The Fiduciary Principle of Insider Trading Needs Revision

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The rationale for the prohibition against trading on inside information was first articulated by the Securities and Exchange Commission (SEC or Commission) in *Cady, Roberts & Co.*,[1] an administrative proceeding in which a director of an issuer who was also a principal of a brokerage firm used undisclosed adverse information about the issuer—a decision to cut a dividend—to recommend and effect the sale of securities for customers of the broker.[2] In holding that the director's actions violated Section 10(b) and Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act)[3] the SEC stressed the existence of a relationship affording access to inside information intended to be available only for a corporate purpose and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.[4]

In *SEC v. Tex. Gulf Sulphur Co.*[5] the Second Circuit endorsed the SEC's views in *Matter of Cady, Roberts & Co.*, finding that trading on inside corporate information by corporate insiders and their tippees violated the antifraud provisions by allowing insiders to profit from their special access to sensitive information.[6] According to the court, such unfairness frustrates "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[7] The SEC thereafter argued that the antifraud provisions of the federal securities laws require a parity of information among all traders in the public securities markets.[8]

In two important cases the Supreme Court rejected the principle that Section 10(b) of the Exchange Act insures equality of information in the

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1. 40 S.E.C. 907 (1961).
2. *Id*. at 908–10.
3. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012); 17 C.F.R. § 240.10b-5 (2017).
4. *See Cady, Roberts*, 40 S.E.C. at 911–12.
5. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).
6. *See id.* at 848.
7. *Id.*
8. *Id.* at 857–58 (finding that an insider of a company has a duty to disclose to the public market any material information that he may have possessed).

public securities trading markets,[9] or that buyers and sellers of securities owe a general duty to the market place to disclose inside information or abstain from trading.[10] In *Chiarella v. United States*[11] the Court held that liability for silence in connection with the purchase or sale of securities under Section 10(b) "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[12] This case involved a financial printer who was able to deduce the identities of takeover targets from documents sent to the printer, although the names of the bidder and target were coded (apparently not very cleverly).[13] The Court held that:

> [N]o duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.[14]

This language gave rise to the doctrine that liability under Section 10(b) in an insider trading case requires the breach of a fiduciary duty in trading on the information.[15] Nevertheless, because of Chief Justice Burger's language in a dissenting opinion in *Chiarella*, this case also gave rise to the misappropriation doctrine: misappropriation of information by an employee from an employer,[16] or breach of an attorney-client or other fiduciary relationship might be sufficient to create a duty to the buyer or seller.[17] The misappropriation doctrine was thereafter used by the SEC and

9. Dirks v. SEC, 463 U.S. 646 (1983).
10. Chiarella v. United States, 445 U.S. 222, 227–28 (1980).
11. 445 U.S. 222.
12. *Id.* at 230.
13. *Id.* at 222.
14. *Id.* at 232–33.
15. *See id.* at 227–28.
16. *See Chiarella*, 445 U.S. at 240–42 (Burger, J., dissenting) (finding that an employee "who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading").
17. *See id.* at 243 (Burger, J., dissenting) (arguing that the "mere failure to disclose nonpublic information, however acquired," is not a deceptive practice, but rather, the means by which the trader acquired his informational advantage is critical to the finding of misappropriation).

the Department of Justice (DOJ) in countless insider trading cases.[18] The theory is unsound because it is based on the idea that the trader of information was committing a fraud on the source of the information, but the source could have traded on the information without violating the law.[19] Further, as I describe below, the misappropriation theory became problematic in some tippee cases.

These problems became apparent in *Dirks v. SEC*[20] and *United States v. Winans*.[21] In *Dirks*, a security analyst and officer of a broker-dealer received information from a former officer of Equity Funding Corporation of America (Equity Funding) to the effect that Equity Funding's business was entirely fraudulent.[22] Dirks conducted his own investigation and tried to publicize his findings.[23] He then apprised his clients of the fraud and many of them sold their Equity Funding stock before the facts became public and the price of Equity Funding stock fell from $26 to less than $15 a share.[24] Although Dirks did not have a client or fiduciary relationship with Equity Funding, the SEC charged him in an administrative proceeding, holding that "where 'tippees'—regardless of their motivation or occupation—come into possession of material 'information that they know is confidential, and know or should know came from a corporate insider,' they must publicly disclose that information or abstain from trading" on it.[25] The D.C. Circuit Court affirmed the SEC's decision on a ground not argued by the Commission: that Dirks, by virtue of his fiduciary position as a securities analyst associated with a broker-dealer, was subject to a broad legal disclosure obligation in favor of the public at large.[26] The Supreme Court rejected all of these theories, holding that a

18. *See* U.S. v. O'Hagan, 521 U.S. 642 (1997); *see also* SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003); *see also* SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).

19. *See Chiarella*, 445 U.S. at 229; *see also* Gen. Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

20. 463 U.S. 646 (1983).

21. 612 F. Supp. 827 (S.D.N.Y. 1985), *aff'd*, 791 F.2d 1024 (2d Cir. 1986), *aff'd in part*, 484 U.S. 19 (1987).

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

23. *Id.* at 649–50

24. *See id.* at 649–50.

25. *Id.* at 651 (citing 21 S.E.C. Docket 1401, 1407 (1981) (quoting Chiarella v. U.S., 445 U.S. 222, 230, n. 12 (1980)).

26. Dirks v. SEC, 681 F.2d 824, 839–40 (D.C. Cir. 1982), *rev'd* 463 U.S. 646 (explaining that the "obligations, implicit in the scheme of broker-dealer registration under the federal securities laws,

tippee cannot be held liable under Section 10(b) unless use of the information breaches a fiduciary duty that the tipper owed to either his clients or his organization, and in addition, the insider must have realized a personal benefit.[27]

R. Foster Winans was a *Wall Street Journal* columnist who profited from trading in securities in advance of stories he wrote for his *Heard on the Street* column.[28] He also tipped his roommate, and both of them were prosecuted.[29] Initially, the SEC brought a civil action against Winans on two different theories.[30] One was that he breached his duty to his readers by not disclosing his intentions to profit on price movements expected from his stories about corporate matters.[31] The government's other theory, then used to prosecute Winans criminally, was that he violated his duties of honesty, loyalty and confidentiality to his employer by in effect misappropriating and trading on information about the contents of forthcoming columns.[32] The Second Circuit affirmed Winans' conviction under Section 10(b) of the Exchange Act and the mail fraud statute in a 2-1 split decision.[33] The dissenting judge pointed out that use of the misappropriation theory in this case was ludicrous since the government had admitted that the *Wall Street Journal* could have traded on this information.[34] The criminal case then went to the Supreme Court, which also split 4-4, so Winans' conviction was affirmed.[35]

Chiarella, *Dirks* and *Winans* were misguided prosecutions, serving as examples of bad cases making bad law. None of these defendants really stole information belonging to others, and to some extent the defendants came to their trading conclusions based on their own efforts to dig out facts.[36] Justice Powell, who wrote the opinions in both *Chiarella* and

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provide a basis for imposing a duty to disclose-or-refrain" on those associated with broker-dealers due to "the importance of broker-dealers within the securities markets" where "broker-dealers [are] required to meet a high standard of ethical behavior in their activities").

27. *Dirks*, 463 U.S. at 661–64.
28. United States v. Winans, 612 F. Supp. 827, 829 (S.D.N.Y. 1985).
29. *Id.*
30. *Id.* at 844.
31. *Id.*
32. *Id.*
33. United States v. Carpenter, 791 F.2d 1024, 1025 (2d Cir. 1986).
34. *Id.* at 1037 (Miner, J., dissenting).
35. Carpenter v. United States, 484 U.S. 19, 24 (1987).
36. *See Carpenter*, 484 U.S. at 22-23. *See also* Dirks v. SEC, 463 U.S. 646, 649-50 (1983);

Dirks, rejected the SEC's broad parity of information principle for insider trading, limiting Section 10(b) by the common law.[37] But Congress passed the federal securities laws as broad remedial legislation to make the public securities markets fair and equitable and to instill confidence in those markets and in investors because the common law was inadequate to do so.[38] In addition, Justice Powell tacked on the personal benefit requirement in *Dirks* without any real analysis or justification.[39] The purpose of the personal benefit requirement was to limit liability and not leave insider trading prosecutions to the prosecutorial discretion of the SEC.[40] Surely, it would have been better to develop a doctrine to distinguish between diligent research and information obtained through dishonest methods. On the other hand, the SEC should have developed such a doctrine rather than trying to cast the widest possible net to catch insider traders.

Many years ago, I argued that the prohibitions against trading on inside information should be justified as necessary to enforce the mandatory disclosure provisions of the securities laws.[41] Further, instead of trying to suppress the use of nonpublic information, the SEC should encourage more rapid disclosure of material information.[42] Thereafter, these ideas were taken up to some extent by the SEC and the Congress by the adoption of Regulation FD,[43] which requires public companies to make prompt disclosure if material information is given, intentionally or inadvertently, to a securities analyst or other securities professional, and by the provisions of the Sarbanes-Oxley Act of 2002, which requires accelerated disclosure timelines for annual and period reports by public companies.[44]

The difficulties in distinguishing between legitimate research by

Chiarella v. United States, 445 U.S. 222, 224 (1980).

37. *Dirks*, 463 U.S. at 653; *Chiarella*, 445 U.S. at 227-28.

38. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

39. *See* 463 U.S. at 647.

40. United States v. Martoma, 869 F.3d 58, 76 (2d Cir. 2017) (Pooler, J., dissenting).

41. Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83 (1998).

42. *Id.* at n. 40.

43. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881 (Aug. 15, 2000).

44. *See* Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 33-8128, 67 Fed. Reg. 58,480 (Sept. 16, 2002).

securities industry professionals and inside information subject to the disclose-or-abstain rule were highlighted by recent cases involving portfolio managers.[45] In *United States v. Newman* a group of financial analysts who were remote tippees received information from insiders at two public companies that disclosed earnings numbers before they were publicly announced.[46] The analysts then passed this information on to the defendants, who were portfolio managers for hedge funds who earned $4 million and $68 million in profits.[47] The defendants were three or four steps away from the tippers and the case lacked any proof that they were aware of the source of the inside information.[48]

Although the portfolio managers were convicted, their convictions were overturned by the Second Circuit on the ground that, under *Dirks*, in order for a tippee to be guilty of insider trading, the government must prove:

> (1) The corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit.[49]

Further, the court took a narrow view of the personal benefit requirement, holding that it should be objective, consequential, and represent a potential gain of a pecuniary or similarly valuable nature.[50] Also, the tipper and tippee should have a meaningful close personal relationship.[51] This last requirement was later repudiated by the Second Circuit.[52]

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45. United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014); United States v. Martoma, 869 F.3d 58, 76 (2d Cir. 2017).
46. *Newman*, 773 F.3d at 443.
47. *Id.*
48. *Id.* at 444.
49. *Id.* at 450; *see* United States v. Jiau, 734 F.3d 147, 152-53 (2d Cir. 2013); Dirks v. United States, 463 U.S. 646, 659-64 (1983).
50. *Newman*, 773 F.3d at 452.
51. *Id.*
52. United States v. Martoma, 869 F.3d 58, 76 (2d Cir. 2017).

The DOJ then looked for a case with better facts to challenge this holding in the Supreme Court and found that case in *Salman v. United States*.[53] The Court upheld the conviction of a tippee of information emanating from a former Citibank investment banker about mergers and acquisitions by clients of the bank.[54] The banker gave the information to his brother, who in turn gave it to a friend and relative by marriage.[55] The Court simply reaffirmed the reasoning of *Dirks* in this case and held that when a tipper gives inside information to a trading relative or friend, the jury can infer that the tipper meant to the provide the equivalent of a cash gift.[56] Thus, one of the unsatisfactory aspects of *Newman*, *Salman* and other remote tippee cases is a lack of reasoning as to why the tippee and not the tipper were prosecuted.

The fiduciary principle by which the Supreme Court has limited Section 10(b) insider trading cases is inadequate in at least three factual situations—trading in advance of tender offers[57]; leaks of information or trading on information by government officials[58]; and trading on hacked information.[59] These scenarios will be discussed below.

Many insider trading cases arise in the context of a contest for control. While some prosecutions have proceeded under Section 10(b), many have been combined with actions under Section 14(e) of the Exchange Act governing the conduct of tender offers.[60] Section 14(e) was passed as part of the Williams Act in 1968, and is a self-operating provision prohibiting the use of all fraudulent, deceptive and manipulative

53. 137 S. Ct. 420 (2016); *see also* Peter J. Henning, *Supreme Court Shores Up Insider Trading Law*, N.Y. TIMES (Dec. 7, 2016), https://www.nytimes.com/2016/12/07/business/dealbook/ supreme-court-shores-up-insider-trading-law.html.

54. *Salman*, 137 S. Ct. at 421-22.

55. *Id.*

56. *Id.* at 428.

57. *See* Tender Offers, 44 Fed. Reg. 9956, 9957 (Feb. 15, 1979).

58. *See* Alan D. Jagolinzer et al., *Political Connections and the Informativeness of Insider Trades* at 9 (Rock Center for Corporate Governance at Stanford University, Working Paper No. 222, 2016); *see also* Patrick Radden Keefe, *The Empire of Edge*, NEW YORKER (Oct. 13, 2014), https://www.newyorker.com/magazine/2014/10/13/empire-edge; Roger Parloff, *The Gray Art of Not Quite Insider Trading*, FORTUNE (Aug. 15, 2013), http://fortune.com/2013/08/15/the-gray-art-of-not-quite-insider-trading/.

59. *See, e.g.*, SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

60. 15 U.S.C. § 78n(e) (2012).

acts and practices in connection with a tender offer.[61] In 1970, Congress amended the Williams Act to give the SEC rulemaking power to define, and prescribe means reasonably designed to prevent, such acts and practices that are fraudulent, deceptive, or manipulative.[62] After the *Chiarella* decision, the SEC adopted Rule 14e-3, which provides that as soon as any person "has taken a substantial step or steps to commence" a tender offer, such action

> shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information . . . has been acquired directly or indirectly from the offering person . . . to purchase or sell [securities of the target company].[63]

The SEC purposefully did not include a fiduciary duty requirement in Rule 14e-3, as this rule was designed in part to overcome the fiduciary principle imposed by *Chiarella* in Section 14(e) cases.[64]

The SEC proposed and adopted Rule 14e-3 as part of a large package of rules designed to protect target company shareholders under the Williams Act.[65] Accordingly, it was not justified under the parity of information rationale argued by the SEC earlier in Section 10(b) cases. Rather, it imposed a disclose-or-abstain duty on tippees of potential bidders in takeovers in order to protect target company shareholders.[66]

The SEC could eliminate some of the abuses of insider trading in connection with tender offers by closing the ten-day window that allows persons or groups who acquire five percent or more of a public corporation's stock from filing a 13D report disclosing such a position for ten days.[67] Although the SEC was given the authority to do so in Sarbanes-

61. *Id.*
62. *See* Williams Act, Pub. L. No. 91-567 (Dec. 22, 1970).
63. 17 C.F.R. § 240.14e-3 (2017); United States v. Marcus Schloss & Co., 710 F. Supp. 944, 957 (S.D.N.Y. 1989).
64. Tender Offers, 44 Fed. Reg. 9956, 9977 (Feb. 15, 1979).
65. *See id.*
66. Proposed Amendments to Tender Offer Rules, 44 Fed. Reg. 70349, 70353 (Dec. 6, 1979); *see also* U.S. v. O'Hagan, 521 U.S. 642, 645 (1997).
67. *See* Securities Exchange Act of 1934, Rule 13d-1(a), 17 C.F.R. § 240.13d-1(a) (2007).

Oxley, it has not exercised this authority.[68] In my opinion, leaving the ten-day window open is an inappropriate policy, as it prefers the interests of activist investors over target company shareholders.[69]

Ultimately, Rule 14e-3 is a very narrow exception to the fiduciary principle since it applies only to change of control transactions involving a tender offer.[70] Other tippee problems in the merger and acquisition arena necessarily depend on Rule 10(b)(5) and, as demonstrated by the *Newman* case, can result in failed prosecutions because of the restrictions of *Dirks*.[71]

There have been few cases testing the scope or validity of Rule 14e-3. In *United States v. O'Hagan*[72] the Eighth Circuit took the position that Rule 14e-3 exceeded the SEC's authority under the Exchange Act and that the Supreme Court's jurisprudence under Section 10(b) should be imported into any interpretation of Section 14(e) and Rule 14e-3 because the statutory language was essentially the same.[73] The Supreme Court did not agree with either of the Eighth Circuit's positions.[74] The defendant in *O'Hagan* was an attorney who traded on information that he learned at his law firm about an upcoming tender offer by a client of the firm.[75] He was convicted under Section 14(e).[76] The Eighth Circuit overturned the conviction, but the Supreme Court reversed the Eighth Circuit, applying the misappropriation theory.[77] According to the majority opinion, a "misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through

68. *See* Sarbanes-Oxley Act of 2002, Pub. L. 107-204 (July 30, 2002), 116 Stat. 715, 788 (2002) (The SEC did exercise its authority to accelerate reports by insiders as to their beneficial ownership positions under Section 16(a)); *see also* 4 James D. Cox and Thomas Lee Hazen, Treatise on the Law of Corporations § 24:2 (3d) at 1 (explaining that while the SEC advisory group has considered amending the rules, no such change has taken place).

69. By leaving the ten-day window open, large activist investors are given the unfair opportunity to acquire shares without the necessary disclosure that would help target company shareholders protect their interests. In addition, this window threatens the stability of the company by preventing a proper warning of unwanted prospective buyers.

70. 15 U.S.C. § 78n(e) (2012).

71. *See* United States v. Newman, 773 F.3d 438, 450 (2d Cir. 2014); *but see* Dirks v. SEC, 463 U.S. 646, 649-50 (1983).

72. United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

73. *Id.* at 612-13.

74. *O'Hagan*, 521 U.S. at 649.

75. *Id.* at 647.

76. *Id.* at 649.

77. *Id.* at 666.

deception; he deceives the source of the information and simultaneously harms members of the investing public."[78] Although this rationale would seem to go beyond the fiduciary principle, the majority opinion adheres to that principle, stating that

> because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information there is no 'deceptive device' and thus no Section 10(b) violation.[79]

This is a very strained rationalization of the property rights theory of the inside information prohibition and makes little sense as applied to the facts of *O'Hagan* and many other cases.[80]

With regard to Rule 14e-3, the Court in *O'Hagan* held that the rule was a proper exercise of the SEC's authority to define and prescribe "means reasonably designed to prevent" tender offer fraud.[81] Further, a minority opinion recognized that it might be difficult to prove that the trader with inside information about a tender offer obtained such information in breach of a duty.[82] Accordingly, the Court affirmed O'Hagan's conviction under the rule.[83]

A different type of case involving trading based on hacking into a computer system and trading on information thus obtained cannot be prosecuted under the fiduciary principle since a hacker is not anyone's fiduciary.[84] Nevertheless, some cases of this type have been successfully prosecuted.[85] In *SEC v. Dorozhko* the Second Circuit upheld such a conviction on the theory that tricking the host system into believing that

78. *Id.* at 656.

79. *Id.* at 655.

80. *See* Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and the Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable*, 59 BROOKLYN. L. REV. 149 (1993) (rejecting the idea of protecting inside information as intellectual property and arguing for a balanced perspective on the law of insider trading where prohibitions against trading on inside information are necessary to supplement the mandatory disclosure regime in order to protect investors and the integrity of the public securities markets).

81. *O'Hagan*, 521 U.S. at 673.

82. *Id.* at 697–98 (Thomas, J., dissenting).

83. *Id.* at 677–78.

84. *See* SEC v. Dorozhko, 574 F.3d 42, 49–50 (2d Cir. 2009).

85. *See id*.

access was authorized was a form of deception, making application of the fiduciary principle unnecessary.[86] Hacking could be a "deceptive device or contrivance" within Sections 10(b) and Rule 10b-5.[87] Subsequent hacking cases have followed this reasoning.[88] If any such cases reach other circuits or the Supreme Court, it surely would require a form-over-substance approach to find that trading on hacked information does not violate Section 10(b).

In the STOCK Act of 2012 Congress provided for liability for insider trading, enforceable by the SEC, on federal government officials, including members of Congress.[89] Section 10(b) of the Exchange Act provides that congressional officials have:

> [A] duty arising from a relationship of trust and confidence to the Congress, the United States Government and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[90]

Section 10(b) of the Exchange Act imposes a similar duty on executive and judicial branch employees.[91] The SEC has not been very successful in investigating or prosecuting cases pursuant to this authority.[92] Nevertheless, it would appear that many insider trading cases originate from improper leaks of information about government actions.[93]

Prior to the *Chiarella* decision, the SEC was arguing for an overly

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86. *Id.*

87. *Id.* at 51.

88. *See* Leslie Picker, *3 Men Made Millions by Hacking Merger Lawyers, U.S. Says*, N.Y. TIMES, Dec. 27, 2016, at B1-B2.

89. Stop Trading on Congressional Knowledge (STOCK) Act of 2012, Pub. L. No. 112-105; 126 Stat. 291.

90. 15 U.S.C. § 78u-1(g)(1) (2012).

91. 15 U.S.C. § 78u-1(h)(1).

92. *See* Martin O'Sullivan, *House*, *SEC End Health Care Insider Trading Subpoena Row*, LAW 360 (Jan. 19, 2017), https://www.law360.com/articles/882785/house-sec-end-health-care-insider-trading-subpoena-row; *see also* Craig Homan, Ph.D., *The Impact of the STOCK Act on Stock Trading Activity by U.S. Senators 2009-2-15,* PUBLIC CITIZEN, June 22, 2017.

93. *See* Jagolinzer et al., *supra* note 58; Press Release, U.S. Attorney's Office, S.D.N.Y., Four Charged In Scheme To Commit Insider Trading Based On Confidential Government Information (May 24, 2017); *see also* Keefe, *supra* note 58; Parloff, *supra* note 58.

broad doctrine for insider trading cases—the parity of information theory that all players in the public securities market should have equal access to information.[94] Justice Powell, a conservative and pro-business jurist, seized upon this untenable formulation to introduce the fiduciary principle into insider trading cases.[95] It is highly unlikely that the Supreme Court will delete the fiduciary principle from insider trading 10(b)(5) cases, even though it is theoretically unsatisfactory and has been undermined by Rule 14e-3, the hacking cases and the STOCK Act.[96] Statutory reform would be a better solution to the problems discussed in this essay.

In 1987, there was a serious effort to define insider trading by statute. A committee of securities lawyers suggested a definition that was then introduced as part of The Insider Trading Proscriptions Act of 1987.[97] The bill provided that "information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other duty-relationship of trust and confidence."[98] The SEC objected to this definition as too narrow because it sought to outlaw trading when a person was in possession of inside information.[99] After hearings, proposals introduced a revised definition that would have prohibited trading by anyone in possession of inside information, defined as information obtained by:

> (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.[100]

94. *See.* SEC v. Tex. Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

95. *See* Dirks v. SEC, 463 U.S. 646, 653 (1983); *see also* Chiarella v. United States, 445 U.S. 222, 227–28 (1980).

96. *See* United States v. O'Hagan, 521 U.S. 642, 679 (1997); 17 C.F.R. § 240.14e-3 (2017); Stop Trading on Congressional Knowledge (STOCK) Act of 2012, Pub. L. No. 112-105; 126 Stat. 292.

97. S. 1380, 100th Cong., 1st Sess. (1987).

98. *Id.*

99. *See* Accompanying Letter, and Analysis by Ad Hoc Legis. Comm., 19 Sec. Reg. & L. Rep (BNA) 1817 (Nov. 27, 1987).

100. *Id.*

This effort to define insider trading by statute floundered because of the possession versus use controversy and the SEC's lack of cooperation with the legislative effort.[101] Nevertheless, since the context of this initiative was rampant, insider trading and other abuses by risk arbitragers and others loosely connected with Michael Milken in the hot mergers and acquisition market, Congress did pass the Insider Trading and Securities Fraud Enforcement Act of 1988.[102] Among other things, this Act created a private right of action on behalf of contemporaneous traders,[103] inserted a bounty provision into the Exchange Act for persons providing information about insider trading,[104] and increased criminal fines for insider trading.[105] Unfortunately, a definition of insider trading was left to the courts.[106]

The prohibition against insider trading was injected into Section 10(b)(5) by the SEC and the courts.[107] The statute does not define insider trading, and the courts therefore are free to structure this violation as they choose.[108] Although Congress has passed legislation, such as the 1988 Act to increase sanctions for insider trading, it has not defined this crime. That lack of a definition has troubled some jurists[109] and led to some of the anomalies in interpreting the statute described below.

After the *Newman* decision, there was a flurry of activity in the direction of a new effort to define insider trading by statute, which fizzled out after the *Salman* decision and in view of the general deregulatory climate in Washington.[110] Even before the *Newman* case the DOJ was

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101. *See* Karen Schoen*, Insider Trading: The "Possession Versus Use" Debate,* 148 U. PA. L. REV. 239, 249 (1999); *See also* Roberta S. Karmel, *A Critical Look at Insider Trading Policies*, NEW YORK LAW JOURNAL, Feb. 19, 2015.

102. *See* Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, 82 IND. L.J. 575, 583 (2007).

103. Exchange Act § 20A, 15 U.S.C. § 78t-1(a) (2012).

104. Exchange Act § 21A, 15 U.S.C. 78u-1(e) (2012).

105. Exchange Act § 32(a), 15 U.S.C. § 78ff(a) (2012).

106. Cindy A. Schipani & H. Nejat Seyhun, *Defining "Material, Nonpublic": What Should Constitute Illegal Insider Information?,* 21 FORDHAM J. CORP. & FIN. L. 327, 334–41 (2016)

107. 15 U.S.C. § 78u-1 (2012).

108. 15 U.S.C. § 78u-1.

109. *See* Chiarella v. United States, 445 U.S. 222, 236-37 (1980). Justice Powell refused to uphold the conviction of Chiarella because the misappropriation theory had not been argued in the lower court. *Id.* at 236–37; *see also* United States v. O'Hagan, 521 U.S. 642 (1997). Justice Scalia complained about lenity in the O'Hagan case. *O'Hagan*, 521 U.S. at 679.

110. *See The Second Circuit's Insider Trading Feud*, WALL ST. J., Sept.18, 2017; *See also* Che Odom, *Congress Should Define 'Insider Trading': Ex-SEC Official*, 48 SEC. REG. & L. REP. 405 (Feb.

having difficulty in prevailing in some of its remote tippee insider cases.[111] Although the SEC may have put too much of its resources into insider trading cases, especially remote tippee cases, over the years, the ban on insider trading is important to investor confidence in the markets. Because this is a criminal as well as a civil violation of the law, it should be defined. One would hope that in a more enlightened atmosphere in Washington than now exists, a statutory definition of insider trading could be put into law. Further, such a definition would include duties of confidentiality beyond fiduciary duty. The fiduciary principle is too narrow and the misappropriation exception is based on a property rights theory which has little to do with protecting investors.

24, 2016) (stating "[a] statute is needed to create some certainty in the law").

111. *See* Thomas O. Gorman, *SEC v. Cuban: Another Major Loss for the SEC*, LEXISNEXIS, Oct. 17, 2013, https://www.lexisnexis.com/legalnewsroom/securities/b/securities/archive/2013/10/17/ sec-v-cuban-another-major-loss-for-the-sec.aspx?Redirected=true; Nate Raymond, *SEC Loses Insider Trading Case Against New York Fund Manager*, REUTERS (May 30, 2014), http://www.reuters.com/article/us-sec-insidertrading-idUSKBN0EA26Q20140530.