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Moral Principle in the Law of Insider Trading

Alan Strudler* and Eric W. Orts**

[N]o stigma attaches to love of money in America, and provided it does not exceed the bounds imposed by public order, it is held in honor.¹

[Insider trading] is a most serious offense, a fraud on the trading public by which individual investors are invariably victimized²

Introduction

Why is insider trading wrong? Or, more precisely, why is trading on inside information wrong in some circumstances but not wrong in others? Courts and commentators have struggled with these questions since the federal courts and the Securities and Exchange Commission (SEC) held insider trading to be actionable as securities fraud.³ Despite many cases

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1. ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 621 (J.P. Mayer ed., George Lawrence trans., Anchor Books 1969) (1848).

2. ARTHUR L. LIMAN, *LAWYER: A LIFE OF COUNSEL AND CONTROVERSY* 270 (1998).

3. Insider trading is illegal under a number of federal statutes and regulations, most notably the fraud provisions of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. See 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1999). For early influential federal securities fraud cases under the 1934 act, see *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (holding that a parent company committed fraud when it failed to reveal to stockholders the true value of a subsidiary, the stock of which the parent company bought from stockholders); *Kardon v. Nat'l Gypsum*

and a huge literature on the subject, a coherent answer has remained elusive.⁴

We argue that insider trading is wrong because it is a kind of fraud. The sparse legislative history of federal regulation supports this view.⁵

Co., 73 F. Supp. 798 (E.D. Pa. 1947) (declaring that the directors violated § 10(b) of the Securities Exchange Act of 1934 when they failed to disclose known material facts); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (concerning a broker's use of nonpublic information gleaned from a coworker who also acted as director of the corporation in question) and *In re Ward La France Trucking Co.*, 13 S.E.C. 373 (1943) (discussing a corporation's failure to disclose improved earnings prior to purchasing its own stock from its shareholders). The United States Supreme Court describes § 10(b) as "a catchall provision," but emphasizes that "what it catches must be fraud." *Central Bank v. First Interstate Bank*, 511 U.S. 164, 174 (1994) (quoting *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980)). Other statutes which make insider trading illegal include § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1994), which is substantially similar to Rule 10b-5, and the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343 (1994); see, e.g., *Carpenter v. United States*, 484 U.S. 19, 22-23 (1987) (affirming a conviction for insider trading based on mail and wire fraud statutes where the defendant misappropriated confidential information designed for a future newspaper column). In fact, Rule 10b-5 is an amalgam of the language of § 10(b) and § 17. See *infra* note 5.

4. See James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628, 634 ("The fact that such an aggressive level of regulation exists without a coherent, let alone articulated, philosophy of regulation is one of the most unsettling aspects of the federal securities laws."); Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1293, 1293-94 (1998) (stating that "there is a great deal of debate on just what kinds of insider trading to prohibit" and that where to draw legal lines "remains problematic"); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 179, 184 (1991) (explaining that because of the ad hoc nature in which insider trading regulation has developed, the doctrine governing such regulation is "seriously flawed" and "confused"); Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 83 (1998) (asserting that "despite the large number of articles discussing insider trading, a general consensus among commentators has not developed as to why insider trading is unlawful"); Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1091 (1997) (describing federal insider trading law as "controversial," "complicated," and "unclear"); Jonathan E.A. ten Oever, Case Note, *Insider Trading and the Dual Role of Information*, 106 YALE L.J. 1325, 1326 (1997) (arguing that a "final resolution of the controversy surrounding insider trading awaits a coherent policy rationale that would simultaneously support and limit insider trading liability").

5. The creation of Rule 10b-5 is illustrative. According to an eyewitness:

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from . . . the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with [the S.E.C. Regional Administrator in Boston] and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale [of securities]" should be, and we decided it should be at the end. We called the Commission and we got on the calendar. . . . All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike. "Well," he said, "we are against fraud aren't we?" That is how it happened.

But the jurisprudence of insider trading has developed in a manner that strains the very concept of fraud it invokes. This generates difficult problems regarding both how people should treat each other in securities transactions and what it means to be a victim of securities fraud. A moral understanding of insider trading as a particular kind of fraud provides a rational framework for judges, legislators, and administrators to deal with hard cases.⁶

Milton V. Freeman, *Conference on Codification of the Federal Securities Laws: Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967) (quoted in *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1290 n.32 (2d Cir. 1972)).

6. We begin with the traditional assumption that insider trading is a kind of securities fraud under Rule 10b-5(a), 17 C.F.R. § 240.10b-5(a) (1999) (prohibiting "any device, scheme, or artifice to defraud") and Rule 10b-5(c), 17 C.F.R. § 240.10b-5(c) (1999) (prohibiting "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person"). For the most part, we limit our analysis to Rule 10b-5 cases, though we recognize that other federal statutes and regulations designed to curb insider trading sweep more broadly than the most expansive understanding of fraud. See, e.g., Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1994) (imposing liability on directors, officers, and 10% shareholders who purchase and then sell (or sell and then purchase) securities of their own corporation within a six month period); Rule 14e-3, 17 C.F.R. § 240.14e-3 (1999) (prohibiting any person from trading on the basis of knowledge about undisclosed plans for a tender offer). Our philosophical analysis of insider trading may suggest limits to the scope of liability under § 16(b) and Rule 14e-3. Our analysis may also prove useful in the context of state shareholder derivative actions for insider trading. See, e.g., *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969) (allowing a shareholder to bring a derivative action for insider trading against a corporate officer); *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949) (allowing a shareholder to bring a fraud action for insider trading against an employee). But these extensions lie outside the scope of our analysis in this Article, which applies directly only to Rule 10b-5 insider trading cases.

Obviously, we also disagree with Richard Posner's recent diatribe against the use of moral theory in legal interpretation. See RICHARD A. POSNER, *THE PROBLEMATICS OF MORAL AND LEGAL THEORY* x, 50 (1999) (asserting such broad claims as "moral theory, and such cousins of it as jurisprudence and constitutional theory, are useless in the resolution of concrete legal issues" and "moral theory is like a system of mathematics that has never gotten past addition"). Posner himself embraces a strange brew of what he describes as moral relativism, subjectivism, skepticism, and emotivism. See Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1645 (1998) ("I embrace a version of moral relativism, reject moral particularism, and accept diluted versions of moral subjectivism, moral skepticism, and emotivism."). It is sufficient, at one level, to respond to Posner's attacks on moral theory by pointing out that he at least implicitly adopts a moral position from which to make his attack. Posner does not consider moral principles as relevant, but instead considers them "pernicious"; he believes that "judges and other practical professionals," including legal academics, should devote themselves to generating economic and other kinds of knowledge that will "maximize the social utility of law." POSNER, *supra*, at xi. But "maximizing social utility" is itself a chosen moral objective. See GEORGE P. FLETCHER, *BASIC CONCEPTS OF LEGAL THOUGHT* 156 (1996) ("Though they are loathe to identify their theories as 'normative' as opposed to 'positive' and scientific, the advocates of efficiency espouse a new morality for the law—or at least a new mode of expressing the principles of utilitarian morality."); see also Ronald Dworkin, *Darwin's New Bulldog*, 111 HARV. L. REV. 1718, 1732-35 (1998) (pointing out the circularity of Posner's pragmatic moral arguments).

Other commentators have pointed out the defects of Posner's views on the relationship between law and moral theory. See, e.g., Dworkin, *supra*, at 1735-38 (suggesting that a hidden social Darwinism is the true end of Posner's theory); Charles Fried, *Philosophy Matters*, 111 HARV. L. REV. 1739, 1741-50 (1998) (arguing that Posner's empirical claim that moral theory does not influence law is "spectacularly wrong" and that his normative claim that moral theory should not influence law is

The puzzles one confronts in trying to explain what makes insider trading wrong are illustrated by comparing the famous case of *SEC v. Texas Gulf Sulphur Co.*⁷ with a few hypothetical situations based on similar facts. In *Texas Gulf Sulphur*, officers, directors, and employees of Texas Gulf Sulphur learned of their company's rich ore strike in Canada and traded on this information before the news became public.⁸ They were liable for breaching a duty to disclose material nonpublic information or abstain from trading with others in public securities markets.⁹ Although it was illegal for these insiders to trade securities on the information they possessed about the ore strike, other transactions made on the basis of the same undisclosed information are less problematic. For example, having learned of the ore strike, Texas Gulf Sulphur may itself bargain with adjacent landowners to purchase property likely to contain ore deposits without disclosing this information.¹⁰ If the company's insiders may not, without committing fraud, personally trade securities while relying on information that their company possesses regarding an ore strike, why should the company itself have the right to use this information when buying land from its neighbors? What distinguishes securities fraud from garden-variety fraud, such as fraud in the purchase of real estate?

mistaken); Martha C. Nussbaum, *Still Worthy of Praise*, 111 HARV. L. REV. 1776, 1778 (1998) (contrasting Posner's "sound-bite style of criticism" of philosophical legal arguments to the preferred method of philosophical debate, which demands a "careful reconstruction of an argument's premises before launching a critique"). We wish here only to make clear the limitations of our use of moral principle in this Article. A couple of different approaches are possible, depending on one's jurisprudential and ethical perspective. First, one may say that moral principle matters in the law of insider trading because moral concepts play an essential role in our legal system, and any adequate interpretation of law must come to terms with the law's ethical content. Second, one may make the pluralistic argument that a number of considerations are relevant to legitimate legal interpretation. In the case of insider trading, as we argue here, traditional statutory materials are not sufficient to decide the issue. No statutory definition of "insider trading" is given, and the closest language that we have speaks in general terms of "fraud" from which we begin our analysis. In addition, even if one believes that economic considerations should determine the correct legal result, then a problem arises in insider trading cases given the indeterminacy of the economic evidence (both theoretical and empirical). See *infra* notes 24-25 and accompanying text. Given that insider trading seems intuitively to be wrong, and given that neither traditional legal sources nor economic considerations provide analytical answers to the legal questions raised, ethical theory has a place. The moral theory of insider trading law that we spell out in this Article comports with both of these jurisprudential orientations. We believe readers who embrace legal philosophies that are more practically realistic than the absolutist antimoralism of Posner's most recent work will find our ethical approach to insider trading relevant.

7. 401 F.2d 833 (2d Cir. 1968).

8. *Id.* at 839-42.

9. *Id.* at 848 ("[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned . . .").

10. A "land acquisition program" was the apparent reason why the ore strike was kept confidential. *Id.* at 843-44. For further discussion, see *infra* notes 119-21 and accompanying text.

What if the company purchases its own stock or formally authorizes its corporate insiders to trade on the basis of the undisclosed inside information about the ore strike? According to some theories of insider trading and securities law, it is not clear that this behavior is either immoral or illegal.¹¹ In this Article, we offer a conceptual resolution of these questions.

Puzzles about the concept of fraud in insider trading have become more acute in the aftermath of the Supreme Court's recent decision in *United States v. O'Hagan*.¹² In this case, the Court upheld the conviction of a partner in a law firm for securities fraud when he traded in the stock of the takeover target of his firm's client.¹³ The Court found the partner to have "misappropriated" information "in connection with" trading securities, and he was therefore liable for securities fraud even though he was an "outsider" with respect to the corporation in whose stock he traded.¹⁴ The Court licensed a finding of securities fraud for insider trading even when the partner trading securities did not make an affirmative misrepresentation or wrongful nondisclosure to the person with whom he traded. The wrong seems to be the "misappropriation" of information from the partner's client rather than the advantage the partner takes "in connection with" those with whom he trades. By asserting that the relevant wrong is committed against someone with whom the alleged wrongdoer has not traded securities, *O'Hagan* stretches the concept of fraud beyond any easily identifiable limit.¹⁵

Recognizing such conceptual problems, many commentators declare current insider trading jurisprudence as exhibited by *O'Hagan* to be confused.¹⁶ What explains the theoretical mess? We believe that as

11. In particular, the currently popular economic theory of insider trading law that emphasizes the property rights in information has difficulty handling cases of a company trading in its own stock on the basis of material nonpublic information or authorizing its own insiders to do so. See *infra* note 115 and subpart V(B).

12. 521 U.S. 642 (1997).

13. *Id.* at 646-47.

14. *Id.* at 642-43. Rule 10b-5 provides that securities fraud must occur "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1999). As we discuss more fully below, insider trading under current law covers "outsiders" as well as "insiders" who trade on material, non-public information. See *infra* text accompanying notes 51-59. We use the term "insider trading" generically to refer to both types of traders who wrongfully misuse inside information against investors with whom they trade.

15. *O'Hagan* is discussed *infra* Parts II and III. As intimated in the text, this direction in the law is especially curious given Rule 10b-5's apparently clear requirement that a fraudulent practice must occur "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1999). For further discussion, see *infra* notes 80-88 and accompanying text.

16. See Victor Brudney, *O'Hagan's Problems*, 1997 SUP. CT. REV. 249, 260 (arguing that *O'Hagan* "generates—and obscures—several troublesome questions" in the "tangled jurisprudence" of insider trading); Karmel, *supra* note 4, at 84 (arguing that *O'Hagan* "did not develop a broad doctrine

insider trading law has evolved, courts and commentators have had to face the fact that the traditional concept of fraud is difficult to apply in many insider trading cases. Typical cases involve no overt fraudulent misrepresentation, but rather a failure to disclose information. Traditionally, the law of fraud by nondisclosure imposes a duty to disclose only in a narrow set of circumstances, such as when fiduciary relationships are involved.¹⁷ Courts and commentators have strained to find some kind of fiduciary relationship to be the basis of a duty to disclose in insider trading cases.¹⁸ These efforts have failed because insider trading cases ordinarily involve no breach of a fiduciary duty sufficient to explain the occurrence of fraud. We argue that there are good moral reasons, even in the absence of a fiduciary relationship, to recognize a duty to disclose in certain circumstances when people with material nonpublic information trade with those who lack such information. In this Article, we explain the theoretical basis of a moral and legal duty to disclose material nonpublic information before trading on it in securities markets—and the limits of such a duty.

To this end, we address conceptual questions about fraud in insider trading through the use of an analytical framework we take from ethical theory. We propose a general theory of insider trading that uses moral concepts to specify duties of disclosure owed by those who trade with each

or policy rationale that will assist the lower courts in distinguishing between lawful and unlawful outsider trading"); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 155 (1998) (referring to *O'Hagan* as "a confusing opinion that left many questions unresolved"); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999) (arguing that *O'Hagan* "underscores the astonishingly dysfunctional nature of the current insider trading regime"); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 125 (1998) (arguing that *O'Hagan's* approach has "serious problems" that "leave[] the way open to further confusion and an unpredictable expansion of insider trading liability"); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1160 (1997) (stating that "the Court's decision [in *O'Hagan*] represents a valuable opportunity lost, leaving important old questions unanswered, creating troublesome new issues for future consideration, and advancing policy rationales not consistent with the holding"); see also *supra* note 4. But see Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1, 1-2 (1998) (arguing that the "haiku-like references" in *O'Hagan* may be read as providing "a relatively clear synthesis of insider trading law"); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 397-98 (1998) (claiming that *O'Hagan* "effectively resolved" important tensions in the Court's precedents).

17. See, e.g., W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEXAS L. REV. 1, 11-14 (1936) (discussing situations in which nondisclosure constitutes fraud).

18. See, e.g., Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984) (arguing that when insider trading occurs, a fiduciary duty is ordinarily breached, though this duty will not always be owed to a person involved in a securities transaction); see also *infra* Parts II and III (discussing critically various judicial theories of insider trading law).

other in public securities markets. We agree with the criticisms of some defenses of insider trading law on general grounds of "fairness" as too imprecise.¹⁹ We respond to these criticisms by offering a more sustained analysis of the moral principles that underlie insider trading law than has previously been given. Our analysis provides a more precise understanding of what exactly is unfair about trading on inside information. We rely on the standard deontological view that what makes an act morally justifiable is the respect it expresses for the autonomy, rights, and dignity of those persons affected by it, and not merely the social welfare or the utility that the act produces.²⁰

19. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 254-55, 261-62 (1991) (asserting that proponents of the "fairness" argument against insider trading inappropriately concentrate on extreme episodes of insider trading and mischaracterize the factual justifications for the disparate treatment of managers and stockholders); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323-30 (criticizing the typical fairness argument for its lack of content).

20. See ALAN DONAGAN, *THE THEORY OF MORALITY* 17-31 (1977) (noting that deontological moral theory is based on the inherent rationality of all persons and the idea that by doing wrong the actor acts against his own rationality); IMMANUEL KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* 17, 46-51 (Lewis White Beck trans., Bobbs-Merrill 1959) (1785) (arguing that rational beings must always be treated as ends in themselves and never as a mere means to an end); F.M. Kamm, *Nonconsequentialism, the Person as an End-in-Itself, and the Significance of Status*, 21 PHIL. & PUB. AFFAIRS 354 (1992) (asserting that as ends-in-themselves, persons are valuable regardless of their utility, and respecting this principle may mean sacrificing the maximization of utility); Alan Strudler & David Wasserman, *The First Dogma of Deontology: The Doctrine of Doing and Allowing and the Notion of Say*, 80 PHIL. STUD. 51 (1995) (arguing that the moral distinction between doing and allowing within deontological moral theory serves to undergird respect for autonomous choice).

Classic examples of deontological claims include the following: (1) As the judge presiding over a trial in a small racist town, you realize that an angry mob will lynch several innocent people unless the mob's passions are quelled by a conviction in your trial. An innocent person is being tried, and it would be socially beneficial to have a scapegoat. You know that the defendant is innocent and that the real perpetrator cannot be found. Even if convicting the innocent person would prevent a murderous riot, the conviction would be unequivocally wrong on a deontological account, no matter how great the social benefits. See DONAGAN, *supra*, at 203-04. (2) Legislation is proposed to allow one or more persons to be involuntarily killed in order to use various of their organs in surgical transplants to keep many more people alive. The immorality of this policy does not depend on a comparison of lives lost or some other calculation of social utility. Intentionally killing a person to redistribute organs to others is wrong because it violates a basic duty owed to fellow human beings. See CHARLES FRIED, *RIGHT AND WRONG* 139-41 (1978) (asserting that a person's "moral entitlement to her bodily integrity" outweighs the need of the prospective organ recipients, even if the redistribution takes place pursuant to some "fair scheme"). (3) Subjecting a small minority of people in a society to serve as slaves—even if they voluntarily consent as adults—cannot be justified by a calculation of the possible increase of happiness or utility of the majority of people in the society. Slavery is wrong not because it is assumed to decrease aggregate happiness, pleasure, or utility, but because it violates a basic moral principle of human dignity. See JOHN RAWLS, *A THEORY OF JUSTICE* 152-57 (1971) (explaining that in "the original position" it would be irrational for individuals to assent to a system in which the worst possible outcome was intolerable to them); see also LEO KATZ, *ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES OF THE LAW* 185-88 (1996) (giving deontological examples in arguing against the morality of insider trading).

For the purposes of this Article, we identify utilitarianism as the main normative alternative to deontological theory. We do so for two reasons. First, proponents of economic analysis, the dominant

We argue in particular that insider trading law protects the autonomy of public securities traders from unfair and wrongful deception. We maintain that a deontological theory of insider trading specifies a relevant set of circumstances when such unfair and wrongful deception occurs.

Much of the scholarly debate about insider trading among economists and lawyers has focused on whether insider trading is economically harmful and whether its prohibition is therefore socially beneficial.²¹ Distinguished scholars in law and economics disagree fervently about the economic costs and benefits of insider trading rules. Some argue for the legalization of insider trading because they believe such trading would provide an appropriate form of corporate executive compensation and improve allocative efficiency by transferring important information quickly to the securities markets.²² Others respond that an insider trading prohibition protects investors, supports investor confidence in the securities markets, and encourages productive decision making within firms.²³ This

approach to insider trading, often regard utilitarianism as the moral foundation of economic analysis. See JEFFRIE G. MURPHY & JULES L. COLEMAN, *THE PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE* 264 (1984) (observing that law-and-economics scholars attempt to justify their prescriptions by arguing that they promote social utility). Second, utilitarianism has historically been perceived as the strongest competitor to deontology. See FLETCHER, *supra* note 6, at 152 (describing utilitarianism and Kantian deontology as having "dominated moral and legal philosophy for the last two hundred years"); SHELLY KAGAN, *NORMATIVE ETHICS* 70-105 (1988) (surveying normative ethical theory). Because of considerations of space, we have had to make some editorial choices about moral theories we discuss and to omit discussions of theories other than deontology and utilitarianism. We intend no slight to virtue ethics, moral development theory, social contract theory, or any of the other moral theories we do not discuss.

21. For an analysis of insider trading that includes a component rooted in moral theory, but that emphasizes a social rather than an individual perspective, see Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992) (rejecting the misappropriation theory).

22. See, e.g., STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 127-39 (1999); EASTERBROOK & FISCHER, *supra* note 19, at 256-59; HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* vii-viii, 80-90, 110, 116-19 (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861-72 (1983). But see WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 2.2, at 14-29 (1996 & Supp. 1999) (casting doubt on these economic arguments); John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y. L.J., July 31, 1997, at 5 (arguing that insider trading creates less efficient markets); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 629-34 (1984) (claiming that insider trading without disclosure distorts informational efficiency of markets); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1442-57 (1967) (arguing that no empirical evidence supports Manne's economic arguments in favor of insider trading).

23. See, e.g., WANG & STEINBERG, *supra* note 22, § 2.3, at 29-39; see also BAINBRIDGE, *supra* note 22, at 149-69 (reviewing economic arguments that insider trading injures investors and issuers and violates established property rights); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1053-67 (1982) (arguing that insider trading law enhances the "internal efficiency" of corporate enterprises); Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 477-78 (1969) (arguing that

debate, however, is notoriously inconclusive.²⁴ A primary reason for continuing disagreement is the immense empirical difficulty in trying to ascertain the economic efficiency of particular legal rules in a world in which securities markets have become very large and complex.²⁵

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.

We do not say that economics is unimportant. On the contrary, ethics and economics seem strongly linked in securities regulation.²⁶ Before arguing about economic costs and benefits, however, we maintain that a threshold issue should be addressed: whether the acts proscribed as insider trading are morally wrong. Even if economic arguments conclusively favored unfettered insider trading, moral arguments would potentially give an independent reason for prohibiting insider trading to "satisfy such noneconomic goals as fairness, just rewards, and integrity."²⁷ Most

insider trading increases the cost of capital for firms known to engage in it); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) (stating that the "primary policy reason" for insider trading law is "to make investors confident" and "guarantee the integrity of the market"). Cf. SEC v. Anar, 15 F. Supp. 2d 477, 481 (D.N.J. 1998) ("There is perhaps no more insidious drain on the overall welfare of society than greed unchecked.").

24. See, e.g., WANG & STEINBERG, *supra* note 22, § 2.4, at 39 (concluding that "the supposed beneficial and harmful effects of insider trading on society are quite speculative"); Stephen M. Bainbridge, *Insider Trading*, in *ENCYCLOPEDIA OF LAW & ECONOMICS* (forthcoming) (manuscript at 2-3, on file with authors) ("Most observers of the literature likely would conclude that neither side has carried the field"); Cox, *supra* note 4, at 635-55 (finding economic arguments on both sides to be unpersuasive); Easterbrook, *supra* note 19, at 338 (arguing that economic-based arguments are "closely balanced" because some cases of insider trading are "unambiguously detrimental" to shareholders, other cases "unambiguously beneficial," and still others "difficult to judge"); Haft, *supra* note 23, at 1053 (describing arguments for and against insider trading as "hotly debated" but concluding that none have "achieved universal acclaim").

25. See Cox, *supra* note 4, at 654 ("Unfortunately, it is not . . . easy to estimate the costs and benefits of insider trading, for the problem of quantification is substantial."); Easterbrook, *supra* note 19, at 338 (finding that "the questions ultimately are empirical"); see also Peter M. DeMarzo et al., *The Optimal Enforcement of Insider Trading Regulations*, 106 J. POL. ECON. 602, 603 (1998) (arguing that previous economic analysis has not taken account of enforcement costs).

26. Securities markets may most effectively advance economic goals when trading occurs in an ethical climate. For example, the economic arguments in favor of insider trading law that rely on arguments about promoting investor confidence depend in part on an assumption that investors are more likely to invest funds in markets that are felt generally to be ethical or fair. See *supra* note 23 and accompanying text.

27. Schotland, *supra* note 22, at 1439.

courts and commentators, along with Congress, the SEC, and the general public, "share the intuition that—regardless of the economic consequences—it is simply unfair for those with inside information to trade" on it.²⁸ Our goal in this article is to provide a solid analytical foundation for this widely shared moral intuition.

In adopting a deontological approach to the law of insider trading, our method is both radical and conservative. It is radical compared with many previous attempts to justify insider trading law because most of these theories rely on corporate law concepts such as fiduciary duty or economic analysis to cabin the scope of insider trading liability.²⁹ We go back to the roots of fraud to find a fundamental justification for the law against insider trading. Our method is also conservative, however, because we offer a justification for what we believe are the correct results reached by the most important Supreme Court insider trading cases, including *Carpenter v. United States*,³⁰ *Dirks v. SEC*,³¹ and *United States v. O'Hagan*.³² We argue that our theory succeeds in situations where the Court's own account fails to give a coherent and persuasive rationale.

Our analysis makes a few assumptions. We assume the applicability of common terms and standards adopted by the courts, including an understanding of insider trading as involving "material nonpublic" information³³ and "scienter" of the party accused of fraud.³⁴ These

28. Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 308 (1998); see also *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (Blackmun, J., dissenting) (criticizing the majority opinion for downplaying the "inherent unfairness" argument against insider trading); *United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987) (referring to the "fundamental unfairness" of insider trading); Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123, 150-68 (developing a contractarian ethical theory of the unfairness of insider trading).

29. See *supra* notes 18, 22-25 and accompanying text. For an argument in favor of limiting federal insider trading law to violations of fiduciary duties, see M. Breen Haire, Note, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251, 1253-54, 1289 (1998).

30. 484 U.S. 19 (1987).

31. 463 U.S. 646 (1983).

32. 521 U.S. 642 (1997).

33. Materiality is required for proof of federal securities fraud, including Rule 10b-5 insider trading cases. The test is whether "there is a substantial likelihood that a reasonable shareholder would consider [the undisclosed] information important" in making a decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); see also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (stating that materiality balances the "probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity"); *SEC v. Hoover*, 903 F. Supp. 1135, 1148 (S.D. Tex. 1995) (discussing the *Basic* materiality standard adopted in Rule 10b-5 insider trading cases). Insider trading also necessarily involves trading on "nonpublic" information. Cf. Rule 14e-3, 17 C.F.R. § 240.14e-3 (1999) (prohibiting trading on the basis of "material nonpublic information" about a tender offer). See also *Lampf v. Gilbertson*, 501 U.S. 350, 361 (1991) (defining insider

elements suggest the usefulness of an ethical rather than an economic analysis of insider trading, but we do not develop these concepts further in this Article.³⁵ "Causation" in securities fraud is another important element established by the courts that we do not develop here, though the concept seems to have important moral implications.³⁶ Neither do we enter the important debate about whether wrongful insider trading should be punished with criminal as well as civil penalties.³⁷

Our Article proceeds as follows. In Part I, we examine the implications of a constraint imposed by a deontological approach to insider trading law: the requirement of a wrong to a victim. In Parts II and III, we analyze the two leading theories that support insider trading liability in Rule 10b-5 cases, which the Supreme Court calls the "traditional theory" and the more recently developed "misappropriation theory."³⁸ In Part II,

trading as "purchasing or selling a security while in possession of material, nonpublic information"). Effective public disclosure of inside information eliminates the potential for the wrong. See, e.g., *Texas Gulf Sulphur*, 401 F.2d at 853-54.

34. *Scienter*, in the form of either intent or recklessness, is a required element of proof in federal securities fraud. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1985) (defining *scienter* as referring to "a mental state embracing intent to deceive, manipulate, or defraud"). Rule 10b-5 insider trading cases are no exception. See *In re Time Warner Inc. Securities Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) (stating that *scienter* is a "necessary element of every 10b-5 action"); WANG & STEINBERG, *supra* note 22, § 4.4 (collecting cases). Most appellate courts have adopted a "recklessness" standard. See WANG & STEINBERG, *supra* note 22, § 4.4.2, at 168.

35. Materiality is probably best understood as a moral limitation on insider trading liability because it addresses the issue of whether particular information is important enough to actually cause a wrong if it is traded on without disclosure. *Scienter* requires a culpable mental state, and culpability is a transparently moral concept. In this Article, however, we adopt the traditional legal understandings of materiality and *scienter* without entering into a discussion of the complex set of ethical and legal issues that these elements raise.

36. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1100 (1991) (requiring causation in private actions alleging securities fraud for proxy misrepresentation). An unresolved issue in Rule 10b-5 insider trading cases is whether liability requires proof of actual "use" or mere "possession" of inside information when trading. Compare *United States v. Teicher*, 987 F.2d 112, 119-21 (2d Cir. 1993) (arguing that "knowing possession" without a "causal connection" between possession and use is sufficient for insider trading liability), with *United States v. Smith*, 155 F.3d 1051, 1066-69 (9th Cir. 1998) (holding that "use" of inside information as well as "possession" must be proven). Compare also DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION* § 3.04, at 3-23 to 3-24 (1996), and 7 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3504-05 (3d ed. 1991) (both arguing in favor of a "possession" rule), with ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 7.4, at 610, 620, 621 (2d ed. 1996) (arguing for "nonuse" of inside information as an "affirmative defense") and Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235, 1237-38, 1242-78 (1997) (arguing for a use and causation requirement for liability).

37. For a discussion on that debate, see, e.g., Fisch, *supra* note 4, at 237-38, 51 (arguing on moral grounds that criminal penalties for insider trading should be "reconsidered" and preferring "civil disgorgement"); see also John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875 (1992) (arguing against current tendency toward "overcriminalization" in white collar crime and that criminal prosecutions should, at the least, require a higher standard of *scienter* than applied in civil cases).

38. *United States v. O'Hagan*, 521 U.S. 642, 651-53 (1997) (distinguishing between the "'traditional' or 'classical theory' of insider trading liability" and the "misappropriation theory").

we discuss the traditional theory that relies on a breach of fiduciary duties as the touchstone of insider trading liability and argue that this theory is deeply flawed. In Part III, we discuss the misappropriation theory and distinguish between two versions of the theory, which we call "fraud-on-the-investor" and "fraud-on-the-source." Although we agree with the result that the Supreme Court reaches in *O'Hagan*, we argue that the fraud-on-the-source misappropriation theory which the Court advances cannot identify a relevant victim of a wrong to support a claim of securities fraud. In part for this reason, *O'Hagan* provides neither a satisfactory theory of insider trading nor a sufficient guide for future cases.

In Part IV, we show that our theory, based on a deontological "equitable disclosure rationale," justifies a fraud-on-the-investor approach that resolves some problems and inconsistencies found in previously advanced theories of insider trading. We distinguish two rival justifications for insider trading law that have previously been put forward: an "equal information rationale" and an "illicit acquisition rationale." We find significant problems with each of them and suggest instead an "equitable disclosure rationale," which supports our fraud-on-the-investor theory with moral arguments that emphasize respect for autonomy and concern about fairness.³⁹ On our theory, one has a duty under the law of fraud to refrain from trading securities on the basis of material nonpublic information without effectively disclosing the information *unless* one has a superior equitable right to the information which may derive from intelligent analysis, skillful observation, or even luck.

In Part V, we show how our fraud-on-the-investor theory can justify the major insider trading decisions of the Supreme Court. We also demonstrate that our theory of insider trading has some important conceptual advantages. First, our approach gives theoretical guidance in deciding hard cases of insider trading on material nonpublic information acquired by "moral luck."⁴⁰ Second, we develop a novel analysis of some leading cases which we believe are best understood as involving the "frontrunning" or "self-frontrunning" of investors in securities markets. These cases involve situations in which a financial adviser trades in advance of information given to its clients,⁴¹ a reporter trades on information contained in a news story in advance of its publication,⁴² a judicial clerk trades on

39. Cf. David Chamy, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1823-40 (1991) (discussing principles of autonomy and fairness as justifications and methods of construction in contract law).

40. For a collection of philosophical essays on this topic, see MORAL LUCK: PHILOSOPHICAL PAPERS (Daniel Statman ed., 1993). For example, we describe *Dirks v. SEC*, 463 U.S. 646 (1983), in these terms. See *infra* subpart V(A).

41. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

42. See *Carpenter v. United States*, 484 U.S. 19 (1987); *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993).

information about an important court decision before it is announced,⁴³ or a corporation trades in its own shares or authorizes its directors, officers, or employees to do so without prior disclosure of material nonpublic information.

I. The Deontological Requirement of a Wronged Victim

Deontological moral theory imposes a simple but severe constraint on a system of justice. It requires that ordinarily a person may be penalized for an act only when that act involves committing a wrong against someone. If nobody is wronged, if there is no victim, then ordinarily no actionable offense occurs.⁴⁴

43. See *Chiarella v. United States*, 445 U.S. 222, 242 n.3 (1980) (Burger, C.J., dissenting). For a recent thriller based on the hypothetical of a Supreme Court clerk getting tricked into disclosing inside information to a person posing as a former clerk, see BRAD MELTZER, *THE TENTH JUSTICE* (1997).

44. For a discussion of the importance of the victim in retributive justice, see Jean Hampton, *Correcting Harms Versus Righting Wrongs: The Goal of Retribution*, 39 UCLA L. REV. 1659 (1992) (arguing that retribution is justified when wrongful conduct results in a "moral injury"—an injury that harms the "acknowledgement and realization of the value of the victim"); Alan Strudler, *Mass Torts and Moral Principles*, 11 LAW & PHIL. 297, 315-21 (1992) (arguing on deontological grounds that an essential point of imposing harsh treatment in law, whether in criminal or tort law, is to restore a victim's moral status as inviolable, and that unless this point is respected, law wrongly compromises the dignity of those it affects). We will not take up the issue of whether there exists a peculiar class of wrongs that involves no victims, i.e., so-called pure moral offenses such as incest or sodomy between consenting adults. See generally JOEL FEINBERG, *HARMLESS WRONGDOING* (1990) (assessing the possibility of wrongs without victims and wrongs without harms). Such wrongs, if they exist, are the exception rather than the rule, and they bear little resemblance to our target: the wrong that occurs in securities fraud. Unlike so-called pure moral offenses, securities fraud involves a person attempting to take advantage of others. We think it is important to ask who is the victim of such fraud.

Kant's position on the necessity of a victim for a moral wrong is complex and perhaps even confounded. On occasion, he makes remarks which seem to indicate that no victim is required for a moral wrong. For example, in his essay, *On a Supposed Right to Lie Because of Philanthropic Concerns*, Kant examines the ethics of telling a lie to a person up to no good. Kant's analysis:

[A]lthough by telling a certain lie I in fact do not wrong anyone, I nevertheless violate the principle of right in regard to all unavoidably necessary statements generally (i.e. the principle of right is thereby wronged formally, though not materially). This is much worse than committing an injustice against some individual person, inasmuch as such a deed does not always presuppose that there is in the subject a principle for such an act.

IMMANUEL KANT, *ETHICAL PHILOSOPHY* 166 (James W. Ellington trans., 1994) (1785). In these remarks, Kant apparently says that sometimes a deceptive act may be wrong because it violates an abstract moral principle and not because it wrongs some individual. Should Kant therefore be regarded as denying the necessity of a victim in wrongdoing? We think not. Before considering our explanation, consider why the explanation is difficult.

Kant's moral theory contains two candidates for the status of a fundamental moral principle: the principle of universalizability and the respect-for-persons principle. The universalizability principle provides, roughly, that an action is wrong for an agent when she cannot will a maxim prescribing the action as a universal law. See CHRISTINE M. KORSGAARD, *CREATING THE KINGDOM OF ENDS* 140-46 (1996). The respect-for-persons principle provides, on the other hand, that an action is wrong when committing it involves treating a person as a mere means rather than an end. *Id.* Kant's quoted remark is best construed as an application of the principle of universalizability; the principle of universalizability does not rely on the idea of a victim in any obvious way. As the distinguished Kant scholar, Christine Korsgaard, plausibly argues, it is the respect-for-persons principle (which she calls the

This deontological constraint of a wronged victim suggests a moral limit to the expanding scope of insider trading law.⁴⁵ Our strategy will be to examine the leading Supreme Court cases on insider trading with a view to identifying the underlying moral principle on which the cases may be said to rest. We show that the Court has embraced a variety of very different theories of insider trading at different times and in different cases. Scrutiny of these theories reveals that they are driven by rival moral principles. Selecting among these principles advances the task of constructing a coherent jurisprudence of insider trading. This task requires both (1) an analysis of the normative principles that the Court uses in its various legal theories of insider trading, and (2) an investigation of the connection between legal principles employed by the Court in insider trading cases and defensible moral principles.

We do not, of course, contend that the Court has self-consciously crafted deontological moral explanations for its decisions. The Court states the principles it employs in non-philosophical, commonsense terms. We suggest instead that the power and coherence of these principles are augmented by identifying the most persuasive rationale to explain the Court's insider trading cases.⁴⁶

II. The Traditional Theory: Corporate Fiduciary Duty

What the Supreme Court calls the "traditional theory" of insider trading under Rule 10b-5 identifies the relevant wrong in insider trading as a violation of a fiduciary duty owed by a corporate director, officer, or employee to the corporate insider's principal, namely, the corporation or

Formula of Humanity), and not the universalizability principle (which she calls the Formula of Universal Law), that best explains the wrongness in wrongful deception. *Id.*

Moreover, because the respect-for-persons principle analyzes a wrong as a particular morally problematic way of treating a person, it always requires a victim. On the most plausible rational reconstruction of Kantian deontology, we believe that the role of the victim is essential in most wrongful actions. How, then, should one understand the import of the passage from Kant we quote? We agree with Sally Sedgwick that it forms part of an unartfully expressed and overstated dialectical response to Kant's intellectual foe, Benjamin Constant. See Sally Sedgwick, *On Lying and the Role of Content in Kant's Ethics*, 82 KANT-STUDIEN 42 (1991). The debate between Kant and Constant, though important in other contexts, is not worth exploring here. For our purposes, what matters is that Kant insists on the truth and generality of the respect-for-persons principle, and that principle analyzes a wrong in a way that presupposes the existence of a victim.

45. Katz also recognizes the deontological necessity for wrong to a victim in insider trading law. See KATZ, *supra* note 20, at 171.

46. This methodology combines philosophical analysis with the reality of legal doctrine. Cf. Scott Brewer, *Scientific Expert Testimony and Intellectual Due Process*, 107 YALE L.J. 1535, 1541 (1998) ("There is an important heuristic relation between . . . abstract philosophical analysis . . . and the rather concrete analysis of doctrine: Each keeps the other intellectually honest. Philosophical analysis without detailed facts is blind; recitation of detailed facts without philosophical analysis is ignorant.").

its shareholders.⁴⁷ The traditional theory can be summarized as the following principle:

Insider trading is wrong because whenever it occurs, the inside trader breaches fiduciary duties owed to the trader's principal, namely, the corporation or the corporate shareholder with whom he engages in a securities transaction. By trading without disclosing material nonpublic information to the principal, the insider violates a duty owed to the principal corporation or its shareholders.

Under the traditional theory, the person one harms and the person to whom one owes a duty are one and the same. We maintain that the traditional theory fails for at least two reasons. It does not coherently identify relevant victims for many of the most important insider trading offenses, and it does not adequately explain the nature and scope of the duties it invokes.

From a deontological perspective, a strength of the traditional theory is the clarity with which it identifies at least some victims who are wronged by insider trading. For example, suppose that Ethel is an officer of Acme, Inc. She knows that her firm is about to release a very profitable product that will improve Acme's stock price, but neither the public nor Acme's shareholders know about the forthcoming product. Nonetheless, Ethel purchases shares of her company through an over-the-counter exchange, and these shares happen to have been owned by Fred. Under the traditional theory, because Fred owns stock in Acme, and Ethel stands in a fiduciary relation to Acme, Ethel stands in a fiduciary relation to Fred. As a fiduciary to the corporation and derivatively to Fred, Ethel cannot engage in a securities transaction with Fred unless she discloses all information that Fred may reasonably deem relevant to the transaction.⁴⁸ If Ethel does not disclose what she knows about the new product, she commits insider trading punishable as securities fraud. On the traditional theory, an insider who trades in the stock of the insider's corporation occupies a fiduciary relation with the person on the other side of the transaction. This fiduciary relation creates a duty to disclose before trading. If a transaction occurs without prior disclosure, it is fraud. The identity of the victim and

47. See *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997). See also Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 343, 347-48 (1979) (describing "corporate insiders" to include "directors, officers, and executive employees" and describing "tippees" who gain access to the same information). Nonexecutive employees have also been held to owe fiduciary duties sufficient to support liability for insider trading. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 843, 852 (2d Cir. 1968) (holding geologist employees liable for insider trading).

48. Whether it would be reasonable for Fred to deem the information relevant to his decision implicates the materiality requirement for securities fraud. See *supra* note 33 (describing the test for materiality).

the wrongness of Ethel's act are logically linked—the victim is the seller of stock, Fred, who is directly harmed, or at least put at risk, by Ethel's act, and what makes Ethel's act wrong must be understood in terms of what she does to this victim.

As other scholars have observed, the traditional theory fails to explain why the fiduciary duty concept borrowed from the law of agency and corporations should be applied in the context of securities trading.⁴⁹ It is not self-evident that corporate insiders should be regarded as standing in a fiduciary relationship to shareholders when trading stock. In fact, the traditional theory relies on an incorrect legal assumption. Technically, corporate directors, officers, and employees do not owe fiduciary duties to shareholders but rather to the corporation as a legal entity.⁵⁰ But the problems with the traditional theory run deeper. Even if the theory's reliance on the fiduciary concept borrowed from state law could be defended, it would not suffice to vindicate this theory as a basis for existing insider trading law.

The traditional theory cannot account for all of the relevant cases that the Supreme Court recognizes as insider trading. Traditional theory was devised to handle a distinctive category of securities fraud, namely, "insider trading" understood as fraud committed by people who are corporate insiders, including directors, officers, and employees who owe fiduciary duties to a corporation and its stockholders. The problem is that the Supreme Court has recognized that "outsider trading" on material nonpublic information by people who are neither insiders nor tippees may also count as federal securities fraud.⁵¹ A simple but notorious example of outsider trading is *Carpenter v. United States*.⁵² In *Carpenter*, R. Foster Winans, a reporter for the *Wall Street Journal*, traded on information that would appear in his forthcoming columns containing stock market gossip.⁵³ When he did so, he acted in contravention of the *Wall Street Journal's* employment policy.⁵⁴ He therefore used information that he stole from his employer. But notice that Winans's "inside information" did not come from the firms in whose stock he traded. He was an outsider

49. See, e.g., EASTERBROOK & FISCHER, *supra* note 19, at 269 (describing the use of fiduciary duty to distinguish insiders from outsiders as "questionable" and "not a useful line" of thought).

50. Shareholders may enforce corporate fiduciary duties under state corporate law, but they do so derivatively on behalf of the corporation. See, e.g., Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 310 n.241 (1998).

51. Perhaps the first to recognize the distinction between insider and outsider trading was Victor Brudney. See Brudney, *supra* note 47, at 339-47. As discussed *infra* subpart V(B), we describe these outsider trading cases as a type of frontrunning or "scalping," which Brudney also sees as problematic. See *id.* at 368-71.

52. 484 U.S. 19 (1987).

53. *Id.* at 23.

54. *Id.*

to those firms, and thus owed no fiduciary duty to them. Thus, the traditional theory, which rests on the borrowed concept of fiduciary duty, cannot explain the wrongness of his action.⁵⁵

*United States v. O'Hagan*⁵⁶ presents another case of outsider trading. In *O'Hagan*, the defendant, James O'Hagan, was a partner in a law firm representing Grand Metropolitan PLC, which planned to make a tender offer for Pillsbury Company. After learning of the prospective tender offer, O'Hagan bought Pillsbury stock and call options resulting in profits of more than \$4.3 million.⁵⁷ O'Hagan was neither a corporate insider at Pillsbury nor the beneficiary of a tip from such an insider. He was an outsider with respect to Pillsbury. If he committed securities fraud, it was not insider trading, but outsider trading. Had O'Hagan used his stolen information to purchase stock in Grand Metropolitan and not Pillsbury, his action would have neatly fit the traditional conception of insider trading, and he would have been liable under the traditional theory.⁵⁸ But he did not. The Court nevertheless argued that it would be nonsensical to proceed against someone like O'Hagan for trading on information stolen from his client only when that information is about the client, but not when it is about the target of the client's activity.⁵⁹ The Court found, and we agree, that the traditional theory is inadequate to cover outsider trading.⁶⁰

Ironically, the traditional theory also fails to account for a vast number of insider trading cases that involve no outsiders. Suppose that a corporate insider possessing material nonpublic information about his company sells shares to a person who is not yet a stockholder of the insider's firm. Because the prospective purchaser of stock had no relationship with the firm before the transaction, the corporate insider violates no corporate fiduciary duty.⁶¹ Hence this is a case of wrongful insider trading that

55. One might argue that Winans is an "insider" with respect to the *Wall Street Journal* and that the wrong of stealing the information supports a finding of insider trading. We address this version of "fraud-on-the-source" misappropriation theory in greater detail *infra* subpart III(B). A significant conceptual problem with this theory is that even though it convincingly identifies exploiting misappropriated information as a wrong, it cannot explain why that wrong amounts to fraud.

56. 521 U.S. 642 (1997).

57. *Id.* at 648.

58. Even though O'Hagan did not personally work on the Grand Metropolitan matter, partners in his firm did. *Id.* at 647. Therefore, if he had traded in Grand Metropolitan's stock O'Hagan would have arguably qualified as a temporary insider under the traditional theory. See also *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (noting that when information is legitimately revealed to an outsider, the outsider may become a fiduciary of the corporation and its shareholders).

59. *O'Hagan*, 521 U.S. at 659 (stating that "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").

60. See *id.* at 665-66 (embracing misappropriation theory rather than traditional theory as the basis for the majority opinion).

61. See BAINBRIDGE, *supra* note 22, at 9 n.6; Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, HOFSTRA L. REV. 341, 356 (1982) (highlighting the shortcomings of traditional theory in cases where the insider trading involves prospective shareholders); A.C. Pritchard, *United States v.*

involves no breach of a fiduciary duty.⁶² One might respond to this problem by suggesting that the prospective shareholder will soon be a real shareholder, and it is therefore fair to extend the company's fiduciary obligations to soon-to-be-shareholders.⁶³ But this extension would be an evasion. Until the sale of securities is completed, the company stands in no fiduciary relation to a prospective purchaser of stock who does not yet own stock. The prospective purchaser is a stranger to the company, and no fiduciary duties are owed to strangers. Although we agree that it would be unfair to allow trading on inside information against strangers to the company in these circumstances, the traditional theory cannot adequately explain the nature of this unfairness.

Finally, the traditional theory cannot easily handle insider trading in publicly traded bonds rather than stock. Because the traditional theory presumes a fiduciary relationship, and because creditors, such as bondholders, ordinarily are not considered to have enforceable fiduciary duty claims against a corporation, the traditional theory leaves creditors unprotected from insiders who trade in public debt.⁶⁴ The traditional theory gives no sound reason for making a distinction between insider trading in public debt and insider trading in stock. Because the roles of debt, equity, and hybrid debt-equity instruments in the capital structure of the firm are to a significant extent interchangeable, and because various kinds of debt qualify as "securities" subject to federal law, there seems to be no relevant difference between stock and public debt for purposes of insider trading law.⁶⁵ Because firms finance themselves through issuing

O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 26 (1998) (criticizing "classical theory" for failing to resolve insider trading cases involving prospective shareholders). A similar problem is raised by the purchase or sale of stock options to "incipient shareholders." See Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 41-42 (1982) (arguing that stock options present another challenge to traditional theory due to the difficulty of establishing a fiduciary duty with a prospective buyer).

62. For a case supporting the proposition that a corporate insider has no fiduciary relationship with the firm regarding prospective shareholders, see *Marhart, Inc. v. Calmat Co.*, No. 11820, 1992 WL 212587, at *1 (Del. Ch. Aug. 19, 1992) (holding that "fiduciary duties run to stockholders, not prospective shareholders").

63. See *Chiarella v. United States*, 445 U.S. 222, 227 n.8 (1980) (Burger, C.J., dissenting).

64. See BAINBRIDGE, *supra* note 22, at 90 (noting that the traditional theory requiring a fiduciary relationship is "especially problematic" in cases of "insider trading of debt securities" because of the usual rule that corporate fiduciary duties are not owed to debt-holders); see also Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1175 (1990) (explaining that bondholders have been dealt with in the traditional manner of creditors, with the law assuming arm's-length dealings between them and the corporation, and limiting creditors to the terms of their contract for their remedies); Orts, *supra* note 50, at 306-08, 323-35 (discussing the general rule that creditors have no extra-contractual protection against a corporation and exceptions to it).

65. See Orts, *supra* note 50, at 306-09; see also Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1738-39 (1992) (arguing on economic grounds that insider trading law should not distinguish between equity and high-yield public debt).

public debt as well as equity, both of which are often traded in securities markets, a formal legal distinction between debt and equity in insider trading law does not make sense.⁶⁶

It appears, then, that the fiduciary duties emphasized by the traditional theory cannot support the duties to disclose of all people who engage in wrongful insider or outsider trading. There are at least three possible responses. First, one might declare the cases of tippees, prospective shareholders, outsiders, and public bondholders beyond the scope of insider trading. But this approach would condone much behavior that has been recognized by courts and commentators to be wrongful. Second, one might expand the set of fiduciary relations relevant to finding duties to disclose. This is the approach adopted by "fraud-on-the-source" misappropriation theory.⁶⁷ Third, one might declare that a duty to disclose may exist even in the absence of a fiduciary relation. This is a version of "fraud-on-the-investor" theory.⁶⁸ In Part III we explain how different proponents of misappropriation theory embrace each of these latter two responses, and we investigate the pitfalls attending them.

III. Two Judicial Versions of the Misappropriation Theory

Dissatisfaction with the traditional theory of insider trading under Rule 10b-5 has led to the emergence of the misappropriation theory, which expands the categories of insider trading law. "Misappropriation" refers to the theft or otherwise improper use of information belonging to another for the purpose of securities trading.⁶⁹ There are two different types of misappropriation theory: fraud-on-the-investor and fraud-on-the-source. Both versions of misappropriation theory identify a broad class of insider and outsider traders as wrongdoers. Both also have difficulty in explaining the nature and scope of the wrong that insider and outsider traders commit.

Although the theory of insider trading we propose in Part IV of this Article does not expressly address insider trading in bonds, the fact that our theory does not rely on the idea of a fiduciary duty indicates that it is at least consistent with liability for insider trading in publicly traded bonds. This is an advantage that our theory holds over the traditional theory.

66. An exception may apply to face-to-face debt transactions between corporate insiders negotiating on behalf of a corporation with large banks or other institutional creditors. In these situations, there is no obligation to disclose material nonpublic corporate information to sophisticated creditors who may negotiate for any needed representations or disclosure. Nondisclosure of inside information in these circumstances would be in the corporate interest. Our argument is only that insider trading liability under the same criteria as applied to trading in publicly held stock should extend to publicly held debt that qualifies as a "security."

67. See *infra* subpart III(B).

68. See *infra* subpart III(A).

69. In addition, we argue that insider trading liability should extend to the misuse of one's own information for securities trading in cases of what we call "frontrunning" and "self-frontrunning." See *infra* subpart V(B).

A. *Fraud-on-the-Investor Misappropriation Theory*

"Fraud-on-the-investor misappropriation theory" is the name that we use to identify the first version of misappropriation theory to be taken seriously in the Supreme Court. Chief Justice Burger offered this theory in his dissenting opinion in *Chiarella* to fill the normative gap left by the traditional theory.⁷⁰ It purports to explain how corporate outsiders like Winans and O'Hagan are properly found to have committed securities fraud.

In *Chiarella*, a financial printer divined the true identity of five companies who were takeover targets of a client bidder. The printer purchased stock in the target companies and made about thirty thousand dollars in profits over fourteen months.⁷¹ From a moral point of view, *Chiarella's* act appears to be no better than an act of insider trading in which a corporate executive trades on information regarding his or her own firm. If the CEO of a takeover target company in *Chiarella* had purchased stock in the target company for the CEO's own personal account, the CEO would have violated a corporate fiduciary duty to the company and committed insider trading under the traditional theory. Trading on material nonpublic information about an impending takeover for one's own self-interest seems to be morally problematic behavior—both the CEO and the printer are taking advantage of the identical information. But according to the majority opinion in *Chiarella*, the printer owed no fiduciary duty to those with whom he traded. Because "he was not a corporate insider and he received no confidential information from the target company" and had no "duty to disclose" the information before trading on it,⁷² the Court reversed *Chiarella's* conviction for insider trading.⁷³

Burger's response in his dissent in *Chiarella* was to abandon the fiduciary duty requirement. He asserted that "a person who has

70. See 445 U.S. 222, 239-43 (1980) (Burger, C.J., dissenting) (arguing that the purchase of securities based on misappropriated public information violates securities law). Three other Justices appeared to agree with at least some version of Burger's misappropriation theory. See *id.* at 238-39 (Brennan, J., concurring); *id.* at 245-46 (Blackmun, J., joined by Marshall, J., dissenting).

71. *Id.* at 224. Although he figured out the puzzle of blank spaces and false names in the documents, *Chiarella* was obviously not a very sophisticated trader given the modest returns he gained for his risk.

72. The Court said:

[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Id. at 231-33.

73. *Id.* at 225, 237. This same argument was advanced on behalf of O'Hagan 17 years later, but the times and the law had changed, and the Court affirmed O'Hagan's conviction under the different fraud-on-the-source misappropriation theory discussed *infra* subpart III(B).

misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."⁷⁴ Burger's fraud-on-the-investor version of misappropriation theory may be restated as follows:

Insider trading is wrong because it violates a general duty each person owes not to trade on misappropriated material nonpublic information. If a person trades securities on the basis of such information—even with someone to whom he owes no fiduciary duty—he commits securities fraud.

Fraud-on-the-investor misappropriation theory assumes the existence of a general duty not to trade on misappropriated confidential information, but the Supreme Court has not accepted the idea of such a "general duty."⁷⁵

In Part IV, we argue that Burger's argument for the fraud-on-the-investor theory is incoherent because it relies on a pair of flawed and mutually inconsistent rationales. We then offer a revised rationale derived from deontological theory as a superior justification for a fraud-on-the-investor theory that unifies the traditional and misappropriation theories. Before doing so, however, we set forth the Court's current misappropriation theory, which relies on fraud-on-the-source as its guide.

B. Fraud-on-the-Source Misappropriation Theory

Fraud-on-the-source misappropriation theory, as embraced in Justice Ginsburg's majority opinion in *United States v. O'Hagan*,⁷⁶ agrees with the majority in *Chiarella* that liability for securities fraud in insider trading requires the existence of a fiduciary duty. It differs from traditional theory, however, in considering the fiduciary duty to be independent from the relationship between a corporate insider (or tippee) and the shareholder or bondholder investors in the corporation. Ginsburg's fraud-on-the-source theory comports with Burger's fraud-on-the-investor theory that an insider trading violation must involve both (1) "fraud" and (2) trading on information that has been stolen or otherwise "misappropriated." But Ginsburg's theory adds a requirement that the information must be misappropriated from a person to whom one owes a fiduciary duty.⁷⁷ According to fraud-on-the-source theory, then:

74. *Id.* at 240 (Burger, C.J., dissenting).

75. See *United States v. O'Hagan*, 521 U.S. 642, 663 (1997) ("There is no 'general duty between all participants in market transactions to forgo actions based on material, nonpublic information.'" (quoting *Dirks v. SEC*, 463 U.S. 646, 655 (1983) (quoting, in turn, *Chiarella*, 445 U.S. at 233))).

76. 521 U.S. 642 (1997).

77. Justice Ginsburg's majority opinion describes "misappropriation theory" as holding that "a person commits *fraud* 'in connection with' a securities transaction . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652 (emphasis added).

Insider trading is wrong because when it occurs a person, acting as a fiduciary, violates duties owed to his principal. Each fiduciary owes a duty not to use material nonpublic information that belongs to the principal without informing the principal of that use and obtaining the principal's consent. When a fiduciary trades on material nonpublic information that belongs to the principal without informing the principal of the trade and without consent, the fiduciary commits fraud against the principal. Moreover, if this fraud against the principal occurs in connection with the purchase or sales of securities, then it is securities fraud.

Fraud-on-the-source theory therefore differs from the traditional and fraud-on-the-investor theories in that fraud-on-the-source identifies the defrauded party in an insider trading case as the *source of the information the violator uses* in a securities transaction. Both the traditional and fraud-on-the-investor theories identify the *person with whom the violator trades* as the defrauded party.⁷⁸

Traditional theory and fraud-on-the-investor misappropriation theory have a relatively easy time addressing the deontological concern of identifying a relevant victim in many insider trading cases. Each theory identifies somebody who is relevantly wronged: the party whom an insider or outsider defrauds in a securities transaction. Fraud-on-the-source theory, in contrast, has a much harder time identifying a relevant victim. In fact, we believe that it can identify no relevant victim.

Two candidates for victims stand out under fraud-on-the-source theory: the party whom the defendant defrauds by misappropriating information and the party with whom the defendant engages in a securities transaction. Neither party, however, satisfies the deontological constraint of a wronged victim. Consider first the party from whom information has been misappropriated, for which *Carpenter v. United States*⁷⁹ provides a

78. The problem of identifying relevant individual victims in securities fraud transactions is complicated by the fact that public securities markets are liquid, complex, and anonymous. As Leo Katz argues, when someone purchases shares on the basis of inside information, the victim is often not the immediate seller of the shares. This seller often would have sold anyway. However, the wrong still occurs to someone, "if not the person who sold the stock, then the person who would have bought the stock if the insider had not bought it." KATZ, *supra* note 20, at 172. For our purposes, and for ease of explanation, we follow convention and refer to a defrauded investor generically (and somewhat simplistically), though we agree with Katz that the nature of securities markets makes it "nearly impossible" to identify the particular individuals who are the victims of insider trading. See *id.* It is sufficient for deontological theory that there clearly *are* individual victims even though it may be difficult or even impossible to identify exactly who they are. Note, interestingly, that the continuing evolution of electronic trading may further complicate identification of victims. Cf. Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1 (1998) (warning that the pervasiveness and volume of the internet creates dangerous securities situations).

79. 484 U.S. 19, 22 (1987).

concrete example. Under fraud-on-the-source theory, Winans, the defendant reporter, committed fraud only against the *Wall Street Journal*, which was Winans's employer.⁸⁰ Even though Winans would have been guilty under fraud-on-the-source theory, the *Wall Street Journal* was hardly a victim of securities fraud. Arguably, Winans may have harmed or put at risk the *Wall Street Journal*'s reputation for honest reporting, but this is not a securities fraud. Because the Journal did not engage in a securities transaction with Winans, it is impossible for the Journal to have been the victim of a securities fraud. In this respect, the fraud-on-the-source theory also violates the principle that the fraud occur "in connection with" a securities transaction.⁸¹

Perhaps, then, the victim of securities fraud in *Carpenter* was not the *Wall Street Journal*, but instead the investors with whom Winans traded stock. If they were victims, there must have been some way in which they were wronged. But on the Court's own account, Winans owed no duty to the people with whom he traded.⁸² In general, outsiders owe no relevant duties to the people with whom they engage in trading under the fraud-on-the-source misappropriation theory. Thus there is no way to say that the outsiders commit a wrong.

In summary, the fraud-on-the-source theory says the *Wall Street Journal* suffers a wrong in *Carpenter*, but the Journal cannot be the victim of a securities fraud because it does not enter a securities transaction with Winans. The theory also declares that Winans owes no relevant duty to the persons with whom he traded securities. Because the fraud-on-the-source theory cannot identify a victim, it is inconsistent with deontological moral theory.

There are two other possible defenses against the charge that fraud-on-the-source theory violates deontological constraints. One might argue that because the wrong against the principal subsequently harms a third party participating in a securities market, the wrong is "in connection with" a securities transaction and therefore identifies a relevant victim.⁸³ Or one might argue that even if no wrong occurs, forbidding outsider trading is nonetheless justified on economic or social policy grounds.⁸⁴

Neither of the above arguments succeeds. Even if the wrong done against the *Wall Street Journal* was done in connection with the purchase or sale of securities, it does not follow that the wrong involved securities fraud, and the Supreme Court has consistently held that even securities

80. See *supra* text accompanying notes 52-55.

81. See *supra* notes 14-15 and accompanying text.

82. *Carpenter*, 484 U.S. at 22.

83. See *supra* notes 14-15, 81 (reciting the "in connection with" requirement); see also *United States v. O'Hagan*, 521 U.S. 642, 656 (1997) (embracing the "in connection with" rationale).

84. See *supra* notes 21, 23 and accompanying text.

fraud caught by the broad reach of Rule 10b-5 must be "fraud."⁸⁵ The wrong committed in fraud-on-the-source theory is *theft* rather than *fraud*, and *theft* cannot become *fraud* without another step being taken, namely, the use of what has been stolen to deceive someone.⁸⁶ Moreover, one may impose adverse treatment against a person only for a wrong he commits against some victim. Even if substantial economic or other social advantages would flow from ignoring this constraint, it would be wrong to do so.⁸⁷

Fraud-on-the-source theory identifies the prohibited act underlying a securities fraud committed by misappropriation, but it fails to identify a relevant victim of *fraud*. The theory therefore needs repair. Consider again how the fraud-on-the-source theory evolved. The Supreme Court started with the idea that insider trading liability under Rule 10b-5 involved the breach of a fiduciary duty owed to a purchaser or seller of securities. The Court then noticed that some cases, such as outsider trading, did not involve a breach of a fiduciary duty to a purchaser or seller of securities. So the Court expanded the category of insider trading by arguing that as long as a fiduciary duty is breached "in connection with" the purchase or sale of securities, the act amounts to securities fraud. The problem, from a deontological perspective, is that this argument does not identify a relevant wrong to a victim because the breach of duty is not "in connection with" and directly related to a defrauded party.⁸⁸ It is time to reconsider how insider trading wrongs its victims.

IV. A Deontological Fraud-on-the-Investor Theory of Insider Trading

In this Part we advance and defend a revised fraud-on-the-investor theory of insider trading liability rooted in deontological theory. The core idea is that insider trading is fraudulent when a person takes wrongful advantage of an investor with whom he trades securities by failing to disclose material nonpublic information. Our fraud-on-the-investor theory offers a distinctive account of the nature of the relevant wrongful advantage and a distinctive reason for imposing a duty to disclose in insider trading

85. See *O'Hagan*, 521 U.S. at 656 ("The [misappropriation] theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions."); see also *supra* note 3.

86. This is also the essence of Justice Thomas's dissent in *O'Hagan*. *Id.* at 691 (Thomas, J., concurring in judgment in part and dissenting in part) ("[U]se of nonpublic information to trade is not itself a violation of § 10(b). Rather, it is the use of fraud 'in connection with' a securities transaction that is forbidden." (citations omitted)). As will become clear below when we present our own version of fraud-on-the-investor theory, we agree with both Justice Ginsburg's result and Justice Thomas's criticism of her reasoning in *O'Hagan*. See *infra* Part V.

87. See *supra* note 20 and accompanying text.

88. See *supra* notes 14-15, 81, 83 and accompanying text.

cases. We argue that a duty to disclose material nonpublic information before trading securities should not depend on the presence of a fiduciary relationship. We therefore reject arguments for a return to traditional theory as the sole grounds for legitimate insider trading liability.⁸⁹ We also reject fraud-on-the-source theory for failing to identify a relevant victim of securities fraud.⁹⁰ Because the Supreme Court maintains that insider trading liability must involve a species of *fraud*,⁹¹ and because fraud requires identification of a *victim*,⁹² we return to Burger's fraud-on-the-investor theory in his *Chiarella* dissent and the influential precursors he identifies in this opinion. We rebuild a general fraud-on-the-investor theory of insider trading on this foundation and offer a coherent rationale to support it. In essence, we argue that a person has no right to trade securities on ill-gotten or otherwise morally tainted information, and that failure to disclose the use of such information before trading breaches a duty to disclose and serves as a predicate for fraud.

A. Precursors: From Keeton to Brudney to Burger

The seeds of our fraud-on-the-investor theory of insider trading are found in Burger's defense of misappropriation theory in *Chiarella* and two law review articles on which his opinion relies.⁹³ In *Fraud—Concealment and Non-Disclosure*, W. Page Keeton grapples with a longstanding problem in theories of fraud by nondisclosure.⁹⁴ He focuses on when nondisclosure of material facts operates as an "implied misrepresentation" or deception sufficient to justify liability.⁹⁵ We find his arguments useful because insider trading liability presents the same issue of fraud by nondisclosure. Most insider trading cases do not involve lies or direct misrepresentations. Instead, courts determine that the trader with inside information has a "duty to speak" in some circumstances.⁹⁶ In *Insiders, Outsiders, and Informational Advantage under the Federal Securities Laws*, Victor Brudney draws the important distinction between insider and outsider trading discussed above.⁹⁷ He focuses also, as Keeton did in a more general framework, on the importance of informational advantages

89. See *supra* Part II.

90. See *supra* subpart III(B).

91. See *supra* notes 3, 85 and accompanying text.

92. See *supra* Part I and text accompanying notes 78-86.

93. *Chiarella*, 445 U.S. at 240, 241 n.1 (Burger, C.J., dissenting).

94. Keeton, *supra* note 17.

95. *Id.* at 1-2, 11-12.

96. See *Central Bank v. First Interstate Bank*, 511 U.S. 164, 174 (1994) ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." (quoting *Chiarella*, 445 U.S. at 234-35)); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 865 (2d Cir. 1968) (Friendly, J., concurring) ("Silence, when there is a duty to speak, can itself be a fraud."); see also Keeton, *supra* note 17, at 24 (discussing cases imposing a duty to speak and a duty of disclosure).

97. Brudney, *supra* note 47.

in securities markets.⁹⁸ We build on Keeton's and Brudney's arguments, as well as Burger's insight, in constructing our deontological theory of insider trading.

Burger's own fraud-on-the-investor misappropriation theory is suggestive but analytically unclear. In his *Chiarella* dissent, Burger vacillates between two competing rationales. On one hand, he invokes the SEC's early case of *In re Cady, Roberts & Co.*,⁹⁹ which adopts what we will call the "equal information rationale" for the law of insider trading.¹⁰⁰ On the other hand, Burger emphasizes the misappropriation of information "by some unlawful means."¹⁰¹ We will call this approach the "illicit acquisition rationale." Unfortunately, Burger does not clearly distinguish between these two rationales. And as we will show, each has its own distinctive problems and advantages.¹⁰²

B. The Equal Information Rationale

According to the equal information rationale, fraudulent insider trading occurs when one party to a securities transaction possesses significantly better information than does the other party to the transaction. For this rationale to be persuasive, it must explain why taking advantage of an acute asymmetry of information is wrong in the trading of securities.¹⁰³ It must explain also why the use of unequal information amounts to fraud. We argue that taking advantage of unequal information may be wrong under some very special circumstances, but that it is not inherently wrong.

According to proponents of the equal information rationale, including most prominently the SEC (at least in the early days of federal insider trading law), the purpose of insider trading regulation is to assure that all participants in securities markets have equal access to information about the companies represented by securities traded in the market.¹⁰⁴ *In re Cady,*

98. *Id.* at 326-39, 341-46, 353-67.

99. 40 S.E.C. 907 (1961).

100. See *Chiarella*, 445 U.S. at 241-42 (discussing *Cady* in support of the "equal information rationale"). Justice Blackmun's dissenting opinion in *Chiarella* also adopts a version of the equal information rationale when he argues that the "principle" of the "structural disparity in access to material information" is a "critical" factor in deciding to impose a duty to disclose. *Id.* at 251.

101. *Id.* at 240.

102. Justice Powell's majority opinion in *Chiarella* did not address Burger's misappropriation theory on the merits. It rejected the argument instead on procedural grounds, observing simply that the jury had not been instructed on a misappropriation theory. *Id.* at 237 n.21.

103. Our emphasis on "significant" and "acute" informational disparity is in deference to the traditional element of "materiality" required for securities fraud. See *supra* notes 33, 35.

104. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (arguing for protection of "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information"). For leading proponents of this view, see Scheppele, *supra* note 28, at 150-68 (advancing "an 'equal access' approach to the ethics of insider trading"); Seligman, *supra* note 23, at 1090, 1137-40 (arguing for a "parity of information" approach).

*Roberts & Co.*¹⁰⁵ adopted this approach when the SEC sanctioned a broker-dealer named Robert Gintel who traded on advance information provided by the director of a corporation (who was also at the same time a Cady, Roberts executive) that a quarterly dividend would be cut.¹⁰⁶ Gintel received the information before the information had been disclosed to the market, and Gintel sold the company's stock short.¹⁰⁷ In approving a fine imposed by the New York Stock Exchange and a suspension from trading,¹⁰⁸ the SEC held that the duty to disclose material nonpublic information or refrain from trading "rests on two principal elements": (1) "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone," and (2) "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."¹⁰⁹ Because the broker-dealer knew the information was confidential, argued the SEC, it was unfair to trade on the information before it had been disclosed to the market.¹¹⁰

Although this reasoning may sound compelling at first, it is misguided. The equal information rationale fails for several reasons. First, it cannot work in practice because securities markets depend in their very nature upon some traders having better information than others. Markets are not perfectly efficient, and a relatively efficient securities market requires "a critical mass of persons believing that it is worthwhile to try to beat the market" with better information.¹¹¹ Even the most efficient markets will therefore be characterized by a dynamic flux in the distribution of information, not by equality of information.¹¹²

Second, informational disparity in securities markets is not only inevitable but arguably desirable on economic grounds.¹¹³ For example, informational inequality is likely to encourage the development of traders

105. 40 S.E.C. 907 (1961).

106. *Id.* at 909.

107. *Id.* at 916.

108. *Id.* at 917-18.

109. *Id.* at 912.

110. *Id.* at 915.

111. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 852 n.6 (1992); see also Gilson & Kraakman, *supra* note 22, at 622-25 (reflecting on the "efficiency paradox" of information and markets); Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 405 (1980) (observing that "because information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation").

112. See Gilson & Kraakman, *supra* note 22, at 622-26.

113. As we argue above, we do not believe that economic arguments are decisive in the insider trading context. See *supra* notes 21-26 and accompanying text. But we include a discussion of economic arguments here because we are aware that many readers find them credible.

specializing in particular industries and companies. This specialization arguably improves the overall informational efficiency of securities markets by enhancing the transfer of information to them through the price mechanism.¹¹⁴ This argument is merely another version of the economic argument that society should encourage people and businesses to seek out valuable information by establishing disclosure rules that provide incentives to invest time and effort to search for such information.¹¹⁵

A third, and more important, reason to reject the equal information rationale is that an informational advantage may be morally deserved or at least morally neutral. From a deontological point of view, not all informational disparity is wrongful, and sometimes it is morally deserving of protection. If one works hard to discover or produce valuable information, or otherwise legitimately acquires a right in information, then one deserves to enjoy the benefits, including the right to use that information to a bargaining advantage.¹¹⁶ A person might also deserve to take advantage

114. See Brudney, *supra* note 47, at 341 (arguing that incentives for profiting on information in securities markets will improve the accuracy of pricing and enhance the allocative efficiency of the markets); see also Easterbrook, *supra* note 19, at 326-27, 329-30 (arguing against the equal information rationale on economic grounds).

115. See Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 2 (1978) (arguing that "a legal privilege of nondisclosure is in effect a property right" but only "where special knowledge or information is the fruit of a deliberate search. . . . [T]he assignment of a property right of this sort is required in order to insure production of the information at a socially desirable level").

Some scholars and judges argue that the economic need to protect the unequal property rights to information justifies the prohibition of insider trading. See *United States v. Chestman*, 947 F.2d 551, 576-77 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part) ("Information is perhaps the most precious commodity in commercial markets. . . . If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information."); JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* 7-12 (1991) (asserting that "the fragile and ephemeral nature of insider information" suggests that the need to protect property rights in this commodity is particularly strong); BAINBRIDGE, *supra* note 24, at 17-19 (arguing that "protecting property rights in information" is the leading economic justification for the regulation of insider trading laws); Easterbrook, *supra* note 19, at 330-39 (discussing the protection of business property as a justification for insider trading laws). This is the "business property" rationale for insider trading law. See Kenneth F. Scott, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. LEGAL STUD. 801, 805, 814-15 (1980). We are not persuaded by the business property approach, at least as it is developed by Scott, because it relies too heavily on ungrounded economic speculation about the incentive consequences of various property rights regimes. See *supra* notes 24-25 and accompanying text. In addition, we believe the business property rationale is inadequate to deal with some of the tougher questions of insider trading law, such as those presented in frontrunning and self-frontrunning situations. See *infra* subpart V(B); see also Scott, *supra*, at 815 (recognizing limitations to the business property rationale). We agree that a property right in information may justify an advantage in securities trading, but only if it is morally deserved, or at least not morally tainted.

116. See Alan Strudler, *Moral Complexity in the Law of Nondisclosure*, 45 UCLA L. REV. 337, 375 (1997) (arguing that information one has acquired by the dint of one's labor or through other legitimate means is information which one has a presumptive right to use and which may give one a "deserved advantage" in market transactions); see also MARVIN A. CHIRELSTEIN, *CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS* 70 (3d ed. 1998) (arguing that "an individual who spends time and money developing information about the intrinsic value of certain property does not and should not have a legal duty to disclose her findings to the property's present owner"). For general philosophical

of information acquired by mere chance or luck.¹¹⁷ Nothing is inherently wrong with disclosure rules that permit a general condition of disparity of information among people who engage in exchanges. On the contrary, it would be morally wrong to require everyone to sit on a level playing field when trading securities or anything else. The equal information rationale is not, therefore, a coherent justification for a misappropriation theory of insider trading law, and the Supreme Court has rightly rejected it.¹¹⁸

These considerations suggest a path toward a resolution of one of the hypothetical puzzles of *Texas Gulf Sulphur* with which we began.¹¹⁹ If Texas Gulf Sulphur absorbs significant costs to do a legitimate search for valuable information about whether there are minerals under some neighboring land, then the company should not have a legal obligation to disclose that information before making an offer to purchase the land from its owner. The corporation may legitimately use its inside information about an ore strike to purchase real estate without disclosing this information to the owner because the company invested in geological surveys to get this information and therefore deserves to take advantage of it in bargaining.¹²⁰ Not only does it make economic sense to allow Texas Gulf Sulphur to profit from this undisclosed material information, it also makes moral sense.¹²¹

accounts of the moral principle of desert, see FLETCHER, *supra* note 6, at 95-108, and GEORGE SHER, DESERT (1987); see also JOHN LOCKE, THE SECOND TREATISE ON GOVERNMENT 17 (Thomas P. Peardon ed., Bobbs-Merrill 1952) (1690) ("Whatsoever then he removes out of the state that nature has provided and left it in, he has mixed his labor with, and joined to it something that is his own, and thereby makes it his property.").

117. We expand on this difficult problem in our discussion of what we call the "equitable disclosure rationale" *infra* subpart IV(D).

118. The argument advanced by the Second Circuit Court of Appeals in *Chiarella* that "the federal securities laws have 'created a system providing equal access to information necessary for reasoned and intelligent investment decisions'" was expressly rejected by the Court. *Chiarella*, 445 U.S. at 232 (quoting *United States v. Chiarella*, 588 F.2d 1358, 1362 (2d Cir. 1978)). As the Court explained, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." *Id.* The Court also noted that "neither the Congress nor the [SEC] ever has adopted a parity-of-information rule." *Id.* at 233; see also *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (noting that "informational disparity is inevitable in the securities markets"); *Dirks v. SEC*, 463 U.S. 646, 658-59 (1983) ("It is commonplace for analysts to 'ferret out and analyze information' It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally." (quoting an SEC report)). On this point generally, Keeton writes that "law cannot hope to put all parties to every contract on an equality as to knowledge, experience, skill, and shrewdness." Keeton, *supra* note 17, at 22-23.

119. See *supra* text accompanying notes 7-10.

120. Texas Gulf Sulphur obtained the information through aerial geophysical survey and test drilling samples. *Texas Gulf Sulphur Co.*, 401 F.2d at 843-44.

121. But cf. Easterbrook, *supra* note 19, at 331-38 (rejecting duty and fairness arguments in favor of an economic analysis in assessing liability under insider trading laws); Kronman, *supra* note 115, at 20-21 (discussing Texas Gulf Sulphur in economic terms). Although we agree with the results reached by Easterbrook and Kronman, we disagree with their appeal to a utilitarian or social welfare

C. *The Illicit Acquisition Rationale*

Despite the fact that Burger invokes the equal information rationale in his *Chiarella* dissent, he adds an important twist that really amounts to a different and competing approach. Burger argues that trading on securities with an "informational advantage" is wrong only when the advantage is obtained "not by superior experience, foresight, or industry, but by some unlawful means."¹²² This is the illicit acquisition rationale, which proves more tractable than its cousin, the equal information rationale.¹²³ According to Burger, "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."¹²⁴ Trading on such information is wrong because it results in an "ill-gotten informational advantage."¹²⁵ Burger relies on Keeton, who develops similar arguments to deal with nonsecurities cases of fraud by nondisclosure, and Brudney, who applies similar arguments to insider trading.¹²⁶

To illustrate the illicit acquisition rationale, consider another hypothetical based on the facts of *Texas Gulf Sulphur*. What if the company trespassed in order to obtain the geological information from the neighboring landowner and then negotiated with this landowner without disclosing the information? Keeton poses exactly this example (though based on cases decided before *Texas Gulf Sulphur*).¹²⁷ After he points

calculation to determine whether property rights in information are "deserved." On our analysis, Texas Gulf Sulphur morally deserves to take advantage of its information about an ore strike. This does not mean, however, that corporate insiders or the company itself has a similar right to trade securities on this information. See *infra* subpart V(B).

122. *Chiarella*, 445 U.S. at 240.

123. For a lucid exposition and defense of the illicit acquisition rationale, see Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1288-1309 (1998).

124. *Chiarella*, 445 U.S. at 240.

125. *Id.* at 245.

126. See *id.* at 240 & n.1 (citing Keeton and Brudney). Brudney considers why it makes sense to deny corporate insiders their informational advantage in trading in their own company's securities. One plausible answer returns to the traditional theory: "Denying insiders the informational advantage could rest merely upon the narrow premise that they are not entitled to it in dealing with corporate stockholders because they acquired the information as agents or fiduciaries of the stockholders in the course of pursuing the latter's business." Brudney, *supra* note 47, at 344; see also Pritchard, *supra* note 61, at 17, 47-54 (advancing a similar "agency theory" of misappropriation). As we show above in Part II, however, and as Brudney agrees, "such denial also rests on a broader base." Brudney, *supra* note 47, at 344-45. Brudney then makes an economic argument to justify a rule of disclosure. See *id.* But we believe an ethical argument along these lines is stronger. Brudney agrees that "a sense of unfairness" arises when an insider trades on an informational advantage of a sort that the party on the other side of the transaction cannot "lawfully . . . erode." *Id.* at 346. It is because of the fact that inside information is lawfully protected for the proper and legal use of the corporation itself that a corresponding legal duty arises for insiders not to misuse this information for improper purposes of their own. See *infra* subpart V(B).

127. See Keeton, *supra* note 17, at 25.

out that many common law cases allowed a mining or investment company to purchase real estate from an unknowing seller without disclosing information about a valuable mineral discovery, Keeton argues that the situation is different if *A* trespasses on *B*'s property to obtain the information. In this circumstance, Keeton argues that *A* has a legal duty to disclose this information before purchasing.¹²⁸ *A* does not deserve to take advantage of the information that it has obtained by committing a wrong against the landowner.

One defense of the illicit acquisition rationale argues that it supports a general duty to disclose material nonpublic information in insider trading cases.¹²⁹ The illicit acquisition rationale has the virtue of applying to both insiders and outsiders who trade on material nonpublic information because both insiders and outsiders can obtain information illegally—by trespass, theft, violation of contract, or whatever. For example, the rationale covers both the corporate executive who steals material nonpublic information from the company and trades on it and the newspaper reporter like Winans in *Carpenter* who violates agreements to keep information confidential.

Although it has strengths, the illicit acquisition rationale is not self-evident, and it has significant conceptual limitations. Its proponents defend the rationale by appealing to economic considerations¹³⁰ or their own intuitive sense of fairness,¹³¹ but these defenses fail for familiar reasons: (1) the economic consequences of insider trading rules are disputed and perhaps unknowable,¹³² (2) the relevance of economic concerns cannot be established without determining whether insider trading morally wrongs those who are its alleged victims,¹³³ and (3) an intuitive sense of fairness is too vague and unreliable to serve as a basis of legal decision making.¹³⁴ To sustain the illicit acquisition rationale, it is necessary to

128. See *id.* at 25-26; see also Nagy, *supra* note 123, at 1289-91 (supporting Keeton's argument that a duty to disclose exists when information is obtained through wrongful or illegal means). One old English case addressing the issue is *Phillips v. Homfray*, 6 L.R.-Ch. App. 770 (1871) (denying specific performance of a contract for sale to a purchaser of land who had trespassed to test subsurface coal). See also *Mallon Oil Co. v. Bowen/Edwards Assoc.*, 965 P.2d 105, 112 (Colo. 1997) (recognizing an exception to the rule of nondisclosure in sale of land cases "when the buyer acquires the information [about oil and gas reserves] through improper means, such as trespass" (citing RESTATEMENT (SECOND) OF CONTRACTS § 161 illus. 11 (1981))).

129. See Nagy, *supra* note 123, at 1288-96.

130. See John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. CHI. L. REV. 1307, 1315-19 (1981) (noting that information-gathering improves market efficiency and the incentive to conduct entrepreneurial market research is heightened to the extent that the information gathered is protected through nondisclosure).

131. See Brudney, *supra* note 47, at 346.

132. See *supra* notes 24-25 and accompanying text.

133. See *supra* notes 44-45 and accompanying text.

134. See *supra* note 19 and accompanying text.

identify a moral principle or set of principles more precise than a simple appeal to an intuitive sense of fairness.

The illicit acquisition rationale succeeds at most in showing that it is wrong for someone to trade on wrongfully acquired information. But not every wrong is a fraud. The illicit acquisition rationale does not show how trading on wrongfully acquired information amounts to fraud, and it does not connect the wrongful acquisition of this information to a victim in a securities transaction.¹³⁵ The wrong identified is probably best understood as a violation of a principle proscribing unjust enrichment. This principle, alluded to by Burger in *Chiarella*,¹³⁶ states simply that one should not be allowed to gain from one's wrongdoing, and that because any gain one makes from wrongdoing is tainted, one should not be entitled to keep it.¹³⁷

Unjust enrichment theory has been skillfully deployed by Ronald Dworkin¹³⁸ in his famous discussion of the case of *Riggs v. Palmer*.¹³⁹ That case concerned a grandson who stood to become a beneficiary under a will and murdered his grandfather to accelerate his inheritance.¹⁴⁰ Dworkin argues that *Riggs* demonstrates the role of moral principle in law.¹⁴¹ Because it is morally abhorrent that a person should gain by his own wrongdoing, the law of wills should be interpreted to disqualify the wrongdoing grandson from inheriting a portion of his grandfather's estate.¹⁴² Similarly, a person who steals material nonpublic information to use as the basis for making decisions about buying and selling securities also attempts to gain by his wrongdoing. If the thief succeeds, he is unjustly enriched. One might therefore argue that just as the court in *Riggs* interpreted the law of wills to block unjust enrichment, the law of securities fraud should also block unjust enrichment from trading on stolen information.

135. See *supra* notes 3, 85-87 and accompanying text (discussing the need for fraud and a victim in a securities transaction for insider trading liability).

136. See *Chiarella*, 445 U.S. at 241 (asserting that insider trading is wrong because it serves no useful function except the insider's own enrichment) (Burger, C.J., dissenting); see also Langevoort, *supra* note 61, at 2 n.3 (identifying the unjust enrichment principle as a justification for insider trading law).

137. See DAN B. DOBBS, LAW OF REMEDIES 366 (1993) (describing the equitable principles underlying the concept of restitution).

138. See RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 23 (1977).

139. 22 N.E. 188 (N.Y. 1889).

140. *Riggs*, 22 N.E. at 189.

141. See DWORKIN, *supra* note 139, at 23.

142. See *id.* at 23. Posner argues unpersuasively that *Riggs* instead can be understood as a matter of statutory interpretation in which the "probable intentions" of the legislators cannot be assumed to have meant to include a "murdering heir." See POSNER, *supra* note 6, at 140-41. This interpretative strategy, however, merely removes the ethical issue one step. Even a Posnerian judge deciding *Riggs* must assume a norm of ethical, or at least not psychopathic, legislators.

Although the unjust enrichment answer provides a defense of the illicit acquisition rationale rooted in a moral principle, it cannot explain the prohibition on insider trading. The principle of unjust enrichment suggests that insider trading is wrong because of the unconscionability of allowing a person to profit from his own wrongdoing. But the unjust enrichment principle, taken as a full explanation of the prohibition against insider trading, would prove too much. If one accepted unjust enrichment as the basic justification for what is wrong with insider trading, there is no reason why the principle should apply only to the illegal acquisition or misuse of information. Unjust enrichment may occur not only in connection with wrongfully obtained information, but also in connection with anything else one has illegally obtained. The implications would be drastic. For example, suppose Ted embezzles money rather than stealing information from his employer, Beta Corporation, and then uses this stolen money to invest in securities purchased from Carol. Ted is unjustly enriched, but his use of stolen money for trading is not fraudulent with respect to Carol. The reason is that she has not been misled and now possesses the funds used in the transaction. Beta Corporation, the "source" of the embezzled funds, has a legal claim against Ted for theft, but not for securities fraud. Therefore, the principle of unjust enrichment cannot fully explain why trading on misappropriated information qualifies as securities fraud, unless the federal law of insider trading is to be greatly expanded to address every kind of unjust enrichment.¹⁴³

The idea of "fraud" is important in insider trading law not only because the Supreme Court has recognized the concept as a limit to expanding liability,¹⁴⁴ but also because "the proscription of fraud" expresses one of the basic purposes of federal securities regulation.¹⁴⁵

143. Justice Thomas also distinguishes between embezzled money and stolen information in his *O'Hagan* dissent when he correctly calls the majority opinion to task for failing to explain why the fraud-on-the-source theory satisfies the "in connection with" the sale or purchase of securities requirement. *O'Hagan*, 521 U.S. at 680-82.

A recent variation in economic theory of "unjust enrichment" recasts the argument in terms of "inefficient enrichment." See Eric Kades, *Windfalls*, 108 YALE L.J. 1489, 1515 (1999) (arguing that in the law of contracts "unjust enrichment cases are appropriately decided on efficiency grounds"). Under this approach, insider trading is considered a windfall, but whether to redistribute the windfalls of insider trading depends on an economic analysis of whether insider trading is good or bad for society. *Id.* at 1554-57. This approach therefore runs into the same empirical and theoretical difficulties that we describe above with respect to other economic theories of insider trading. See *supra* notes 21-25 and accompanying text. Also, like some other economic theories of law, this approach is blind to the normative assumptions it makes when assuming that an economic approach is superior to an ethical one. See *supra* note 6.

144. See *supra* note 3, 85 and accompanying text.

145. See William C. Tyson, *The Conceptual Problems with the Law of Insider and Outsider Trading* 1 (June 8, 1999) (unpublished manuscript on file with the *Texas Law Review*) (identifying "public disclosure of information" and "proscription of fraud" as recurrent themes that run through the Securities Exchange Acts of 1933 and 1934).

Protecting the property rights of newspapers from theft by reporters or the property of corporations from theft by their employees are not basic purposes of federal securities regulation.¹⁴⁶

In summary, the point of unjust enrichment is to block a person from enjoying a wrongfully obtained benefit by forcing the disgorgement of ill-gotten gains.¹⁴⁷ The point of the law of fraud is to protect people from becoming victims of trickery or deception.¹⁴⁸ These two points are logically distinct. An adequate moral theory of securities fraud in insider trading must show not merely why corrective action should be taken against someone who wrongfully gains from using stolen information in a securities transaction; it must also show an essential link between taking such corrective action and vindicating the rights of a victim of securities fraud.¹⁴⁹ Unjust enrichment does not provide a justification for describing insider trading as a kind of fraud. At the heart of securities fraud by insider trading is the idea of deception.¹⁵⁰ A person who has been defrauded is a victim of deceit. The unjust enrichment principle contains important insights for finding solutions to conceptual problems of insider trading law, but it is only a starting point. Additional analysis is required to get from unjust enrichment to fraud.

D. *An Equitable Disclosure Rationale*

Having canvassed a number of the justifications for insider trading law presented in various Supreme Court opinions and by commentators, we are now in a position to offer a more satisfactory justification. We call it the "equitable disclosure rationale." It draws on some of the themes raised in the equal information and the illicit acquisition rationales, but we believe it is stronger because it advances an analysis of the particular kind of fraud

146. A second basic purpose of federal securities regulation is to promote "the public disclosure of information" relevant to investors. *Id.*; see also LOSS & SELIGMAN, *supra* note 36, at 8 (describing "a recurrent theme" in federal securities statutes as "disclosure, again disclosure, and still more disclosure"). One recent proposal for the reform of insider trading law recommends tightening regular disclosure requirements as an antidote to some forms of insider trading. See Fried, *supra* note 28, at 306. Although there is merit in this proposal, we do not believe a disclosure strategy alone is sufficient to counteract all forms of present and future insider trading. An antifraud strategy is also needed.

147. See DOBBS, *supra* note 137, at 366.

148. For an argument that tort law essentially serves the role of vindicating victims, see Strudler, *supra* note 44, at 315-21. See generally Fleming James, Jr. & Oscar S. Gray, *Misrepresentation*, 37 MD. L. REV. 286, 286 (1977) (part 1), 37 MD. L. REV. 488 (1978) (part 2) (both asserting that the interest protected by the law of fraud is the interest "in not being cheated").

149. This is not to say that the converse is also true. If a securities fraud is proven, then the principle of unjust enrichment may be invoked by the SEC in favor of an appropriate and just remedy. Under § 21A of the Insider Trading Sanctions Act of 1984, 15 U.S.C. § 78u-1, the SEC may also recover civil penalties in an amount up to "three times the profit gained or loss avoided" by the insider trading. *Id.*

150. See *supra* note 6 (quoting Rule 10b-5).

involved in insider trading, namely, fraud-on-the-investor.¹⁵¹ It is also grounded in a traditional deontological argument emphasizing respect for autonomy and fairness in securities trading.

1. *The Deontological Argument from Principles of Autonomy and Fairness.*—At the core of deontological moral theory is its prohibition against interfering with a person's autonomous decision making. On the deontological view, human choice is a source of value, and so long as a person competently makes choices in a manner that does not wrong others, morality requires that one refrain from interfering with these choices.¹⁵² Even if one knows that a person, if left alone, will make a choice that is less than optimal, it does not follow that it would be acceptable to interfere with that choice. Suppose, for example, that your friend, Jim, confronts a choice about which of several offers of employment to accept. Suppose further that Jim seems committed to accept the offer from Firm A, and that he does not understand, but you do, that the offer from Firm A is much worse than the offer from Firm B. On the deontological view, you may, of course, attempt to persuade Jim by rational means that he should change his mind about which offer to accept. If you fail to persuade him, however, you may not interfere with his choice, even if he would be happier if you interfered. You may not, for example, covertly use your connections with Firm A to get them to withdraw their offer, even if that would be better for Jim in the long term. Deontological theory provides that the wrong of interfering with autonomous choice cannot be corrected by benefits to society, or even by benefits to the person who is wronged. Matters of moral principle prevail over a calculation of costs and benefits.¹⁵³

151. See *supra* note 2 and accompanying text. Cf. Nagy, *supra* note 123, at 1227, 1287-96 (advancing a "fraud on investors" theory of insider trading on grounds of an illicit acquisition rationale); *The Supreme Court, 1996 Term—Leading Cases*, 111 HARV. L. REV. 197, 410-11, 416-17, 420-21 (1997) (arguing for a "fraud-on-the-marketplace-traders theory" of insider trading on economic and legal interpretation grounds).

152. See, e.g., Alasdair MacIntyre, *Truthfulness, Lies, and Moral Philosophers: What Can We Learn From Mill and Kant?*, in 16 THE TANNER LECTURES ON HUMAN VALUES 336 (Gareth B. Peterson ed., 1995) (distinguishing between "two rival moral traditions with respect to truth-telling and lying, one for which a lie is primarily an offense against trust and one for which it is primarily an offense against truth"). Of course, the importance of respect for autonomous choice is not unique to deontological theory. Even utilitarian theorists argue against interfering with autonomous choices. See Lawrence Haworth, *Autonomy and Utility*, in THE INNER CITADEL 155-69 (John Christman ed., 1989). Deontological theory is distinctive in that it requires that we arrange our affairs so that we respect autonomy. Utilitarian theory, on the other hand, suggests that pleasure as well as a variety of other goods may have value distinct from autonomy, and that optimal moral policy may require tradeoffs between these various sources of value. See *id.*

153. See *supra* notes 6, 20 and accompanying text.

Lying is a form of deception that sometimes compromises autonomy in ways that are clearly wrongful from a deontological point of view.¹⁵⁴ For example, if acting from purely benevolent motives you lie to Jim, telling him that Firm A just telephoned to withdraw its job offer, you would interfere with his deliberative processes in a manner which is wrongful on a deontological view. Lying, however, is only one form of deception. It is characterized by active misrepresentation. Wrongful deception can also occur without active misrepresentation. It can occur through nondisclosure: a wrong of omission rather than commission. For example, suppose that you are Jim's roommate as well as his friend, and Firm A calls to offer Jim a job. You intentionally fail to mention the call to Jim, and when he asks whether anyone has called, you change the subject. Perhaps this nondisclosure or avoidance is not quite as bad as a direct lie, but it may cause just as much harm to Jim, as well as being a wrongful act. Much of the same explanation for what makes lying wrong, on a deontological account, also explains why nondisclosure is sometimes wrong: both lying and nondisclosure can wrongly infringe individual autonomy of choice.

Nondisclosure about material facts that are otherwise assumed in an economic exchange, including an exchange of securities, is ordinarily wrong for the purely moral reason that it compromises the autonomy of the person denied disclosure. We believe an exception to this generalization applies, however, when nondisclosure is necessary in order to protect deserved property rights in information.¹⁵⁵ To establish our position, we begin by examining the application of normative principles to some comparatively simple examples of disclosure issues not involving securities. We then consider application of these principles to securities law.

Consider a famous pair of nondisclosure cases from the law of mistake.¹⁵⁶ If Buyer purchases an object in Junk Store, and Buyer knows, but Junk Store's owner does not, that the object is worth much more than the label indicates, then Buyer does nothing legally wrong by taking advantage of the apparent bargain. If, on the other hand, Buyer purchases an object in Antique Store that has a similarly inviting price tag, but where the owner knows the value of the objects he sells and has made a mere clerical error in writing the price on the object's tag, Buyer does something legally problematic. How should one understand the relevant differences between Junk Store and Antique Store? Is there a moral principle that distinguishes these two cases?

154. See Thomas E. Hill, Jr., *Autonomy and Benevolent Lies*, 18 J. VALUE INQUIRY 251, 265 (1984) (arguing that truth-telling enhances "one's opportunity to live in rational control of one's life" because the autonomous actor can identify those who will tell the truth).

155. See *supra* notes 116-17 and accompanying text.

156. This example is adapted from Kronman, *supra* note 115, at 31 (citing illustrations from the RESTATEMENT OF RESTITUTION § 12, cmt. c (1936)).

There is a plausible deontological interpretation of the difference between Junk Store and Antique Store. In both Junk Store and Antique Store, Buyer takes advantage of the owner's ignorance about a fact in the transaction, but only in Antique Store does Buyer's action seem unfair to the owner. In Junk Store, the Buyer profits from superior knowledge, but in Antique Store the Buyer knows that the owner has made a simple mistake. This suggests that one potential function of nondisclosure law is to prevent a person from taking unfair advantage of another person's ignorance.¹⁵⁷ We maintain that Buyer in Antique Store takes an unfair advantage, but that Buyer in Junk Store does not. In Junk Store, Buyer did something to acquire a legitimate informational advantage over Junk Store's owner—Buyer became an expert, but Junk Store's owner did not. In Antique Store, Buyer and Antique Store's owner were relatively equal with respect to their expertise; only a simple clerical mistake prevented the Antique Store's owner from exploiting his expertise. Only in Junk Store did Buyer acquire a legitimate right to use the information.

The relevance of this distinction is captured in the following equitable disclosure rationale:

If one possesses material nonpublic information which one has no more right to use than does the person with whom one makes an exchange, then one is wrong to use that information to the disadvantage of the other person. To avoid wrongly taking advantage of the other person, and thereby committing fraud, one must disclose the relevant information before making the exchange.

This equitable disclosure rationale has important implications for insider trading law because it tracks differences between securities traders who steal or otherwise misuse information and those who acquire information through entrepreneurial means or even mere luck. But first we must address why this rationale should be accepted.

One argument in favor of the equitable disclosure rationale appeals to moral intuition. A standard approach in contemporary moral theory purports to identify plausible moral principles by testing candidate principles for their ability to cohere with "moral intuitions," or intuitively plausible moral judgment, about a spectrum of relevant cases.¹⁵⁸ If the equitable disclosure rationale fits with a general sense of the "unfairness" involved in insider trading cases, then one might conclude that it is confirmed by its

157. Cf. Alan Smudler, *Incommensurable Goods, Rightful Lies, and the Wrongness of Fraud*, 146 U. PA. L. REV. 1529, 1560 (1998) (providing an extension of this argument with respect to the law of nondisclosure in general).

158. See W. DAVID ECROSS, *FOUNDATIONS OF ETHICS* 187-89 (1939) (referring to the intuitionist view and its appeal to intuitions to establish moral principles); see also Scheppele, *supra* note 28, at 123 (referring to the moral intuition of Professor Manne's famous law student who declared simply that insider trading was "just not right" and attempting to "fill out the reasoning behind this intuition").

consonance with moral intuitions. Appeal to moral intuition, however, is not the only way to conduct argument in moral theory, and moral philosophers are increasingly skeptical about the sufficiency of mere appeal to intuition.¹⁵⁹ Fortunately there are deeper theoretical reasons to think the equitable disclosure rationale is correct. The plausibility of the rationale derives in part from its consonance with the deontological notion of autonomy. The equitable disclosure rationale forbids a person from interfering with another person's autonomous deliberations by withholding material nonpublic information *unless* the interference results from the defense of legitimate rights to use the information in trading.

On our account, then, two deontological ideas drive the law of nondisclosure: respect for autonomy and concern for fairness. These ideas are intertwined. Consider a sales transaction between a buyer, Ralph, and a seller, Alice. Any advantage that Ralph gains over Alice by violating her autonomy is an unfair advantage *unless* Ralph is protecting legitimate informational rights of his own. If Ralph fails to disclose important information that he possesses, then he violates Alice's autonomy because his nondisclosure interferes with Alice's ability to make a rational choice about the purchase *unless* a requirement to disclose would be inconsistent with Ralph's rights in the information.¹⁶⁰ Suppose that Ralph steals the information that he uses to get a bargaining advantage over Alice in their sales transaction. Ralph's advantage does not derive from his rights in information, and it follows that Ralph's use of that information wrongly interferes with Alice's autonomous choice. Ralph has an unfair advantage over Alice by using stolen information. Thus, the use of stolen information ordinarily compromises autonomy and triggers a duty to disclose before trading. Any time someone trades on stolen information, the trader violates an equitable duty to disclose. The violation has nothing to do with whether the trader is a fiduciary and nothing to do with the source from whom the trader steals. The wrong is against the victim whose autonomy the trader unfairly violates. In simpler terms, the victim is cheated.¹⁶¹

159. See, e.g., THOMAS NAGEL, *OTHER MINDS* 123-24 (1995) (arguing for both a method of "reflective equilibrium" that identifies principles with "intuitive moral plausibility of their own" and for a more general theory that "should not merely summarize but illuminate and make plausible the particular judgments that it explains"); RAWLS, *supra* note 20, at 34 (suggesting that intuitionism leaves no rational way to resolve conflicts).

160. In more complex examples, which are common in cases involving business organizations, Ralph may also legitimately withhold important information from Alice if he is protecting the rights of an organizational entity or other person as an agent of the organization. Conversion of the information for his own personal use, however, is inconsistent with this right, and there are also limits to the organization's own use of inside information when trading with investors. We address these issues of what we will call "frontrunning" and "self-frontrunning" in subpart V(B).

161. Cf. BAINBRIDGE, *supra* note 22, at 5 (suggesting that people who trade with those who have inside information "probably feel they were cheated").

2. *Why Failure to Disclose Material Information Compromises Autonomy.*—Our account may provoke controversy for at least two reasons. First, it assumes that the wrongness of nondisclosure of material nonpublic information in a sales context can be explained in terms of the violation of individual autonomy. Second, it assumes that when nondisclosure would otherwise compromise autonomy and prove wrong in a sales context, it might nonetheless prove morally acceptable when the nondisclosure protects legitimate rights in information.

As we already observed, it is commonplace since Kant that moral theory emphasizes the importance of respect for autonomy in understanding the norms of deception.¹⁶² The most obvious implication is a severe stricture against lying. Lying interferes with the most fundamental efforts of a person to make rational judgments, and hence lying is a deontological paradigm of wrongful action.¹⁶³ If deception by lying is wrong because it interferes with autonomous choice, however, deception by nondisclosure can be wrong for similar reasons.

Deception through nondisclosure and deception through lying can both cause the victim to have a false belief. Lying is ordinarily a more causally significant factor than nondisclosure in causing a false belief.¹⁶⁴ But our use of the word "ordinarily" acknowledges that in some circumstances deception by silence or nondisclosure may be just as wrong as deception by lying.¹⁶⁵

Deontological reasoning faces similar complexity in assessing the morality of causing harm. Ordinarily, it is more obvious that one is morally responsible for harm that one personally inflicts on another person than for harm that one merely allows to befall another person; hitting someone is ordinarily more obviously wrong than standing by and allowing someone to be hit.¹⁶⁶ It also seems true, however, that one may

162. See *supra* note 152 and accompanying text.

163. We forgo the temptation to add to the debate about whether lying under oath in court is worse than lying to one's friends and family, and whether lying about sex is worse than lying about great matters of state.

164. This common empirical assumption underlies the now famous distinction between perjury and "not being particularly helpful" in sworn testimony.

165. See THOMAS M. SCANLON, *WHAT WE OWE TO EACH OTHER* 317-22 (1998) (observing that the potential recipients of information only care about whether they have been deceived and not about the means by which they were deceived). It is not unusual for philosophers to qualify their arguments with the term "ordinarily," which is used almost as commonly as lawyers use the word "reasonable." See, e.g., Nicholas Rescher, *Moral Luck*, in *MORAL LUCK*, *supra* note 40, at 157-58 ("Moral evaluation as we actually practice it generally reflects the ordinary course of things. . . . Moral appraisals are *standardized* in being geared to the situations of the ordinary common run of things." (emphasis in original)).

166. Cf. Harold F. McNiece & John V. Thornton, *Affirmative Duties in Tort*, 58 *YALE L.J.* 1272, 1273 (1949) (asserting that positive actions create a new risk of harm, but passivity merely fails to benefit the unfortunate individual).

sometimes be responsible for harm that one merely allows to occur, and sometimes it is as wrong to allow harm to occur as it is to cause harm more actively.¹⁶⁷ No area in moral theory is more rife with controversy than the debate about the differences between causing harm and allowing harm to occur.¹⁶⁸ We cannot expect to resolve the controversy in this area as a means to getting a solution to our problems about the ethics of deception in the law of insider trading. Instead we want only to point out the following conceptual symmetry. Even if actively causing harm is, all other things being equal, worse than passively allowing harm to occur, it does not follow that allowing harm to occur is not often quite wrong. Similarly, even if, other things being equal, lying is usually worse than nondisclosure, occasions may nevertheless arise where nondisclosure is just as wrong as lying. The conceptual problem is to identify the circumstances when nondisclosure is wrong.

There are obviously relevant moral differences between a typical lie and a typical instance of deception by nondisclosure. Often nondisclosure is nothing more than a simple omission of a true statement relevant to another person's choice; in such a case, it may not interfere with the principle of autonomy. For example, if Rob knows that his neighbor, Laura, intends to purchase a car at Acme Auto, and he knows that Laura could get a better price at Beta Auto, then providing that information might well improve Laura's deliberative process. It would be a distortion to say that Rob interferes with Laura's autonomy by not providing this information. In this case, Rob does not interfere with Laura's autonomy because he is not involved in a morally relevant causal interaction with her. The matter becomes more difficult, however, if Rob is selling his own car to Laura, and Rob knows of a superior alternative down the street. In this

167. This line of thinking underlies the gradual repudiation of "no duty to rescue" in favor of an affirmative duty to prevent obvious harm, at least when it is very easy to do so. See, e.g., John Kleinig, *Good Samaritanism*, 5 PHIL. & PUB. AFFAIRS 382, 383-84 (1976); Saul Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations*, 72 VA. L. REV. 879, 900-01, 936-37 (1986). Currently, in tort law a person may owe a duty to rescue another if he is responsible for putting the other in peril. See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 56, at 377 (5th ed. 1984) (recognizing that when a defendant's actions have created a perilous situation, there is a duty imposed on the defendant to make a reasonable effort to give assistance). By insisting that a possessor of ill-gotten information must disclose before trading, we may seem to impute the equivalent of a duty to rescue. One may wonder why a person owes such a duty to the person with whom he trades securities, who is almost always an anonymous stranger. To stay within the bounds of our analogy: A person owes a duty to this stranger because his act of trading unjustifiably puts the stranger in economic peril.

168. See, e.g., JONATHAN BENNETT, *THE ACT ITSELF* 118-19 (1995) (arguing that there is no moral difference between causing harm and allowing harm to occur); Frances M. Kanum, *Harming Some to Save Others*, 57 PHIL. STUD. 227 (1989) (proposing a theory to explain the moral difference between causing harm and allowing harm to occur); Judith Jarvis Thomson, *Killing, Letting Die, and the Trolley Problem*, 59 MONIST 204 (1976) (describing the difficulties of asserting that causing harm by killing is always morally worse than causing harm by allowing someone to die).

case, Rob lacks the excuse that he engages in no relevant causal interaction with Laura. His negotiation with her may count as a relevant causal interaction. But respecting Laura's autonomy does not require providing her with information that is already accessible to her, because a normal adult can be expected to uncover on her own such information; respect for a person's autonomy is instead consistent with expecting that person to uncover easily accessible information. Therefore, Rob has no duty to provide the information.¹⁶⁹

The hypothetical case of Rob and Laura resembles a famous and controversial Supreme Court case, *Laidlaw v. Organ*.¹⁷⁰ Decided in 1817, this case involved a few American merchants who learned, through the brother of one of the merchants who happened to be on a U.S. navy ship immediately after the Battle of New Orleans, that a peace treaty had been signed with the British ending the War of 1812.¹⁷¹ The merchants then bought a large quantity of American tobacco at the market price without revealing the news about the war to the seller of the tobacco. The announcement of peace ended the naval blockade of New Orleans, and the price of tobacco shot up thirty to fifty percent.¹⁷² The tobacco seller claimed fraud by nondisclosure. The Court reversed a directed verdict for the buyer merchants on the grounds of conflicting testimony about the merchants' response to the seller's alleged question "if there was any news which was calculated to enhance the price or value" of the tobacco.¹⁷³ The case is more well-known, however, for the Court's observation in dicta that "non-disclosure of the treaty of peace would not constitute a fraud."¹⁷⁴ *Laidlaw* therefore asserts that a buyer, in negotiating a purchase, need not disclose material information about market conditions.

169. Note that this line of argument bears a resemblance to the equal information rationale, but with different implications. One version of the equal information rationale would require Rob to reveal the information to Laura unless Laura has "equal access" to the information. See, e.g., Brudney, *supra* note 16, at 251. We agree, but emphasize the interference of Laura's autonomy in making a choice. Rob and Laura may both have information about the market for automobiles, and on our account each has a right to discover and use this market information when bargaining with the other. We therefore stand the "equal access" rationale on its head. In situations where either party may rightfully acquire *unequal* information, such information may be used in bargaining. But information that is wrongfully acquired or used results in an *inequitable* nondisclosure.

170. 15 U.S. (2 Wheat.) 178 (1817).

171. See Keeton, *supra* note 17, at 21-22; Kronman, *supra* note 115, at 10; see also DOUGLAS BRINKLEY, *AMERICAN HERITAGE HISTORY OF THE UNITED STATES* 133 (1998).

172. See Kronman, *supra* note 115, at 10.

173. See *id.* The merchants' response was either "no" (and therefore fraud by direct lying) or silence (which would raise an intermediate question in the law of fraud about the effect of silence in response to a directly material inquiry). See *id.*

174. See Keeton, *supra* note 17, at 22 (summarizing the Court's observation). Against an early version of the equal information rationale, the defendant's lawyer argued that it was "a romantic equality" because "[p]arties can never be precisely equal in knowledge, either of facts or the inferences from such facts." *Laidlaw*, 15 U.S. at 193-94.

If true, this proposition would lend comfort to Rob, who prefers not to disclose market conditions to Laura.

On the surface, *Laidlaw* may seem to be a hard case for our equitable disclosure rationale. Surely the tobacco seller's deliberative processes would have been enhanced by disclosure of news of the peace treaty. By not providing that information, aren't the merchants interfering with the tobacco seller's right to make an autonomous choice and therefore violating the equitable disclosure rationale? We think not. Although it is often wrong to interfere with a person's autonomous decision making by failing to disclose information that the person would find useful, this equitable principle is balanced by the right to protect one's own legitimate interests in information.¹⁷⁵

From a moral point of view, the difficulty in *Laidlaw*, as compared with cases where a person obtains an informational advantage through work, skill, or intelligence, is that the merchants in *Laidlaw* seem to gain an informational advantage as a matter of mere luck.¹⁷⁶ The next question

175. Kronman offers an argument with a similar conclusion on economic grounds. See Kronman, *supra* note 115, at 11-13. We do not address whether affirmative lies may be justified on the grounds of protecting one's rights to information because this problem does not ordinarily arise in insider trading cases. Some scholars have argued in favor of a right to lie in some securities cases. See Marcel Kahan, *Games, Lies, and Securities Fraud*, 67 N.Y.U. L. REV. 750, 794 (1992) (arguing that lies during merger negotiations should be exempt from federal securities laws); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 139-41 (1982) (arguing for a standard of "optimal dishonesty" that would allow transactional lies in some situations). But see *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 (1988) (rejecting this view in merger situations). For a moral defense of lies in some nonsecurities contexts, see Strudler, *supra* note 157.

We acknowledge that our position has a superficially paradoxical implication: It suggests that autonomy will be compromised by illicitly acquired information but not by properly acquired information, even when the content of the information is exactly the same. For example, suppose that in *Laidlaw* the tobacco buyer had stolen the information about the end of the war. On our account, the buyer's failure to disclose would then constitute a violation of the seller's autonomy and therefore amount to wrongful deception. Because the seller's decision to sell at a particular price would seem to be equally affected by withholding the information, whether it was stolen or properly acquired, one might suspect that we are mistaken to think that whether nondisclosure of information is wrongful depends on whether or not the information is ill-gotten. This doubt is misplaced. Although it is not easy to say exactly what respect for autonomy requires in commercial trading situations, respecting a person's autonomy does not require sacrifice of one's own rights. If a person, because of innocent ignorance, trespasses on one's land, one may force the trespasser off one's land without compromising the trespasser's autonomous choice. On the other hand, if a person crossing some land does not threaten one's property rights, it would be wrongful to interfere. Reflection on this example demonstrates that a person's autonomy may be constrained by another person's property rights. Thus, the wrongful acquisition or use of information may compromise one's autonomy even when the rightful acquisition and use of the very same information would not. Respect for autonomy does not mandate a rule of full and complete—or equal—disclosure of important information.

176. The luck was in the happenstance of the merchant's brother learning of the advance news of the peace treaty. *Laidlaw*, 15 U.S. at 182-83. Arguably, the merchants had prepared themselves by working in the business of buying and selling tobacco to take advantage of this good fortune, which reminds us of the old American football adage that "luck is what happens when preparation meets opportunity." Even so, *Laidlaw* presents a rather clear case of circumstantial or situational luck.

is whether this difference between obtaining an informational advantage by luck as compared to effort, skill, or intelligence is morally relevant. This question translates into a crucial one in the law of insider trading: When a securities trader acquires material nonpublic information by luck, does the trader have a moral and legal right to keep this information secret, or does respect for the rights of others in the market require the trader to disclose this information?

3. *Why Trading on Inside Information Gained by Luck Is Not Always Wrong.*—There is nothing untoward or uncommon about acquiring property rights through mere luck. Whether one acquires a one-hundred dollar bill by stumbling upon it when somebody had the misfortune to lose it on the street, or one acquires it through diligent and arduous labor, the right to possess the one-hundred dollar bill stands on par under the common law of property.¹⁷⁷ Lotteries are recognized in most states, and gambling of some kind is legal in almost all.¹⁷⁸ Wealth, intelligence, and talent can be inherited by good fortune. The mere fact that personal property has been acquired by luck does not undermine morally strong ownership claims. Indeed, a burgeoning literature in moral philosophy suggests that moral rights and other advantages often unavoidably and quite properly derive from luck.¹⁷⁹ Because luck in finding or otherwise acquiring personal property is often recognized as creating a legitimate right in that property, we maintain that it is coherent and morally defensible for *Laidlaw* to declare that information acquired through luck need not be

177. This is the well-known "finder's rule." In most cases, the finder of abandoned property has a right to the property superior to everyone except the original owner, and the passage of time (along with the relevant statute of limitations) converts the finder's property right into a superior one even with respect to the first owner. See Levmore, *supra* note 167, at 904. The result is different, of course, if the one-hundred dollar bill is found in a wallet that identifies the true owner.

178. See Naomi Mezey, Note, *The Distribution of Wealth, Sovereignty, and Culture Through Indian Gaming*, 48 STAN. L. REV. 711, 711-12 (1996) (observing that lotteries are played in 37 states and some form of gambling is legal in all states except Hawaii and Utah).

179. For two of the most influential treatments of the topic in contemporary philosophy, see THOMAS NAGEL, *Moral Luck*, in MORTAL QUESTIONS 24, 24-38 (1979) and BERNARD WILLIAMS, *Moral Luck*, in MORAL LUCK: PHILOSOPHICAL PAPERS 20, 20-39 (1981). Nagel distinguishes four kinds of moral luck: (1) constitutive luck which determines "the kind of person you are" in terms of "inclinations, capacity, and temperament," (2) circumstantial luck which involves "the kind of problems and situations one faces," (3) causal antecedent luck in which prior circumstances determine future events, and (4) causal future luck, which is "luck in the way in which one's actions and projects turn out." NAGEL, *supra*, at 28; see also MARTHA C. NUSSBAUM, *THE FRAGILITY OF GOODNESS: LUCK AND ETHICS IN GREEK TRAGEDY AND PHILOSOPHY* 1-8, 322-40 (1986) (discussing classical Greek thought about moral luck); MORAL LUCK: PHILOSOPHICAL PAPERS, *supra*; Margaret Urban Walker, *Moral Luck and the Virtues of Impure Agency*, 22 METAPHILOSOPHY 14, 14 (1991) ("Moral luck consists in the apparent and allegedly problematic or even paradoxical fact that factors decisive for the moral standing of an agent are factors subject to luck.").

disclosed in a sales transaction.¹⁸⁰ The same rationale applies by analogy to the law of insider trading.

Despite the fact that it may be acceptable for a person to acquire property rights through mere luck, fairness may require limiting windfall advantages that a person receives through such acquisition. Consider, for example, the law of inheritance. People who are lucky enough to have rich parents inherit more money than those who do not, and liberal social institutions grant some deference to this phenomenon.¹⁸¹ Estate and inheritance taxes may nevertheless fairly impose some limits on the extent to which a person can enjoy such good fortune.¹⁸² Indeed, one plausible interpretation of John Rawls's classic work, *A Theory of Justice*, argues that his defense of the principles of justice rests mainly on the contention that social institutions should adjust the comparable advantages that a person obtains as a matter of luck in the inheritance of social and natural endowment.¹⁸³

In any event, it would be virtually impossible to limit the full impact of luck when dealing with issues of disclosure in market transactions. Consider *Laidlaw*. If a rule required disclosure in this case, then the tobacco merchants would not enjoy the benefit of their good fortune in discovering valuable information. If instead a rule is adopted that permits nondisclosure, as in *Laidlaw*, then the tobacco buyers, rather than someone else, enjoy the benefits of their luck. Whoever is able to take advantage of this information first—whether buyers or sellers—will get a windfall from the normal operations of the market. Because either disclosure rule gives someone a benefit and someone a loss, equitable considerations are

180. Here we differ from Keeton, who argues that while it may have been morally problematic for the tobacco merchants not to disclose in *Laidlaw*, it is acceptable for law to adopt a lower standard than morality, and that the duty to disclose may not be a legal duty but rather a mixed question of law and fact. See Keeton, *supra* note 17, at 32-33 (concluding that the law should track the actual customs of society and not its moral views). In explaining why it is acceptable for law to impose a lower standard than morality, Keeton argues that law should not impose a sanction against a person for committing an act that most people would also commit if confronted with similar circumstances. See *id.* (arguing in favor of applying the "standard man" approach, consisting of what an ordinary man would do with respect to questions of moral judgment). We disagree with Keeton's suggestion that an immoral act that most people would commit should be tolerated under the law. Carried to its logical extreme, this argument condones any immoral act whenever it is an act that most people, in the right circumstances, would do. Evidence from social psychology, for example, suggests that most people would commit criminal assault if instructed to do so in certain noncoercive circumstances by a person in authority. See STANLEY MILGRAM, *OBEDIENCE TO AUTHORITY* (1974) (describing findings of various social science experiments testing individuals' responses to perceived authority figures). But it hardly follows that law should tolerate assault actually committed by people in these circumstances. In addition, our position differs from Keeton's because we believe that there is not necessarily anything morally wrong with failing to disclose information that one has acquired through sheer luck.

181. See Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990) (noting the lack of public support for increased restrictions on inheritances despite the possibility of increasing the equality of opportunity to children through greater taxation on inheritance).

182. See *id.* at 72-73.

183. See BRIAN BARRY, *THEORIES OF JUSTICE* 213-32 (1991).

compromised no matter which rule is adopted. We conclude that there is nothing wrong with a rule that permits people who are lucky enough to stumble on valuable information from using the information to their advantage in the market.¹⁸⁴

V. Equitable Disclosure, Fraud-on-the-Investor, and the Structure of Insider Trading Law

The equitable disclosure rationale supporting our fraud-on-the-investor theory of insider trading provides that if you have no more right to material nonpublic information than does the person with whom you make an exchange, and your using that information would put the other person at a disadvantage in making the exchange, then you wrong that person by using that information, and your failure to disclose the information renders the trade fraudulent.¹⁸⁵ For example, if you steal material nonpublic information relevant to a securities transaction, then you have no moral or legal right to use it against the person with whom you are transacting. Or if someone entrusts you with material nonpublic information on the assumption that you will keep it confidential, then you similarly have no moral or legal right to convert this information to your own use in securities trading.¹⁸⁶

An important corollary to the equitable disclosure rationale is that if you *do* have a superior right to material nonpublic information then you may use it in trading without liability. The easiest cases are those in which a person has invested "effort, time and money in research, and talent and training in analysis" to acquire the information.¹⁸⁷ In these situations, the person has a deserved advantage in having superior information to the market. Neither ethical nor legal principles should deny a person from

184. We recognize an exception to this rule, however, in situations in which luck may put one in such an extremely advantageous position compared to the weakness of another that the principle of unconscionability should apply. Cicero gives an example from Roman law. See Keeton, *supra* note 17, at 23. A merchant from Alexandria takes corn by ship to Rhodes. On the journey, he passes other ships also laden with foodstuffs. When the merchant arrives in Rhodes, he finds that the people are starving and thus willing to pay an enormous premium for the corn. Under Roman law, according to Cicero, failure to disclose the nonpublic material information that other ships were just over the horizon constitutes fraud. Even though the merchant finds himself in a superior position due to luck, we agree that the weak position of starving people justifies an exception to the rule that one can take advantage of this situation, though we would frame the argument in terms of unconscionability. It is, for example, unconscionable to extract a premium for food from starving persons. See ALAN WERTHEIMER, *EXPLOITATION* 55-64 (1996). Insider trading cases, however, would almost never pose so severe a test.

185. For lack of a better term, we follow convention in using "insider trading" to refer to both insider and outsider trading situations. See *supra* note 14 and accompanying text.

186. Justice Ginsburg's majority opinion in *O'Hagan* echoes this reasoning: "Deception through nondisclosure is central to the [misappropriation] theory of [insider trading] liability." *O'Hagan*, 521 U.S. at 654.

187. Brudney, *supra* note 47, at 341. Profiting from one's natural talents and intelligence would also qualify as what Nagel calls "constitutive luck." See *supra* note 179.

profiting from this informational advantage. And neither ethical nor legal principles should require disclosure before a person lawfully in possession of this information trades on the basis of it.¹⁸⁸ In this Part, we argue that the major Supreme Court opinions on insider trading follow this corollary and allow nondisclosure of a deserved informational advantage in securities trading.

An intermediate category is obtaining material nonpublic information by circumstantial or situational luck.¹⁸⁹ In these cases, we argue that a person who gains inside information purely by chance, and without relying on theft or any other illicit act, does not ordinarily have a moral duty to refrain from using this information in securities trading before disclosing it. As we discuss next, *Dirks v. SEC*¹⁹⁰ provides a good example of this kind of situation.¹⁹¹ Our discussion of *Dirks* and similar cases allows us to draw some implications about the logical structure of insider trading, including an explanation of why the law of insider trading should protect investors in securities even in the absence of fiduciary duties owed to them either by the firm in whose securities they trade or the person with whom they trade in the market.

Especially difficult cases arise on the border between inside information received by luck and inside information that is legally possessed but "misappropriated" and misused. Examples include situations in which a person with material nonpublic information who does not have a right to trade on it "tips" a friend or family member as a misguided favor. These cases are difficult because they do not involve an illicit acquisition of the information by the tippee (thus exemplifying a limitation of the illicit acquisition rationale).¹⁹² Instead, the tippee converts rightfully acquired information to an impermissible use. We show how our equitable disclosure rationale provides an analytical resolution for these difficult cases.

In another group of important and difficult cases, one may legitimately acquire information but then misuse it to the disadvantage of other market participants by what we call "frontrunning" or "self-frontrunning." These kinds of cases include the following: a corporation trades in its own securities on the basis of inside information or authorizes its officers, directors, employees, or other fiduciary agents to do so;¹⁹³ a reporter or a media

188. As we note above, there are also economic arguments in favor of allowing persons to trade on the basis of unequal information. See *supra* notes 114-15 and accompanying text.

189. See *supra* section IV(D)(3).

190. 463 U.S. 646 (1983).

191. For an argument on different grounds that *O'Hagan* precludes "holding inadvertent or accidental recipients of material nonpublic information liable" for insider trading, see Seligman, *supra* note 16, at 22.

192. See *supra* subpart IV(C).

193. See, e.g., Securities Exchange Act of 1934 § 13(e)(1), 15 U.S.C. § 78m (1994) (forbidding stock issuers from purchasing their own stocks when such a purchase violates the SEC antifraud regulations issued pursuant to the statute).

company trades on the basis of news stories in advance of publication;¹⁹⁴ a government official trades on the basis of confidential information about a planned contract or major purchase;¹⁹⁵ or a law clerk or judge trades in advance of the announcement of a decision that alters stock prices.¹⁹⁶ Our fraud-on-the-investor theory of insider trading and its equitable disclosure rationale provide a viable analytical approach to these cases.

A. *Moral Luck, Dirks v. SEC, and the Logical Structure of Insider Trading Law*

In *Dirks*, the defendant was a broker who received inside information from a former executive of Equity Funding of America. The executive had reported the assets of the company to be "vastly overstated" because of "fraudulent corporate practices."¹⁹⁷ Dirks investigated the allegations by traveling from his office in New York to Los Angeles and interviewing employees of Equity Funding. Some of the employees corroborated the information, and Dirks advised some of his clients to liquidate their holdings in Equity Funding of approximately \$16 million.¹⁹⁸ Immediately before Equity Funding's fraudulent activity became public, the New York Stock Exchange halted trading in the stock when it fell from \$26 to \$15 per share.¹⁹⁹ Equity Funding then went bankrupt.²⁰⁰ We argue that Dirks properly took advantage of this information because he received it in a manner untainted by theft or any wrongful act.

Dirks avoided millions of dollars in losses for his clients. But the SEC investigated his role in uncovering the fraud at Equity Funding and decided to bring an enforcement action against him, relying on the "traditional theory" of insider trading liability.²⁰¹ The SEC alleged that Dirks was a "tippee" of the former executive from whom he received inside information.²⁰² Recognizing at least that Dirks had helped to uncover a major case of internal corporate fraud, the SEC sought only to

194. This is the situation addressed in *Carpenter v. United States*, 484 U.S. 19 (1987). See *supra* notes 52-55 and accompanying text; see also Martin Kimel, Note, *The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters*, 38 STAN. L. REV. 1549, 1570-76 (1986) (recommending federal legislation to regulate financial reporting).

195. See, e.g., Seligman, *supra* note 23, at 1127-29. An example is provided by the facts of *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) (involving the conviction of a former director of the West Virginia Lottery for using confidential nonpublic information in the purchase of securities companies doing business with the Lottery), *overruled by* *United States v. O'Hagan*, 521 U.S. 642, 650 (1997).

196. See *supra* note 43 and accompanying text.

197. *Dirks*, 463 U.S. at 649.

198. *Id.*

199. *Id.* at 650.

200. *Id.* at 649-50.

201. *Id.* at 650-51; see also *supra* Part II (discussing the "traditional theory").

202. *Dirks*, 463 U.S. at 651.

"censure" him.²⁰³ Dirks appealed, and the Supreme Court overturned his censure.²⁰⁴

Under the fraud-on-the-investor theory that we have developed, Dirks should never have been disciplined by the SEC for insider trading in the first place. It shouldn't even have been a close case. Although the Supreme Court reversed Dirks's censure, thus arriving at the correct result, the Court followed a convoluted reasoning under the "traditional theory" of insider trading, arguing that Dirks, like the broker Gintel in *Cady, Roberts & Co.*, was the "tippee" of a corporate fiduciary.²⁰⁵ The Court arguably added a requirement to the "tippee" test that an insider who tipped Dirks had to receive "a direct or indirect personal benefit from the disclosure" before the tippee could be found liable.²⁰⁶ But this test is not sufficient. Even under the facts of *Dirks*, the former corporate insider who tipped Dirks arguably received at least an "indirect" benefit in terms of his own reputation or even revenge against his former employer.²⁰⁷ Under this theory, Dirks's innocence and the innocence of "tippees" in the future turns on whether the corporate insider who "tips" the information benefits from the disclosure. It is not self-evident that a benefit to an insider is relevant to the wrongfulness (or not) of the tippee's conduct. Instead, the relevant moral analysis would seem properly to fall on the tippee's actions and state of mind.

If it were true that Dirks had stolen the information, then his resulting informational advantage would have been improper on our account. But Dirks did nothing wrong. The information that he acquired from Equity Funding was information about the firm's own wrongful activity, and he received this information from a former insider who volunteered the "tip." Dirks did not bribe the insider or steal the information from him. Dirks had a legitimate right to take advantage of the information gained by his luck, effort, and investment (including a round-trip coast-to-coast plane ticket).²⁰⁸ The fact that the insider received no benefit tends to confirm

203. *Id.* at 651-52. The irony of this has not gone unnoticed. See EASTERBROOK & FISCHEL, *supra* note 19, at 267 (stating that the SEC should have given Dirks a medal even while condemning forms of insider trading that injure investors).

204. *Dirks*, 463 U.S. at 652.

205. *Dirks*, 463 U.S. at 655-56 (stating that a tippee "inherits" a duty from the corporate insider under *Cady, Roberts*). For discussion of *Cady, Roberts* and the fiction of a tippee's "inheritance" of an insider's fiduciary duty, see *supra* notes 99-110 and accompanying text.

206. *Dirks*, 463 U.S. at 663-64.

207. Revenge is not an uncommon motive in insider trading cases. See *United States v. Cherif*, 943 F.2d 692, 694 (7th Cir. 1991) (involving a scheme by a former bank employee to steal information to "make some easy money" and "get back" at a former employer).

208. See *Dirks*, 463 U.S. at 649. Even if the issue of moral luck could be argued differently another equitable fact that helped the Court decide the case was that Dirks had attempted to report the fraud to the financial press. The *Wall Street Journal* refused to print the story because the Los Angeles bureau chief disbelieved the story and feared a libel suit. *Id.* at 649-50. How can Dirks be moral

Dirks's innocence, and hence the propriety of his using the information.²⁰⁹ An analyst who uncovers material information by luck rather than thievery or other misappropriation should be allowed to benefit from using the information.²¹⁰

Our equitable disclosure rationale for fraud-on-the-investor theory helps to explain several other notable court decisions. In *SEC v. Switzer*²¹¹ Barry Switzer, the famous football coach, was attending a state track meet where both his son and the son of the CEO of Texas International Company (TIC) were competing. Switzer knew the CEO socially, but they were not good friends.²¹² At one point when Switzer was sunbathing, he accidentally overheard the CEO's discussion with his wife about TIC's planned merger with Phoenix Resources Company (Phoenix).²¹³ After the track meet, Switzer called some friends with whom he had often made investments on the basis of "rumors or gossip."²¹⁴

Switzer and his friends bet heavily on Phoenix and were rewarded with hundreds of thousands of dollars in profits when the stock increased from \$44.50/share on the day after the track meet to \$61/share two days later when the merger was made public.²¹⁵ The SEC alleged that Switzer and his friends had committed securities fraud, but the court held under *Dirks* that "Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider."²¹⁶ The SEC argued on the basis of circumstantial evidence that Switzer and the CEO had in fact intentionally exchanged the information, but the court instead believed the

at fault for failing to disclose information when he made a bona fide attempt to do so? Dirks's moral position is at least equivalent, if not superior, to the position of the American merchants who traded in tobacco in *Laidlaw*. See *supra* notes 170, 174-176 and accompanying text.

209. This evidence is also relevant to Dirks's scienter, but we leave this issue outside the scope of this Article. See *supra* note 34.

210. Cf. Paul P. Brountas Jr., Note, *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1545-49 (1992) (arguing that strict enforcement of an equal information rationale would unfairly affect securities analysts). But see Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1023-25 (1990) (arguing that concern for investment analysts is "substantially overstated"). In 1991 the SEC brought an action against an executive of a public corporation for tipping inside information to financial analysts (who then tipped their clients) when the only arguable "personal benefit" to the executive was enhancing his reputation with the analysts. The case settled before the SEC had to test its theory in court. See Boris Feldman & Ignacio E. Salceda, *The Disclosure Dichotomy*, 2 INVESTOR RELATIONS Q. 4, 9 (1999).

211. 590 F. Supp. 756 (W.D. Okla. 1984).

212. *Id.* at 761.

213. *Id.* at 758-59, 762. The facts in *Switzer* may have occurred before the adoption of Rule 14e-3, which prohibits trading on undisclosed plans for a tender offer when one "knows or should have known" that it derives from an insider. See *supra* notes 6, 33.

214. *Id.* at 761.

215. *Id.* at 759.

216. *Id.* at 766.

testimony of Switzer and the CEO.²¹⁷ Because the information was "not intentionally imparted . . . for an improper purpose," the court found no securities fraud.²¹⁸

This result comports with our argument that so long as there is nothing improper in the manner in which a person acquires or uses information, then he may trade on it. According to the facts found by the court, Switzer was no thief. The information fell into his lap. The CEO accidentally revealed the information in public, and to that extent he compromised the company's property interests in the information. But if the CEO had accidentally blurted out the information while bragging during a drinking bout at a local pub or during a television interview, nobody would doubt a listener's right to trade on it. The fact that he accidentally revealed the information to a smaller audience does not diminish the lucky listener's rights. According to the facts found by the court, Switzer had obtained information from the CEO through a combination of his own good luck and the CEO's foolishness. The situation would be different if Switzer intentionally eavesdropped to hear and therefore steal material nonpublic information. Then the information would have been acquired not by luck but by ill-intentioned design.²¹⁹

217. *Id.* at 768. If Switzer had been the beneficiary of an intentional tip and then traded on it, we argue that he should have been liable for securities fraud. See *infra* notes 225-30 and accompanying text.

218. *Id.* at 766.

219. There is a tension between the right that Switzer possesses, which allows him to trade on information that he luckily stumbled upon, and the right that the Buyer in Antique Store possesses, which disallows the Buyer from trading on the opportunity of a mistaken price. See *supra* text accompanying note 156. Why should the Buyer in Antique Store disclose to the owner the mistaken price, when at the same time Switzer and his friends may trade on mistakenly disclosed information? What distinguishes these two examples? One important difference is in the nature of the information "found." Switzer found information that was intended by its owner to remain a secret; the Buyer in Antique Store found mistaken information that was intended by its owner to be public. In some sense, disclosure is required out of respect for the owner of information in Antique Store, but not in *Switzer*. Concern about the intentions of the owner of information may seem to suggest the opposite result; after all, the CEO in *Switzer* did not intend that someone in Switzer's position would trade on the information. But we doubt that the CEO in *Switzer* has a legitimate complaint.

Information is a unique kind of property. Once its rightful owner loses control of it, there is little sense in the idea of restoring it. When one accidentally loses secret information to the public, its value is destroyed. The secret is out. The original owner's right to the information dissipates. The contrast with property other than information is striking. If one sees that a particular person has dropped a one hundred dollar bill, it would be theft to take it; the morally right action is to return the money. If, however, one is in a room full of people and someone reveals a confidence to everyone gathered, it makes little sense to contemplate returning the information. Once confidential information is disclosed, "the cat's out of the bag."

Despite our insistence that an owner of secret information ordinarily loses rights in the information by accidentally disclosing it, we acknowledge that reasonable people might disagree about the application of this rule in *Switzer*. One might doubt the CEO really let the cat out of the bag. If few people knew the information and if Switzer became the only member of the public privy to it, he could easily have preserved the secret. One might therefore think that it was wrong for Switzer to use the

*SEC v. Maio*²²⁰ presents an example of impermissible tipping of inside information among friends amounting to securities fraud under our deontological theory. Much more than a trader's luck or an insider's foolishness is required to explain how the defendants in *Maio* came to possess inside information; illicit intentions to misappropriate the information were involved. Michael Maio and Patricia Ladvac were close friends with the CEO of Anacomp, Inc.²²¹ When Anacomp entered merger discussions with Xidex Corporation, Anacomp's CEO tipped the material nonpublic information to Maio and Ladvac, who traded in the stock of both Anacomp and Xidex, allowing them to make a few hundred thousand dollars in profits.²²² The SEC brought a civil enforcement action against all three of the friends. Anacomp's CEO pled no contest and agreed to pay \$275,000. Maio and Ladvac denied receiving or sharing tips, but were found liable for insider trading after a trial.²²³ The court held, correctly in our view, that the CEO's tip was an "improper gift of inside information" to "a trading friend."²²⁴ On our account, what matters is that the CEO used the information in a manner inconsistent with a respect for the legitimate interests of his corporation and its shareholders, not whether he received any direct benefit by his action.²²⁵ The CEO was in effect a thief, but a thief who stole for his friends rather than for himself. His illicit communication of confidential information sufficed to morally taint the information that he gave to his friends, and to render that information an improper basis for his friends to make a securities transaction.²²⁶

A variant of this situation is presented by cases involving tips within families, but there is often a wrinkle in these cases. Family and friend

information. But people who fail to protect their own secrets cannot ordinarily expect others to protect them, at least in commercial situations. If, as we suggest, a commercial secret blurted out in a crowded room is no longer secret, it seems arbitrary to impose a special burden of confidentiality on Switzer merely because other people were not also present when he overheard the secret. It seems fair for Switzer to regard the information he overheard as "found." For that reason, we believe that *Switzer* was correctly decided, though we agree that it is a difficult case.

220. 51 F.3d 623 (7th Cir. 1995).

221. *Id.* at 627.

222. *Id.* at 628-29. Maio made \$211,000 and avoided \$66,250 in losses, and Ladvac made \$78,750 and avoided \$15,750 in losses.

223. *Id.* at 630.

224. *Id.* at 632.

225. This case illustrates the difficulty with the "direct or indirect benefit" test for tippee liability under *Dirks*. See *supra* notes 206-10 and accompanying text. Even if the CEO in *Maio* freely gave away the information to a friend without any personal benefit to himself, it would be wrong for a friend who is a tippee to trade on this information knowing that the information has been intentionally given in violation of a fiduciary duty.

226. For this reason as well, Switzer should have been found liable if he had received an intentional tip of inside information from the CEO as a favor. In fact, this was the SEC's theory of the case, but the court believed the testimony of Switzer and the CEO that the disclosure was inadvertent. See *supra* note 217 and accompanying text.

situations often involve violations of promises of confidentiality.²²⁷ In *United States v. Reed*,²²⁸ for example, Thomas Reed traded on information about a proposed merger confidentially imparted to him by his father, Gordon Reed, who served as a director of one of the companies involved in the merger.²²⁹ The court imposed liability under the misappropriation theory, but in our view for the incorrect reason of "fraud-on-the-source."²³⁰ The wrong in situations like *Reed* occurs when the tippee (who is not intended as a tippee) improperly converts confidential information imparted for a different purpose to a purely personal use of securities trading. For reasons similar to those in our discussion of *Maio*, we believe that sharing material nonpublic information with family or friends gives rise to a duty not to trade on this information with investors because there is no deserved right to do so. When a family member or friend intentionally misuses information against the wishes of the donor of the information and in violation of a confidence promised to the donor, the wrong of using this information morally taints the securities transaction because the person trading on it does not have a superior right to use the information compared to others in the securities market. Unlike in *Dirks* or *Switzer*, the information is not acquired by circumstantial or situational luck. Instead, it is acquired confidentially and with the understanding that it is not to be used for trading purposes. Although the trader may have a legal right to possession of the confidential information, this right does not extend to use of the information for securities trading.²³¹

227. For recent cases involving friends who tip inside information, see *SEC v. Mayhew*, 121 F.3d 44, 47-49 (2d Cir. 1997) (upholding the conviction of a retired pilot trading on material nonpublic information received from his friend, neighbor, and jogging partner) and *United States v. Mylett*, 97 F.3d 663, 666 (2d Cir. 1996) (affirming the conviction of a vice president for labor relations of AT&T who tipped a friend about information of an impending merger with NCR). Another well-known insider trading case raising this issue of duty and disclosure within families is *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (tracing the chain of tipped inside information within a family).

228. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

229. *Id.* at 690-91.

230. The court applied fraud-on-the-source misappropriation theory and held that the "confidential relationship" of "trust and confidence" shared by the father and son could supply the breach of fiduciary duty necessary to apply the theory. *Id.* at 703-08, 711-18. Curiously, the court agreed that if the relationship between the father and son had *not* been confidential, then the court would have had to dismiss the indictment for securities fraud. *Id.* at 717. The court, remarkably, named the relevant harm suffered in the securities fraud to be the "sullied reputation" and "shame and misfortune" visited on the father. *Id.* at 720. This example reinforces our argument that the fraud-on-the-source misappropriation theory does not maintain a rational connection with securities trading. See *supra* subpart IV(B). The purpose of the federal securities laws is neither to encourage arms-length relationships between parents and children nor to police the harm that children can do to their parents' reputations!

231. Again, this example demonstrates the superiority of our equitable disclosure rationale as compared with the illicit acquisition rationale. See *supra* subpart IV(C). Our theory accounts for inequitable use of information even when the information is lawfully and rightfully acquired and possessed. In this respect, our approach is also superior to the "business property" theory of insider trading. See *supra* note 115 and accompanying text.

A related situation arises when a professional adviser receives material nonpublic information in confidence and then uses the information to trade in securities. Even though these professionals are not usually friends or family of their tippee clients, a similar analysis applies. In *United States v. Willis*,²³² for example, a psychiatrist traded on personal and confidential information confessed in therapy by the wife of a CEO of a corporation.²³³ The client confided the undisclosed interest that her husband had in becoming the CEO of BankAmerica Corporation. Willis then bought BankAmerica stock on the basis of this information, made about \$27,000 on his trading, and was indicted.²³⁴ On these "novel facts," the court upheld the indictment under the misappropriation theory, arguing that Willis had violated a duty of confidentiality owed to his client.²³⁵ We agree. Although Willis did nothing wrong when he initially acquired the information on which he traded, it was information that both his contractual relationship with his client and his professional responsibility required to be kept confidential. He obtained the information from his patient on the understanding that it would not be used for the purpose of securities trading. By using the information to trade securities, Willis wrongly converted the information under the equitable disclosure rationale. Because he had obtained the information in professional confidence, he did not have a better right to this information than anyone else trading in the market and had no justification to defend his use of the information. He therefore had a duty not to trade on the information.²³⁶

232. 737 F. Supp. 269 (S.D.N.Y. 1990).

233. *Id.* at 270-71. *O'Hagan* and other cases involving lawyers also present a version of this issue, though they are often easier because lawyers are considered "temporary insiders" for most purposes and therefore are considered to have direct duties not to trade on confidential information. See *supra* text accompanying notes 12-16, 56-60 (discussing *O'Hagan*). For a closer case involving an attorney, however, see *SEC v. Singer*, 786 F. Supp. 1158 (S.D.N.Y. 1992). *Singer* involved two stock purchases in WearEver Proctor-Silex Corporation by an attorney who was an adviser and close friend of one of WearEver's outside directors. *Id.* at 1161. With respect to the earlier purchase, the attorney claimed that he had heard information about a possible leveraged buyout of WearEver from someone else. *Id.* at 1161-62. If true, these facts would absolve the attorney under our theory of moral luck. On the other hand, the WearEver outside director testified that it was "inconceivable" that he would not have had told his attorney about the proposed leveraged buyout, though he did not remember details. *Id.* at 1165-68. A tip under these circumstances would involve a misappropriation of the information by the attorney sufficient for insider trading liability. Given the dispute about material facts, the court properly denied the defendant's motion for summary judgment. *Id.* at 1168-69, 1172.

234. *Willis*, 737 F. Supp. at 271.

235. *Id.* at 271-75.

236. Some further examples may help to clarify the line that our deontological theory draws in these difficult cases of circumstantial moral luck. Imagine a bank of telephones at an airport. On one phone, Han, a corporate CEO, calls his office and discusses an impending announcement of significantly increased earnings of his company. Leia is standing next to Han at the airport by chance and overhears the conversation. She gains the information by innocent luck, and because Han has no intention to impart the information to Leia for an improper purpose, Leia's trading does not qualify as

In obvious ways, our analysis of *Maio*, *Reed*, and *Willis* is reminiscent of an analysis that might be advanced under the fraud-on-the-source misappropriation theory. We have maintained that because the information on which a friend, family member, or professional psychiatrist trades was acquired in a breach of trust, its use is fraudulent. We differ from fraud-on-the-source misappropriation theory, however, in that (1) we identify the victim of fraud as the party with whom the misappropriating party trades, not the party to whom the fiduciary duty is owed, and (2) although the fraud-on-the-source misappropriation theory requires breach of a fiduciary duty as a condition precedent for finding securities fraud, we argue that such a breach represents only one way in which the acquisition of information can be morally tainted and rendered an illicit basis for securities trading. On a practical level, our account differs from the fraud-on-the-source misappropriation theory because it requires that if Willis, for example, had stolen the relevant information from a stranger, then the information would have still been tainted in a way that creates an improper informational advantage and hence a duty to disclose. On our account, the existence of a fiduciary relationship in *Willis* and other cases is relevant because it helps explain how the trader wrongly acquired and used the information on which he or she traded, not because a breach of a fiduciary relationship is a prerequisite for insider trading liability. Our account incorporates the same moral intuitions that drive misappropriation cases, but without the fiction of a "fraud-on-the-source."

Our account also incorporates intuitions about "fiduciary duties," but not in the mechanical manner of current traditional and fraud-on-the-source misappropriation theory. On our account, in each instance of insider trading a person must wrongly acquire material nonpublic information or wrongly convert properly possessed information to a misuse that is inconsistent with the autonomy rights of others. When information is morally tainted by illicit acquisition or misuse, a securities trade based on it would compromise the rights to autonomy of the person with whom the

unlawful insider trading. (Leia's situation is similar to *Dirks* and *Switzer*. See *supra* text accompanying notes 197-219.) Yoda, however, has implanted an eavesdropping device in the telephone to surreptitiously record conversations. He hears the material nonpublic information and also trades on it. Yoda is liable for insider trading because Yoda steals the information, even though Han is unaware that he is being recorded. Lastly, Han hangs up the phone to his office and then quickly telephones his friend, Luke. He tips Luke with the information and, if Luke trades on the information, then he commits insider trading because both Han and Luke intended the tip to be used to defraud an investor in the securities market. (Luke's situation is similar to *Maio*. See *supra* text accompanying notes 220-26.) In all of these cases, whether insider trading has occurred turns on the issue of whether relevant information has been stolen or intentionally misused. Whether a theft or intentional misuse has occurred is often difficult to determine as a matter of fact, but we maintain that it forms a steadier fulcrum from which to decide real insider trading cases than the see-saw of the traditional theory and fraud-on-the-source misappropriation theory.

wrongdoer trades. Wrongful acquisition or misuse of information often, but not always, involves a breach of a fiduciary duty. For example, when a corporate officer, director, or employee trades in the stock of the company on the basis of material nonpublic information with an existing shareholder, then the insider arguably breaches a fiduciary duty. But even when such an insider trades with someone who does not yet own stock in the company or in public debt, we argue that the insider still has an equitable duty to disclose, even if it is not a corporate "fiduciary duty" owed to the person with whom one trades.²³⁷ Respect for an investor's rights to autonomy requires the fair disclosure of important information, except when one has a legitimate right to withhold the information.

Our fraud-on-the-investor account of insider trading is also superior to fraud-on-the-source misappropriation theory because it does not focus myopically on the wrong done to the "source" of information. This wrong amounts to securities fraud only when it is subsequently used to defraud investors. Willis, for example, does not commit securities fraud against his patient with whom he engages in no securities transaction.²³⁸ On our account, Willis defrauds the investor on the other end of his securities trade. Our account therefore avoids what might be called the "consent of the source" problem. Under our analysis of *Willis*, it would not matter if the psychiatrist's patient imparted inside information either as an intentional gift or as a form of payment for services. Trading on the information would still be wrong from the perspective of other investors with whom the psychiatrist would trade. Fraud-on-the-source theory instead allows for the possibility that the "source" may authorize an otherwise illicit use of information for trading. Because our fraud-on-the-investor account has a conceptual coherence that both traditional theory and fraud-on-the-source misappropriation theory lack, it promises to stand as a more stable guide to reasoning about cases, such as "consent of the source," that are otherwise difficult to explain. Other important problems are raised by cases of what we call "frontrunning" and "self-frontrunning."

B. Insider Trading by Frontrunning and Self-Frontrunning

Frontrunning and self-frontrunning constitute fraudulent practices that lie at the heart of some of the most sensational Supreme Court cases on insider trading. Our fraud-on-the-investor theory of insider trading illuminates the wrong that occurs in these cases.

"Frontrunning," as we use the term, occurs when a person lawfully possesses material nonpublic information but improperly converts it for

237. See *supra* text accompanying notes 47-66 (discussing the problem of defining fiduciary duty in the context of traditional theory).

238. See *supra* text accompanying note 230 (discussing the problem of identifying the wrong in the context of fraud-on-the-source theory).

personal use in securities trading in a manner that works to the detriment of other parties who have rights in the information.²³⁹ Several variations of frontrunning should be recognized analytically. First, a form of frontrunning known as "scalping" occurs when investment advisers trade on material nonpublic information that they provide to their clients ahead of their clients and without disclosing this practice to their clients.²⁴⁰ Second, frontrunning by broker dealers may occur when they have information about large trades that their clients may make and trade ahead of their clients in the market on the basis of this information.²⁴¹ Third, frontrunning by nonbroker dealers, such as newspaper reporters or judicial clerks, involves trading on confidential nonpublic information which is perceived by investors as material before this information is publicly disclosed.

For example, if Samantha is a broker dealer or investment adviser who possesses material nonpublic information that her client will make or is very likely to make a large purchase that will increase the price of a specific security, and if she uses that information as the basis for purchasing the same security for her own account in anticipation of a rise in the price, then Samantha frontruns her client and other investors with whom the client may trade in the market.²⁴² Although Samantha does not acquire this information through theft or other illicit means, her conversion of the information for a personal use in advance of public disclosure violates the autonomy of investors because it compromises at least an implicit confidence that her clients placed in her. Note that frontrunning, like other insider trading under a fraud-on-the-investor theory, may occur in any public security, whether a stock, bond, option, or hybrid, and "cross-market frontrunning" is possible when the price of an option derivatively reflects the price of a stock.²⁴³ Similarly, if Samantha is a financial reporter who trades securities on information that she has acquired

239. For an overview of the phenomenon of frontrunning and related activity as it is traditionally understood, see Lewis D. Lowenfels & Alan R. Bromberg, *Securities Market Manipulations: An Examination and Analysis of Domination and Control, Frontrunning, and Parking*, 55 ALB. L. REV. 293, 313-37 (1991).

240. See David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the "Money Game"*, 7 ST. THOMAS L. REV. 103, 103-04 (1994) (defining scalping).

241. See generally *id.* at 103-04. Bovi distinguishes frontrunning by broker dealers from "scalping" by investment advisers. See *id.* at 106-07. But we believe that both are better considered as different forms of a broader functional category called frontrunning.

242. Again, it is important to note that frontrunning, like other forms of insider trading, wrongs an investor, but not necessarily directly. In typical broker-client frontrunning, for example, the client may not be harmed by the broker's fraudulent use of the information that the client is very likely to trade because the client may buy or sell anyway, but then the person with whom the client trades is wronged by the practice. See *supra* note 78 (describing Katz's discussion of the relevant victim in cases of securities fraud).

243. See Bovi, *supra* note 240, at 105-06.

and developed into a news story before publication of the story, then Samantha would frontrun her readers and those with whom she trades in the public securities markets who may have learned about her story through its publication and who rightfully assume that Samantha does not have a financial interest in the information. Again, Samantha lawfully possesses this information because she has developed it, but she misuses it to trade securities in a deceptive manner.

Self-frontrunning involves a similar phenomenon with the only difference being that a company frontruns the securities markets by using material nonpublic information to trade in securities in competition with its own investors. Self-frontrunning also occurs if a company authorizes its corporate insiders to trade on material nonpublic information ahead of public investors. Texas Gulf Sulphur trading in its own stock on the basis of its inside information about an ore strike—or the company authorizing its directors and officers to do so—is an example of self-frontrunning.²⁴⁴

The leading Supreme Court decision on frontrunning is *SEC v. Capital Gains Research Bureau, Inc.*,²⁴⁵ though as we will show, *Carpenter*, *Chiarella*, and *O'Hagan* should also be read as frontrunning cases. *Capital Gains* is not often included in academic discussions of insider trading because it arises under section 206 of the Investment Advisers Act of 1940.²⁴⁶ Section 206 includes a fraud provision that is broadly similar to Section 10(b) and Rule 10b-5.²⁴⁷ In addition, Section 206 prohibits "any investment adviser" from "acting as a principal for his own account . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."²⁴⁸ In *Capital Gains*, the defendant investment adviser published a "Capital Gains Report" for its investment clients who paid a subscription. Without disclosing the practice, the adviser purchased shares in stocks recommended for long-term investments in issues of Capital Gains Report immediately before publication, and then sold the shares immediately after publication, thus frontrunning or, in the Court's words, "scalping" its own clients who believed the advice and purchased the stocks.²⁴⁹ The Supreme Court

244. See *supra* text accompanying note 11.

245. 375 U.S. 180 (1963).

246. 15 U.S.C. § 80b-6 (1994).

247. Section 206 provides that "any investment adviser" may not "employ any device, scheme, or artifice to defraud any client or prospective client," "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client," or "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." *Id.*

248. *Id.* § 80b-6(3). The SEC may make exemptions to this rule by regulation "in the public interest and consistent with the protection of investors." *Id.* § 80b-6a.

249. *Capital Gains*, 375 U.S. at 181-83. The practice is called "scalping" because the trader will, due to the advance purchases, tend to reduce the average gains for the investors who purchase later,

upheld the SEC's request for an injunction against the investment adviser: "The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients."²⁵⁰

A proponent of the traditional theory of insider trading might seek to explain *Capital Gains* as a fiduciary duty case.²⁵¹ It is true that the Court characterized the relationship between the investment adviser and client as involving "fiduciary obligations" and a "relationship of 'trust and confidence.'"²⁵² But it is important to observe that the violation of this fiduciary relationship by the investment adviser is not central. As we argued in discussing cases of moral luck in insider trading, fiduciary duties are relevant on our account, but only because they help to explain how a party may have wrongly acquired and used material nonpublic information for making a securities trade.²⁵³ In *Capital Gains*, the investment adviser legally possessed the information about a client's trading orders but had no right to use this information for trading in the investment adviser's own account ahead of the client. Use of this information is wrong because it defrauds public investors with whom the investment adviser trades.²⁵⁴

Carpenter, *Chiarella*, and *O'Hagan* may also be described as insider trading by frontrunning.²⁵⁵ All three cases involve "outsiders" who trade on misappropriated material nonpublic information ahead of other investors in the market.²⁵⁶ In *Carpenter*, the newspaper reporter traded on information contained in his own business column, thus frontrunning his customers. He legally had possession of this information, of course, since he wrote the columns, but misappropriated the information when he

thus "tak[ing] the top off" some of the profits investors may otherwise have gained. Schodand, *supra* note 22, at 1466. The Court's account is not quite accurate because the adviser's client may trade even if the frontrunning practice were disclosed, but some public investors would be wronged. See *supra* note 78.

250. *Capital Gains*, 375 U.S. at 181, 201.

251. See *supra* Part II.

252. *Capital Gains*, 375 U.S. at 189-90 (quoting *Hearings on S. 3580 before Subcomm. of the Senate Conference Comm. on Banking and Currency*, 76th Cong. 3d Sess. 719 (1940) (statement of Alexander Standish, President, Racey and McKay, Inc.)).

253. See *supra* subpart V(A).

254. Because of the uncertainty about whether the client or some other investor is harmed by the frontrunning of an investment adviser, see *supra* note 78 and accompanying text, we would argue with others that such frontrunning should probably be banned entirely. See Schodand, *supra* note 22, at 1474-78. Section 206 permits frontrunning if the practice is disclosed to an adviser's clients. See 15 U.S.C. § 80b-6(3) (1995). But because the adviser's clients are not the only possible victims, their consent may not be enough. We do not develop this argument at length here, however, because it is tangential to our primary focus on Rule 10b-5 insider trading cases.

255. See LOSS & SELIGMAN, *supra* note 36, at 830-35 (recognizing *Chiarella* and *Carpenter* as Rule 10b-5 outsider "scalping" cases under the misappropriation theory of insider trading).

256. See *supra* text accompanying note 14.

misused it for trading securities with his customers and other investors before the information was disclosed.²⁵⁷ In *Chiarella*, the financial printer also legitimately possessed information as a corporate outsider.²⁵⁸ He had a right to the information in order to perform the task of putting it into a publishable form. After decoding the confidential information, however, he misappropriated it by frontrunning the market ahead of the announcement of the takeovers.²⁵⁹ In *O'Hagan*, the defendant lawyer was also a corporate outsider. O'Hagan's law firm legitimately possessed the information about its client's takeover target in order to do legal work, but O'Hagan misappropriated the information when he converted it for the purpose of frontrunning other investors in the securities market.²⁶⁰ The same analysis applies to other outsiders who possess legally privileged or confidential material information, including judges and clerks who may trade on advance knowledge about legal decisions and other government officials trading on confidential policy discussions, such as Federal Reserve employees who trade on advance information about interest rates.²⁶¹ In all of these cases, our fraud-on-the-investor theory of insider trading would give the same result. It is inequitable to trade on material nonpublic

257. See *Carpenter*, 484 U.S. at 23; see also *United States v. Libera*, 989 F.2d 596, 597-99, 602 (2d Cir. 1993) (upholding securities fraud convictions under the misappropriation theory for conspiracy in frontrunning on information to be published in *Business Week*).

258. See *Chiarella*, 445 U.S. at 231. *Chiarella* was not what has been called a "temporary insider" of his corporate client, but was instead an "outsider" with respect to the target corporations in whose stock he traded. The Court in *Dirks v. SEC*, 463 U.S. 646 (1983), alluded to this distinction as well:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

Id. at 655 n.14 (emphasis added).

259. Although the Court reversed *Chiarella*'s conviction over Burger's dissent, the SEC quickly adopted Rule 14e-3, which again made trading ahead of the market on confidential information about an impending tender offer illegal, thus reasserting misappropriation theory with respect to frontrunning on information about tender offers. See 17 C.F.R. § 240.14e-3(a) (1999). The authority of the SEC to adopt Rule 14e-3 was affirmed in *O'Hagan*, 521 U.S. at 644-45. But we do not address Rule 14e-3 and its interpretation in detail in this Article. See *supra* note 6 and *infra* note 262.

260. *O'Hagan*, 521 U.S. at 653-54. Because the information was about an impending tender offer, O'Hagan committed securities fraud under both Rule 10b-5 and Rule 14e-3. *Id.* at 642.

261. See *supra* note 9 and accompanying text. *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), which was overruled by *O'Hagan*, presents facts of a government lottery official misusing advance information to frontrun in securities of the companies to be awarded contracts for the purchase of gambling equipment. *Id.* at 937. Note that even Henry Manne, the academic scourge of insider trading law, believes that SEC officials who possess material nonpublic information about companies should be prevented from trading on it because he believes they are not entitled to the information. See MANNE, *supra* note 22, at 182-84; see also Schotland, *supra* note 22, at 1456-57 n.88.

information when using this information would violate an important fiduciary obligation or other confidential relationship, not because of the wrong to the source of the information, but because the conversion and misuse of otherwise legitimately possessed information compromises the autonomy of public investors. Such informational advantages are not deserved because they are gained by a wrongful act rather than by skill, intelligence, effort, or even luck.²⁶²

Our fraud-on-the-investor theory of insider trading also proves superior to competing theories in accounting for laws against what we call self-frontrunning.²⁶³ These cases involve situations in which a company or its authorized insiders trade in the company's own securities on the basis of material nonpublic information possessed by persons within the company. The illicit acquisition rationale and property rights theories of insider trading have difficulty accounting for self-frontrunning cases, though courts and commentators agree that insider trading rules should apply in these circumstances.²⁶⁴

262. Although Rule 14c-3 is outside the scope of this Article, note that our theory is consistent with the regulation of insider trading on tender offers in the following respect. A financier who identifies a target for a tender offer by skill, intelligence, effort, or even luck deserves the right to take advantage of the information (up to a statutory maximum of five percent before required disclosure). See 15 U.S.C. § 78(n)(d) (1994). A tippee of the information does not.

263. See Lowenfels & Bromberg, *supra* note 239, at 319. Complicated issues are presented by investors who self-frontrun their own block trades and other securities trading strategies which may fall under the general heading of market "manipulation," but not "fraud." Although Rule 10b-5 appears to be limited to policing "fraud," see *supra* note 5, Section 10(b) would seem to grant authority to prevent the use of "any manipulative or deceptive device" whether or not it is fraudulent. See 15 U.S.C. § 78j(b) (1994). Compare Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets*, 105 HARV. L. REV. 503, 507, 533 (1991) (arguing that the concept of trade-based and other alleged securities market manipulations are too vague and should be abandoned), with Steve Thel, *\$850,000 in Six Minutes—The Mechanics of Securities Manipulation*, 79 CORNELL L. REV. 219, 296-97 (1994) (arguing that manipulative securities trading strategies are real and should be policed). "Parking" securities for purposes of stock manipulation, for example, was at the center of many of the scandals involving Ivan Boesky, Michael Milken, and others in the 1980s. See CONNIE BRUCK, *THE PREDATOR'S BALL* 321 (1988); DANIEL R. FISCHEL, *PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION* 70-82 (1995). See generally JAMES B. STEWART, *DEN OF THIEVES* (1991). For a description of parking violations, see BROMBERG & LOWENFELS, *supra* note 36, at 337-64. We do not attempt an extended analysis of parking here, though we note that parking can be used in an attempt to hide insider trading. *Id.* at 364.

264. See, e.g., *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203 (1st Cir. 1996) ("The policy rationale for the 'disclose or abstain' rule carries over to contexts where a corporate issuer, as opposed to an individual, is the party contemplating a stock transaction."); *McCormick v. Fund Am. Cos.*, 26 F.3d 869, 876 (9th Cir. 1994) ("Numerous authorities have held or otherwise stated that the corporate issuer in possession of material nonpublic information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them."); see also LANGEVOORT, *supra* note 36, § 3.02, at 5 ("Conceptually, extending the insider trading prohibition to instances of issuer insider trading makes perfect sense."); LOSS & SELIGMAN, *supra* note 36, at 3490 (explaining that the disclose-or-abstain-from-trading rule applies to corporate issuers). Other provisions of the federal securities laws have the effect of extending liability for insider trading to corporate issuers. See, e.g., Securities Act of 1933 §§ 11, 12(2), 15 U.S.C. §§ 77k, 77l (establishing liability

The conceptual problem is that if material nonpublic information is "property" and "belongs to" a company, it is not clear under these theories what is wrong with trading on the information. Here, we return to the last of our initial hypothetical situations based on the facts of *Texas Gulf Sulphur*.²⁶⁵ Recall that we have resolved the easier questions. First, the inside directors, officers, and other employees of Texas Gulf Sulphur commit securities fraud if they trade on the information about a rich ore strike before it is disclosed effectively to investors in the market. Tippees or temporary insiders of Texas Gulf Sulphur are also prevented from trading on this information. These cases have been analyzed as involving the theft of information from the company.²⁶⁶ We have also argued that Texas Gulf Sulphur may itself use the inside information to purchase real estate to exploit the ore strike because the company has a deserved advantage in the information derived from its investment and effort in obtaining it, with an exception if the company has trespassed or otherwise illicitly acquired the information.²⁶⁷ But now what about the following harder questions: (1) May Texas Gulf Sulphur itself properly use its inside information about the ore strike to invest in its own securities? (2) May Texas Gulf Sulphur formally authorize its insiders to trade on material nonpublic information ahead of the company's investors?²⁶⁸ Similar hypotheticals may be constructed from the facts of other outsider trading cases. In *Carpenter*, for example, may the *Wall Street Journal* authorize its own reporters to frontrun their columns as an added bonus to their compensation? Or may the *Wall Street Journal* itself trade on its own news before it is published?²⁶⁹ In *O'Hagan*, may the law firm's client give the lawyers it hires permission to frontrun a takeover attempt by purchasing stock in the target ahead of the market?²⁷⁰

for omissions in registration statements or prospectuses). In particular, scholars who follow the requirement of "a breach of fiduciary duty" to sustain insider trading liability under Rule 10b-5 have found difficulties accounting for the problem of self-frontrunning. See, e.g., Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 719-28 (1999) (finding the fiduciary duty requirement to be "a fly in the ointment" for extending insider trading liability under Section 10(b) for corporate issuers, but arguing for an alternative basis for corporate liability in cases of interim nondisclosure of material nonpublic information under Item 303's "Management Discussion and Analysis" requirement of Regulation S-K).

265. See *supra* text accompanying notes 7-11.

266. See *supra* text accompanying notes 7-9.

267. See *supra* subpart IV(B).

268. See *supra* text accompanying note 10.

269. See WILLIAM A. KLEIN & J. MARK RAMSEYER, BUSINESS ASSOCIATIONS 390 (3d ed. 1997) (posing these questions).

270. In fact, the Supreme Court seems to suggest in dicta that this is permissible under its version of the fraud-on-the-source misappropriation theory. See *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) ("[F]ull disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no

Our answer to these questions is no. The advantage that Texas Gulf Sulphur has in the information about its ore strike may rightfully be held confidential if the information is used to advance the business interests of the company and its investors. If the information was not stolen or otherwise improperly obtained, nondisclosure is permitted when the company makes appropriate use of the information in acquiring land. But if the company uses information about its discovery in the securities market in competition with its own investors, it wrongly converts that information to an impermissible use. Why is such use of information wrongful conversion? We assume that it is ordinarily wrong for the firm to act in ways that harm its shareholders, and that ordinarily a firm must act for the benefit of shareholders. If Texas Gulf Sulphur uses inside information to trade in its own securities, it puts its investors at risk in a manner in which they are not put at risk when the company buys neighboring property. By competing with its own investors' rights to the company's profits when using information in which its investors have an interest, the firm or its authorized insiders would steal information that rightly belongs to its investors. In this manner, use of this information for securities trading in self-frontrunning cases is morally tainted, and its use in any securities transaction must, on our account, be disclosed before the firm or its insiders may trade on it. Our account therefore provides that Texas Gulf Sulphur may trade in real estate on inside information it possesses about a mineral find, but it may not trade securities while the same information remains nonpublic.²⁷¹

'deceptive device' and thus no § 10(b) violation . . ."). We believe this is another indication of the conceptual weakness of the opinion. See *supra* text accompanying notes 76-88 (criticizing *O'Hagan*).

271. An obvious retort to our view is that Texas Gulf Sulphur and other firms could avoid charges of wrongdoing in insider trading by contractually stipulating as a condition of sale of their stock or other securities that they retain the right to allow insiders to trade on material nonpublic information. If such a contract were valid, then purchasers of securities would in effect waive their rights to protection against insider trading. If this objection were successful, then it could be used against anti-insider trading arguments more generally. For this retort to succeed, however, it would at minimum have to show that the relevant rights could be knowingly and voluntarily waived, and we doubt that that can be shown. It would be equivalent to showing that one can give up a right not to be manipulated. Therefore, we agree with those who insist that such waiver is typically impossible. See KORSGAARD, *supra* note 44, at 133-58 (employing Kantian arguments against the idea that one can give up the right to be treated honestly). The retort also ignores wrongs to third parties. Securities derive their value from their roles in very large markets. If some market participants permit insider trading, it naturally lowers the confidence level in the transparency and integrity of the market more generally. People who hold securities in firms that do not allow insider trading may reasonably fear that insiders at firms that allow insider trading will manipulate market forces in ways that work to the detriment of those who trade only in firms that do not allow insider trading; these people are arguably wronged by insider traders, who free ride on the commitment to transparency of people in noninsider trading firms. Cf. Alan Strudler, *Soft Dollars, Moral Costs*, BUS. & SOC'Y REV., Spring 1999, at 18, 18-20 (arguing that even if parties consent in securities transactions to opaque arrangements, third-party effects may be exploitative and otherwise wrongful). For similar reasons, we disagree with the insidious suggestion that a prior disclosure of an intention to trade on material nonpublic information or "candid insider

VI. Conclusion

A century-and-a-half ago, Alexis de Tocqueville observed that Americans had fewer qualms about "love of money" than Europeans,²⁷² but he noticed also that Americans had a strong sense of morality.²⁷³ This moral sense is reflected in the law of insider trading, but despite "widespread popular support for sanctions against insider trading," one scholar admits that "the reasons for such sanctions are hard to identify."²⁷⁴ "Uncertainty about the underlying rationale for the ban on insider trading," says another, "necessarily results in uncertainty about the rule's potential scope."²⁷⁵ In more recent times, it has also become important to resolve the underlying theoretical uncertainty about insider trading law not only in the United States, but in Europe and other countries worldwide that have adopted similar restrictions.²⁷⁶

We have attempted in this Article to provide a rational justification for a theory of insider trading law based on deontological moral principle. A strength of our approach is that it provides a unified and coherent account of insider trading cases instead of the bifurcated and confused "traditional" and "misappropriation" theories that currently threaten to lead to irrational results. Commentators have raised a collective cry of dismay in reaction to the Supreme Court's fraud-on-the-source misappropriation theory announced in *O'Hagan*, though most agree with the result.²⁷⁷ We believe that our general fraud-on-the-investor theory, informed by an equitable disclosure rationale, is consistent with the results reached not only in *O'Hagan* but also the other major Supreme Court cases decided in the

trading" should be countenanced as an exception. See Prakash, *supra* note 16, at 1506-09, 1516-32. We also disagree that current law permits "candid" self-frontrunning. See *supra* note 264.

272. See DE TOCQUEVILLE, *supra* note 1, at 621.

273. *Id.* at 526-27 (emphasizing the strong influence of "the principle of self-interest properly understood" on "morality" and the importance of "moral laws").

274. James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413, 1429 (1992).

275. Anderson, *supra* note 61, at 342.

276. A major step occurred in Europe with the adoption of an Insider Trading Directive in 1989, which was to have been implemented by national legislation throughout the European Union by 1992. See Council Directive 89/592 Coordinating Regulations on Insider Dealing art. 14, 1989 O.J. (L 334) 30, 32 (mandating implementation of the directive by June 1992). Germany, which previously allowed insider trading, finally outlawed the practice in 1994. See Roberta S. Karmel, *Transnational Takeover Talk—Regulations Relating to Tender Offers and Insider Trading in the United States, the United Kingdom, Germany, and Australia*, 66 U. CIN. L. REV. 1133, 1149-50 (1998). Japan has also tightened its legislation against insider trading in light of relatively recent securities scandals. See George F. Parker, Note, *The Regulation of Insider Trading in Japan: Introducing a Private Right of Action*, 73 WASH. U. L.Q. 1399, 1399-1400 (1995). Previously, Japan had allowed insider trading or did not enforce laws against it vigorously. See, e.g., Tomoko Akashi, Note, *Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296, 1296 (1989).

277. See *supra* note 16 and accompanying text (collecting articles and summarizing opinions).

field.²⁷⁸ Our theory also provides a coherent explanation for a number of difficult issues in other cases that are likely to arise again in the future.²⁷⁹ Our fraud-on-the-investor theory gives courts, legislatures, and administrators guidance in how to apply, in a limited and principled fashion, the law of securities fraud in insider trading cases.²⁸⁰ In particular, we have argued that those who trade on material nonpublic information gained through their own effort, skill, intelligence—or pure luck—should not be found to violate the general federal prohibition against insider trading. However, those who steal or misappropriate material nonpublic information—or those who convert information that they properly possess for the purpose of defrauding investors—should be.

278. See *supra* text accompanying notes 82, 190, 249 (discussing *Carpenter*, *Dirks*, *Capital Gains*, and *O'Hagan*).

279. See *supra* text accompanying notes 211-38 (discussing *Maio*, *Reed*, *Switzer*, and *Willis*).

280. A number of commentators press for a congressional or administrative definition of "insider trading" as a solution to the confusion in the field. See, e.g., Painter et al., *supra* note 16, at 158-59, 200-05, 211-28 (1998) (discussing Congress's failure to define illegal trading on material nonpublic information); Thel, *supra* note 4, at 1134 (asserting that if Congress cannot construct securities legislation on the assumption that judge-made law is settled, it will be hard-pressed to participate in the lawmaking process at all). We are skeptical that Congress or the SEC will turn its attention to this issue in the near future, but our theoretical approach is meant to be persuasive to legislators and administrators, as well as judges and fellow academics.