Volume 45 | Issue 1 Article 11

2000

Stock Market Insider Trading: Victims, Violators and Remedies - Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect

William K.S. Wang

Recommended Citation

William K. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies - Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 Vill. L. Rev. 27 (2000).
Available at: https://digitalcommons.law.villanova.edu/vlr/vol45/iss1/11

Reuschlein Lecture

STOCK MARKET INSIDER TRADING: VICTIMS, VIOLATORS AND REMEDIES—INCLUDING AN ANALOGY TO FRAUD IN THE SALE OF A USED CAR WITH A GENERIC DEFECT*

WILLIAM K.S. WANG**

I. INTRODUCTION

STOCK market insider trading is buying or selling a publicly traded stock based on information that is both nonpublic[1] and material.[2] This Article will address the following four questions:

---

* This Article is adapted from my Reuschlein Lecture held on April 23, 1999 at the Villanova University School of Law. I would like to thank Dean Mark Sargent and the faculty of the Villanova University Law School for inviting me to be the Reuschlein Distinguished Visiting Professor in the spring of 1999. I greatly admire the late Dean Harold Reuschlein and felt deeply honored to hold the Reuschlein chair. My visit at Villanova was an immense pleasure.

I am grateful to my wife, Kwan Wang, for her many suggestions about my speech and manuscript and to Professor Vik Amar for reading my manuscript and making helpful comments. I would also like to thank Dean Joel Seligman and Professors Steve Bainbridge, Rich Booth, Bill Carney, Jim Cox, David Faigman, Henry Hansmann, Kim Krawiec, Jon Macey, Aaron Rappaport, Larry Ribstein, Bob Thompson, Dick Turkington, Kelly Weisberg, Elliott Weiss and particularly Lynn Stout for comments or suggestions about certain portions of my manuscript. I greatly appreciate the help of my research assistants at Villanova: Jeffrey Campisi, Robert Smith and especially Jeffrey Bodle.

Parts of this Article are drawn from the treatise: WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING (1996 & Supp. 2000).

** Professor of Law, University of California, Hastings College of Law. B.A., Amherst College. J.D., Yale Law School.

1. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 4.3, at 153-66 (1996) [hereinafter INSIDER TRADING] (discussing meaning of "nonpublic"); WILLIAM K.S. WANG & MARK I. STEINBERG, INSIDER TRADING 2000 SUPPLEMENT § 4.3, at 61-65 (2000) [hereinafter INSIDER TRADING SUPP.] (same).

The Securities and Exchange Commission ("SEC" or "Commission") is considering adopting a clarifying rule in this area. *See* Neil Hare, *Four Insider Trading Rules Possible, SEC Solicitor Gonson Says*, 31 SEC. REG. & LAW REP. (BNA) No. 29, at 973 (July 23, 1999) (discussing possibility of new rules on insider trading).

2. For discussion of the definition of materiality for § 10(b) and SEC rule 10b-5 and its application to insider trading cases, see INSIDER TRADING, *supra* note 1, § 4.2, at 129-52; INSIDER TRADING SUPP. § 4.2., at 39-61.

Section 10(b), 15 U.S.C. 78j(b) (1999), and its accompanying rule 10b-5, 17 C.F.R. § 240.10b-5 (1999), are important antifraud provisions of the federal securities laws. For § 10(b) and rule 10b-5, *one* definition of material information adopted by the United States Supreme Court is: information which there is a substantial likelihood that a reasonable shareholder would consider important in deciding whether to buy or sell. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (paraphrasing definition of materiality adopted in *TSC Indus. v. Northway,*

1. Is the *act* of stock market insider trading a victimless crime (Part II)?[3]
2. Is stock market insider trading fraud (Part III)?[4]
3. When does insider trading or tipping violate federal securities law (Part IV)?[5]
4. Under federal securities law, what are some remedies and sanctions against a stock market insider trader or tipper (Part V)?[6]

II. IS THE *ACT* OF STOCK MARKET INSIDER TRADING A VICTIMLESS CRIME?

Perhaps surprisingly, a lively debate exists among academics over whether to regulate insider trading at all.[7] Supporters of regulation argue that society should forbid insider trading to preserve confidence in the securities market.[8] Opponents of regulation have a variety of arguments.[9] One is that insider trading makes stock prices more accurate.[10] Remarkably, both opponents and supporters of regulation often assume that insider trading has no specific victims.[11] In other words, these commentators assume that insider trading is not even a but-for cause of harm. This assumption is wrong.

The presence of victims is important to the debate. Analogous to this issue is the controversy about regulating pornography. Some argue that pornography is a victimless crime. Others contend that pornography increases sex crimes or undermines respect for women.[12] Whether pornog-

---

Inc., 426 U.S. 438, 449 (1976), for SEC rule 14a-9 and § 14(a) of the Securities Exchange Act of 1934).

3. *See* Part II *infra* notes 7-43 and accompanying text.

4. *See* Part III *infra* notes 44-49 and accompanying text.

5. *See* Part IV *infra* notes 50-96 and accompanying text.

6. *See* Part V *infra* notes 97-122 and accompanying text.

7. For discussion of this debate, *see* INSIDER TRADING, *supra* note 1, § 2, at 13-39; INSIDER TRADING SUPP. § 2, at 3-16.

8. *See* INSIDER TRADING, *supra* note 1, § 2.3.1, at 29-33 (discussing loss of investor confidence and harm to stock market); INSIDER TRADING SUPP., *supra* note 1, § 2.3.1, at 8-12 (same).

9. *See* INSIDER TRADING, *supra* note 1, § 2.2, at 14-29 (discussing arguments in favor of insider trading); INSIDER TRADING SUPP., *supra* note 1, § 2.2, at 3-8 (same).

10. *See* INSIDER TRADING, *supra* note 1, § 2.2.2, at 19-29 (discussing enhanced stock market price accuracy that may result from insider trading); INSIDER TRADING SUPP., *supra* note 1, § 2.2.2, at 4-8 (same).

11. *See* INSIDER TRADING, *supra* note 1, § 3.3.5, at 62 & n.32 (citing commentary stating that insider trading does not harm individual investors); INSIDER TRADING SUPP., *supra* note 1, § 3.3.5, at 22 (same).

12. For discussion and criticism of the research on the effects of pornography on those who view it, see David L. Faigman, *To Have and Have Not: Assessing the Value of Social Science to the Law as Science and Policy*, 38 EMORY L.J. 1005, 1059-66 & nn.194-95 (1989). For discussion and excerpts from materials on the relationship between obscenity and crime, see JOHN MONAHAN & LAURENS WALKER, SOCIAL SCIENCE IN LAW: CASES AND MATERIALS, 223-42 (4th ed. 1998). *See generally* APPLICATIONS OF FEMINIST LEGAL THEORY TO WOMEN'S LIVES: SEX, VIOLENCE, WORK, AND REPRODUCTION 5-183 (D. Kelly Weisberg ed., 1996) (discussing pornography); Andrea Dworkin, *Against the Male Flood: Censorship, Pornography, and Equality*, 8 HARV. WOMEN'S L.J. 1 (1985) (attacking pornography for its harmful effects on women).

raphy has victims does not resolve the question of how to regulate it. Nevertheless, society is more likely to regulate pornography strictly if it has victims. Similarly, whether insider trading is a victimless crime does not resolve the question of how to regulate it. Nevertheless, society is more likely to regulate insider trading strictly if it has victims.

In fact, each *act* of stock market insider trading has *specific* victims. This part of the Article will discuss the victims of the *act* of insider trading. These victims are those who would be better off, but for the *act* of insider trading. This part of the Article will not focus on the victims of the *nondisclosure* accompanying a stock market insider trade.[13]

Assume that the outstanding number of shares of a company remains constant between the time of the insider trade and public disclosure. Let us focus on the shares outstanding at the time of public disclosure.

With an insider *purchase* of stock, the insider has more of that issue at public disclosure. Someone else must have less. That someone is worse off because of the insider trade.

With an insider *sale* of shares, the insider has less of that issue at public disclosure. Someone else must have more. That someone is worse off because of the insider trade.

Paraphrasing "the law of conservation of mass-energy,"[14] I call this phenomenon "the law of conservation of securities."[15] I label as "trade victims" those harmed by the phenomenon of the "law of conservation of securities."

Who are those harmed by the phenomenon of the "law of conservation of securities"? The victims are those whose transactions were either

---

13. Victims of the nondisclosure include those who would not have traded had the information been disclosed to them. For discussion of the distinction between *trade* victims and *nondisclosure* victims, see INSIDER TRADING, *supra* note 1, §§ 3.2-3.4, at 42-105; INSIDER TRADING SUPP., *supra* note 1, §§ 3.3.1-3.4.4, at 17-32; *infra* notes 24, 55, 65 and accompanying text.

If an *independent* duty to disclose exists, the nondisclosure accompanying an insider trade may harm the party owed the duty of disclosure. For discussion of possible *independent* duties to disclose either to the party on the other side of the insider trade or to the information source, see *infra* Part IV notes 50-96 and accompanying text.

Furthermore, if the *act* of insider trading triggers a duty to disclose to a large class, the victims of the accompanying nondisclosure may be huge in number. For discussion of such duty-triggering, see *infra* Part V notes 99-100 and accompanying text.

14. *See* LLOYD MOTZ & JEFFERSON HANE WEAVER, THE STORY OF PHYSICS 341-45 (1989) (discussing "conservation of mass-energy in particle interactions"); TONY ROTHMAN, INSTANT PHYSICS: FROM ARISTOTLE TO EINSTEIN, AND BEYOND 129-30 (1995) (discussing law of conservation of mass-energy).

15. *See* INSIDER TRADING, *supra* note 1, §§ 3.3.5-3.3.8, at 62-86 (discussing "Law of Conservation of Securities"); INSIDER TRADING SUPP., *supra* note 1, §§ 3.3.5-3.3.7, at 22-29 (same).

preempted or induced by the insider trade.[16] To paraphrase Milton Friedman, there is no such thing as a free insider trade.[17]

To explain preempted and induced traders, I shall use an analogy to used cars. The used automobile market is roughly comparable to the securities market.[18] Over the counter dealers, stock exchange specialists and large block positioning firms often trade stock for their own account with the public.[19] All these market-makers are somewhat like used car dealers.

Many commentators assume that stock exchange transactions are anonymous. This is an oversimplification, at least with large block trades between an institutional investor and a block positioner.[20] In fact, if Prudential Life Insurance Company wants to sell a large block of IBM stock, Prudential may sell to Goldman Sachs, a block positioner. Prudential and Goldman Sachs know each other's identity before, during and after the trade.

They could even ask each other questions before the transaction. At least conceivably, Goldman Sachs could ask Prudential: "Do you have any

---

16. *See* INSIDER TRADING, *supra* note 1, § 3.3.6, at 65-73 (discussing insider trading as cause in fact of harm to preempted or induced traders); INSIDER TRADING SUPP., *supra* note 1, § 3.3.6, at 24-26 (same). For discussion of an analogy to sale of used cars with a generic defect, see *infra* notes 22-26 and accompanying text.

17. In 1975, Professor Milton Friedman published a book entitled, *There is No Such Thing as a Free Lunch. See* MILTON FRIEDMAN, THERE'S NO SUCH THING AS A FREE LUNCH (1975). For a brief discussion of the history of this maxim, see David A. Hyman, *Consumer Protection in a Managed Care World: Should Consumers Call 911?*, 43 VILL. L. REV. 409, 412 n.11 (1998).

18. For discussion of how the stock market functions, see INSIDER TRADING, *supra* note 1, § 3.3.1; INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 17-21 (same).

19. *See* INSIDER TRADING, *supra* note 1, § 3.3.1, at 48-56 (discussing over counter market makers, stock exchange specialists, and block positioners); INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 17-21 (same).

20. *See* INSIDER TRADING, *supra* note 1, § 3.3.1, at 52-56 (discussing transactions between institutions and block positioners); INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 21 (same).

Measured by number of shares traded, roughly half of all New York Stock Exchange reported volume consists of block trades (transactions of 10,000 shares or more). *See* N.Y.S.E. FACT BOOK 1998 DATA, at 16, 93 (1999) [hereinafter N.Y.S.E. FACT BOOK] (defining "block trade" as transaction of 10,000 or more shares, "block trades" constituted 48.7% of all New York Stock Exchange reported volume in 1998); INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 21 & nn.9-10 (same, *citing* N.Y.S.E. FACT BOOK, *supra*, at 16, 93).

Such blocks are often bought and sold by block positioning brokerage firms. *See* N.Y.S.E. FACT BOOK, *supra*, at 16 (New York Stock Exchange estimates that roughly 27% of New York Stock Exchange block volume (transactions of 10,000 or more shares) is facilitated by "block positioners" or "block traders"); INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 21 & n.11 (same, citing N.Y.S.E. FACT BOOK, at 16).

In 1992, institutional investors (both customer and broker-dealer) accounted for an estimated 75-80% of the average daily volume on the New York Stock Exchange. *See* INSIDER TRADING, *supra* note 1, § 3.3.1, at 52 & n.13 (citing various sources).

material, nonpublic information about IBM?" At least conceivably, Prudential might lie in response. In other words, much trading in New York Stock Exchange listed shares has aspects of face-to-face dealing.[21] This strengthens the analogy between stock market and used car transactions.

To illustrate how induced and preempted stock traders are harmed by insider trading under the law of conservation of securities, I shall use two analogies to used car trading:

(1) the *solitary* defect hypothetical, and

(2) the *generic* defect hypothetical.[22]

In the solitary defect hypothetical, only one automobile is a lemon. In contrast, in the generic defect situation, many individuals are buying and selling cars, *all* the same year model and *all* with the same defect. Even a slight change in price may dissuade or induce trading. Stock market insider trading resembles the *generic* defect used car hypothetical.

The *generic* defect used car analogy will demonstrate two points: First, each act of stock market insider trading has one or more particular victims. Second, these victims are anonymous. They exist, but, practically, cannot be identified.

I shall start with the *solitary* defect used car hypothetical. Suppose Mr. Greedie owns a 1998 Cadillac. He discovers that his particular automobile has a major defect. He goes to a car dealer and sells the car for the going price, $25,000.

Assume in the alternative that:

(1) the dealer does not ask Greedie about any defect, or

(2) the dealer asks Greedie about defects, and Greedie *lies.*

The dealer discovers the defect and is stuck with a lemon. The victim of Greedie's sale is clearly the dealer.

Suppose the dealer does not discover the defect and resells the car to Mr. Public Buyer. This resale is illustrated in Figure 1 below:

---

21. *See* INSIDER TRADING, *supra* note 1, § 3.3.1, at 54-56 & nn.14-21 (discussing how stock transaction between institution and block positioner has aspects of face-to-face trade). *Cf. id.* § 8.2.2, at 681-83 (discussing practical problems of distinguishing between "fortuitous" and "nonfortuitous" transactions as defined in American Law Institute's proposed Federal Securities Code).

22. For a much shorter discussion of used car analogies to insider trading, see *id.* § 3.2, at 43, § 3.3.7, at 80-82.

For a brief discussion of a similar analogy involving sale of used law casebooks based on inside information about a forthcoming new edition, see *id.* § 3.3.7, at 82-83.

For a somewhat similar hypothetical involving the president of a closely held corporation who sells company stock based on material nonpublic information (by undercutting the selling price offer of one of the company's other ten shareholders), see *id.* § 3.2, at 44-46.

FIGURE 1:
SOLITARY DEFECT HYPOTHETICAL
(ONLY GREEDIE'S 1998 CADILLAC HAS DEFECT)

GREEDIE ————>	DEALER ————>	MR. PUBLIC BUYER,
SELLS LEMON TO	SELLS SAME LEMON TO	THE VICTIM

Assume that Mr. Public Buyer is now stuck with a lemon. Who is the victim of Greedie's sale? Only *one* 1998 Cadillac is a lemon. If Greedie had not sold his lemon to the dealer, the dealer would not have been able to resell the lemon to Mr. Public Buyer. The victim of Greedie's sale is Mr. Public Buyer.

Now, I shall turn to the *generic* defect example. (This hypothetical is analogous to stock market insider trading.)

Suppose Mr. Greedie is an employee of General Motors. Through his job at GM, Greedie receives material, nonpublic information that *all* 1998 Cadillacs have a major defect. By coincidence, Greedie personally owns a 1998 Cadillac. He immediately sells his Cadillac to a car dealer for the going price, $25,000.

Again, assume in the alternative that:

(1) the dealer does not ask Greedie about any defect, or

(2) the dealer asks Greedie about defects, and Greedie *lies.*

When GM announces the news of the defect to the public, the price of the 1998 Cadillac falls by $10,000. Greedie is clearly better off.

Who is the victim of Greedie's sale? Who in the universe would be better off had Greedie not sold? Is it the car dealer who bought the Cadillac? The answer is not necessarily.

Suppose, *without changing its prices,* the dealer resold Greedie's Cadillac to Mr. Public Buyer before announcement of the defect. Mr. Public Buyer is stuck with the lemon after the announcement.

Nevertheless, Mr. Public Buyer is also not necessarily the victim of Greedie's sale. *All* 1998 Cadillacs are lemons, although only Greedie knows this. Had Mr. Public Buyer not bought Greedie's car, he might have purchased *another* 1998 Cadillac.

These transactions are illustrated in Figure 2 below:

FIGURE 2:
GENERIC DEFECT HYPOTHETICAL
(ALL 1998 CADILLACS HAVE THE SAME DEFECT)

GREEDIE ————>	DEALER ————>	MR. PUBLIC BUYER,
SELLS LEMON TO	WITH *NO CHANGE IN PRICE,* DEALER SELLS SAME LEMON TO	NOT NECESSARILY THE VICTIM

What is the difference between this *generic* defect hypothetical and the *solitary* defect hypothetical? In the *solitary* defect hypothetical, Greedie's car was the only one with the defect. In the *solitary* defect hypothetical, had Greedie not sold his Cadillac, and had Mr. Public Buyer bought another 1998 Cadillac, Mr. Public Buyer would have been *better off*.

In the *generic* defect hypothetical, *all* 1998 Cadillacs have the same defect. Innocent individuals without Greedie's information compete with Greedie to sell 1998 Cadillacs with the same defect. Had Greedie *not* sold his Cadillac, and had Mr. Public Buyer bought another 1998 Cadillac instead of Greedie's, Mr. Public Buyer would have been *equally worse off*.[23]

This phenomenon has prompted some commentators to conclude that each act of insider trading has *no* specific victims.[24] This conclusion is wrong.

In the *generic defect* example, the insider trade has a specific victim. Identifying this victim is easier if we assume that the dealer does not sell Greedie's automobile to Mr. Public Buyer and still owns Greedie's car at the time of public disclosure (as illustrated in Figure 3 below).

FIGURE 3:
THE VICTIM IN THE GENERIC DEFECT HYPOTHETICAL (ASSUME THAT DEALER STILL OWNS GREEDIE'S CAR AT TIME OF PUBLIC DISCLOSURE)

GREEDIE ————>	DEALER,
SELLS LEMON TO	MAY OR MAY NOT BE VICTIM DEPENDING ON SIZE OF INVENTORY AT DISCLOSURE
DEALER MAY *LOWER PRICES*, AND	*MAY* INDUCE MR. POTENTIAL TO BUY ANOTHER 1998 CADILLAC (INDUCED BUYER);
OR	*MAY* DISSUADE MS. MARGINAL FROM SELLING (PREEMPTED SELLER)

Even if the dealer still owns Greedie's car at the time of the public announcement of the defect, the dealer is not necessarily the victim of

23. *See id.* § 3.3.3, at 58-61 (discussing why party in privity is not necessarily harmed by small stock market insider trade). For a discussion of why the party in privity is not necessarily harmed by a large block trade based on material, nonpublic information, see *id.* § 3.3.4, at 61.

24. *See id.* § 3.3.5, at 62 & n.32 (citing sources suggesting that insider trading does not have specific victims); INSIDER TRADING SUPP., *supra* note 1, § 3.3.5, at 22 (same).

These commentators' conclusions apply only to the *act* of trading. For discussion of the distinction between *trade* victims and *nondisclosure* (or deceit) victims, see *supra* note 13 and accompanying text; *infra* notes 55, 65 and accompanying text. Victims of nondisclosure include those who would not have traded had the information been disclosed to them.

Greedie's sale. Prior to public disclosure, the dealer *may* have passed the harm to someone else.

The dealer desires a certain inventory level. Because of Greedie's sale, the dealer's inventory of 1998 Cadillacs increased. The dealer sets a price at which it will purchase a car *from* the public. The dealer sets a *higher* price at which it will sell *to* the public. In an attempt to reduce inventory, the dealer may have slightly reduced both its buying and selling prices for 1998 Cadillacs.

Assume that Mr. Potential was interested in purchasing a 1998 Cadillac. The lower price *may* have induced him to buy *another* 1998 Cadillac (other than Greedie's) from the dealer. All 1998 Cadillacs have the same defect. As an induced purchaser, Mr. Potential may be the victim of Greedie's sale.

Alternatively, assume that Ms. Marginal owned a 1998 Cadillac and was thinking about selling her automobile. The lower price *may* have dissuaded her from selling the car to the dealer. She may still hold the car at the time of the public announcement of the defect. As a *preempted* seller, Ms. Marginal may be the victim of Greedie's sale.

What is the difference between this generic defect hypothetical and the solitary defect hypothetical? In the *solitary* defect situation, Greedie's automobile was the only one with the defect. In the *solitary* defect hypothetical, if the dealer owned Greedie's particular car at discovery of the defect, the dealer was worse off. *The size of the dealer's total inventory of 1998 Cadillacs at discovery of the solitary defect was not relevant.*

In the *generic* defect hypothetical, *all* 1998 Cadillacs have the defect. The size of the dealer's inventory of 1998 Cadillacs at public disclosure is crucial. The size of the inventory determines the dealer's damage.

The dealer is only worse off as a result of Greedie's sale if his sale causes the dealer's inventory at disclosure to be higher than it otherwise would have been. Initially, Greedie's sale increased the dealer's inventory. Nevertheless, the dealer may have *decreased* its inventory by lowering prices. The dealer *may* have shifted the harm to a preempted seller or induced buyer.

In practice, identifying the preempted seller or induced buyer is impossible. In order to identify the victim, one must determine the prices the dealer would have charged absent Greedie's sale. Then, one must ascertain how the public would have reacted to these prices. This information is unknowable.[25] Nevertheless, the victim still exists.

At the time of the defect's announcement, there are a fixed number of 1998 Cadillacs. If Greedie has one less Cadillac at the time of the announcement, someone else must have one more. That someone is the

25. *See* INSIDER TRADING, *supra* note 1, § 3.3.7, at 73-83 (discussing practical difficulty of identifying those harmed by stock market insider trade); INSIDER TRADING SUPP., *supra* note 1, § 3.3.7, at 27-29 (same).

victim of Greedie's sale. I call this "the law of conservation of used automobiles."

If the sale of one car on inside information to the car dealer causes even a slight lowering of the dealer's prices for 1998 Cadillacs, that decline may dissuade or induce a transaction. If the dealer's prices do not change (or if the price declines fail to dissuade or induce a trade), the loss falls on the automobile dealer (an induced buyer). Under the "law of conservation of used automobiles," Greedie's sale *must* induce a purchase or preempt a sale.

Only one victim exists: either a preempted seller, like Ms. Marginal, or an induced buyer, like Mr. Potential or the dealer. The loss is not spread among a large number of victims. The price decline after disclosure falls on this *one* victim; that loss corresponds to Greedie's gain.

The law of conservation of used automobiles is similar to the law of conservation of *securities*. Each stock market insider trade has one or more specific victims, either induced and/or preempted traders.[26]

26. In the landmark insider-trading case, *United States v. O'Hagan*, 521 U.S. 642 (1997), the Supreme Court said: "A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public. *See* [Barbara Bader Aldave, *Misappropriation, A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101] at 120-21 & n.107 (1984)." 521 U.S. at 656. For a discussion of *O'Hagan*, see INSIDER TRADING SUPP., *supra* note 1, §§ 4.4.5 at 85-88, 4.5 at 107-13, 5.4.1 at 188-89, 191-97, § 9.3.3, at 329-33.

Professor Aldave's article, cited above, stated:

> As Professor Wang has explained, each act of "inside trading"—i.e., trading on material nonpublic information—benefits the "inside trader" and harms other specific investors. It is virtually impossible, however, to identify the particular investors who are injured. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1230-40 (1981). In [United States v. Newman, 664 F.2d 12 (2d Cir. 1981)], the conspirators' trading injured the investors who were induced to sell, or who were preempted from buying, securities of the target companies. The improper trading may also have injured other investors by affecting the prices of the targets' securities.

Aldave, *supra*, at 120 n.107.

One commentator has stated: "The [*O'Hagan*] Court, in finding that the connection to a purchase or sale had been formed by the "simultaneous harm [to] members of the investing public," relied on Professor Aldave's article and on a footnote therein citing to an article by Professor William K.S. Wang." Daniel A. McLaughlin, *The "In Connection With" Requirement of Rule 10b-5 as an Expectation Standard*, 26 SEC. REG. L.J. 3, 62 (1998); *cf* Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1269 n.224 (1998) ("Professor Barbara Bader Aldave was one of the first securities law scholars to advance investor protection concerns as specific policy justifications for the "fraud on the source" version of the misappropriation theory. . . . Professor Aldave was influenced, in part, by Professor William Wang's arguments that insider trading directly damages contemporaneous traders in the marketplace by causing them to sell (or buy) at an improper time or price.").

One may make the following objection. Suppose an innocent individual fortuitously sells *stock* in advance of an announcement of adverse, material information. Under the law of conservation of securities, does not this innocent sale also cause harm? Does not this innocent sale either preempt a sale or induce a purchase? The answer is yes.

Clearly, society will not impose liability on traders who *unknowingly*, fortuitously make advantageous trades prior to public disclosure. Therefore, causing harm under the law of conservation of securities is not *sufficient* in itself to impose liability.

Unlike innocent traders, however, stock market insider traders *knowingly* profit by taking advantage of others. This difference alone may or may not be sufficient to impose liability. (Suppose an analyst discovers material nonpublic information about a corporation through diligent outside research with no contact with company employees. If the analyst's firm traded on this information, the transaction would harm preempted or induced traders. Nevertheless, the analyst and the firm might not be liable.[27])

One analogy is to but-for causation and proximate causation.[28] The law of conservation of securities demonstrates that the insider trade is a *but-for* cause of injury to specific victims. Whether the insider trade is a *proximate* cause of harm is a separate issue.[29] Nevertheless, if the insider trade is not even a but-for cause of injury, liability is much less likely. As mentioned earlier, as with pornography, whether insider trading has victims, affects, but does not resolve the question of how strictly to regulate it.[30]

---

27. *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 322 (1979) (for an argument that federal securities law should not bar transactions where one party possesses informational advantage that public investors may lawfully overcome).

For an argument somewhat similar to Professor Brudney's but not limited to stock transactions, see Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 9 (1978) (arguing that law should encourage deliberate search for information that reveals change in circumstances affecting relative values, because expediting relay of such information to market promotes allocative efficiency). For discussion of possible weaknesses in Dean Kronman's analysis, see INSIDER TRADING, *supra* note 1, § 2.2.2, at 20 (arguing that is it difficult to apply Kronman's standard).

For discussion of the difficult issue of selective disclosure to analysts, see *infra* notes 83-93 and accompanying text.

For discussion of whether the dictum in *Dirks v. SEC*, 463 U.S. 646, 657-58 & nn.16-18 (1988), may suggest a reluctance to regulate analysts' use of material nonpublic information because analysts help to preserve a "healthy market," see *infra* notes 90-92 and accompanying text.

28. For a general discussion of but-for causation (also called "causation in fact"), see W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS 263-66 (5th ed. 1984). For a general discussion of proximate cause, see *id.* at 263-321.

29. For discussion of when insider trading or tipping violates federal securities law, see *infra* Part IV.

30. *See supra* text accompanying note 12.

The analysis above deals with the specific ex post victims of a stock market insider trade. What are *some* of the broader possible adverse effects of insider trading?

If the public becomes aware of insider trading, the prices of stocks generally may decline (although estimating the risk may be difficult).[31] If the employees of a *particular* corporation acquire a reputation for trading on nonpublic information, that specific company's stock may decline in price.[32] *Such declines would increase the cost of capital of particular companies or of publicly traded corporations generally.*[33]

Ex ante, these price decreases might partially compensate new buyers for the risk of being victims of stock market insider trading[34] (although, as mentioned earlier, estimating the risk would be difficult). Nevertheless, ex post the harm of insider trading would not be spread equally. An insider trade has arbitrary, but specific victims. These victims are *disproportionately* harmed by the trade. (Some victims, preempted buyers, may never own stock in the issuer.)

Even ex ante, a decline in the price of all publicly traded stocks (or of a particular stock) would not adequately compensate all investors for the risk of being victims of a stock market insider trade. This risk of harm is associated with the act of trading (or of *almost* trading, in the case of a preempted trader). Consequently, the risk varies with the frequency of one's trades (or "near trades").

Even if the return on all publicly traded stocks (or of a particular stock) were slightly higher because of the risk of harm from insider trading, the higher return would not adequately compensate *frequent* traders for incurring that risk. Nor would risk-averse investors who trade *often* be able to diversify away the risk of becoming a victim.

In short, ex post, victims of a stock market insider trade are *disproportionately* injured even if they originally purchased their stock at a price that

31. *See* INSIDER TRADING, *supra* note 1, § 2.3, at nn.1-4, n. 18 and accompanying text (discussing insider trading's harm to investor confidence and consequent possible increase in public corporations' cost of capital); INSIDER TRADING SUPP., *supra* note 1, § 2.3, at 8-10, 12-13.

32. *See* INSIDER TRADING, *supra* note 1, § 2.3.2, at nn.16-17 and accompanying text (noting possible decline in price of company's stock if public becomes aware of insider trading by company's management).

33. *See id.* § 2.3.2, at nn.16-18 and accompanying text (discussing arguments that if some investors refrain from purchasing shares because of possible insider trading, cost of capital will increase); INSIDER TRADING SUPP., *supra* note 1, § 2.3.2, at 12-13.

To return momentarily to the generic defect used car hypothetical, if public buyers and sellers of used cars were often victims of insider trading, the sale prices of new cars generally might decline. If the employees of a particular manufacturer gain a reputation for trading that company's cars on nonpublic information, the sale prices of that corporation's new automobiles might decrease.

34. *See* INSIDER TRADING, *supra* note 1, § 3.3.6, at 72 & nn.48-49 and accompanying text (discussing partial compensation of new buyers if prices of stocks decline because of general public awareness of insider trading).

accurately reflected the possibility of insider trading. Even ex ante, frequent traders definitely suffer harm from insider trading.

To analogize, suppose apartment rents in one neighborhood are slightly lower because a small percentage of arbitrarily chosen residents will be mugged and/or assaulted. Ex post, the unfortunate victims suffer disproportionately and are only minimally compensated by the lower rents. Ex ante, residents who take walks often are not adequately compensated because they take more risk than others.[35]

Because specialists and market-makers trade so frequently, they may be disproportionately harmed from insider trading.[36] Nevertheless, specialists and market-makers may sometimes pass the injury to others prior to disclosure by altering prices and thereby readjusting inventory to the level preferred.[37] The presence of insider trading may cause specialists and market makers to widen their spreads to compensate for the risk of becoming a victim.[38] If so, ex ante, specialists and market makers may

35. *See id.* § 3.3.6, at 65-73 & n.50 and accompanying text; INSIDER TRADING SUPP., *supra* note 1, § 3.3.6, at 26. For a somewhat similar analogy, see *id.* § 3.5.2 and text accompanying note 20, *supra.*

36. *See* INSIDER TRADING, *supra* note 1, § 3.3.7, at 82 n.66 (discussing how market-makers are especially exposed to risk of harm of insider trading); INSIDER TRADING SUPP., *supra* note 1, § 3.3.7, at 27, 29 (same).

For Professor Jonathan Macey's conclusion that market-makers are disproportionately harmed by insider trading, see JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 13-16 (1991). For an argument that the insider trading profit represents a transfer of wealth from the market-maker to the trader, see Norman S. Douglas, *Insider Trading: The Case Against the 'Victimless Crime' Hypothesis,* 23 FIN. REV. 127 (1988). *See generally* David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading,* 80 NW. U. L. REV. 1449, 1457 (1987) ("Specialists and other market makers systematically profit from trades with outsiders. But they systematically lose to insiders who are trading on inside information.").

37. *See* INSIDER TRADING, *supra* note 1, §§ 3.3.6-3.3.7, at 65-82 (discussing identity of victims of insider trading); INSIDER TRADING SUPP., *supra* note 1, §§ 3.3.6-3.3.7, at 24-29 (same); *supra* notes 24-25 and accompanying text at the first printing of Figure 3.

A surge in orders may itself send a message to the specialist or market-maker that something good or bad is happening to the issuer, especially if he or she can deduce the identity of the insider traders. *See* INSIDER TRADING, *supra* note 1, § 2.2.2, at 26-27 & nn.37-38 and accompanying text (describing how trading volume and/or price movement may indicate that something positive or negative is happening to issuer). Such a message would cause the specialist or market-maker to adjust prices earlier and ease the task of maintaining the desired level of inventory.

38. *See* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 855-56 (1995) (explaining that market maker must increase spread to compensate for losses to unidentified insider traders); Haddock & Macey, *supra* note 36, at 1457 (same); *see also* INSIDER TRADING SUPP., *supra* note 1, § 2.3.4, at 15-16 (noting insider trading may cause market-makers to widen spread); William J. Carney, *Signaling and Causation in Insider Trading,* 36 CATH. U. L. REV. 863, 888-89 (1987) (explaining that market-makers increase their bid-ask spread to compensate for risk of dealing with insider traders); John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?,* 218 N.Y.L.J. 5-6 (July 31, 1997) (same); Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Op-*

timization of Insider Trading Regulation, 26 CONN. L. REV. 1, 18 n.45 (1993) (same); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71, 72 (1985) (same); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 331 (1987) (same); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUPREME CT. ECON. REV. 123, 161-62 (Ernest Gelhorn & Nelson Lund eds., 1998) (noting that insider trading may cause market-makers to widen spread); Elliott J. Weiss, United States v. O'Hagan*: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 434 (1998) (noting that market-makers increase their bid-ask spreads to compensate for risk of dealing with insider traders); Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 397 (1989) (same); Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1722-24 (1992) [hereinafter *Junk Bonds*] (same, *citing* Hartmut Schmidt, *Insider Regulation and Economic Theory*, in EUROPEAN INSIDER DEALING 21, 26-27 (Klaus J. Hopt & Eddy Wymeersch eds., 1991)); Chung & Charoenwong, *Insider Trading and the Bid-Ask Spread*, 33 FIN. REV. 1, 8-11 (1998) (showing through results that, although market-makers may not be able to detect insider trading when it occurs, they protect themselves by maintaining larger spreads for stocks with greater extent of insider trading, as reported to SEC in filings under § 16(a) of the Securities Exchange Act of 1934) for a general discussion of § 16(a) filings, see INSIDER TRADING, *supra* note 1, § 15.2, at 1001-06; INSIDER TRADING SUPP., *supra* note 1, § 15.2, at 606-12); Lawrence R. Glosten & Lawrence E. Harris, *Estimating the Components of the Bid/Ask Spread*, 21 J. FIN. ECON. 123, 123-24 (1988) (noting that spreads are apparently determined in part by exposure of market-makers to traders who are better informed than market-makers). One of the amici briefs in *O'Hagan* made the following argument:

> Trading in organized securities markets is usually effected through specialized intermediaries (e.g., market makers in dealer markets or specialists on the exchanges), who determine a bid-ask spread at which they trade with public customers. The width of the spread between the prices at which intermediaries will buy or sell (the bid-ask spread) is essentially a measure of the efficiency of the market for a security. While dealers and specialists are the initial victims of those who trade on misappropriated material nonpublic information, they pass this injury along to public customers through a widened bid-ask spread. To the extent it is foreseeable that people will trade with misappropriated material nonpublic information, intermediaries must protect themselves in advance by widening the bid-ask spread. Thus trading by those who misappropriate material nonpublic information for personal profit necessarily injures all public customers by decreasing the price at which they can sell to intermediaries (the bid) and increasing the price at which they can buy from intermediaries (the ask). Indeed, customers trading other securities will also be injured, because dealers cannot anticipate which securities will be traded by those in possession of material nonpublic information and will consequently widen the bid-ask spread for all securities that may be the subject of such information.

Amicus Curiae Brief of North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner, at 8, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842) (I assisted in the drafting of this brief). This excerpt from the brief is reprinted in Ribstein, *supra*, at 161-62. For criticism of the arguments in this excerpt, see *id.* at 161.

While discussing the likelihood that market markers will widen bid-ask spreads to compensate for the risk of dealing with insider traders, one commentator has noted: "This risk of dealing with insider traders is magnified in the options market, a favorite haven for insider traders because of the leverage it provides to the value of the information." A.C. Pritchard, United States v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 50 (1998).

pass some or all of their injury from insider trading to the public. The increase in spreads would harm all public trading investors,[39] but especially those who trade often. Again, ex ante, more frequent traders would bear the brunt of the harm of insider trading.[40] (In addition, the increase in bid-ask spreads may deter investors from trading.[41] This would decrease the liquidity of the market.[42])

These are only some of the possible adverse effects of insider trading. A full discussion of the broader arguments both for and *against* regulation is beyond the scope of this Article.[43]

For discussion of how the stock market functions, see INSIDER TRADING, *supra* note 1, § 3.3.1, at 48-56; INSIDER TRADING SUPP., *supra* note 1, § 3.3.1, at 17-21.

To return momentarily to the generic defect used car hypothetical, if used car dealers were frequent victims of insider trading, their profits would decline. To compensate for this loss, they would widen the spread between the price at which they buy from the public and the price at which they sell to the public.

39. *See* INSIDER TRADING SUPP., *supra* note 1, § 2.3.4, at 15-16 (discussing insider trading's possible harm to investors generally); *supra* note 38. *But see* Ribstein, *supra* note 38, at 162 ("Increased spreads hurt investors only in the trivial sense that stock returns are not as high as they might be in a perfect world.").

40. For a discussion of the disproportionate harm of insider trading on frequent traders, see *supra* notes 34-35 and accompanying text.

41. *See Junk Bonds*, *supra* note 38, at 1724 (noting that trading by outsiders will decrease as spread widens).

42. *See id.* (noting decreased outsider trading will reduce liquidity); Weiss, *supra* note 38, at 434 (same); *see also* Georgakopoulos, *supra* note 38, at 30-31, 36 (discussing how reducing transaction costs of outsider traders increases liquidity). *But cf.* Ribstein, *supra* note 38, at 163-65 (questioning whether decreased liquidity is harmful); Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERV. RES. 101, 102-03 (1989) (arguing that stock transfer tax is likely to increase overall efficiency of American economy by discouraging short-term speculative trading); Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791, 808-10 (1997) (arguing that, if investor demand for speculative trading is highly elastic, increasing investors' marginal costs of trading may actually decrease both speculative trading and investors' aggregate transaction costs and thereby increase investor welfare); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 667-91 (1995) (concluding that much stock trading is speculative: "Alleged efficiency benefits of speculative trading are at least exaggerated, and possibly illusory." *Id.* at 691); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERV. RES. 261, 262-72 (1989) (noting that United States stock markets may have "excessive" liquidity, thereby encouraging speculation and increasing volatility). For disagreement with Professor Stout's *Virginia Law Review* article and the suggestion of an alternative reason for excessive stock trading (incentive structures facing investors and financial intermediaries), see Paul G. Mahoney, *Is There a Cure for "Excessive Trading?,"* 81 VA. L. REV. 713 (1995). For Professor Stout's reply to Professor Mahoney, see Lynn A. Stout, *Agreeing to Disagree Over Excessive Trading*, 81 VA. L. REV. 751 (1995).

Extrapolating from these contrary authorities, any increase in bid-ask spreads arguably might benefit society by deterring excessive stock trading and speculation.

43. For an extensive discussion of the arguments for and against regulation of stock market insider trading, see INSIDER TRADING, *supra* note 1, §§ 2-3, at 13-118; INSIDER TRADING SUPP., *supra* note 1, §§ 2-3, at 3-34.

III. IS STOCK MARKET INSIDER TRADING FRAUD?

In a traditional fraud scenario, the victim is the party on the other side of the trade. Also, disclosure in advance of the transaction would have saved the victim from harm.

To examine whether stock market insider trading is fraud, I shall rely on the Greedie used car hypothetical. The typical fraud situation is the *solitary* defect Greedie hypothetical. Greedie's *particular* automobile is a lemon. Greedie sells the car to the dealer. Greedie either lies to the dealer or fails to disclose a material defect. The dealer discovers the defect and is stuck with the lemon.

Below is a reprint of Figure 1 (the *solitary* defect hypothetical):

FIGURE 1:
SOLITARY DEFECT HYPOTHETICAL
(ONLY GREEDIE'S 1998 CADILLAC HAS DEFECT)

GREEDIE ————————>	DEALER ————————>	MR. PUBLIC BUYER,
SELLS LEMON TO	SELLS SAME LEMON TO	THE VICTIM

Suppose the dealer does *not* discover the solitary defect and sells the car to Mr. Public Buyer. Suppose Mr. Public Buyer is stuck with the lemon. Is Greedie's conduct fraud?

The victim is not the party on the other side of Greedie's trade, *i.e.*, the dealer. Still, disclosure by Greedie in advance of his proposed sale would have prevented the dealer from purchasing and would have saved Mr. Public Buyer from loss.

Maybe Greedie's conduct is still fraud even when Mr. Public Buyer is the victim. *Maybe the victim of fraud need not be the party on the other side of the trade.*

Now I shall examine whether Greedie's conduct in the generic defect hypothetical constitutes fraud. Below is a reprint of Figure 3 (the *generic* defect hypothetical):

FIGURE 3:
THE VICTIM IN THE GENERIC DEFECT HYPOTHETICAL (ASSUME THAT DEALER STILL OWNS GREEDIE'S CAR AT TIME OF PUBLIC DISCLOSURE)

GREEDIE ————————————>		DEALER,
SELLS LEMON TO		MAY OR MAY NOT BE VICTIM DEPENDING ON SIZE OF INVENTORY AT DISCLOSURE
DEALER MAY *LOWER PRICES*, AND		*MAY* INDUCE MR. POTENTIAL TO BUY ANOTHER 1998 CADILLAC (INDUCED BUYER);
	OR	*MAY* DISSUADE MS. MARGINAL FROM SELLING (PREEMPTED SELLER)

Again, assume alternatively that: (1) the dealer does not ask Greedie about any defect, or (2) the dealer asks Greedie about defects, and Greedie lies. Is Greedie's conduct in the *generic* defect hypothetical fraud?

In the generic defect situation, *all* 1998 Cadillacs have the defect. The victim of Greedie's sale is not necessarily either the dealer or Mr. Public Buyer. The victim exists, but cannot be identified. The victim might be either a preempted seller, like Ms. Marginal, or an induced buyer, like Mr. Potential or the dealer.

Is Greedie's misconduct fraud? Greedie's lie or nondisclosure facilitates or even enables Greedie's sale to the dealer. The sale causes harm to the anonymous victim. Nevertheless, even though a *lie* or nondisclosure facilitates misconduct, the misconduct may not necessarily be fraud. For example, nondisclosure facilitates embezzlement. Embezzlement is not necessarily labeled fraud.

At least three significant differences exist between traditional fraud and Greedie's misconduct in the *generic* defect situation. First, in the generic defect hypothetical, premature disclosure by Greedie to either the dealer or to the world may be a breach of duty to Greedie's employer, General Motors. Second, disclosure of the generic defect by Greedie to just the dealer might also be offensive. This would give an unfair advantage to the dealer in its transactions with others.[44] Third, disclosure by Greedie may not help the victim of Greedie's misconduct if the victim is a preempted seller. Suppose the real victim of Greedie's sale is a preempted seller, like Ms. Marginal. (Ms. Marginal is someone who would have sold a 1998 Cadillac, but for Greedie's sale. Greedie's sale decreased the dealer's price for 1998 Cadillacs. This price decline dissuaded Ms. Marginal from selling.[45])

Had Greedie disclosed just to the dealer, the dealer would have ceased buying 1998 Cadillacs. Ms. Marginal still would not have sold. Ms. Marginal would not be saved from loss. Suppose Greedie disclosed the defect to the world in a press release. The price of 1998 Cadillacs would have drastically declined. Ms. Marginal still would not be saved from

44. *But see* Dirks v. SEC, 463 U.S. 646, 654-64 (1983) (stating that insider/tipper does not violate rule 10b-5 under "classical relationship" theory unless tip is for "personal benefit." Conceivably, selective disclosure to avoid committing fraud in a face-to-face transaction might be considered motivated by "personal benefit"). For a discussion of SEC rule 10b-5 liability for tipping under the "classical relationship" theory, see INSIDER TRADING, *supra* note 1, § 5.2.8, at 336-43; INSIDER TRADING SUPP., *supra* note 1, § 5.2.8, at 174-81; *infra* notes 75-80 and 83-93 and accompanying text. For a discussion of the "classical relationship" theory, see INSIDER TRADING, *supra* note 1, §§ 5.2-5.3, at 283-354; INSIDER TRADING SUPP., *supra* note 1, §§ 5.2.1-5.3.5, at 144-86; *infra* Part IV and notes 57-65.

45. *See supra* Part II, text accompanying Figure 3 (discussing Ms. Marginal as preempted seller victim).

harm. In other words, disclosure by Greedie would not have saved the victim of his sale, Ms. Marginal.[46]

In short, in the generic defect hypothetical, Greedie's conduct has some features of fraud, especially if he lies. Nevertheless, his conduct differs from traditional fraud in several respects. Disclosure by Greedie to the party on the other side or to the public might breach other duties. Also, such disclosure would not save the victim of the trade if the victim is a preempted seller. Whether Greedie's misconduct is fraud is not clear.

What difference does it make whether his misconduct is fraud? Suppose a federal statute provides: "thou shalt not commit fraud in connection with the purchase or sale of a *used automobile*." Assume that violation of the statute is a federal crime. Should the federal used car fraud statute apply to Greedie's sale in the generic defect hypothetical?

How a judge answers this question depends in part on judicial conservatism versus judicial activism. An extremely conservative judicial solution would be to refuse to apply the federal act.[47]

True, Greedie either has lied or has failed to disclose material information. Nevertheless, what seems objectionable about his conduct is not the fraud, but the unjust taking from the *anonymous* victim of the transaction. The victim may not be the dealer.

One principle of statutory construction is to interpret criminal statutes narrowly.[48] The judiciary could wait for Congress to amend the Act to prohibit *expressly* this type of unjust enrichment.

---

46. This hypothetical involves the seller of a used car with a generic defect. For a somewhat similar hypothetical involving the president of a closely held corporation who sells company stock based on material nonpublic information (by undercutting the selling price offer of one of company's other ten shareholders), see INSIDER TRADING, *supra* note 1, § 3.2, at 44-46.

47. *Cf. Transcript of the Roundtable on Insider Trading: Law, Policy, and Theory after* O'Hagan, 20 CARDOZO L. REV. 7, 12 (1998) [hereinafter *Roundtable*] (comments of Mr. Arthur R. Mathews) (stating that members of majority in *United States v. O'Hagan*, 521 U.S. 642 (1997), "really gave no treatment to the fact that their decision was letting the courts manufacture a crime rather than having Congress legislate a crime. I think that violates the separation of powers concept . . . .").

48. *See* United States v. Lanier, 520 U.S. 259, 266 (1997) (discussing briefly rule of lenity as one of "three related manifestations of the fair warning requirement"); WAYNE R. LAFAVE & AUSTIN W. SCOTT, JR., CRIMINAL LAW § 2.2(d) (2d ed. 1986 & Supp. 1998) (explaining rule that requires strict construction of criminal statutes in favor of defendant); Steven B. Duke, *Legality in the Second Circuit*, 49 BROOK. L. REV. 911, 911 (1983) (discussing doctrine of strict construction of criminal statutes, also known as rule of lenity); *see also* United States v. Brennan, 183 F.3d 139, 149-50 (2d Cir. 1999) (noting in dictum that case against defendants is seriously problematic in part because of rule of lenity); Audrey Strauss, *Mail Fraud and the Rule of Lenity*, 222 N.Y.L.J. 5 (Nov. 4, 1999) (discussing *Brennan* and *Lanier*). *See generally* Dan M. Kahan, *Lenity and Federal Common Law Crimes*, 1994 SUP. CT. REV. 345 (discussing debate among Supreme Court justices over lenity and recommending abolition of rule of lenity and substitution of theory of federal common law crimes). *But cf.* Holloway v. United States, 526 U.S. 1, 12 n.14 (1999) ("We have repeatedly stated that: '[t]he rule of lenity applies only if, after seizing everything from which aid can be derived, . . . we can make no more than a guess as to

A more activist *judicial* solution would be to extend the federal used car fraud statute to Greedie's misconduct. The conduct seems offensive and close enough to fraud to include within the act.

What about *stock market* insider trading under the federal *securities* laws? No federal statute expressly prohibits stock market insider trading. Federal statutes *do* prohibit securities fraud.[49] As with the hypothetical used car fraud act, there is no obvious answer to the question whether

---

what Congress intended.'" (quoting *Muscarello v. United States*, 524 U.S. 125, 138 (1998), which in turn quoted *United States v. Wells*, 519 U.S. 482, 499 (1997), which in turn quoted *Reno v. Koray*, 515 U.S. 50, 65 (1995), which in turn quoted *Smith v. United States*, 508 U.S. 223, 239 (1993) and *Ladner v. United States*, 358 U.S. 169, 178 (1958)).

In his dissent in *United States v. O'Hagan*, Justice Scalia rejected the rule 10b-5 misappropriation doctrine. *See* United States v. O'Hagan, 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting with respect to misappropriation doctrine). For discussion of the misappropriation doctrine, see *infra* Part IV, notes 66-72 and accompanying text. Justice Scalia said:

> In light of that principle [of lenity applied to criminal statutes], it seems to me that the unelaborated statutory language: "[t]o use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance," [in] § 10(b), must be construed to require the manipulation or deception of a party to a securities transaction.

O'Hagan, 521 U.S. at 679. For discussion of this dissent, see INSIDER TRADING SUPP., *supra* note 1, § 4.5, at 108 n.25(1) and accompanying text.

For discussion of the application of rule of lenity to regulation of insider trading under the federal securities laws, see *Roundtable*, *supra* note 47, at 12 (comments of Mr. Arthur R. Mathews) (noting members of *O'Hagan* majority "[r]eally gave no treatment to the fact that their decision was letting the courts manufacture a crime rather than having Congress legislate a crime. I think that violates the separation of powers concept and it violated other doctrines of criminal law"); *id.* at 16 (comments of Professor Roberta S. Karmel) (recognizing "in a criminal case, courts are confronted with the doctrine that criminal statutes are not supposed to be construed as broad remedial statutes. They are supposed to be construed strictly"). *Cf. id.* at 17 (comments of Professor Marcel Kahan) (stating "[t]he best argument against the case [*O'Hagan*] is that this is a criminal case and it is not right for courts to define crimes out of fresh clothes"); *id.* at 18 (comments of Judge Ralph K. Winter) (stating "[b]ut, in criminal law, to have a crime that is not defined, either in terms of what it is or what the rationale is for its being illegal, invites prosecutorial misconduct"). *But cf. id.* at 27 (comments of Professor Marcel Kahan) (arguing that because federal mail/wire fraud statutes already broadly prohibit stock market insider trading, there is less need to construe narrowly federal securities laws: "[a] lot of people on the panel have voiced the argument that there is a very undefined law here and we are sending people to jail. Does the argument not apply to the same extent against mail and wire fraud?").

49. *See* INSIDER TRADING, *supra* note 1, § 4, at 119-277 (explaining basic elements of § 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5); INSIDER TRADING SUPP., *supra* note 1, § 4, at 35-142 (same); INSIDER TRADING, *supra* note 1, § 10, at 711-32 (discussing § 17(a) of the Securities Act of 1933); INSIDER TRADING, *supra* note 1, § 10, at 339-43 (same). For a discussion of SEC rule 14e-3, which does expressly regulate insider trading and tipping in the context of tender offers, see INSIDER TRADING, *supra* note 1, § 9, at 685-709; INSIDER TRADING SUPP., *supra* note 1, § 9, at 321-38.

stock market insider trading violates the federal securities fraud statutes. An activist court would say yes. A conservative court might say no.

IV. WHEN DOES STOCK MARKET INSIDER TRADING AND TIPPING VIOLATE FEDERAL SECURITIES LAW?

A. *Introductory Remarks*

The Securities and Exchange Commission ("SEC" or "Commission") has adopted a special rule, 14e-3, prohibiting insider trading (and tipping) about a forthcoming *tender offer*.[50] (Incidentally, the extent to which this rule is valid is still unsettled, even after *United States v. O'Hagan*).[51]

Section 10(b) of the Securities Exchange Act of 1934 authorizes the SEC to adopt rules prohibiting "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance."[52] The Commission has adopted rule 10b-5.[53] Loosely paraphrased, that rule states: "thou shalt not commit fraud in connection with the purchase or sale of any security."[54]

Does rule 10b-5 cover stock market insider trading? Has the Supreme Court taken an activist or a conservative view of this issue? The Court has chosen a middle course. Rule 10b-5 covers most, but *not* all, insider trading.

Rather than focus on the victims of the *act* of trading, the Court has focused on the victims of certain *independent* disclosure duties. These independent duties are breached by the nondisclosure that *accompanies* the stock market insider trade.[55]

The Court has endorsed two bases of rule 10b-5 liability:

---

50. *See* 17 C.F.R. § 240.14e-3 (1999); INSIDER TRADING, *supra* note 1, § 9, at 685-709 (discussing SEC rule 14e-3); INSIDER TRADING SUPP., *supra* note 1, § 9, at 321-38 (same). For the text of the rule 14e-3 see INSIDER TRADING, *supra* note 1, § 9.1, n.2.

51. *O'Hagan* is ambiguous about the validity of 14e-3. *See* INSIDER TRADING SUPP., *supra* note 1, § 9.3.3, at 329-33. Unfortunately, examining rule 14e-3 is beyond the scope of this Article.

52. 15 U.S.C. 78j(b) (1999). For the full text of § 10(b), see INSIDER TRADING, *supra* note 1, § 4.1, at 121 n.1. For a general discussion of § 10(b), see INSIDER TRADING, *supra* note 1, § 4, at 119-277; INSIDER TRADING SUPP., *supra* note 1, § 4, at 35-142.

53. 17 C.F.R. § 240.10b-5 (1999). For a general discussion of rule 10b-5, see INSIDER TRADING, *supra* note 1, § 4, at 119-277; INSIDER TRADING SUPP., *supra* note 1, § 4, at 35-142.

54. For the text of rule 10b-5, see INSIDER TRADING, *supra* note 1, § 4.1, at 121 n.1.

55. For discussion of the distinction between *trade* victims and *nondisclosure* victims, see INSIDER TRADING, *supra* note 1, §§ 3.2-3.4, at 42-105; INSIDER TRADING SUPP., *supra* note 1, §§ 3.3-3.4, at 17-32 (same); *supra* notes 12, 24 and accompanying text (same); *infra* note 65 and accompanying text (same).

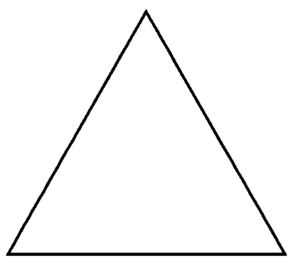
(1) the "classical relationship" theory, and (2) the misappropriation doctrine.[56]

B. *The "Classical Relationship" Theory*

A stock market insider trader has a duty to disclose material information to the party on the other side of the trade when the two have a so-called "classical relationship."[57] This duty is breached by the material nondisclosure accompanying the insider trade.

A "classical relationship" exists when the insider trader is an *employee* or *independent contractor* of the company that issued the shares bought or sold. The "classical relationship" is a triangle, illustrated in Figure 4 below.

FIGURE 4:
THE "CLASSICAL RELATIONSHIP" TRIANGLE



At the apex of the triangle is the issuer (A), the corporation that issued the stock traded. At one end of the base of the triangle is the stock market insider trader (B-1). (I shall discuss tippers and tippees (B-2) later.[58]) At the other end of the base of the triangle is the innocent party on the opposite side of the insider trade.[59]

56. On December 20, 1999, the SEC proposed rule 10b5-2, which would furnish a nonexclusive list of circumstances when a person has a duty of trust or confidence under the misappropriation docutrine. For a discussion of this proposed rule, see *infra* note 66.

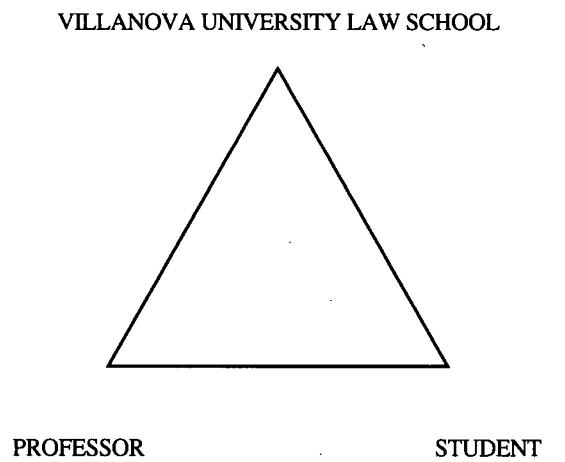
57. *See* INSIDER TRADING, *supra* note 1, §§ 5.2-5.3, at 283-354 (discussing "classical relationship" theory); INSIDER TRADING SUPP., *supra* note 1, §§ 5.2-5.3, at 144-86 (same).

58. *See infra* notes 75-93 and accompanying text.

59. For a discussion of the "classical relationship" *triangle* specifically, see Dirks v. SEC, 463 U.S. 646, 653-55, 657-58 (1983); Chiarella v. United States, 445 U.S. 222, 227-35 (1980); INSIDER TRADING, *supra* note 1, § 5.2.1, at 283-90; INSIDER

To explain the nature of this "classical relationship" triangle, I shall briefly describe a similar triangle, illustrated in Figure 5 below.

FIGURE 5:
THE VILLANOVA/PROFESSOR/STUDENT TRIANGLE



Professor Teacher is on the faculty of Villanova University Law School. She has no direct contractual relationship with the school's students. Nevertheless, she has an employment relationship with the law school. The students have a relationship with the law school as well. They pay tuition. Because of the *mutual* relationship to the school, Professor Teacher has a fiduciary or quasi-fiduciary relationship with *each* student.

Similarly, as illustrated in Figure 4,[60] any employee or independent contractor (B-1) of a corporation has an *employment* relationship with the issuing company (A). The innocent party on the other side of the trade (C) also has a relationship with the issuing corporation (A). That party (C) is either a shareholder of the issuer (A), or becomes one simultaneous with the insider trade.[61]

Because of the *mutual* relationship to the issuing company (A), the shareholder (C) and the employee/independent contractor (B-1) have a "classical relationship."

Figure 6 below provides a concrete example of the "classical relationship" triangle:

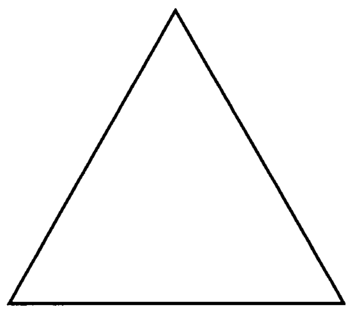
TRADING SUPP., *supra* note 1, § 5.2.1, at 144-48 (citing *United States v. O'Hagan*, 521 U.S. 642, 651-52, 660-61 (1997)).

60. *See* Figure 4 and text accompanying notes 58-59 *supra*.

61. *See Chiarella*, 445 U.S. at 227 n.8 (suggesting that innocent buyer may enter into classical relationship with insider seller simultaneously with trade between them); INSIDER TRADING, *supra* note 1, § 5.2.1, at 290 & n.31 (citing and quoting *Chiarella*, 445 U.S. at 227 n.8).

FIGURE 6:
THE "CLASSICAL RELATIONSHIP" TRIANGLE
(ISSUER/JANITOR/SHAREHOLDER EXAMPLE)

ISSUER (A) OF STOCK TRADED



JANITORIAL SERVICE FIRM

MR. CLEAN, THE
JANITOR (B), WHO DID NOT
DISCLOSE TO THE PARTY ON
OTHER SIDE OF THE INSIDER TRADE

INNOCENT PARTY ON
OTHER SIDE OF TRADE (C)

(ALREADY A S/H OR
BECOMES ONE WITH THE TRADE)

Suppose Mr. Clean works for a janitorial service that contracts to clean the offices of a company at night. Some executives are working late. Mr. Clean overhears material, nonpublic information. On the basis of that information, Mr. Clean buys or sells the corporation's stock.

Mr. Clean is in the "classical relationship triangle." Mr. Clean, the janitor (B), works for an independent contractor, the janitorial service, that works for the company (A) that issued the stock Mr. Clean trades.

The party on the other side of Mr. Clean's transaction (C) is also in the triangle. That party (C) is either an existing shareholder or becomes one simultaneously with the insider trade.

Mr. Clean has traded on material, nonpublic information *without disclosing* the information to the party on the other side. This material nondisclosure is a breach of the duty resulting from the "classical relationship" between Mr. Clean ("B") and the party in privity ("C"). The insider trade violates rule 10b-5.[62]

In its "classical relationship" approach, the Supreme Court ignores the possibility that, absent the insider trade, the party on the other side might have traded with someone else. In other words, *at first blush, the Court seems to treat "classical relationship" stock market insider trading as analogous to the solitary defect hypothetical, even though, in reality, such stock market*

62. *See* INSIDER TRADING, *supra* note 1, §§ 5.2.1, 5.2.7, at 283-90, 335-36 (explaining "classical relationship"); INSIDER TRADING SUPP., *supra* note 1, § 5.2.1, at 144-47 (same).

insider trading is comparable to the generic defect used car hypothetical.[63] With stock market insider trading, many individuals are buying and selling the same stock.

The Court might respond as follows: although the party on the other side of the insider trade, "C," is not necessarily the victim of the *act* of insider trading, "C" is the victim of the *nondisclosure* accompanying the insider trade that breaches the *independent* duty to disclose created by the "classical relationship."[64] Had the insider trader disclosed in advance to "C," "C" would not have traded.[65]

C. *The Misappropriation Doctrine*

The Supreme Court has also endorsed a *second* basis of insider trading liability under rule 10b-5: the misappropriation doctrine. Under this theory, stock market trading on material, nonpublic information violates rule 10b-5 when both:

(1) the trade breaches a fiduciary duty to the information source, *e.g.*, a direct or indirect employer,[66] and

---

63. For the *solitary defect* and *generic defect* hypotheticals, see *supra* Part I, especially text accompanying printings of Figures 1, 2 and 3.

64. For a discussion of why the party on the other side of the insider trade is not necessarily the victim of the *act* of insider trading, see INSIDER TRADING, *supra* note 1, §§ 3.3.3-3.3.4, at 58-61; INSIDER TRADING SUPP., supra note 1, § 3.3.3, at 22 (same). For a used car analogy, see the text accompanying both note 23 and first printing of Figure 2.

65. For a discussion of the distinction between *trade* victims and *nondisclosure* victims, see INSIDER TRADING, *supra* note 1, §§ 3.2-3.4, at 42-105; INSIDER TRADING SUPP., *supra* note 1, §§ 3.3-3.4, at 17-32; *supra* notes 13, 24, 55 and accompanying text.

66. *See* United States v. O'Hagan, 521 U.S. 642, 655 n.7 (1997) (stating "[w]here . . . a person trading on the basis of material, nonpublic information owes a duty of loyalty and confidentiality to two entities or persons—for example, a law firm and its client—but makes disclosure to only one, the trader may still be liable under the misappropriation theory").

On December 20, 1999, the SEC proposed rule 10b5-2, which would furnish a nonexclusive list of circumstances when a person has a duty of trust or confidence under the misappropriation doctrine:

> (1) Whenever a person agrees to maintain information in confidence;
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the person communicating the material nonpublic information has a reasonable expectation that the other person would maintain its confidentiality; or
> (3) Whenever a person receives or obtains material nonpublic information from the person's spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that the spouse, parent, child, or sibling that was the source of the information had no reasonable expectation that the person would keep the information confidential, because the parties had neither a history, pattern, or practice of sharing confidences, nor an agreement or understanding to maintain the confidentiality of the information.

(2) the trader fails to disclose this breach to the information source before transacting.[67]

For example, suppose Ms. Junior clerks for a state judge. Her employer prohibits her from trading on material, nonpublic information gained through her employment. She learns that the judge is about to issue a decision dramatically benefitting a company. She buys that corporation's stock.

Ms. Junior does not work for that company. Therefore, she is not in the "classical relationship triangle." Nevertheless, she violates rule 10b-5 under the misappropriation doctrine.

Where is the fraud? The Supreme Court finds fraud in the failure to inform the information source in advance of the plan to breach a duty.[68]

Figure 7 below provides a concrete example designed to highlight the difference between the "classical relationship theory" and the misappropriation doctrine.

SEC Rel. Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99 (Dec. 20, 1999), 1999 WL 1217849, *37 (S.E.C.) (emphasis added), *available in* <www.sec.gov.rules/proposed/34-42259.htm>. For additional discussion of proposed rule 10b5-2, see 1999 WL 1217849, *2, *17, *21-25, *30, *33.

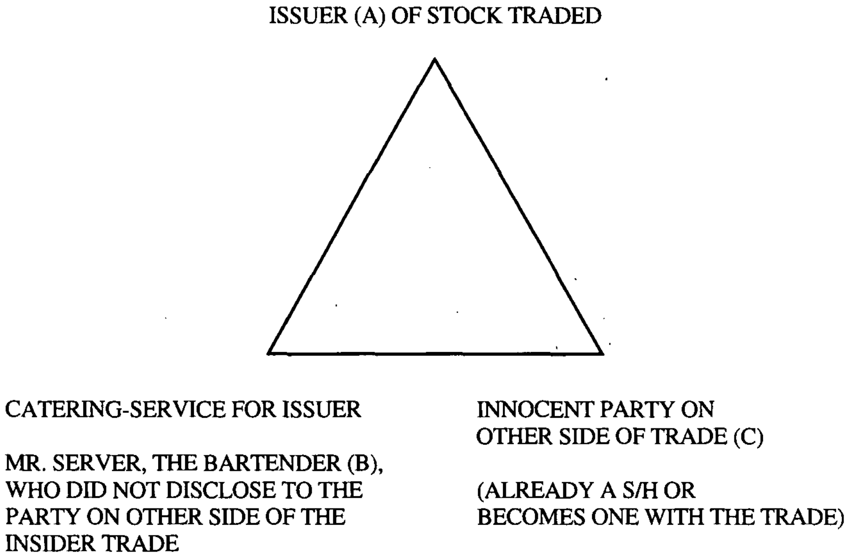
On December 20, 1999, the Commission also proposed rule 10b5-1, which would provide that insider trading liability generally arises when someone trades while "aware" of material nonpublic information, but also would provide four exceptions from liability. *See* 1999 WL 1217849, *2, *17-20, *30, *33, *35-37.

On the same date, the SEC proposed Regulation FD (Fair Disclosure), which would prohibit publicly traded companies from selectively disclosing material nonpublic information. *See id.* at *2-17, *27-30, *32-35, *37-40. For additional discussion of this proposed regulation, see *infra* note 93.

67. *See O'Hagan*, 521 U.S. at 646-66 (1997) (discussing misappropriation doctrine); INSIDER TRADING, *supra* note 1, §§ 4.5, at 192-96, 5.4, at 354-89 (same); INSIDER TRADING SUPP., *supra* note 1, §§ 4.5, at 106-13, 5.4, at 186-222 (same).

68. *See O'Hagan*, 521 U.S. at 653-55, 659 n.9 (finding no § 10(b) liability for misappropriation when insider trader discloses his or her trading plans to, or obtains authorization from, principal); INSIDER TRADING SUPP., *supra* note 1, § 5.4.1, at 192 & nn.49(k)-49(p) and accompanying text (disussing *O'Hagan*).

FIGURE 7:
THE "CLASSICAL RELATIONSHIP" TRIANGLE (ISSUER; CATERING-SERVICE/ BARTENDER; SHAREHOLDER EXAMPLE)



Suppose Mr. Server (B) is a bartender working for a *caterer* at a *company function.* He overhears material, nonpublic information and trades the company's stock.

Mr. Server (B) indirectly works for the corporation (A) whose shares he trades. He is in the "classical relationship" triangle and violates rule 10b-5.[69]

In contrast, suppose Mr. Server is a bartender at a bar in the financial district, called "The Bull and the Bear." He overhears some customers discussing material, nonpublic information about a company. The information does not relate to a tender offer. Mr. Server trades on that information. Does he violate federal securities law?

Mr. Server does *not* work directly or indirectly for the company whose stock he trades. Therefore, he is not in the "classical relationship" triangle.

What about *misappropriation*? Has he breached a duty to the information source?

There are two possible information sources:

(1) The customers whose conversation Mr. Server overheard.

(2) Mr. Server's employer, because Mr. Server overheard the conversation during his employment.

69. *See supra* Figure 6 and accompanying text and text accompanying note 62 (providing similar analysis involving janitorial service rather than catering service).

Has Mr. Server breached a duty to the customers? A lawyer owes a duty to a client not to trade on confidential information from the client.[70] What about a bartender and a customer? *Probably*, the bartender has no duty to a customer,[71] but this is not certain.[72]

Has Mr. Server, the bartender, breached a duty to his employer? That depends on the policy of the bar, "The Bull and the Bear." If the "Bull and the Bear" prohibits insider trading by its employees based on information obtained during employment, then Mr. Server's trade violates rule 10b-5 under the misappropriation doctrine. In short, his trading may or may not violate rule 10b-5, depending on the facts and on judicial interpretation of when the trader owes a duty to the information source.

D. *Summary of the Federal Securities Law Liability of Insider Traders*

To summarize and oversimplify, insider trading violates federal securities law in three instances:[73]

(1) When it relates to information about a forthcoming tender offer. This is SEC rule 14e-3.

(2) When the insider trader has a "classical relationship" with the party on the other side of the trade. This is the rule 10b-5 "classical relationship" theory.

(3) When the trade on material, nonpublic information breaches a duty to the information source, *e.g.*, a direct or indirect employer, *and* the trader fails to disclose this breach to the information source before transacting. This is the rule 10b-5 misappropriation doctrine.

To digress, if an *employee* breaches a duty to an *employer* not to trade based on material, nonpublic information, two federal *criminal* statutes,

70. *See* INSIDER TRADING, *supra* note 1, § 5.4.2.6, at 379-80 (discussing attorney/client relationship and rule 10b-5 misappropriation doctrine); INSIDER TRADING SUPP., *supra* note 1, § 5.4.2.6, at 209-12 (same).

71. *Cf.* Thomas Lee Hazen, *"Insider Trading" Under Rule 10b-5*, American Law Institute-American Bar Assn. Continuing Legal Education, SC20 ALI-ABA 377, 382 (Aug. 14, 1997) (stating that it is legal for waiter to trade on overheard conversation between two directors dining at restaurant); Stefan Rubin, Comment, *Corporate Law: Misappropriation Theory of Liability Upheld for Rule 10b-5 Criminal Convictions*, 50 FLA. L. REV. 405, 416 (1998) (same citing Thomas Lee Hazen, *supra*).

72. For a discussion of the uncertain source of the fiduciary duty in misappropriation, see INSIDER TRADING SUPP., *supra* note 1, § 5.4.1A, at 197-203.

73. *See* INSIDER TRADING, *supra* note 1, at 4 (providing longer list, with five instances (the following list plus mail/wire fraud and § 17(a) of the Securities Act of 1933)); INSIDER TRADING SUPP., *supra* note 1, at 1 (same). For discussion of the federal mail and wire fraud statutes and their application to stock market insider trading, see INSIDER TRADING, supra note 1, § 11, at 733-60; INSIDER TRADING SUPP., *supra* note 1, § 11, at 345-63. For discussion of § 17(a) of the Securities Act of 1933 and its application to stock market insider trading, see INSIDER TRADING, *supra* note 1, § 10, at 711-32; INSIDER TRADING SUPP., *supra* note 1, § 10, at 339-43.

the federal mail and wire fraud provisions, would cover such a deprivation of "another of the intangible right of honest services."[74]

E. *Liability of Tippers and Tippees*

Not only may insider *trading* violate rule 10b-5, *tipping* others may also be illegal. Oversimplifying again, if someone would violate the rule 10b-5 "classical relationship" theory by *trading*,[75] he or she violates the rule by *tipping* someone who trades, *provided* the tip confers a "personal benefit" on the tipper.[76] Even a vicarious "personal benefit" suffices.[77]

Below is a reprint of Figure 4:

74. For discussion of the federal mail and wire fraud statutes and their application to stock market insider trading, see INSIDER TRADING, *supra* note 1, § 11, at 733-60; INSIDER TRADING SUPP., *supra* note 1, § 11, at 345-63. For discussion of the 1988 amendment to the mail and wire fraud statutes extending their coverage to the deprivation of "another of the intangible right of honest services," see INSIDER TRADING, *supra* note 1, § 11.3.2.1, at 750-57 & nn.39, 47-48; INSIDER TRADING SUPP., *supra* note 1, § 11.3.2.1, at 355-59 & n.39.

Thus far, the courts have not explored the insider trader's mail/wire fraud duty to disclose to *the party on the other side of the trade.* Under this unexamined obligation, a stock market insider trader might conceivably have a duty to disclose to the party on the other side even in the absence of a "classical relationship." For discussion of the insider trader's possible mail/fraud duty to disclose to the party on the other side of the trade, see INSIDER TRADING, *supra* note 1, § 11.3.2.2, at 757-60; INSIDER TRADING SUPP., *supra* note 1, § 11.3.2.2, at 361-63. For discussion of the rule 10b-5 classical relationship theory, see INSIDER TRADING, *supra* note 1, §§ 5.2-5.3, at 283-354; INSIDER TRADING SUPP., *supra* note 1, §§ 5.2-5.3, at 144-86; *supra* notes 57-65 and accompanying text.

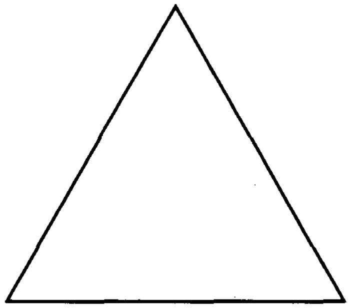
75. For a discussion of the "classical relationship" theory, see INSIDER TRADING, *supra* note 1, §§ 5.2-5.3, at 283-354; INSIDER TRADING SUPP., *supra* note 1, §§ 5.2-5.3, at 144-86; *supra* notes 57-65 and accompanying text.

76. *See* Dirks v. SEC, 463 U.S. 646, 661-64 (1983) (stating tip is breach of insider's fiduciary duty if insider receives personal benefit from tip); INSIDER TRADING, *supra* note 1, § 5.2.8, at 336-43 (describing breach of fiduciary duty when insider tips for personal benefit); INSIDER TRADING SUPP., *supra* note 1, § 5.2.8, at 174-81 (same).

77. *See Dirks*, 463 U.S. at 664 ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend."); INSIDER TRADING, *supra* note 1, § 5.2.8.3, at 338-40 (discussing how to demonstrate tipper's personal benefit); INSIDER TRADING SUPP., *supra* note 1, § 5.2.8.3, at 176-77 (same).

FIGURE 4:
THE "CLASSICAL RELATIONSHIP" TRIANGLE

ISSUER (A) OF STOCK TRADED



EMPLOYEE/INDEPENDENT-CONTRACTOR TRADER/TIPPER (B-1)

[TRADING OUTSIDER/TIPPEE (B-2); OUTSIDE TRIANGLE, BUT MAY BE PARTICIPANT AFTER THE FACT IN B-1'S VIOLATION

INNOCENT PARTY ON OTHER SIDE OF TRADE (C)

(ALREADY A S/H OR BECOMES ONE WITH THE TRADE)

Suppose "B-1" has material, nonpublic information and trading on the information would be illegal under the rule 10b-5 "classical relationship" theory. "B-1" violates rule 10b-5 by tipping "B-2" (*e.g.*, a friend or relative) who trades, *provided* that "B-1" receives a "personal benefit"[78] (*e.g.*, feeling better off because "B-2" is better off[79]).

If "B-1", the *insider/tipper*, is liable, "B-1's" *tippee* ("B-2") may also be liable if the tippee trades and knows or should know of "B-1's" (the insider/tipper's) breach of duty. The trading tippee may be a participant after the fact in "B-1's" rule 10b-5 violation.[80]

78. *See Dirks*, 463 U.S. at 661-64 (stating that insider's tip is breach of fiduciary duty if insider personally benefits); INSIDER TRADING, *supra* note 1, §§ 5.2.8.1., at 336-37, 5.2.8.3, at 338-40 (describing "personal benefit" test for insider/tipper liability); INSIDER TRADING SUPP., *supra* note 1, §§ 5.2.8.1, at 174, 5.2.8.3, at 176-77 (same).

79. *See Dirks*, 463 U.S. at 664 ("The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a relative or friend."); INSIDER TRADING, *supra* note 1, § 5.2.8.3, at 338-40 (discussing how to demonstrate tipper's personal benefit); INSIDER TRADING SUPP., *supra* note 1, § 5.2.8.3, at 176-77 (same).

80. *See Dirks*, 463 U.S. at 659-661, 662 (discussing trading tippees as "participants after the fact" and the "know or should know" test); INSIDER TRADING, *supra* note 1, §§ 5.3.1-5.3.2, at 344-46 (same); INSIDER TRADING SUPP., *supra* note 1, §§ 5.3.1-5.3.2, at 181-83 (same).

For discussion of the "classical relationship" theory and nontrading tippees who tip others, see INSIDER TRADING, *supra* note 1, § 5.3.3, at 346-47.

For rule 10b-5 misappropriation, tipper and tippee liability is similar to that under the "classical relationship" theory. Oversimplifying somewhat, if trading (and failing to disclose the trade in advance) would breach a duty to the information source, then tipping for a "personal benefit" (and failing to disclose the tip in advance to the information source) also constitutes rule 10b-5 misappropriation.[81] Again oversimplifying, a trading tippee may participate after the fact in the misappropriating tipper's violation if the tippee knows or should know of the tipper's breach of duty.[82]

F. *A Difficult Issue in "Classical Relationship" Tipper/Tippee Liability: Selective Disclosure to Analysts*

One difficult issue in "*classical relationship*" tipper/tippee liability is selective disclosure to analysts. Suppose Ms. Tycoon is the president of a company. An analyst of a stockbrokerage firm has given her company favorable coverage in the past and may do so in the future.

Ms. Tycoon gives the analyst material, nonpublic information about her company one day before the public announcement. She intends that the analyst's firm trade and tip its favorite clients. Assume that Ms. Tycoon, the president, is authorized to act for the corporation when tipping.

For discussion of the "classical relationship" theory and remote tippees who trade or tip, see *id.* § 5.3.5, at 350-54; INSIDER TRADING SUPP., *supra* note 1, § 5.3.5, at 183-86.

For discussion of the "classical relationship" theory and an evil-hearted outsider/tippee with a pure-hearted insider/tipper, see INSIDER TRADING, *supra* note 1, § 5.3.4, at 347-50.

81. *Cf.* INSIDER TRADING, *supra* note 1, § 5.4.3, at 381-83 (discussing whether misappropriation doctrine requires that tipper receive personal benefit and citing some cases supporting this proposition); INSIDER TRADING SUPP., *supra* note 1, § 5.4.3, at 212-13 (same). *But see* SEC v. Willis, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (dictum) (stating that misappropriation doctrine does not require showing of "personal benefit" to tipper); SEC v. Musella, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989) (dictum) (same). *But cf.* United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993) (holding that misappropriating tipper can violate rule 10b-5 even if he or she does not specifically know that his or her leak would lead to tippee trading; this holding may suggest that plaintiff or prosecutor need not demonstrate personal benefit in misappropriation cases).

82. *Cf.* INSIDER TRADING, *supra* note 1, § 5.4.4, at 383-85 (discussing whether "know or should know" test applies to misappropriation and mentioning cases discussing this proposition); INSIDER TRADING SUPP., *supra* note 1, § 5.4.4, at 214-15 (same). *But see* United States v. Mylett, 97 F.3d 663, 668 (2d Cir. 1996) ("Rule 10b-5 requires that the defendant [tippee of a misappropriator] subjectively believe that the information received was obtained in breach of a fiduciary duty.") (citing *United States v. Chestman,* 947 F.2d 551, 570 (2d Cir. 1991) (en banc)).

For discussion of the liability of remote tippees of a misappropriator, see INSIDER TRADING, *supra* note 1, § 5.4.6, at 387-89; INSIDER TRADING SUPP., *supra* note 1, § 5.4.6, at 217-21.

For discussion of a misappropriating tipper's liability when the tippee trades but is not liable, see INSIDER TRADING, *supra* note 1, § 5.4.5, at 385-89; INSIDER TRADING SUPP., *supra* note 1, § 5.4.5, at 216-17.

The analyst's firm does exactly what Ms. Tycoon intends. It transacts for its own account and tips favorite clients, who trade massive amounts of stock.

Has anyone violated rule 10b-5? In my opinion, the answer is yes.[83] Nevertheless, many, if not most commentators, say there is no violation.[84] The analyst and the stockbrokerage firm are not in the "classical relationship" triangle. They have breached no duty to the information source (Ms. Tycoon's company); so there is also no misappropriation.

Is the corporation liable for tipping? The corporation has a "classical relationship" with its own shareholders.[85] It cannot trade its own shares based on material, nonpublic information.[86] If corporate trading would violate rule 10b-5, corporate tipping for a "personal benefit" is also illegal.[87]

Many commentators, however, feel that a corporation can never receive a "personal benefit." Only human beings can have a "personal benefit." Therefore, the corporation is not liable.[88]

I disagree. A corporation, as an entity, can obtain reciprocal benefits by tipping analysts and others. A corporation, as an entity, can receive an improper "personal benefit." *If* the corporation is liable for tipping, its tippees may also be liable as participants after the fact.[89]

Dictum in *Dirks v. SEC*[90] may suggest a reluctance to regulate analysts' use of material nonpublic information because analysts help to preserve a

---

83. *See* INSIDER TRADING, *supra* note 1, § 5.2.3.3(b), at 302-05 (arguing that issuer should be liable whenever it selectively discloses material nonpublic information about itself with expectation that recipient will trade on tip); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(b), at 153-61 (same).

84. *See* INSIDER TRADING, *supra* note 1, § 5.2.3.3(b), at 302 n.83 (citing sources that suggest that issuer tips are lawful, even if they result in trading advantage for recipient); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(b), at 153 n.83 (same).

85. *See* INSIDER TRADING, *supra* note 1, § 5.2.3.3(a), at 297-302 (explaining that issuer has "classical relationship" with its shareholders); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(a), at 152-53 (same).

86. *See* INSIDER TRADING, *supra* note 1, § 5.2.3.3(a), at 297-302 (stating that issuer violates rule 10b-5 by trading its own stock based on material nonpublic information); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(a), at 152-53 (same).

87. *See* INSIDER TRADING, *supra* note 1, § 5.2.3.3(b), at 302-05 (arguing that liability should result when tipping corporation gains improper personal benefit); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(b), at 153-61 (same). For discussion of the "personal benefit" test for insider/tippers under the "classical relationship" theory, see INSIDER TRADING, *supra* note 1, § 5.2.8, at 336-43; INSIDER TRADING SUPP., *supra* note 1, § 5.2.8, at 174-81; *supra* notes 75-79 and accompanying text.

88. Some of these commentators are cited in INSIDER TRADING, *supra* note 1, § 5.2.3.3(b), at 302 n.83; INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(b), at 153-54.

89. For discussion of the tippee's participation after the fact in the tipper's violation under the "classical relationship" theory, see INSIDER TRADING, *supra* note 1, §§ 5.3.1, 5.3.2, at 344-46; INSIDER TRADING SUPP., *supra* note 1, §§ 5.3.1-5.3.2, at 181-83; *supra* note 80 and accompanying text.

90. 463 U.S. 646, 658 (1983) ("Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an in-

"healthy market."[91] Commentators disagree on the significance of this dictum.[92]

In any event, this is an unsettled area of the law. Without addressing when selective disclosure violates rule 10b-5, the SEC has proposed a rule designed to prevent publicly traded companies from selectively disclosing material nonpublic information.[93]

---

sider and trades on it could have an inhibiting influence on the roles of the market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.") (footnote omitted).

91. *See id.* at 657-58 & nn.16-18 (recognizing value of analysts in ferreting out and analyzing information and preserving healthy market); *see also* INSIDER TRADING, *supra* note 1, § 5.2.3.6, at 316 & n.139 (discussing this dictum in *Dirks*); INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.3(b), at 155-56 n.87 (same).

92. *See* sources cited in INSIDER TRADING, *supra* note 1, §§ 5.2.3.6, at 316 & n.139; INSIDER TRADING SUPP., *supra* note 1, § 5.2.3.6, at 165-66 n.139. *Cf.* 130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement of Rep. Dingell) (anticipating that courts will be careful "to avoid unduly inhibiting traders from generating and acting upon valid research information of the sort upon which efficient markets necessarily depend"); LOUIS LOSS & JOEL SELIGMAN, 8 SECURITIES REG. 3590, 3609 (3d ed. 1991) (describing dictum from *Dirks* as "paean to the analyst"); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1037-54 (1990) (questioning special treatment given to analysts under insider trading rules); Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1120-24 (1985) (criticizing special treatment of analysts).

93. On December 20, 1999, the SEC proposed Regulation FD (Fair Disclosure), which provides in part:

> § 243.100 General rule regarding selective disclosure.
> (a) Except as provided in paragraph (b) of this section, whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person or persons outside the issuer, the issuer shall:
> (1) In the case of an intentional disclosure, make public disclosure of that information simultaneously; and
> (2) In the case of non-intentional disclosure, make public disclosure of that information promptly.
> (b) Paragraph (a) of this section shall not apply when a disclosure is made to a person who owes a duty of trust or confidence to the issuer (including, for example, an outside consultant such as an attorney, investment banker, or accountant) or to a person who has expressly agreed to maintain such information in confidence.
> § 243.101 Definitions
> For purposes of this Regulation FD (§ 243.101), the following definitions shall apply:
> (a) Intentional. A selective disclosure of material nonpublic information is "intentional" when the individual making the disclosure either knew prior to the disclosure, or was reckless in not knowing, that he or she would be communicating information that was material and nonpublic.
> (b) Issuer. Every issuer having securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or which is required to file reports under Section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), including closed-end investment companies (as defined in Section 5(a)(2) of the Investment Company Act of 1940) (15 U.S.C. 80a-5(a)(2)) but not including other investment companies, shall be subject to this Regulation.

G. *Concluding Comments*

Section 10(b) and SEC rules 10b-5 and 14e-3 are only some of the federal statutes and regulations governing insider trading and tipping. As

---

> (c) Person acting on behalf of an issuer. Any officer, director, employee, or agent of an issuer, who discloses material nonpublic information while acting within the scope of his or her authority, shall be considered to be a "person acting on behalf of the issuer." An officer, director, employee, or agent of an issuer who discloses material nonpublic information in breach of a duty of trust or confidence to the issuer shall not be considered to be acting on behalf of the issuer.
>
> (d) Promptly.
>
> (1) "Promptly" shall mean disclosure as soon as reasonably practicable (but in no event more than 24 hours) after a senior official of the issuer (or, in the case of a closed-end investment company, a senior official of the issuer's investment advisor) knows, or is reckless in not knowing, of the non-intentional disclosure.
>
> (2) For purposes of paragraph (d)(1) of this section, a "senior official" means any director, any executive officer (as defined in § 240.3b-7 of this chapter), any investor relations or public relations officer, or any other person with similar functions.
>
> (e) Public Disclosure.
>
> (1) Except as provided in paragraph (e)(2) of this section, an issuer shall make the "public disclosure" of information required by § 243.100(a) of this chapter by filing with the Commission a Form 8-K (17 CFR 249.308) disclosing that information, or if the issuer is a foreign private issuer it shall file a Form 6-K (17 CFR 249.306).
>
> (2) An issuer shall be exempt from the requirement to file a Form 8-K or Form 6-K if it instead does one of the following:
>
> (i) Disseminates a press release containing that information through a widely circulated news or wire service; or
>
> (ii) Disseminates the information through any other method of disclosure that is reasonably designed to provide broad public access to the information and does not exclude any members of the public from access, such as announcement at a press conference to which the public is granted access (e.g., by personal attendance or by telephonic or other electronic transmission).

SEC Rel. Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99 (Dec. 20, 1999), 1999 WL 1217849, *38-*39 (S.E.C.), *available in* <www.sec.gov./rules/proposed/34-42259.htm.>. For the text of the entire proposed rule, see 1999 WL 1217849 at *37-40.

In its release accompanying the proposed regulation, the Commission noted that it was not addressing the insider trading issues raised in *Dirks* but instead was proposing adoption of Regulation FD under its authority to require disclosure by issuers, primarily under Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1999). *See* 1999 WL 1217849 at *6.

For additional discussion of the proposed Regulation FD, see 1999 WL 1217849, at *2-17, *27-30, *32-35.

For description of a possible leak to at least one analyst in advance of the public announcement and a brief discussion of the pressure to leak and the legal issues, see Susan Pulliam, *Abercrombie & Fitch Ignites Controversy Over Possible Leak of Sluggish Sales Data*, WALL ST. J., Oct. 14, 1999, at C1.

On December 20, 1999, the Commission also proposed rule 10b5-1 and rule 10b5-2, dealing with various aspects of insider trading regulation. For discussion of these two rules, see *supra* note 66.

briefly mentioned earlier,[94] federal mail/wire fraud is an important weapon in *criminal* prosecutions of insider trading defendants.[95] Congress, the SEC and the courts have built a complicated patchwork of laws and regulations to deal with the problem of insider trading. A complete description is beyond the scope of this Article.[96]

V. UNDER FEDERAL SECURITIES LAW, WHAT ARE SOME REMEDIES AND SANCTIONS AGAINST A STOCK MARKET INSIDER TRADER OR TIPPER?

Under federal securities law, who can bring a *private* civil action against a stock market insider trader or tipper? Again, I shall rely on the generic defect used car hypothetical.[97]

Suppose a federal statute provides: "Thou shalt not commit fraud in connection with the purchase or sale of a used automobile." Further assume that the law creates a private cause of action. Who should be able to sue Greedie under the statute? At least three alternatives exist.[98]

First, the courts could hold that Greedie's sale triggered a duty to disclose to some larger group of 1998 Cadillac buyers. An example of such a group would be all those buying 1998 Cadillacs around the same time as Greedie's sale.[99] (An even larger possible group would be all those buying between the time of his sale and public disclosure of the defect).[100]

---

94. *See supra* text accompanying note 74.

95. *See* INSIDER TRADING, *supra* note 1, § 11, at 733-60 (discussing application of federal mail and wire fraud statutes to insider trading and tipping); INSIDER TRADING SUPP., *supra* note 1, § 11, at 345-63 (same).

Thus far, the courts have not explored the insider trader's mail/wire fraud duty to disclose to *the party on the other side of the trade.* Under this unexamined obligation, a stock market insider trader might conceivably have a duty to disclose to the party on the other side even in the absence of a "classical relationship." For discussion of the insider trader's possible mail/fraud duty to disclose to the party on the other side of the trade, see INSIDER TRADING, *supra* note 1, § 11.3.2.2; INSIDER TRADING SUPP., *supra* note 1, § 11.3.2.2, at 361-63. For discussion of the rule 10b-5 "classical relationship" theory, see INSIDER TRADING, *supra* note 1, §§ 5.2, 5.3, at 283-354; INSIDER TRADING SUPP., *supra* note 1, §§ 5.2, 5.3, at 144-86; *supra* notes 57-65 and accompanying text.

96. For discussion of the federal law regulating insider trading, see INSIDER TRADING, *supra* note 1, §§ 4.1-6.14, at 119-546, 9.1-12.4, at 685-806, 15.1-15.12, at 993-1103; INSIDER TRADING SUPP., *supra* note 1, §§ 4.1-6.14, at 35-264, 9.1-12.3.2 at 321-91, 15.1-15.11.4 at 603-38.

97. For a discussion of this hypothetical, see *supra* Part I.

98. *See* INSIDER TRADING, *supra* note 1, § 6.9, at 484-87 (discussing four alternatives in context of stock market insider trading (variants of three following alternatives)).

99. *See id.* §§ 6.5, at 444-55, 6.9 at 485-86 (discussing contemporaneous trader plaintiffs against stock market insider trader); INSIDER TRADING SUPP., *supra* note 1, § 6.5, at 245-46 (same).

100. *Cf.* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (finding liability to "not only the purchasers of the actual shares sold by the defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in the possession

This is a bootstrap means of artificially manufacturing fraud and can lead to absurdly large civil liability. Greedie would be liable for the losses of all those throughout the world who bought a 1998 Cadillac around the time of his sale (or between his sale and public disclosure). The sum of all these losses might be huge.

To avoid that result, Greedie's total liability could be limited to the amount of his profit, or loss avoided. Suppose he sold his car for $25,000, and the price fell to $15,000 after the public announcement. His profit, or loss avoided, would be $10,000. That $10,000 could be spread among all those buying 1998 Cadillacs around the same time as his sale (or all those buying between the time of Greedie's sale and public disclosure). This spreading could result in each plaintiff receiving a trivial amount.

Second, the courts could hold that the only private civil plaintiffs allowed are those who can demonstrate harm from Greedie's sale itself.[101] This would require that the plaintiff demonstrate that he or she is *the* preempted seller or *the* induced buyer harmed by Greedie's *act* of selling.[102] Such parties may be the most appropriate private civil plaintiffs; but, in practice, these victims are not identifiable. Consequently, no private civil plaintiff could sue.

Third, the courts could allow a suit by the party on the other side of the trade, the dealer.[103] The courts could conclusively presume harm, even when it is absent.

Under United States securities law, who can sue a *stock market* insider trader or tipper? Congress has granted "contemporaneous traders" an express private cause of action against insider traders and tippers who violate federal securities law.[104]

---

of the defendants"); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,377, at 98,877-78 (S.D.N.Y. 1975) (holding defendants liable to all purchasers of Douglas stock from time of first illegal insider sale to full public disclosure); INSIDER TRADING, *supra* note 1, §§ 6.5.2, at 446-47, 6.9, at 484-85 (discussing two *Shapiro* opinions); INSIDER TRADING SUPP., *supra* note 1, § 6.5.2, at 245 (same); Veronica M. Dougherty, *A [Dis]semblance of Privity: Criticizing the Contemporaneous Trader Requirement in Insider Trading*, 24 DEL. J. CORP. L. 83, 86, 116-22, 139-43 (1999) (arguing that plaintiff class against stock market trader should include all those who traded between time of inside trade and public disclosure); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1256-62, 1282-83 (1981) (discussing two *Shapiro* opinions); *see also* Dougherty, *supra*, at 97-101 (discussing Second Circuit opinion in *Shapiro*).

101. *See* INSIDER TRADING, *supra* note 1, §§ 6.6, at 455-65, 6.9, at 486 (discussing plaintiffs who can demonstrate harm from act of insider trading); INSIDER TRADING SUPP., *supra* note 1, § 6.6, at 246 (same).

102. *See supra* Part II (discussing induced and preempted traders).

103. *See* INSIDER TRADING, *supra* note 1, §§ 6.7, at 465-79, 6.9, at 486 (discussing plaintiffs on other side of stock market insider trade); INSIDER TRADING SUPP., *supra* note 1, § 6.7, at 246-50 (same).

104. *See* Securities Exchange Act of 1934, § 20A, 15 U.S.C. § 78t-1 (1994), *reprinted in* INSIDER TRADING, *supra* note 1, § 6.2, at 397 n.2; INSIDER TRADING, *supra*

"Contemporaneous" roughly means "around the same time."[105] If the defendant *purchases* or tips someone who buys, the "contemporaneous traders" would be *sellers* of the same stock between the precise time of the insider trade and shortly thereafter.[106] If the defendant *sells* or tips someone who sells, the "contemporaneous traders" would be *buyers* of the same stock between the precise time of the insider trade and shortly thereafter.[107]

In this express cause of action, the insider trader's total liability to these "contemporaneous traders" is limited to the insider trader's profit or loss avoided (minus any amounts paid by the defendant in an equitable action for disgorgement[108] brought by the SEC).[109] A tipper is liable jointly and severally with those "to whom the communication was directed."[110]

"Contemporaneous" traders are not necessarily the victims of the *act* of insider trading (as opposed to the accompanying nondisclosure). The real victim might be an induced trader who transacted well after the insider trade (but before public disclosure). The real victim might be a preempted trader, someone who did not trade at all.[111]

Nevertheless, Congress' solution does manage to create private civil plaintiffs. Congress' approach also enables a class action.

---

note 1, § 6.2, at 395-99 (discussing § 20A; INSIDER TRADING SUPP., *supra* note 1, § 6.2, at 223-28 (same)).

For discussion of whether "contemporaneous" traders have both an express and an *implied* cause of action for damages against stock market insider trading defendants, see INSIDER TRADING, *supra* note 1, § 6.3, at 400-12; INSIDER TRADING SUPP., *supra* note 1, § 6.3, at 228-32.

105. *See* INSIDER TRADING, *supra* note 1, § 6.4, at 412-15 (discussing case law defining "contemporaneous"); INSIDER TRADING SUPP., *supra* note 1, § 6.4, at 232-45 (same).

106. *See* INSIDER TRADING, *supra* note 1, §§ 6.4.1, at 415-17, 6.4.2, at 418-30 (discussing judicial interpretations of meaning of "contemporaneous"); INSIDER TRADING SUPP., *supra* note 1, §§ 6.4.1, at 232-33, 6.4.2, at 233-37 (same).

107. *See* INSIDER TRADING, *supra* note 1, §§ 6.4.1, at 415-17, 6.4.2, at 418-30 (discussing judicial interpretation of meaning of "contemporaneous"); INSIDER TRADING SUPP., *supra* note 1, §§ 6.4.1, at 232-33, 6.4.2, at 233-37 (same).

For an argument in favor of abandoning the "contemporaneous" requirement and allowing suit by all opposite-type traders from the time of the insider trade to public disclosure, see Dougherty, *supra* note 100, at 86, 116-22, 139-43.

108. For discussion of the SEC's power to seek disgorgement, see INSIDER TRADING, *supra* note 1, § 7.3.2, at 571-80; INSIDER TRADING SUPP., *supra* note 1, § 7.3.2, at 286-94; John H. Sturc & Russell T. Goin, *Disgorgement: A Primer*, 32 REV. SEC. & COMMODITIES REG. 153 (1999).

109. *See* INSIDER TRADING, *supra* note 1, § 6.2, at 398 & n.5 (describing § 20A's ceiling on damages).

110. *See* Securities Exchange Act of 1934, § 20A(c), 15 U.S.C. § 78t-1(c) (1994), *reprinted in* INSIDER TRADING, *supra* note 1, § 6.2, at 397-98 n.2 (providing that individual who communicates inside information is liable jointly and severally with person "to whom the communication was directed"). For discussion of § 20A(c), see INSIDER TRADING, *supra* note 1, § 6.2, at 399; INSIDER TRADING SUPP., *supra* note 1, § 6.2, at 224.

111. *See supra* Part II (discussing induced and preempted traders).

The statutory cause of action for "contemporaneous traders" specifically states that it does not supplant any other implied private cause of action the courts create.[112] I think that the courts would also allow the party on the other side of the transaction to sue, at least for rescission.[113] Indeed, § 20A of the Securities Exchange Act itself may create an express statutory cause of action for rescission by the party on the other side of the insider trade.[114] In my opinion, the party in privity with the insider trader may also bring an implied action for *damages* against a defendant liable under the "classical relationship" theory.[115]

It is even possible that contemporaneous traders might be able simultaneously to bring two causes of action for *damages* against an insider trading defendant. The first action would be an express one under the statute. The second claim would be an *implied* cause of action under SEC rule 10b-5.[116]

Private civil remedies are not the only sanctions against a stock market insider trader or tipper who violates federal securities law. The SEC can go to court to obtain various forms of civil relief and civil penalties against stock market insider traders and tippers who violate the law,[117] including either or both of the following:

---

112. *See* Securities Exchange Act of 1934 § 20A(d), 15 U.S.C. § 78t-1(d) (1994), *reprinted in* INSIDER TRADING, *supra* note 1, § 6.2, at 397-98 n.2 ("Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this title."). For discussion of § 20A(d), see INSIDER TRADING, *supra* note 1, §§ 4.9.1, at 259 n.15 and accompanying text, 4.9.2, at 270 n.47, 6.3, at 405-10 & nn.22, 24, 26, 36-40, 50, 6.8, at 479-84; INSIDER TRADING SUPP., *supra* note 1, § 6.3, at 229-32, § 6.8, at 250-51.

113. *See* INSIDER TRADING, *supra* note 1, § 4.9, at 248-77 (discussing rescission as remedy against stock market insider trader); INSIDER TRADING SUPP., *supra* note 1, § 4.9, at 139-42.

114. *See* INSIDER TRADING, *supra* note 1, § 4.9.4, at 273-76 (discussing whether § 20A creates statutory cause of action for recission); INSIDER TRADING SUPP., *supra* note 1, § 4.9.4, at 142 (same).

115. *See* INSIDER TRADING, *supra* note 1, § 6.8, at 479-84 (discussing whether § 20A precludes party on other side of insider trade from bringing implied action for damages against someone liable under "classical relationship" theory); INSIDER TRADING SUPP., *supra* note 1, § 6.8, at 250-51 (same).

116. *See* INSIDER TRADING, *supra* note 1, § 6.3, at 400-12 (discussing whether contemporaneous traders have both express and implied action for damages); INSIDER TRADING SUPP., *supra* note 1, § 6.3, at 228-32 (same).

Allowing contemporaneous traders both an implied and an express action for damages would still not make the plaintiffs whole if, with both claims, the insider trading profit is spread pro rata among the members of the plaintiff class. Even after recovery of damages under both causes of action, each plaintiff would receive only a small portion of his or her actual loss. *See* INSIDER TRADING, *supra* note 1, § 6.3, at 401-02 & nn.6-9; INSIDER TRADING SUPP., *supra* note 1, § 6.3, at 229.

117. *See* INSIDER TRADING, *supra* note 1, § 7.3, at 564-614 (detailing enforcement remedies available to SEC); INSIDER TRADING SUPP., *supra* note 1, § 7.3, at 281-317 (same).

(1) disgorgement[118] of the profit (or loss avoided) for the benefit of so-called "victims" (generally contemporaneous opposite-type traders)[119]; (2) up to three times the profit (or loss avoided) for payment as a civil penalty to the United States Treasury.[120]

In addition to the *civil* remedies and penalties obtainable by the SEC, the Justice Department can seek criminal penalties for stock market insider traders and tippers who violate federal law.[121] In short, the SEC and the Justice Department may ask a court to impose on a stock market insider trading defendant a variety of equitable remedies, civil penalties, and criminal sanctions.[122]

VI. SUMMARY

A. *Is the* Act *of Stock Market Insider Trading a Victimless Crime?*

Each *act* of stock market insider trading has specific, although *anonymous,* victims. This Article employed two used car analogies: the solitary defect hypothetical and the generic defect hypothetical.

In the solitary defect example, Mr. Greedie owns a 1998 Cadillac and discovers that his particular automobile has a major defect. He goes to a dealer and sells it. Greedie either lies to the dealer or fails to disclose the flaw. The dealer discovers the defect and is stuck with the faulty car.

In the solitary defect hypothetical, only one automobile is a lemon. In contrast, in the generic defect situation, many individuals are buying and selling cars, *all* the same year model and *all* with the same defect.

The *generic* defect example resembles stock market insider trading, especially large block trades between an institutional investor and a block positioner. Such block transactions have aspects of face-to-face dealing.

In the generic defect hypothetical, Mr. Greedie, an executive employed by General Motors, receives material, nonpublic information that *all* 1998 Cadillacs have a major defect. By coincidence, Greedie personally

118. *See* INSIDER TRADING, *supra* note 1, § 7.3.2, at 571-80 (discussing SEC obtained disgorgement of ill-gotten profits); INSIDER TRADING SUPP., *supra* note 1, § 7.3.2, at 286-94 (same); Sturc & Goin, *supra* note 108, at 154, 157 (discussing SEC's power to seek disgorgement from insider trading defendants).

119. *See* INSIDER TRADING, *supra* note 1, § 7.3.2, at 571 n.32 (discussing to whom disgorgement of insider trading profits is awarded).

120. *See id.* § 7.3.3, at 581-89 (discussing civil monetary penalty obtainable in court by SEC); INSIDER TRADING SUPP., *supra* note 1, § 7.3.3, at 294-99 (same). For a discussion of the civil monetary penalty that the court may impose on a "controlling person" of someone who engages in illegal insider trading or tipping, see INSIDER TRADING, *supra* note 1, §§ 7.3.3, at 582 n.52, 588-89, 13.2.2, at 813-19; INSIDER TRADING SUPP., *supra* note 1 §§ 7.3.3, at 296, 13.2.2, at 398.

121. *See* INSIDER TRADING, *supra* note 1, §§ 7.1.2, at 549, 7.2, at 552-64 (discussing criminal liability for securities fraud and for insider trading); INSIDER TRADING SUPP., *supra* note 1, § 7.2, at 269-81.

122. *See* INSIDER TRADING, *supra* note 1, §§ 7, at 547-672 (discussing government enforcement against securities fraud and insider trading); INSIDER TRADING SUPP., *supra* note 1, § 7, at 265-317 (same).

owns a 1998 Cadillac and immediately sells it to a car dealer. (Assume in the alternative that (1) the dealer does not ask Greedie about any defect, or (2) the dealer asks Greedie about defects, and Greedie *lies.*) During the period between Greedie's sale and the time of the defect's public announcement, many individuals are buying and selling 1998 Cadillacs, *all* with the same defect.

At the time of the defect's announcement, there are a fixed number of 1998 Cadillacs. If Greedie has one less Cadillac at the time of the public announcement, someone else must have one more. That someone is the victim of Greedie's sale. I call this "the law of conservation of used automobiles."

If Greedie's sale of one car on inside information to the automobile dealer causes even a slight lowering of the dealer's prices for 1998 Cadillacs, that decline *may* dissuade or induce a transaction. If the dealer's prices do not change (or if the price declines fail to dissuade or induce a trade), the loss falls on the car dealer (an induced buyer). Under the "law of conservation of used automobiles," Greedie's sale *must* induce a purchase or preempt a sale.

In order to identify the victim, one must determine the prices the dealer would have charged absent Greedie's sale. Then, one must ascertain how the public would have reacted to these prices. This information is unknowable.

The *generic* defect used car analogy demonstrates two points. First, each act of insider trading has one or more particular victims. Second, these victims are anonymous. They exist, but, practically, cannot be identified.

The "law of conservation of used automobiles" is similar to the "law of conservation of *securities*" and stock market insider trading. Assume that the outstanding number of shares of a company remains constant between the time of the insider trade and public disclosure. Let us focus on the shares outstanding at the time of public disclosure.

With an insider *purchase* of stock, the insider has more of that issue at public disclosure. Someone else must have less. That someone is worse off because of the insider trade.

With an insider *sale* of shares, the insider has less of that issue at public disclosure. Someone else must have more. That someone is worse off because of the insider trade.

The "law of conservation of securities" shows that each stock market insider trade *must* induce an adverse trade and/or preempt an advantageous transaction. The price move after public disclosure enriches the insider trader. This gain (or loss avoided) corresponds to the loss (or gain avoided) of the induced and/or preempted trader. Society's antipathy towards stock market insider trading is based on the unjust enrichment of the insider trader at the cost of the *anonymous* victims of the trade.

The law of conservation of securities demonstrates that the insider trade is a *but-for* cause of injury to specific victims. Whether the insider trade is a *proximate* cause of harm is a separate issue.[123] Nevertheless, if the insider trade is not even a but-for cause of injury, liability is much less likely.

If the public becomes aware of insider trading, the prices of stocks generally may decline (although estimating the risk would be difficult). If the employees of a *particular* corporation acquire a reputation for trading on nonpublic information, that specific company's stock may decrease in price. *Such declines would increase the cost of capital of particular companies or of publicly traded corporations generally.*

Ex ante, these price decreases might partially compensate new buyers for the risk of being victims of stock market insider trading (although, as mentioned earlier, estimating the risk would be difficult). Even ex ante, frequent traders definitely suffer harm from insider trading. The risk of injury from insider trading varies with the frequency of one's trades or "near trades." (Ex post, victims of a stock market insider trade are *disproportionately* injured even if they originally purchased their stock at a price that accurately reflected the possibility of insider trading.)

Because market-makers transact so often, they are especially exposed to the risk of harm from insider trading (although they may sometimes pass the injury to others prior to disclosure by altering prices and thereby readjusting inventory to the level preferred). Ex ante, the presence of insider trading may cause specialists and market-makers to widen their spreads to compensate for the risk of becoming a victim. This increase in spreads would harm all public trading investors, but especially those who trade *often*. Again, ex ante, frequent traders would bear the brunt of the injury from insider trading. In addition, the increase in bid-ask spreads may deter investors from trading and thereby decrease the liquidity of the market.

As with pornography, whether insider trading has victims, affects, but does not resolve the question of how strictly to regulate it. A full discussion of the arguments for and against regulation is beyond the scope of this Article.[124]

B. *Is Stock Market Insider Trading Fraud?*

Stock market insider trading has some features of fraud, but differs from traditional fraud in several ways. Disclosure to the party on the other side or to the public may breach other duties. Also, such disclosure would

123. For discussion of when insider trading or tipping violates federal securities law, see *supra* Part IV text and notes 50-96. This part is summarized below under the question, *"When Does Stock Market Insider Trading or Tipping Violate Federal Securities Law?"*

124. For an extensive discussion of the arguments for and against regulation of stock market insider trading, see INSIDER TRADING, *supra* note 1, §§ 2.1-3.6, at 13-117; INSIDER TRADING SUPP., *supra* note 1, §§ 2.1-3.5.1, at 3-34.

not save the victim of the insider trade if the victim is a preempted trader. Whether a court classifies insider trading as fraud depends in part on whether the court is judicially conservative or activist.

C. *When Does Stock Market Insider Trading or Tipping Violate Federal Securities Law?*

Despite the differences between stock market insider trading and traditional fraud, the United States Supreme Court has endorsed two bases of insider trading liability under rule 10b-5: the "classical relationship" theory and the misappropriation doctrine. Rather than focus on the victims of the *act* of trading, the Court has focused on the victims of certain *independent* disclosure duties. These independent duties are breached by the nondisclosure that *accompanies* the stock market insider trade.

The "classical relationship" is a triangle involving (1) the issuer, (2) the insider trader/tipper and (3) the shareholder on the other side of the insider trade.[125] An employee or independent contractor of a company has a "classical relationship" with a corporate shareholder by virtue of a mutual relationship to the company. This relationship imposes a duty on the employee or independent contractor to disclose material, nonpublic information to the shareholder on the other side of the transaction.

The court treats the "classical relationship" as analogous to the solitary defect used car hypothetical. In reality, however, such stock market insider trading is comparable to the *generic* defect used car hypothetical.

The Court might respond as follows. Although the party on the other side of the stock market insider trade is not necessarily the victim of the *act* of insider trading, the party in privity is the victim of the *nondisclosure* accompanying the insider trade that breaches the *independent* duty to disclose created by the "classical relationship."

Under the misappropriation doctrine, stock market insider trading or tipping violates rule 10b-5 when the trade or tip breaches a fiduciary duty to the information source (*e.g.*, a direct or indirect employer), and the trader or tipper fails to disclose this breach to the information source before transacting.

The "classical relationship" and misappropriation theories cover, most, but not all, insider trading and tipping. This summary discusses only some of the federal statutes and SEC rules governing insider trading and tipping. Congress, the SEC and the courts have built a complex patchwork of laws and regulations to address the problem.

125. *See supra* Figure 4, at notes 58, 77 for a diagram of the "classical relationship" triangle.

D. *Under Federal Securities Laws, What Are Some Remedies and Sanctions Against a Stock Market Insider Trader or Tipper?*

In theory, the most appropriate private civil plaintiffs against a stock market insider trader or tipper might be the victims of the *act* of trading, the preempted and/or induced traders. In practice, however, these victims are not identifiable.

As a solution, Congress has granted "contemporaneous traders" an express private cause of action against insider traders and tippers who violate federal securities law. The real victims of the *trade* may not be in this class.

The statutory cause of action for "contemporaneous traders" specifically states that it does not supplant any other implied private cause of action the courts create. In my opinion, the courts would allow a party on the other side of an illegal insider trade to sue for rescission and for damages against a defendant liable under the "classical relationship" theory.[126] It is even possible that "contemporaneous traders" might be able simultaneously to bring both an express and an implied cause of action for damages against an insider trading defendant.[127]

Remedies in private suits are not the only sanctions against a stock market insider trader or tipper who violates federal law. The SEC and the Justice Department may go to court to impose on a stock market insider trader or tipper a variety of equitable remedies, civil penalties and criminal sanctions.

---

126. *See supra* notes 113-14 and accompanying text (discussing rescission of illegal insider trade).

127. *See supra* note 116 and accompanying text (discussing whether contemporaneous traders have both express and implied action for damages).