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Insider Trading: Incoherent in Theory, Inefficient in Practice

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INSIDER TRADING: INCOHERENT IN THEORY, INEFFICIENT IN PRACTICE

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I. INTRODUCTION

Insider trading: The words alone evoke conflicting feelings of jealousy and greed. But what is wrong with insider trading? Nothing. In fact, insider trading is good for the economy. Insider trading results in an efficient allocation of capital and thus makes the world wealthier.

If insider trading is in fact good for the economy, why is it illegal? Jeanne Schroeder argues, I think correctly, that one source of the prohibition of insider trading is envy: Envy by those who do not have the intelligence or discipline to understand the science of stock trading, let alone climb to the heights of corporate success directed against those who do. It is human, all too human, to suppose that when we fail, those who succeed must have had some trick. It is also a vice. When we fail there is usually a reason and generally it is our own fault.

2. Freeman v. Decio, 584 F.2d 186, 190, 196 (7th Cir. 1978) (noting that there is no derivative action to disgorge profits under Indiana law and that insider trading helps assure efficient capital markets).
4. Jeanne L. Schroeder, Envy and Outsider Trading: The Case of Martha Stewart, 26 CARDOZO L. REV. 2023 (2005). Schroeder argues that Martha Stewart was not an insider. I would add that Stewart was obviously a patsy; a proxy for the corporate misfeasance exemplified, but not limited to the Enron Corporation. Such is the cautionary tale.
I analyze insider trading using several different theories. However, these various theories are interlocking and mutually supporting. The different theoretical views all support the thesis that insider trading is good for the economy. I conclude therefore that any wrongful economic activity involving stock trading is best handled by the common law tort of deceit or by contract. Since this article analyzes insider trading critically, it must first expose the theory on which its normative positions are based prior to parsing the various statutes. We can understand the statutes and rules only if we understand their basis.

The thesis of this article is that the legal concept of insider trading is, at least as currently formulated, theoretically untenable and practically incoherent. Since the theoretical basis justifying insider trading law is incoherent, the resulting laws are just as confusing. This incoherence can be seen by simply asking: who is an insider?, what is insider trading?, and why is insider trading wrong? These questions have no definitive answers. In order to understand the causes of the incoherence in insider trading law we need to step back from the problem and examine it.

Insider trading targets the wrong people for the wrong acts and distracts regulators and the public from more serious corporate misfeasance.


Given the uncertain policy values in favor of insider trading, it makes no sense to impose a regulatory standard that creates, at best, tremendous uncertainty regarding when liability will apply for trading on the basis of material nonpublic information and, at worst, strict liability even for those who can conclusively establish nonuse of the inside information.

8. Micah A. Acoba, *Insider Trading Jurisprudence After United States v. O’Hagan: A Restatement (Second) of Torts § 551(2) Perspective*, 84 Cornell L. Rev. 1356, 1362 (1999) (“In fact, section 10(b) and Rule 10b-5 (or any of the federal statutes, rules, or regulations) do not define ‘insider trading’ or ‘inside information’ (or ‘misappropriation,’ for that matter).”); Oliver Perry Colvin, *A Dynamic Definition of and Prohibition Against Insider Trading*, 31 Santa Clara L. Rev. 603, 617 (1991) (“[The SEC has asserted, and the House Committee has blindly agreed, that a legislative definition is unnecessary because the courts have purportedly developed an adequate definition of insider trading. As detailed above, however, the court-created parameters of insider trading are woefully inadequate and uncertain.”).

theoretically. Thus we now turn to a theoretical circumspection of theories of insider trading.

II. THEORY: PERSPECTIVES ON INSIDER TRADING

A. Capital Market Theory

1. The Efficient Capital Market Hypothesis (ECMH) - An Erroneous Theory Whose Time Has Come

“I'd be a bum in the street with a tin cup if the markets were efficient.”

-Warren Buffet

The efficient capital market hypothesis ("ECMH")\(^{11}\) hypothesizes that capital markets already reflect all information perfectly. Present prices, according to the ECMH, are a perfect reflection of past prices.\(^{12}\) The ECMH is a keystone of insider trading theory\(^{13}\) and is used to justify...
the prohibition on insider trading. According to the ECMH, a stock’s price is, at any time, an exact representation of all information regarding that stock and thus stock prices in an efficient market are accurate measures of the value of the stocks in that market. The ECMH is a simple and elegant explanation of market movements. It is widely accepted both in academia and in law.


Financial economists often classify efficiency into three categories based on what is meant as “available information”—the weak, semistrong, and strong forms. Weak-form efficiency exists if security prices fully reflect all the information contained in the history of past prices and returns. (The return is the profit on the security calculated as a percentage of an initial price.) If capital markets are weak-form efficient, then investors cannot earn excess profits from trading rules based on past prices or returns. Therefore, stock returns are not predictable, and so-called technical analysis (analyzing patterns in past price movements) is useless.

Under semistrong-form efficiency, security prices fully reflect all public information. Thus, only traders with access to nonpublic information, such as some corporate insiders, can earn excess profits. Under weak-form efficiency, some public information about fundamentals may not yet be reflected in prices. Thus, a superior analyst can profit from trading on the discovery of, or a better interpretation of, public information. Under semistrong-form efficiency, the market reacts so quickly to the release of new information that there are no profitable trading opportunities based on public information.

Finally, under strong-form efficiency, all information—even apparent company secrets—is incorporated in security prices; thus, no investor can earn excess profit trading on public or nonpublic information.


17. Lynn A. Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 J. Corp. L. 635, 635, (2003) [Mechanisms of Market Inefficiency] (“During the 1970s and early 1980s, the Efficient Capital Market Hypothesis (ECMH) became one of the most widely-accepted and influential ideas in finance economics.”). Stout also states that

This essay argues that the weaknesses of the efficient market theory are, and were, apparent from a careful inspection of its initial premises, including the presumptions of homogeneous investor expectations, effective arbitrage, and investor rationality. By the same token, a wide range of market phenomena inconsistent with the ECMH can be explained using market models that modify...
There is just one problem: it is wrong. If the ECMH were true, no one could ever outperform or underperform the market. But investors do both regularly. One implication of the ECMH is that a “random walk” strategy, such as picking stocks by throwing darts, would be just as effective a trading strategy as any theory proposed by any analyst. But in fact that is not the case. The dartboard theory of investing slightly underperforms the market and notably underperforms expert investors. The disturbing fact is that both the courts and the SEC are willing to these three assumptions.

Id. 18. Douglas C. Ashton, Revisiting Dual-Class Stock, 68 ST. JOHN’S L. REV. 863, 934 n.322 (1994) (“ECMH has been widely accepted by scholars, regulators, and judges.”).


21. John R. Dorfman, Investment Dartboard: Random Stock Picks Give Pros the Woes, WALL ST. J., NOV. 4, 1988, at C1 (reporting that in the first month of the contest, the dartboard portfolio had risen 0.7% while the pros’ choices declined an average of 2.5%).


23. How Efficient Markets Undervalue Regulation, supra note 13, at 476:

The Journal has now run the Investment Dartboard contest for over eight years, and over that time a clear pattern has emerged: although the darts frequently give the pros a drubbing, on average the pros are beating both the darts and the market. Indeed, as of October 1996, the pros’ portfolios had produced average annual gains of 20.6%, compared to 11.2% for the darts, and 11.6% for the Dow Jones Industrial Average.

24. See Georgette Jasen, Investment Dartboard: Luck Out: Stock Experts Top the Darts, WALL ST. J., Oct. 9, 1996, at C1 (reporting that during eight years of contest, pros’ portfolios produced average six-month gains of 8.7%, compared to 7.8% for dart portfolio and 5.8% for the Dow Jones Industrial Average).

look at the ECMH as if it were a theorem. But the ECMH is a hypothesis, not a theorem. A theorem is a proven point based on axioms\(^\text{27}\) and postulates. If the axioms and postulates are true then the theorem is necessarily also true.\(^\text{28}\) A hypothesis, in contrast, is merely a supposition.\(^\text{29}\) Hypotheses serve as a base empirical test,\(^\text{30}\) which either verifies or falsifies them.\(^\text{31}\) In fact, the empirical evidence provides that the ECMH is false.\(^\text{32}\) So why is it the basis of insider trading law?

Unlike the ECMH, I take the realistic position that stock market movements are not random\(^\text{33}\) and that a stock’s price may significantly

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26. Talosig III, supra note 10, at 694 (“The Securities Exchange Commission itself has relied expressly on the ECMH for justifying its rules establishing the integrated-disclosure system and rules authorizing shelf registration of securities. The SEC has also recognized ECMH when formulating Reg. FD.”); Berberet v. Myers, 144 S.W. 824, 829 (Mo. 1912) (“Law axioms are nothing more than the conclusions of common sense, which have been formed and approved by the wisdom of ages. This rule prevails equally in a court of equity and a court of law . . . .”).


30. Sarah H. Ramsey & Robert F. Kelly, Social Science Knowledge in Family Law Cases: Judicial Gate-Keeping in the Daubert Era, 59 U. Miami L. Rev. 1, 41 (2004) (“Rigorous empirical testing is at the core of the logic of falsification. If an empirical test of a hypothesis is not rigorous, its results might be used either to incorrectly falsify or to incorrectly support a hypothesis.”).

31. Amer S. Ahmed, The Last Twist of the Knife: Encouraging the Regulation of Innovative Surgical Procedures, 105 Colum. L. Rev. 1529, 1546 n.87 (2005) (citing Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 593 (1993)) (asserting that a “key question to be answered” about a hypothesis is whether it can be tested to determine if it “can be falsified,” an inquiry that “distinguishes science from other fields of human inquiry”).

32. How Efficient Markets Undervalue Regulation, supra note 13, at 492 (“During the past two decades, an extensive body of empirical evidence has accumulated indicating that, in many situations, investors and securities markets simply refuse to behave the way the ECMH/CAPM predicts they should.”).

deviate from the stock’s value.\textsuperscript{34} The fact that a stock price deviates from the underlying value of the security is, incidentally, the key to the investment strategy of Warren Buffet.\textsuperscript{35} But even if stock movements were random, a stochastic analysis (the random walk theory,\textsuperscript{36} like Brownian motion,\textsuperscript{37} is stochastic\textsuperscript{38}) would in fact justify insider trading.\textsuperscript{39} To Henry Manne, without the insider, the stock market would be completely random, and thus could not serve as a capital allocation resource.\textsuperscript{40}

I do not go so far as Manne. Even hampered by rules against “inside information,” market prices do not move randomly.\textsuperscript{41} However, absent inside information, prices do not move as efficiently as they could. Manne correctly points out that inside traders present the market with clear and important signals that make the market more efficient. According to Manne, “[w]hen market observers become aware of insider trad-

\[S]tock price movements are not strictly lognormal random variables. Although stochastic modeling of the range of probable asset price movements in a multivariate context provides a significantly better understanding of risk and return, such modeling makes too many simplifying assumptions. Although the lognormal distribution explains most of the movement in asset price over time, this distribution seriously underestimates the probability of sudden, large, unexpected jumps in value.

\textsuperscript{34} Lawrence A. Cunningham, \textit{Behavioral Finance and Investor Governance}, 59 \textit{Wash. \\& Lee L. Rev.} 767, 786 (2002) (“The net results of these behavioral phenomena in financial economic thought are theoretical, empirical, and psychological accounts showing that stock prices systematically deviate from values. The story of the EMCH turns out to be like a fairy tale . . . .”).


\textsuperscript{39} \textit{Henry G. MANNE, INSIDER TRADING AND THE STOCK MARKET} 97 (1966).


\textsuperscript{41} Marcel Kahan, \textit{Securities Laws and The Social Costs Of “Inaccurate” Stock Prices}, 41 \textit{Duke L.J.} 977, 996 n.87 (1992) (“Stock price movements themselves will, of course, not be random. Rather, stock prices will tend to revert to fundamental values.”).
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ing, they will act accordingly, and the information will quickly diffuse throughout the entire market.”

Thus, insider trading is good because it accelerates the movement of information, resulting in greater systemic optimality, and the market reaches desirable temporary equilibrium more rapidly. The balancing of market asymmetries into temporary equilibrium is nothing other than Adam Smith’s invisible hand applied not to butchers and bakers but to stock traders.

The ECMH can be proven false by pointing to traders who consistently outperform the market. The two most famous examples of traders who regularly “beat the market” are Warren Buffet and George Soros. Both are educated and astute. They profit from their knowledge and intellect, and society is better off as a result. Society is better because the trades made by Buffet and Soros act as market signals to less informed traders:


43. Id.


By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain; and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it.

45. Id. (“It is not from the benevolence of the butcher the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages.”).

46. How Efficient Markets Undervalue Regulation, supra note 13, at 492 (“During the past two decades, an extensive body of empirical evidence has accumulated indicating that, in many situations, investors and securities markets simply refuse to behave the way the ECMH/CAPM predicts they should.”).

47. See Roger Lowenstein, Modern-day Midas, BUS. TIMES, Mar. 9, 1996, at 2 (reporting that over the past four decades Warren Buffett has earned annual gains of 28.6%, while major stock averages have enjoyed annual gains of about 10%).


traders. Some researchers even study their valuation models in order to emulate them. Thus, their successful trading also has a secondary educational effect. Their success automatically “levels the playing field” because of this educational effect. Trading decisions by the Buffets of the world result in correct capital allocation. Proper capital allocation, in turn, leads to technological progress in the production of goods to the benefit of all people, even those who wrongly allocated their resources. Insider trading is not a victimless crime: it is no crime at all. Yet, although the ECMH is empirically, demonstrably wrong, it is a key justification that most courts use for prohibiting insider trading. Some courts even seem to be under the impression that the ECMH is a normative goal and not a simplified economic model. The courts want
to establish a system that prevents distortions of the market because market distortions cause inefficiencies in allocation of capital, leading in turn to sub-optimal production. Yet the courts’ premise that insider trading is wrong because it falsifies market signals\(^{54}\) resulting in sub-optimal capital allocation is incorrect. The distortion that the courts seek to prevent is no distortion at all. The fact that inside information is rare makes it valuable, and the natural market function is to link profitability to value. Rather than prevent market distortions, the prohibition of insider trading introduces them. The court essentially tries to ration information by introducing an artificial price control, the result being shortages that in turn disrupt production. Unsurprisingly, this irrationality leads to critique from astute academics.\(^{55}\) Happily, some members of the Supreme Court and certain lower courts recognize the illogic of the ECMH. Justice Blackmun correctly criticized the theory in his dissenting opinion to Basic, Inc. v. Levinson,\(^{56}\) pointing out that courts do not have the expertise required\(^{57}\) to assess exotic hypotheses of economists’ simplified models.\(^{58}\)

The ECMH relates to some other basic assumptions of neo-classical economic theory that are only slightly less realistic, namely:

1. That information is perfectly distributed (for example, instant global communication);

2. That transaction costs are nil or nearly so (no lawyers, accountants

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55. See, e.g., Goforth, supra note 11.

56. Levinson, 485 U.S. at 224 (Both Justice White and Justice O’Connor concurred with Justice Blackmun.).

57. Id. at 253 (Blackburn, J., dissenting) (“[W]ith no staff economists, no experts schooled in the ‘efficient-capital-market hypothesis,’ no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.”).

or translators to pay, no haggling of prices nor wheeling and dealing); and

3. That there are no externalities in production (costs of pollution are imputed to sources of pollution);\(^{59}\) and

4. That market agents are rational profit maximizers.\(^{60}\)

These assumptions are unrealistic. However, one can reject the ECMH without rejecting these central tenets of neo-classical economic theory. These assumptions are simplifications used to make it possible to model selected market processes.\(^{61}\) Thus, when courts apply these simplified abstractions as either description of reality or as normative instructions as to what reality ought to be, illogical outcomes result.\(^{62}\) If the presumption of the ECMH (that information flow is perfect, instanta-

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59. Patrick J. Ryan, Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy, 23 GA. L. REV. 97, 170 n.295 (1988) (“‘[E]fficient capital markets’ require that participants have perfect information, incur no transaction costs, and that there are no externalities not reflected in the market information . . . .”).

60. USX Corp. v. United States, 682 F.Supp. 60, 66 (Ct. Int’l Trade 1988) (This last assumption, though also not without exceptions, is least problematic and is even taken up by courts.); Tasty Baking Co. v. Ralston Purina, Inc., 653 F.Supp. 1250, 1275 (E.D. Pa. 1987) (Even then the courts recognize its limits: “few (if any) sellers are always rational profit-maximizers.”).

61. Paul H. Brietzke, The Politics of Legal Reform, 3 WASH. U. GLOBAL STUD. L. REV. 1, 24 n.57 (2004) (“All models use different simplifying assumptions in an attempt to be clear and understandable. The relevant question is how useful is a model for our particular purposes and does it get us where we want to go? ECMH does not get us where we want to go. We want to determine whether and why insider trading is good for the economy. And ECMH being a trinity of three theories in one cannot answer the question courts need to ask.”).

62. Ryan J. York, Comment, Visages of Janus: The Heavy Burden of Other Constituency Anti-Takeover Statutes on Shareholders and the Efficient Market for Corporate Control, 38 WILLAMETTE L. REV. 187 (2002). For Example, “[i]f the securities markets exhibited only a weak form of the EMH, the result would be ‘inefficiently priced stocks [which] will distort the functioning of the market for control.’” Id. at 194. That statement is illogical. Recall that the weak form of ECMH says that technical analysis cannot work because all technical information (stock history) is already incorporated into the price. Stocks are efficiently priced where the stock’s price is an exact reflection of the stock’s fundamental value. Under weak ECMH trading on fundamental data, i.e. the stock’s underlying value is possible (i.e., can outperform the market average). So market inefficiency, that is divergence between price and value of a stock, is corrected by trading under the weak form of ECMH. Sure, a stock under weak ECMH could be wrongly priced, but it is also possible under weak ECMH to discover this and this profitable fact explains why the market -- true to Adam Smith -- self corrects to an efficient price, i.e., the price equaling the value. Warren Buffett never claims to speculate in stocks. His profits come in principle not from speculative bubbles -- he missed out entirely on the tech bubble and still outperformed the market. His profits come from correctly pricing undervalued stocks.
The best that can be said for the ECMH is that “[w]hile substantial empirical data supports certain aspects of the ECMH, much of the data is anomalous, and numerous aspects of the theory have not been researched adequately.” 66 Other commentators correctly conclude that the “ECMH is insufficiently understood or documented to serve as an appropriate basis for judicial rulemaking.” 67 Even if insider trading were a problem, its solution is not found in legislation, as “[e]mpirical research is generally skeptical as to the effectiveness of insider trading regulation.” 68

2. Correct Theories About the Market

a. Market Assumptions

The ECMH is wrong, but what theory would be right?

A correct analysis of insider trading must proceed from correct presumptions about markets. Does information flow perfectly, that is, instantly and completely? Or does information flow with delays in time?

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64. John F. Barry III, The Economics of Outside Information and Rule 10b-5, 129 U. Pa. L. Rev. 1307, 1350 (1981) (noting that “[i]f the ECMH were completely valid, and capital markets were perfectly efficient, there would be no need for regulation because the existence of market prices incorporating all relevant information would make manipulation and fraud theoretically impossible”).
65. William H. Widen, Spectres of Law & Economics, 102 Mich. L. Rev. 1423, 1437 n.45 (2004) (noting that “[i]f the perfect market merely eliminates the subset of costs identified as “transaction costs” (i.e., the costs associated with bargaining) then scarcity would still exist and some desires would go unsatisfied, though all trading would cease because no individual would be able to improve her position by further exchange”); Jeanne L. Schroeder, Rationality in Law and Economics Scholarship, 79 Or. L. Rev. 147, 223 (2000) (“[A]ccording to neo-classical theory, if we were ever successful in maximizing our utility, then the caucus race of trade would stop. But, this will never happen because the perfect market (i.e., the conditions that would result in utility or wealth maximization) is both empirically and theoretically impossible.” This illustrates the paradox of neoclassical economic assumptions: If we accept them all at once the system simply “freezes up.”).
66. See, e.g., Goforth supra note 11, at 897.
67. Id. at 898.
and only partially? Obviously, information flow is almost never perfect. Delays in communication, language barriers, cultural barriers, and ignorance explain why information flow is inevitably imperfect. If information flow were perfect, ignorance would be limited. Sadly, information flow is imperfect.

What about transaction costs? Are there costs to engage in any transaction? Because obtaining information in the real world is imperfect, it is not surprising that transaction costs are also inevitable. Deals must be negotiated. Taxes must be paid. In fact, all legal services are a transaction cost.

A correct theory proceeds from correct assumptions based on the real world. Information that flows in the real world is imperfect and asymmetrical. Transaction costs in the real world are inevitable. These correct assumptions are reached not using deduction divorced from empirical reality, but rather by empirical observation. When we look at the economy as it actually is and not as it is in some economists’ simplified models.

69. Merritt B. Fox, Measuring Share Price Accuracy, 1 BERKELEY BUS. L.J. 113 (2004):

Each newly arriving bit of information will on average move price closer to actual value but will, as appears to be the case in the real world, include a significant amount of random noise. The random noise I refer to here is not the speculative noise discussed earlier. It simply reflects the idea that any new piece of information is not perfect. While, on an expected basis, each bit of information moves price toward actual value, it contains a random element that in any given case may move price in the opposite direction.

Id. at 122.


72. Michael S. Greve, Consumer Law, Class Actions, and the Common Law, 7 CHAP. L. REV. 155, 157 (2004) (“Information is asymmetric in business as well as consumer transactions (the seller almost always knows more than the buyer) . . . .”).

ideal model, we observe pervasive transaction costs and inevitable imperfections in information flow. This is the proper standard for legal judgment. That is, this is what happens in reality, not in simplified models of reality.

b. Normative Goals

Ontological assumptions based on empirical observation are, by definition, an accurate reflection of material reality and are thus correct. From correct assumptions we are likely to reach proper inferences. What are the normative goals that follow from these ontological observations? Although information is imperfect and transaction costs are positive, both are undesirable facts of life. If we take wealth creation and preservation as valid normative goals (not wealth for its own sake but as a means to the end of the good life) then we will want to reduce transaction costs in order to allocate scarce resources as efficiently as possible. Similarly, we also will want information flow to be as perfect as possible to allow rapid corrections in resource allocation.

How are we to best obtain rapid and cost-free information flow? Through trade. F.A. Hayek provides the most recent and cleanest analysis of mercantile transactions as they relate to the problems of informa-

74. Mark Klock, Dead Hands--Poison Catalyst or Strength-Enhancing Megavitamin? An Analysis of the Benefits of Managerial Protection and the Detriments of Judicial Interference, 2001 COLUM. BUS. L. REV. 67, 78-79 (2001) (“Greatly simplified models can be quite useful in pedagogy, in developing an understanding of basic principles, in gaining insights about how things work, and in applications to specific situations. However, overly simplistic models can also be easily applied out of context.”).

75. Richard Posner is the best advocate of wealth maximization as the goal of the common law. However, I respectfully diverge from Posner. Wealth maximization is a normative goal, not a positive description. Moreover, it is not even the primary goal of society. We need only look to Locke to see that the goals of a democracy are preservation of life (here, Locke echoes Aristotle), liberty, and ownership of property (which were implemented in the United States as life, liberty and pursuit of happiness). Aristotle tells us, however, that the state exists to assure the good life for its members. Posner makes the mistake of confusing the means, wealth production and preservation, with the end, the good life for all citizens. Aristotle rejects wealth as an end (Politics, Book I Part IX) and sees it as but a means to an end, rather than and not an end in itself. I think Aristotle has the better argument than Posner, if I have understood Posner rightly. Richard A. Posner, Legal Reasoning from the Top Down and from the Bottom Up: The Question of Unenumerated Constitutional Rights, 59 U. CHI. L. REV. 433, 443 (1992).


tion theory. A dollar is no more or less than a piece of information. It is an estimate of labor and an estimate of value. In every trading situation there is a comparison of information. The bargain struck is an objective reflection of the subjective positions of the trading parties. Trade is the principal and best resource allocation tool in capitalism.

How does the view of trade as a resource allocation tool and as a problem of information theory impact insider trading? When the law punishes insider trading it is actually rewarding those who are uniformed and punishing those who are informed, which is bad for the overall economy. Critics of capitalism constantly bemoan the fact that a fool and his money are soon parted. However, that is exactly the strength of capitalism. Capitalism punishes futility and rewards prudence. The result is greater societal wealth.

c. The Market Has Many Voluntary Mechanisms to Manage Uncertainty and Thus Legislative Intervention Is Unnecessary

Are there market mechanisms for correcting any supposedly unfair errors from insider trading? Yes. Markets deal with quantitative and qualitative uncertainty by using various market based mechanisms to manage it. These include and are not limited to stop-loss orders, stop-buy orders, limits, insurance, options, futures, derivatives, and hedge funds. If markets can deal with risk resulting from uncertainties, such as weather-

78. M. Bruce Johnson, *Hayek and Markets*, 23 Sw. U. L. Rev. 547, 548 (1994) ("Hayek argued that markets coordinate the various bits of information and knowledge scattered among individuals spontaneously, without design or comprehension by any human mind."). This might seem to be what Adam Smith said. However, Smith focuses on self love as the driving economic force reasoning inductively. For Hayek, in contrast, the driving economic force is information. Thus Hayek would reject the labor theory of value. Money to Hayek is just information. Smith, like Locke and Marx, argues that money is but crystallized labor (the labor theory of value). For Hayek, money is reified. It may represent labor, in its origin, but in its ends it is more than just labor. It is labor applied to projects. Hayek thinks this is best coordinated by decentralized market transactions. Money, for Hayek, has both a past (the labor it represents) and a future (the investments it will fund) and is also a signal (a quantum of information). This is why Hayek does not, in my opinion, reject the labor theory of value. His theory of money and trade, in my opinion, goes beyond what Smith, Locke and Marx were saying.

er, political security, and economic cyclicality, then why should they not be able to deal with any uncertainty resulting from inside information? Companies manage risk constantly and can manage inside information using either trade secret or contract law. Traders, whether institutions or individuals, can likewise reduce risks by contract.\textsuperscript{80}

Because most lawyers and judges are not accountants it is worth showing some basics of finance to support the counterintuitive argument that insider trading is beneficial.\textsuperscript{81} A stop-loss order allows a trader to manage risk. Essentially, a stop-loss order executes a trade, selling a security owned already at the best price possible if the stock reaches a certain price. For example, if one buys a stock from an insider at $100 per share and prudently places a stop loss at $90 per share, the “inside” information becomes public, provoking a sell off. The stop-loss order means that the share will automatically be sold when the stock hits $90. Therefore, insider trading is simply not objectively unfair to a prudent investor. The risk of a price drop can be easily managed by a simple stop-loss order. The other contractual mechanisms, insurance, options, futures, and limits can, inter alia, be used as well to limit risk.

In short, the evils used to justify the vague “insider trading” prohibition can be better protected against using either common law torts (fraud or deceit), contractual restrictions (secrecy agreements), trade secret law, or by trading strategies such as stop-loss, limit, or through economic instruments, such as options, futures and insurance contracts. Because a diverse array of risk management tools exists, why should the law intervene? It should not. This becomes clearer when one recognizes that insider trading is economically desirable.


Some Speculators and Institutional Investors can be harmed by insider trading, but again the inefficient bear the loss. Both are injured only because inside traders are more efficient at performing the market function of Speculators and Institutional Investors, namely moving the price of a company’s stock in the most accurate direction. Not all Speculators and Institutional Investors are hurt, moreover. Efficient Speculators and Institutional Investors may notice unexplained trading in a company’s shares, accurately identify it as a consequence of insider trading, and then trade themselves. So far as performing the market function of the Speculator or Institutional Investor is concerned, therefore, insider trading is good rather than bad.
B. Law and Economics

The theory of law and economics ("L&E") argues that legal mechanisms parallel economic mechanisms. That is, the law reaches economically efficient outcomes and essentially mirrors results that would have been reached had laws been negotiated on an open market. The weaker version of L&E looks to economics for methods of analyzing the law in order to inform the law as to what decision would be best. My take on L&E is critical. L&E, at least in its strong version, assumes the existence of a homo economicus ("H.E."). H.E. is a rational profit maximizer. Strong L&E also embraces the pernicious and inaccurate view that information flow is perfect (i.e., instantaneous and complete) and that there are no transaction costs, such as lawyer’s fees, brokers commissions, translation fees, etc.

Strong L&E is demonstrably false on numerous grounds: Legal processes do not always mirror outcomes on an open market, information is not perfect, transaction costs are inevitable, investors are not always rational, and profit maximization is only one of many possible goals. Because of these weaknesses, which inevitably arise in any simplified descriptive model, strong L&E is not very useful as a tool to describe legal reality and is quite useless as a prescriptive model of how legal reality should be. Yet, a weak form of L&E, borrowing some methods of classical economics, can be a useful tool for legal analysis. For example,


84. See Theresa A. Gabaldon, Assumptions about Relationships Reflected in the Federal Laws, 17 Wis. Women’s L.J. 215 (2002). She critiques the model not because it is objectively unrealistic, but because it stereotypes the roles drawn from it -- the false image of professional stock traders as cold and greedy, preying on uninformed women such as widows. That is, the insider trading prohibition is founded on some sexist assumptions and Martha Stewart illustrates what happens to people who go against the grain and upset social bias.
the cost-benefit analysis in law is a result of weak L&E.

What does a weak theory of L&E say about insider trading? One of the great mechanisms of classical economics is the law of supply and demand. If we look at information as a product then we know that when information is in low supply it will be expensive and when widely available it will be cheaper. This is exactly the case with insider trading. The “insider” has a rare commodity and is essentially selling that commodity when he or she executes a trade. Of course, the very fact that an insider sells is a market signal that will incite curiosity. Market participants will then research the company, which is why insider trading results in better information flow and self-corrects to equilibrium. Eventually, some will discover the “inside” information. They too will trade on it at a lesser premium. This in turn will further incite curiosity, leading to greater scrutiny and more trading until finally the cat is out of the bag and all persons know that the stock is overvalued and no one will get a premium from this information. The supposed problem is self-correcting and weak L&E, relying on the law of supply and demand, shows us why. But who and how the market rewards and punishes in this process is a matter of who is diligent and prudent versus who is lazy and greedy. Weak L&E says the law of supply and demand explains why the “problem” of insider trading is in fact self-correcting.

We can also get a good perspective on insider trading by asking a couple of pointed questions. Does the law reward stupidity? Should the law reward imprudence? No is the correct answer to these questions. Are the putative victims (identifying the supposed victims of insider trading is impossible) of insider trading somehow imprudent? Yes, because they ignored the market signals and did not perform the research necessary to determine why the “insider” was selling. Why is caveat emptor one of the first maxims of commercial law? Because the law is not paternalistic. The law is a neutral judge on the rectitude of the transactions of adults in possession of their mental faculties. Because of this, the law inherently and implicitly rewards the prudent and intelligent and rightly so.

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85. I do think economics is a nomothetic science. Of course, all social sciences are dialectical, not natural. But economic science is the most verifiable of the human sciences for it is based on measurable empirical facts. That is my strongest claim from economics.
Game theory can also provide useful insights into the practice of insider trading. In game theory, trade is a positive sum game, not just for the individuals trading but also for society as a whole. Knowing that trade is a positive sum game, it is much easier to accept the notion that insider trading is good for the economy. We also know that trading is an asymmetric game with imperfect information. This makes it easier to see why insider trading is not different from ordinary trading. Ordinary trading is asymmetric anyway; therefore, asymmetry of information cannot be the problem of insider trading.

1. Chess

What games can we compare the positive sum game with asymmetric and imperfect information known as trading? Chess is an example of a zero sum symmetric game with perfect information. In chess, each player has equivalent material forces (symmetric abilities) and knows everything about his own and his enemy’s pieces (perfect information) and in any transaction one player benefits to the other’s detriment (zero sum). In contrast, traders know their opponents position imperfectly (imperfect information). Yet, unlike chess players, each partner to a trade thinks he benefits from trading. Otherwise he would not trade (positive sum). Chess and trading are also dissimilar in that chess has no chance (deterministic) elements, while trading does. Furthermore, unknown market information may upset the position of either or both traders (potentially indeterminate).

Chess is unlike trading with one important exception: both trading and chess are analytical. By analyzing one’s position in both chess and trading, one can make the best exchange. The non-random elements of trading are far outweighed by the determinate aspects of trading.

2. Poker

If trading is in most respects unlike chess, what game is it like? Some, even those who should know better, think trading is like poker.

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But trading is not like poker or any other game of chance. Poker is a game with imperfect information and is very dependant on chance. Information in stock trading is also imperfect. However, information in poker is both more hidden and clearer than in trade. Traders generally face unknowns, even in their own portfolio but are not completely ignorant of the position of other traders. Further, unlike trading, poker is a zero sum game. Finally, poker is heavily dependant on chance. Positional analysis is limited to the question of how many cards to draw, how many cards one opponent has drawn, and whether to ante up. In contrast, winning stock traders are analytical, like winning chess players.

Stock trading is like chess, in that both are analytical. A proper analysis of one’s position in either game results in correct tactical moves. Yet, poker and stock trading are alike in that poker is a game with hidden information, just like stock trading. No matter how deep one’s analysis of a stock there will always be unknown relevant market information, as even a cursory examination of the commodities futures market reveals. Commodities would not fluctuate so wildly were the information about future performance, often climate dependant, known.

A hybrid of poker and chess shows many aspects of stock trading. Imagine if when playing chess, at each capture of a chess piece one played a hand of poker to determine which side lost its piece. This hybrid “poker chess” would be somewhat like stock trading. Even then the analogy is incomplete. Stock trading is a positive sum game, as to both the traders, each of whom believes he benefits from the trade. The stock market in the long term returns not only the investment but also significant capital appreciation. A long term “buy and hold” strategy is, ceteris paribus, a winning strategy that even an uninformed investor could follow if he had the patience and discipline. However, if an uninformed trader were patient and disciplined they would likely become an informed trader.

their resources to a marketplace they don’t believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed.”). The analogy is wrong and outright pernicious. Stock trading is no gamble. A long term buy and hold strategy over three decades, at most four, always pays out handsomely. This is of course not the optimal strategy. It does however show that the stock market is just not at all like poker, even without a “house” taking a “cut” of the “percentage.”
3. Lottery

Sometimes stock trading is compared to the lottery. This is an unfair comparison and best illustrates the reason why comparing stock trading to zero sum games, particularly zero sum games of chance, is wrong. A lottery’s payout is, by definition, lower than the input of all players combined. In stocks, particularly over the long term, a payout greater than the player’s contribution is almost guaranteed, either as dividends, capital appreciation, or both. Lotteries are zero sum. The house wins only to the extent that the players lose and the players who profit do so at the expense of the other players and the house. This is the error of comparing stocks with gambling. Stocks are positive sum. The only similarity between lotteries and the stock market trading is the element of chance. If lottery players invested their money in stocks they would be better off.

4. Role Playing Games

In fact, the closest parlor game to trading is a fantasy role playing game (“FRPG”). FRPGs are positive sum games. There are no absolute winners, only relative winners. All transactions in FRPGs can be positive sum. Information in an FRPG is imperfect: the game’s host knows things the players do not. There are also random elements in an FRPG (dice). FRPGs also feature the element of fantasy (achieving one’s wildest dreams), and certainly many stock traders dream of fortunes, such as the players in these games. Such dreams are not unrealistic. A 40 year monthly investment of $200 in an annuity, with an annual return of 10%, would result in making even the most inexperienced investor a millionaire.

Stock market computer games (simulations really) are an even better parlor game model of how trading works. If one player gets more experience points (wealth) than the others, at the end of the day, all players are better off. In insider trading one player gets a greater payout due to the information he possesses. How is this different from profiting on the basis of any other information? It is not. All payouts in trade are due to information asymmetry.

I can even suggest a story line for a FRPG about stock trading: the

tortoise and the hare. Long term, steady investments win in the end. Short range, ill considered speculations often do not. Sun Tzu teaches that “[i]f you know the enemy and know yourself, you need not fear the results of a hundred battles.”89 This principle as applied to trading dictates that knowing your stocks and knowing the market will win you a hundred trades.

The source of indignation regarding insider trading is due to a distorted view of markets as characterized by perfect and/or symmetrical information with zero sum results. This is simply untrue. When we see that stock trading is positive sum, although asymmetrical, any indignation about the supposed injustice of insider trading vanishes. To get a really good perspective on insider trading compare stock trading to the negative sum game known as war. War is also asymmetrical, with imperfect information and elements of chance. Unlike trading, war is negative sum. Each “player” has fewer resources after the war than before. These similarities explain why some wrongly conclude that trading is negative sum. Ironically, people needlessly die in war all the time. So where is the outrage about war? The world would be a brighter place if the jealousy directed against successful capitalists were directed against warmongers.

As shown, war, poker, and chess all have some of the elements of stock trading. Yet, each has other elements that set them apart from stock trading. The analogy of trading to FRPGs shows the distorted view of trading held both by the public and even by some analysts. This view is the theoretical source of the prohibition on insider trading. Adam Smith90 and David Ricardo91 both have shown why trade is positive sum. Because trading is a positive sum game, outrage over insider trading is misplaced.

89. SUN Tzu, THE ART OF WAR, Ch. III, para. 18. (Lionel Giles trans.) (1910), available at http://www.chinapage.com/sunzi-e.html:

If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat. If you know neither the enemy nor yourself, you will succumb in every battle.


D. Conclusion: Insider Trading Is Not Harmful

The theory I have outlined of insider trading is logically coherent. Does it correspond to empirical reality? I think so. Two justifications of the prohibition on insider trading are reduced capital market liquidity and a greater spread on the “bid-ask” split. Both of these justifications are not demonstrated. Inside information theoretically results in a more perfect market and thus less liquidity. In practice, however, the effect of insider trading on liquidity is not so large as to be observable: “there is practically no evidence that insider trading caused significant losses for liquidity providers in the United States or other countries before the emergence of the enforced prohibition.”

Likewise, it is quite uncertain whether insider trading has any effect on the spread between bid and ask prices. The supposed effect of insider trading on this spread is one of the more sophisticated defenses of insider trading. However, “the magnitude of the effect of insider trading on the bid-ask spread is rather uncertain.”

To an unsophisticated investor, insider trading may seem intuitively unfair. The uninformed investor is cautious and usually confused as markets are complex. For exactly this reason the uninformed investor is not the proper measure of the propriety of trading. Uninformed investors lack expert information. In fact, all trading with uninformed investors is inherently unfair, if we take fairness to mean informational symmetry. If, on the other hand, we take fairness to mean that which rewards those who have done their due diligence in investigating the propriety of this investment and punishes those who have not adequately considered their investments then it is quite unfair to provide naive investors any protection from their own folly. Investors who know about fundamental and technical analysis of stocks are simply undaunted by the presence of insiders. Even if Warren Buffet outperforms me by 300%, I am still profiting by trading stocks. It is a positive sum game. “Sophisticated” (i.e., intelligent and well informed) investors do not find insider trading intuitively objectionable. Of course not, they have much less informational asymmetry than a naive trader. If anything a sophisticated investor is going to seek out so-called “inside” information. And this is exactly why allowing trading on inside information improves the flow of informa-

92. Dolgopolov, supra note 68.
93. Id. at 180.
In sum, “[i]nsider trading is quite different from market manipulation, false disclosure, or direct expropriation of the company’s wealth by corporate insiders, and trading on asymmetric information is common in many other markets.” Yes, insider trading looks “unfair” from the perspective of naive investors, who, due to their own ignorance, make losing investments and then blame someone else for their own imprudence. Naive investors have no business on the stock market. It is too risky for them. If the uninformed investor wishes to obtain competitive returns with little or no risk then they should seek out investment grade low yield bonds, or better yet, find a qualified investment analyst. If naive investors insist on helping themselves and are willing to tolerate some risk they should look at mutual funds that have the advantage of being diversified investments, yet are affordable even to beginning investors. But absolutely no one without some background in finance should be investing in stocks, much less commodities, options, futures or other derivative instruments. Here, American law could learn a lesson from Germany, where risky investments are permitted only after counseling (informed consent) to warn uninformed investors of the very real risks that their ignorance subjects their hard earned money to. Insider trading renders markets more efficient, as does permitting foolish investors to literally pay the price for their folly. From the perspective of the market, in toto, insider trading is a good thing.

III. PRACTICE: INSIDER TRADING LAW

A. What Is Inside Information?

As I have noted, the insider trading law is incoherent not only in the-

94. *Id.* at 146 (“[I]nsider trading may be beneficial for an emerging economy, which is unlikely to possess sophisticated security analysts, in order to improve price efficiency and allocation of capital.”).
95. *Id.* at 84 n.3.
96. Freeman v. Decio, 584 F.2d 186, 190 (7th Cir. 1978):

In addition to the costs associated with enforcement of the laws prohibiting insider trading, there may be a loss in the efficiency of the securities markets in their capital allocation function. The basic insight of economic analysis here is that securities prices act as signals helping to route capital to its most productive uses and that insider trading helps assure that those prices will reflect the best information available.
ory but also in practice. This can be shown by trying to answer some simple questions about insider trading law. The first question is what is inside information? The quick answer is “material nonpublic information.” But does that answer the question? Not really. All information, to some extent, is nonpublic. All information is at once material to some investors to a certain extent but irrelevant to other investors to a certain extent. The untenability of the concept of “inside information” becomes clear when we understand some facts about “information.” First, the law presumes that information is free (i.e. not property) unless and until proven otherwise by the party claiming the information is proprietary. Second, information is inevitably asymmetric and inevitably imperfect. And last, trading is inevitable and desirable because information is asymmetric. These facts lead to the conclusion that “insider information” cannot be defined in a meaningful sense. All information is, to some extent, material and nonpublic for some investors but irrelevant or known to other investors.

1. Information Is Free Unless Proven Otherwise

Federal legislation does not define inside information. Definitions have arisen through controversial case law. However, inside information can never be completely defined because all information is, to vary-

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98. Acoba, supra note 8, at 1362 (“In fact, section 10(b) and Rule 10b-5 (or any of the federal statutes, rules, or regulations) do not define “insider trading” or “inside information” (or “misappropriation,” for that matter).”).

Since there is no explicit statutory definition of insider trading, it has been established through controversial case law. One important issue is the definition of inside information. Inside information initially meant information concerning a company’s assets or earning power that affected the stock price. Thus, traditional insider trading usually involved trading by directors, officers, and employees of the corporation. This definition has expanded over time to include “market information,” which is any information that affects the market for a company’s security, not just information affecting the company’s assets or earning power. This more expansive definition of inside information has led to individuals besides traditional insiders being found guilty of insider trading. Today, courts do not make the distinction between these two types of information. Therefore, trading based on traditional inside information as well as outside information is considered insider trading in violation of Rule 10b-5.
Insider Trading

ing degrees, nonpublic. Unlike the ECMH, a realistic assumption is that most information is unknown and often unknowable. For example, most people do not know generally accepted accounting principles (“GAAP”). Yet, the GAAP is well established and quite necessary to a solid fundamental analysis of any stock. Is GAAP inside information? Are accountants “insiders”? Do they have an “unfair” trading advantage? Their knowledge of fundamental analysis of stock values (ratios) does in fact give them a trading advantage. But correctly we do not punish accountants for their expertise, even though their expertise is based on a thorough knowledge of exactly the type of information that is regarded as “inside.”

The untenability of the “inside” information distinction becomes clear if we look at insider trading from the perspective of information theory. Information, like any product, has a life cycle. All information starts its life cycle as “unknown.” Information is somehow discovered or invented. Then, it is “known only by a few.” We might call these persons “insiders,” and the law sometimes does. Over time this “inside” information is disseminated at a rate corresponding to its value. When does the information stop being “inside” and start being “public?” I think that question is unanswerable. In any event, once information becomes widely disseminated it has little value. The value of “inside” information exists because it is rare. Like any product, “rare” information has greater value than “common” information. And it is the value of a piece of information that encourages its dissemination. Outlawing the use of “inside” information is a very good way to slow down its publication. In no other market do we punish those who would profit from their knowledge. In fact, in a few regimes, such as patents, trademarks and copyrights, the law actually makes information monopolistic. When the law imposes restrictions on the use of insider information it is distorting market processes, restricting information flow, and generating market inefficiency.

The inability to conjure up a defensible justification for the prohibition of insider trading is a damning condemnation of the law as it stands. Were insider trading something other than an inevitable and good part of the market, it would be easy to find a rationale to justify it and ways to prohibit it.

The best justification for considering some information “inside” is based on theories of ownership. “Inside” information is supposedly the property of the corporation. However, that analysis is erroneous. “In-
side” information is no trade secret. And if it were a trade secret the corporation would have an action for deceit or fraud, making insider trading law superfluous. Information, ordinarily, is not property.\textsuperscript{100} The law recognizes only a few limited instances where information is property, namely trade secrets, trademarks, patents, and copyrights. If the corporation wishes to protect its information it can do so merely by observing the legal requirements of trade secret law. The corporation can also contractually bind its officers, directors and employees from disclosing or trading on the information acquired during their employment or tenure.

A related defense of the prohibition of “insider” trading is that the inside trade injures the corporation’s shareholders. However, some shareholders in fact clearly benefit from insider trading. Further, the supposed detriments of insider trading are speculative and ambiguous. Finally, the rapid and complete flow of information is to the benefit of shareholders. It may seem paradoxical that rapid, complete information flow results from allowing trades on asymmetric information. However, greed is a great motivator. When people learn that the informed trader may know something they do not, which is always the case, they will be more careful in their trading and more inquisitive as to the cause of the insider’s trade. Prohibiting insider trading creates a false sense of security among “outsiders” and hinders market signals.

If the corporation wishes to defend its shareholders from the officers, employees and/or directors it can do so with ordinary contract law.\textsuperscript{101} This raises an interesting question: Would a defense that the corporation explicitly contracted away its confidentiality in some piece of information be a defense to a claim of insider trading? If we take the fiduciary duty argument seriously in some cases, the answer would be yes. In fact, the general principle of freedom of contract shows why, absent a compelling state interest, the corporation should be able to contract away the

\textsuperscript{100} Evan Hendricks et al., The Conflict Between Commercial Speech And Legislation Governing The Commercialization Of Private Sector Data, 11 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 59, 78 (2000) (“As a general matter, when you are creating property rights in information, you are doing a very difficult thing, and something that is traditionally limited to narrow exceptions. The default rule remains the freedom of information.”); Raymond T. Nimmer & Patricia Ann Krauthaus, Copyright on the Information Superhighway: Requiem for a Middleweight, 6 STAN. L. & POL’Y REV. 25, 30 (1994) (“Property rights in copyright law are treated as exceptions from the general rule that information lawfully obtained is available to everyone . . . .”).

right to trade on information. In all events, the corporation could contractually protect confidentiality and thereby prohibit trading on the information. Supposedly, the courts want to protect shareholders. Since when have persons with wealth needed or even wanted protections of the state? The general principle of law in a liberal democracy is that the freedom of contract governs private transactions. Since the supposed wrongs of insider trading can be better remedied by the corporation, why should the law take on a paternalistic role? Why should the law protect the imprudent from the natural consequences of their problems? Protecting folly only encourages it.

Were insider trading somehow fundamentally wrong it would be possible to prohibit it simply with the ordinary tort of deceit. But it is not possible to paint all conduct currently held culpable as “insider trading” as a form of fraudulent misrepresentation. This should make us suspect whether anything wrongful is happening here at all.

An analogy to property as a justification for prohibiting insider trading does not stand up to scrutiny. If information is not like property, what is it like? Information not yet widely disseminated is like a found object; it is a *ferae naturae* and can, absent some contractual reason to the contrary, be freely disposed of.

2. Information Is Inevitably Imperfect Because It Is Asymmetric

It is utopian to expect information in trading to be symmetrical. Inside information is just one more example of the type of information asymmetry that is endemic to market transactions and is, in fact, the very reason that market transactions occur at all. Were information symmetric, no trading would ever occur because perfect equilibrium would be instantly attained, resulting in perfect information and no transaction costs. Were information perfect, there would be no trading at all because all persons would have maxed out their utility functions for all time.

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102. HENRY N. BUTLER, ECONOMIC ANALYSIS FOR LAWYERS 785 (1998) (“Most corporation laws are enabling statutes in the sense that they reflect the philosophy of freedom of contract which has guided corporation law since the first truly modern general incorporation laws were passed in the late nineteenth century.”).


105. Krawiec, supra note 101, at 699 (noting that if information were perfect and there
Thus, perfect information would result in frozen transactions because no person would be able to improve their position by trading in a universe with perfect information. Yet, trading is exactly the means by which information flows approach perfection.

Information flow is like an asymptote; it is a limit. As more transactions occur, information flow approaches perfection. Yet, paradoxically, as information flow increases reasons for trading on it decrease. The result of perfect information flow would be no trading, yet trading is no more or less than the flow of information. This explains exactly why information flow will never be perfect. Although information flow is imperfect, information at any time is in some equilibrium of supply and demand. Information that is not widely disseminated may appear to be out of equilibrium; however, the very rarity of that information makes it valuable and thus provides an incentive for its dissemination. In other words, apparent information asymmetries automatically result in equilibrium due to the law of supply and demand. Thus, legal intervention does not help markets reach equilibria of information, but instead distorts the market. There is no real difference between wage and price controls and prohibitions on insider trading. Wage and price controls look sensible and good but in reality destroy market signals resulting in inflation and disequilibria of supply and demand (gluts and shortages). Prohibiting insider trading, likewise, results in an information shortage that leads to a greater disequilibrium than would have resulted had the market been allowed to perform its function of correcting information asymmetries through pricing.

An analogy to physics may, with qualifications, be helpful. One will never reach the speed of light but may approach it. If all objects are matter/energy and the speed of light is constant, then one can never exceed the speed of light precisely because it is the very measure of existence and motion. As the number of market transactions increase, information flow increases. Yet, paradoxically, as information flow increases, reasons for trading decrease. Thus, like the speed of light, you can never
reach perfect information flow because information asymmetries are the very force that drives market transactions that increase the flow of information. Were perfect information reached there would be no market transactions, just as if we were to reach the speed of light, time would simply stop. Although it is possible that time might be reversible, it is not in Albert Einstein’s model. This analogy is of course only that. I am not stating information flow reflects the matter/energy continuum. I am only stating only that a similar paradox occurs. As transactions increase, information flow approaches perfection, but as information approaches perfection, reasons for transactions decrease. Thus, perfect information will never be attained.

3. Because Information Is Asymmetric Trade Is Inevitable and Desirable

Information is inevitably asymmetric and this explains why trade is inevitable and good. The author happens to speak French and German. Would the author’s trading of stocks based on information discovered in French or German be “unfair?” Of course not, for that would be the result of the author’s diligent search. Is it wrong when the author profits by his work as a translator? No, just the opposite. Translations improve information flow and are driven by information flow. This asymmetry is inevitable. And trading on “inside” information is also one of many market asymmetries that inevitably arise in daily life. This asymmetry is corrected only by the invisible hand of the free market.

Because information is inevitably imperfect and asymmetric and because information is free and not property until proven otherwise, the concept of “inside information” is untenable. All information is, to some extent, nonpublic.

B. Who Is an Insider?

1. The Common Law

Who is an insider? This is a very good question. Unfortunately, federal law has no clear answer to this question.106 Are corporate direc-

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tors, officers, employees, their relatives, their friends, the friends of their friends, their acquaintances, their business partners, etc. insiders? Where does the chain of “being inside” stop? And more importantly, what effect does creating this chain have on information flows? Creating this chain distorts information flow and the result is market distortion. The indeterminacy of this chain explains why the term is undefinable.

Federal courts could have taken the common law bright line approach and defined “insiders” as officers and executives. A bright line approach seems reflected in the courts distinction between “insiders” and “tippees.” Tippees are fairly well defined. A tippee is a person who acquires material, nonpublic information from a source who is in a fiduciary relationship to the company to which the information refers. So long as the tipper does not directly or indirectly benefit from tipping there is no liability to the tipper or tippee, even though the tipper may have breached a fiduciary duty. Where an insider breaches his fiduciary duty to the corporation and the tippee knew or should have known that the information was wrongfully obtained, a fiduciary duty is imputed to the tippee. In that case the tippee must then disclose the information prior to trading on it or abstain from trading. However, defining who is owed a fiduciary duty raises more ambiguities.

Unfortunately the courts do not follow through on the black letter/bright line method to define insider. One can, however, look at the facts of individual cases. A printer who derived confidential information from his work or a trader who tried to inform people of systematic fraud is not liable for insider trading. Based on these facts, does that mean they were not tippees? Or does that mean that their conduct was not wrongful? Your guess may be better than mine. At least it is clear that there must be a specific duty that arises out of the relationship between the two trading parties. In other words, “no duty” is a valid defense to an accusation of insider trading. Again, the tort origins of any prohibition on insider trading are illuminated. But if insider trading law is just one special subset of torts, why define the tort of insider trading as distinct from fraud or deceit?

107. BLACK’S LAW DICTIONARY 718 (7th ed. 1999).
109. Id. at 660.
111. See Dirks, 463 U.S. at 646.
The courts, although making overtures, do not embrace a bright line test to determine whether a person is an insider. Because the courts do not take a bright line approach, that may imply that they perhaps instead took up a multifactor interest balancing test approach. That would be logical and might give us some guidance. A multifactor balancing test would look at the relationships of the parties to the trade\textsuperscript{113} and to the securities being traded. It would also look at the information, how it was obtained, who obtained it, and from whom it was obtained. But although the courts could work these factors out to determine who is an insider or a tippee, they have not yet done so. The best we seem to be able to do to determine who is an insider or a tippee is to examine the actual facts of litigated cases. This is an unsatisfying approach but is at least somewhere to start.

In any case, courts do look to whether the “insider” owed a fiduciary duty to the corporation. As to “tippees,” they are defined as those to whom a fiduciary duty can be imputed based on their relationship to an insider and/or the character of the information they received.\textsuperscript{114} Note however that this definition of tippee is broader and more flexible than the bright line definition provided above. I would not be surprised were courts to adopt a more flexible and hence ambiguous balancing approach in light of the jurisprudence rejecting balancing tests as “inflexible,” “manipulable,” or “arbitrary.”

Federal law is terribly ambiguous. The common law on insider trading is where we see some bright line clarity as to the definition of “insiders.” In the common law, just as in section 16 of the SEA, the definition of insiders is restrictive. At common law, the courts took one of three positions. Insiders (officers and directors) had no obligation to disclose trading information so long as the result of the trade did not harm the corporation.\textsuperscript{115} That is, their duty was to the corporation as a whole and

\textsuperscript{113} Mann & Lustgarten, \textit{supra} note 106, at 7 (“[T]he relationship of a person, and the corresponding duty that person owed to: (a) the corporation that issued the securities traded (the issuer); (b) the issuer’s shareholders; and (c) other entities from which the person acquired material non-public information concerning the issuer.”).

\textsuperscript{114} Chiarella, 445 U.S. at 230 n.12. However, the court determines an “insider” based on two factors: 1) Relationship as a fiduciary either to the corporation or to the corporation’s shareholders (as opposed to the trading party); and 2) relationship to the information. The Court has in no way clarified the exact contours of the definition of an insider.

\textsuperscript{115} Kim Lane Schepple, “\textit{It’s Just Not Right}”: The Ethics of Insider Trading, 56 LAW & CONTEMP. PROBS. 123, 126-127 (2003).
not any particular shareholder or shareholders, let alone the market as a whole. A slightly more extensive view extended the fiduciary duty of insiders to existing shareholders when purchasing the shares of those shareholders.\footnote{116}{Id.} Again, the remedy was to disclose the information to the shareholder. Still another intermediate view imposed a duty to disclose only if it was apparent on actual facts that there was a fiduciary relationship between the parties prior to the sale of the securities.\footnote{117}{Id.}

Because the common law, like section 16 of SEA, defines insiders restrictively, essentially considering only corporate officers or executive insiders, insiders under 10b and 13e should also be a limited class of people (only officers and directors) trading with a definite class of persons (those to whom a fiduciary duty exists at the time of the trade). “Constructive insiders,” such as “tippees,” are so attenuated that they should be free to trade at least on their own accounts or those of their clients without sanction.

2. The Tort of Deceit

The common law in several states essentially limit insider trading to cases involving officers or directors trading with those to whom they owe a fiduciary duty. Thus, at common law, any more expansive view of insider trading would have to fall within the common law tort of deceit.\footnote{118}{See, e.g., Dewey v. Lutz, 462 N.W.2d 435 (N.D. 1990); Hellman v. Thiele, 413 N.W.2d 321 (N.D. 1987).}

Fraud and deceit may be slightly different actions, at least as deceit may refer to cases where there is no contract, whereas fraud refers to cases where a contract exists.\footnote{119}{Goforth, supra note 11, at 911 (citing W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 108 (5th ed. 1984)); Gruber v. Price Waterhouse, 117 F.R.D. 75, 81 (E.D. Pa. 1987) (“It is clear that a plaintiff in a common law securities fraud case must prove direct reliance. A fraud on the market theory is not available.”).} The issue is complicated by state anti-fraud statutes that compliment or displace the common law. However, an aggressive plaintiff’s lawyer would argue that fraud and deceit are separate causes of actions and plead them in the alternative.

Fraud is less strictly defined than deceit and is of more modern vintage given that it is generally codified in statutes. There are two types of fraud: 1) a material misstatement, or 2) omission upon which the plaintiff relies. Causation is shown merely by actual reliance.\footnote{119}{Goforth, supra note 11, at 911 (citing W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 108 (5th ed. 1984)); Gruber v. Price Waterhouse, 117 F.R.D. 75, 81 (E.D. Pa. 1987) (“It is clear that a plaintiff in a common law securities fraud case must prove direct reliance. A fraud on the market theory is not available.”).}
the materiality of a misrepresentation is based on a “reasonable investor” standard: “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”

There is one noteworthy problem with this approach. Different investors have different opinions. Some investors are risk averse and base investment decision on dividends. Other investors are risk friendly and will regard growth in sales as more important factors in their investment decision. Although we might describe investors as “bears” and “bulls,” the fact is that there is no one reasonable investor but rather a spectrum of reasonable investment strategies depending on the investors’ ages and income levels. A retiree is more likely to adopt a cautious investment strategy whereas a younger investor may accept greater risk in order to obtain greater reward. Further, some investors trade based on fundamental analysis, while others on the basis of technical analysis, and still others based on some combination.

The common law tort of deceit is more difficult to prove than fraud, but it is also more widely recognized and not tied to any statute. The elements of deceit are clear:

1. An affirmative misrepresentation of a material fact (mere silence will not support a claim for the tort of deceit),
2. Made with knowledge of falsehood;
3. Where the misrepresentation is intended to induce reliance; and
4. Where the misrepresentation in fact induces reliance.

Although individual cases for fraud can be maintained at the state level, a class action at the state level for securities fraud is no longer possible due to the Securities Litigation Uniform Standards Act of 1998 (“Uniform Standards Act”). This act preempts class actions for securities fraud at the state level.

Obviously, any action that undermines the free will of the party to a trade is wrongful because it prevents trading parties from securing their best possible position given their trading profile. Yet, where does insider

trading undermine the will of the trading party who is not privy to the supposedly secret information? Nowhere. There is no duress, force majeure or fraud in insider trading. Simply put, most insider trading will not be covered by common law fraud or deceit. Why should it, since it is not harmful.

C. What Is Insider Trading?

Just as federal law does not define who is covered by its prohibitions, it also does not clearly define prohibited conduct. That opens the law to attacks on grounds of vagueness. The short swing profits provisions are relatively clear. But section 10b of SEA is notoriously ambiguous. However, attacks on the basis of ambiguity are unlikely to succeed. In United States v. Chestman, an attempt to attack section 14e-3 was


(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the “offering person”), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

   (1) The offering person,
   (2) The issuer of the securities sought or to be sought by such tender offer, or
   (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

(b) A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

   (1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) of this section or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and
   (2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration
rejected. Section 14e-3\textsuperscript{127} was held to be a valid exercise of rulemaking

the nature of the person’s business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) Notwithstanding anything in paragraph (a) of this section to contrary, the following transactions shall not be violations of paragraph (a) of this section:

(1) Purchase(s) of any security described in paragraph (a) of this section by a broker or by another agent on behalf of an offering person; or
(2) Sale(s) by any person of any security described in paragraph (a) of this section to the offering person.

(d) (1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section except that this paragraph shall not apply to a communication made in good faith,

(i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;
(ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or
(iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(2) The persons referred to in paragraph (d)(1) of this section are:

(i) The offering person or its officers, directors, partners, employees or advisors;
(ii) The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;
Anyone acting on behalf of the persons in paragraph (d)(1)(i) of this section or the issuer or persons in paragraph (d)(1)(ii) of this section; and
(iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from any of the above.


Rule 14e-3(a) forbids any person to trade on the basis of material, nonpublic information that concerns a tender offer and that the person knows or should know has been acquired from an insider of the offeror or issuer, or someone
authority.\textsuperscript{128} Global challenges to the SEA or SEC rules are likely to fail. Examination of the substantive content of these vague laws is required to see where they might be challenged or how to fight them within their own terms.

1. Section 16b of SEA 1934 (Short Swing Trades)\textsuperscript{129}

Section 16 is the most coherent piece of legislation dealing with insider trading. However section 16 does not use the term insider. Section 16 governs transactions by those who are “directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempted security) which is registered pursuant to Section 78l of this title, or who is a director or an officer of the issuer of such security.”\textsuperscript{130} Likewise, section 16 covers the “beneficial owner, director, or officer by reason of his relationship to the issuer.”\textsuperscript{131} One could argue that any insider trading legislation could concern only these people, for they are the only ones expressly named. However, to the delight of legal realists everywhere, courts simply ignore such constructions to reach the result they prefer.\textsuperscript{132} A systemic interpretation, wherein we look at a law not in isolation but in comparison with flanking provisions to understand the extent of that law, also leads to the same result. Congress legislated insider trading in sections 16a and 16b at the same time as section 10b. Section 16 deals with insider trading. Thus, section 10 deals with something else. Again the courts do not accept this argument. What types of trading does section 16 cover? Short swing trades. Short swing trades are trades in which profits of a purchase and sale by a person of the company’s stock within six months must be disgorged to the company. Trades covered by section 16 are subject to a two-year sta-

\begin{itemize}
\item working on their behalf, unless within a reasonable time before any purchase or sale such information and its source are publicly disclosed. Rule 14e-3(a) imposes a duty to disclose or abstain from trading whether or not the trader owes a fiduciary duty to respect the confidentiality of the information.
\end{itemize}

\textsuperscript{128} Chestman, 947 F.2d at 556.
\textsuperscript{130} Id.
\textsuperscript{131} Id.
\textsuperscript{132} Herman & MacLean v. Huddleston, 459 U.S. 375, 387 n.23 (1983) (rejecting \textit{expresso unius} as supposedly contrary to purpose of the 1933 Securities Act). A court ought only to examine legislative intent where the text of the statute is unclear. When the \textit{expresso unius} maxim resolves ambiguity the court ought to follow it in the interests of legal certainty.
tute of limitations from time of sale. Section 16 imposes liability without fault, and short swing trades are covered. No wrongful conduct need be shown to be liable under section 16. In practice, section 16 is rarely invoked. However, the real role of section 16 is to indicate what types of persons might be covered by any inside trading inferred from section 10b.

A good argument can be made that the short swing trading provision is the exclusive remedy of insider trading. Statutes such as section 10b will ordinarily be interpreted in accord with their plain meaning, and the term “insider trading” is not found in section 10b. However, although the legislation clearly addresses insider trading only in section 16, the courts do not accept this argument and permit section 10 to cover transactions that should be covered instead by section 16. The court reasons that “Congress’ failure to impose criminal sanctions for nonfraudulent conduct under § 16(b) does not mean that it intended to immunize insider trading that is fraudulent under section 10b and Rule 10b-5.” That is true but also irrelevant. The issue is not whether conduct is immune but whether conduct is wrongful at all.

2. Section 10b and Rule 10b-5


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

(a)(1) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(2) Paragraph (1) of this subsection shall not apply to security futures products.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the
Section 10b attempts to catch all types of fraud involving the purchase or sale of a security (sale is broadly interpreted). Pursuant to section 10b, Rule 10b-5 essentially codifies common law actions for deceit. However, Rule 10b-5 does not preempt state remedies. State and federal laws have concurrent, not exclusive jurisdiction, over stock fraud. One could argue that it creates the risk of double jeopardy.

Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
Rules promulgated under subsection (b) of this section that prohibit fraud, manipulation, or insider trading (but not rules imposing or specifying reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading), and judicial precedents decided under subsection (b) of this section and rules promulgated thereunder that prohibit fraud, manipulation, or insider trading, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities. Judicial precedents decided under section 77q(a) of this title and sections 78j, 78o, 78p, 78t, and 78u-1 of this title, and judicial precedents decided under applicable rules promulgated under such sections, shall apply to security-based swap agreements (as defined in section 206B of the Gramm-Leach-Bliley Act) to the same extent as they apply to securities.


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

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

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

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


139. 79A C.J.S. Securities Regulation § 255.

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However, court created doctrines regarding liability under section 10b have extended section 10b to cover not only executives and directors, but also employees and tippees. Liability may be based either on a classic theory or a theory of misappropriation/breach of fiduciary duty.

a. The Classic Theory of 10b Liability

The classic view of section 10b and Rule 10b-5 is that liability shall be imposed for “trad[ing] in the securities of his corporation on the basis of material, nonpublic information.”\(^{141}\) However, none of these magic words appear anywhere in the statute or rule. The theory is that the insider is breaching a trust owed to the corporation’s shareholders.\(^{142}\) Direct benefit to the tipper is a precondition for the liability of the tipper who does not trade on the information they (wrongly?) divulge.\(^{143}\) Likewise, the tippee will not be liable under Rule 10b-5 unless the plaintiff shows benefit to the tipper.\(^{144}\) Benefits can be intangible,\(^{145}\) and gift transactions can be a basis of liability.\(^{146}\) These views on tipper and tippee liability under the classical theory were affirmed in \textit{SEC v. Sargent}.\(^{147}\)

b. Misappropriation Theory

The misappropriation theory is based on the idea that the inside information is somehow (how?) proprietary to the corporation. However, if the theory is that corporate information was wrongly appropriated, then any wrong committed by insider trading could be immunized by a contract or provision in the corporate charter. The misappropriation theory was developed in the case of \textit{United States v. O’Hagen}.\(^{148}\) Then the court held that “a person commits fraud ‘in connection with’ a securities transaction, and thereby violates § 10(b) [of the Securities Exchange Act of 1934] and Rule 10b-5, when he mis-

\begin{itemize}
\item[142.] \textit{Id.} at 652.
\item[143.] Dirks v. SEC, 463 U.S. 646, 662 (1983).
\item[144.] \textit{SEC v. Warde}, 151 F.3d 42, 47 (2d Cir.1998).
\item[145.] \textit{Id.} at 48-49.
\item[146.] \textit{Id.}
\item[147.] \textit{SEC v. Sargent}, 229 F.3d 68, 77 (1st Cir. 2000).
\end{itemize}
appropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”

The elements of a 10b-5 breach are:

1. Misappropriation;
2. of confidential information;
3. for securities trading purposes; and
4. in breach of a duty owed to the source of the information.

Disclosure of the source of the information will immunize the trader from an accusation of insider trading under the misappropriation theory. The victim is not the party traded with but the source of the information.

When does a fiduciary duty exist? The existence of a fiduciary relationship turns on whether the source of the misappropriated information granted the misappropriator access to confidential information in reliance on a promise by the misappropriator that the information would be safeguarded. The theory is that the fiduciary has wrongly used confidential information: “[T]he misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.” Deception must be shown for the breach of fiduciary duty to occur under the misappropriation theory. However, in O’Hagan, the Court seemed willing to accept mere non-disclosure as deception (i.e. deception may be only implied from conduct). However, the misappropriation theory is also based not just on a fiduciary relationship but also on entrusting property to the fiduciary. Thus, I would argue that both a fiduciary duty and a misuse of property must be shown.

Because the misappropriation theory is based on the existence of a fiduciary duty, if no duty is owed to the corporation or no duty to the corporation was violated, there can be no insider trading under the mis-

149. Id. at 652.
150. Id. at 655 (noting that “if the fiduciary discloses to the source that he plans to trade on the information, there is no ‘deceptive device’ and thus no §10(b) violation”).
151. Id. at 652-53 (noting that “[t]he transaction and the breach of duty coincide, even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information”).
152. Id. at 652.
154. O’Hagen, 521 U.S. at 682.
155. Id. at 660 (noting that “deceptive nondisclosure is essential to § 10(b) liability under the theory”).
appropriation theory. If no fiduciary duty exists then “disclose or abstain” rule developed in SEC v. Texas Gulf Sulphur Co. does not apply. Thus, “a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.”

The competing concepts of fiduciary relationship and property in information that is in fact not proprietary underlie the misappropriation theory. Because of these conflicts “a theory of insider trading based solely on fiduciary duties, as currently used by the U.S. Supreme Court, is inadequate to regulate insider trading.” If a director or officer owes fiduciary duties not just to the corporation, which is unquestioned, but also to all shareholders, then the officer or director will be subject to multiple conflicting fiduciary duties. “The best interests of the corporation . . . may not coincide with the best interests of an individual shareholder transacting business with the corporation.” The interest of one shareholder may directly oppose the interest of another, and both may have interests different from the corporation. Misappropriation theory is unsound because the supposedly proprietary information is generally not in fact property. If property were the basis of the wrong, then the corporation could simply contract away the problem. I suspect that would be unacceptable to the SEC and the courts.

The misappropriation theory raises the specter of multiple conflicting duties between the directors and officers of a corporation as to the various shareholders of the corporation and the corporation itself. This conflict shows the incoherence of misappropriation theory. It also raises a related puzzling problem. Can a corporation be liable for trading its own shares on “inside” information? I will not try to answer this question because the SEC and judicial theories are simply incoherent. In keeping with the desire to punish those who rise by their intelligence and thereby invoke the ire of others they would find that the corporation could be liable. The fact that such illogical problems arise under existing insider

157. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc).
159. Scheppele, supra note 115, at 173.
161. See id.
162. Green v. Hamilton Int’l Corp., 437 F.Supp. 723, 728 (S.D.N.Y. 1977) (noting that “there can be no doubt that the prohibition against ‘insider’ trading extends to a corporation”).
trading law are, I think, the consequence of flawed assumptions about the nature of insider trading.

c. ECMH Revisited – Basic, Inc. v. Levinson

Just as duty must be shown to prove a 10b case, so also must causation. The causal link must be made between the false statements or omissions and the resulting injury. Thus, reliance on fraudulent statements must be shown when using the misappropriation theory because reliance demonstrates the causal link between the plaintiff’s act and the defendant’s injury. This view was reaffirmed in Basic, Inc. v. Levinson. However, at least in class actions, one can show reliance by demonstrating that the insider trading worked a fraud on the market.

Here is where the erroneous ECMH theory comes into the picture. The argument that reliance can be inferred due to supposed fraud on the market is an attenuated and unrealistic argument based on faulty premises. The result is to create open-ended liability. Moreover, proving reliance (really, presuming it) because of a supposed fraud on the market is in fact a tautological argument. Wrong presumptions generally (but not inevitably) lead to wrong conclusions, as is the case here.

The first faulty premise of the reliance based on a fraud on the mar-

167. Donald Eric Remensperger, Comment, Causation in Fraud-on-the-Market Actions—Investors’ Insurance in the Second Circuit?, 49 BROOK. L. REV. 1291 1302 (1983) (“Although other courts have used a similar standard, the Second Circuit extended the presumption to cover a more attenuated chain of causation, thereby creating the possibility of unlimited liability under the fraud-on-the-market theory of recovery.”).
168. Mechanisms of Market Inefficiency, supra note 17, at 641 (“Combining the ECMH with the CAPM produces a prediction of fundamental value efficiency through a different and more troubling analytical path—by tautology.”).
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ket is the ECMH itself. As demonstrated, the ECMH does not accurately describe reality. The second faulty premise of the theory is that insider trading is somehow unfair, either to investors, the market, or society and thus defrauds the market as a whole. In fact, insider trading has exactly the opposite result; it makes capital markets more efficient.

The fraud on the market theory, like the ECMH, is tautological. If we were to assume that insider trading somehow distorts market signals, which is not at all the case, then any such trade would always work a fraud on the market and thus reliance would always exist. The fraud on the market theory is thus illogical. Its illogic provoked a spirited dissent in Basic, Inc. v. Levinson.

D. Why Is Insider Trading Treated as a Wrong?

The lack of clarity in the substantive law is a reflection of the lack of clarity in the rationales justifying the law. If you ask five people who think insider trading is wrong why they think it is wrong, you are likely to get five different answers. “[E]ven among those who intuit that insider trading is unfair, there is no clear consensus as to what is unfair about it . . . .” Congress has given no justification for outlawing insider trading. Why should the Congress have done so? The statutes invoked (10b-5, 16a) do not even use the term “insider trading.” Thus, unsurprisingly, they do not define an insider or an inside trade. If you think that is unsettling for democracy I am in your company.

Before the background of this silent legislative abdication, it is noteworthy that most objections to insider trading are based ultimately, not on economic arguments, but on moral arguments. Henry Manne thinks that moral criticisms of insider trading are a “refuge for the intellectually bankrupt.” If one takes the view that moral choice is a subjective matter and that no objective moral standards exist, he is right. That is, most of what presents itself as moral theory is unscientific be-

169. Barry III, supra note 64, at 1340 n.129 (“The ECMH assertion that prices reflect all relevant information is essentially tautological.”).
172. Schroeder, supra note 4, at 2050.
173. See Macey, supra note 104.
175. Manne, supra note 3, at 549.
cause moral theories generally are not based on an empirical analysis of facts. However, I disagree with Manne in that I think an objective moral science based in materialism is possible. But, even if I am right on this point, the courts just do not have or apply such a standard, at least not in cases of “insider trading.”

Supposedly, insider trading is somehow unfair. But when we ask for details, for facts, we get tautologies or even ad hominem. When authors try to define fairness in contemporary terms they flounder on the fact that “fairness” is a term of many meanings, that it is polysemic. Likewise, authors who try to define fairness run aground on the subjectivism of late modern and post-modern discourse theory. If fairness is defined subjectively, either due to its multiple meanings or due to the supposed inter-subjectivity of moral claims, then it is impossible to use fairness as an objective legal standard. This is why Manne says discussion of morals is for intellectual bankrupts. Moral claims might be possible, but not on a subjective or even inter-subjective basis.

A principled argument for outlawing insider trading would be that it somehow distorts market signals. However, this is simply not the case. “For exchange-listed stocks . . . 88.3 percent of the private information that informed traders have at the beginning of each trading day is absorbed in one day for the average stock . . . . For over-the-counter stocks, an average of 85.1 percent of private information is absorbed in one day.” In other words, the “cat gets out of the bag” very quickly.

177. Id. at 141-42:

From where does the normative force of fairness come? The answer may well depend on one’s philosophy. Some may view it as a corollary of a deontological obligation to treat others as equals. Utilitarians and other consequentialists, on the other hand, may view the rules of fairness as being a condition for the possibility of welfare-improving cooperative action, the solution to a chronic Prisoners’ Dilemma in which members of society have an incentive to exploit each other’s situational vulnerabilities even though all of them would be much better off in a society where such exploitation did not occur. It is also possible that a weak form of consequentialism can be reconciled with deontology, for example, if cooperation is not merely an instrumental means of achieving some overall and independently specified good, but rather adds a vector of value to the idea of being better off. Perhaps there is a kind of good that we can only hope to achieve through cooperation and the logic of such cooperation includes rules we describe as rules of fairness.

This is because inside information is a powerful and rapid market signal: “insider trading is associated with immediate price movements and quick price discovery [and that] the stock market detects informed trading and impounds a large proportion of the information . . . before it becomes public.” This is partly why insider trading is good for the economy.

Insider trading does not distort markets. Rather, it is a vector for rapid transmission of important information. By seeking to control the market the courts create the very evil they seek to correct.

**E. What Are We to Make of the Ambiguity Both as to the Object and Subjects of “Insider Trading”?**

The legal ambiguity of insider trading could be attacked as constitutionally vague, as an undue delegation of congressional legislative power, as failing to provide adequate notice of prohibited conduct. To date, such attacks have not been successful. However, when a law is unclear both as to its object and as to its subject, the law as defined is

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Antifraud rules have been upheld consistently and in diverse contexts when challenged, for example on grounds of vagueness or excessive delegation of legislative authority. See, e.g., Charles Hughes & Co. v. Securities and Exchange Commission, 139 F.2d 434, 436, (C.C.A. 2d Cir. 1943) (Rule 15c1-2 valid; sufficiently definite; no unconstitutional delegation; broker-dealer revocation affirmed); Speed v. Transamerica Corp., 99 F. Supp. 808, 831-32 (D. Del. 1951) (10b-5 valid; not unconstitutionally vague; no improper delegation; civil liability imposed); U.S. v. Persky, 520 F.2d 283, 286-88, Fed. Sec. L. Rep. (CCH) ¶95209 (2d Cir. 1975) (10b-5 valid; despite expansive interpretation in civil cases, it provided fair warning that defendant’s conduct was unlawful; conviction affirmed); U.S. v. Chiarella, 588 F.2d 1358, 1369, Fed. Sec. L. Rep. (CCH) ¶96608, 3 Fed. R. Evid. Serv. 1347 (2d Cir. 1978) (10b-5 sufficiently clear to satisfy due process and affirm conviction of financial printer for trading without disclosure of nonpublic information of forthcoming tender offers).

bad. This bad law is not the result of bad legislative drafting. Rather it is inevitably bad. When information passes from “inside” to “public,” it is inherently unknowable and cannot be defined. Further, who might be considered an “insider” is so fact dependant that no answer could be reached that would be satisfactory. If a “bright line” test were taken, such that all officers and directors are insiders, that would leave lots of similar traders uncovered (spouses,\textsuperscript{183} relatives,\textsuperscript{184} friends and acquaintances of the bright line class). If a “flexible” standard is taken up, uncertainty arises as to what conduct by what people are prohibited or permitted. And, legal uncertainty is a very large transaction cost. Of course, uncertainty can be reduced with insurance, but insurance is not cost free. Thus, it is only a partial solution. But all of these considerations are irrelevant since they are predicated on an erroneous assumption. Insider trading is in fact good for the economy.

IV. CONCLUSION

The perceived “problem” of insider trading is not a problem at all, but rather a natural part of a market that functions to properly allocate scarce resources.\textsuperscript{185} The real problem of insider trading is its prohibition. The ECMH, which is used to justify much of insider trading law, is wrong and based on faulty assumptions that pervade SEC law. The unsurprising consequence of erroneous theoretical foundations are incoherent law both as to the object of the law (what is insider trading) and as to its subject (who is an “insider”). Moreover, these ambiguous laws founded on erroneous assumptions reach objectives that are already obtained by other laws or private contract. All objectionable insider trading activities can be covered by the common law tort of deceit and/or statutory fraud. Moreover, companies can protect themselves and their shareholders by using trade secret law and through non-disclosure contracts with their employees. Individual investors can also protect themselves

\textsuperscript{183} United States v. Chestman, 947 F.2d 551, 568 (2d. Cir. 1991) (”[M]arriage does not, without more, create a fiduciary relationship. ’[M]ere kinship does not of itself establish a confidential relation’ . . . . Rather, the existence of a confidential relationship must be determined independently of a preexisting family relationship.”).

\textsuperscript{184} Id. (noting that ”more than the gratuitous reposal of a secret to another who happens to be a family member is required to establish a fiduciary or similar relationship of trust and confidence”).

\textsuperscript{185} Wilson, supra note 5, at 198 (“In pure teleological terms, insider trading is good because its consequences benefit both the trader and the company.”).
with diverse portfolios and trading tactics, including the taking of insider trades as signals. Prohibiting insider trading rewards industrious investors and punishes diligent ones. Furthermore, the insider trading prohibition distorts the very market it tries to protect. Congress or the SEC should simply amend or abolish section 10 of the SEA to eliminate this source of economic inefficiency.