutes "use" in other contexts,[87] so it may well agree with the SEC's approach without necessarily deferring to its interpretation of the law.

Any significant restriction would require the Court to narrow, and perhaps even dispense with entirely, the misappropriation theory of insider trading liability, which significantly expanded the scope of the law to those outside the company whose securities were traded. To go that far would necessitate reversing the 7-2 decision in *United States v. O'Hagan*,[88] an opinion that resolved a circuit split by coming down strongly in favor of the government's expansive view of insider trading liability.[89] There has been no indication that a majority of the Justices are inclined to engage in wholesale revisions that would probably involve overturning a precedent in order to cut back the scope of insider trading liability.[90] Moreover, it has been eighteen years since the Court decided *O'Hagan*, one of only three cases it has ever reviewed in this area since 1980.[91] The chance of a

86. Whitman v. United States, 135 S. Ct. 352, 353 (2014) (statement of Scalia, J., respecting the denial of certiorari).

87. For example, the Supreme Court's interpretation of 18 U.S.C. § 924(c)(1), which makes it a crime for a defendant to "use[] . . . a firearm" during or in relation to a drug trafficking offense, includes exchanging the gun for drugs as the "use" of the firearm. The Court rejected the argument that "use" means that the gun is employed as a weapon, opting for the expansive dictionary definition that included "dervived service" from the weapon. *See* Smith v. United States, 508 U.S. 223, 228 (1993). Surely the notion of "use" of inside information could cover much of what the SEC views as coming within the prohibition on insider trading in Rule 10b5-2(b), Justice Scalia's criticism of the reliance on an administrative agency's interpretation notwithstanding.

88. 521 U.S. 642 (1997).

89. *See id.* at 659 ("[C]onsidering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder.").

90. Justice Thomas dissented in *O'Hagan* on the application of the misappropriation theory "[b]ecause the Commission's misappropriation theory fails to provide a coherent and consistent interpretation of this essential requirement for liability under § 10(b)." *Id.* at 680 (Thomas, J., concurring in judgment and dissenting in part). Justice Scalia also did not agree with the majority's analysis of the misappropriation theory: "While the Court's explanation of the scope of § 10(b) and Rule 10b-5 would be entirely reasonable in some other context, it does not seem to accord with the principle of lenity we apply to criminal statutes (which cannot be mitigated here by the Rule, which is no less ambiguous than the statute)." *Id.* at 679 (Scalia, J., concurring in part and dissenting in part). This is similar to the position he took in *Whitman* in questioning reliance on the SEC's interpretation of the law in a criminal prosecution.

91. The other two insider trading cases to be decided by the Supreme Court were *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983). Another case that reached the Court was *Carpenter v. United States*, 484 U.S. 19 (1987), but the Justices were evenly divided on

significant reordering of apparently well-settled law appears to be rather slim. That does not mean the Justice Department or the SEC will not take an aggressive position in a case that might strike the Court as overreaching, like what happened in *Chiarella* and *Dirks*. Even with Justices Scalia and Thomas agitating for a different approach, it would likely take an egregious case of governmental overreaching to get the rest of the Justices to cut back significantly on the scope of insider trading law. And even then, Congress can always restore the law to its prior state in an effort to appeal to voters by showing no mercy to Wall Street.

As far as the general public is concerned, there appears to be widespread support for the prohibition on insider trading.[92] The Justice Department has done well in its recent prosecutions—despite an acquittal in a case that ended a long streak of courtroom victories[93] and the Second Circuit overturning two convictions in another case[94]—that has built support for the crackdown on miscreant hedge funds and expert network firms. The effort earned the United States Attorney for the Southern District of New York, Preet Bharara, a cover photo on *Time* magazine behind the headline "This Man Is Busting Wall St."[95] The notion that insider trading is not morally wrongful, or at least not socially reprehensible, is pretty much a non-starter in most quarters, despite the howls of protest from law and economics scholars.[96] Thus, the short answer to the question of why insider trading is illegal is the one that an exasperated parent is wont to give

the issue of the propriety of the misappropriation theory, which was decided a decade later in *O'Hagan* in favor of an expansive view of insider trading liability. *Id.* at 24.

92. *See* Stuart P. Green & Matthew B. Kugler, *When Is It Wrong to Trade Stocks on the Basis of Non-Public Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 484 (2011) ("It was only when the trader obtained the confidential information in some presumably illicit manner, such as by appropriating it from his employer or client, that our subjects regarded it as clearly worthy of prohibition and censure.").

93. *See* Matthew Goldstein, Benjamin Protess & Rachel Abrams, *Prosecutors Winning Streak in Insider Trading Cases Ends*, N.Y. TIMES, July 8, 2014, at B1, *available at* http://dealbook.nytimes.com/2014/07/08/jury-clears-rengan-rajaratnam-in-insider-trading-case/.

94. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).

95. *This Man Is Busting Wall St.: Prosecutor Preet Bharara Collars the Masters of the Meltdown*, TIME MAG. (Feb. 13, 2012), http://content.time.com/time/covers/0,16641,20120213,00.html.

96. *See* STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE COLLAR CRIME 236 (2006) ("[T]he most interesting thing to note about the law and economics literature on insider trading is the way in which it consistently ignores or trivializes the question of moral wrongfulness."); Strudler & Orts, *supra* note 1, at 383 ("Our working hypothesis is that economic analysis is not the best approach to understanding insider trading because the core controversies in this area of law are really about ethics and not economics. The hard problems in insider trading law are paradigmatically moral, such as whether nondisclosure of material nonpublic information deprives a participant in a public securities market of the ability to make an autonomous choice, or whether an inside securities trader uses information that is stolen, converted to an improper use, or otherwise morally tainted."). For a detailed discussion of the morality of insider trading, see Anderson, *supra* note 46, at 27 ("[T]he law locates the section 10(b) liability in a failure to disclose that violates a duty of trust and confidence (either to the shareholder or to the source of the information). It remains, however, to settle the question of whether this conduct proscribed by law is also morally wrong.").

to a misbehaving child: "Because it is!"[97] So there is unlikely to be any appreciable movement to change the law in the near future, despite academic claims that it needs to be reshaped.

IV. Can Insider Trading Law Be Improved?

The law of insider trading is complex, involving terms that do not have precise meanings, so it is hard to determine in advance whether a particular transaction comes within the proscription.[98] For example, the Supreme Court's test for what constitutes "material" information can best be described as broad and dependent on the circumstances of a case. Insider trading cases involve a failure to disclose the information prior to trading on it, so the omission is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding" whether to invest.[99] Just about any nugget of information could conceivably fit within this description, which allows the prohibition to be applied to new types of data that have not been the subject of prosecutions before

97. Professor Buell made this same basic point, but much more elegantly, when he wrote:

> In the case of insider trading, the nondisclosure is deceptive because the counterparty assumes that the trader does not have a particular kind of informational advantage, such as a corporate secret about an upcoming transaction. Or, in the common scenario of highly liquid, faceless markets, the counterparty assumes that the market is relatively free of such traders. This theory is oddly circular. Why would the counterparty assume that the seller/buyer is not trading on the basis of an informational advantage in the form of nonpublic knowledge acquired as a result of her insider position? Because robust legal prohibitions on insider trading in securities markets now exist, so people are not supposed to do that! The law itself has created the conditions that justify its treatment of insider trading as fraud. Despite this oddity, the argument for insider trading as a form of fraud has some merit.

Buell, *supra* note 57, at 563.

98. *See* Dent, *supra* note 61, at 265 ("The law of insider trading is complex with respect to issues like materiality and scienter."); Ted Kamman & Rory T. Hood, *With the Spotlight on the Financial Crisis, Regulatory Loopholes, and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?*, 2009 Colum. Bus. L. Rev. 357, 364 ("[T]he United States' complex laws on insider trading highlight the commonly criticized deficiencies of a common law approach: the inaccessibility of the law to non-lawyers and lack of a clear, systemic code of conduct."); Joan MacLeod Heminway, *Martha Stewart and the Forbidden Fruit: A New Story of Eve*, 2009 Mich. St. L. Rev. 1017, 1031 (2009) ("Unlike God's rule forbidding consumption of the forbidden fruit, the insider trading prohibitions established by Congress and the SEC lack simplicity and clarity. Specifically, the elements necessary to prove an insider trading violation can be frustratingly imprecise in their content, largely because they emanate from a broad-based antifraud rule.").

99. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). The Court went on to explain that:

> What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id. Under this analysis, almost any information relevant to the market can be considered material, depending on the context of the trading. In *SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997), a case involving trading on information that confirmed press speculation about a possible deal for a company, the Second Circuit said that "[t]o be material, the information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significantly altering the 'total mix' of information available." *Id.* at 52.

and to reach persons who seem far removed from the traditional corporate world where insider trading on confidential information about earnings and acquisitions often occurs.[100]

Vague terms and complex proof requirements are not unique to insider trading law. For example, RICO requires the government to prove a "pattern or racketeering activity," which is defined as "at least two acts of racketeering activity," the last of which occurred within the past ten years.[101] To give the lower courts a little more guidance as to what qualifies as a pattern, the Supreme Court explained that it requires showing that the criminal acts establish both "continuity" in the conduct and a "relationship" between the racketeering activity, but "the precise methods by which relatedness and continuity or its threat may be proved, cannot be fixed in advance with such clarity that it will always be apparent whether in a particular case a 'pattern of racketeering activity' exists."[102] That is no worse than proving a "duty of trust and confidence" for an insider trading violation, another malleable element that does not impart precision to the analysis for determining when a violation takes place.

One means to cut down on insider trading would be for the SEC to enforce Regulation FD more rigorously to keep companies from selectively leaking information.[103] The rule requires disclosure to the entire market when material nonpublic information is made available. If the focus were on cutting off the information at the source, rather than prosecuting the end user, then at least some of the insider trading taking place could be curtailed. But that would not entirely solve the problem because market-moving information can emanate from a number of different places, like the decision of an institutional investor or hedge fund to buy a large block of shares, that is not subject to Regulation FD.

If there is a push to simplify the law of insider trading, then perhaps that process should be viewed from the perspective of traders in the market who must deal with its vagaries, rather than looking at whether the law meets the requirements of the rational economic actor. Unlike the corporate insider who tips fam-

100. *See* Karmel, *supra* note 78, at 83 ("Many prosecutions of insider trading, however, do not involve true insider trading. Rather, they involve trading by outsiders, that is, persons who are not employed by the issuer whose securities are traded, and who trade on nonpublic market information."); David A. Wilson, *Outsider Trading—Morality and the Law of Securities Fraud*, 77 GEO. L.J. 181, 182 (1988) ("Over the last twenty-five years, the relationship required between the breach of fiduciary duty and the company whose stock is traded has become more attenuated as courts have extended this doctrine to cover certain 'outsiders.'"). Professor Karmel asserted, "The failure of securities regulators and courts to highlight this principle and articulate when, and why, insiders, their tippees, and other professionals do owe a duty to refrain from taking advantage of market information has maintained the continuing confusion concerning the parameters of the crime of trading on inside information." Karmel, *supra* note 78, at 85.

101. 18 U.S.C. § 1961(5) (2012).

102. H.J. Inc. v. Nw. Bell Tel. Co., 492 U.S. 229, 243 (1989). Justice Scalia pointed out that the test enunciated by the Court provided no concrete guidance to the lower courts, so that "[t]his seems to me about as helpful to the conduct of their affairs as 'life is a fountain'." *Id.* at 252 (Scalia, J., concurring).

103. 17 C.F.R. § 243.100 (2014).

ily members about an impending deal, or the outside lawyer who passes on information to a circle of investors, it is the trader—whether a professional or just an ordinary investor seeking out information in the market—who deals with the gray areas of the law on a daily basis. Some of them will cross the line and engage in insider trading regardless of how confusing the law might appear, but I suspect most want to steer clear of illegal conduct. Finding the line can be difficult, so maybe it needs to be brightened. One way this can be accomplished is to simplify what constitutes insider trading, which can eliminate some of the conundrums in the current regime.

A handy example found in the history of insider trading bespeaks a much more straightforward approach to when a violation has taken place, which could make the life of those who deal in corporate information much easier: the possession theory. As advanced by the SEC in *Cady, Roberts*[104] and *Texas Gulf Sulphur*,[105] a person violates the law by trading while in possession of material nonpublic information, regardless of the source. This approach has been enshrined in Rule 14e-3[106] for trading on information related to a tender offer, which was endorsed by the Supreme Court in *O'Hagan* as a permissible use of the SEC's rulemaking authority.[107] The European Union's recently adopted "Market Abuse Regulation" directs Member states to prohibit "insider dealing," which is defined as arising "where a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates."[108]

The primary benefit of the possession theory is the clarity it brings to the law of insider trading. Once a link between the person and the information is established,

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

105. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

106. 17 C.F.R. § 240.14e-3(a) (2014). The rule provides:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he 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.

Id.

107. 521 U.S. 642, 673 (1997).

108. Commission Regulation 596/2014, art. 8, ¶ 1, 57 O.J. (L 173) (EC), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.173.01.0001.01.ENG.

then any trading prior to disclosure to the market would be a violation.[109] From a compliance perspective, the prohibition can be easily summarized this way: "If you think it might be inside information, then don't trade until it becomes public." The possession theory does not solve all the problems with the law of insider trading. For example, the test of materiality—whether a reasonable investor would consider the information important—would remain an area of some opaqueness.[110] Yet, it is the rare insider trading prosecution that involves a significant question whether the information had an impact on the company's shares, and the generality of the materiality requirement is not limited to insider trading cases. Beyond that, however, difficult issues regarding whether there was a duty of trust and confidence owed to the source of the information or, in the case of tipping, whether a quid pro quo with the tipper can be shown, would drop away when all that must be shown is mere possession of confidential information.

Such a change in the law would require a congressional fix to permit the SEC to reach cases under section 10(b) and Rule 10b-5 that do not involve a breach of a duty, something that is never an easy task.[111] But the legislation would be easy to draft, given the European Union's regulation that can serve as a model. And there may be some political appeal, given the general public's revulsion directed at Wall Street.

The obvious downside to the possession theory is that the much broader sweep of the law would make a wider array of trading potentially subject to civil and criminal charges. For example, the SEC's pursuit of Mark Cuban for trading on information about a company in which he held a substantial stake, before disclosure to the market, would likely constitute insider trading.[112]

109. *See* Crimmins, *supra* note 37, at 358 ("In the present environment of uncertainty as to whether trading is permitted in many circumstances, some might ask whether the Supreme Court got things wrong in *Chiarella* and its progeny. In contrast, the European Union has taken the opposite position and fully embraced a parity-of-information approach to insider trading liability. The EU approach avoids the uncertainties of the U.S. analytical scheme by simply forbidding trading by any person possessing material nonpublic information. Interestingly, the EU couples this across-the-board prohibition with a requirement that issuers continuously disclose inside information as it becomes available. In short, issuers must disclose inside information on a current basis (with certain exceptions), and when traders come across inside information, they know it is illegal to use it to trade.").

110. Raj Rajaratnam offered the "mosaic theory" to try to avoid liability by arguing that any inside information he received was not material in itself, but rather only when combined with other publicly available information that led to the investment decision. The jury soundly rejected that approach, and it is unlikely to be successful when the confidential information has any appreciable impact, something that is assessed post hoc. See Aaron S. Davidowitz, Note, *Abandoning the "Mosaic Theory": Why the "Mosaic Theory" of Securities Analysis Constitutes Illegal Insider Trading and What to Do About It*, 46 WASH. U. J.L. & POL'Y 281, 283 (2014) ("[T]he mosaic theory is eroding as a valid method of securities analysis."); Marron C. Doherty, Note, *Regulating Channel Checks: Clarifying the Legality of Supply-Chain Research*, 8 BROOK. J. CORP. FIN. & COM. L. 470, 479 (2014) ("As a defense to insider trading allegations, mosaic theory is risky.").

111. *See* Crimmins, *supra* note 37, at 361 ("It is unrealistic to suppose that Congress or the courts will soon switch to the EU's clear and direct parity-of-information approach.").

112. *See* SEC v. Cuban, 620 F.3d 551, 557 (5th Cir. 2010) ("The allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement.").

That would change the result of his jury trial in which he was found not liable for a violation. Shifting the focus to possession rather than a breach of fiduciary duty could make investment firms hesitant to engage in research about companies if it involves contacting employees or conducting field research, such as channel checking, because trading could trigger a violation.[113] For the possession theory to work well, it would require quicker disclosure of confidential information to the public so that it is less likely anyone can trade on it—a change most corporations are likely to resist. For outsiders, the ten-day window before disclosure of a stake of more than 5 percent in the corporation's securities would also need to be tightened, which is unlikely to please activist investors who prefer to stay out of the public eye as long as possible. And the possession theory could bar information providers from selectively disclosing information to those willing to pay a higher price before its release to the public because any market-moving data could be the basis for a violation, thus allowing the government to pursue "Insider Trading 2.0."

V. Conclusion

Would moving to the possession theory be a good idea? The answer depends on whether the current state of the law is ambiguous enough that there is a need to move toward greater precision in the prohibition. But the likely price for that clarity is wider potential liability for violations. Traders may well prefer the current regime that gives them some leeway in gathering information on which to trade profitably. Sometimes, an unclear line is better than knowing exactly what constitutes a violation if the clear prohibition includes much more conduct that will be subject to criminal prosecution and civil enforcement. As it stands, the current insider trading edifice works fairly well as a legal doctrine, despite issues with how far it can extend to new forms of conduct and types of market information. There are questions about whether it is the best rule from an economic viewpoint to encourage efficient trading, but that is likely not the only goal in prohibiting trading that carries a stigma of unfairness or cheating. The requirement in the law today that a breach of duty must be proven for liability

113. *See* Michael Byun, Note, *Channel Checking and Insider Trading Liability*, 2 Mich. J. Private Equity & Venture Cap. L. 345, 345–46 (2013) ("Channel checking, the analysis of the upstream suppliers and downstream consumers of a given company's products, is reportedly common practice in the market analysis industry. However, the SEC's interest in investigating channel checking in the marketplace puts the legality of this practice in doubt. As a consequence of the current broadness of insider trading liability, firms that either outsource channel checking to market analysis firms or conduct the channel check in-house may be at risk of incurring insider trading liability."); Marron C. Doherty, Note, *Regulating Channel Checks: Clarifying the Legality of Supply-Chain Research*, 8 Brook. J. Corp. Fin. & Com. L. 470, 482 (2014) ("Banning or disincentivizing aggressive research may limit the amount of public information firms use in their analyses as they take precautionary steps back. The costs of compliance and the amount of human capital needed to ensure that expert networks and channel checkers are on the right side of the insider trading laws are already enormous and growing rapidly in the wake of the Primary Global Research cases.").

allows for an assessment of some measure of harm and focuses on the defendant's misconduct, even if it is challenging to figure out who is the actual victim of the violation. The insider trading prohibition as developed by the federal courts and the SEC may not be perfect, but then, what in the law ever really is? Improvement is likely to mean more trading will be the subject of criminal and civil charges, not less.