

**TRADING SECURITIES ON THE BASIS OF NONPUBLIC INFORMATION:
WHY U.S. LAW ALLOWS CHEATING TO GO UNPUNISHED WHY NOW IS THE
TIME FOR A STATUTE BASED ON THE “EQUAL ACCESS” THEORY**

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Abstract

This article makes the case for a new statutory provision in the U.S. that will define insider trading under an “equality of access” theory. It supports this claim, and contributes to the important academic dialogue concerning this prevalent practice, by highlighting the moral and legal gaps in existing U.S. law that result from understanding the harms of insider trading solely with reference to fiduciary breach or misappropriation, as evidenced by the recent case of *United States v. Newman*. It weaves legal analysis together with literature in business ethics, moral philosophy and recent finance literature to offer new arguments in the long-standing debate over insider trading based on Rawlsian social contract theory, applied deontology and empirically-informed utilitarianism. It endeavors to make the case for adopting a statute that will prohibit the use, by anyone, of material information concerning a financial instrument that is not, at least in principle, available to others through due diligence.

Introduction

As it turns out, cheaters do win. This was the lesson recently taught by the Second Circuit Court of Appeals in the December 2014 case of *United States v. Newman*, which acquitted two hedge fund portfolio managers who knowingly received and traded on the basis of tips of material nonpublic information to reap more than \$72 million in profits.¹ Dismissing the indictment with prejudice, the *Newman* court held that prosecutors had failed to show that the insiders from whom the advanced earnings tips emanated had violated their fiduciary duties to their corporate principals by receiving personal benefits in exchange for their tips that were “objective, consequential, and represent at least a potential gain of a pecuniary or similarly valuable nature,” or that the traders knew of the tippers’ fiduciary breaches, including the fact

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¹ U.S. v. Newman, 773 F.3d 438 (2014)

that they received a personal benefit.² By tightening the personal benefit requirement from *Dirks v. SEC* and adding a new knowledge requirement, the *Newman* case further narrowed the already anemic definition of unlawful trading under Section 10(b) and Rule 10b-5, effectively immunizing from prosecution certain forms of cheating by outside traders. According to the U.S. Department of Justice, which unsuccessfully petitioned for *en banc* review, the precedent set in *Newman* “arguably represents one of the most significant developments in insider trading law in a generation.”³

Commonly and colloquially termed “insider trading,” all questionable forms of the practice involve trading in financial instruments on the basis of “material, nonpublic information.” Despite the misnomer, however, such trading is not limited to corporate insiders.⁴ For purposes of this Article, the term “insider trading” refers to the buying or selling of any security on the basis of material non-publicly-available information concerning such traded financial instruments regardless of whether the trading is done by (1) an insider, i.e., a corporate officer, director, employee, controlling shareholder, or independent contractor such as a lawyer, accountant or consultant working as a “temporary insider” of the issuer, or (2) an outsider, including any person or entity unaffiliated with the issuer of the traded instrument who receives material nonpublic information through intentional or inadvertent tips, selective disclosure, eavesdropping, or misappropriation from corporate personnel.

Outside of very limited circumstances,⁵ insider trading is only punishable, however, if it is accompanied by a breach of fiduciary duty (lying and self-dealing) or misappropriation (theft).⁶ This is largely because insider trading in the U.S. is currently not defined by any dedicated statute,⁷ but rather is governed by general “catch-all” securities fraud provisions like Section 10(b) of the 1934 Act, which prohibits “any manipulative or deceptive device or contrivance” in connection with securities, and SEC Rule 10b-5 which bars the use of “any

² *Id.* at 452,

³ Pet. of U.S.A. for Rehr’g and Rehr’g En Banc at 22-23, *United States v. Newman* 773 F.3d 372 (2014) (No. 13-1837(L)/ 13-1917(CON)).

⁴ *U.S. v. Hagan* 521 U.S. 642 (1997); *Dirks v. SEC* 463 U.S. 646 (1983)

⁵ Trading on the basis of material nonpublic information is actionable, without a breach of fiduciary duty or misappropriation, under SEC Rule 14e-3. Likewise, corporate insiders are prohibited from making short-swing profits within a period of less than six months, the prophylactic rule of Section 16(b) of the 1934 Securities Exchange Act.

⁶ *U.S. v. Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. U.S.*, 445 U.S. 222 (1980).

⁷ Robert W. McGee, *Applying Ethics to Insider Trading*, *J. Bus. Ethics*, 2007, at 214.

device, scheme, or artifice to defraud.”⁸ The Supreme Court made clear, however, that even though these are “catch-all” provisions, what they catch “must be fraud”⁹ and “not every instance of financial unfairness constitutes fraudulent activity.”¹⁰ To constitute fraud, there must typically be an affirmative false statement.¹¹ If there is merely silence—as is the case with virtually all modern securities transactions conducted anonymously over an exchange—it is only fraudulent if there is a “duty to disclose” material facts in one’s possession.¹²

The Court has held that the duty to disclose or abstain from trading until the information is public generally only applies to (1) people who are fiduciaries (like corporate officers or directors or trustees), agents or persons between whom there is a relationship of trust and confidence,¹³ and (2) people who misappropriate material nonpublic information.¹⁴ Inside tippers that provide material nonpublic information are generally not subject to prosecution unless they receive a personal benefit in exchange,¹⁵ although their employers may terminate them and they could theoretically be subject to relatively minor non-criminal penalties by the SEC under Regulation FD.¹⁶ And people who receive and trade on such tips (“tippees”), like the traders in *Newman*, are only prohibited from trading on undisclosed nonpublic information where the tip comes from an insider who has breached his fiduciary duties for personal benefit and where they know that such a personally-motivated fiduciary breach has occurred.¹⁷ Insiders who freely gift out information to their colleagues in the securities industry are generally not subject to prosecution. And folks savvy enough to remain plausibly ignorant of the source of the tip they receive or what such tippers got in exchange, also remain untouchable. Thus, many cheaters go unpunished.

Although exact figures on the prevalence of insider trading remain elusive due to the secrecy with which such practitioners operate to avoid detection by Exchanges and the SEC, a recent study by Professors Augustin, Brenner and Subrahmanyam found that nearly one quarter of all mergers or acquisitions involving publicly traded companies may involve some kind of

⁸ Securities Exchange Act of 1934, 15 U.S.C. § 78a (1934); Securities Act of 1933, 15 U.S.C. § 77a (1933)

⁹ *Chiarella v. U.S.*, 445 U.S. 222 (1980).

¹⁰ *Id.* at 232.

¹¹ *In Re Cady Roberts*, 40 SEC 907 (1961) at 911.

¹² 445 U.S. 222 at 232.

¹³ *Id.* at 233.

¹⁴ *United States v. O’Hagan*, 521 U.S. 642 (1997)

¹⁵ 773 F.3d 438 at 447.

¹⁶ Selective Disclosure and Insider Trading, Exchange Release Nos. 33-7881, 34-43154 (Oct. 23, 2000).

¹⁷ *Dirks v. Sec. Exch. Comm’n*, 463 U.S. 646 (1983)

insider trading.¹⁸ The prevalence of such trading has led some to conclude, as Professor McGee has, that “[t]here are just too many individuals who are violating the law to find and prosecute them all.”¹⁹ Yet the magnitude of the problem of rampant cheating ought not lead us to conclude that society is entirely powerless to minimize it.

Despite being a moral leader and first-mover in the fight to secure the integrity of the securities markets by regulating insider trading more than 30 years before any other country,²⁰ the United States has now fallen significantly behind other developed market economies in Europe that have adopted the “equal access to information” theory pursuant to E.U. Market Abuse Directives.²¹ Federal law in the U.S. has become pigeonholed in analytically off-base, overly narrow, and outdated theories of what makes trading on the basis of nonpublic information morally wrongful. The resultant enforcement gaps that follow from these theories, and that allow blatant cheating to go unpunished, dangerously un-moor federal securities law from its expressly intended ethical foundations.²² The 1934 Act was “purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges.”²³ That Act, adopted alongside the 1933 Securities Act in the wake of the frauds that preceded the Great Depression, was intended to “substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.”²⁴

The solution to this problem is not simply to overturn *Newman*, and this Article is not intended as a mere indictment of that Second Circuit decision. That decision, as explained above, is largely (although not entirely) the product of constraints imposed by decades of Supreme Court precedent and the failure of the United States to have a dedicated and comprehensive statute, defining insider trading.²⁵ The solution, therefore, lies in the creation of

¹⁸ Augustin, P., Brenner, M., and Subrahmanyam, M., *Informed Options Trading Prior to M&A Announcements: Insider Trading?* (May, 2014) http://irrcinstitute.org/pdf/Informed-Options-Trading_June-12-2014.pdf.

¹⁹ McGee, *supra* note 7 at 213.

²⁰ Marco Ventoruzzo, *Comparing Insider Trading in the United States and in the European Union: History and Recent Developments* (ECGI Working Paper Series in Law, Working Paper No. 257/2014, 2014) at 1.

²¹ *Id.* (Numerous European countries, under the E.U. Market Abuse Directives, have adopted the “equal access to information” theory, which is “more clear, easy to apply and broad.”)

²² *Sec. Exch. Comm’n v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 847-48 (1968)

²³ *Id.* at 848.

²⁴ *Sec. Exch. Comm’n v. Cap. Gains Res. Bureau*, 375 U.S. 180, 187

²⁵ McGee, *supra* note 7 at 214 (noting that U.S. insider trading legislation has not defined the term “insider trading”).

a new statutory provision defining insider trading, as distinct from other forms of securities fraud appropriately governed by the 1933 Securities Act and 1934 Securities Exchange Act.

Fortunately, the public backlash against *Newman* has prompted renewed interest—among certain legislators, judges, prosecutors, financiers, and academics—in legislative solution.²⁶ Three new bills are currently pending in Congress that would finally statutorily define insider trading, including one in the Senate that would make it unlawful “to purchase, sell, or cause the purchase or sale of any security on the basis of material information that the person knows or has reason to know is not publicly available” unless it is “information that the person has independently developed from publicly available sources.”²⁷

This Article contributes to the long-standing academic debate over insider trading by adding to the voices of those like UVA Professor Emeritus Patricia Werhane and Princeton Professor Kim Lane Scheppele who have argued that insider trading is ethically repugnant,²⁸ as well as those from both sides of the debate who have recognized that a dedicated and comprehensive U.S. statutory provision that defines insider trading finally should be enacted.²⁹ It argues that any effort to define when insider trading is illegal must more squarely overlap with all of the fundamental reasons why it is morally wrongful, instead of continuing to moor the law solely to principles of fiduciary duty breach or misappropriation. Weaving together disparate threads of research from the literature in moral philosophy, business ethics, law and finance, I submit that the wrongfulness of insider trading derives not only from the fact that it offends the sanctity of fiduciary, familial, agency or employment relationships— or that it arguably steals value from issuers and trading counterparties—but also because (a) it constitutes a form of unfairness and cheating that violates the basic requirement of *equality of opportunity* that we expect in our social contract (Section II below), (b) it violates categorical imperatives to act only on maxims that can be universalized and that treat individuals as more than mere means to our profit-driven ends (Section III below), and (c) it demonstrably harms the capital markets by

²⁶ Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015).; Stop Illegal Insider Trading Act, S. Res. 702, 114th Cong. (2015). Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015).

²⁷ Ban Insider Trading Act of 2015, H.R. 1173, 114th Cong. (2015).; Stop Illegal Insider Trading Act, S. Res. 702, 114th Cong. (2015).; Insider Trading Prohibition Act, H.R. 1625, 114th Cong. (2015).

²⁸ Patricia H. Werhane, *The Ethics of Insider Trading*, *J. Bus. Ethics*, Vol. 8, 841-845 at 842; Kim Lane Scheppele, *It's Just Not Right: The Ethics of Insider Trading*, *Law and Contemp. Probs*, vol. 56, No. 3, *Modern Equity* (Summer 1993), 123-173 ; Dan Ostas, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 *Am. Bus. L. J.* 571, 582 (Winter 2007).

²⁹ McGee, *supra* note 7 at 214 (noting that “[t]o charge Congress with irresponsibility for this omission is an understatement. Insider trading is now officially a crime, yet nobody knows how to define the crime.”)

undermining trust, deterring investment and raising the cost of equity capital, according to empirical finance research (Section IV below). Accordingly, I argue that, any such insider trading statute must ensure *equality of access to material information* by prohibiting trades made on the basis of information that is not at least, in principle, accessible to all other investors through independent diligence.

Insider Trading Violates the Social Contract Applicable to the Securities Industry

To begin any meaningful discussion of reforming law to prohibit certain behaviors, it is helpful to start with the foundation of such law: ethics. As Thomas Dunfee has eloquently explained, the domains of ethics and law “synergistically and intimately related. They are so much so, that neither can be fully meaningful or realized without the other. Law without reference to ethics and community moral values is in danger of becoming disconnected from the public will.”³⁰ I submit that the ethical imperative to curtail cheating by legally ensuring such equality of access to material information concerning a security—and prohibit trading on the basis of information that is not, in principle, available to all other investors through diligence—is evident under contractarian, deontological and consequentialist theories of justice.

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

Insider Trading Undermines Even Our Most Limited Expectations of Fairness By Denying Equality of Opportunity

So, what exactly is meant by “fairness”? Professor Scheppele has aptly recognized that “[d]iscussions of the ‘fairness’ of insider trading have been plagued by charges that fairness is a fuzzy idea that needs to be clarified with the pure logic of economic theory” and “have been

³⁰ Thomas W. Dunfee, *On the Synergistic, Interdependent Relationship of Business Ethics and Law*, 34 Am. Bus. L.J. 317 (1996).

criticized for failing to provide any clearly defined sense of what would be prohibited.”³¹ Too often, it seems, straw-man arguments are set up simply so that they can easily be knocked down. Robert McGee’s argument in *Applying Ethics to Insider Trading* from the Journal of Business Ethics does just this.³² In oversimplified terms, McGee defines the so-called “fairness” argument as one asserting that “[t]he market should be fair to all participants,” which he interprets as requiring symmetry of information and skill.³³ After setting up the straw man, he then knocks it down, noting “it is not possible or desirable to ever have a level playing field in the realm of economics.”³⁴ He contends that the true unfairness lies in forcing “experts who work 60 hours a week to gather information as part of their job...to disclose such information to people who have done nothing to earn it.”³⁵ Those of us without inside information, asserts McGee, are like “Alaskan banana farmers” seeking to impose “punitive regulations and higher tax burdens” to compensate for the fact that “some individuals are naturally better at some things than others.”³⁶

So, let me be clear here: perfect fairness—i.e., equality of skill, sophistication, financial resources, information, luck or outcome—is not, has never been, and probably never will be a fundamental feature of the securities markets. And few of us, if offered a Rawlsean *ex ante* opportunity to devise securities laws from behind a veil of ignorance in the Original Position,³⁷ would probably want it to be. While we likely would seek to maximize our minimums in the probable event that we did not become Wall Street tycoons, we would not demand absolute equality on most fronts.

The ability to accumulate wealth and achieve economic development—which, in principle, benefit us all and are “to the greatest benefit of the least-advantaged members of society”³⁸—are often realized through the buying and selling of securities precisely because there are differences in the sophistication and skill possessed by traders of the same security. In

³¹ Kim Lane Scheppelle, *It’s Just Not Right: The Ethics of Insider Trading*, Law and Contemp. Probs, vol. 56, No. 3, Modern Equity (Summer 1993), 123-173 at 125 (citing Easterbrook & Fischel’s comment at page 251 of *The Economic Structure of Corporate Law* that they “suspect that few people who invoke arguments on fairness have in mind any particular content for the term.”)

³² McGee, *supra* note 7 at 210-211.

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ John Rawls, *Justice as Fairness: A Restatement* (Erin Kelly, 3rd ed. 2003) at 80-89.

³⁸ *Id.* at 43 (arguing for the “Difference Principle”). Notably, I do not here intend to suggest that the least advantaged amongst us are always, in practice, served by inequalities of wealth.

large measure, such differences are inevitable; some spend their lives mastering the markets, while others simply dabble. These differences allow certain securities traders to make money in a transaction— and cause others to lose money—precisely because they lead to differing judgments as to the value (future cash flow) of a given security relative to its current price. Yet this type of unfairness is something that most of us living in a capitalist society would probably accept as largely inevitable and indeed morally permissible. Part of our acceptance of such a system lies in the fact that it seemingly encourages hard work, due diligence and thorough analysis. It provides most of us with the belief that, if we too become educated—or at least if we hire somebody educated to manage our money— we can also eventually succeed in the market.

Most of us are probably also willing to accept that trading gains and losses are morally permissible—and should continue to be legally permissible—even if they are just the result of dumb luck. Although Henry Manne defended insider trading, in part, as a means to minimize chance in the allocation of trading gains and losses in the market,³⁹ most of us probably perceive no problem with the influences of luck so long as the allocation of luck is truly random. The ubiquity of state lotteries suggests that most of us would probably would not want Congress to force us to disgorge profits based on pure luck, even if it were possible to so. After all, in the stock market—like any casino—we, too, might eventually choose a winner, get lucky, and become rich.

As to differences in financial resources amongst traders, most of us probably recognize that a blanket rule denying the advantages that money brings would also be undesirable. Apart from the perverse incentives for free-riding that such a rule would produce, it would also be difficult to maintain for long, if we are to maintain a free and capitalist society.⁴⁰ Even if we might occasionally want to eliminate certain market advantages occasioned by differences in wealth—for example, by barring well-financed high-speed traders from purchasing closer server proximity to the Exchanges,⁴¹ or gaining access to the University of Michigan’s Consumer Sentiment Index via Thomson Reuters 300 or 302 seconds earlier than everyone else⁴²—most of us likely recognize that such instances are best dealt with on a case-by-case basis, and with rules that limit the definition of “inside information” to specific information related to a

³⁹ Henry G. Manne, *Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 Iowa J. Corp. L 167, 182 n.60.

Patricia H. Werhane, *The Ethics of Insider Trading*, J. Bus. Ethics, 842-44

⁴⁰ Robert Nozick, *Anarchy, State and Utopia* (NEED EDITOR, 1st ed. 1974) (Wilt Chamberlain example); *see also* Michael Sandel, *Justice: What’s the Right Thing to Do* (1st ed. 2010) at 62-66 (Michael Jordan example).

⁴¹ Michael Lewis, *Flash Boys: A Wall Street Revolt*, (1st ed. 2014)

⁴² Peter Lattman, *Thomson Reuters to Suspend Early Peeks at Key Index*, N.Y. TIMES, July 7, 2013.

particular issuer, rather than general market information, which can be independently gathered in lieu of purchase.

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

I submit with substantial credit to John Rawls that, apart from equal basic liberties (which would not include the liberty to harm others or society), the most fundamental form of fairness that most of us would probably want if we did not otherwise have entrenched privilege is *equality of opportunity*.⁴³ Appearing 17 times in the Republican Party platform and 21 times in the Democratic Party platform,⁴⁴ the concept of “opportunity” forms a cornerstone of our national identity and pervades many of our public policy decisions, from education to employment to healthcare. It is also a hallmark of the ethical codes adopted by international organizations and MNCs alike,⁴⁵ and serves as the basis for many contemporary business-related initiatives like microfinance.

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

⁴³ Rawls, *supra* note 37 at 42-43 (“Social and economic inequalities are to satisfy two conditions: first, they are to be attached to offices and positions open to all under conditions of fair equality of opportunity; and second, they are to be to the greatest benefit of the least-advantaged members of society (the difference principle).”)

⁴⁴ 2012 Republican Party Platform, GOP.COM, <https://cdn.gop.com/docs/2012GOPPlatform.pdf> (last visited May 31, 2014) and 2012 Democratic Party Platform, <http://www.scdp.org/wp-content/uploads/2013/07/2012-National-Platform.pdf>.

⁴⁵ Dinah Payne & Cecily Raiborn, Jorn Askvik, *A Global Code of Business Ethics*, J. Bus. Ethics, (1997), 1729 (citing the United Nations International Labor Organization’s declaration of “equality of opportunity and treatment” as one of the key issues concerning foreign direct investment in developing countries, and citing the Johnson & Johnson Credo, which states “There must be equal opportunity for employment, development and advancement of those qualified.”)

Here, though, it is critical not to conflate the claim that fairness requires *equality of access to information* with “impossibly utopian” calls for *equality of information*.⁴⁶ Yet this the error made by the majority of the U.S. Supreme Court on more than one occasion, in both *Chiarella v. United States* and *Dirks v. S.E.C.*

Chiarella was a case involving a “mark-up man” at a financial printing company who traded in securities of a takeover target company after its identity from confidential and redacted dealbooks from the acquiring company. *Chiarella*’s access to the dealbooks was the proximate and structural cause of his informational advantage, rather than any true financial acumen on his part that could not now be accomplished with a quick Google search. Thus, as pointed out by dissenting Justices Blackmun and Marshall, a rule barring *Chiarella* from exploiting his position of access against his counterparties whom he knew could not possibly lawfully access the same information have could have formed the basis for a limited rule about why *he* should have been under a unique obligation to abstain from trading. In fact, a similar rule was adopted nearly 20 years earlier by the SEC in the groundbreaking matter of *In re Cady, Roberts*.⁴⁷ Yet, the majority interpreted took pains to reject a “parity-of-information” theory, even though the dissent by Justices Blackmun and Marshall argued for access dissent reminded them that “there is a significant conceptual distinction between parity of information and parity of access to material information” for which they argued.⁴⁸

Dirks involved a securities analyst who was censured by the SEC because he passed on to his institutional clients a former insider’s tip concerning corporate fraud at the issuer, and they traded on it, before it was disclosed to the public or the SEC. While it was clear that the information concerning the fraud derived not from purely independent diligence, but rather the access offered by the tipper’s position as former employee of the issuer and the access offered by *Dirks*’ position as an analyst, the majority of the Court wrongly believed that upholding the SEC’s censure against *Dirks* would “equal information among all traders.”⁴⁹

⁴⁶ Scheppele, *supra* note 31 at 125.

⁴⁷ *In Re Cady Roberts*, *supra* note 11 (noting that certain people were subject to the disclose-or-abstain obligation where there is “[1] the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and ... [2] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”). Notably, the Commissioner interpretation of the *In Cady Roberts* rule would have imposed the “disclose or abstain” obligations on certain “insiders,” while the rule for which I advocate in the article would impose it on everyone when they have *inside access*.

⁴⁸ Compare *Chiarella*, 445 U.S. 222, 233 (Majority) with 445 U.S. at 252 n.2 (Dissent)

⁴⁹ 463 U.S. 646 at 657.

The difference between “equality of information” and “equality of access” is that the former is neither required by fairness nor tenable,⁵⁰ while the latter “rewards investment in the production of information in markets and also protects structurally disadvantaged parties in securities transactions.”⁵¹ Requiring equality of access to corporate information or disclosure prior to trading incentivizes the production of information because it would give “free rein to certain kinds of informational advantages that result in differences in diligence and acumen.”⁵² It safeguards the structurally disadvantaged “by limiting opportunities for profit from manipulation of confidential connections or resort to stealth.”⁵³

Even supporters of legalized insider trading have noted that insider traders often obtain this “secret” information through “the good old boy network.”⁵⁴ Yet most of us are not current or former senior corporate officials with access to advanced information on price-moving issuer information such as earnings, dividends, mergers or undisclosed frauds like the tipping insiders in *In re Cady Roberts* and *Dirks*.⁵⁵ Most of us are not analysts able to command meetings with corporate insiders like the tippee in *Dirks*.⁵⁶ Most of us do not socialize with corporate insiders that are capable of providing meaningful tips like the two analysts in *Newman*, one of whom knew a guy in the investor relations department at Dell from business school, and the other who got tipped about Nvidia’s earnings because he knew a guy in the finance department from church.⁵⁷ Most of us do not even work in positions that would grant us access to insider information without tipping, like the white collar lawyer in *O’Hagan* who noticed his partners working to facilitate Grand Met’s acquisition of Pillsbury before he bought options,⁵⁸ or even the mark-up man in *Chiarella* who worked nightly with confidential dealbooks.

Because of these issues of structural access, such unfairness would not be remedied, as has been previously suggested by some, by simply allowing everyone to trade on the nonpublic

⁵⁰ Schappele, *supra* note 31 at 125 (“Fairness does not require equality to extend so far” as to require informational symmetry)

⁵¹ *Id.* at 125.

⁵² *Chiarella*, 445 U.S. at 252 n.2 (Blackmun, J., dissenting).

⁵³ *Id.*

⁵⁴ McGee, *supra* note 7 at 212.

⁵⁵ *In re Cady Roberts*, *supra* note 11.

⁵⁶ 103 S.Ct. 3255

⁵⁷ 773 F.3d 438

⁵⁸ 521 U.S. 642

information in *their* possession.⁵⁹ For while such a rule could conceivably be fair in respect of those whose positions of access allow them to be in the know at least some of the time, it would not provide equality of opportunity to most retail investors.

For these reasons, if we were in the Original Position deciding *ex ante* on rules to govern the securities industry, we would probably decide that “fairness” does not require perfect equality of information, money, skill, sophistication, or luck. It merely requires the ability to obtain meaningful investment information through diligence. That is, fairness under the social contract requires *equality of access* to information.

B. Insider Trading Constitutes “Cheating”

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

However tempting it may be fall back upon Justice Stewart’s famous statement on obscenity— “I know it when I see it”⁶⁰— both business and society as whole deserve more precision. Yet “the concept of cheating—despite its apparent importance in our everyday lives— has been mostly ignored in the literature of moral philosophy.”⁶¹ And although the concept of insider trading is a recurring topic in the legal literature, seldom is it identified or analyzed as a mode of cheating as opposed to a form of lying or stealing. For example, in accordance with the theoretical focus of current law on fiduciary duty and misappropriation, Professor Ostas describes insider trading as a crime that “combine[s] the sin of theft with the sins of betrayal and deceit.”⁶² Even Black’s Law Dictionary conflates lying and stealing (fraud) with “cheating” as it defines that term as “the fraudulent obtaining of another’s property by means of a false symbol or token or by other illegal practices.”⁶³

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

⁵⁹ Patricia H. Werhane, *The Ethics of Insider Trading*, *J. Bus. Ethics*, Vol. 8, 841-845 at 842.

⁶⁰ *Jacobellis v. Ohio*, 378 U.S. 184 (1964) (Stewart, J., Concurring)

⁶¹ Stuart P. Green, *Lying, Cheating and Stealing: A Moral Theory of White Collar Crime*, Oxford University Press, Chapter 4, 2007 - Published to Oxford Scholarship Online: January 2010

⁶² Daniel T. Ostas, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 *Am. Bus. L. J.* 571, 582 (Winter 2007).

⁶³ *Black’s Law Dictionary*, Bryan A. Gardner, Ed., West, 7th Edition 1999.

misappropriation⁶⁴—that, I would argue, has resulted in the dismal state of U.S. insider trading law and the prevalence of this destructive practice.

In his book, *Lying, Cheating and Stealing: A Moral Theory of White Collar Crime*, Professor Green offers that “in order for us to say that X has cheated, X must (1) violate a fair and fairly enforced rule, (2) with the intent to obtain an advantage over a party with whom she is in a cooperative, rule-bound relationship.”⁶⁵

As to the first requirement, Green explains with considerable reference to the pioneering work of H.L.A. Hart, Dworkin and Rawls that cheating, insofar as it obtains moral condemnation, generally involves the violation of a mandatory, proscriptive rule that regulates conduct in a particular endeavor.⁶⁶ However, Green rightly does not indicate that such a rule must be codified in order for its violation to constitute “cheating” because codification is a necessary function of law, not morality. The function of Green’s first requirement is simply to indicate that there must be some degree of rule specificity before one’s violation of such a rule can be deemed “cheating.” Thus, it would seem that only if we are willing to accept that there are no mandatory proscriptive rules governing appropriate behavior in the markets can the moniker of cheating, in the moral sense, be necessarily inapplicable or absent from our insider trading lexicon. Only the most callous Gordon Gecko’s amongst us, however, would today claim that “anything goes” in the securities markets. This author is aware of no issuer, financial institution or fund that makes this claim. Thus, rules do exist in the securities markets— both express and implied— and their violation can, under certain circumstances, be condemned as

⁶⁴ Although it is not expressly recognized as cheating, one notable exception to the general rule that insider trading is not punishable unless it is accompanied by fiduciary breach or misappropriation is SEC Rule 14e-3, which prohibits trading on the basis of material nonpublic information concerning a tender offer that the trader “knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

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

⁶⁵ Stuart P. Green, *Lying, Cheating and Stealing: A Moral Theory of White Collar Crime*, Oxford University Press, at 57 (2007 - Published to Oxford Scholarship Online: January 2010)

⁶⁶ *Id.* at 58-62

cheating. I submit that the “rule” violated by insider trading is the implied rule that “thou shalt not trade in securities on the basis of information concerning that issuer unless such information could also be available to others through their independent and lawful diligence.”

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

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

The third requirement, however, is worth substantially more explanation. Are securities traders “part of a cooperative rule-governed activity that involves another party” such that they may be capable of cheating? Certain free-marketeers may be tempted at first glance to deny that there is any “cooperative” activity in the securities markets because there are undoubtedly zero-sum aspects to trading: in many securities transactions, there must be a buyer and seller—a ‘winner’ and a ‘loser.’ But this would be a fundamental misunderstanding of both Green’s requirement of ‘cooperative’ activity and the securities markets themselves. The requirement of ‘cooperative’ activity does not mean that the parties must cooperate, but rather that they are “engaged in a mutually beneficial cooperative enterprise, such as a game, a market or a political contest.”⁶⁷ Without a counterparty to purchase what is being sold, or sell what one wishes to purchase, there can be no securities market. And without a securities market, there can be scant capital accumulation for people or enterprises. Thus all issuers and traders are involved in a mutually beneficial endeavor to raise capital, grow wealth, and develop economies.

The fourth requirement is perhaps the *sine qua non* of cheating: that the rule breaker must “intend to gain an unfair advantage over others engaged in the same activity.” We have already established that “fairness” in the context of the securities markets, under the principle of equality of opportunity, requires equality of access to material information. It thus follows that “unfairness” means inequality of access to information. And “gaining an unfair advantage”

⁶⁷ Id. at 64.

means exploiting this inequality of access to information. Indeed, this was the SEC's original recognition in *In Cady Roberts* back in 1961 when it explained that a duty to disclose or abstain ought to arise as a function of two factors: "the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone," and "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

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

Insider Trading Violates the Categorical Imperative

Trading on the basis of information known to be inaccessible to others through diligence also is wrongful because it violates deontological duties of morality. Immanuel Kant explained that the morality of an act depends upon the intent of its author to adhere, as a matter of duty, to the "categorical imperative." Under his first formulation, known as the Formula of the Universal Law, Kant explains that one must "act only on that maxim whereby you can at the same time will that it should become a universal law."⁶⁸ In his second formulation, the "Formula of Humanity," he defines the imperative as "[s]o act that you treat humanity, whether in your own person or in the person of any other, always at the same time as an end, never merely as a means."⁶⁹ Since these two formulations effectively boil down to the same thing,⁷⁰ the question concerning the morality of insider trading basically becomes would we want the principle of cheating to become something that everyone should do all the time, or are traders who exploit information they know to be structurally inaccessible to others simply "put[ting] [their] interests and special circumstances ahead of everyone else's."⁷¹ The answer appears clear under either formulation: it violates the categorical imperative.

⁶⁸ Immanuel Kant, *Groundwork of the Metaphysics of Morals* in *Immanuel Kant: Practical Philosophy*, trans. Mary Gregor (Cambridge, 1996), p. 429, italics omitted.

⁶⁹ *Id.*

⁷⁰ Michael J. Sandel, *Justice: What's the Right Thing to Do?*, Farrar, Straus and Giroux, New York (2009) at 120.

⁷¹ *Id.*

Insider trading violates the Formula of Universal Law, because traders operate in a market system that depends on the existence of somebody willing to buy what they are selling, and sell what they are buying. If everyone were to use *their* own nonpublic information, and could be expected to do so, then the market for trading would likely cease to exist or function effectively. Much like Kant's famous example of promise-breaking that would destroy the reliability of promises and thus destroy their value undermine the institution of promising itself existence, I would submit that if everyone traded on their own privately-accessible information, few people would willingly purchase stocks. Why relinquish your money if the odds are that your counterparty knows something that you don't and that your investment will promptly devalue. Such trading would undermine trust, deter investing and potentially destroy the ability to accumulate capital. Indeed, even staunch defenders of insider trading note that there is some evidence of this occurring insofar as liquidity providers, who anticipate some degree of insider trading, adjust their bid-ask spread in order to self-insure and thereby pass along an "insider trading tax" upon all other investors. If the practice of insider trading were to become universal, the problem would only intensify.

Insider trading also violates the Formula of Humanity, which commands that we never treat people as mere means to an end, but rather always as inherently-valuable ends in themselves. To understand why it does so, it is critical to understand what is meant by treating people as "mere means." Esteemed Cambridge philosopher, Baroness O'Nora O'Neil, has aptly explained that there is a difference between occasionally using people as means—for example, using a teller to cash our checks at the bank—and using them as "mere means," or like "a prop to be manipulated."⁷² The difference lies in respecting the other's ability to consent to our treatment, at least in principle.⁷³ We deny the other's ability to provide such consent when we deceive them, coerce them, or otherwise fail to provide them with the information that would allow them, as rational beings deserving of respect, the ability to make their own fully-informed judgments. In the case of securities transactions that depend upon counterparties being unaware that we possess information that they could never possess through their independent diligence, we deny them the opportunity to make such choices on their own.

In sum, since the value of insider trading depends on the insider trader's ability to obtain exceptions to the rules they expect others generally to follow, and requires the trader necessarily

⁷² Onora O'Neill, "A Simplified Account of Kant's Ethics" from *Matters of Life and Death*, McGraw-Hill Publishing Company (Tom Regan, ed. 1986) excerpted in *Morality and Moral Controversies* (John Arthur, 5th ed.), 48.

⁷³ *Id.* at 48.

to deny others the chance to obtain our inside information, it violates deontological duties of justice.

Insider Trading Undermines Social Utility Because, Among Other Reasons, It Undermines Trust, Deters Retail Investment and Statistically Correlates With Economically Significant Increases in the Cost of Equity and Capital

In this section, I shall argue that insider trading is unethical because it undermines social utility, by bringing more harm than good. The vast majority of the arguments concerning the ethics of insider trading are consequentialist along these lines—perhaps, in part, to speak the language of economists like Henry Manne and adherents of the law and economics movement like Judge Frank Easterbrook and Daniel Fischel who have engaged heavily in this debate and tend to dismiss “fairness” arguments as “puerile.”⁷⁴ Since the academy has already long debated the ethics of insider trading on these lines I shall only briefly recap the major arguments before offering my contribution: based on empirical evidence from the finance literature, insider trading harms the economy by undermining trust, which deters retail investment and correlates with increases in the cost of equity capital.

A. Proponents’ Consequentialist Arguments: The Alleged Benefits of Insider Trading and the Harms of Prohibition

Proponents of insider trading argue that insider trading provides a number of benefits. In his famous 1966 book, *Insider Trading and the Stock Market*, Manne argued that insider trading served as a relatively low-cost form of corporate compensation for the insider-entrepreneur for creating the valuable information in the first place.⁷⁵ This argument, which he has subsequently all but abandoned,⁷⁶ was shown to be fallacious because such a regime would allow many individuals to reap “compensation” they have not earned and potentially even profit off of information that actually harms the company.⁷⁷

⁷⁴ Manne, *supra* note 39; see also, Easterbrook & Fischel, *The Economics of Corporate Law*, *supra*, note ___ at 251 (dismissing fairness argument as lacking content).

⁷⁵ *Id.* at 138.

⁷⁶ *Id.* at 171 (noting that the argument is “perhaps less robust than I and other proponents had originally assumed”).

⁷⁷ Robert A. Prentice and Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 *Am. Bus. L. J.* 1, 4-6 (Spring 2010).

Manne also argued that insider trading “contribute[s] importantly to the efficiency of stock market pricing,” insofar as the increased flow of information occasioned by insider trading allows the price of stocks to better reflect their true value.⁷⁸ McGee similarly argues that “insider trading serves as a means of communicating market information, which makes markets more efficient” because “it serves as a signal to others that a stock’s price will likely move in a certain direction.”⁷⁹ It thus has been contended by McGee that “restricting insider trading may have long-term adverse effects on the economy” insofar as it “decreases market efficiency” by arguably stifling information flow. This argument, while persuasive to an extent if true (at least insofar as more accurate pricing benefits outsiders choosing whether to invest initially) has been criticized by Werhane as logically inconsistent because, while it champions market efficiency, it seemingly ignores the fact that market-efficiency also requires self-restrained competition, which is thwarted by insider trading.⁸⁰ In my view, this argument by Manne and McGee would only have potential merit insofar as it pertains to trading by true insiders (i.e., corporate officers and directors) because those are the only people whose trades might be perceived as reliable signals. Trading by outsider-tippees would likely offer no such signaling benefit.

Nearly 40 years after his first salvo, Manne subsequently argued that insider trading could improve internal corporate efficiency by generating price swings, which would signal to upper management that problems are afoot.⁸¹ These signaling arguments, however, were effectively rebutted by Robert Prentice and Donelson who pointed out, among other things, that they rest on faulty assumptions about senior management’s need for such signals (if there’s something afoot, senior management is already in the best position to know it) and management’s ability to discern meaningful information from insider trades that may be too small, anonymous, intentionally slow-played, or otherwise shielded by market noise to be detectable or provide actionable information.⁸²

Yale Professor Jonathan Macey also advanced an argument about the beneficial signaling effects of insider trading, although more limited circumstances involving whistleblowing.

⁷⁸ Manne, *supra* note 39 at 167-185

⁷⁹ McGee, *supra* note 7 at 209.

⁸⁰ Patricia H. Werhane, *The Ethics of Insider Trading*, *J. Bus. Ethics*, Vol. 8, 841-845 at 842-44.

⁸¹ Manne, *supra* note 74 at 174; see also Henry G. Manne, *Insider Trading Symposium – January 27, 2007: Keynote Address*, 4 *J.L. Econ. & Pol’y* 225 (2008).

⁸² Robert A. Prentice & Dain C. Donelson, *Insider Trading as a Signaling Device*, 47 *Am. Bus. L.J.* 1, 18-22 (Spring 2010).

Macey argued, as some before him similarly suggested,⁸³ that “[p]ermitting insider trading on the basis of [information about ongoing corporate misconduct] would...provide the strongest incentives for people to seek out and expose such corporate wrongdoing.”⁸⁴ While interesting, this argument was also rebutted by Prentice and Donelson who note that insider trading occasioned by undisclosed news of corporate fraud would send only a vague signal to the markets unless it was coupled with explanatory disclosures, which would immediately destroy the “value” of the secret information, and thus prompt would-be whistleblowers to delay or forego disclosure altogether.⁸⁵

In the context of takeovers, McGee argues that “[t]he potential acquirer in a takeover attempt may also benefit by insider trading” because if arbitrageurs acquire shares in advance on the basis of a tip of the pending acquisition, they presumably intend to subsequently tender them, thereby increasing the likelihood that the takeover will succeed.⁸⁶ He adds that insider trading regulations like the Williams Act that require would-be tender-offerors to announce their intentions well in advance actually harm the shareholders of the target issuer whose shares are traded might be harmed, because they make it easier for management to adopt defensive tactics to thwart the takeover. These arguments, however, are based on the assumption that takeovers are always good—an assumption he fails to support—and that appears belied in many circumstances by the anti-competitive consequences that such consolidations may bring.

In that same takeover context, and under the premise that “insider trading has a tendency to increase the stock’s price,” McGee further argues such price increases will benefit (1) “the shareholders who sell at the time such [tipped] arbitrageurs are buying” whom he speculates “would probably have sold anyway,” (2) the shareholders who do not sell, since the price of their shares will have increased, and (3) the target corporation itself.⁸⁷ He also offers a version of

⁸³ See e.g., Geoffrey C. Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.Y.U. L. Rev. 91, 151-153 (2007) (arguing for an exception to insider trading laws ‘for insiders blowing the whistle on corporate fraud’); Michael Abramowicz, *The Law-and-Markets Movement*, 49 Am. U.L. Rev. 327, 360-61 (1999) (indicating that insider trading could foster the release of information related to mass torts); Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. Davis L. Rev. 21, 67 (2006) (arguing for allowing “a current or past employee . . . who is not technically an insider for insider trading purposes” to trade on the basis of nonpublic information to facilitate the exposure of fraud).

⁸⁴ Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 Mich. L. Rev. 1899, 1939 (2007).

⁸⁵ Prentice & Donelson, *supra* note 82 at 52.

⁸⁶ McGee, *supra* note 7 at 209.

⁸⁷ *Id.* at 209.

Manne's original argument that insider trading by intentionally tipped traders might even benefit the acquiring corporation, to the extent it serves as "indirect compensation" for various services rendered.⁸⁸ These arguments, too, seem flawed. First, the assumption that existing shareholders would have sold anyway is speculative. Second, as Prentice and Donelson have noted, inside information certainly can be negative information that harms the value of the issuer,⁸⁹ such as the information about corporate fraud in *Dirks*.

Some proponents of the practice also argue that, if insider trading were banned, various harms may ensue. First, intentional tippers and tippees would allegedly be harmed because corporate information is a property right, which should be disposable at will, either for profit or for free.⁹⁰ By forcing the analyst to give this to the world would eliminate the incentive to obtain it, harm the market by reducing available information, and be unjust to the analyst because others would be free-riding on his efforts.⁹¹ This argument also seems suspect since the inside information allegedly being tipped out belongs not to the insider-tipper but rather his corporation and its shareholders.

Finally, as a last refuge, McGee has argued that insider trading regulation would increase taxpayer costs by requiring public compliance monitors like the SEC.⁹² Such an argument could only hold water, however, if indeed it "does not result in any harm to any identifiable group"⁹³ or if the costs of regulation were not outweighed by the benefits of prohibition and the harms associated with insider trading. So, I shall now turn to those.

B. Opponents Consequentialist Arguments: The Ostensible Harms of Insider Trading and Benefits of Prohibition

Opponents of insider trading focus on the harms caused by insider trading, focusing largely on shareholders whose value is stolen by insider traders, and the harms done to the sanctity of agency relationships like that of a director to his corporation when corporate information is misappropriated for the personal benefit of a director or employer. Of course, the gradual legal recognition of these harms have given rise to the body of U.S. insider trading law. For these reasons, "practically all the articles that have been written on insider trading in recent

⁸⁸ *Id.* at 210.

⁸⁹ Prentice & Donelson, *supra* note 82

⁹⁰ *Id.* at 212.

⁹¹ *Id.* at 212.

⁹² McGee, *supra* note 7 at 210.

⁹³ *Id.* 208

years have treated it as something evil”⁹⁴ and insider trading (in at least some of its forms) currently commands “a strong sense of moral disapproval.”⁹⁵

1. Harms to Selling Shareholders

It should be noted at the outset of this discussion that trading on the basis of material nonpublic information was not always perceived as wrongful in the United States, at least insofar as practice did not involve public officials.⁹⁶ Up until the early part of the 20th century, states were split on the question of whether it was appropriate for corporate insiders to use material nonpublic information to obtain a trading advantage in the market—even over one’s own shareholders.⁹⁷ Although outright fraud through affirmative factual misrepresentation was generally prohibited under the common law of contracts of all states, the majority of states held that there was no obligation on the part of a corporate insider when buying shares from existing shareholders to proactively disclose information known only to him.⁹⁸ Rather, the ability to capitalize on corporate inside information through silence while trading was deemed by many to be “a normal emolument of corporate office.”⁹⁹ Only a small minority of states by the early prior to 1909 had established a different rule, by court decision or Blue Sky statute, which created a fiduciary relationship between corporate insiders and selling shareholders and required full disclosure of all relevant facts.¹⁰⁰ Since that time, however, the ostensible harms from insider trading have received legal recognition.

⁹⁴ McGee, *supra* note 7 at 217

⁹⁵ Ostas, *supra* note 62 at 582

⁹⁶ The first known case of insider trading the United States traces back to 1792, when William Duer was convicted of using knowledge obtained by virtue of his position as Assistant Secretary of the Treasury to guide his speculation in federal bonds. See Steve Fraser, *The Genealogy of Wall Street Crime*, L.A. TIMES, Jan. 30, 2005, <http://articles.latimes.com/2005/jan/30/opinion/oe-fraser30>.

⁹⁷ Henry Manne, *Insider Trading and the Stock Market* (1st. 1966), 18

⁹⁸ *Id.* at 19.

⁹⁹ *In Re Cady Roberts*, *supra* note 11 at fn. 15; *Texas Gulf Sulphur* at fn9 (noting that, by the 1934 Exchange Act, Congress intended to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.)

¹⁰⁰ Manne at 18-19

First and foremost, the main argument offered by opponents of insider trading is that it harms existing shareholders who sell their stock to an inside trader because such sellers lose the value they would have received had they not sold, or at least not sold at the price at which they sold to an insider who possesses information that indicates the shares are worth more. This type of harm gave rise to the first U.S. Supreme Court case to address insider trading: *Strong v. Repide* (1909). In *Strong*, the Court held that a corporate insider with knowledge of an impending sale of corporate land assets to the U.S. government that would affect the price of the underlying securities was barred from effectuating a stock purchase from a minority shareholder where he had concealed the fact of the land sale and used an intermediary to keep his identity secret.¹⁰¹ Without squarely deciding whether corporate insiders necessarily had a duty to disclose material facts, the Court based its decision to bar the sale upon the so-called “special facts rule.”¹⁰² Under that doctrine, it was legally noteworthy that the defendant-insider was not only director, but also that (1) he owned three-fourths of the shares of its stock, (2) he was administrator general of the company imbued with substantial powers to act as chief negotiator regarding the corporate asset sale with the government on behalf of the other shareholders and therefore was privy to the probability of the sale, and (3) that the sale was for the whole of the property of the company--its only valuable asset.¹⁰³ Accordingly, the court held “there was a legal obligation on the part of the defendant to make these disclosures.”¹⁰⁴

Harms to selling shareholders involving no affirmative misrepresentation (only silence) because they were conducted over an anonymous exchange only became truly established in 1961, when the SEC decided *In re Cady Roberts*, holding “it would be anomalous indeed if the protection afforded by the antifraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions.”¹⁰⁵ Until that time, state courts like the

¹⁰¹ *Strong v. Repide*, 213 U.S. 419 (1909)

¹⁰² Manne, *supra* note 97. After *Strong*, the “special facts” doctrine became the “prevailing approach in the states” for the decades at least insofar as securities transactions were conducted in person, rather than anonymously over an exchange, as most are today.

¹⁰³ 213 U.S. 419 at 431-32.

¹⁰⁴ *Id.* at 434.

¹⁰⁵ *In re Cady*, *supra* note 11 involved the question of whether a selling broker and his firm committed fraud by trading on the basis of not-yet-public information that Curtiss Wright Corporation would soon reduce its quarterly dividend, which had been tipped to them by an associate of the firm who was also a director of Curtiss Wright corporation. Finding that cognizable harm had been committed by the trader, notwithstanding the lack of any affirmative false statement, Chairman Cary also noted that silence may also constitute fraud in cases of “corporate ‘insiders,’ particularly officers, directors or controlling stockholders” because such individuals “must disclose

Massachusetts state court in *Goodwin v. Agassiz* (1933) often regrettably reasoned: “Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness.”¹⁰⁶

By 1961, of course, the 1933 Securities Act and 1934 Securities Exchange Act had been enacted upon a recognition that a “staggering portion of the securities issued in the bubble economy of the 1920s had been tainted with fraud.”¹⁰⁷ “A significant purpose of the Exchange Act was the eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office.”¹⁰⁸ The SEC had also, by then, promulgated Rule 10b-5 in 1942,¹⁰⁹ even though when the SEC adopted it, it did not consider its possible application to insider trading.”¹¹⁰

Individuals like Professor McGee, dismiss the harms to these selling shareholders, assuming they “who would have sold anyway” and arguably received a better price than they would have had inside-trader demand not existed.¹¹¹ However, even Manne appears to

material facts which are known to them by virtue of their position but which are not known to persons with whom they deal, and which, if known, would affect their investment judgment” or, abstain from trading. He explained that

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

¹⁰⁶ *Id.*

¹⁰⁸ Walsh, J., *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 Hofstra L. Rev. 1015 (2000-2001) at [PIN].

¹⁰⁸ In re Cady Roberts, supra note 11 at 912, fn. 15.

¹⁰⁹ Securities Exchange Act, Release No. 3230 (May 21, 1942), 7 Fed. Reg. 3804 (1942). (Rule 10b-5 makes it unlawful in connection with the purchase or sale of any security... “(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.”)

¹¹⁰ Ventrizzo, supra note 20 (citing Sec. Exch. Comm’n v. Tex. Gulf Sulphur Co., 401 F.2d 833 (1968), 885 (Moore, J., dissenting)).

¹¹¹ *Id.* at 208.

recognize the tremendous assumption imbedded here, and thus simply argues now that “the practice of insider trading [does] no significant harm to long-term investors.”¹¹²

2. Harms to Buyers

Insider trading also ostensibly harms people who buy stock from insiders. The main problem here is that these people may be buying junk from an insider with the secret knowledge that security is worth less than the current price that does not reflect the insider’s potentially negative information. This harm was also recognized in 1961 when the SEC in *In re Cady Roberts* held that Rule 10b-5 was “also applicable to a defrauded buyer.”¹¹³ To find otherwise, according to the Commission “ignores the plight of the buying public—wholly unprotected from the misuse of special information.”¹¹⁴ The Commission noted that “there is no valid reason why persons who *purchase* stock from an officer, director or other person having the responsibilities of an insider should not have the same protection afforded by disclosure of special information as persons who *sell* stock to them,” adding “it would be a very sorry distinction to allow [an insider] to use the advantage of his position to induce the buyer into the position of a beneficiary [of fiduciary duties owed by corporate insiders to corporate shareholders] although he was forbidden to do so once the buyer had become one.”¹¹⁵

3. Harms to Issuers

Opponents of insider trading also focus on harms that it may cause to issuers. The harm can take several forms, depending upon whether the underlying information is good or bad for the issuer, whether the insider is buying or selling, or whether the transaction involves shares in the insider’s own company or another. Imagine for example, an insider learns of his company’s plans to conduct a takeover of another company. If the inside information is potentially positive, then when an insider trades on information she had gleaned by virtue of her position, she may be personally benefitting from information that belongs to the issuer and that was entrusted to the insider for the benefit of the issuer and its shareholders. In the process, he or she may be

¹¹² Manne, *supra* note 39

¹¹³ *In re Cady Roberts* *supra* note 11 at 913.

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 914 at fn 23.

inadvertently disclosing corporate plans. Thus, insider trading “does not protect the privacy of information it is supposed to protect.”¹¹⁶

Harms to Employers

Even if no issuer is harmed in the process of insider trading, it may also harm other stakeholders like employers who often depend upon their employee’s discretion in order to maintain the confidences of their clients, lest they lose business. In the case of a misappropriating employee who seeks to capitalize off of material nonpublic information belonging to his employer’s client, like the mark-up man in Chiarella or the lawyer in O’Hagan, it seems probable that such an employee will cause their employer to lose a client or potentially even get sued.

5. Harms to Economy

An oft-neglected harm caused by insider trading is the harm that it causes to the economy. For years, economists using economic models riddled with assumptions have held that insider trading actually benefits the economy insofar as it may allow prices to better reflect the true value of stock.¹¹⁷ However, based on a growing body of empirical evidence in current finance literature, I would submit that the opposite is actually true: the failure to effectively prevent insider trading—including the tendency of current U.S. law to allow certain forms of cheating to go unpunished because they do not fit neatly into theories of fiduciary duty or misappropriation—may have disastrous economic effects. In several different ways, it raises the cost of equity and capital.

First, insider trading (a form of cheating) erodes the public’s confidence in the financial and legal institutions that support the capital markets. Such loss of investor trust has an empirically proven economically and statistically significant effect upon retail participation in the stock market, reduces household demand for equity and thus raises the return required before many retail investors choose to participate in a seemingly rigged game.¹¹⁸ Recent empirical research has found “unambiguous evidence that household stock market participation decreases...following corporate scandals in the state where the household resides.”¹¹⁹ Such

¹¹⁶ Werhane, *supra*, note 28.

¹¹⁷ Manne, *supra* note 39

¹¹⁸ Luigi Guiso et al., *Trusting the Stock Market*, J. Fin., (Dec. 2008).

¹¹⁹ Mariassunta Giannetti & Tracy Yue Wang, *Corporate Scandals and Household Stock Market Participation*, (European Corporate Governacne Institute, Working Paper No. 405/2014, 2015)

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2331588

participatory declines do not just affect the wrongdoing issuer. Rather, “households decrease their stock holdings in fraudulent *as well as* non-fraudulent firms.”¹²⁰ Accordingly, misconduct perpetrated by some may “create a negative externality for non-fraudulent firms by increasing their cost of capital and impairing their ability to raise equity.”¹²¹ Moreover, “[e]ven households that did not hold the stocks of fraudulent firms decrease their equity holdings.”¹²² Thus, “the decrease in household stock market participation is not driven by financial losses associated with holdings in fraudulent stocks.” It appears to be driven, instead, by the fundamental lack of trust occasioned by such misconduct.

The relationship between trust and stock market participation has been studied by academics for a number of years. Guiso, Sapienza and Zingales have defined trust as “the subjective probability individuals attribute to the possibility of being cheated,”¹²³ and they have recognized that “a low level of trust can explain why a large fraction of individuals do not invest in the stock market.”¹²⁴ This is because “[t]he decision to invest in stocks requires not only an assessment of the risk-return tradeoff given the existing data, but also an act of faith (trust) that the data in our possession are reliable and that the overall system is fair.”¹²⁵ Olisi has recognized that “investing in stock requires a great deal of confidence in many institutions” as the investor must be convinced, for example, that “the stock broker will not abscond with her investment” and that “the institutional and legal framework is sufficient” to ensure that their money will not effectively be stolen or squandered.¹²⁶ “Stock market participation can be discouraged ... by a mistrust in the institutions that should facilitate stock market participation (brokerage houses, etc.)”¹²⁷ Lack of trust reduces stock market participation in a number of ways by, amongst other things, reducing expected return,¹²⁸ and by increasing the amount of necessary in a nest egg before an individual is willing risks funds in the market casino.

¹²⁰ *Id.* at 2 (emphasis in original)

¹²¹ *Id.* at 30.

¹²² *Id.* at 2.

¹²³ Guiso, *supra* note 118 at 2557

¹²⁴ *Id.* at 2558

¹²⁵ *Id.* at 2557.

¹²⁶ Una Okonowo Osili & Anna L. Paulson, Institutional and Fin. Dev.: Evidence from Int'l Migrants in the U.S., *Rev. of Econ. and St.* (2008) at 500

¹²⁷ *Id.* at 2559)

¹²⁸ *Id.* at 2568)

Second, the prevalence of insider trading increases the bid-ask spread demanded by liquidity providers like financial institutions before they are willing to purchase and sell equities thus imposing an “insider trading tax” on all outside investors with whom they deal.¹²⁹ This is because a world dominated by insider trading, liquidity providers like financial institutions “would protect themselves by increasing their sell price and decreasing their buy price” which would “increase the transaction cost” in connection with trades, which “induces a stock traders to require an even higher return on equity.”¹³⁰

Third, minority shareholders in a corporation would likely demand increased return on equity in a world in which “controlling large shareholders could easily be tempted by management to make profits from stock tips rather than profits from hard-to-do monitoring.”¹³¹

Fourth, ineffectively policed insider trading is correlated with lower country credit ratings, further increasing the cost of capital.¹³²

The effect of these harms is significant. In their highly influential and exhaustive empirical study on the issue of whether the existence or enforcement of insider trading laws affected the cost of equity, Bhattacharya and Daouk surveyed each of the 103 countries that had a stock exchange at the time of writing to determine whether they had any insider trading laws on their domestic books and, if so, whether such laws had been enforced against a violator at least one in actual practice. Using regression analysis on four different analytical models, they concluded that “insider trading enforcement is associated with a significant decrease in the cost of equity” up to as much as 6%, and a “positive and significant effect on country credit ratings.”¹³³

In sum, the harms caused by insider trading appear to substantially outweigh any benefits they may bring.

IV. Conclusion

¹²⁹ Manne, *supra* note 39 at 168

¹³⁰ Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, J. of Fin, (Feb. 2002)

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.* They also concluded that “the mere existence of insider trading regulations does not affect the cost of equity.” However, this conclusion ought be taken with a grain of salt, as they made no attempt—as finance professors—to ascertain whether there were any qualitative differences in the law, and if so, whether such differences had any effect.

This article has endeavored to make the case for a new statutory provision in the U.S. that will define insider trading under an “equality of access” theory. It has supports this claim, and hopefully contributed to the important academic dialogue concerning this prevalent practice, by highlighting the moral and legal gaps in existing U.S. law that result from understanding the harms of insider trading solely with reference to fiduciary breach or misappropriation, as evidenced by the recent case of *United States v. Newman*. It has sought to weave legal analysis together with literature in business ethics, moral philosophy and recent finance literature to offer new arguments in the long-standing debate over insider trading based on Rawlsean social contract theory, applied deontology and empirically-informed utilitarianism. It endeavors to make the case for adopting a statute that will prohibit the use, by anyone, of material information concerning a financial instrument that is not, at least in principle, available to others through due diligence.