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REREADING *CADY, ROBERTS:* THE IDEOLOGY AND PRACTICE OF INSIDER TRADING REGULATION

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William Cary's opinion for the SEC in In re Cady, Roberts & Co. *built the foundation on which the modern law of insider trading rests. This article takes three aspects of* Cady, Roberts, *and relates them to contemporary ideology and practice. The first part asks why insider trading has such political and legal resonance given the ambiguity about the harms that flow from it. The second considers the most important current doctrinal issue in insider trading regulation: the "possession" versus "use" debate. The third considers why the SEC has historically preferred adjudication to rulemaking as a way of articulating the scope of the prohibition.*

INTRODUCTION

We are told that when William Cary became Chairman of the SEC in 1961, he had only a short policy agenda.[1] One item on it, however, was to overturn the Supreme Judicial Court of Massachusetts's decision in *Goodwin v. Aggasiz*,[2] which had held thirty years earlier that open-market insider trading was not actionable as common law fraud. Cary soon wrote the Commission's opinion in an administrative broker-dealer disciplinary proceeding, *In re Cady, Roberts & Co.*,[3] that for the first time treated exchange-based insider trading as federal securities fraud. He thus set in motion the modern law of insider trading.

So much insider trading precedent has been made since then—including three authoritative Supreme Court decisions in the 1980s and 90s—that Cary's opinion has the status of a relic, often cited, seldom read. But reading it again is interesting because of what it anticipates. It frames the subsequent intellectual history of insider trading regulation, providing a good grounding for how and why the SEC has made insider trading a centerpiece for its program of securities enforcement. It also helps place the most recent Supreme Court case, *United States v. O'Hagan*, in historical context.[4]

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* Professor of Law, Georgetown University Law Center. Thanks are due to Joel Seligman, Jim Cox, Elliott Weiss, and participants at a Vanderbilt Law School Dean's lunch for helpful comments.

1. See Joel Seligman, The Transformation of Wall Street 344–45 (2d ed. 1995).
2. 186 N.E. 659 (1933).
3. 40 S.E.C. 907 (1961).
4. 521 U.S. 642 (1997). For other efforts along the same lines, albeit somewhat more celebratory of *O'Hagan* than I will be, see A.C. Pritchard, United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading, 78 B.U. L. Rev. 13 (1998); Joel Seligman, A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems, 23 Del. J. Corp. L. 1 (1998); and Elliott J. Weiss, United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading, 23 J. Corp. L. 395 (1998). See also Victor Brudney, O'Hagan's Problems, 1997 Sup. Ct. Rev. 249 (1998). On a far

The following three Parts seek to tie *Cady, Roberts* to aspects of insider trading law and policy that are still intriguing and controversial. Part I traces an ideology of insider trading regulation that connects *Cady, Roberts* to *O'Hagan,* with their displacement of the technical requirements of fraud as understood at common law in favor of a highly expressive condemnation of fiduciary irresponsibility in the name of "investor confidence." It explores, sympathetically, the "mythic" nature of the justification for aggressive insider trading enforcement. Part II then turns to a doctrinal issue that links *Cady, Roberts* to today's case law: whether an insider trading enforcement action must prove that the insider actually took advantage of inside information, or simply that he possessed it at the time of trading. Finally, Part III asks why the SEC has not yet sought to codify the law of insider trading, instead (as in *Cady, Roberts*) being content to proceed via piecemeal adjudication.

I. *Cady, Roberts* and the Myth of Investor Confidence

> [T]he securities acts may be said to have generated a wholly new and far-reaching body of federal corporation law.
>
> — *In re Cady, Roberts & Co.*[5]

Cary's speeches and writings during and after his chairmanship at the SEC leave little doubt that he believed that state corporate law was moribund, perhaps even corrupt.[6] Investor protection required a body of federal law far more sensitive to the temptations managers face to overreach at shareholders' expense, embodying a higher ideal of fiduciary responsibility. Given the textual emphasis on disclosure in the securities statutes, that goal required a substantial blurring of the line between fraud and fiduciary duty, and something of a disdain for the spirit of federalism. As the Commission's opinion candidly acknowledged, *Cady, Roberts* was very much a "new corporation law" case.[7]

Indeed, fraud plays relatively little formal role in the decision. Cary does draw from what he concedes is "minority"-view common law author-

more critical note, see Richard W. Painter et al., Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan, 84 Va. L. Rev. 153 (1997); Larry Ribstein, Federalism and Insider Trading, 6 Sup. Ct. Econ. Rev. 123 (1998).

5. 40 S.E.C. at 910

6. The best known expression of this is William Cary, Federalism and Corporate Law: Reflections on Delaware, 83 Yale L.J. 663 (1974). See also William Cary, Corporate Standards and Legal Rules, 50 Cal. L. Rev. 408 (1962).

7. See *Cady, Roberts,* 40 S.E.C. at 910. Cary's other major administrative proceeding opinion along these lines is In re Franchard Corp., 42 S.E.C. 163 (1964) (compelling disclosure of controlling person's conflicts of interest, but not of director's failure to monitor effectively), a more cautious initiative that perhaps reflects the additional years of political experience that Cary had gained. The "new corporation law" aphorism was celebrated by Cary's former legal assistant (a principal drafter of the *Cady, Roberts* opinion) in Arthur Fleischer, "Federal Corporation Law": An Assessment, 78 Harv. L. Rev. 1146 (1965).

ity that had compelled disclosure of inside information in face-to-face dealings between managers and shareholders, and notes the incorporation of this approach in a handful of federal securities fraud cases. But this then quickly gives way to a cascade of fiduciary rhetoric: The antifraud provisions "are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."[8] "Intimacy," he then says, "demands restraint lest the uninformed be exploited."[9] True, but never confronted or even mentioned in all of this is the central holding of the despised *Goodwin*, that what is lacking in open market insider trading (as opposed, arguably, to face-to-face dealings) is anything resembling detrimental reliance by the so-called victims of the fraud on any aspect of the insider's conduct.[10]

In this sense, as I have argned before, it is apt to characterize *Cady, Roberts* and its judicial progeny as treating insider trading as "constructive fraud."[11] Under the received learning with which Cary was enamored, insiders are supposed to work for the company's shareholders, not take advantage of them. Insider trading is unfair, and it is hidden from public view. Hence, the term fraudulent is properly applied, without undue worry about what Cary termed "fine distinctions and rigid classifications."[12]

If this is right, *Cady, Roberts* was an important first step in the line of authority that quickly sprang up treating corporate mismanagement as fraud when it involved self-dealing purchases or sales between insiders and the company itself, or other unfair transactions not involving any active investor involvement. The rapid extension of this line was famously blocked by the Supreme Court in the mid-1970s, most notably by the language in *Santa Fe Industries v. Green* that refused to equate fraud and fiduciary responsibility and doubted the very propriety of a "new federal corporation law."[13] Fine distinctions and rigid classifications became

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8. *Cady, Roberts*, 40 S.E.C. at 911.

9. Id. at 912.

10. This concern was raised in one of the first major critical commenatries on *Cady, Roberts*. See William Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 Colum. L. Rev. 1361, 1381 (1965) [herinafter Painter, Inside Information]. Interestingly, Painter in a later work notes that throughout the 1950s, the SEC seemed to publicly concede that it was statutorily unable to reach insider trading via Rule 10b-5 for this reason. See William Painter, The Federal Securities Code and Corporate Disclosure 221–23 (1979). Later, it became the basis of the Sixth Circuit's determination denying damage recovery to other marketplace traders in an insider trading case, Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

11. See Donald C. Langevoort, Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement, 70 Cal. L. Rev. 1, 5–9 (1982); Weiss, supra note 4, at 397.

12. *Cady, Roberts*, 40 S.E.C. at 912. The seminal judicial endorsement of *Cady, Roberts*—SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc)—contained no significant discussion of deception or reliance either.

13. 430 U.S. 462 (1977). For an evaluation of the pre-*Santa Fe* development of the law relating to corporate mismanagement, see James D. Cox, Fraud is in the Eyes of the Beholder: Rule 10b-5's Application to Acts of Corporate Mismanagement, 47 N.Y.U. L.

more fashionable once again, lest Rule 10b-5 expand to cover the corporate universe.

Curiously, however, the law of insider trading (indeed, much of securities regulation) survived this doctrinal retrenchment. Three years after *Santa Fe*, the Court had an opportunity in *Chiarella v. United States*[14] to expose the fragile deceptive foundation of insider trading liability but chose not to do so. It refined and narrowed the scope of liability in the name of notice and predictability, but ironically in light of *Santa Fe*, structured what remained of insider trading liability in terms of fiduciary duty.[15] Once again, the reliance requirement—so well-recognized elsewhere in securities fraud litigation—was swept under the rug.

Chiarella, at least, spoke in terms of a disclosure obligation running to other marketplace traders, and hence described something with at least the trappings of conventional fraud. Not so with the principal alternative insider trading theory devised in the 1980s to counter *Chiarella*'s restrictiveness, the misappropriation theory. There, insider trading is unlawful to the extent that the trader deceives the source of the information, who entrusted him with the secret on the misplaced expectation that he would respect the confidence.[16] That brings us to the close intellectual (if not doctrinal) connection between *Cady, Roberts* and the Supreme Court's recent affirmation of the misappropriation theory in *O'Hagan*.

Rev. 674 (1972). Even outside of the law of insider trading, there is reason to doubt whether the Supreme Court put much of a damper on the development of federal corporation law. See Joel Seligman, The New Corporate Law, 59 Brook. L. Rev. 1 (1993); see also Donald C. Langevoort, Fraud and Deception by Securities Professionals, 61 Tex. L. Rev. 1247 (1983).

14. 445 U.S. 222 (1980).

15. In essence, *Chiarella* held that an insider had a duty to abstain or disclose to other marketplace traders only where he or she stood in some sort of fiduciary relationship to those traders. See Langevoort, supra note 11, at 12–14. There has been an interesting debate ever since as to whether this fiduciary duty is measured by reference to state law or some notion of federal common law. Compare Stephen Bainbridge, Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition, 52 Wash. & Lee L. Rev. 1189 (1995), with Theresa Gabaldon, State Answers to Federal Questions: The Common Law of Federal Securities Regulation, 20 J. Corp. L. 155, 199 (1995). No court has thus far suggested that the fiduciary analysis in insider trading cases is anything but a matter of federal law, and it is difficult to imagine any logic behind so doing except a desire to limit or confuse the scope of the insider trading prohibition. For an effort along these lines that seems driven by the implicit assumption that the Supreme Court's affirmation of the misappropriation theory in *O'Hagan* was wrong, see Steven Ramirez & Christopher Gilbert, The Misappropriation Theory of Insider Trading Under *United States v. O'Hagan*: Why the Bark is Worse than the Bite, 26 Sec. Reg. L.J. 129 (1998). To me, it seems extraordinarily forced to try to see *O'Hagan* as a pro-federalism opinion: It is just the opposite.

16. See United States v. Newman, 664 F.2d 12 (2d Cir. 1981). The misappropriation theory has generated extensive commentary, both before and after *O'Hagan*. In addition to the sources cited in note 4 supra and note 17 infra, see Donald Langevoort, Insider Trading: Regulation, Enforcement and Prevention § 6.02 (1998 ed.); Barbara B. Aldave, The Misappropriation Theory: *Carpenter* and its Aftermath, 49 Ohio St. L.J. 373, 375 (1988).

Ever since the misappropriation theory was invented and endorsed by the Second Circuit, its shaky underpinnings have been thoroughly discussed in the literature.[17] Two main concerns were identified, both derived directly from *Santa Fe*. One was that the misconduct was simply a breach of fiduciary duty, not any active form of fraud. The other was the difficulty in seeing misappropriation as fraud "in connection with" a securities transaction when the source/victim of the fraud is unlikely to have engaged in any securities trading at all. What seems fairly clear is that the misappropriation theory is a paradigmatic example of Cary's "new federal corporation law," albeit extended even beyond the corporation itself to other sites of common law fiduciary responsibility. It thus invited a dual strict constructionism and federalism attack, and, after a surprisingly long time, finally received one from the Fourth Circuit[18] and then the Eighth.[19]

Justice Ginsburg's response in *O'Hagan* is strikingly Cary-esque in its willingness to embrace the rhetoric of fiduciary responsibility within the conduct norms of Rule 10b-5. The discussion of why misappropriation is a fraud almost treats the issue as self-evident—so long as a breach of fiduciary duty is secretive, it is deceptive. That is all well and good (and it is hard to imagine the contrary given the jurisprudence of the mail and wire fraud statutes established by the Court in the *Carpenter* case[20]). But notwithstanding a respectful bow to the earlier decision, it renders *Santa Fe* of minimal significance given that very few breaches of fiduciary duty are ever done brazenly. There is almost always some element of concealment. The only interesting consequence here is the necessary acknowledgement that this duty is essentially contractual, that no breach occurs if the trader gains consent from the source in advance or (more hypothetically) discloses the trading just before it occurs.[21] This pleases those who see the insider trading prohibition largely as a corporate property protection mechanism,[22] but that view then runs straight back into the federal-

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17. See Langevoort, supra note 11, at 46–48; Richard Phillips, Insider Trading Liability After *Dirks*, 16 Rev. Sec. Reg. 841 (1983). More belatedly, see Michael P. Kenny & Teresa D. Thebaut, Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b), 59 Alb. L. Rev. 139 (1995).

18. See United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).

19. See United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996).

20. Carpenter v. United States, 484 U.S. 19 (1987) (determining that insider trading constitutes fraud within the meaning of the mail and wire fraud statutes).

21. See United States v. O'Hagan, 521 U.S. 642, 654–55, 659 n.9 (1997). Though one can doubt that very few employees would dare try this approach of disclosing their breach to their employer so as to clear the way to trade, it might be more likely to happen in a family relationship, where the threat of firing is less. See Donna M. Nagy, Reframing "The" Misappropriation Theory of Insider Trading Liaility: A Post-*O'Hagan* Suggestion, 59 Ohio St. L.J. 1223 (1998).

22. The best judicial expression of this view, which is widely shared among law and economics-oriented scholars, is Judge Winter's concurring opinion in United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (en banc). Though Winter recognized the federalism point, he said that the law was "too far down this road" to let that stand in the

ism question of why the protection of corporate property interests ought to be a matter of federal rather than state law.

The heart of the *O'Hagan* opinion is Ginsburg's explanation of why the "in connection with" language is satisfied by a fraud that is practiced on a victim (the source of the information) who need not be, and usually is not, a purchaser or seller of securities.[23] Both the Fourth and Eighth Circuits had made much of the fact that in earlier misappropriation cases, the types of injuries found sufficient to trigger federal securities liability included violations of patient-psychiatrist and spousal confidentiality and the threat to the journalistic integrity of a newspaper—all matters plainly more of state than federal interest, and very far removed from the historic concerns of the securities laws. Ginsburg's retort was simple: While the *fraud* may be on a non-trader, there is still an *injury* to investors from the trading.[24] Unfortunately, she never says what the injury is. There is simply a citation to a law review article by Barbara Aldave,[25] which in turn cites William Wang's study of the marketplace impact of insider trading.[26] Wang's view is incisive if highly academic: He argues that the harm from insider trading is visited not so much on the opposite parties to the transaction (because there is no real deception or reliance) but rather on the traders whose purchases or sales are crowded out. Ginsburg could also have cited some finance literature that suggests a harm from insider trading that is visited largely on marketmakers and stock exchange specialists, forcing them to widen their bid-ask spreads.[27]

That, too, is all well and good, if still a little muddy as an empirical matter. But we have landed in a strange place, because in all the legislative, administrative, and judicial hand-wringing over insider trading, no one has ever really suggested that the prohibition of insider trading is motivated by a desire to narrow bid-ask spreads or help preempted trad-

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way. Id.; see also Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9 (1984).

23. In *O'Hagan*, the victims were O'Hagan's law firm (clearly not a purchaser or seller) and the firm's client, Grand Met (which arguably was one).

24. See *O'Hagan*, 521 U.S. at 656.

25. See Barbara B. Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 120–21 & n.107 (1984).

26. 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 So. Cal. L. Rev. 1217, 1230–40 (1981). This view is further elaborated in W. Wang & M. Steinberg, Insider Trading ch. 3 (1996). For thorough examinations of the harms and benefits of insider trading, see James D. Cox, Insider Trading and Contracting: A Response to the "Chicago School," 1986 Duke L.J. 628, and Merritt B. Fox, Insider Trading in a Globalizing Market: Who Should Regulate What?, Law & Contemp. Probs., Autumn 1992, at 263.

27. See, e.g., Lawrence R. Glosten, Insider Trading, Liquidity and the Role of Monopolist Specialist, 62 J. Bus. 211 (1989). More generally, arguing that the finance literature is largely undecided on the relative costs and benefits of insider trading, see Hu & Noe, The Insider Trading Debate, Econ. Rev. (Fed. Res. Bank of Atlanta) 34 (4th Quarter 1997).

ers. Nor does Justice Ginsburg seem to want to place too much weight on evidence of actual marketplace injury, for she quickly moves to a different explanation for why a ban on misappropriation is properly grounded in the federal securities laws, rather than left a matter of state trade secret or corporate law. Here she invokes the very same point that led Cary to *Cady, Roberts*: Absent an acceptably broad prohibition on insider trading, investor confidence in the integrity of the American trading markets would diminish, threatening their depth and liquidity.[28] And that is squarely within the zone of interests of federal regulation. Having declared this, the remainder of the 10b-5 portion of the opinion is then denouement. In an unnecessarily scholastic debate, Ginsburg rejects Justice Thomas's argument that there is no distinction in kind between the misappropriation of information and the embezzlement of money which is then used to purchase securities (which government counsel had conceded is not securities fraud);[29] after that, there was only the relatively simple matter of distinguishing the Court's more restrictive holdings in *Chiarella*, *Dirks*,[30] and *Central Bank of Denver*.[31]

What neither Ginsburg nor Cary ever does, however, is rigorously try to justify the "investor confidence" rationale. It is stated as self-evident. Yet at least since Henry Manne's attack on insider trading regulation in

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28. See *O'Hagan*, 521 U.S. at 658. Cary's obsession with this notion is not explicit in *Cady, Roberts* itself, but does appear clearly in his widely read commentary on the case, wherein he explains much of its background and derivation. See William Cary et al., Insider Trading in Stocks, 21 Bus. Law. 1009 (1965).

29. Thomas's dissent is a broad-based, strict constructionist attack on the misappropriation theory. He placed great emphasis on the conundrum created by the concession that it would not be fraud within Rule 10b-5 to embezzle money for the purposes of engaging in securities trading. If so, what is the difference in stealing information for the purpose of engaging in securities trading? There are a number of answers. One is that with embezzlement, the harm is complete before the trading ever occurs; in misappropriation, the harm and the trading coalesce. That is an intuitively appealing answer, but creates difficulties if the misappropriation theory is then extended to cases where misappropriators tip instead of trade. See Nagy, supra note 21. A better answer would be simply to say what Ginsburg did elsewhere: that misappropriation of information has a more direct link to investor confidence and marketplace integrity. That is enough; it is unnecessary to then, as Ginsburg did, talk about whether information has fewer potential uses than money—a point that set Thomas off for more than a page of his dissent.

30. Dirks v. SEC, 463 U.S. 646 (1983). This was easy; in both *Chiarella* and *Dirks*, the Court seemed explicit in reserving judgment on the misappropriation theory.

31. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994). *Central Bank* was not an insider trading case, but did indicate a highly textualist, strict constructionist approach to Section 10(b) and Rule 10b-5. *O'Hagan* seems to be a mild repudiation of *Central Bank*, limiting it to cases involving private rights of action. Though many found this surprising, I thought it a predictable move. See Donald C. Langevoort, Words from on High About Rule 10b-5: *Chiarella*'s History, *Central Bank*'s Future, 20 Del. J. Corp. L. 865, 881–82 & nn. 89–90 (1995).

the 1960s,[32] there has been a strong current among scholars (even among those who tend toward the pro-regulatory side with respect to insider trading on other grounds[33]) that the confidence point is an illusion. One of the common moves is to note the widespread and growing willingness to invest among the American public even though people sense that, the prohibition notwithstanding, insider trading is still fairly commonplace.[34] Indeed, I strongly suspect that disturbingly large numbers of people are actually *led* to trade by the belief (often a false hope, but nonetheless carefully fostered by some brokers, investment advisers, and the like) that they themselves have some sort of inside advantage.[35] Others invest in mutual funds to gain an edge from the superior (occasionally unfair) access to sensitive corporate information that analysts have.

We need not be concerned here with the normative question of whether insider trading actually is unethical.[36] The investor confidence point has to do with social perception, not philosophy. Surveys say that a sizable portion of the public doubts the fairness of insider trading. Yet those same surveys hint that, like cheating on taxes, many of the same people who object would probably do the unethical thing if the temptation were strong enough and the risk of detection minimal. The perceived "badness" seems to be at a fairly low level, which has led some to wonder whether policymakers may have misperceived the strength of the demand for insider trading restrictions.[37]

The debate over the economics of insider trading regulation has been well played out, and I do not want to repeat it here.[38] I am con-

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32. Henry Manne, Insider Trading and the Stock Market (1966). See also Hsiu-Kwang Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 Colum. L. Rev. 260 (1968).

33. See, e.g., Macey, supra note 22; Kenneth E. Scott, Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy, 9 J. Leg. Stud. 801 (1980).

34. A good collection of the evidence on this can be found in Wang & Steinberg, supra note 26, § 3.5.1. A common citation is to a Business Week/Harris poll in 1986 that if given a tip, over half the people surveyed would trade; of those who wouldn't, the largest number explained that the reason was that the tip was unlikely to be reliable. See id. at 106–07, citing Insider Trading Isn't a Scandal, Bus. Week, Aug. 25, 1986, at 74. Both business students and businesspeople regularly acknowledge that insider trading is commonplace. See id. at 106.

35. See Donald C. Langevoort, Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers, 84 Cal. L. Rev. 627, 652 (1996).

36. See generally Leo Katz, Crime, Consent and Insider Trading, 5 J. Contemp. Legal Issues 217 (1994); Kim Lane Scheppele, "It's Just Not Right": The Ethics of Insider Trading, Law & Contemp. Probs., Summer 1993, at 123.

37. See Michael P. Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 48–55 (1980).

38. In addition to the articles cited earlier, perhaps the most important paper attacking aggressive insider trading regulation is Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857 (1983). These articles emphasize that even if investors deem insider trading to be a threat, the threat will be "priced" in the market. This pricing, supplemented by the preventive mechanisms that firms will have an

vinced that the real *informational* risk that an investor is likely to respond to is the risk of corporate nondisclosure of material information generally, whatever the reasons (many of which are perfectly legitimate and permitted under the otherwise disclosure-forcing regulatory regime). If that risk is adequately managed, so that investors have some confidence that stocks will usually be fairly priced based on accurate and timely disclosure, the separate risk of the presence of insider trading will largely be subsumed and pose only a subsidiary threat. Of course, this still leaves the possibly distortive relationship between allowing insider trading and corporate compliance with disclosure obligations,[39] but this, too, is a derivative (and, I suspect, not very salient) issue. While it might very well justify federal insider trading regulation, it does not offer a compelling explanation for the rhetorical fervor behind the regulation or the devotion of resources to its enforcement. For this, only the investor confidence point will suffice, and it is this notion I want to revisit more candidly than Ginsburg and her principal sympathizers.

The criticisms of the fairness rationale of Manne and its progeny have had a highly rationalist tinge to them, taking little account of the role of emotions in economic behavior.[40] There is reason to believe that people will often refuse to engage in a transaction that they perceive as unfair to them, even if they would be better off financially by going forward than by refusing to deal.[41] An aversion to social practices tends to lie hidden from public view until a critical mass of bottled up frustration emerges; then it surfaces suddenly.[42] In this light, one cannot fully dismiss the fear that negative investor perceptions could be triggered by insider trading with adverse market impact simply by showing that it would be irrational. But even conceding the emotional force, this fear is at best still empirically speculative.[43] It also probably underestimates the

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incentive to adopt to lower their cost of capital, is a more efficient control mechanism than government regulation. On the pro-regulatory side, the two classic articles are Victor Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322 (1979), and Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L.J. 1083 (1985).

39. See Cox, supra note 26 (exploring the disclosure disincentives created by insider trading opportunities); Jill E. Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, 26 Ga. L. Rev. 179, 189–94 (1991).

40. For a recent survey of this emergent topic, see Jon Elster, Emotions and Economic Theory, 36 J. Econ. Lit. 59 (1998).

41. See Daniel Kahneman et al., Fairness as a Constraint on Profit Seeking: Entitlements in the Markets, 76 Am. Econ. Rev. 728 (1986); Matthew Rabin, Incorporating Fairness Into Game Theory and Economics, 83 Am. Econ. Rev. 1281 (1993).

42. See Timur Kuran, Private Truths, Public Lies: The Social Consequences of Preference Falsification (1995); Cass Sunstein, Social Norms and Social Roles, 96 Colum. L. Rev. 903 (1996).

43. To be clear here, I am not suggesting that public perception that markets are dishonest is unimportant. But assuming a basic confidence in the integrity of the stock market itself (i.e., how it is operated and run), the additional risk posed by insider trading is speculative.

chronic optimism of the investing public (arguably induced by influence peddlers) that they can compete effectively with insiders and other professionals.[44] The realists have long since shifted to index funds.

If the connection between insider trading regulation and the necessary baseline of investor confidence is at best speculative, why are statements of the sort we have seen from Cary and Ginsburg—and so many others—so confidently made? Are they disingenuously political, or simply unsophisticated? I would rule out the former possibility. My experience in this area is that feelings about the need for insider trading regulation are genuinely and surprisingly strong.[45] As to lack of sophistication, we will have to reserve judgment.

The possibility I want to pursue, in all seriousness, is the connection between the insider trading prohibition and investor confidence as a myth. I am using the word "myth" carefully, not in its common sense where it equates with falsity, but in the more formal sense of a social belief that is useful as an expression, explanation, or justification *regardless* of its truth or falsity. My argument is that although there are perfectly rational reasons to regulate insider trading as a matter of federal law, the deep belief that insider trading is a wrong that needs legal remedy—the feeling that actually motivates the resource-heavy enforcement agenda—derives from the more fundamental attitude that economic power and status demand a strong dose of self-restraint and accountability. Left alone, the feeling goes, market norms too easily create subcultures that glorify and rationalize selfishness.[46] Because the riches from insider trading can be so great and the opportunity to "pull it off" otherwise so simple for those with special access to sensitive information, insider trading poses *the* quintessential temptation in a larger company to pursue self-interest rather than stay in role as a habitually virtuous fiduciary. Responding to this quintessence, securities law has drawn a very visible and symbolically important line. There is a natural tie here to the desire to promote investor confidence, but also a good dose of the belief in the expressive function of law generally—the idea that both law and society are better off if the law systematically expresses certain virtues.[47] And

44. See Langevoort, supra note 35, at 639–41; see also Lynn Stout, Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation, 81 Va. L. Rev. 611 (1995).

45. This is not to say that political rent-seeking is absent from the demand for insider trading regulation. See, e.g., David D. Haddock & Jonathan R. Macey, Regulation on Demand: A Private Interest Model, With an Application to Insider Trading Regulation, 30 J.L. & Econ. 311 (1987). My sense, however, is that this is only a part of the descriptive story.

46. See Nancy Reichman, Insider Trading, *in* Beyond the Law: Crime in Complex Organizations 55 (Michael Tonry & Albert J. Reiss eds., 1993).

47. See Dan M. Kahan, Social Influence, Social Meaning and Deterrence, 81 Va. L. Rev. 349 (1997); see also Lawrence Lessig, The Regulation of Social Meaning, 62 U. Chi. L. Rev. 943 (1995); Sunstein, supra note 42. For an economist's standpoint, see Samuel Bowles, Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions, 36 J. Econ. Lit. 75 (1998).

while this social expressionism has a rational base, I would concede that there may be an emotional component in which envy and frustration at the wealth and power of economic elites, and resulting mistrust, also play a role. To this extent, support for insider trading regulation probably correlates positively with attitudes about the policing of managerial self-dealing, the need for a functional system of derivative litigation and class actions, and robust disclosure obligations, all of which have sizable expressive and rhetorical components.

For most of this century, the dominating political triumph for this attitude about accountability and restraint has been the system of federal securities regulation established in 1933–34. The "creation story" of securities regulation was about the failure of markets and the dangerous potential for deep public resentment of economic privilege, requiring aggressive legal intervention. It was a public story authored by people like Louis Brandeis and William O. Douglas, and soon—for the benefit of lawyers, judges, and policymakers, at least—turned over to two major apostles, Louis Loss and Douglas's former student, William Cary. And in this creation story, told without any serious expression of doubt in scores of books, articles, and law school courses up to the early 1970s, insider trading was at the top of the litany of perceived abuses leading to the new order; "investor confidence" was the oft-repeated creedal justification.[48] When Cary became SEC chairman in 1961, he wanted to cement this historic connection, beyond what section 16 of the Securities Exchange Act of 1934 had more narrowly done.[49] *Goodwin*—the retrograde ruling made in the otherwise sacred year of 1933—had to go. Cary's speeches and writings leave no doubt that he viewed expressionism as one of the core attributes of a good legal regime, and that fiduciary responsibility was an important subject for securities laws' lessons.

But the place of insider trading regulation in the securities regulation myth is not simply historical. As sociologists know, myths must be adaptive to survive. One reason why insider trading regulation takes on such prominence in contemporary securities enforcement is its seemingly unique ability to interest the public and hence operate as a vehicle for the SEC to seek both visibility and support for its mission. Insider trading stories are wonderful drama: When they involve the rich and famous like Ivan Boesky and Michael Millken, they tap into images of power, greed, and hubris; when they deal with the smaller traders, they conjure up images of Everyman with luck and far too little self-restraint. It is little surprise that one Congressman on the floor of the House of Representatives during the debate leading to the 1988 insider trading sanctions legis-

48. For a careful retelling of the insider trading story by the most notable current apostle of the historic tradition, Joel Seligman, see Seligman, supra note 1. See also David Ferber, The Case Against Insider Trading: A Response to Professor Manne, 23 Vand. L. Rev. 621 (1970); Louis Loss, The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States, 33 Mod. L. Rev. 34 (1970).

49. 15 U.S.C. § 78p (1994).

lation compared Boesky to Icarus of Greek mythology.[50] Like any good mythological story, these proceedings trigger richly complex public feelings about fortune and responsibility, and allow the government to appear as *deus ex machina* to pronounce the just desserts.[51]

History counts, however, and it is the inspirational nature of the creation story itself—of which insider trading is a central plot—that most interests me. Here I want to distinguish between the ability of the insider trading story to gain public support because of its mythic qualities and the ability of that story to motivate those who make and enforce the law. Securities regulation is a challenging and frustrating endeavor: Market participants far outweigh the SEC in numbers, resources, and (probably) ingenuity. Those who practice securities regulation—principally the members and staff of the SEC, but also the portion of the bar that deals with securities law compliance—are likely to perform with much more persistence and energy if they believe that what they are doing is necessary, and the expression and retelling of a story about the compelling historical justification for their role bolsters the shared commitment to the effort.[52] Ambiguity deadens enthusiasm; a credible theology sparks it. During the explosion in the reach of securities regulation that occurred in the 1960s and 70s, I suspect, the creation myth of federal securities regulation served an important cultural function in making the agency (and its adjunct professionals[53]) more potent than the usual bureaucracy. The stories that Cary and Loss told were internalized by key staff members like Manny Cohen, Irving Pollack, and Stanley Sporkin, and repeatedly retransmitted to successive generations of staff.[54] Sup-

50. The myth of Icarus relates the story of a young man who, ignoring his father's advice, flew toward the sun on wings of wax only to crash to earth when the gods, insulted by his hubris, melted his wings. See 134 Cong. Rec. H7469 (daily ed. Sept. 13, 1988) (statement of Rep. Dingell).

51. The dramaturgical role of the SEC has not escaped the notice of scholars. See Bealing et al., Early Regulatory Actions by the SEC: An Institutional Theory Perspective on the Dramaturgy of Political Exchanges, 21 Acct., Org. & Soc'y 317 (1996). Though it had not assumed such a role during Cary's time, there is reason to believe that the Delaware courts also see themselves as having an expressive role, especially in the world of mergers and acquisitions. See Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1063–64 (1997).

52. This is an important lesson in the literature on organization theory, especially its cognitive dimension. See e.g., Donald Langevoort, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms), 146 U. Pa. L. Rev. 101, 152–56 (1997); John W. Meyer & Brian Rowan, Institutionalized Organizations: Formal Structure as Myth and Ceremony, 83 Am. J. Soc. 340 (1977).

53. It should be noted that the fervor of many securities practitioners for an aggressive system of securities regulation was a happy marriage of socialization and economic self-interest: the more aggressive the system, the more work for elite members of the profession. Self-interest and ideology often go hand in hand.

54. See generally Seligman, supra note 1. As one who joined the SEC staff in the late 1970s, I can attest to the theological fervor of the senior staff's approach to securities regulation.

porting insider trading enforcement as a priority, then, became a way of signaling one's commitment to the Commission's identity. Doubting the insider trading enforcement program became a way of rejecting that identity.

As students of religion have long been aware, the risk of all theology is that it gradually becomes a self-justification for the priesthood.[55] The work of Manne and George Bentson in the 1960s, and the law and economics movement ever since, has questioned many of the assumptions of securities regulation, with special attention to insider trading. It has made headway not so much in calling into question the need for some regulatory apparatus but in making debatable nearly all the more finite judgments about what appropriate regulatory policy should be, and who should make the policy.[56] When securities regulation becomes a question of choosing among multiple efficiency-driven strategies, the case for the very existence of a single authoritative regulator weakens. What the theology treated as simple and self-evident became difficult, which can easily sap regnlatory coherence and energy.

Over the last two decades, the SEC staff has overcome its first-stage denial of the economists' criticism, and is intellectually the better for it. The question is whether the internalized mission remains. As one who believes enough in the creation myth to think that a relatively unconflicted, motivated SEC is probably a public good given the strength of the countervailing forces that have the capacity to do such social damage in the world of investing, I worry a bit about the faith. In this one sense, I find it strangely comforting that the Commission has not weakened its resolve on insider trading in the face of the intellectual challenges of the last thirty years, but—as if it were still a true believer—seemingly strengthened it. At least in this respect it is preserving its history, sensing (probably with out realizing it) that belief in the virtue of insider trading regnlation is inextricably intertwined with the cosmology of securities regulation, that to question it too deeply could start the entire belief system unraveling. In this sense *O'Hagan*'s respectful bow to the creation story—something not seen from the Court in two decades—might fuel Cary's mythic flame somewhat longer.

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55. The theology concept as applied to securities regulation is not new. See, e.g., Homer Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 4, 18–20 (1979).

56. This is well illustrated by notable recent efforts to argue for a shifting of greater regulatory responsibility from the SEC to the securities exchanges. See Paul Mahoney, The Exchange as Regulator, 87 Va. L. Rev. 1453 (1997); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2365–72 (1998).

II. *Cady, Roberts* as a Take on the Use/Possession Distinction in Insider Trading

> [W]e do not accept respondents' contention that Gintel was merely carrying out a program of liquidating the holdings in his discretionary accounts—determined and embarked upon prior to his receipt of the dividend information.
>
> — *In re Cady, Roberts & Co.*[57]

Until I reread *Cady, Roberts*, I had not taken much note of the small piece of the opinion rejecting the respondents' claim that Gintel's receipt of inside information from his colleague Cowdin was not the "cause" of the sale of the Curtiss-Wright shares. Thus, in the first open market insider trading case under Rule 10b-5, the Commission was confronted with a claim that is still standard in insider trading enforcement proceedings: "I would have bought [or sold] anyway—therefore I didn't misuse any information."

Almost by definition, any corporate insider (or close associate of an insider) is almost constantly thinking about whether to sell or buy more company shares. This is especially so today, when compensation in the form of options and shares is so commonplace and portfolios made up largely of issuer stock are a large portion of the insider's personal wealth. Many executives, wanting to turn stock compensation to needed cash, do have regular plans to sell securities in monthly amounts small enough to be protected under Rule 144. The legal question is whether the disclose or abstain duty is triggered simply upon receipt of the material nonpublic information ("possession") or only upon its actual "use." *Cady, Roberts* did not confront the legal issue, but simply rejected respondents' defense factually. Gradually, the Commission staked out the possession test as the appropriate one, engaging in a not-so-subtle campaign of administrative and legislative drafting to try to bolster its position.[58] In 1998, however, support for the Commission's position crumbled. In *SEC v. Adler*, the Eleventh Circuit rejected the possession test, at least in its full breadth.[59]

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57. 40 S.E.C. 907, 916 (1961).

58. See Langevoort, supra note 16, § 3.04. In fact, this was a halting evolution. In In re Investors Management Co., 44 S.E.C. 633 (1971), the Commission seemed to concede that the information must be a factor in the decision. The Commission's possession test ripened in In re Sterling Drug, Inc., 14 S.E.C. Docket 824 (1978). By the 1980s, the Commission was committed to it as an important enforcement item, and drafted Rule 14e-3 (the tender offer insider trading rule) carefully to reflect a possession test. In the two congressional initiatives on insider trading enforcement in the 1980s, the Commission worked hard and successfully to see to it that whenever the prohibition was described, it was in terms of a possession standard. See Hearing on H.R. 559 Before the Subcomm. on Telecommunication, Consumer Protection and Finance, 98th Cong. 48–49 1983.

59. 137 F.3d 1325 (11th Cir. 1998). The case for a use standard is well presented in Allan Horwich, Possession versus Use: Is There a Causation Element in the Prohibition on Insider Trading?, 52 Bus. Law. 1235 (1997).

A few months later, the Ninth Circuit did the same in the context of a criminal prosecution, in *United States v. Smith*.[60]

The problem arises in a number of different settings. One is where there really is a fixed plan of buying or selling relatively fixed amounts. Insiders may well have periodic selling plans; companies may be in the market to repurchase their own stock on a regular basis to comply with Rule 10b-18.[61] A mild variation on this occurs when the insider has given a broker instructions to sell (e.g., a limit order) which has not yet been executed when he learns the inside information. The murkier factual issue—the one that has truly troubled the SEC—arises when there is no plan or order, but the insider or tippee claims that for a number of reasons relating to permissible information or advice, he had already made the subjective determination to buy or sell before receiving the information. In a very different context, the possession test raises the famous problem of what to do in the case of institutional trading by banks and investment firms when one department trades without knowledge of the inside information at the same time that another department has learned information in some advisory capacity, so that both the transaction and the knowledge would, under normal agency law principles, be attributed to the firm.[62]

This narrow question must be carefully distinguished from another, perhaps more common one. In many cases, a defendant argues that he was not in possession of any inside information when he traded, much less misused it. The SEC or private plaintiff has only circumstantial evidence of possession. In this setting, many courts have wisely taken the position that the timing of the trade (e.g., shortly after a telephone conversation with someone who clearly knew the information and had some reason to pass it on) suffices to create an inference of insider trading, but only if such a trade was inconsistent with the defendant's prior pattern of trading activity. As such, if the defendant had some predetermined plan of selling, or was buying or selling only in normal amounts, it would rebut any inference of either possession *or* use.[63] These cases, however, have

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60. 155 F.3d 1051 (9th Cir. 1998).

61. Some early concern about *Cady, Roberts* concerned precisely this issue. See Cary et al., supra note 28, at 1026–27 (remarks of Thomas Halloran). In a settled proceeding, SEC v. Baker, 55 S.E.C. Docket 823 (Oct. 27, 1993), the Commission went after a member of a creditor's committee of an insolvent firm for going through with a prearranged plan to sell stock after coming into possession of nonpublic information.

62. Here, the Commission's position—codified in Rule 14e-3—is that the firm is liable unless it demonstrates that it had effective preventive procedures in place that demonstrate that the trading department did not actually have access to the information. See Langevoort, supra note 16, § 3.05.

63. For example, in In re Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1427–28 (9th Cir. 1994), the court took note of a preplanned selling program under Rule 144 in affirming a district court decision that plaintiffs in that private action had not established a strong inference of scienter on the part of the selling defendants. However, this was in the context of a case where defendants refused to concede that they were in possession of any information at the time they sold. The court's ruling, then, was simply that some greater

no bearing whatsoever on choosing *between* the two standards—a point that the courts in *Adler* and *Smith* unfortunately missed.

As a formal legal matter, the possession test seems well grounded. After *Chiarella* (and *Dirks* for tippees), the duty to abstain or disclose arises because of the fiduciary status of the person in question vis-a-vis other marketplace traders. The law of fraud on which this is based is a clear-cut disclosure duty for the benefit of the protected party, not limited to situations where it is shown that the fiduciary was trying to take advantage of the information. Like almost all elements of fiduciary responsibility, the disclosure duty is a prophylactic. The same can be said of the abstain or disclose theory's fiduciary cousin, the misappropriation theory.

The fact, unknown to Cary at the time of *Cady, Roberts,* that Rule 10b-5 has a scienter requirement[64] does not necessarily cut against the possession test either. As the courts have interpreted the scienter question, the key issue is the defendant's knowledge or awareness of the truth, as opposed to negligent disregard of it. The courts have not shown much interest in making motivation or excuse relevant to the scienter inquiry.[65]

The rejection in both *Adler* and *Smith* of the possession test, then, was hardly compelled by text or precedent.[66] Rather, it is based on the intuition—supported by ample dicta from *Cady, Roberts* through *O'Hagan*—that the reason insider trading is prohibited is to protect against unfairness. Insider trading is only unfair when it is abusive, and only abusive when the information is actually used. Indeed, *Adler* took note of *Cady, Roberts*'s failure to reject the firm's contention as a matter of law as evidence that even the SEC has at times been willing to entertain factual use-based defenses.[67]

That intuition left standing only the SEC's argument that the possession test is good policy because use is hard for it to prove.[68] That, of course, is an especially prophylactic kind of argument, and by and large, prophylaxis has fallen heavily into disfavor in the jurisprudence of Rule

evidence of iusider trading—such as sales in an unusual amount or at an unusual time, rather than pursuant to a predetermined plan—was necessary at the pleadings stage before an inference of possession (or use) was appropriate. Citation to these sorts of cases as authority in favor of a use standard, see *Adler*, 137 F.3d at 1335; Horwich, supra note 59, seem more advocacy than analysis.

64. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

65. See James Cox et al., Securities Regulation: Cases and Materials 705–07 (2d ed. 1997).

66. There is, of course, much dicta—including in Supreme Court decisions such as *O'Hagan*—that describes the insider trading prohibition in terms of trading on the basis of inside information. See United States v. O'Hagan, 521 U.S. 642, 651–53 (1997). But given that so many cases do not involve a use/possession issue (i.e., use is effectively conceded), it is hardly unsurprising that such language is adopted.

67. See 137 F.3d at 1338.

68. The leading case that supports the possession test—though not a square holding—makes this the crucial factor. See United States v. Teicher, 987 F.2d 112 (2d Cir. 1993).

10b-5. But after rejecting the prophylactic approach in theory, *Adler*, at least, gave the Commission much of what it needs by holding that possession does create an *inference* of use,[69] thereby shifting the burden of proof to the defendant to substantiate his claim that there was no causal relationship between the information and the trading. In so doing, it reversed the district court's grant of summary judgment to the defendant, allowing the SEC to go to trial on the allegations that the principal defendant violated Rule 10b-5 notwithstanding his claim that he had already conceived a definite plan to sell his shares. On the facts, then, the defendants lost badly in *Adler*.

It is hard to be troubled very much by *Adler* in the abstract. And so long as courts that follow it take the inference seriously and approach defendants' inevitable "I would have done it anyway" defense with an appropriate degree of skepticism, there is probably not much harm that will be done to the Commission's enforcement effort.[70] But that skepticism is important both for the reasons the court mentioned—the generic difficulties of inquiring into subjective motivation—and for one serious concern that the court never considered. Materiality is a fluid concept: Insiders at almost all times have the advantage of superior insight and a sense of which way things are going even if they do not possess a fact that a court would call material and nonpublic.[71] Accordingly, a corporate insider can readily initiate a "plan" to purchase or sell stock at a time when he senses that either good or bad news may be forthcoming, but when there is no hard material nonpublic information as yet. If nothing happens, the plan can readily be called off.[72] To be true to purposes behind the insider trading prohibition in rebutting the inference, the decision to buy or sell should not only be reasonably documented but also under circumstances where the causal link between the insider's informational advantage and the trade is broken completely and unambiguously. Absent compelling circumstances (e.g., a medical emergency), plans formulated at a time when the material nonpublic information could have been anticipated should be given little weight.

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69. 137 F.3d at 1337.

70. In *Smith*, the Ninth Circuit refused to follow *Adler*'s presumption because of the criminal nature of the enforcement action. Thus, its effect is not that great. And even in criminal prosecutions, it is still possible to argue that in the context of the particular facts and circumstances, an inference of intent can properly be drawn.

71. This is seen by some as a significant gap in the way the insider trading prohibition is currently structured. See, e.g., Jesse Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303 (1998) (suggesting a reorientation of insider trading regulation to deal, at least in part, with the trading advantage insiders have with respect to "sub-material" information).

72. This is easiest for sales, since selling plans are commonplace. Buying plans are less common, though not unheard of. But even here, it would not be hard for an insider to institute a practice of "planning" purchases of stock, with an appropriate record, as soon as favorable news was anticipated.

Because of the concern about "prematerial" inference, that skepticism seems especially important when dealing with issuer repurchases of its stock.[73] Indeed, there is something troubling about ever allowing a corporation to repurchase securities while knowing some highly sensitive information, even if it has a regular buy-back plan. While I recognize the argument that some disruption—perhaps even a market signal—can occur if an issuer is forced to cancel a planned repurchase, such plans do represent an inevitable potential for speculative abuse given management's predictable awareness of what sorts of things lie just around the corner.

III. *Cady, Roberts* and the Virtues of Vagueness

> [W]e are not to be circumscribed by fine distinctions and rigid classifications.
>
> — *In re Cady, Roberts & Co.*[74]

The discussion in the previous section about the possession versus use standard raises a natural question: Why has there been no effort to define the standards for insider trading liability with enough precision to settle such an important threshold issue? That, too, ties back to *Cady, Roberts*. What adverse reaction there was to Cary's opinion seemed more based on concern about the law-making process than objection to the result reached on the facts of the case.[75] The procedural objections were two-fold. First, by bringing the case as an enforcement proceeding to establish such a novel result, the Commission had circumvented the notice and comment that would accompany rulemaking. Second, by leaving the scope of the prohibition so open-ended—the infamously amorphous "fairness/access" standard that was shortly thereafter incorporated into judicial case law in *SEC v. Texas Gulf Sulphur*—there was insufficient guidance to the investment community as to when, if ever, an informational advantage could lawfully be exploited. This led to the first of what has been a constant series of calls for more determinate insider trading regulation by statute or rule, rather than simply through interpretation of an antifraud rule that does not, as we have seen, support the prohibition all that well in the first place.[76]

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73. Interestingly, there is some basis for wondering whether the probibition against insider trading applies to the issuer. See Langevoort, supra note 16, § 3.02[1][d]. The courts, however, have recognized what makes sense conceptually: that sales and repurcbases should not occur to the disadvantage of investors. See Shaw v. Digital Equipment Corp., 82 F.3d 1194 (1st Cir. 1996).

74. 40 S.E.C. 907, 912 (1961).

75. For some of the early reactions, see Cary et al., supra note 28; Daum & Phillips, The Implications of *Cady, Roberts*, 17 Bus. Law. 939 (1962); Painter, Inside Information, supra note 10.

76. See Langevoort, supra note 16, cb. 13; Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 3762–70 (3rd ed. 1995); Fisch, supra note 39 (arguing for an approach emphasizing insider's duty to the marketplace, rather than one focusing on

After the Supreme Court's decision in *O'Hagan*, there is little pressure for rulemaking or legislation. The flurry of serious drafting activity that occurred in the late 1980s was driven by the fear that the misappropriation theory would fall. But both academic and practical concerns about the fairness of a case law-based prohibition on such a sensitive topic persist in *O'Hagan*'s wake,[77] making the issue still worth discussing. To be sure, the patchwork system of two separate theories of liability, each in its own way intellectually awkward, further supplemented by the wholly inconsonant Rule 14e-3, is no model of policy formulation. Few doubt that we could do better.

Ever since *Cady, Roberts*, however, the SEC has resisted these calls. This resistance has been at substantial cost: I doubt that the government would have lost in *Chiarella* and *Dirks* had the SEC had in place a rule that clearly prohibited the kind of misconduct involved there. The standard line, however, echoed by Cary in his commentary on the infant federal law of insider trading,[78] was that any effort to define creates a "blueprint for fraud," allowing opportunists to exploit unintended loopholes and stop just barely short of the proscribed line.

The "blueprint" notion is so frequently uttered that it deserves some critical reflection. It is no doubt true that an insider trading prohibition could not be drafted that would *unambiguously* provide an answer to every possible question, unless it were to have an extraordinary degree of either overbreadth or underinclusiveness in relation to the kind of trading we intuitively deem abusive. Few legal rules seek that much clarity, choosing instead to allow many matters to turn on an evaluation of the facts and circumstances in light of the purpose of the standard in question. For example, no one has suggested that an insider trading provision could or should define "material" in anything more than some variation on the standard locution of information that a reasonable investor would likely consider significant. Yet, in my experience, the largest portion of the frustration that insiders have in deciding whether they can trade in a particular situation comes in trying to characterize the significance of the information that they know under the so-called "probability/magnitude" test.[79]

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fiduciary duty); Richard Phillips & Robert Zutz, The Insider Trading Debate: The Need for Legislative Repair, 13 Hofstra L. Rev. 65 (1984); Symposium, Defining Insider Trading, 39 Ala. L. Rev. 337 (1988). For an interesting article tracing the common law history of the duty to disclose as it relates to insider trading regulation, see Paula Dalley, From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate, 39 Wm. & Mary L. Rev. 1289 (1998).

77. A recent thoughtful step along these lines is Painter et al., supra note 4. During the past year, SEC General Counsel Harvey Goldschmid has indicated that the Commission is considering a rulemaking project to clarify certain open issues. See 31 Sec. Reg. & L. Rep. (BNA) 201 (Feb. 12, 1999).

78. See Cary et al., supra note 28.

79. See Basic Inc. v. Levinson, 485 U.S. 225 (1988), codifying the test first propounded in the insider trading context in SEC v. Texas Gulf Sulphur Inc., 401 F.2d 833

But to say that total clarity is unachievable does not by itself justify the absence of a statute or rule. No doubt there is something that an explicit insider trading prohibition could do to avoid threshold legal disputes such as the possession versus use debate or whether the misappropriation theory applies in family and other nonemployment settings. It would create a text that actors and their counsel could actually look at, even if not all answers would be forthcoming.

In fact, almost all the efforts thus far to draft an effective insider trading prohibition have been of limited ambition in terms of either scope or clarity. The American Law Institute's proposed Federal Securities Code had a conventional definition of insider trading but made little or no effort to prohibit "outsider" trading except as applied to classic tippees,[80] a scope to which the SEC objected and sought to expand in the course of its deliberations about whether to support the Code. Its primary reform, to which the Commission also objected, was to alter the definition of materiality for insider trading purposes to a "fact of special significance," albeit without saying what the difference between the two terms was other than that the "fact" standard was a more rigorous one. In the European Community, the Insider Trading Directive of 1989 broadly applies the prohibition to anyone who has access to inside information "by virtue of the exercise of his employment, profession or duties"—a broad standard bound to raise messy interpretive questions.[81] Probably the most determinate of the serious insider trading prohibitions is that found in Australia, which achieves a good deal of its clarity by having a strikingly broad scope.[82]

Drafting a provision that increases the clarity of the law is not hard.[83] Simply to illustrate this, I have set forth in the Appendix a prohibition that eliminates the intellectual awkwardness of the prevailing fiduciary

(2d Cir. 1968). The test says that uncertain information may be material; to apply it, one presumably multiplies the probability of the impact coming to pass based on what is known as of the date of trading by the expected impact of the event should it come to pass.

80. See A.L.I. Federal Securities Code § 1603 and cmts. (1979).

81. For a variety of analyses of this approach, all of which stress the questions deliberatly left unresolved by the Directive, see Thomas Hazen, Defining Illegal Insider Trading: Lessons from the European Community Directive on Insider Trading, Law & Contemp. Probs., Autumn 1992, at 231 (noting that the Directive does not address stock acquisitions by tender offerors, analyst estimates derived from public information, or legitimate brokerage activities by investment firms); Klaus Hopt, The European Insider Dealing Directive, 27 Common Mkt. L. Rev. 51 (1990); Manning Warren, The Regulation of Insider Trading in the European Community, 48 Wash. & Lee L. Rev. 1037 (1991) (arguing that the Directive fails to criminalize insider trading or prescribe penalties). A favorite example is whether a cab driver who overhears a confidential discussion in the back of his cab receives information "by virtue of his employment, profession or duties."

82. See James Cox, An Outsider's Perspective on Insider Trading Regulation in Australia, 12 Sydney L. Rev. 455, 463–69 (1990); Langevoort, supra note 16, § 14.06[2]. In essence, Australia prohibits all trading by persons possessing material nonpublic information, and then sets forth a surprisingly limited set of exceptions.

83. I would concede, of course, that the ability to draft a statute today is aided immeasurably by the experience of nearly forty years of insider trading enforcement by the

basis for the duty to disclose to marketplace traders, the *Dirks* "personal benefit" test[84] (which has never provided the notice or certainty that the Supreme Court thought it would), and the cramped nature of the misappropriation theory,[85] without substantially expanding or contracting the scope of the prohibition as currently applied. I am completely confident that such a draft would have comparable scope to, but achieves greater doctrinal clarity than, current law. Who, then, would possibly object to it?

I am, of course, being facetious. While there might be a fairly broad political consensus that there should be some sort of insider trading prohibition, there is no consensus whatsoever about where the line should be drawn on the specifics. The SEC, no doubt, would object to my incorporation of something like the *Adler* result, on grounds that it is bad policy. The corporate community—especially from places, like Silicon Valley, where insider trades are part and parcel of managerial behavior—would rush to its defense (and then probably try to broaden the protection for "pre-planned" transactions). We would have the same discussion about the need for some kind of "Chinese Wall" standard of the kind now found in Rule 14e-3, which I deliberately eliminated in order to accommodate *Adler*. Legal contractarians would take harsh note of my revision of the misappropriation standard into a more fixed prohibition.

The most vigorous lobbying, of course, would come from the securities industry, a group with a interestingly mixed set of incentives regarding insider trading and its regulation. Neither my draft nor current case law is particularly illuminating about hard questions such as front-running or scalping, or the degree of protection to give to investment analysts who gain access to arguably material information through "selective disclosure."[86] It would not be all that hard to answer those questions one way or another with at least moderate clarity. But any fairly clear answers would be very upsetting to some group or another.

SEC. For a discussion of efforts by the American Bar Association and the SEC to craft an insider trading definition, see Loss & Seligman, supra note 76.

84. In Dirks v. SEC, 463 U.S. 646 (1983), the Supreme Court held that a tipper and tippee are liable under Rule 10b-5 only if the insider-tipper is engaged in a breach of fiduciary duty for personal benefit in passing on the information. Though the Court was motivated by a desire to provide more notice and certainty, its test fails in this regard. The intent to benefit is inherently subjective and hard to assess, and the Court compounded the difficulty by giving as an example of personal benefit the desire to do a favor for a family member or friend.

85. I side with those commentators who have doubted whether deception of the source really has much to do with why we want a misappropriation theory. In essence, this draft builds on the insight best articulated by Victor Brudney in his seminal article: The law ought to forbid trading except in situations where the trader has earned the right to exploit or otherwise have proprietary interest in the information in question. See Brudney, supra note 38.

86. Compare Paul P. Brountas, Jr., Note, Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts, 92 Colum. L. Rev. 1517 (1992), with Donald Langevoort, Investment Analysts and the Law of Insider Trading, 76 Va. L. Rev. 1023 (1990).

My sense is that the Commission's aversion to rulemaking or seeking statutory clarification in the fraud area, then, really does not always have that much to do with avoiding a "blueprint for fraud." The blueprint is bad only if the prohibition is underinclusive, a risk that comes mainly when the regulators are dealing with an unfamiliar subject. The fear of underinclusion in the insider trading area comes not from the Commission's inability to foresee so much as the likelihood that the political character of the law-making process, so visible and contested, will one way or another lead to a prohibition that does not have the scope the Commission thinks it should. Special interests often disingenuously seek freedom in the name of clarity.

As I have written elsewhere, there is an adaptive virtue to the vagueness of Rule 10b-5 in this way.[87] To leave hard issues open to ad hoc judicial resolution is a good way to avoid (or at least defer) costly political confrontation. When a statute or rule is open textured, both the Commission and the defense can hold out the hope that they will win their arguments. Vagueness is the political path of least resistance. I strongly suspect that Cary's choice to overturn *Goodwin* via the narrow enforcement action against Cady, Roberts & Co. was politically astute,[88] and that it put in place a strategy that, to this day, the SEC has never really wanted to abandon.

87. See Donald Langevoort, Rule 10b-5 as an Adaptive Organism, 61 Fordham L. Rev. S7, S19–21 (1993).

88. Cary's appreciation for the politics of securities regulation was clear. See William L. Cary, Politics and the Regulatory Agencies (1967).

APPENDIX

Section 16A(a)(1) An insider of an issuer may not purchase or sell any security or intentionally induce the purchase or sale of a security by another[89] if he knows material information relating to that security that has come into his possession as a result of his insider status, unless he reasonably believes that the information in question is publicly available.

(2) For purposes of subsection (a)(1), an insider is any controlling shareholder, officer, director, partner, employee or agent of the issuer; any person who otherwise has a fiduciary or agency relationship to the issuer pursuant to which a duty of confidentiality is either express or reasonably implied; or any member of the immediate family of any insider.[90]

(3) An issuer may not initiate the purchase or sale of its own securities if one or more of its directors or executive officers, acting within the scope of his authority, knows material nonpublic information relating to that security.

(b)(1) Once any person has taken a substantial step toward an action that would reasonably be expected to have a material effect on the price of the security of any issuer, neither that person nor any insider of that person who knows such information may purchase or sell any security of the issuer or intentionally induce the purchase or sale of such a security by another, unless that person or insider reasonably believes that the information in question is publicly available.

(2) Subsection (b)(1) does not apply to purchases or sales by

(i) a bidder if the action expected to have a material effect on the security of the issuer is a tender offer for the shares of the issuer;

(ii) any person if the action expected to have a material effect on the security of the issuer is either the fact of those purchases or sales or the disclosure of that person's purpose, plans, or intentions with respect to those transactions; or

(iii) an investment adviser or broker-dealer for its own account if the action expected to have a material effect on the security of the issuer is its recommendation of the purchase or sale of the securities of an issuer or a change in its recommendation regarding those securities, *provided, however,* that nothing herein shall affect the responsibilities of such

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89. This is designed not only to bar tipping but to deal far better than current law with the situation where an insider strongly recommends a purchase or sale to a third person without conveying any actual information about the issuer.

90. There is under the misappropriation theory a grave difficulty in determining whether family relationships are fiduciary in character, so that a spouse or other family member who is told information in the course of an innocent conversation is barred from trading. See United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc). Rather than making the issue turn on ad hoc inquiry, as current law arguably does, this would resolve it explicitly. Presumably, immediate family would be defined as it is under Rule 16a-1(e).

investment adviser, broker or dealer under any other provision of the federal securities laws or rule or regulation thereunder.[91]

(3) For purposes of subsection (b)(1), an insider of the person in question is any controlling shareholder, officer, director, partner, employee, or agent of that person; anyone who otherwise has a fiduciary or agency relationship with that person pursuant to which a duty of confidentiality is express or reasonably implied; or any member of the immediate family of such person or insider.

(c) A person may not purchase or sell any security, or intentionally induce a purchase or sale of a security by another, if he has come into possession of material information that he knows is nonpublic and

(1) he knows that he received the information directly or indirectly as a result of a tip or other improper communication from an insider, if such tip or other improper communication was a violation of subsection (a)(1) or (b)(1), or

(2) he received the information from an insider while acting in a fiduciary capacity for the benefit of that insider.[92]

(d) For purposes of this section

(1) "Induce" means to recommend the purchase or sale of the security in question to another, or to tip another person. A "tip" occurs when a person directly or indirectly conveys material nonpublic information regarding a security for the purpose of enabling another person to profit by purchasing or selling the security; the communication of material nonpublic information by an insider to another person without a legitimate business purpose raises an inference of inducement.[93]

(2) "Purchase" or "sell" includes the direction or authorization, or participation in the direction or authorization, of the purchase or sale of a security for the person's own account or the account of another over which he exercises investment discretion; *provided, however,* that a person does not violate subsections (a)(1), (b)(1) or (c) if he demonstrates that transaction was directed or authorized prior to coming into possession of

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91. I am of the view that frontrunning can be a violation of the securities laws, but it makes more sense to prohibit it as a matter of broker-dealer or investment adviser regulation, rather than insider trading per se. For a treatment of current law, see David M. Bovi, Rule 10b-5 Liability for Front Running: Adding a New Dimension to the "Money Game," 7 St. Thomas L. Rev. 103 (1994); Lewis D. Lowenfels & Alan R. Bromberg, Securities Market Manipulations: An Examination of Domination and Control, Front-running and Parking, 55 Alb. L. Rev. 293 (1991). In my view, it is not a violation of Rule 10b-5 for a firm to trade in advance of its own recommendation, so long as it discloses its interest at the time of the recommendation (though it may be a violation of self-regulatory organizations' rules to do so).

92. This reaches the physician-patient cases such as United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990).

93. This is a reasonable reading of current law. See, e.g., SEC v. Maio, 51 F.3d 623, 633 (7th Cir. 1995).

the information in question and would have occurred even in the absence of that information.[94]

(3) "Know" or "knows" includes the reckless disregard of facts that would give rise to such knowledge. Except as provided in subsection (a)(3), no corporation or other entity is liable under this section if the natural persons responsible for effecting, directing, or authorizing the purchase or sale for the account of that entity did not know the information in question.[95]

(4) "Nonpublic" means information that is not known or available to significant segments of the investing public. Information that is widely known among investment analysts and professional traders is public information.

94. Thereby codifying the result in SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998).

95. This would be a change from SEC policy. See supra note 62. But now that broker-dealers and investment advisers are required by statute to have preventive procedures in place, and can be penalized directly for failure to do so, this seems unnecessary.