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Steven R. Salbu

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TIPPER CREDIBILITY, NONINFORMATIONAL TIPPEE TRADING, AND ABSTENTION FROM TRADING: AN ANALYSIS OF GAPS IN THE INSIDER TRADING LAWS

Steven R. Salbu*

Abstract: The regulation of insider trading in the United States prohibits only a fraction of the kind of behaviors which the Securities and Exchange Commission sought to curb in the 1930s. This Article explains the problems created by trading on tipper credibility and noninformation, as well as the difficulties associated with insider abstention from trading. These practices are conceptually akin to trading on inside information, yet they fall beyond the purview of existing prohibitions. The Article examines potential vehicles for rendering the regulations more consistent, including authorization of all insider trading, policing of information, the creation of inferences of fraud from circumstantial evidence, the prohibition of entire classes of trades, and the application of a reduced threshold "fraudulent scheme" concept to trigger liability in loophole cases.

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* Assistant Professor, University of Texas at Austin. B.A., Hofstra University (1977); M.A., Dartmouth College (1980); J.D., The College of William and Mary (1980); M.A., Ph.D., The Wharton School of the University of Pennsylvania (1986, 1990). The author gratefully acknowledges the contribution of discussions with John Allison and Robert Prentice. This Article was written under a research grant provided by the Graduate School of Business at the University of Texas at Austin.

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INTRODUCTION

Law reviews are cluttered with articles concerning insider trading laws.[1] Legal scholars have analyzed the purposes and applications of Securities Acts and Exchange Acts,[2] most notably the Securities Act

1. *See infra* notes 2, 6–8. These references are intended to be illustrative of a vast body of literature regarding insider trading.

2. *See, e.g.*, David J. Guin & David R. Donaldson, *The Insider Trading and Securities Fraud Enforcement Act: Has Congress Supplied a Limitations Period Appropriate for Use in Private 10b-5 Actions?*, 47 WASH. & LEE L. REV. 541 (1990); Peter J. Henning, *Between* Chiarella *and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws*, 39 KAN. L. REV. 1 (1990); Jerry W. Markham, *"Front-running"—Insider Trading Under the Commodity Exchange Act*, 38 CATH. U. L. REV. 69 (1988); Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REVIEW 309 (1989); S.S. Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. ON LEGIS. 511 (1988).

of 1933,[3] the Securities Exchange Act of 1934,[4] the Commodities Exchange Act,[5] and applicable state laws.[6] Scholars have interpreted the rules promulgated by the Securities and Exchange Commission (SEC) under the federal acts,[7] and have made all manner of policy recommendations to Congress, the SEC, and the courts.[8] Behind the suggestions lie efforts at statutory construction, both historic and contemporary, as well as theoretical analysis from the fields of economics, ethics, and law. While the securities laws have been subject to minor modifications since their legislative inception in the 1930s, they remain essentially intact today. Yet something crucial is missing from the analysis: we have failed to address some evasive tactics that are seemingly immune from the law in its current configuration. In the pages that follow, I will attempt to persuade the reader that only a fraction of those who seek to exploit what I shall term "inside advantage" are dissuaded from doing so under existing law. Implicit in this statement is an assumption that use of inside advantage may be rampant, and that unlawful incidents of insider trading may form only a tiny fraction of a much larger sphere of undesirable behavior. In section I, I discuss the problem of insider abuse as it is currently addressed by existing insider trading laws. Section II describes the forms of inside advantage that are not technically insider trading and which, therefore, circumvent the reach of our present laws. Section III discusses

3. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (1988 & Supp. II 1990)).

4. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78ll (1988 & Supp. II 1990)).

5. 7 U.S.C. §§ 2–26 (1982 & Supp. II 1990).

6. *See, e.g.*, Christopher J. Bebel & Kenneth C. Vert, *State Takeover Laws, Insider Trading, and the Interplay Between the Two: A New Perspective*, 91 W. VA. L. REV. 1001 (1989); Don Berger, *Issuer Recovery of Insider Trading Profits Under Section 25502.5 of the California Corporation Code*, 21 PAC. L.J. 221 (1990).

7. *See, e.g.*, Gregory S. Crespi, *The Availability After* Carpenter *of Private Rights of Action Under Rule 10b-5 Based Upon the Misappropriation of Information Concerning Acquisitions*, 26 AM. BUS. L.J. 709 (1988); Willis W. Hagen II, *Insider Trading Under Rule 10b-5: The Theoretical Bases for Liability*, 44 BUS. LAW. 13 (1988); David M. Phillips, *An Essay: Six Competing Currents of Rule 10b-5 Jurisprudence*, 21 IND. L. REV. 625 (1988); Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391 (1991).

8. *See, e.g.*, H. Ward Classen, Basic, Inc., v. Levinson: *Is Silence Really Golden?*, 23 WAKE FOREST L. REV. 607 (1988); Richard J. Hunter, Jr. & Philip Frese, *The Genesis of an Ethical Imperative: The SEC in Transition*, 25 GONZ. L. REV. 9 (1989–90); Gary Lawson, *The Ethics of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 727 (1988); Saul Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 101 (1988); Bill Shaw, *Shareholder Authorized Inside Trading: A Legal and Moral Analysis*, 9 J. BUS. ETHICS 913 (1990); Roman Tomasic & Brendan Pentony, *Insider Trading and Business Ethics*, 13 LEGAL STUD. F. 151 (1989); Jonathan R. Macey, Comment, *Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 HARV. J.L. & PUB. POL'Y 785 (1988).

the feasibility and potential effectiveness of several proposed solutions. The conclusion provides comments of synthesis.

I. THE CURRENT REGULATORY APPROACH TO THE PROBLEM OF INSIDER TRADING

Under our current regulatory approach, insider trading is prohibited as a form of fraud.[9] The elements of fraud are intent, misrepresentation of fact, materiality of the fact misrepresented, reliance on the misrepresentation by the defrauded party,[10] and injury.[11] Because insider trading has been prohibited indirectly, subsumed within fraud rather than attacked explicitly, the impact of both common law[12] and regulation[13] on insider trading has been limited. The scope of our current approach to insider trading covers only a small fraction of the behaviors that are objectionable. The discussion that follows identifies the extent and limitations of coverage under our present regulatory system.

A. Liability Requires a Breach of Fiduciary Duty

Liability for silent trading is predicated upon a breach of a fiduciary duty. The execution of a trade breaching the duty constitutes fraud,

9. 17 C.F.R. § 240.10b-5 (1992). Rule 10b-5 states:

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

10. The reliance requirement has been somewhat relaxed in recent securities fraud cases, partially because it is difficult for a trader to prove that she would have acted differently in absence of the misrepresentation. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988) (creating a rebuttable presumption that the plaintiff relied on the misrepresentation as part of a defrauded market); Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 152–53 (1972) (dispensing with proof of the reliance element). Likewise, the requirement that the plaintiff prove a causal nexus between the defendant's act and the plaintiff's ostensible injury has been eroded over the years. By statutory provision, those who trade contemporaneously against the defendant in the relevant shares have a civil cause of action, provided they can prove the basic elements of fraud apart from specific causality. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter ITSFEA].

11. *See generally* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

12. Under the common law, a special relationship between parties was found to create an obligation to divulge inside information to the party to whom a duty was owed, or else to abstain from trading on that information. *See* Strong v. Repide, 213 U.S. 419 (1909).

13. *See* sources cited *supra* notes 3–4.

which is prohibited by rule 10b-5 as promulgated under the Securities and Exchange Act of 1934.[14] Trading on nonpublic information is unlawful under the rule only if the trading constitutes fraud.[15] Whereas cases through the 1960s essentially construed all trades made on inside information, regardless of the source, to constitute fraud,[16] criticism in the 1970s pressured the courts to scrutinize allegations more rigorously for the elements of fraud before establishing liability.[17] Where there is no express misrepresentation,[18] the fraud must be inferred from the act of silently trading despite a fiduciary duty either to disclose the relevant information or to abstain from dealing in the relevant securities.[19] Under this approach, misappropriation of information rather than inequality of information is the prohibited force.[20] A corporate insider, owing a fiduciary duty to the company that employs him, is bound by the duty to abstain from trading on nonpublic information.[21] A corporate outsider, such as a lawyer, accountant, consultant, or underwriter,[22] may be characterized as a "temporary insider," and thereby be bound by the same fiduciary duties as an insider.[23] Even an outsider who does not qualify as a temporary insider may nonetheless be held liable for trading on nonpublic information if the trade is in contravention of a fiduciary duty which the outsider owes to another.[24] An outsider or a temporary

14. 17 C.F.R. § 240.10b-5 (1992).

15. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

16. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

17. *See, e.g.*, Neil S. Cross & David S. Ruder, *Limitations on Civil Liability Under Rule 10b-5*, 1972 DUKE L.J. 1128, 1132 (suggesting that civil compensation be limited to parties injured by fraud and covered by privity of contract, and not extended to all simultaneous traders). *But see* LOUIS LOSS, SECURITIES REGULATION 1827–29 (2d ed. 1961) (observing the benefit of having the SEC litigate claims to protect an ostensibly large number of victims who suffer from an incident of insider trading).

18. This condition encompasses virtually all insider trading cases. Because the trades are made over anonymous securities markets, buyers and sellers seldom make any representations at all regarding the securities being transferred.

19. Fraud via misappropriation does not require that the breach of duty be directed to the shareholders of the stock being traded. Fraud can be inferred as well in cases of misappropriation from non-shareholder parties, such as one's employer. *See, e.g.*, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

20. The nature of the misappropriation requirement is discussed in detail in several recent cases. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting); Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied sub nom.* Moss v. Newman, 465 U.S. 1025 (1984).

21. *See* cases cited *supra* note 20.

22. *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

23. SEC v. Lund, 570 F. Supp. 1397, 1402–03 (C.D. Cal. 1983).

24. *See supra* note 19.

insider is liable for trading on inside information only if he owes a fiduciary duty to another, either by virtue of a special relationship thereto, or derived from a tipper of information.[25] The fiduciary duty requirement for insider trading liability reflects the Supreme Court's growing tendency to view the function of rule 10b-5 as protection against micro-transactional fraud rather than preservation of generic, macro-level market integrity.[26] While the nature of the unfair advantage held by insiders, temporary insiders, and outsiders may be indistinguishable, their liability for trading on that advantage varies dramatically, based on differences in the obligations they owe to the owners of the information.[27]

B. Liability Requires the Existence of Inside Information

Because fraud requires an express or implied misrepresentation of material fact,[28] insider trading claims based on fraud must be predicated on the utilization of factual information. Fraud does not exist when the misrepresentation is one of opinion rather than one of fact.[29] Virtually all recent insider trading cases entail transactions based on factual information, rather than on hints or suggestions of tacit or latent advantage.

SEC v. Texas Gulf Sulphur Co.,[30] for example, concerned trading on information regarding the discovery of ore at a company drilling site. *Chiarella v. United States*[31] involved information concerning planned tender offers. Although the prospective acquisitions were speculative

25. *See* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984). One who inadvertently overhears inside information in a public place is not liable for trading on that information, because the inadvertent inside tipper is benefited neither directly nor indirectly from the disclosure. *Id.* at 766. *But see* 17 C.F.R. § 240.14e-3 (1991) (forbidding trades by those in possession of nonpublic information of a tender offer, even if derived only indirectly from an insider).

26. For a discussion of the shortcomings of this approach, and the value of applying the federal securities laws to the maintenance of the integrity of national markets, see Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law,* 80 Nw. U. L. REV. 1473, 1487 (1986), observing as a general principle:

> To the extent federal law explicitly governs disclosure and/or substantive behavior in specific transactions, such as public offerings, proxy solicitations, and tender offers, courts should attempt to determine the *federal* policy or purpose underlying the statute or administrative regulation and to implement that policy or purpose without appeal to general principles of either federalism or full disclosure.

27. For a critique of this phenomenon, see Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information,* 73 GEO. L.J. 1083 (1985).

28. RESTATEMENT (SECOND) OF TORTS § 525 (1977).

29. *Id.* § 538A.

30. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

31. 445 U.S. 222 (1980). Chiarella was exonerated because he was neither an insider nor a tippee owing a fiduciary duty not to trade. I cite this case here not as evidence of liability, but as

at the time of trading, the existence of the proposals themselves was factual in nature. Perhaps the farthest a court has gone in stretching the "factual information" element of fraud concerned the prosecution of R. Foster Winans and stockbrokers at Kidder Peabody.[32] Winans revealed to the brokers the content and publication dates of future articles he wrote to appear in the "Heard on the Street" column of *The Wall Street Journal*.[33] Although the content of the articles was comprised of Winans' opinions, the district court viewed the details of their prospective publication as both material and factual,[34] finding a rule 10b-5 violation.[35] While the Second Circuit Court of Appeals affirmed this decision,[36] the Supreme Court was split on the issue of insider trading, limiting its finding of liability to the related issue of mail fraud.[37] The dates and content of future publications, while clearly factual in nature, are probably on the extreme end of what is likely to comprise factual information as required for a finding of fraudulent misrepresentation under rule 10b-5. There are apparently no cases to date in which a defendant has been held accountable for trading on opinions or credibility, even if the tip of opinion or credibility has been founded on undisclosed inside information.

C. *Liability Requires a Transaction*

Rule 10b-5 prohibits fraud "in connection with the purchase or sale of any security."[38] The court in *Chiarella* thus observed, "liability is premised on a duty to disclose which arises from a relationship of trust and confidence *between parties to a transaction*."[39] Because the gravamen of insider trading claims is fraud rather than the act of insider trading per se, liability focuses on injury sustained by a party in the process of a transaction, rather than market disintegration that may

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another example of a baseline requirement of factual information to support prosecution under the current insider trading regulations.

32. The pre-publication views to be contained in a *Wall Street Journal* investment column were viewed as opinions. The future publication of the information in the columns was viewed as factual, and as material in its impact upon market activity. United States v. Winans, 612 F. Supp. 827, 830 (S.D.N.Y. 1985), *aff'd in part, rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd,* 484 U.S. 19 (1987).

33. *Id.* at 833–35.

34. *Id.* at 830.

35. *Id.* at 849.

36. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986) (affirming rationale of district court but reversing conviction of Winans for conspiracy), *aff'g in part* United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), *aff'd,* 484 U.S. 19 (1987).

37. Carpenter v. United States, 484 U.S. 19 (1987) (4-4 decision).

38. 17 C.F.R. § 240.10b-5 (1992).

39. Chiarella v. United States, 445 U.S. 222, 230 (1980) (emphasis added).

result from wrongful but non-transactional behavior on the part of the defendant.[40]

The transaction threshold for rule 10b-5 liability began as a privity requirement, borne of a post-*Texas Gulf Sulphur*[41] desire to interpret the rule literally and conservatively.[42] Under common law, the element of fraud in rule 10b-5 should consist of an intentional misrepresentation, including silence when under a duty to speak, upon which the opposing party relies to her detriment in entering the transaction.[43] The element of inducement to enter a contractual transaction has traditionally been an essential element of the cause of action in fraud,[44] so that the securities laws derived thereunder focus on insider trading rather than insider decisions not to trade.

Given that the concept of fraud is derived from the law of contract and focuses on amelioration of deficiencies in inducement or execution of a transaction, the recent emphasis on privity is not surprising. Unfortunately, while the courts are restricting themselves under the guise of stricter statutory construction, they exacerbate the difficulties associated with tying a cause of action to an inappropriate doctrine of law.[45] Fraud is and always has been an inadequate and obliquely fash-

40. *See* Jeffrey P. Strickler, Note, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain,* 73 CAL. L. REV. 483, 510 (1985) (observing that rule 10b-5 liability focuses on the plaintiff's injury rather than the defendant's wrongful behavior).

41. I refer here to the Supreme Court's attempts in the 1980s to scrutinize insider trading claims carefully for the elements of fraud. For more detailed discussion of this trend, see Steven R. Salbu, *Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach,* 66 TUL. L. REV. 837, 843–46 (1992).

42. *See* Douglas M. Branson, *Prescience and Vindication: Federal Courts, SEC Rule 10b-5, and the Work of David S. Ruder,* 85 NW. U. L. REV. 613, 620–21 (1991) (discussing the tendency of more lenient federal courts in the 1950s through the 1970s to permit "recovery in cases in which privity could not exist for the reason that the defendant, usually a corporate issuer of shares, had not engaged in any securities transaction whatsoever").

43. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

44. The elements of privity and transaction have begun to separate as threshold rule 10b-5 requirements. While a transaction is still a necessary component of a private claim, the privity requirement has been substantially eroded by statutory contemporaneous trader standing, and the fraud on the market theory. Under the ITSFEA, those who have traded simultaneously and in the opposite direction of a defrauding party can sue that party without proving privity of contract. *See* sources cited *supra* note 10. The fraud on the market theory has also attenuated the privity element by creating a rebuttable presumption that all contemporaneous traders have relied on a misrepresentation, because that misrepresentation defrauds the entire market mechanism. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). The fraud on the market theory has been criticized for imposing excessive costs on investors. *See* Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets,* 78 VA. L. REV. 623 (1992).

45. Transactional causality and privity of contract have also been difficult logistical issues in the prosecution of insider trading cases because the anonymous marketplace depersonalizes exchanges. This is in part a justification for allowing civil claims to be made by all "contemporaneous traders" under the ITSFEA. ITSFEA, *supra* note 10.

ioned avenue for addressing the inequities and inefficiencies that result from unfair utilization of information.[46] If the law were concerned strictly with the fairness of securities markets, it would consider non-transactional inequities to be as compelling as those that result in a transaction.[47] This is because pecuniary advantage resulting from an inside trade is conceptually indistinguishable from the financial rewards resulting from inside decisions to hold stocks or refrain from purchasing stocks.[48] Yet the requirements of fraud restrict the law's ability to regulate the latter forms of abuse.[49]

II. THE INADEQUACY OF EXISTING REGULATORY POLICY

The approach to regulating insider trading discussed in the prior section has been criticized and evaluated on many levels.[50] Critics have generally restricted themselves to assessing the laws and regulations in existence, recommending minor changes rather than substantial modification which questions the entire approach.[51] In other words, the insider trading laws are ordinarily evaluated in terms of their effectiveness at thwarting the occurrence of trades made on misappropriated, nonpublic information. In accepting this framing of the problem as a starting point, we have circumvented important issues which have been implicitly resolved in the very process of framing. We assume that a misappropriation must exist in order for an outsider to be held liable for misconduct,[52] and that some form of factual information must be held by the defendant to establish culpability.[53] By accepting the judicial framing of the problem and working within that framework, we have allowed our scholarship to be funnelled into the evaluation of prefabricated issues. If we take a step back, we shall find

46. For a discussion of the inadequacy of fraud as the means of monitoring insider trading, see Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992).

47. *See infra* notes 136–37 and accompanying text.

48. *See infra* notes 136–37 and accompanying text.

49. In particular, the elements of causality and reliance prove intractable in regard to abstention from activity.

50. *See* sources cited *supra* notes 2, 6–8.

51. The notable exception is the body of scholarship recommending the abolition of all regulation of insider trading. *See, e.g.*, Henry G. Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113 (1966). Those scholars who believe in the ethical and economic justifications for regulation tend to limit their analyses to tinkering with small questions of statutory or regulatory interpretation or policy.

52. *See supra* notes 14–27 and accompanying text.

53. *See supra* notes 28–37 and accompanying text.

that the framing of the legal issues has masked some crucial problems regarding exploitation of inside advantage.

Because I have addressed in detail the shortcomings of the misappropriation requirement in previous articles,[54] I shall restrict my discussion here to a different set of regulatory imperfections. In particular, rule 10b-5 creates by omission a number of technicalities through which the rule's spirit and essential purpose can be circumvented while a trader remains technically within the bounds of the law.[55] These holes in our current regulatory approach are important for two reasons. First, they suggest that the effectiveness of our insider trading prohibitions is greatly overestimated, targeting only a fraction of the types of activities that can create market unfairness and inefficiencies. This deficiency may be self-perpetuating, as the misguided complacency engendered by the sense that we have already addressed the problem encourages us to reduce our vigilance. Second, as prospective participants in securities markets become more aware of the tactics available for evasion of civil and criminal sanctions, existing laws will become increasingly ineffective and irrelevant. We are likely to witness a growing reliance on the technical means of avoiding liability as market players become more aware of their options.

Three important gaps in our regulation of insider trading are covered in this section: trading on tipper credibility, trading on noninformation, and abstention from trading. The problems associated with credibility and noninformational tipping are a function of the non-finite nature of information, which falls along a continuum from highly definitive to highly vague,[56] and the difficulties associated with monitoring and regulating these varying degrees of information. Abstention from trading is troublesome because, although inactivity is beyond the technical purview of fraud, decisions to refrain from trad-

54. *See* Steven R. Salbu, *A Critical Analysis of Misappropriation Theory in Insider Trading Cases,* 2 BUS. ETHICS Q. 465 (1992); Steven R. Salbu, *A Legal and Economic Analysis of Insider Trading: Establishing an Appropriate Sphere of Regulation,* 8 BUS. & PROF. ETHICS J. 2 (1990).

55. The inadequacy of rule 10b-5 in inhibiting abusive practices may be in large part a function of unnecessarily restrictive application. While the judicial trend favors narrow interpretation of the rule, there is evidence that Congress intended, in the enabling language of section 10(b) of the 1934 Act, to grant the SEC substantially greater power than it currently wields. For a detailed discussion of the purposes of Congress in drafting section 10(b), see Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act,* 42 STAN. L. REV. 385 (1990).

56. Thus, for example, the problem of rumors, and the effect of speculative information on market efficiency, has proved to be a thorny one. *See, e.g.,* Thomas Lee Hazen, *Rumor Control and Disclosure of Merger Negotiations or Other Control-related Transactions: Full Disclosure or "No Comment"—The Only Safe Harbors,* 46 MD. L. REV. 954 (1987).

ing based on inside information are no more equitable than decisions to trade using that information.

A. Trading on Tipper Credibility

A tip, in the broad sense of the word, is simply advice given by one person to another to buy or sell a particular security at a particular time.[57] Under this definition, a tipper can develop the proclivity for or against a particular security either professionally or nonprofessionally,[58] and on the basis of inside information, public information, or both. A tippee who receives a tip to buy or sell the relevant security must, like any investor, assess the risk of the transaction, which will be partially a function of the tipper's credibility. A tip based on inside information is rationally advantageous if the tippee believes that the product of two elements—inside advantage and the likelihood of tip validity— outweigh the advantage obtained by that tippee's customary research. Since inside advantage is always valuable in markets driven by information, tipper credibility can be the crucial factor in a tippee's market decision.

While nonprofessional tippers are unlikely to have systematic access to inside information, professional tippers routinely obtain many bits of information, large and small, important and irrelevant, both publicized and confidential. The fact that professionals invariably receive nonpublic information forms a component of their credibility. Thus, a "bald tip"—a tip given by a professional with absolutely no justification—has the invisible power of potential insider information behind it. The tippee who has technically received no information from the bald tip has, nonetheless, received the laundered benefit of publicly unavailable information, the type of advantage which our laws otherwise attempt to eliminate. The tippee who trades on credibility comprised partly of inside information has probably not violated our present insider trading laws, yet his trade is fundamentally at odds with the ethical concerns those laws ostensibly address.

To understand how tippees trading on credibility can evade liability for insider trading, we must examine existing legal restraints upon tip-

57. I am intentionally using an extremely broad definition of tipping here, in order to distinguish later between tipping of inside information and tipping without divulgence of inside information. Some definitions of a tippee are more specific, and stipulate that a tip contains inside information. *See, e.g.*, WILLIS W. HAGEN II & GORDON H. JOHNSON, DIGEST OF BUSINESS LAW 236 (3d ed. 1986) (defining a tippee as the recipient of material nonpublic information).

58. The professionals most likely to have access to inside information include directors, officers, and managers of the firm at issue, as well as securities analysts, investment bankers, and attorneys who deal in securities or mergers and acquisitions.

pee trading, as well as their limitations. Under the present approach, a tippee is liable for insider trading only if (a) the tipper had a fiduciary duty appurtenant to the owner of the relevant information,[59] (b) the tipper breached that duty by knowingly divulging the information to the tippee,[60] and (c) the tippee knowingly traded upon that information.[61] Under this three prong test, a tippee can avoid liability in several ways.

If a tipper acts in good faith, unaware that the tippee will use the information to trade, then the tipper has not breached his duty.[62] Unless the tippee qualifies as a temporary insider under *SEC v. Lund*,[63] by virtue of a "special relationship with the corporation,"[64] the breach of duty must be derived from the tipper.[65] Even though the tippee evinces bad faith, he will be exonerated from liability in the event of a technical failure in tracing to the tipper a breach of duty.[66]

If the tippee has not received the underlying information, but is simply the beneficiary of the tipper's credibility, which includes generic access to nonpublic information, the tippee will lack the scienter required as an element of fraud.[67] Moreover, in order for the tipper to have breached his or her fiduciary duty, it is necessary that the tipper have received some personal benefit, direct or indirect, from the disclo-

59. *See* Dirks v. SEC, 463 U.S. 646 (1983). Under *Dirks*, a tippee's duty to disclose inside information or abstain from trading is derived from the duty of the tipper. The Court observes that the obligation to refrain from trading on inside information must be based on a fiduciary duty, and is not derived from one's mere "ability to acquire information because of [one's] position in the market." *Id.* at 657–58. The derivative duty requirement of tippee liability prohibits tippee trading only in instances wherein the tipper had a legal obligation to disclose the information or abstain from trading.

60. *Id.; see also* ITSFEA, *supra* note 10. The ITSFEA extended the power of *Dirks* by establishing the liability of those who control tippers by passing information to them which the tippers in turn deliver to trading tippees. While the ITSFEA suggests that the chain of liability can extend among numerous links in the tipping process which leads to the eventual trade, it does not dispense with the usual scienter requirements.

61. *See In re* Investors Management Co., 44 S.E.C. 633, 643 (1971) (creating a duty to disclose information or abstain from trading if the tippee "knew or had reason to know the information was nonpublic and had been obtained improperly by selective revelation or otherwise").

62. United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), *rev'd*, 773 F.2d 477 (2d Cir. 1985).

63. 570 F. Supp. 1397 (C.D. Cal. 1983) (holding a tippee to be a temporary insider regarding information he received for a legitimate purpose from the relevant firm's chief executive officer).

64. *Id.* at 1403.

65. *See Reed*, 601 F. Supp at 696.

66. *Id.* at 699.

67. Scienter requires intent to deceive. For a discussion of the scienter requirement in insider trading cases, see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195–97 (1976) (emphasizing the statutory language of section 10(b), which prohibits manipulation or deception, therein suggesting a scienter requirement).

sure.[68] In *Dirks v. SEC,*[69] the Supreme Court identified two situations in which this requisite benefit exists: (a) when the tipper expects compensation from the tippee,[70] and (b) when the tip, even if made without expectation of compensation, is given to a friend or relative.[71] This creates a situation in which tips received for consideration comprise a breach of fiduciary duty, whereas gratuitous tips that do not indirectly benefit the tipper fail to establish the requisite breach from which tippee liability might be derived.

Both tips that gain their value from generic credibility and tips given without consideration will confer substantial, unilateral benefit[72] upon the tippee if they are supported by inside information. The benefit is unilateral because its access is not universally shared within the market. The trades that result are made upon asymmetric information, yielding potential inefficiencies and inequities.[73] While the results are precisely the variety intended to be proscribed by rule 10b-5, they are lawful based on technicality of definition.[74]

In many instances, tips based on credibility rather than explicit information arguably confer indirect as well as direct benefit upon the tipper. I refer here specifically to the credibility of investment professionals, whose future business prospects are indirectly enhanced when their generic (as well as information-specific) recommendations prove successful to clients. Added to the compensation they receive for their services, professional investment advisors clearly meet the personal benefit test of *Dirks.*[75] Yet even if the benefit test is thus met, insuperable obstacles to both tipper and tippee liability often remain. The tippee cannot be held liable because the investment advice is generic rather than information-specific. While the tippee understands that there is a wealth of both public and inside information behind a sophisticated analyst's recommendations, he or she becomes insulated from liability because the scienter requirement[76] cannot be met when

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68. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983).

69. 463 U.S. 646 (1983).

70. *See id.* at 664.

71. *Id.*

72. I define a "unilateral benefit" as an informational advantage, based on information either explicitly or implicitly disclosed to the tippee, obtained by the tippee but not generally available to the public.

73. For a discussion of the effects of information asymmetry on market efficiency and fairness, see Salbu, *supra* note 46.

74. I have addressed this shortcoming of our existing insider trading laws in an earlier work. *See id.*

75. *See supra* notes 68–71 and accompanying text.

76. *See supra* note 67.

the tippee is intentionally denied the background information implicit in the tip.[77]

If a professional tipper is held to have received a benefit in the form of present and future consideration for services rendered, he or she is liable under the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)[78] for the tippee's profits, as long as the tipper's generic tip was predicated on actual inside information sufficient to establish the breach of fiduciary duty necessary under the misappropriation test.[79] Unfortunately, as we shall observe in the following section, professional investment analysts often receive "noninformation" tips which, while conferring significant advantage, are sufficiently vague to suggest a lack of scienter in originating the tip.

B. Trading on Noninformation

In this section, I address insider advantages that consist of something less than factual information, such as factual suspicions, shrouded or veiled information, and sensations communicated without language but rather by attitude, implication, enthusiasm, or a figurative wink. The section begins with a discussion of stock analysts' privileged relations with corporate insiders, and the opportunities they have for receiving noninformational advantage. This discussion is followed by an explanation of the economic and ethical problems that arise from such noninformational trading. The analysis culminates in an assertion and defense of the proposition that informational and noninformational insider trading are indistinguishable on principle and should therefore be treated, to whatever extent possible, as like cases under the law.

The *Dirks* tipper liability standard, which requires that the tipper expect to receive a personal benefit in order to be held liable for tippee trades under rule 10b-5, allows corporate agents to disclose information selectively to stock analysts.[80] Professor Langevoort observes, "if the reason for an insider's disclosure to an analyst is to serve some corporate end, such as to enhance the company's standing with the investor community or to strengthen pre-existing lines of communica-

77. While the exoneration of tippee liability is rational under our current system, it highlights a problem in that system itself. Those investors who can afford the "best" advising, often a euphemistically shrouded reference to the best inside-connected advice, are conferred with an advantage over those who do not have such access.

78. ITSFEA, *supra* note 10.

79. *See id.*

80. *See* Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1023-24 (1990).

tion, liability apparently will not follow."[81] Likewise, the ITSFEA's extension of liability to those who control tippers[82] does not prohibit communications between corporate insiders and stock analysts.[83]

Corporate insiders, permitted to divulge information selectively to investment analysts,[84] have strong incentives to do so. A company's financial public relations officers are evaluated directly on the quality of analysts' reports regarding the company's past performance and future prospects, as well as indirectly on the basis of stock prices as they presumably incorporate public perceptions created by these analysts. Under either assessment criterion, the performance of financial public relations personnel is closely tied to the cultivation of effective relationships with professional analysts. The latter group, knowing they wield significant power over public relations representatives, receive several forms of hidden advantage as the insiders try to cultivate their good will.[85]

Consider, for example, the following hypothetical. Quality Corporation's financial agent is aware of an important technological discovery resulting from recent in-house research that has been executed *sub rosa*. Agent receives a telephone call from an investment analyst at Analco, a premier group of securities analysts. Analyst wants information regarding the present health and the future prospects of Quality. The agent is likely to (i) discuss explicitly only publicly available information, and (ii) evaluate that information as well as publicly unavailable information based on experience and expertise. Perhaps performance has been poor for several years, and the agent may indirectly suggest that this year's income statement will be typically unimpressive.[86] Last year, prior to the technological discovery, Agent

81. *Id.* at 1024.

82. *See* ITSFEA, *supra* note 10.

83. *See* HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 910, 100th Cong., 2d Sess. 1 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043. According to the House report, the ITSFEA was not intended to "inhibit honest communication between corporate officials and securities analysts." *Id.* at 19, 1988 U.S.C.C.A.N. at 6056.

84. *See* Langevoort, *supra* note 80, at 1023–24.

85. While the courts have not attempted to address problems associated with the systematic asymmetrical access to information held by professionals, they are aware that investment professionals regularly gain access to inside advantage that is not shared with the public at large. Thus, the court in *Dirks* observed, "It is commonplace for analysts to 'ferret out and analyze information' . . . by meeting with and questioning corporate officers and others who are insiders. . . . [S]uch information cannot be made simultaneously available to all of the corporation's stockholders or the public generally." Dirks v. SEC, 463 U.S. 646, 658–59 (1983).

86. Corporate financial public relations agents face pressures to be somewhat candid, even regarding bad news. Because financial analysts are powerful, corporate agents are reluctant to deceive them, even when this reluctance compels admission of poor performance.

projected to Analyst a realistic sense of hope regarding future performance, significantly constrained by knowledge of pending annual report data.[87] This year, while the insider is constrained by a real need for confidentiality as well as an understanding of the nature of the securities laws, the spirit[88] of the new discovery is clearly communicated.

A corporate insider with a reputation for sober restraint and aversion to hyperbole can easily convince the analyst community that something special is about to happen, without actually revealing any real information. I refer to this communication of enthusiasm as the conveyance of "noninformation"[89] because, although an important, informed, and accurate sense of the company's destiny has been transmitted, there is no hook upon which to hang prospective liability for insider trading. While the analyst and her clients benefit from the communication, there is no locus for liability under our present regulatory scheme. The corporate insider, the only party with sufficient information to meet a scienter requirement, is not constrained by either *Dirks* or the ITSFEA from communicating either information or noninformation to investment analysts.[90] Both the analyst and the analyst's clients are insulated from liability, because no information has passed and thereby been misappropriated, and because without real information, the analyst and client lack scienter. The result is that the analyst benefits in terms of deserved reputation, and the analyst's client benefits from gains connected to the noninformational advantage, while the marketplace becomes increasingly characterized by information asymmetry and systematic unfairness.

Critics who have challenged the need to restrain any kind of insider trading would in all likelihood consider the noninformational variety to be especially innocuous. Scholars have argued in general that

87. At first glance it may seem beneficial for such agents always to convey a prognosis as optimistically inflated as possible, yet there are countervailing incentives to convey accurate rather than acritically sanguine projections. Most crucially, investment analysts have a large stake in receiving accurate, rather than whitewashed, information. When their need for accuracy is communicated to corporate insiders, coupled with the power implicit in the overall favorability of their reports, insiders are motivated to develop a reputation over time for reliability.

88. I distinguish the spirit of facts from the facts themselves, the former being a distillation of the latter sufficiently vague to be considered an attitude or posture rather than either a fact or an opinion.

89. The distinction between information and noninformation is one of degree, and there are varieties of disclosure that do not clearly fit into either category. *See* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 636 (noting the possibility of "[a]mbiguous corporate disclosures and signals," which can be used not only to convey inside information, but to create opportunity for manipulative practices).

90. *See* sources cited *supra* notes 83–85.

insider trading enhances market efficiency by expediting the incorporation of true information into the pricing mechanism.[91] Some have suggested the utility of insider information as managerial emolument under varying conditions,[92] and others contend that no one is injured when a person trades on publicly unavailable information.[93] Those who contend that trading on inside information is harmless for these reasons are likely to object strenuously to the argument that trading on noninformation creates either an ethical or an economic problem.

My response to skeptics is twofold: (1) Potential advantages of insider trading are outweighed by real concerns regarding both ethics and efficiency; (2) The insurmountable problems pertaining to insider trading are as compelling in the case of trading on noninformation as they are in the case of trading on information, because the two types of insider trading are conceptually indistinguishable.

1. Potential Advantages of Insider Trading Are Outweighed by Real Concerns Regarding Both Ethics and Efficiency

Ostensible advantages of allowing insider trading fall into two categories: market efficiency and managerial incentive. Neither of these advantages is compelling in itself, and both are outweighed by negative effects of insider trading.

91. For the classic discussion in this vein, see HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET (1966). For a discussion of the relevance of market efficiency goals in the development of securities laws in general and of insider trading regulations in particular, see Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation,* 87 MICH. L. REV. 613 (1988).

92. *See* MANNE, *supra* note 91, at 131–45 (suggesting that allowing corporate insiders to trade on inside information can act as a managerial incentive); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857 (1983) (proposing that permitting insider trading may help resolve agency conflicts that arise due to the separation of ownership and control of corporations); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698 (1982) (recognizing insider trading as a form of reward).

93. *See, e.g.,* Michael P. Dooley, *Enforcement of Insider Trading Restrictions,* 66 VA. L. REV. 1, 31 (1980) ("It is difficult . . . to draw a convincing, or even plausible, causal connection between . . . insider trading and the market losses experienced by other investors."); Ralph K. Winter, *On "Protecting the Ordinary Investor,"* 63 WASH. L. REV. 881, 900 (1988) (suggesting that insider trading is not unfair to ordinary investors, who "buy or sell according to current cash position or need to change the ratio of various categories of investments in their portfolio"). Judge Winter's catalogue of motives for buying or selling seems incomplete. Those who decide to enter a securities transaction because they incorrectly assess the prognosis for a given stock are in fact at an unfair disadvantage in their dealings with those who have inside information. *See* Iman Anabtawi, Note, *Toward a Definition of Insider Trading,* 41 STAN. L. REV. 377, 388 (1989):

> Where managers are permitted to trade on information superior to that of shareholders, shareholders will be systematically disadvantaged when trading the company's stock. On average, shareholders will be net sellers to insiders whenever insiders know of an impending share price rise because insiders will place themselves on the purchasing side of the market.

a. Market Efficiency

The argument that insider trading improves market efficiency contains several flaws. The essence of the argument is that all informed trading, regardless of whether the information behind it is public, renders pricing in a large, anonymous marketplace more efficient by expediting the assimilation of a maximum of relevant information.[94] Yet incremental gains in efficiency are likely to be overestimated in several ways. First, such gains are only significant if the proportion of confidential inside information relative to all information is significant. If inside information forms a small fraction of all information, the effect of such information on market efficiency will be diluted to the point of insubstantiality.[95] Secondly, the potential gain to be made in permitting such trades is further reduced by the fact that some insiders choose to divulge information rather than abstain from trading. Those who choose to divulge rather than abstain already confer efficiency advantages upon the market, so that incremental gains in efficiency attributable to allowing insider trading would likely be extremely small.

Perhaps most importantly, even substantial gains in the market's expedient assimilation of information must be considered in tandem with countervailing negative effects of insider trading. Insider trading reduces investor confidence, thereby reducing investor participation as well.[96] If prospective investors are driven from American securities markets as a result of dissatisfaction with market inequities, loss of demand will result in declining stock prices while loss of capitalization will harm the growth potential of American industries.[97]

b. Managerial Incentive

Permitting insider trading as a form of managerial emolument is equally unpersuasive. Management is currently given sufficient or even excessive incentive to remain in their jobs and to do them well. A recent spate of criticism centers around these excesses in managerial

94. *See* sources cited *supra* note 91.

95. In defense of the practice of insider trading, it can be argued that the potential participants form an insignificant number. This line of reasoning undermines market efficiency arguments by implying that the crucial gains would be so small as to confer little real benefit on the free market. While small incidence of insider trading may have little effect on the efficiency of the marketplace, it creates conditions of inequality and unfairness that are objectionable in principle, regardless of the degree of pervasiveness of the practice.

96. *See infra* notes 117, 127.

97. For discussion of these concepts in greater detail, see *infra* notes 109–10 and accompanying text.

compensation.[98] As activist shareholders have begun to place pressures on their companies to curb compensation packages that are either excessive or insufficiently tied to meaningful performance measures,[99] executives have not retreated en masse from corporate America.[100] Annual pay packages upwards of seventy-five million dollars in 1991 are apparently considered to be more than enough,[101] so that the execution of a trend toward restraint is unlikely to affect managerial incentive to remain in office or continue to operate as effectively as always. At a more conservative margin, we could expect executives to be motivated by the financial advantages conferred by any pecuniary perquisite. But as high-level corporate management salaries become severely inflated, providing a large margin of slack beyond what is necessary to keep the best management, the marginal utility of prospective pecuniary gain should decline and approach zero, as non-pecuniary utilities dominate the motivation of executives.[102]

Of course, not all executives are overpaid, and it can be argued that many are underpaid, especially since the excesses heralded in the popular press tend to focus on an elite corps of large companies that in fact represent only a small fraction of American businesses.[103] Yet even in companies in which increased executive compensation may be desirable, the provision of such compensation through insider trading privileges is managerially irrational. It confers financial gain arbitrarily, based on the sporadic and gratuitous receipt of valuable and secret information. As Professor Cox has observed, "the manager's incentives are hopelessly confused and certainly are not focused exclusively

98. *See, e.g.*, John A. Byrne et al., *Executive Pay: Compensation at the Top Is Out of Control*, BUS. WK., Mar. 30, 1992, at 52.

99. *Id.*

100. While some pressures regarding CEO compensation have resulted in a steadying of salaries and bonuses, CEO option grants are still growing. *See* Shawn Tully, *What CEOs Really Make*, FORTUNE, June 15, 1992, at 94.

101. *See* Maria Mallory, *Tony O'Reilly: Turning Ketchup into Big Dough*, BUS. WK., Mar. 30, 1992, at 58 (observing that Anthony O'Reilly of H.J. Heinz was the highest paid CEO in 1991, receiving a total pay package of $75.1 million).

102. Apart from the economic concept of declining utilities, psychological attribution theory suggests that excessive salaries should be ineffectual because at some point extrinsic rewards simply displace effective, internally-generated sources of personal satisfaction. For a discussion of the attribution theory from a managerial perspective, see Barry M. Staw & Jerry Ross, *Commitment in an Experimenting Society: An Experiment on the Attribution of Leadership from Administrative Scenarios*, 65 J. APPLIED PSYCHOL. 249 (1980).

103. *See generally* Mallory, *supra* note 101 (discussing compensation of the highest-paid CEOs annually since the 1980s, including representatives of Federal Express, NCR, Mesa Petroleum, DWG, Chrysler, Toys 'R' Us, Walt Disney, McCaw Cellular, UAL, and H.J. Heinz).

upon the stockholders' interest . . . ."[104] Compensation in the form of whatever inside information happens to reach an executive is both highly uncertain and disconnected to any meaningful performance measures. A poorly performing executive may be richly rewarded solely because he or she has had the good fortune to receive valuable confidential information in the course of a particular year.

Apart from its motivational dysfunction, authorized insider trading is likely to incur both opportunity and agency costs. Opportunity costs arise as managers spend their time trying to cash in on their own insider transactions. Agency costs are associated with this process as the conflict of interest between work for self and work for shareholders is heightened.[105] Because ownership and control of corporations have been separated in the professionalization of management,[106] executives operating under conditions of relative autonomy have occasion to engage in opportunistic behavior, creating value for themselves rather than for shareholders. Unfortunately, a compensation scheme that fails to tie executive payment with performance probably fails, in the process, to monitor agency costs. Provision of fluctuating compensation based on activities unconnected with the creation of shareholder value is likely to increase agency costs by encouraging self-serving behavior not correlated to shareholder wealth.[107]

Professors Carlton and Fischel suggest that managers need incentives to overcome the tendency to risk-averse behavior, and that the ability to turn corporate failure to personal gain through insider trading will encourage management to engage in some risky activities.[108] While the prospect of personal insider trading profits may enhance the attractiveness of risky activity, it does not necessarily follow that the company will benefit as a result. Although American companies may lose opportunities because of unnecessary risk aversion,[109] Carlton and Fischel's prescription overshoots the mark. Allowing insiders to com-

104. Cox, *supra* note 89, at 651.

105. For a discussion of the nature of agency costs that are associated with professional management, see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

106. For the classic discussion of this phenomenon, see ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

107. *See* ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE 6–9 (1986) ("Critics of large corporations often allege that corporate managers have too much power and that they act in ways to benefit themselves at the expense of shareholders and other corporate constituencies.").

108. *See* Carlton & Fischel, *supra* note 92, at 873–76.

109. *See* Charles W.L. Hill et al., *Declining U.S. Competitiveness: Reflections on a Crisis*, 2 ACAD. MGMT. EXECUTIVE 51, 54–55 (1988) (discussing causes of risk avoidance and lack of innovation in American businesses).

pensate risk-related losses through personal trading gain indiscriminately encourages all risk taking. Managers should not be encouraged to take wildly speculative and foolhardy risks; rather, they should feel comfortable taking intelligent, informed risks that may bear justifiable rewards. It may well be true that current thresholds for intelligent managerial risk assessment have been systematically rendered undesirably low. The appropriate solutions to cultural and social forces that discourage risk will be managerial solutions in which decision makers better understand the ways in which to serve their businesses.[110] To encourage all manner of risk, and to base that encouragement in selfish motives, will bring both desirable and undesirable risk taking, and is likely to provide no net gain to the companies involved.[111]

Because inside information as emolument is not connected with either the accomplishment of desirable goals or the achievement of performance measures considered important to the corporation, it is ineffective as an incentive or motivator.[112] The behavioral theory of psychology suggests that rewards reinforce desirable behaviors only when the rewards are connected to those behaviors in a systematic

110. The problem of risk aversion in American business may also be a product of systemic forces at work in our securities markets. Short-term pressures to meet financial performance measures utilized by stock analysts may render risky behavior impracticable. *See id.* at 55–57.

111. It is also odious to suggest that well-compensated managers need or should need superfluous incentives to do their jobs well. *See* Michael J. Chimel, *The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Cause of Action,* 1990 U. ILL. L. REV. 645, 648 (observing that managers, who are compensated for their work in the form of salary, are compelled under a fiduciary duty to serve the company).

112. Observe in this regard that compensation of executives through the authorization of insider trading is only one of many forms of feasible compensation. Others might include bonuses based on performance, salary and option increases, and deferred tax options related to retirement benefits. The option of providing compensation via authorized insider trading is simply one more means among many already existing processes for paying management. Professor Dyer has noted that the mere addition of one new method of payment will not alter the "basic process of deciding the dollar amount of each manager's compensation." Boyd Kimball Dyer, *Economic Analysis, Insider Trading, and Game Markets,* 1992 UTAH L. REV. 1, 13. If Professor Dyer's assertion is correct, then no real gains in executive compensation can be expected to result from authorized insider trading. In fact, a net loss should result due to the inadvisability of compensating executives in a manner that has no connection to performance. However, it is conceivable that there is a benefit to be gained from authorized insider trading perquisites: if such trading can be done at no cost to the company, or at less cost to the company than commensurate direct compensation, then this form of compensation, while inferior from a motivational standpoint because unassociated with performance, may be cost efficient. The true corporate costs and benefits of authorized insider trading are an issue that needs to be addressed, both theoretically and empirically. For the most thorough treatment of this question to date, see David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading,* 80 NW. U. L. REV. 1449 (1986) (defending the practice of authorized insider trading from a transaction cost perspective).

way.[113] If the rewarded party cannot discern a pattern from which he or she can attribute the reward to one type of activity exclusive of others, the reward cannot stimulate any particular response.[114] Executive compensation acts as an incentive only when the executive makes a connection between what he or she does and the likelihood that the reward will be attained. Because inside information and the trading advantages it can confer are random with regard to managerial performance, authorized insider trading is an irrational means of tying compensation to performance at a time when pay for performance is considered a basic tenet in determining executive salaries.[115]

2. *Objections to Insider Trading Are as Compelling in the Case of Trading on Noninformation as They Are in the Case of Trading on Actual Information, Because the Two Types of Insider Trading Are Indistinguishable in Principle and in Effect*

Insider trading is objectionable because it is unfair,[116] and because it discourages ordinary investors from participating in markets they perceive to be unfair.[117] These basic grounds for regulation of insider trading are relevant regardless of whether the trade is made on the basis of real information or mere credibility. The objections to trading on inside credibility[118] are addressed individually herein.

a. *Trading on Inside Credibility Is Unfair*

The distinction between inside information and inside credibility is technical rather than substantive. Rather than relay actual information, the corporate insider has conveyed noninformation tantamount to an assurance that information exists which would be acted upon if known. Although the noninformation is cleansed in the hands of an analyst who technically fails to send factual information, the benefit is substantial to the degree that the insider's noninformation is credible. The only effective distinction between a tip of information and a tip of

113. For a discussion of the importance of linking reward structures to performance, see Edward E. Lawler III, *New Approaches to Pay: Innovations that Work*, 53 PERSONNEL 11 (1976).

114. *Id.*

115. *See* Byrne et al., *supra* note 98, at 53.

116. For a discussion of fairness arguments pertinent to insider trading, see Jennifer Moore, *What Is Really Unethical About Insider Trading?*, 9 J. BUS. ETHICS 171 (1990).

117. John W. Bagby, *The Evolving Controversy over Insider Trading*, 24 AM. BUS. L.J. 571, 579 n.55 (1986) (quoting Arthur Levitt, Jr., Chairman of the American Stock Exchange, "If the investor thinks he's not getting a fair share, he's not going to invest and that is going to hurt capital formation in the long run"); Classen, *supra* note 8, at 608 ("[I]nvestor confidence in the securities markets directly impacts upon their stability.").

118. Since credibility trading and noninformational trading are two descriptive names emphasizing different characteristics of an identical effect, I use the terms interchangeably.

noninformation in the hands of the analyst is one added layer of risk: the tippee of information bears only the risk that information is inaccurate, while the tippee of noninformation bears two risks—the risk that the information behind the tipper's advice is inaccurate, and the risk that the tipper's judgment regarding the hidden information is poor.[119] It is precisely this second layer of risk that transforms trading on noninformation into, in essence, trading on tipper credibility.

Because traders who use either inside information or inside noninformation do bear these risks, the unfairness of their trades must be grounded in the even greater risks of those who trade using neither of these advantages. In fact, all rational trades employing inside information or noninformation entail less risk than rational trades made in the absence of inside advantage. The diminution of risk attendant to rational inside trading can be conceptualized by creating an expected value score for inside advantage. The three relevant kinds of trades have different risk profiles, as follows:

> Assume that the risk of purchasing the stock attributable to all factors publicly known = 1.
>
> Assume that the risk that relevant inside information is inaccurate = 2.
>
> Assume that the risk that a tipper of noninformation will apply poor judgment in distilling the relevant information into a generic credibility tip = 3.

One who trades using no tip trades subject to the risk designated 1. One who trades using inside information trades subject to the risk of 1 fine-tuned by the added information contained in the tip and evaluated with knowledge of the risk level designated 2. One who trades on a noninformational tip trades subject to the risk designated by 1, fine-tuned by the credibility tip which has a bi-faceted risk, represented by 2 and 3. Given these theoretical risk profiles, a preference ranking develops, such that the lowest risk is associated with trades made on inside information, a middle level of risk is associated with trades made on noninformation, and the greatest risk is associated with trades made on solely public information.[120] The following hypotheti-

119. The risk in noninformational tips that the tipper's judgment regarding hidden information is poor is arguably matched by an analogous risk in the case of informational tips—the risk that one's own judgment regarding the information will be poor. The former risk is arguably greater because the ultimate decision maker has less information to assess than in the case of the latter risk.

120. Note that I refer to risk in this discussion in terms of investor uncertainty. The more information available, the less uncertainty. While information may be inaccurate, it is preferable to have that information with concomitant risk probabilities than to be denied that information.

cal example helps us to understand the nature of these three risk patterns.

Public knowledge of Acme Co. includes the possibility of new licensing agreements with Zenith, bearing valuable patent rights in new pharmaceutical products. Because the products appear to be extremely promising, the risk that an investor would not reap a 15% minimum return over one year is calculated at only 30%. Insider Tom has secret knowledge, however, that Ann, a scientist friend at Acme, has in fact successfully completed the fundamental research involved in creating the product. If Ann has in fact made the relevant discovery, the risk that an investor would not reap the 15% annual return is reduced to a mere 5%. If there is a 50% chance that Tom's secret knowledge is correct, his investment risk[121] = .5 x 30% + .5 x 5%, or 17.5%. If Tom relays a noninformational tip to Sue, exhorting her to trade but refusing to divulge the source of his confidence, Sue must assess Tom's credibility. If she believes that Tom is 70% reliable in his investment judgments, Sue's investment risk = (.5 x 30%) + (.3 x .5 x 30%) + (.7 x .5 x 5%), or 21.25% The risk is greatest (30%) when trading on the least information, reduced (21.25%) when trading on a limited increment of information, as when the information is absorbed into tipper credibility, and reduced further (17.5%) as the information becomes more precise—the case of actual information rather than noninformational credibility.

The principle just demonstrated is associated with statistical error: each bit of information, in conjunction with the probability of its accuracy, has the potential to reduce possible trading mistakes. Compared against trades on purely public information, both informational and noninformational tips confer on the trader an elite, reduced-risk status. The only difference between the latter two types of tips is one of reliability: informational tips are associated with one source of error, where as noninformational tips are associated with two. The principle behind them remains the same: each has the effect of reducing trading error by adding a degree of confidence not available to the unadvantaged trader.[122] From the standpoint of fairness, informa-

121. "Investment risk" refers here to the risk of not realizing a 15% minimum return over one year.

122. While I discuss the issue of fairness here in terms of relative degrees of risk undertaken by differing classes of investors distinguished by access to information, fairness can also be addressed in terms of varying costs of investment. Because the elements of risk and return are positively correlated under normative investment theory, those who face greater risks also bear greater costs, in light of a given return. Thus some scholars have criticized the practice of insider trading as unfair by noting the way discrepancies in information confer upon insiders a pricing advantage—either the disadvantaged party enters a transaction that would be avoided under

tional and noninformational tips are therefore on equal footing, both objectionable because they create an inequitable disparity of risk among various classes of investors.[123] Because the disparity is not grounded in principle[124] and because it confers no social advantage, it is ethically unjustified.[125]

b. Trading on Inside Credibility Is Likely to Discourage Ordinary Investors from Participating in Markets Because They Perceive the Markets To Be Unfair

Whether an advantaged party trades on inside information or inside noninformation, those of us who rely entirely on public knowledge are relatively disadvantaged.[126] As I have observed in the preceding section, information bears less risk than credibility, and has more value as a result. Still, reliable noninformation adds an increment of value apart from the baseline of public information on which the vast majority of traders rely. The perception of unfairness in the marketplace is therefore a function of the inside nature of the advantage, whether informational or noninformational.

parity of information, or she enters a transaction at a price that differs from an informed-decision price. For a discussion of the ways in which insider trading harms non-insiders, see 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, 1235–40 (1981).

123. The reasoning which relates fairness to equality of access to information is best stated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). The court in *Texas Gulf Sulphur* states the purpose of rule 10b-5 to be "equal access [of all investors] to the rewards of participation in securities transactions." *Id.* at 851–52.

124. One commentator argues "[l]osses are caused by . . . legitimate nondisclosure, and this is an ordinary market risk." Stephanie F. Barkholz, Comment, *Insider Trading, the Contemporaneous Trader, and the Corporate Acquirer: Entitlement to Profits Disgorged by the SEC*, 40 EMORY L.J. 537, 556 (1991). By "ordinary" risk, the author presumably means a normal risk that we have come to expect under the present system of limited regulation. Yet attributing these risks as "ordinary" under our present system does not justify them ethically or economically. Such risks reflect an inequity recognized to exist but not grounded in principle.

125. For a discussion of the deontological and teleological analysis of insider trading, see Salbu, *supra* note 46.

126. The source of this disadvantage is disparity in both risk and cost between buyer and seller. *See* Cox, *supra* note 89, at 653 ("the dominant constraint to the belief that parties will enter into mutually advantageous contractual arrangements is that they must know the consequences of their acts. It is essential, therefore, that the parties know the costs and benefits of their actions if they are to negotiate a mutually advantageous contract."). While Professor Cox seems to be addressing an ideal rather than necessary state of contracting, knowledge of future costs and benefits associated with contracting is crucial to assessing the risk of the transaction, so that disparity in access to this knowledge fundamentally changes the nature and equity of the contractual arrangement.

This means that inside information and inside credibility can be distinguished only in terms of degree. If trading on inside information erodes investor confidence, then trading on inside noninformation does the same, although perhaps less dramatically and severely. Therefore, when judges and scholars observe that insider trading damages the integrity of the market via disintegration of investor trust, they implicitly condemn the analogous effects of noninformational advantage in the market as well.

That insider advantages of all sorts detract from the public's overall faith in market integrity is well documented.[127] The Supreme Court has observed that the Securities Exchange Act of 1934 was drafted "to restore public confidence in financial markets."[128] Scholars have observed that investor confidence has been maintained in large part due to the informational egalitarianism created by our securities laws.[129] Journalists likewise report reactions to periodic insider trading scandals in terms of loss of investor confidence,[130] a phenomenon likely in itself to plant the seeds of investor distrust pursuant to publicized securities market abuses. The diminution of investor confidence that is likely to result from use of inside advantage has widespread economic effects. Mistrust of capital markets has been attributed as the cause of poor performance of those markets when established in developing countries;[131] moreover, reduction of individual participation in the stock market causes a concomitant reduction in market liquidity[132] and the level of both domestic and international investor participation in American markets.[133]

Because inside information and inside credibility are analogous on every dimension except degree, the use of each is accountable for a portion of investor apprehension, bearing undesirable increments of

127. For a detailed overview of the relationship between inside advantage and investor confidence, see Spencer D. Klein, Note, *Insider Trading, SEC Decision-making, and the Calculus of Investor Confidence,* 16 HOFSTRA L. REV. 665 (1988).

128. Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 137, 150 (1984).

129. *See, e.g.,* Arthur Fleischer, Jr., et al., *An Initial Inquiry into the Responsibility to Disclose Market Information,* 121 U. PA. L. REV. 798, 816 (1973).

130. *See, e.g.,* Hobard Rowen, *White Knuckles on Wall Street,* WASH. POST, Nov. 20, 1986, at A27, col. 6 (responding to the Ivan Boesky scandal and observing that small investors were likely to lose faith in capital markets as a result of Boesky's highly publicized activities).

131. Hsiu-Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934,* 68 COLUM. L. REV. 260, 264 (1968).

132. *See* DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION, THE OCTOBER 1987 MARKET BREAK xiv (1988).

133. BARRY ALEXANDER K. RIDER & H. LEIGH FFRENCH, THE REGULATION OF INSIDER TRADING 6–7 (1979).

additional macro-market cost and risk. For the public confidence to be wholly maintained or restored, regulatory efforts must address both the obvious and the less obvious sources of unfairness. Ultimately, public awareness of the more insidious varieties of inside advantage may render our present regulatory approach insignificant in protecting the fairness, integrity, and public support of securities markets.

C. Abstention from Trading

Under common law as well as rule 10b-5, the problem of fairness in securities markets has been addressed from the perspective of fraud. The perpetration of fraud requires an intentional misrepresentation of material fact, upon which the deceived party relies to his or her detriment.[134] In the case of largely anonymous securities market trades, fraud related to inside information virtually always occurs through the process of trading without disclosing the secret information while under a fiduciary duty to disclose or abstain from trading. Accordingly, rule 10b-5 prohibits fraud or deception "in connection with the purchase or sale of any security."[135]

It is therefore impossible to violate the laws meant to ensure fairness of informational access without entering into a transaction, just as the notion of fraud is inexorably tied to the contingency of a contract.[136] Yet information is used in securities markets both to transact and to defer from transacting. Some information results in a decision to buy or sell, but other information guides its recipient to abstain from buying or selling. Securities market decisions can be divided in this manner into two categories: decisions to transact and decisions not to transact.

While inside information is equally valuable in making either type of decision, and confers an equally unfair advantage in each case, its use is proscribed only for the purposes of entering transactions. When an investor uses inside information to decide not to buy or sell, there is no transaction upon which to hang the legal doctrine of fraud, and there is no tangible activity from which to deduce that an unfair advantage has been exploited or to prove such exploitation.

Yet this second category of insider advantage—that of "insider abstention"—is indistinguishable from the first category in terms of

134. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

135. 17 C.F.R. § 240.10b-5 (1992).

136. While fraud has taken on the nature of a hybrid between tort and contract law, the gravamen of fraud is misrepresentation as an inducement to enter into a transaction with another. If the deceiving party fails to engage the deceived party contractually, there is no actionable fraud.

fairness and equality of market participation. Decisions not to transact are as important to the investor as the eventual positive investment choices he or she makes.[137] A decision to hold rather than to sell, based on inside information, may be highly profitable, yet remains unrestricted under rule 10b-5 because it entails no purchase or sale. Likewise, the knowledge not to invest represents an advantage in the assessment of opportunity costs, in the form of elimination of certain buying and selling options as undesirable. The ability to discount any options through the employment of inside information thereby confers an advantage over those who choose among investment alternatives without such benefit, resulting in precisely the disparities that the insider trading laws should efface. Unfortunately, as we shall see in the section that follows, it is both legally and logistically difficult to regulate the use of inside information as a factor in the decision to abstain from trading.

III. POLICY ALTERNATIVES TO CLOSE THE GAP BETWEEN THE LETTER AND THE SPIRIT OF INSIDER TRADING REGULATIONS

The elusive forms of insider exploitation discussed in section II are beyond the scope of existing regulations, largely because they are extremely difficult to detect, and have therefore played no role in the development of fraud as a cause of action for insider trading. The discussion in this section begins to explore some possible avenues for closing the gap between currently prohibited and currently permitted practices, all of which are unfair as well as inefficient. While each potential response to these disparities in the law has some potential to reduce inconsistency, all are costly as well, and are meant only to begin the scholarly discourse necessary to approach a feasible solution.

A. Authorization of Insider Trading

An obvious means of closing the gap between the letter and the spirit of our insider trading laws is to eliminate them, an option that has been recommended by numerous legal scholars and economists.[138]

137. My decision on a given day not to sell shares of Meridian stock is conceptually indistinguishable from my decision to buy those shares on that same day, assuming in the latter instance that I did not have them at the beginning of that day. Holding a given piece of a currently existing portfolio is tantamount to purchasing a piece of the same size and character that is presently missing from my portfolio. Although the economic nature of these two decisions is identical, only the former is prohibited under our insider trading laws, because the latter entails no trade.

138. *See, e.g.*, MANNE, *supra* note 91; Carlton & Fischel, *supra* note 92.

Professor Manne has suggested that insider trading is economically efficient, expediting market assimilation of information[139] and providing a form of managerial compensation.[140] Others have argued that concerns regarding the fairness and efficiency effects of insider trading should be supported by empirical evidence before the freedom to trade on inside information is abrogated.[141] Professors Branson[142] and Dooley[143] both suggest that the pervasiveness of insider trading and the difficulty of controlling it render its regulation ineffectual. This impracticability is exacerbated by the phenomena we have observed, in the form of evasive cognates of classical insider trading. If it is difficult to monitor and sanction insider trading, and even more difficult to identify and punish other forms of exploitation of inside information, then effective, consistently applied regulation may simply not be feasible.[144]

While legalization of insider trading laws would eliminate the disparities discussed in section II, consistency would be gained at the expense of fairness and efficiency. As discussed earlier, insider trading creates disparate classes of investors based on fortuitous differences in situation rather than on merit.[145] Such a distinction is morally suspect. Likewise, we have examined in detail the creation, through insider trading, of economic inefficiencies associated with erosion of investor confidence[146] and increased agency costs.[147] Because the reduction of exploitation of insider advantage is both morally and economically sound, we should support regulation that ameliorates such practices whenever possible. Thus, the best solution to disparate treatment of abusive practices would be to prohibit all the practices. Our present system is incomprehensive, but beneficial to the limited extent

139. MANNE, *supra* note 91, at 77–91. The assimilation of information argument is usually discussed in terms of market signals which drive the price of securities closer to equilibrium, thereby enhancing overall market efficiency. For a critique of the market signalling hypothesis, see Ronald K. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. 549, 572–79 (1984).

140. *See* MANNE, *supra* note 91, at 138–41; *see also* discussion *supra* part II.B.1.b.

141. *See, e.g.,* Frank Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* 1981 SUP. CT. REV. 309, 338.

142. Douglas M. Branson, *Discourse on the Supreme Court's Approach to SEC Rule 10b-5 and Insider Trading,* 30 EMORY L.J. 263 (1981).

143. *See* Dooley, *supra* note 93.

144. For a more detailed discussion of the logistical difficulties in monitoring these kinds of abuses, see Diana L. Hegarty, Note, *Rule 10b-5 and the Evolution of Common-Law Fraud—The Need for an Effective Statutory Proscription for Insider Trading by Outsiders,* 22 SUFFOLK U. L. REV. 813 (1988).

145. *See* Moore, *supra* note 116.

146. *See supra* notes 126–33 and accompanying text.

147. *See supra* notes 105–07 and accompanying text.

of its current reach. Some restraint of insider advantage is better than no restraint, despite the inconsistencies that result. Following this line of analysis, abolition of all insider trading laws is a poor mechanism for establishing consistency. By permitting all forms of insider abuse, it resolves a leaky dam problem by tearing down the dam itself. While complete equality of access to usable information is the ideal, some equality is better than none. Legalizing insider trading is not an effective solution to the problem at issue.

B. Policing Information

The policies that regulate insider trading are inadequate because the uses of information are more complex than we often realize. Information that supports tipper credibility allows for trading on noninformation, technically circumventing the regulations.[148] Likewise, trades on non-facts are not easily regulated, and abstention from trading based on inside information cannot practicably be monitored, sanctioned, or even observed, because the decisions behind abstention manifest no behavior.[149]

Because the methods of evading the present regulations are multifarious and appear intractable, one alternative to simply policing trades is to police the information itself. This can be accomplished in two ways: through mandatory disclosure and through mandatory confidentiality.[150] While regulation of disclosure and confidentiality have been minimal in the United States,[151] they are more pervasive in the securities laws of the European Economic Community (EEC) and Japan. The EEC Directive on Insider Trading prohibits, for example, tipping by insiders outside of the "normal course of . . . employment, profession or duties."[152] Japanese securities laws, while often criti-

148. *See supra* notes 86–89 and accompanying text.

149. *See supra* notes 134–37 and accompanying text.

150. Neither mandatory disclosure nor mandatory confidentiality has been a popular policy choice among American academic and judicial commentators, probably because they are viewed as an abrogation of individual and corporate freedoms. Of the two, mandatory disclosure has received more serious attention than mandatory confidentiality. *See, e.g.*, Theresa A. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218 (1987) (recommending the establishment of a duty to announce preliminary merger negotiations).

151. American disclosure laws are limited to a few sensitive areas such as potential takeovers and corporate stock issue prospectuses. *See* Securities Exchange Act of 1934 § 16(a), 15 U.S.C. §§ 78p(a), 78(m)(d) (1988). Mandatory confidentiality laws are virtually nonexistent.

152. Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing, art. 3, 1989 O.J. (L 334) 30, 31.

cized for being sporadically and ineffectively enforced,[153] require that certain broad classes of information remain confidential,[154] while others must be publicly disclosed.[155]

Although they appear to be conceptual opposites, mandatory disclosure and mandatory confidentiality both have the potential to curb abuses connected with nonpublic information. Mandatory disclosure laws reduce the body of such information, thereby indirectly reducing the opportunities that exist for unfairly exploiting it. Mandatory confidentiality rules inhibit the movement of nonpublic information, effectively isolating it to limited pockets. As the information is less fluidly dispersed, the number of parties with access to it declines.

Whereas disclosure laws reduce the quantity of secrets, confidentiality laws help to keep the remaining secrets from being scattered among a select network of insiders, each of whom may potentially exploit the secret in securities market transactions or non-transactions. Because disclosure and confidentiality rules approach the same goal using different techniques, they can exist simultaneously and continue to effectuate in tandem the reduction of abuses. Both of these forms of information policing would be likely to reduce trades made on inside information and on inside noninformation alike, because the ultimate source of noninformational credibility is undisclosed information. As mandatory disclosure reduces the pool of nonpublic information, or as mandatory confidentiality reduces the movement of nonpublic information, both informational and credibility tipping opportunities are reduced.

Mandatory disclosure rules are alluring, apart from their effect of reducing insider exploitation opportunities, because they theoretically expedite the dispersement of information in the marketplace, enhancing the movement of securities prices toward true equilibrium.[156] Investors who are given an optimal amount of information as early as possible should be better able to evaluate the risks of alternative invest-

153. *See* Mark E. Perlmutter, *Developments in the Japanese Securities Markets, in* INTERNATIONAL SECURITIES MARKETS 87, 94 (PLI Corporate Law & Practice Course Handbook Series No. 572, 1987).

154. *See* 10C INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 11.10, at 11-33, (Harold S. Bloomenthal & Samuel Wolff eds., 1st rev. ed. 1992).

155. *Id.*

156. For a discussion of market assimilation of signals and information in general, and effect on market equilibrium, see Kose John & Banikanta Mishra, *Information Content of Insider Trading Around Corporate Announcements: The Case of Capital Expenditures,* 45 J. FIN. 835 (1990).

ments, and are likely to develop an improved sense of confidence in the integrity of markets in general.[157]

While mandatory disclosure and mandatory confidentiality may reduce opportunities to exploit nonpublic information or noninformation,[158] these options are costly. Mandatory disclosure of information is an invasion of corporate freedom, restricting a company's ability to determine what degree of stealth is necessary for the successful implementation of its strategies.[159] Legally compelled disclosure in contravention of the corporation's strategic interests is likely to harm shareholders, whose investment is injured when corporate strategy is undermined.[160] Moreover, the processes of compiling, printing, and disseminating the materials required by disclosure rules impose additional costs.[161] If we add the opportunity costs incurred by the company as it devotes its attention to regulatory compliance instead of its direct business, total costs of mandatory disclosure appear to be significant.[162]

An example of mandatory confidentiality is what Koenig refers to as a "No-Comment" rule regarding pending takeover activity.[163] Such a rule would require companies negotiating mergers and acquisitions to decline from commenting on those negotiations.[164] A mandatory "No-Comment" rule purports to avoid insider exploitation

157. *See* James Harlan Koenig, Comment, *The Basics of Disclosure: The Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1060–61 (1989) (discussing the benefits of early mandated disclosure of takeover activity).

158. Some commentators have questioned the effectiveness of mandatory disclosure laws at curbing insider trading abuses. *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 740 (1984) (suggesting that an interval exists between mandated disclosure and market absorption of information in which insiders could still trade to their advantage, even while technically abiding by disclosure requirements).

159. For a more detailed discussion of this problem, see Salbu, *supra* note 41, at 863–66.

160. Thus, while compulsory disclosure may serve the macroeconomic effect of improving information access parity, it does so at the cost of shareholder wealth. For discussion of the harm to shareholders effectuated by compulsory disclosure, see Dennis S. Karjala, *A Coherent Approach to Misleading Corporate Announcements, Fraud, and Rule 10b-5*, 52 ALB. L. REV. 957, 976 n.97 (1988).

161. *See* Koenig, *supra* note 157, at 1064–65.

162. *Id.*

163. *Id.* at 1065–67; *see also* Hazen, *supra* note 56.

164. Many companies have adopted this strategy voluntarily to avoid liability under Basic, Inc. v. Levinson, 485 U.S. 224 (1988), in which the defendant was held liable under rule 10b-5 for publicly denying the existence of its merger negotiations, thereby committing "fraud on the market" and implicitly causing those who sold their shares to lose prospective appreciation in value. Because companies have compelling reasons for stealth in prospective merger activity, including the avoidance of early price run-ups which increase the cost of the merger, some choose a universal "no-comment" policy to avoid liability under *Basic*.

of information by isolating the information and stanching its flow.[165] Mandatory confidentiality is potentially even more costly than mandatory disclosure, and it is unlikely to be effective—it constitutes a systematic inhibition of information necessary to the efficient functioning of a free marketplace, particularly the market's ability to mediate accurately the prices of securities.[166] Whereas mandatory disclosure is a coercive measure which at least fortifies the foundation of valuable, accurate market information, mandatory confidentiality is likely to deter market efficiency by reducing the pool of information. Mandatory confidentiality is unlikely to be effective, because inevitable and untraceable breaches may continue to support the surreptitious utilization of inside advantage. Most importantly, confidentiality rules do nothing to deter the problems of noninformational trading and abstention from trading. Since confidentiality can only be relative and can never be absolute or complete, abstention from trading by those insiders who are privy to the information will continue to occur. And noninformational credibility tipping which does not technically divulge the supporting information will also be in technical compliance with the confidentiality requirement.[167] Given these valid concerns, courts have been justifiably reluctant to seek gains in market fairness by inhibiting the flow of information.[168]

C. *Closing the Loophole and Allowing Inferences of Fraud from Circumstantial Evidence*

If abstention from trading and trading on tipper credibility are as objectionable as classical insider trading, we can prohibit these more elusive acts and omissions by expanding the interpretation of fraud contained in rule 10b-5, or by enacting new legislation.

Trades made on tipper credibility and noninformation are currently outside the scope of our insider trading laws because they fail to meet the "material fact" component of fraud.[169] While one's credibility is predicated upon a great mass of information and facts which are

165. Koenig, *supra* note 157, at 1065–67.

166. For a discussion of the importance of information to market efficiency, see Dyer, *supra* note 112, at 5.

167. While mandatory disclosure has its limitations as noted, *supra* notes 156–62 and accompanying text, it does help deter the problems of noninformational trading and abstention from trading, whereas mandatory confidentiality is ineffectual against the latter. This is because mandatory disclosure provides the earliest possible level playing field. Once the information becomes public, the value of noninformational tips is diffused, and everyone has an equal chance to abstain from trading, based on the relevant facts.

168. *See, e.g., In re* Investors Management Co., Inc., 44 S.E.C. 633, 646 (1971).

169. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

incorporated into one's judgments and opinions, courts have not attempted to assess the significance of information and facts in the process of credibility tipping.[170] Moreover, it is difficult to prove scienter and intent to defraud in these cases, wherein the misrepresentation of fact is in itself elusive. Abstention from trading is also difficult to proscribe, because our present approach is to outlaw insider trading,[171] and abstention consists of the decision not to trade. Yet none of these complications is insurmountable, in terms of either widening the reach of present regulations or overcoming evidentiary difficulties.

All of the loophole categories discussed in section II can rationally be outlawed under an expansive yet tenable interpretation of the element of fraud contained in rule 10b-5. Trades made on tipper credibility and noninformation can be prohibited as fraudulent when the tippee knows or has reason to know that the source[172] of tipper credibility is comprised of nonpublic information. The tippee's understanding that a tip is supported by implicit inside information can reasonably provide the elements of intent and scienter necessary to prove fraud. Trades based on inside opinion are plausibly fraudulent as well, provided that the tipper's opinion is derived from inside factual information.[173]

It is far more difficult to render abstention from trading fraudulent, even when the exploitation of inside information is supported by evidence. The easiest case is one in which the holder of stocks provides plenty of proof of original intent to sell, such as written memos or conversations to this effect. If the holder then receives inside information that militates against selling, and finally decides to hold the stocks, an inference that he has relied on material information to refrain from trading is plausible. Yet even this case is not simple—in order to extrapolate fraud from trading omission, we must be able to show that the inside information caused the abstention. Proving causality in the case of non-behavior is substantially more difficult than

170. In fact, courts have not even had the opportunity to discover implicit fraud behind credibility tips, because virtually all of the insider trading cases to date entail actual information or knowledge rather than implicit information or knowledge.

171. *See* 17 C.F.R. § 240.10b-5 (1992).

172. "The" source can be replaced by "a" source or "a significant" source, depending on the ultimately desired comprehensiveness of the interpretation of fraud.

173. While the courts can infer fraud from these types of trades in some cases, there will be other cases, probably the preponderance, in which the courts cannot or should not find intent and scienter. Many advisees of investment professionals do not have reason to know that they receive noninformational or nonfactual tips based on inside information; these persons certainly lack the culpability required for criminal and even civil liability. In these instances, the best remedies are derived from tipper liability under the ITSFEA. *See* ITSFEA, *supra* note 10.

proving causality in the case of action. This is because inertia is the human default mode, whereas action is the exception. It is relatively easy to trace an action to effective causes, whereas default may be caused by nothing at all, and is in actuality presumed under most circumstances to reflect no intent. In the great majority of cases that lack the explicit evidence contained in my hypothetical, proof of elements of fraud will be all the harder.

Apart from the difficulties associated with prosecuting individual cases of "fraudulent abstention," there are policy concerns that disfavor such an extension of existing laws. The possibility that one's mere holding of stocks, or one's decisions not to buy stocks, may be evidence of civil and criminal fraud, is likely to have an insupportable chilling effect on participation in securities markets. Given the likelihood of error when courts attribute fraudulent motives to inertia, the marginal risk of investing under fraudulent abstention laws would be significant. Those who might not be dissuaded from market participation by systematic risk may find this marginal threat, over which they have little control, intolerable.

Apart from difficulties in proving intent, fraudulent abstention under both common law and rule 10b-5 interpretation still requires some connection with a transaction.[174] Two possible avenues exist to overcome this difficulty. First, fraudulent abstention could be regulated by statute in its own right. Second, fraudulent abstention could be viewed as fraud on the entire market,[175] as decisions to abstain are coupled with decisions to enter alternative exchange, which would technically qualify as a transaction.

Yet the loophole categories are presently beyond the purview of insider trading regulations. Because they are conceptually analogous to the more explicit forms of behavior that are prohibited, it is likely that the gaps in coverage are a function of implementation difficulties—the problems incumbent upon finding and proving intent to exploit inside information in invisible ways. Trades made on tipper credibility and noninformation are difficult to trace. Records of generic recommendations to buy or sell are by nature more ambiguous than evidence of explicit tipping of information. Inferences of a communication of inside advantage are more precarious because of the

174. *See supra* notes 38–49 and accompanying text.

175. *See supra* note 164. The reasoning behind fraud on the market theory is as follows: Information affects pricing within the marketplace, and intentional misrepresentation will create inaccuracy in market pricing. Anyone who purchases stocks overvalued, or sells stocks undervalued, due to such a misrepresentation, will suffer a loss when the stocks finally absorb the true information and their price adjusts accordingly.

many possible bases for the communication, some of which may be innocent and some of which may reflect exploitation of an unfair advantage. Likewise, patterns of abstention from trading based on inside information are more difficult to prove than analogous patterns of trading, simply because it is more difficult to infer significant meaning from omissions, an infinite number of which exist in our daily lives, than from the finite collection of an individual's actions.

To the extent that fraud can and should be extended to cover the forms of behavior and non-behavior that evade our present regulations, circumstantial evidence can be admitted and weighed to permit inferences of fraud. In *SEC v. Hellberg,*[176] a jury used circumstantial evidence to impose liability on a defendant who denied knowledge of inside information. The defendant's son was employed as a financial analyst.[177] The defendant purchased call options for a company's stock prior to the announcement of a tender offer made by the son's employer, and profited from the increase in price that followed the announcement of the offer.[178] The jury applied circumstantial evidence to infer that the father had knowledge of the impending tender offer, despite the defendant's claims to the contrary.[179]

Circumstantial evidence can be applied in a similar way to determine whether a defendant intended to commit fraud[180] on the basis of implicit rather than explicit information.[181] While circumstantial evidence differs from direct evidence by requiring the intermediate step of inference, it is not by virtue of this distinction inherently inferior to direct evidence. The value of circumstantial evidence, indeed of all evidence, is a function of the likelihood that the conclusions derived from the proof thereof are factually correct. Circumstantial evidence may be highly probative or highly speculative,[182] depending on the

176. 47 SEC Docket (CCH) 1287 (D. Utah Oct. 29, 1990).

177. *Id.*

178. *Id.*

179. *Id.*

180. Circumstantial evidence may be necessary to prove fraud in a large number of cases, simply because the gravamen of fraud is not particularly well-suited to the problems raised by insider trading. For example, it is difficult to show reliance on a misrepresentation when no statement has been made. As a result, reliance must often be inferred from existing circumstances rather than proven using direct evidence. For a discussion of these problems, see Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis,* 100 HARV. L. REV. 1959, 1972 (1987).

181. Circumstantial evidence can also be applied to determine whether an abstention from trading comprises fraud, although this is probably inadvisable.

182. In this vein, McCormick defines relevancy of evidence in terms of the degree to which it "advances the inquiry." McCormick On Evidence 544 (Edward W. Cleary ed., 3d ed. 1984). Relevancy, while affected by the direct or circumstantial nature of the evidence, is a function of

probabilities of viable alternative explanations.[183] A confluence of extremely unlikely events may render an extremely high probability that a trade has been made with knowledge that a tipper's credibility is supported by nonpublic information. Combined with laws that broaden the prohibitions presently in place, increased reliance on circumstantial evidence could help to narrow that gap between permissible and impermissible forms of insider exploitation.

D. *Prohibition of Trading Among the Classes Most Likely to Exploit Inside Information*

Although it is difficult to establish culpable intent based on noninformational trading, or to trace abstention from trading to inside advantage, it may be possible to identify broad classes of investors most likely to have access to these forms of privilege. Because individual infractions are extremely difficult to monitor, prohibition of any trading in particular securities by members of these groups may significantly diminish the opportunities to gain unfair advantage using insider status.

Rule 16(b) of the 1934 Act is just this kind provision.[184] The rule requires disgorgement of profits, gained by purchase and sale or sale and purchase within six months,[185] of ten percent beneficial owners, directors, and officers.[186] Restricting the short-swing profits of insiders is an attempt to deter them from several forms of abuse of nonpublic information:[187] the mere trading upon that information,[188] the manipulation of corporate strategy in order to create individual trading opportunities,[189] and the development of "unorthodox transactions," such as the loophole varieties at issue in this Article.[190]

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probative value, which may be higher for some circumstantial evidence than for other direct evidence.

183. *See* Jonathan J. Koehler, *The Probity/Policy Distinction in the Statistical Evidence Debate,* 66 TUL. L. REV. 141, 147–48 (1991) (suggesting that statistical evidence can be as valuable as "particularistic" evidence, depending on their comparative probative values).

184. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1988).

185. *Id.*

186. Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1988).

187. For a good general discussion of section 16(b), see Arnold S. Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934,* 32 N.Y.L. SCH. L. REV. 209 (1987).

188. While this function appears to overlap that of rule 10b-5, creation of strict liability for short-swing trades of insiders was believed necessary to overcome difficulties in proving the elements of fraud, particularly intent. *See* O'Connor, *supra* note 2, at 321.

189. *See id.* at 322; Samuelson, *supra* note 2, at 517; Thel, *supra* note 7, at 405–52.

190. *See* Philip J. Boeckman, Note, *The War on Insider Trading: Is Fighting over "Officer" a Losing Battle?,* 55 MO. L. REV. 297, 299–300 (1990).

Rule 16(b) should, in theory, limit the possibilities of the more evasive abuses of insider advantage. By strictly prohibiting profits gained in one class of inside transaction, both informational and noninformational advantage alike are thwarted. Unfortunately, the proportion of total noninformational trading actually done by insiders is probably relatively small. Insiders are more likely than outsiders to have factual information, so that most of the persons who trade on noninformational credibility are likely to be outsiders, beyond the scope of section 16(b). The restriction of short-swing profits is even less likely to affect the exploitation of inside knowledge in deciding to abstain from transaction, since the emphasis on six-month turnover requires, like rule 10b-5, a purchase or sale rather than an omission to act.

A more severe restriction than section 16(b), prohibiting managerial insiders from trading in the securities of the companies they manage, might be more effective in reducing possibilities of unfair advantage. In particular, such prohibition would largely inhibit insiders from incurring non-transactional gains based on decisions to hold rather than sell, because they would be prohibited from ever possessing the securities in the first place. Yet both section 16(b) and a more complete proscription of inside ownership come at a high cost.

The prohibition of short-swing profits is arbitrary, establishing liability solely on the basis of time, so that a trade of less than six months is prohibited while a trade one day beyond six months is permitted.[191] The removal of the element of intent, aimed at the broad reduction of undesirable practices that are difficult to detect and to prove, unfortunately renders section 16(b) over-inclusive, and likely to cover innocent actions as well as disingenuous ones.[192] Perhaps more crucially, both section 16(b) and a more severe prohibition of any inside ownership will respectively reduce or eliminate managerial ownership of shares. This reduction has several undesirable implications: the diminution of the pool of potential investors may impair the company's ability to raise capital, as well as artificially depress stock prices by artificially restricting demand. Moreover, restrictions on managerial ownership exacerbate a major problem in corporate governance: the difficulties that arise due to the separation of ownership and control.[193] Managers who are also owners are less likely to be in conflict of inter-

191. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1988).

192. For a detailed discussion of this phenomenon, see Salbu, *supra* note 41, at 859–63.

193. For the classic statement concerning agency problems arising from the separation of corporate ownership and control, see BERLE & MEANS, *supra* note 106.

est with shareholders,[194] so that the greater management's proprietary interests, the lower the agency costs associated with professional management.[195] While restrictions on managerial ownership of stocks will inevitably reduce opportunities for insider abuses, they also widen the chasm of differences between the interests of management and the interests of capital.[196]

E. Application of a Reduced-Threshold "Fraudulent Scheme" Concept to Trigger Liability in Loophole Cases

The concept of a fraudulent scheme[197] has generally been applied in cases concerning securities offerings rather than insider trading of outstanding shares.[198] The idea of a fraudulent scheme has effectively liberalized the application of the elements of common law fraud, operating to replace rigorous proof of reliance with generic "but for" causality.[199] For our purposes here, I would define a fraudulent scheme as a deceptive practice intended to or reasonably likely to undermine the integrity of federal securities markets.[200] This construction of fraudulent scheme liberates rule 10b-5 from the constraints of common law fraud, and allows it to serve the more generic purposes of protecting the integrity of national securities markets.[201] Professor Karjala has observed in this vein, "When . . . fraudulent intent is coupled with the use of the facilities of the national securities

194. For a discussion of the nature of agency costs associated with professional management, see Jensen & Meckling, *supra* note 105.

195. *See* RAPPAPORT, *supra* note 107, at 7 ("Economic rationality dictates that stock ownership by management motivates executives to identify more closely with the shareholders' economic interests. Indeed, we would expect that the greater the proportion of personal wealth invested in company stock or tied to stock options, the greater would be management's shareholder orientation.").

196. For this reason, Professor Demsetz has urged that managers be encouraged to trade and own shares in the companies they manage. *See* Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 387 (1983).

197. The proscription of fraudulent schemes is contained in 17 C.F.R. § 240.10b-5 (1992), which renders it unlawful "to employ any device, scheme, or artifice to defraud," in connection with securities transactions. The terms "fraudulent scheme" and "deceptive scheme" will be used interchangeably in this discussion.

198. *See, e.g.*, Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983).

199. *Id.* at 469–70.

200. In regard to insider trading in particular, the deceptive practice will likely be one exploiting disparity of access to information, so that any utilization of inside information, by act or omission, would be part of a "fraudulent scheme."

201. For a discussion of the notion that rule 10b-5 should be tied to federal rather than state concerns, see Karjala, *supra* note 26.

markets, there is no longer any need to bootstrap into federal court on the basis of a technical violation of state law."[202]

Consistent with this reasoning, proof of a fraudulent scheme to undermine federal securities markets would rely solely on an intentionally deceptive act or omission. All other elements of common law fraud can be supplied by establishing an inference that the elements have been subsumed within market dynamics and are implicit, although largely elusive of direct proof. A "scheme to defraud the market" would technically require all the elements of fraud: intent, misrepresentation, materiality, causation, reliance, and injury. Inference of these elements would reflect the presumption that misrepresentation or intentional acts of deception defraud the entire market mechanism.[203]

The fraud on the market theory, as adopted in *Basic, Inc. v. Levinson*,[204] removes the plaintiff's burden of directly proving the element of reliance.[205] While the decision technically creates a rebuttable presumption of reliance based on the notion that the entire market absorbs misrepresentations,[206] the Court did not explain how rebuttal of the broad economic principles supporting the theory could occur, and Justice White observed that the nominally rebuttable presumption is de facto irrebuttable.[207] Combined with the tendency of courts to obfuscate distinctions between causality and reliance in securities fraud cases,[208] the fraud on the market theory has substantial potential to erode the plaintiff's burden of proving both the causation of injury and the reliance elements in rule 10b-5 claims.

While the fraud on the market theory is still in the process of development, it is likely to be used increasingly in the future to establish by presumption elements of fraud apart from causation and reliance. If intent of a scheme to defraud and materiality can be proved, inferences regarding market dynamics can be used to establish the element of injury as well as causation and reliance. The concept of a fraudulent scheme under rule 10b-5, established with the assistance of fraud on

202. *Id.* at 1534.

203. *See* sources cited *supra* note 10.

204. 485 U.S. 224 (1988).

205. *Id.* at 250.

206. For more detailed discussion of fraud on the market theory, see *In re* LTV Sec. Litig., 88 F.R.D. 134, 142–45 (N.D. Tex. 1980); Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435 (1984); Michael A. Lynn, Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 627 (1982).

207. *Basic*, 485 U.S. at 256 n.7 (White, J., concurring in part and dissenting in part).

208. *See* Karjala, *supra* note 26.

the market inferences, can help close the gaps created by loophole situations. Justification of this line of reasoning requires two steps: (1) acceptance of the utilization of fraud on the market theory to establish a fraudulent scheme based solely on direct proof of an intentional deceptive act or omission, and (2) an understanding of how this reduced threshold cause of action will be so inclusive as to encompass abstention from trading, as well as credibility and noninformational trading.

1. *Expanding Application of Fraud on the Market Theory*

The fraud on the market theory can be used to establish a justifiable inference, not only of reliance but also of causality and injury, in combination with direct proof of a scheme of intentional deceptive act or omission. Under the reasoning in *Basic,* the market as a whole systematically relies on the veracity of information by incorporating that information into the pricing of securities.[209] Imagine, for example, a shareholder who sells stocks based on an intentional misrepresentation of fact, such as the denial of current merger negotiations. Although the equilibrium value of the stocks would have been $65 per share in the absence of misrepresentation, the market price at time of sale is $50. Under the fraud on the market theory, all who sell at $50 have sold in reliance upon the misrepresentation, regardless of whether they were aware that it was made, because the $50 price which incorporated that misrepresentation was part of the inducement to sell, as indeed price is always a consideration in hold-or-sell decisions. Because price differentiation is a factor in buy, hold, or sell decisions, it is reasonable to presume that the deceptive statement was an efficient cause of the plaintiff's injury. A misrepresentation that can be shown to effect undervaluation of stocks can be presumed to cause injury to those who sell. Likewise, a misrepresentation that can be shown to effect overvaluation of stocks can be presumed to cause injury to those who buy.

The case of silent trading based on inside information as well as inside noninformation is analogous to this example of active, explicit misrepresentation. Although the deceptive scheme which causes the plaintiff's injury is comprised of entering a transaction without disclosing the information or noninformation, the effect of silent deception is indistinguishable from that of express deception. As in the case of an active misrepresentation, the marketplace absorbs the inaccuracy that is based on the defendant's failure to disclose the inside informa-

209. *See Basic,* 485 U.S. at 244–50.

tion. When the plaintiff either buys or sells under the resulting inaccurate presumptions of valuation, she suffers an economic injury identical to the injury caused by an explicit lie. Because the gravamen of a fraudulent scheme can be proven to exist simply by a showing of an intentional act or omission of deception, trades on both inside information and inside noninformation can be covered under the fraudulent scheme cause of action.

2. *The Effect of an Expanded Fraud on the Market Theory on Elusive Abuses*

Application of a reduced threshold deceptive scheme cause of action would help deter credibility and noninformational trading, as well as insider abstention from trading. By reducing the plaintiff's burden of proof to a showing of an intentional deceptive scheme, we eliminate both technical substantive requirements and some, but not all, evidentiary barriers to liability. Those who intentionally trade on inside credibility or noninformation would be liable despite the lack of factual knowledge upon which to pin a literal reading of fraud. The reduced-threshold conception of a deceptive scheme recognizes that trading on implicit information is conceptually indistinguishable from trading on factual information, and that the crucial element of culpability should be deceptive intent rather than a spurious distinction between factual information and noninformation.[210] Applying the fraud on the market theory to establish presumptively the existence of causation, reliance and injury would help ameliorate the difficulties of proving noninformational fraud.[211]

Regulation of insider abstention remains highly elusive, even if we apply fraud on the market theory and a deceptive scheme cause of action. One difficulty stems from the notion that while there may be one or a few efficient causes of a decision to trade, there are potentially an infinite number of reasons that a party abstains from trading. If

210. There is still a loophole here, but it is a smaller one. Those who receive a credibility tip without knowledge of the inside information that serves as the tip's foundation would receive an unfair advantage in market transactions but would be immune from liability due to lack of scienter. A more stringent approach would be to remove insider trading liability from the gravamen of fraud entirely, and require civil disgorgement of profits derived due to unfair advantage, with or without scienter. One disadvantage to this stricter approach is the possibility of creating "unjust disenrichment" for those who innocently rely upon their profits in making future resource allocation decisions, and are subsequently required to disgorge.

211. One significant evidentiary difficulty remains: proof of scienter regarding the tipper's inside sources of credibility and intent to exploit noninformational inside advantage. It is more difficult to infer intent from use of a noninformational tip than from an informational tip, as the former requires an added step: proof that the defendant knew or had reason to know the informational source of a noninformational tip.

liability were attached to situations in which insiders abstained from trading, insiders might actually feel compelled to enter disadvantageous transactions which they would otherwise never have considered, simply because they believe they might be held liable for exploitation of that information in abstaining.[212]

Even if such liability for abstention were theoretically tenable, difficulties in proving causation to abstain from trading seem insurmountable. This is because the occurrence of a trade is the great exception, whereas the millions of trades we never even consider are the rule of default. It is virtually impossible, except in the rare instance in which there is clear written or oral evidence of intent, to prove that abstention from trading was caused by inside information. In fact, abstention is generally not a decision at all, since the abstainer in most instances never even considered making the trade at issue. For all these reasons, while insider abstention remains ethically indistinguishable from insider trading, it also seems to elude effective regulation.

CONCLUSION

Credibility and noninformational insider trading, as well as insider abstention, create real problems in the fair, effective, and thorough regulation of parity of access to market information. The approach as developed under rule 10b-5 restrains only a small fraction of ethically and economically indistinguishable situations.

A number of exploratory solutions to this problem have been addressed in the preceding section, all of which contain significant flaws. Perhaps the most promising avenue for controlling noninformational trading is abandonment of common law fraud as the source of insider liability, and the substitution of a "deceptive scheme" concept supported by a liberal application of fraud on the market presumptions. Use of inside information in deciding to refrain from trading appears to be singularly resilient against regulatory efforts.

Legal scholars in this area must continue to address limits in the scope of our present regulatory system and problems associated with inconsistent treatment of theoretically similar cases.[213] Perhaps the

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212. Such a result would be absurd. Fear that abstention from trading might lead to liability for fraud would have a chilling effect on participation in securities markets, adding an intolerable element of risk to the investment process.

213. Two levels of analysis will be particularly important in continuing to examine means of establishing regulatory consistency: (1) development of theoretical bases to overcome the limitations of the gravamen of fraud, as it fails to effect parity of access to market information, and (2) examination of the difficulties of proof that create problems of both regulatory surveillance and evidence for trial.

most compelling threshold question concerns the best direction for establishing consistency—movement toward greater legalization of insider advantage, or movement toward more comprehensive regulation of all such advantage. Whichever direction we choose, we must adopt regulations that are both theoretically sound and internally consistent. The challenge remains to find the best method of ensuring the fairness, integrity and efficiency of securities markets without leaving significant avenues for abuse.