TO LEGISLATE OR NOT TO LEGISLATE: JUDGING THE JUDGE-MADE INSIDER TRADING PROHIBITION THEORIES IN THE UNITED STATES

MANGESH PATWARDHAN*

ABSTRACT

The United States was the first legal jurisdiction to prohibit insider trading. Insider trading is nowhere defined in the U.S. federal law. The prohibition has been read into the general anti-fraud provisions of the federal securities law. Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. Recently, there has been a flurry of activity to remedy this situation. However, merely codifying the law of insider trading may not be the panacea for the current problems. The controversy over the proper nature and scope of the prohibition stems from a disagreement over whether insider trading should be prohibited and if so, what is the appropriate rationale behind the prohibition? Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. At this point in time, it is particularly imperative to attempt a nuanced analysis of the insider trading theories, as enunciated by the U.S. courts. The three "big" judge-made theories – equal access, classical and misappropriation have been discussed in the academic literature. This article offers an assessment of these theories by building on the existing literature and extending it further. Going beyond these, it identifies and analyzes three more theoretical strands in U.S. insider trading jurisprudence – what this article terms the special relationship theory in Cady, Roberts and a version of the misappropriation theory and the structural disparity theory enunciated by the Chief Justice's and Justice Blackmun's respective dissents in Chiarella and offers a critique of these. This article attempts to give a unified treatment of the judge-made insider trading prohibition theories in the U.S. This is the first of the planned series of three articles. In the second article, we plan to identify and offer a critique of the major insider trading prohibition theories proposed in the academic literature. In the last article, we plan to propose a new theory that we argue aligns better with the mandate of securities law, and also avoids certain problems associated with the other theories.

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I. INTRODUCTION

The regulation of insider trading is a comparatively recent phenomenon in most of the jurisdictions around the world. Before the 1980s, most countries left insider trading virtually unregulated; today, the vast majority of these countries prohibit insider trading.[1]

The United States was the first legal jurisdiction to prohibit insider trading, though the term insider trading is not defined anywhere in United States federal law.[2] The prohibition on insider trading has been read into

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*Faculty Member, National Insurance Academy, Pune, India.

[1]JOHN P. ANDERSON, INSIDER TRADING: LAW, ETHICS, AND REFORM 5 (2018).

[2]Han Shen, *A Comparative Study of Insider Trading Regulation Enforcement in the U.S. and China*, 9 J. BUS. & SEC. L. 41, 43 (2009).

the general anti-fraud provisions of the securities law — Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act)[3] and Rule 10b-5[4] thereunder. This has been done through a series of judicial pronouncements. The federal prohibition dates back to at least 1947 when a federal district court held that Section 10(b) and Rule 10-5 prohibit insider trading.[5] Other Courts followed this precedent.[6]

However, *Kardon* and other early cases involved only face-to-face transactions between corporate officers and shareholders. *Cady, Roberts*[7] was the first case to hold that Section 10(b) and Rule 10-5 prohibit insider trading even in the context of market transactions consummated through an impersonal securities market.[8] Thus, it can be fairly said that the evolution of the insider trading jurisprudence in the United States began with *Cady, Roberts*. As the discussion in this article will make clear, this has been a rather tortuous, involved and controversial process.

Bainbridge argues that the Exchange Act and its legislative history suggest that the statute was not intended to prohibit the use of inside information, but only the use of manipulative devices such as market pools.[9] Rather, it is the later courts that have interpreted Section 10(b), a general anti-fraud provision, so as to include a prohibition on insider trading.[10] As he points out, Section 10(b) received minimal attention during the hearings on the Exchange Act and was apparently seen simply as a grant of authority to the SEC to prohibit manipulative devices not

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[3]*Section 10(b) Litigation: The Current Landscape*, BUSINESS LAW TODAY (Oct. 20, 2014), https://www.americanbar.org/groups/business_law/publications/blt/2014/10/03_kasner/ ("Section 10(b) makes it unlawful to 'use or employ, in connection with the purchase or sale of any security' a 'manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe.' 15 U.S.C. § 78j(b)."). Section 10(b).

[4]*Id*. ("[Rule 10b] renders it unlawful, in connection with the purchase or sale of any security, to: [e]mploy any device, scheme, or artifice to defraud; [m]ake any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading; or [e]ngage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."); *see* 17 C.F.R. § 240.10b-5 (2014).

[5]Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947) (holding defendant corporate officers and directors liable under Section 10(b) and Rule 10b-5 because they "fail[ed] to disclose a fact coming to their knowledge by reason of their position, which . . . materially affect[ed] the judgment of the other party to the transaction.").

[6]*See* RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 2.02 (1998) (explaining since Kardon v. National Gypsum Co. in 1947, courts have adopted the position that Section 10(b) and Rule 10b-5 require corporate insiders such as officers and directors to abstain from trading in their own corporation's securities unless they have disclosed all material non-public information).

[7]*See generally In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[8]FERRARA ET AL., *supra* note 6, § 2.02, at 2-15.

[9]Stephen Bainbridge, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 459 (1985).

[10]*Id*.

covered by the other provisions of the Exchange Act.[11] Interestingly, even the U.S. Congress contended that the elimination of insider trading abuses was one of the goals of the Exchange Act.[12]

There is a fundamental debate over the insider trading prohibition. Arguments have been advanced in support of legalizing insider trading. Even among those who favor prohibition, there is no unanimity regarding the appropriate policy rationale for prohibiting insider trading.[13]

Several other jurisdictions have departed from the U.S. model in that these jurisdictions have enacted an explicit statutory prohibition framework.[14] For instance, in the European Union and India: Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse[15] and the Securities and Exchange Board of India Act (1992) and the Regulations made thereunder both respectively provide the statutory basis for the prohibition.[16]

Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. Prakash terms the United States' insider trading regime dysfunctional.[17] Nagy argues that a hodgepodge of theories, rules, and decisions form the basis of today's insider trading law in the United States.[18] Southern District of New York Judge, Jed Rakoff, presided over some of the prominent insider trading trials such as that of Rajat Gupta.[19] Judge Rakoff criticized the judge-made nature of federal insider trading law and called on Congress to address various difficulties that had been created by inconsistent court rulings.[20] Judge Rakoff found insider-trading law has become too obscure to really serve its purposes, which ultimately are punishment, deterrence and

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[11]*Id.* at 460.

[12]*Id.* at 459 (quoting H.R. REP. NO. 355, 98th Cong., 1st Sess., at 3(1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2276).

[13]*See infra* Section II for a rather brief overview of the arguments for and against prohibiting insider trading.

[14]*See infra* Section II.

[15]*See* Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (Apr. 16, 2014), https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0596.

[16]*See* Securities and Exchange Board of India Act (1992), https://www.sebi.gov.in/sebi_data/attachdocs/1456380272563.pdf.

[17]Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).

[18]Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1365 (2009).

[19]Tom McParland, *Judicial Inconsistency Frustrates Purpose of Insider Trading Law, Rakoff Says*, NEW YORK LAW JOURNAL (Feb. 28, 2020), https://www.law.com/newyorklawjournal/2020/02/28/judicial-inconsistency-frustrates-purpose-of-insider-trading-law-rakoff-says/.

[20]*Id.*

creating a better market.[21] According to Preet Bharara, former U.S. Attorney for the Southern District of New York, insider trading laws have for too long lacked clarity, generated confusion, and failed to keep up with the times. This lack of clarity and certainty, in this important area of law and the securities markets, has benefited no one.[22]

Recently, there has been a flurry of activity to remedy this situation. In January 2020, the Bharara Task Force on Insider Trading issued its report.[23] The Task Force comprised experts in the field and members of the judiciary, private practice of law, academia, and former prosecutors and regulators.[24] Judge Rakoff was a member. In addition to studying the history and current state of insider trading law, including both court decisions and efforts at legislative reform, the Task Force received input from various outside groups with expertise and interest.[25]

On December 5, 2019, the U.S. House of Representatives passed the Insider Trading Prohibition Act (ITPA).[26] ITPA amends the Exchange Act, 15 U.S. Code § 78a *et seq.,* to include a new section that expressly defines the elements of insider trading.[27] If passed by the Senate and signed into law by the President, the bill will establish the first statutory prohibition on insider trading in the U.S. and will codify insider trading principles historically developed by the courts.[28]

However, merely codifying the law of insider trading may not be the panacea for the current problems. As noted above, the controversy over the proper nature and scope of the prohibition stems from a disagreement over whether insider trading should be prohibited and if so, what is the appropriate rationale behind the prohibition? The Indian prohibition regime is based on an explicit statutory framework.[29] In spite of this, the evolution and the current state of insider trading law in India also underlie

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[21]*Id*.

[22]*Bharara Task Force on Insider Trading Publishes Report: Recommending Reforms to Insider Trading Law*, BUSINESSWIRE (Jan. 27, 2020), https://www.businesswire.com/news/home/20200127005079/en/Bharara-Task-Force-Insider-Trading-Publishes-Report [hereinafter *Recommending Reforms to Insider Trading Law*].

[23]PREET BHARARA ET AL., REPORT OF THE BHARARA TASK FORCE ON INSIDER TRADING (2020), https://clsbluesky.files.wordpress.com/2020/01/2cdb1-reportofthebhararataskforceoninsidertrading.pdf [hereinafter Bharara Report].

[24]*Id.*

[25]*Recommending Reforms to Insider Trading Law*, *supra* note 22.

[26]Kramer Levin Naftalis & Frankel LLP, *House Passes Insider Trading Prohibition Act*, MONDAQ (Dec. 16, 2019), https://www.mondaq.com/unitedstates/CorporateCommercial-Law/875498/House-Passes-Insider-Trading-Prohibition-Act.

[27]*Id*.

[28]*Id*.

[29]*See* Mangesh Patwardhan, *The Insider Trading Prohibition in India – In Search of a Doctrine*, 14(2) INT'L & COMP. CORP. L.J. 38 (2020).

theoretical discontinuity and incoherence.[30] Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution.

An example should make this point clear. In the U.S., "personal benefit" has been a core element in determining the liability in tipping insider trading cases.[31] In *Dirks v. SEC*, the Supreme Court held that the insider is guilty of violating the prohibition only if she discloses the material, non-public information (MNPI) in breach of her duty.[32] This is contingent on whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.[33] Absent some personal gain, there has been no breach of duty to stockholders, and absent a breach by the insider, there is no derivative breach.[34] There has been a spate of cases in recent years, attempting to interpret the personal benefit requirement.[35]

The Bharara Report discusses this confusion surrounding the test.[36] It acknowledges that the test was introduced as a way of differentiating between an act of self-dealing, and thus a breach of a duty, from a legitimate "corporate" purpose.[37] However, that has led to another set of thorny questions about what constitutes a "personal benefit."[38] In order to root out this ambiguity, the Report recommends eliminating the test altogether.[39]

On the other hand, whereas the initial draft of ITPA did not include the personal benefit requirement, a last-minute amendment added language that requires MNPI to be given "for a direct or indirect personal

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[30]*Id.*

[31]*See infra* Section IX for the discussion of the personal benefit jurisprudence in the U.S.

[32]Dirks v. SEC, 463 U.S. 646 (1983). The term "material non-public information" is used in the U.S., and the Indian prohibition framework uses this term as well as the term "unpublished price sensitive information" at different places, although both terms are used interchangeably throughout this article.

[33]*Id*. at 663.

[34]*Id.* at 662.

[35]*See generally* United States v. Newman, 773 F.3d 438 (2d Cir. 2014); *see generally* Salman v. United States 137 S. Ct. 420 (2016); *see generally* United States v. Martoma, 869 F.3d 58 (2d Cir. 2017), *amended and superseded by,* 894 F.3d 64 (2d Cir. 2018).

[36]Preet Bharara et al., *Report of the Bharara Task Force on Insider Trading* 1, 4, 12, 16 (2020).

[37]*Id.* at 4.

[38]*Id*. at 12,16.

[39]*Id.*

benefit (including pecuniary gain, reputational benefit, or a gift of confidential information to a trading relative or friend)."[40]

However, the decision regarding retaining, refining, clarifying or eliminating the personal benefit element of the current judge-made law ought to be taken based on an assessment of its theoretical merit. For example, if the element underlies a legitimate policy justification, one option could be to delineate it clearly, so as to alleviate the current implementation challenges. Eliminating the element altogether to remove ambiguity or bringing it in as a last-minute amendment to the Bill would not serve the purpose of creating a robust, stable statutory framework. The same is true with the other parts of the prohibition.

Therefore, at this point in time, it is particularly imperative to attempt a nuanced analysis of the insider trading theories, as enunciated by the U.S. courts over the years. The three "big" judge-made theories – equal access, classical and misappropriation have been discussed in the academic literature. This article offers a critique of these theories by building on the existing literature and extending it further. Going beyond these, it identifies and analyzes three more theoretical strands in U.S. insider trading jurisprudence. This article terms and critiques the special relationship theory in *Cady, Roberts,* a version of the misappropriation theory and the structural disparity theory enunciated by the Chief Justice's and Justice Blackmun's respective dissents in *Chiarella v. United States*.[41] This article attempts to give a unified treatment of the judge-made insider trading prohibition theories in the U.S.

Bainbridge notes that the discussion on insider trading jurisprudence is strongly skewed towards U.S. law.[42] This focus is not arbitrary. This is due to the fact that the U.S. was the first jurisdiction to prohibit insider trading and is where a live debate among the academicians regarding the policy and doctrinal underpinning of the prohibition continues to this date.[43] Thus, in any discussion and analysis of the insider trading prohibition, the importance of the United States is undeniable.

This is the first of the planned series of three articles. In the second article, we plan to identify and offer a critique of the major insider trading prohibition theories proposed in the academic literature. In the last article,

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[40]Kramer Levin Naftalis & Frankel LLP, *House Passes Insider Trading Prohibition Act*, MONDAQ (Dec. 12, 2019), https://www.mondaq.com/unitedstates/CorporateCommercial-Law/875498/House-Passes-Insider-Trading-Prohibition-Act.

[41]Chiarella v. United States, 445 U.S. 222, 251 (1980).

[42]Stephen M. Bainbridge, *An Overview of Insider Trading Law and Policy: An Introduction to the Research Handbook on Insider Trading,* RESEARCH HANDBOOK ON INSIDER TRADING 1, 1 (forthcoming 2013).

[43]*Id.* at 1.

we plan to propose a new theory that we argue aligns better with the mandate of securities law, and avoids certain problems associated with the other theories.

The plan of this article is as follows. In Section II, we give a rather brief overview of the arguments for and against prohibiting insider trading, in order to set the context for further discussion. In Sections III through VIII, we analyze and offer a critique of six judge-made theories. This is done based on assessing the internal coherence and the alignment of these theories with the mandate of securities law—to protect the interests of investors in securities and to promote the development of, and to regulate, the securities market.[44] Dooley suggests that the rationale (or demand, as he terms it) for insider trading prohibition determines the legitimacy of the substantive prohibition.[45] Thus, investors and/or the securities market must be the primary beneficiaries of insider trading regulation to justify the existence of the regulation.[46]

In Section IX, we discuss the rather tortuous journey of "personal benefit" jurisprudence. Section X discusses the recent judicial ruling on Title 18 charges and its implications for the insider trading jurisprudence. The final Section summarizes the discussion and concludes.

II. INSIDER TRADING PROHIBITION – THE POLICY DEBATE

A. *Arguments for Legalization of Insider Trading*

At the first level, the debate focuses on the very desirability of insider trading prohibition. At least two arguments have been advanced in support of legalizing insider trading. One argument is that it acts as an effective compensation scheme for a company's executives.[47] Manne argues that there is a tendency towards bureaucratization of large companies, therefore insider trading provides one possibility for appropriate executive compensation.[48] Carlton and Fischel argue that companies should have the option to opt out of the regulatory prohibition

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[44]Securities and Exchange Board of India Act (SEBI Act), No. 15, Acts of Parliament, 1992 (stating that the object of the SEBI Act is to provide for the establishment of SEBI to carry out these two functions). *See* United States v. O'Hagan 521 U.S. 642, 658 (1997) (articulating "insuring honest securities markets and thereby promoting investor confidence" as the "animating purpose" behind the Exchange Act).

[45]Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 3 (1980).

[46]*Id.* at 32.

[47]Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 936 (1985).

[48]*Id*.

on insider trading.[49] On this view, legalizing insider trading may encourage executives to innovate and enhance corporate value.[50] Executives can reap the benefits of their innovation by buying company shares before this information becomes public and sell it once the publicly disclosed information is reflected in the share price.[51]

The other argument advanced in favor of legalization appeals to the efficiency enhancement due to insider trading.[52] According to Manne, trading by insiders on the basis of undisclosed price sensitive information actually causes share prices to converge to their intrinsic value and in fact enhances market efficiency.[53] Thus, insider trading may be seen as an effective mechanism by which companies can withhold disclosure of sensitive confidential information, while at the same time allowing market prices to become more efficient.

B. *Arguments against Legalization of Insider Trading*

On the other hand, equally powerful arguments have been advanced to make a strong case for the prohibition of insider trading, and indeed its strict enforcement. However, there is a fair amount of disagreement over the precise rationale behind prohibiting insider trading.

Dent questions the benefits of insider trading.[54] He argues that the prevalence of insider trading implies that persons other than the insiders would always have an informational disadvantage and thus would be reluctant to trade, reducing liquidity and increasing the cost of capital for companies.[55] Ultimately, this would lead to the extinction of public stock markets.[56]

Wang argues that insider trading is not a victimless crime, but agrees that the counterparty is not necessarily the victim.[57] A person selling shares based on non-public (negative) information about a company would depress the market price and draw new, unsuspecting buyers in the

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[49]Dennis Carlton & Daniel Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866 (1983).

[50]*See id*. at 858-59.

[51]*Id*. at 868.

[52]Manne, *supra* note 47, at 935.

[53]*Id.*

[54]George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247, 248 (2013).

[55]*Id.* at 259.

[56]*Id*. at 263-64.

[57]William K. S. Wang, *Reuschlein Lecture: Stock Market Insider Trading: Victims, Violators and Remedies – Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 29, 31 (2000) (analogizing insider trading with the sale of a used car with a generic defect).

market.[58] It may also dissuade some potential sellers from entering the market.[59] Such induced buyers or dissuaded sellers are victims of such trading.[60]

Finally, there is a family of arguments that focuses on the harm caused to the company itself. Haft argues that prohibiting insider trading enhances the internal efficiency of large companies.[61] If insider trading is permitted, it would impair corporate decision making since the employees would stall the free flow of information within the company, so as to enable them to trade on such information.[62]

Bainbridge notes the argument that allowing insider trading may create perverse incentives for the executives to engage in activities that generate more insider trading opportunities, such as following policies that increase fluctuations in the price of the company's shares.[63]

With this background, we now turn to an assessment of the six theories enunciated by the U.S. courts over the years.

III. THE SPECIAL RELATIONSHIP THEORY – *CADY, ROBERTS*

We have termed the theory adopted by the Securities and Exchange Commission (SEC) in *Cady, Roberts*[64] the special relationship theory. In the literature, the discussion and holding in *Cady, Roberts* is often taken to have been subsumed under the later judge-made theories such as equal access, classical and misappropriation.

Schoen[65] focuses on the "disclose-or-abstain" rule articulated by the SEC in *Cady*, *Roberts* and states that the Second Circuit embraced this rule in *SEC v. Texas Gulf Sulphur Co*.[66] While Acoba notes the differences in the fairness analysis in the two cases, he ultimately takes *Texas Gulf Sulphur* to clarify the "disclose-or-abstain" rule, as set out in *Cady,*

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[58]*Id.* at 31 (analogizing induced and preempted stock trader's harm to solidary versus general automobile defects).

[59]*Id*.

[60]*Id.* at 34-35.

[61]Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1054-55 (1982).

[62]*Id.* at 1053-54.

[63]Stephen M. Bainbridge, *The Law and Economics of Insider Trading: A Comprehensive Primer*, SSRN 1, 77 (2001), https://dx.doi.org/10.2139/ssrn.261277 (citations omitted).

[64]*In re Cady*, *Roberts*, 40 S.E.C. at 911.

[65]Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 239 U. PA. L. REV. 252-53 (1999).

[66]SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S.976 (1969).

Roberts.[67] Davis comments that in this case, the SEC articulated the rationale for prohibiting insider trading that was effectuated by later courts through the development of classical and misappropriation theories.[68] Murdoch states that "the significance of *Cady, Roberts* is attested to by the fact that the majorities in both *Chiarella* and *Dirks*[69] relied upon the case as the leading one dealing with insider trading, but grossly misinterpreted that decision."[70]

Nonetheless, we argue that in *Cady, Roberts*, the SEC articulated an independent, standalone theory of insider trading prohibition that merits separate analysis. We now turn to analyzing the holding in order to tease out the theory.

A. *Facts of the Case*

Curtiss-Wright Corporation's board of directors decided to reduce the company's quarterly dividend. One of the directors, J. Cheever Cowdin, was also a partner in Cady, Roberts & Co., a stock brokerage firm. Before the news was announced, Cowdin called up one of his partners, Robert M. Gintel, to inform him of the impending dividend cut. Gintel then sold several thousand shares of Curtiss-Wright stock held in customer accounts over which he had discretionary trading authority. When the dividend cut was announced, Curtiss-Wright's stock price fell several dollars per share. Gintel's customers thus avoided substantial losses. The SEC brought an administrative action under Section 10(b) and Rule 10(b)-5.[71]

B. *Two Arguments in Favor*

The principle underlying this theory, as articulated by the SEC, is that persons who are in a special relationship with a company and therefore are privy to its internal affairs suffer correlative duties in trading in its securities.[72] Under this, such persons are bound by the "disclose-or-abstain" rule. They must either disclose to the counterparty any material

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[67]Micah A. Acoba, *Insider Trading Jurisprudence after* United States v. O'Hagan. *A Restatement (Second) of Torts § 551(2) Perspective*, 1356 CORNELL L. REV. 1365-66 (1999).

[68]Craig W. Davis, *Misappropriators, Tippees and The Intent-To-Benefit Rule: What We Can Still Learn from* Cady, Roberts, 35 SETON HALL L. REV. 263, 296 (2004).

[69]Chiarella 445 U.S. at 241; *see generally* Dirks, 463 U.S. at 646.

[70]Charles W. Murdock, *The Future of Insider Trading after Salman: Perpetuation of a Flawed Analysis Or a Return to Basics*, 70 HASTINGS L.J. 1547, 1551 (2019).

[71]*In re Cady, Roberts*, 40 S.E.C. at 908-11.

[72]*Id.* at 912.

information that they are privy to, or abstain from trading.[73] The SEC added that "[i]ntimacy demands restraint less the uninformed be exploited."[74]

Thus, the reach of this theory is fairly limited. It prohibits trading only by those persons who have a special relationship with the company and gain access to material non-public information by virtue of this relationship.

This theory avoids two of the major problems that plague the classical theory.[75] One, the issue whether the securities trade was a face-to-face transaction, or an impersonal, exchange-based transaction becomes irrelevant.

Under the classical theory, the trading prohibition arises from a pre-existing fiduciary relationship between the counterparties.[76] The non-disclosure of material non-public information may arguably be treated as an implied misrepresentation as to the lack of knowledge on the part of the trader regarding any such information. However, in an exchange-based transaction, the counterparties do not even know each other's identity. Therefore, there is no reliance by the counterparty on any express or implied misrepresentation.

The special relationship theory does not suffer from this anomaly. This theory is predicated on the insider's relationship *with the company* and the correlative duty not to trade on any material information obtained due to such relationship. Thus, the issue of any (non)-reliance by the counterparty and consequently the nature of transaction (face to face or exchange-based) is not relevant.

Two, the applicability of the classical theory in cases where the insider is a seller of the security is problematic. This is because the outsider purchasers become shareholders *after* the trade is consummated and thus the insider does not have a *pre-existing* fiduciary relationship with them, as required by the theory.[77]

Indeed, even in *Cady, Roberts*, the individual defendant did argue that "an insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders."[78] The SEC rejected this contention, stating that "[t]his

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[73]*Id.* at 911.
[74]*Id.* at 912.
[75]*See infra* Section V for the discussion of the classical theory.
[76]*See infra* Section V.
[77]*See infra* Section V.
[78]*In re Cady, Roberts*, 40 S.E.C. at 913.

approach is too narrow. It ignores the plight of the buying public-wholly unprotected from the misuse of special information."[79]

In fact, the SEC's stand can be justified based on the underlying theoretical foundation. The theory adopted by the SEC in this case is based on a relationship (giving access to corporate information) between an insider and her company, and not on any pre-existing relationship between the counterparties.

Therefore, the special relationship theory can be consistently applied regardless of whether the insider was a purchaser or seller of the securities as the relationship implicated here is with the company. Also, the special relationship theory would apply even when the insider trades not in the securities of the company, but in derivative contracts with the company security as the underlying. Such trading would arguably not be covered under the classical theory as company insiders do not have a fiduciary duty towards (non-shareholder) derivative traders.

C. *Two-faced Theory*

On the other hand, this theory suffers from a different (and more serious) kind of ambiguity and dichotomy. The SEC enunciated two factors inherent in the theory. The first factor pertains to the fact that the insider had a relationship with the company that gave her access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone. The second factor relates to the inherent unfairness involved (as the SEC perceived it) when one party takes advantage of such information knowing that it is not available to the counterparty.[80]

This two-faced nature of the theory is the source of the dichotomy. The first factor seems to indicate that the concerned information is essentially treated as a corporate resource. This resource has been entrusted to the insider in order to discharge her corporate duties and it should not be used for the personal benefit of anyone.[81] As the U.S. Supreme Court later commented in *Dirks*, officers and directors owe a duty to the corporation itself not to mismanage corporate assets, of which confidential information is one.[82] Thus, this factor implies that insider trading is basically wrongful conversion of a corporate resource (in this case information) for obtaining a personal gain. Thus, it is the company

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[79] *Id.*
[80] *Id.*
[81] *Id.* at 912.
[82] *Dirks*, 463 U.S. at 653, n.10.

itself which is the victim of such trading. The SEC seems to have implicitly accepted this when it held that the counterparties do not have any private right of action against the insider traders due to the lack of privity between them. At the same time, it held that this fact does not absolve an insider from responsibility for fraudulent conduct.[83] In other words, the SEC accepted that insider trading amounts to fraud (so as to bring it within the purview of Section 10(b) of the Exchange Act which is an anti-fraud provision), but it is not the counterparties who are victims of the fraud.[84] Therefore, by implication, the company itself is victimized.

However, the second factor seems to pull the theory in the opposite direction. The reference to the "inherent unfairness" raises the question "unfair to whom?"[85] Since the supposed unfairness arises because one party has information that the other party does not have access to, the conclusion here is that it is unfair to the counterparty. The SEC wrote:

> If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of the information.[86]

Thus, the counterparty is the victim of such trading and arguably should have a legal remedy. Therefore, the theory is ambiguous and even contradictory as to the nature of fraud involved and the victims of such fraud.

Further, the counterparty would suffer from this same disadvantage whenever the trader on the other side had superior access to information, regardless of how she had such superior access. The existence (or otherwise) of a special relationship with the company and access *by virtue of such relationship* becomes totally irrelevant. Even in the case where a rank outsider trades on the basis of inadvertently obtained information results in the same "unfairness" to the counterparty. Thus, the second factor virtually renders the first factor redundant and threatens to collapse the special relationship theory into the equal access theory. On the other hand, assume that before executing the trade, the insider discloses to the counterparty any material non-public information she has access to. In this

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[83] *In re Cady, Roberts*, 40 S.E.C. at 915.
[84] *Id*.
[85] *Id.* at 912.
[86] *Id.* at 914.

case, it arguably amounts to mismanagement of a corporate resource (information) and therefore the company may have a remedy against the insider for disclosing the information in an unauthorized manner. However, such trading would arguably not amount to unfairness to the counterparty as she had access to the same information and still decided to trade. Therefore, the issue of corporate mismanagement (implicated in the first factor) and the issue of "unfairness" to the counterparty are conceptually distinct. In fact, as the two hypotheticals above show, these are not necessarily co-extensive.

D. *Insider Trading as a Related Party Transaction?*

Even leaving aside the contradictory nature of the two factors used by the SEC to flesh out the theory, there is a more fundamental difficulty here. As mentioned above, the theory is founded on the duty to the company not to mismanage corporate assets.[87] In other words, this theory conceptualizes insider trading as an improper use of confidential corporate information by the insider.

However, this argument implies that insider trading is akin to a Related Party Transaction (RPT) wherein there is a transfer of a corporate resource (information) from the company to a related party (in this case the insider). Many jurisdictions regulate RPTs to ensure that these are not abusive and do not cause loss to the company.[88] In particular, there is no *per se* prohibition on RPTs. Since the special relationship theory implicitly treats insider trading as being akin to an RPT, a *per se* prohibition is hard to justify. The theory also does not seem to justify the severe civil and criminal penalties that are attached to insider trading. Logically, it is the company (or derivatively the shareholders) who should have a cause of action against the insider, subject to the proof of loss suffered by the company due to such insider's trading. This can be a complex and fact specific enquiry because the insider's direct gains (any trading profit she realizes or losses that she is able to avoid) come from the counterparty, and not the company – unlike in the case of RPTs. Therefore, any loss that the company allegedly suffers must be of an indirect nature and this needs to be established. For example, in *Cady, Roberts*, there was not even a hint of any loss suffered by the Curtiss-Wright Corporation due to trading by Gintel's trades based on non-public information regarding the impending dividend cut.[89]

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[87]*See supra* note 82 and accompanying text.
[88]In India, RPTs are governed by section 188 of the Companies Act, 2013.
[89]*In re Cady, Roberts*, 40 S.E.C. at 915.

Taking this point further, it may be argued that companies should in fact have the power to authorize insider trading if it is in the interest of the company. For example, assume Company B receives a friendly takeover offer from Company A with the implicit threat of a hostile takeover bid in case the friendly offer is rejected. It should be free to encourage its directors and executives to start buying the shares of the company and tip off others to bid up the price if that would raise the bar for the acquiring company and enable Company B to negotiate a higher price (or more favorable swap ratio). However, the special relationship theory would not permit this as the counterparty does not have access to information regarding the takeover bid.

E. *Two Anomalies in the SEC Fashioned Theory*

There are two anomalies that seem to have crept into the special relationship theory, as fleshed out by the SEC. The SEC opinion noted: "there [was] no evidence of a preconceived plan whereby Cowdin was to 'leak' advance information [to] ... Gintel," and "the evidence points to the conclusion that Cowdin probably assumed, without thinking about it, that the dividend action was already a matter of public information and further that he called registrant's office to find out the effect of the dividend news upon the market."[90]

The fact that the tipper (Cowdin) was held not to be liable while the tippee (Gintel) was at odds with the fundamental logic of the special relationship theory (or, indeed, any duty-based theory). Gintel did not have any special relationship with the company that gave him access to corporate information.[91] Therefore, the only way he could have been held liable was by way of derivatively acquiring the duty from Cowdin. But this implies that Cowdin must have violated his duty in the first place. Holding the non-insider tippee liable even in the absence of any breach of a relationship-based duty by the tipper himself seems to be incoherent.

There is a recognition that in the context of anonymous, exchange-based trading, the outside traders, in the absence of any privity (and one may also say reliance), cannot claim damages from the insider trader.[92] This is perfectly consistent with the SEC theory since the theory focuses on the special relationship between directors, officers and other insiders on one side and the company on the other.[93] At the same time, the second

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[90] *Id.* at 917.
[91] *See in re Cady, Roberts,* 40 S.E.C. at 912.
[92] *See infra* Section IV.E.
[93] *In re Cady, Roberts*, 40 S.E.C. at 912.

prong of the analysis (the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing) raises the question "unfair to whom?"[94] The plain language here seems to indicate that it is unfair to the counterparties, since the insider takes advantage of the information that is unavailable to them. But if we follow this logic, it clearly implies that the counterparties are the victims and should have a remedy against the insider trader. It may be argued that the SEC's approach on this point appears to be vague at best, and probably contradictory.

F. *The Takeaway*

Therefore, it seems that the special relationship theory does not respond to the mandate of securities law in any clear way. If the focus of this theory is on the prevention of improper use of a corporate asset (confidential information), the theory is over-inclusive. This is because it also covers cases where the company does not suffer any loss due to insider trading (or may even be a beneficiary of such trading). Further, even in cases where a loss to the company can be established, the appropriate remedy should be a cause of action for the company (or derivatively by the shareholders). Thus, this theory does not support an insider trading prohibition regime with its *per se* prohibition and the severe civil and criminal penalties provided for.

On the other hand, if the focus is on preventing the presumed "unfairness" to the counterparty, the theory is grossly under-inclusive. This is because on this aspect, any trading by a party based on superior access to information turns out to be unfair to the other party. The enquiry as to whether the party with such superior access had a special relationship with the company and, if so, whether her access to information was by virtue of such relationship becomes totally unnecessary. But this undercuts the very foundation of the theory which is the existence of a special relationship! Also, if the intention is to "protect" investors from the unfairness caused by the other party's superior access to information, such protection must be available regardless of how such access was obtained. Finally, those investors who traded without the benefit of such information must have a remedy against the other party, a contention categorically rejected by the SEC.[95]

To conclude, the special relationship theory is internally incoherent and fails to address the core concerns of securities law in a meaningful

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[94] *Id*.

[95] *See id*. at 915.

way. Significantly, this was the only case in the United States wherein this theory was adopted. Later, this theory was jettisoned as the U.S. Supreme Court adopted classical and misappropriation theories as the exclusive basis for the insider trading prohibition.[96]

IV. THE EQUAL ACCESS THEORY – *TEXAS GULF SULPHUR*

A. *Facts of the Case*

In 1959, Texas Gulf Sulphur (TGS) found evidence of a significant ore deposit in Canada.[97] In October 1963, the company began exploration work in the area. The company President ordered the exploration team to keep the news in strict confidence, even withholding it from directors and other executives.[98] This was obviously necessary in corporate interests, for example, to prevent a run-up in land prices in that area. Finally, after denying the "rumors" several times, the ore discovery was officially announced in a press conference on April 16, 1964.[99]

Throughout 1963 and early 1964, many TGS insiders bought company shares and options on these shares.[100] Some of them tipped off outsiders.[101] In late 1963, the share price was under $18 USD.[102] Since then, the price started rising gradually, and just before the public announcement, the price rose to $30 USD.[103] This indicated that at least some players in the market discounted the earlier denials by the company and had started buying TGS shares. One month after the announcement, the price had reached $58 USD.[104] The SEC brought an action against the insider purchasers for violating the insider trading prohibition under Section 10(b) and Rule 10b-5.[105] The case reached the Second Circuit Court of Appeals for an *en banc* hearing.

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[96] *See infra* Sections V-VI.
[97] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 843 (2d Cir. 1968).
[98] *Id*.
[99] *Id*. at 846.
[100] *Id*. at 847.
[101] *Tex. Gulf Sulphur Co*., 401 F.2d at 847.
[102] *Id*.
[103] *Id*.
[104] *Id*.
[105] *Tex. Gulf Sulphur Co*., 401 F.2d at 847.

B. *De Facto Equality or Equal Access?*

In this case, the Second Circuit articulated the equal access theory.[106] It is based on the policy consideration that "all investors trading on impersonal exchanges have relatively equal access to material information."[107] This is sought to be supported on the ground that this is a "justifiable expectation" of the market.[108] In the case of special relationship, classical or misappropriation theories, the trader owes a fiduciary duty or a similar duty of trust and confidence to the company, the counterparty or the source of information respectively. It is the existence of this duty that prohibits such trader from trading on material, non-public information obtained from the company or the source. The equal access theory completely dispenses with this requirement.

It must be emphasized that this theory does not require that a trader must have actual knowledge of all material information that her counterparty has. Scheppele argues that the U.S. Supreme Court's rejection of the equal access theory was due to its mistaken belief that the theory envisages such *de facto* equal information.[109] Brudney makes the same point stating that (the theory) does not extend so far as to require actual equality or sharing of information.[110] Such a strict rule is simply unworkable. Institutional investors typically subscribe to news and market data feeds supplied by newswire agencies. Retail investors usually do not subscribe to these services. Notwithstanding this, trading by institutional investors on the basis of material information contained in such feeds is perfectly legitimate under the equal access theory. In other words, it is sufficient that all investors in the market "have *in principle access* to the same information."[111]

This theory surely has a strong intuitive appeal. It seems simply unfair that one party trades based on material, non-public information that her counterparty does not have access to. Therefore, the counterparty is seemingly placed in a position of an inherent disadvantage. As Haire

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[106] *Id.*

[107] *See id.*

[108] *Id.*

[109] Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 125 (1993).

[110] Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322, 355 (1979).

[111] Mangesh Patwardhan, *Insider Trading Prohibition Based on the Equal Access Doctrine – A Critique*, 8(3) ONLINE INT'L INTERDISC. RES. J. 15, 20 (2018).

comments, supporters of this theory base their arguments on notions of fundamental fairness.[112]

C. *Equal Access Concerns and Affirmative Action*

As noted above, it is not the actual equality of information that is sought here, only equal access to it. The "unfairness" results because one party is penalized "for not knowing that which they had no legally permissible means of discovering."[113]

However, if the equal access theory is predicated on the assumption that unequal access to material information is unfair, it is not at all clear whether mere in-principle access to such information is sufficient to alleviate such unfairness concerns. As noted earlier, in principle, a retail investor may also subscribe to professional news feeds, even though it may not be an affordable proposition for her. Therefore, in a real sense, she has an informational disadvantage while trading with an institutional investor.

Recently, it came to light that some newswire companies disseminated corporate information to their preferred subscribers (typically high-frequency traders) ahead of their general subscribers.[114] The time differential was a few milliseconds.[115] The preferred subscribers typically paid "thousands of dollars a month" for advance access.[116] Obviously, in this context, the issues implicated in substantive equal information access get even more intractable than those in the traditional distinction between institutional subscribers and retail non-subscribers.

The Second Circuit held that disparities in available capital is an acceptable market risk, but disparities in access to information is not.[117] But the example above indicates that very often disparities in the former aspect actually translate into disparities in the latter as well. As Krawiec emphasizes, "inequalities in access to information will mirror the inequalities in wealth, intelligence, and access to human capital in society at large, as information acquisition is merely a function of these other factors."[118] However, trading on the basis of the advantage gained through such unequal access is permissible under the equal access theory.

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[112]M. Breen Haire, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251, 1262 (1998).

[113]*Id.*

[114]Mercer Bullard, *Insider Trading in A Mannean Marketplace*, 88 TEMP. L. REV. 223, 240-41 (2016).

[115]*Id.* at 239.

[116]*Id.* at 237-38.

[117]*Tex. Gulf Sulphur Co.,* 401 F.2d. at 851-52.

[118]Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 477 (2001).

In this context, it would be instructive to draw on the distinction between formal and substantive equality. Formal equality ignores the "social classifications and attempts to ensure neutral application of laws" to all individuals.[119] Substantive equality recognizes that such neutral application in the context of social inequalities may actually perpetuate discrimination and supports affirmative action in favor of the disadvantaged groups.[120]

If the equal access theory is motivated by the objective of eliminating unequal access to material information and the informational disadvantage arising out of that, permitting trading on in-principle equal access to information is not sufficient. What is needed is an affirmative action initiative to ensure that all investors in the market have substantive and practically equal access to all material information that their counterparties have.[121] But the theory does not go so far as to require such substantive equal access.[122] As discussed earlier, in the context of securities markets, this is clearly impractical. Clearly, focusing on mere formal equal access means that the theory fails to address its underlying policy objective.

Davis argues that lawmakers must look towards Title VII of the 1964 Civil Rights Act for guidance on how to craft a new insider trading law.[123] In that context, he advocates importing the "disparate impact" test from Title VII as well.[124] The U.S. Supreme Court first articulated this test in the *Griggs* case.[125] It held that even in the absence of discriminatory intent, an employment practice may be discriminatory.[126] Congress directed the thrust of the Civil Rights Act to the *consequences* of employment practices, not simply the motivation.[127]

The need to adopt an affirmative action program for ensuring substantive equality of information among all the investors becomes even more crucial from this standpoint. This is because the inability of many market participants to subscribe to costly newswire data surely has a

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[119]Deepti Shenoy, *Courting Substantive Equality: Employment Discrimination Law in India*, 34 J. INT'L L. 611, 618-19 (2013).

[120]*Id.*

[121]*See* Patwardhan, *supra* note 111, at 21.

[122]*Id.*

[123]Kenneth R. Davis, *The Equality Principle: How Title VII Can Save Insider Trading Law*, 39 CARDOZO L. REV. 199, 202 (2017). Title VII makes it illegal to discriminate in the workplace on the basis of race, color, religion, sex, or national origin. *See* Coco Arima, *Protecting the People: Expanding Title VII' s Protection Against Sex Discrimination to Sexual Orientation Discrimination*, 68 DEPAUL L. REV. 69 (2019).

[124]*See* Davis, *supra* note 123, at 232-33.

[125]*See* Griggs v. Duke Power Co., 401 U.S. 424, 433 (1971).

[126]*See id.* at 431.

[127]*See id.* at 432.

disparate impact, as they are denied substantive equal access to market-moving information. As such, allowing only paid subscribers access to such feeds must be outlawed. This is clearly impractical.

Further, as Crimmins notes, some employees may have a general sense of how the company is doing.[128] An employee is able to do this merely through performing their job.[129] Crimmins discusses this example in the course of his discussion as to whether trading on such "sense" is prohibited under current U.S. prohibition.[130] However, it surely seems to be "unfair" to the counterparty in the context of the equal access theory. This is because even though such information is not explicitly articulated even by the employee herself, it may give the employee a comparative advantage as to forming a judgment regarding the value of securities of her company. This counterparty cannot overcome such advantage in any practical sense. But a prohibition on trading in this context would imply that such employees would simply never be able to trade. This is another aspect where the theory may become unworkable in practice.

Levmore discusses the issue of "insider abstention." [131] To use this concept in a different context, suppose an insider may have planned to buy (or sell) her company shares. Meanwhile, she comes in possession of some negative (or positive) material, non-public information. She now decides against going ahead with her planned trade. However, such abstention should also be prohibited as the insider surely benefitted from the material, non-public information she had access to.

Levmore considers alternatives to the "disclose-or-abstain" rule. One such proposal is the "always-disclose" rule.[132] However, in practice, there may be sound business reasons why the entire material information cannot always be made public immediately.[133]

To deal with this problem, Levmore offers yet another proposal, the "disclose-or-suspend" rule.[134] Under this rule, if business exigencies dictate that information cannot be disclosed immediately, trading in the securities should be suspended until the information can be and is finally disclosed.[135] This, of course, is the remedy worse than the disease because trading could

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[128] *See* Stephen J. Crimmins, *Insider Trading: Where Is the Line?*, COLUM. BUS. L. REV. 330, 342 (2013).

[129] *See id.*

[130] *See id.*

[131] Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 125 (1982).

[132] *Id.* at 126.

[133] This is the reason why strategic investors almost never rely exclusively on publicly available information before making a strategic investment but conduct their own due diligence.

[134] Levmore, *supra* note 131, at 128.

[135] *Id.*

be closed for significant periods of time, thereby defeating the very rationale for the existence of the market!

Based on these considerations, Levmore concludes that in the context of insider trading, fairness is a complex and elusive goal.[136]

D. *Equal Access and the Counterparty as the Victim*

The most direct criticism that can be levelled against this theory is regarding its victim analysis. The theory posits the direct counterparty to the inside trade as the victim.[137] However, it can be argued that the counterparties are not harmed in any clear way. In fact, in certain cases, they may even benefit. Insider trading results in a partial, indirect incorporation of non-public information in the price of the security.

Let us take a hypothetical example.[138] The current market price of a company's shares is $50 USD. However, there exists some positive material, non-public information. Once the information is public, it would drive up the price to $53 USD. If insider trading is prohibited, the price would remain at $50 USD until the information is public. If insider trading is permitted and insiders do trade on this information, this information might at least partially get incorporated in the price. The price may go up to $51 USD. Thus, the counterparty is actually better off with insider trading than without it. This is definitely true if the counterparty's decision to sell was independent of the presence of any insider trading. Even if insider trading does not move the price, the counterparty is no worse off, as the price would remain at $50 USD.

What happens in the event that an investor's decision to trade was triggered by the increase in price (due to insider trading)? In that case, she must have figured out the possibility of the existence of some positive material, non-public information. In this context, such trader would buy the shares at $51 USD. Once the information is made public, the price would go up to $53 USD. Now such trader can sell her shares and make a profit.

Some scholars have sought to make a distinction between "time traders" and "price traders."[139] Time traders come to the market strictly on time considerations (e.g., buying securities when they have a substantial

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[136] *Id.* at 120.

[137] We clarify that the discussion here is *modulo* the concerns raised in *infra* Section V.I.E as to whether there are any counterparties in any substantive sense in the context of exchange-based, impersonal trading.

[138] This example is adapted from Patwardhan, *supra* note 111, at 23.

[139] *See, e.g.*, John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1 (2014).

cash inflow or sell due to a liquidity need).[140] Their trading decision is no way affected by the presence of insider trading. On the other hand, price traders are speculators whose trade is triggered by the price movements.[141] It has been posited that such investors may suffer harm as a result of insider trading.[142] But our analysis shows that since insider trading sends a "correct" signal to the market, even such price traders are beneficiaries of such trading.

An example from India serves to illustrate the argument above.[143] In November 2014, there was a public announcement regarding the takeover of ING Vyasa Bank (ING) by Kotak Mahindra Bank (Kotak).[144] The takeover was structured as an all-stock deal where the takeover swap ratio was 725 shares of Kotak for every 1,000 ING shares.[145] In early October, the swap ratio (implicit in the relative market prices of both shares) was 586.[146] When the takeover was publicly announced, it stood at 710.[147] In this case, there have been allegations of insider trading.[148]

Those who were privy to this non-public information would have bought ING shares and/or sold Kotak shares. Time traders who were counterparties to such (alleged) insider trading were sellers and/or buyers of ING and Kotak shares respectively. Clearly, they were able to trade at a more favorable price due to the presence of insider traders. Price traders who detected this price shift would have surely bought ING shares and/or sold Kotak shares, suspecting the presence of some material, non-public information. It should be noted, however, that insider trading resulted only in a partial incorporation of this information. While the implicit swap ratio was nudged in the right direction, it did not completely converge to the takeover swap ratio. Thus, price traders were also able to offer their ING shares for a more favorable swap ratio than the implicit swap ratio prevailing at the time of their purchase of ING shares.

Now the equal access theory posits that the counterparty was the victim of "unfairness" inherent in such trading, so arguably must have a remedy against the inside trader. But the analysis in the preceding paragraphs show otherwise.

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[140] *See id.*

[141] *See id.*

[142] *See id.* at 8.

[143] *See* Jason Monteiro, *Insider Trading in ING Vyasa Stock?*, MONEYLIFE (Nov. 21, 2014), http://www.moneylife.in/article/insider-trading-in-ing-vysya-stock/39536.html.

[144] *See id.*

[145] *See id.*

[146] *See id.*

[147] *See* Monteiro, *supra* note 143.

[148] *Id.*

In the United States, Section 20A of the Exchange Act grants a private right of action by contemporaneous traders against the inside trader.[149] Thus, such traders may sue the inside trader for damages.[150] Leaving aside the question whether *all* contemporaneous traders should have a right of private action, even granting such a right to the counterparties to the insider trader who have not been harmed and (possibly) were beneficiaries is not justified.

In fact, granting such a right to non-harmed (or benefitted) parties would result in undue gains to them and could result in perverse consequences, particularly when the amount of gains made by the insider (which under the equal access theory are assumed to be at the cost of the outsider counterparty) is enormous.

U.S. hedge fund S.A.C. Capital Advisors, L.P., together with its affiliates (SAC) and its employees cultivated relations with two doctors who were overseeing drug trials on behalf of two pharmaceutical companies.[151] The trials began to show a negative outlook on the efficacy of the drugs and their ultimate success, while the securities market was anticipating otherwise.[152] SAC, through the doctors, had access to this information before the same was made public.[153] SAC then sold its entire equity position in the companies and bought put options on the shares of these companies.[154] Once the trial results became public, the price of those companies' shares fell drastically.[155] SAC avoided losses of an estimated $194 million USD on the long positions and obtained an estimated $73 million USD profit on its option position.[156] Investors who traded in the said shares and options contracts contemporaneously with and opposite to SAC sued under Section 20A for seeking damages.[157] The Defendants' motions to dismiss were granted in part and denied in part.[158]

Of course, this case was brought under the misappropriation theory. However, this case indicates the potential for the counterparties (or here the contemporaneous traders) to claim and possibly receive large damages. This is true even in the absence of having to prove either (1) that they relied on any explicit or implicit misrepresentations by SAC, (2) that their

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[149]Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 166 (1989).

[150]*See id*.

[151]*See* Kaplan v. S.A.C. Capital Advisors, LP, 40 F. Supp. 3d 332, 336 (S.D.N.Y. 2014).

[152]*See id.* at 336-37.

[153]*See id.* at 340.

[154]*See id.* at 336.

[155]*See Kaplan*, 40 F. Supp. 3d at 336.

[156]*See id.*

[157]*See id.* at 345.

[158]*See id*.

trading was anyway caused by such insider trading, or (3) any harm that they have allegedly suffered.[159] This is really extraordinary as in other areas of alleged securities fraud, the U.S. Supreme Court has held that the plaintiff must prove, *inter alia*, (1) reliance, (2) economic loss and (3) loss causation for a private right of action to succeed.[160] In case of insider trading, the mere fact that the plaintiff traded contemporaneously with and opposite to the inside trader is sufficient, even in the absence of any proof regarding any of these elements.

The Report of the Emerging Markets Committee of the International Organization of Securities Commissions (IOSCO Report) deals with the question of how to identify investors that have been harmed by insider trading activities and how to compensate those persons for the harm.[161] It identifies the state budget (all taxpayers), the regulatory or supervisory authority (the market—if the authority is financed by the market), a compensation fund (potentially all investors), or individual investors who were harmed by the insider trading activity as potential beneficiaries.[162] It argues that compensating individual investors who were harmed by insider trading is most fair for market participants, but also complicated in terms of implementation.[163]

The IOSCO Report states that the system (then) existing in South Africa proves that it is possible to implement such an approach and that investors may be able to recover damages if they are harmed by insider trading activity.[164] The Financial Services Board (FSB) may institute civil claims against the inside traders.[165] In addition to disgorgement, such a trader will be liable to pay a penalty of up to three times the amount of her ill-gotten gains, plus interest and legal costs.[166] After recouping its legal and investigation costs from this amount, FSB will distribute the balance of the funds to affected investors – those persons who traded in the opposite direction as the offender.[167] However, the question as to what is the precise harm suffered by such traders is left unaddressed.

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[159]*See generally Kaplan*, 40 F. Supp. 3d at 332.

[160]Amgen v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 460-61 (2013) (quoting Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 37-38 (2011)).

[161]*See* International Organization of Securities Commissions, *Insider Trading How Jurisdictions Regulate It*: *Report of the Emerging Markets Committee* 18 (Mar. 2003), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD145.pdf [hereinafter IOSCO Report].

[162]*See id.* at 18.

[163]*See id*. at 18-19.

[164]*Id.* at 18-19. Currently, Section 82 of the Financial Markets Act, 2012 deals with restitution. Its provisions are similar to the ones discussed here, with minor modifications.

[165]*See* IOSCO Report, *supra* note 161, at 82.

[166]*See id*.

[167]*Id.* at 82-83.

E. *Other Victim Candidates*

The analysis in the previous Section shows that the counterparty (or more generally, those who trade on the opposite side of the insider) is not the victim of insider trading. That is not the end of the matter. Some scholars maintain that insider trading is not a victimless act, even if the counterparties are not the victims.

Wang suggests an alternative victim analysis.[168] He draws a parallel with the fraud in the sale of a used car to explain his point.[169] He begins his analysis by making a distinction between the sale of a used car with a solitary defect and that with a generic defect.[170] Suppose a person owns a particular model (in Wang's example a 1998 Cadillac).[171] She discovers a defect in the particular car that she owns.[172] Still, she sells her car to a car dealer and sells it at the going price (for good quality 1998 Cadillacs) for $ 25,000 USD.[173] She does not reveal the defect in that particular car, nor does she lie about it.[174] The dealer never discovers the defect, and in turn, resells the car to another buyer.[175]

It is only this particular 1998 Cadillac which is defective.[176] If the original seller had not sold her defective car to the dealer, the dealer would not have been able to resell it to the other buyer.[177] Wang concludes that the victim of this transaction is the ultimate buyer.[178] Thus, in case of the solitary defect example, the ultimate counterparty in the chain of transactions is clearly the victim.

Wang then turns to the generic defect example, which according to him is analogous to anonymous stock market insider trading.[179] In this case, the person who owns a 1998 Cadillac learns the material, non-public information that all 1998 Cadillacs have a major defect.[180] She again sells her car to a car dealer at the going price of $25,000 USD.[181] The dealer in

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[168] *See* William K.S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies – Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 VILL. L. REV. 27, 30-32 (2000).

[169] *See id*.

[170] *See id*.

[171] *See id*., at 30-31.

[172] Wang, *supra* note 168, at 30-31.

[173] *See id*.

[174] *See id*.

[175] *See id.*

[176] *See* Wang, *supra* note 168, at 31.

[177] *See id*. at 32.

[178] *See id.*

[179] *See id*.

[180] *See* Wang, *supra* note 168, at 32.

[181] *See id*.

turn sells it to another buyer.[182] Now the news regarding the generic defect becomes public, and the market price of all 1998 Cadillacs falls to $10,000 USD.[183]

Wang's conclusion here is that the ultimate buyer is not the victim of this sale.[184] She was in the market looking for a 1998 Cadillac.[185] She could have purchased it from another seller (who possibly did not even know about the generic defect) and anyway got stuck with a defective car.[186] Thus, she is no way worse off simply because she happened to buy it (indirectly) from a seller who knew about the defect.[187]

Analogously, in the context of anonymous stock market trading, the counterparty to the insider trader is not the victim. The counterparty would have anyway bought the security from another trader (who was possibly ignorant of the non-public information) at the same price. Calling the counterparty the victim simply because she happened to trade with the insider trader on the other side is purely fortuitous.

However, Wang argues that from this, one cannot conclude that each act of insider trading has no specific victims.[188] Continuing with the generic defect example, after the seller sold her car to the dealer, the dealer may have lowered the price at which she was willing to buy and sell that particular model, in order to clear the extra inventory.[189] That lower price itself may induce a person to buy a car from the dealer, in which case the dealer's inventory is back to the original level.[190] On the other side, the lower price may dissuade a potential seller from selling her car to the dealer.[191] However, if the reduced price neither induces a person to buy, nor does it dissuade a person from selling, the dealer would be stuck with that extra inventory, as a result of the original transaction.[192] Wang concludes that even in this case, there is only one victim—either the dissuaded seller, the induced buyer, or the dealer.[193] In practice, it is difficult to ascertain whether there was any such buyer/seller and if so,

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[182] *See id.*
[183] *See id*.
[184] *See* Wang, *supra* note 168, at 32.
[185] *See id*.
[186] *See id.*
[187] *See id.* at 33.
[188] *See* Wang, *supra* note 168, at 33.
[189] *See id.*
[190] *See id*. at 34.
[191] *See id*.
[192] *See* Wang, *supra* note 168, at 34.
[193] *See id*. at 32.

who they were. Therefore, in practice it may be difficult to figure out the identity of the victim in a specific case.[194]

There are three points that can be made with respect to this analysis. First, Wang makes the questionable assumption that a marginal change in the price of a car would induce buyers or dissuade sellers from entering into transactions.[195]

More importantly, the analogy with a used car may not be apt. In the context of securities trading, the market may actually interpret a decline in price as a signal that an adverse development has occurred.[196] This may dissuade potential buyers from entering the market. Similarly, a price rise may well alert the market to the existence of non-public, positive information, which in turn may attract buyers.[197] To the extent insider trading has any signaling effects, these drive the trading behavior in the correct direction.[198] Such dissuaded (or induced) buyers would actually be beneficiaries of insider trading, contrary to the used car example.

Finally, by definition, Wang's analysis only covers insider trading on negative information (defect).[199] As such, this analogy cannot be employed to analyze insider trading on positive information.

Murdock argues that in public markets, the persons injured by the insider's trading arguably are persons who trade on the same side as the insider.[200] In a "bad news" situation, such as in *Cady, Roberts,* the insider always sells at a price that is higher than subsequent sellers receive after the adverse information is disclosed.[201] Conversely, in a "good news" situation, the insider always buys ahead of the market, and the price the insider pays will be lower than the price that prevails after the disclosure of the positive information.[202]

He concedes that this reality does not easily translate into a computation of damages for the sellers or buyers who come to the market after the insider trades.[203] Therefore, a private cause of action for insider trading in impersonal public markets is arguably neither feasible nor realistic.[204]

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[194] *See id.* at 34-35.
[195] *See id*. at 35.
[196] *See* Murdock, *supra* note 70, at 1557.
[197] *See id.* at 1558.
[198] *See id.* at 1557.
[199] *See generally* Wang, *supra* note 168, at 32.
[200] *See* Murdock, *supra* note 70, at 1158.
[201] *Id.*
[202] *Id.*
[203] *Id.*
[204] Murdock, *supra* note 70, at 1558.

This proposition is contestable. Let us go back to the earlier hypothetical example. If there is no insider trading, the price of the shares stays at $50 USD. If insiders trade based on material, non-public information, the price goes up to $51 USD. Murdock's argument seems to be that the non-insider buyers end up paying $1 more than what they would have, in the absence of insider trading.

While the buyers have to pay more with insider trading, it is still less than the new "efficient" price, as insider trading by itself is unlikely to nudge the price all the way to its efficient level. If insider trading happens, the non-insider sellers are able to trade at closer to the efficient price. If insider trading does not happen, the shares continue to trade at $50 USD, and the entire "hidden" value of $3 would be pocketed by the non-insider buyers. This actually entails a wealth transfer from the non-insider sellers to the non-insider buyers (since the share continues to trade at the previous efficient price of $50 USD). With insider trading, the non-insider sellers are able to capture a part of this "hidden" value" that is clearly a more equitable outcome than what happens in case of no insider trading. Therefore, traders who are on the same side as the inside trader are not victims of insider trading either.

F. *Special Relationship to Equal Access – Sleight of Hand?*

Significantly, the Second Circuit purportedly based its analysis on and approvingly quoted *Cady, Roberts* to state that:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing."[205]

Now a plain reading of the phrase "such information" in the second prong clearly indicates that the kind of information at issue here is that referred to in the first prong.[206] In other words, it must be information to which a person has access to by virtue of her relationship with the company and such access is provided only for a corporate purpose and not for the personal benefit of anyone. As discussed earlier, the SEC specifically held that the duties that such a person has in respect of trading

[205] *Tex. Gulf Sulphur Co.*, 401 F.2d. at 848.
[206] *See id.*

in the securities of the company are correlative with her special relationship with the company and her access to corporate information. So, it is the existence of a special relationship and access to information by virtue of such a relationship that imposes a duty on such persons not to trade on such information.[207] Therefore, under the special relationship theory, the class of persons to whom the "disclose-or-abstain rule" applies is limited to only such persons.

However, here the Second Circuit took the extraordinary step of converting the *Cady, Roberts* special relationship theory into a general prohibition on trading on material, non-public information by any person whatsoever. The Court stated:

> Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[208]

Of course, the SEC in its opinion did state that the anti-fraud provisions are phrased in terms of "any person."[209] The SEC also observed that (in terms of a prohibition on trading), the three groups (directors, officers and controlling shareholders) do not exhaust the classes of persons upon whom there is such an obligation (not to trade on non-public information).[210] But this observation was specifically made in the context of considering tippee liability where such tippee who herself does not have any relationship with the company receives information from an insider.[211] In particular, the SEC observed that Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the

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[207] *See id*. at 858.
[208] *Id.* at 848 (citations and internal quotation marks omitted).
[209] *Tex. Gulf Sulphur Co.*, 401 F.2d. at 848.
[210] *In re Cady, Roberts*, 40 S.E.C. at 912.
[211] *See id*.

information without disclosure.[212] By logical sequence, it should prohibit Gintel, a partner of the broker.[213]

Thus, the *Texas Gulf Sulphur* court seemingly grounded its analysis in *Cady, Roberts*.[214] But its ruling was at variance with and marked an illicit shift away from the holding in that case.[215] At the hands of the Court, the special relationship theory of *Cady, Roberts* was transformed into the equal access theory. The existence of a special relationship and a correlative duty arising out of that relationship therefore were rendered totally irrelevant.[216]

G. *The Takeaway*

The equal access theory surely has a strong intuitive appeal. It seems simply unfair that one party trades based on material, non-public information to which her counterparty does not have access. Therefore, the counterparty is seemingly placed in a position of an inherent disadvantage.

However, it is not at all clear whether mere in-principle access to such information is sufficient to alleviate such unfairness concerns. What is really needed is an affirmative action initiative to ensure that all investors in the market have substantive, practical equal access to all material information that their counterparties have. Though the theory does not go so far as to require such substantive equal access, as in the context of securities markets, this is clearly impractical. Focusing on mere formal equal access means that the theory fails to address its underlying policy objective.

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[212] *See id.*

[213] *See id.* Of course, as pointed out earlier, there is an anomaly here as the SEC found that Cowdin disclosed the information to Gintel in the sincere belief that the information was already public. Therefore, there was no breach of duty by Cowdin. Logically, it could not have held Gintel liable, as he could have acquired the duty only derivatively from Cowdin. *See supra* note 90 and accompanying text.

[214] *See Tex. Gulf Sulphur Co.*, 401 F.2d. at 848.

[215] *Compare* Securities and Exch. Commn. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) *with* In re Cady, Roberts & Co., 40 S.E.C. 907 (S.E.C. Release No. Nov. 8, 1961).

[216] *See* Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, 71 SMU L. REV. 835, 838-40 (2018) (explaining that the SEC's approach in *Cady, Roberts* was one based on abuse of status, not mere possession). In 1968, the judiciary was at a high point in pursuing a broad, expansive common law style of securities law jurisprudence. While the Second Circuit was not on board with this, the Supreme Court nudged it in this direction. If the *TGS* court genuinely believed that egalitarianism best captured the purpose behind the antifraud provisions of the securities laws, they needed no text, precedent, or legislative history to fashion doctrine around it.

This theory posits the counterparty to the insider trader as the victim of such trading. However, such counterparties (or other contemporaneous traders who are on the opposite side as the insider trader) arguably suffer no harm and are possibly beneficiaries of such insider trading. This is true regardless of whether the counterparty is a time trader or a price trader. Granting such a trader a private right of action against insider traders is not justified.

Other victim candidates, such as the ultimate buyer/seller in a chain of transactions or traders who trade on the same side as the insider trader have also been posited as victims of insider trading. These arguments are not convincing either, at least in the context of exchange-based, anonymous transactions.

Therefore, the equal access theory lacks a policy rationale that addresses any of the substantive concerns of securities law. Rather, it is based on the inchoate notion that securities trading by company insiders based on material, non-public information is somehow unfair to the counterparty and ought to be prohibited.

V. THE CLASSICAL THEORY - *CHIARELLA*

A. *Facts of the Case*

The origin of the classical theory is the opinion of the Court authored by Justice Powell in *Chiarella v. United States*.[217] This was the first insider trading case decided by the United States Supreme Court.[218] Unlike the equal access theory, the insider trading prohibition here arises from a prior duty owed by the trader.[219] The special relationship theory is also a duty-based theory.[220] However, the source and nature of the duty involved in the classical theory is conceptually distinct from that in the special relationship theory.

Vincent Chiarella was a printer by profession.[221] He worked as a mark-up man in New York with Pandick Press, a financial printer.[222] As part of his employment, Chiarella handled the documents related to the announcement of five different corporate takeover bids.[223] When these documents were delivered to the printer, the identities of the acquiring and

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[217]*See Chiarella*, 445 U.S. at 222.
[218]*See generally id*.
[219]*See id*. at 223.
[220]*See In re Cady, Roberts*, 40 S.E.C. at 912.
[221]*Chiarella*, 445 U.S. at 224.
[222]*Id*.
[223]*Id*.

target companies were either concealed by blank spaces or false names.[224] The true names were sent to the printer on the night of the final printing.[225]

Despite this, Chiarella was able to figure out the names of the target companies based on other information contained in the documents.[226] Without disclosing to anyone that he had gained access to this non-public information, Chiarella bought shares in the target companies before the takeover bids were publicly announced and sold the shares after the bids were made public.[227] In the course of fourteen months, he was able to realize a gain of around $30,000 USD.[228]

The SEC began an investigation into his trading activity, after which Chiarella entered into a consent decree wherein he agreed to return the profits made on these trades to the sellers of the shares.[229]

In a parallel criminal case, the trial court convicted Chiarella under Section 10(b) and Rule 10b-5.[230] The jury was instructed to decide whether the petitioner used material, non-public information at a time when he knew other people trading in the securities market did not have access to the same information.[231] The trial court thus relied on the equal access theory which had been upheld in *TGS*. Chiarella was convicted and his conviction was upheld by the Second Circuit.[232] The Supreme Court granted certiorari.

B. *The Nature of the Underlying Duty*

This theory has also been termed the fiduciary rule.[233] This may be due to the observation in *Chiarella* that a person is prohibited from trading based on material, non-public information when such trading constitutes a breach of a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position in that corporation.[234] Now the directors and officers of a company have a fiduciary duty to the shareholders to promote their interests in good faith. Therefore, the insider

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[224] *Id*.
[225] *Chiarella*, 445 U.S. at 224.
[226] *See id*.
[227] *See id*.
[228] *Id*.
[229] *Chiarella*, 445 U.S. at 224.
[230] *See id*. at 231.
[231] *Id.* at 231.
[232] *See id*.
[233] Haire, *supra* note 112, at 1263.
[234] *See Chiarella*, 445 U.S. at 227-28.

trading prohibition imposed on such directors and officers may be seen as a particular aspect of their fiduciary duty.

However, this particular conceptualization of the classical theory is under inclusive. While the directors and officers are definitely prohibited from trading in securities based on material, non-public information, they do not exhaust the category of persons covered by the prohibition under the classical theory.

To appreciate this point, it is necessary to closely follow the reasoning of the *Chiarella* Court because there is no explicit statutory prohibition against insider trading. Therefore, the *Chiarella* Court rightly sought to base its analysis on the text of Section 10(b)[235] and Rule 10b-5[236] under which insider trading cases have been brought by the SEC as well as the U.S. government. These are essentially anti-fraud provisions that target manipulative or deceptive devices or contrivances.[237] Thus it was necessary for the Court to articulate a theory of insider trading prohibition that posits that such trading is manipulative or deceptive.

The Court had previously held that the term "manipulation" is basically a term of art generally referring to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity.[238] Insider trading admittedly is not a market practice that fits this description.

Therefore, Justice Powell turned to the deception prong which *Santa Fe* had held to cover instances of a material misrepresentation, as well as material failure to disclose.[239]

Thus, a person's failure to disclose material, non-public information she has access to and trading on the basis of such information can in principle be held to be deceptive and, therefore, prohibited.[240] However, Justice Powell balked at casting this as a universal proposition applicable to all traders. Rather, he sought to draw on the common law of deceit to flesh out the contours of the prohibition. He wrote:

> At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he

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[235] *See id*.

[236] 17 C.F.R. § 240.10b-5.

[237] *See generally* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

[238] Santa Fe Indus. v. Green, 430 U.S. 462, 476 (1977) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

[239] *See id.* at 474.

[240] *See id*.

> is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[241]

According to Justice Powell, application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholders' welfare before their own, will not benefit personally through fraudulent use of material, non-public information.[242]

Thus, the existence of the fiduciary duty arising out of the fact that the person is a director or officer of the company is only one instance of such a relationship. In general, the insider trading prohibition under the classical theory arises due to any pre-existing fiduciary duty or a similar duty of trust and confidence between the counterparties. In such a situation, the person who has access to material, non-public information must either disclose it to the counterparty prior to trading or abstain from trading.[243]

This "disclose-or-abstain" rule is also applicable in the special relationship theory. However, the origin of the duty in that case not to trade on material, non-public information arises out of a person's duty to the company, while the "disclose-or-abstain" duty runs to the counterparty. As discussed earlier, these two conflicting prongs introduce a fundamental dichotomy in the special relationship theory resulting in internal incoherence. The classical theory avoids this problem as the relationship with the counterparty is the source of the duty and the "disclose-or-abstain" obligation also runs to it.

Therefore, this theory of the insider trading prohibition—as fleshed out in *Chiarella*—is wider in scope as compared to the special relationship theory in *Cady, Roberts* at least as far as trading in company shares is considered.[244] As Justice Powell noted, the Courts had always held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal

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[241]*Chiarella,* 445 U.S. at 227-28 (alteration in original) (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

[242]*See id.* at 230.

[243]*See infra* Section VI. H for the discussion of this in the context of both classical and misappropriation theories. Contrary to the reference in *Chiarella* on the duty of disclosure of the information, there is an interesting argument that the disclosure of the mere intent to trade eliminates any deception.

[244]In the case of derivatives, since the directors and officers have no fiduciary relationship with the non-shareholder counterparty, there is no prohibition under the classical theory, while there would be such a prohibition under the special relationship theory.

and which, if known, would affect their investment judgment.[245] Therefore, every case which would give rise to liability under the special relationship theory would do so under the classical theory as well.

On the other hand, there may be cases where the trader is not in any special relationship with the company, but has a relationship whereby the counterparties have placed their trust and confidence in the trader, such as an agency or a trust relationship. Such cases would be covered by the classical theory, but not by the special relationship theory. Langevoort notes that an argument can be made that even when a fiduciary (such as a director) receives material, non-public information other than through her special relationship with the company, she may be liable under the classical theory,[246] even though she would not be liable under the special relationship theory.

Therefore, the insider trading prohibition under the classical theory surely applies to the directors and officers, but it also casts a wider net.

C. *Two Points in Favor*

There are two points that can be made in favor of this theory. Unlike the equal access theory which does not seem to find any support in the legislative history or text of the Exchange Act, Justice Powell's attempt to base the prohibition on the common law of deceit is far more plausible—not the least because Section 10(b) explicitly seeks to prohibit deception in connection with the purchase or sell of any security.[247] Two, both the nature of duty and the "disclose-or-abstain" rule unambiguously point to the counterparty as the "victim" of such trading, thereby avoiding the dichotomy inherent in the special relationship theory wherein insider trading is seen as akin to RPTs that harms the company and simultaneously posits that it is somehow unfair to the counterparties.[248]

Of course, the "victimization" implicit here is distinct from that in the equal access theory.[249] Under the equal access theory, the counterparty is victimized solely due to the fact that the insider trader's trading was based on her superior access to material, non-public information.[250] In the case of the classical theory, the counterparty is victimized due to the

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[245] *See Chiarella,* 445 U.S. at 227.

[246] *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 21-22 (1982).

[247] *See id*.

[248] *See id*.

[249] *See generally Chiarella*, 445 U.S. 222.

[250] *Id*.

fiduciary (or similar) duty that the trader owes the counterparty *and* her violation of that duty due to trading without disclosure.[251]

Thus, under the equal access theory, Chiarella's counterparties would have been victims of his trading based on non-public information regarding the upcoming tender offers for the shares of companies he traded in, simply because they did not have access to said information. They were not victims under the classical theory since Chiarella owed no pre-existing fiduciary (or similar) duty towards the counterparties, and therefore was under no obligation to disclose the information prior to trading.[252] As Justice Powell noted, "[Chiarella] was not [the counterparties'] 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."[253]

Based on this analysis, Chiarella was acquitted. More importantly, the all-encompassing equal access theory favored by the SEC and the government was rejected.[254] Sabino and Sabino appropriately refer to this judgment as a stunning reversal of fortune for the government.[255]

The natural question to be considered here would be the extent to which Justice Powell was successful in providing a coherent theoretical foundation for the U.S. insider trading prohibition and, in particular, his attempt to articulate the boundaries of the prohibition based on the text of Section 10(b).

D. *The Fiduciary Fiction*

Justice Powell's formulation of the classical theory raises a host of issues. The first fundamental difficulty has to do with respect to the precise nature of the fiduciary duty involved. Relying on state level corporate law in the United States, Pritchard argues that the proposition that directors and officers have a fiduciary duty towards the individual shareholders (as against the company and the shareholders as a class) is difficult to support.[256] For example, in the leading case of *Goodwin v. Agassiz,*[257] the Supreme Judicial Court of Massachusetts held that directors do not

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[251]*See* Langevoort, *supra* note 246, at 21-22.

[252]*See id*.

[253]*Chiarella,* 445 U.S. at 232-33.

[254]*See generally id.*

[255]Anthony Michael Sabino & Michael A. Sabino, *From Chiarella to Cuban: The Continuing Evolution of the Law of Insider Trading*, 16 FORDHAM J. CORP. & FIN. L. 673, 694 (2011).

[256]Adam 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, 22-23 (1998).

[257]Goodwin v. Agassiz,186 N.E. 659 (Mass. 1933).

"occupy the position of trustee toward individual stockholders."[258] Thus, there was "no fiduciary relation between them and the plaintiff in the matter of the sale of his stock."[259] This result was supported by the "imposing weight of authority in other jurisdictions."[260] On this view, the directors' and officers' fiduciary duty is towards the company and possibly to the shareholders collectively and not towards any individual shareholder.[261] This came to be called "the majority rule."[262] If this is correct, the very basis of the classical theory is undercut as the prohibition here is based on a fiduciary or similar duty between *the parties to the securities transactions*.

However, a few state courts did adopt an exception to the majority rule that came to be known as the "special facts" doctrine.[263] Under this doctrine, a director or officer has a duty to disclose in a face-to-face transaction with a shareholder if there are special facts that would make nondisclosure unconscionable.[264]

Pritchard argues[265] that the U.S. Supreme Court adopted the special facts doctrine in *Strong v. Repide*.[266] However, this case was decided on the basis of the local civil code that was in force in the Philippines at that time.[267] The director-seller went to great lengths to conceal his identity, as well as the fact that he was a director and controlling shareholder of the corporation.[268] The Court held this act on the part of the purchaser to be "insidious machination" as defined under the impugned provision and voided the contract.[269]

In India, Section 166 of the Companies Act, 2013 casts a duty on the directors of a company to act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.[270] Thus, even in India,

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[258]*Id.* at 660.

[259]*Id.* (internal citations omitted).

[260]*Id.* (citing cases from Arizona, Illinois, Indiana, Kentucky, Michigan, Minnesota, New Jersey, New York, Tennessee, and Utah).

[261]Pritchard, *supra* note 256, at 23.

[262]*Id*.

[263]*Id.* at 24.

[264]Barbara A. Ash, *State Regulation of Insider Trading-A Timely Resurgence?,* 49 OHIO ST. L.J. 393, 399-400 (1988).

[265]Pritchard, *supra* note 256, at 24.

[266]Strong v. Repide, 213 U.S. 419 (1909).

[267]*Id*. at 430.

[268]*Id*. at 421-22.

[269]*Id*. at 430.

[270]Companies Act, 2013, § 166 (India).

the contention that the directors have a fiduciary duty to the individual shareholders is not supported by the legal position.

E. *Classical Theory and Impersonal Transactions*

Even if the special facts doctrine is accepted in case of face-to-face transactions, the logic of extending it in the context of exchange-based transactions is problematic. Today's stock exchanges are electronic platforms that afford complete anonymity for the traders. Further, the trading systems can be basically classified either as quote-driven or order-driven.[271] In a quote-driven system, certain entities act as market makers for specified securities. They provide liquidity by offering two-way quotes for the purchase and sell for those securities. Other traders in the market may submit their orders at such quoted prices.

In some securities markets such as those in the U.S., market making has undergone a radical transformation with the arrival of high frequency trading.[272] Rather than rely on designated market makers, makers now look to high-speed traders to provide a more informal, functional market making by rapidly buying and selling shares with investors.[273] Functionally, such markets increasingly take on the character of order-driven markets.[274]

In case of order-driven markets, there are no market makers. Rather, traders on both sides independently enter their buy/sell orders in the system. The order matching is done automatically by strict price-time priority.[275] Further, certain entities often act as the Central Counterparty (CCP).[276] A CCP acts as a counterparty to every buy and sell trade, a process known as "novation."[277] Thus, matching happens between two orders, rather than two trading counterparties. The CCP itself stands as a counterparty to both traders and assumes the counterparty risk.[278]

The above-mentioned market structure and design present several challenges from the viewpoint of justifying the reach of the classical

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[271] NATIONAL STOCK EXCH. OF INDIA LIMITED BYELAWS, CH. IX § 3(a).

[272] Yesha Yadav, *Insider Trading and Market Structure*, 63 UCLA L. REV. 968, 987-88 (2016).

[273] *Id.*

[274] *See id.*

[275] *See* NATIONAL COUNCIL OF EDUCATIONAL RESEARCH & TRAINING, *Introducing and Understanding Transaction Cycle*, *Financial Marketing Management*, http://cbseacademic.nic.in/web_material/publication/archive/FMM%20II_Chapter%205.pdf (last visited Nov. 2, 2020).

[276] *Id.*

[277] *Id.*

[278] *Id.*

theory to exchange-based transactions as enunciated by the *Chiarella* Court. One, in the case of an exchange-based transaction, the parties do not even know each other's identity. Unlike a face-to-face transaction, there is no direct negotiation between the buyer and seller and consequently no "active concealment" of facts as implicated either in the special facts doctrine or the statutory provisions impugned in *Strong v. Repide*.[279] As Pritchard puts it, this anonymity implies that there is no reliance on the insider's duty to disclose, and the insider in no way can be said to have induced the other party to trade.[280] Thus, if insider trading is seen as an implicit misrepresentation by a fiduciary regarding her lack of knowledge of any material, non-public information, it is a stretch to carry over this logic in the context of exchange-based transaction. In such cases, the identity of the person on the other side of the transaction is a mere fortuity, irrelevant to the shareholder's decision to trade.[281]

This problem is particularly more pronounced in the case of an order-driven system. In such a case, a fiduciary may enter a buy order based on some material, non-public information to which she has access. As mentioned earlier, her order would be matched with one or more orders on the other side based on price-time priority. There would be no matching of counterparties at all. The CCP becomes the counterparty to both sides of the trade. Unless one is prepared to extend the insider's fiduciary responsibility towards the CCP (a clearly preposterous proposition), the essential element of the presence of the fiduciary duty *between the counterparties* falls away.

Of course, it may be argued that in such cases it is imperative to disregard the legal form of the transaction and instead look at its substance. Thus, traders whose orders are finally matched may be regarded as counterparties at least for this limited purpose. However, a particular trader's order getting matched with that of the insider is merely fortuitous, depending on the price and time of the order flow. For example, even a few seconds' difference in entering the order could well have resulted in a different order getting matched with that of the insider. Thus, the concept of counterparty is meaningless not just as a matter of legal form, but even as a matter of substance. Moreover, the identity of the person on the other side of the transaction is irrelevant to the trader's decision to trade.

Thus, even leaving aside the issue whether the directors and officers have a fiduciary duty towards the individual shareholders, the applicability of the classical theory in case of exchange-based transactions is

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[279] *See supra* notes 266-269 and accompanying text.
[280] *See* Pritchard, *supra* note 256, at 25.
[281] *Id.*

problematic. This is because there is no meaningful sense in which one can pinpoint a counterparty towards which the trader (1) had a fiduciary duty, (2) that the fiduciary was under an obligation to disclose any special facts to that counterparty before trading, or (3) that such counterparty assumed, based on the fiduciary's silence, that no such special facts existed.

F. *Insider Trader as the Seller of Securities*

Another problem with the classical theory is its applicability in cases where the insider is a seller of the security. This is because the outside purchasers become shareholders of the company *after* the trade is consummated and thus the insider does not have a *pre-existing* fiduciary relationship with them, as required by the theory.[282] Therefore, at least when an insider sells shares to an outsider for the first time, the insider trading prohibition under the classical theory should not apply.

The *Chiarella* Court was well aware of this difficulty. However, the Court's response to this issue was to quote Judge Learned Hand who observed that it would be a "sorry distinction to allow the insider to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one."[283] This distinction may be "sorry," but it is a distinction long recognized in the common law.[284] Again, the clear implication is that the insider trading prohibition should apply only in case a fiduciary buys securities based on material, non-public information.

G. *Classical Theory and Trading in Non-equity Securities*

Yet another problem with the classical theory is that it may or may not reach instances where an insider trades in non-equity securities based on her access to material, non-public information. In the United States, the law does not recognize a fiduciary duty running from officers and directors to bondholders, at least while the corporation is solvent.[285] In such jurisdictions, insider trading in bonds should be perfectly legal, at least under the classical theory. Similarly, insider trading in derivative contracts

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[282]Unless, of course, the insider happens to have some other relationship of trust and confidence with the purchaser such as an agency or trustee relationship.

[283]*Chiarella*, 445 U.S. at 227 n.8 (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951)).

[284]Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 993 (2014).

[285]Pritchard, *supra* note 256, at 28.

should arguably not be covered under the classical theory as company insiders do not have a fiduciary duty towards (non-shareholder) derivative traders.

In India, Section 166(2) of the Companies Act, 2013 casts a duty on the directors of a company to act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of the environment.[286] In other words, these are classes of persons towards which the directors owe a fiduciary duty. Therefore, it seems that the bond trading exception as well that for trading in derivatives should carry over here as well. Thus, the scope of the prohibition becomes a highly fact specific and jurisdiction specific enquiry into the nature and scope of the fiduciary duty involved.

H. *"Uncorporate" Insider Trading*

In a recent article, Molk flags the issue of uncorporate insider trading.[287] He notes that in the United States, the existence of a fiduciary duty is required for insider trading liability to attach.[288] The showing of such a duty is comparatively easy in the context of corporations and general partnerships. In the last few years, new types of entities such as limited liability companies (LLCs) and limited partnerships (LPs) have emerged. These "uncorporate entities" now dwarf the rate of new corporate formations.[289]

Many states grant these entities the power for complete elimination of core insiders' state law fiduciary duties.[290] Since breaching a fiduciary duty is a predicate element for imposing insider trading liability, when fiduciary duties disappear, so too does the apparent liability under legal theories.[291] In particular, it precludes any liability under the classical theory.[292] Some of these entities are publicly traded.[293] A few such prominent LLCs are TravelCenters, MGM Growth Properties and

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[286]Companies Act, 2013, §166(2) (India).

[287]Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693 (2020).

[288]*Id*.

[289]*Id.* at 1694 (quoting Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010)).

[290]*Id*. at 1709-10.

[291]*See* Molk*, supra* note 287, at 1709-10.

[292]*Id*. at 1695-96.

[293]*Id*. at 1695.

Enterprise Product Partners.[294] The last-mentioned LLC has a market capitalization of $63 billion USD.[295] In an empirical study of publicly traded Delaware LLCs and LPs, Manesh found that almost half, forty-nine percent, waived all three fiduciary duties of loyalty, care, and good faith.[296]

This development creates a fresh puzzle for the classical theory.[297] While insider trading in the securities of corporations and general partnership is prohibited (*modulo* the fiduciary fiction concerns), trading in the securities of LLCs and LPs is not.[298] As Molk notes, many LLCs and LPs are indistinguishable from their partnership and corporate counterparts in their need to protect investors, so policy arguments for regulating general partnerships and corporations also apply to regulating at least these LLCs and LPs. This is not an ideal policy outcome.[299] Molk offers two proposals for reform.[300]

Under the first proposal, liability could be imposed through the single mandatory governance protection demanded of alternative entities: the implied covenant of good faith and fair dealing.[301] Molk concedes that while this option might be easy to implement, it is unsatisfying from an enforcement perspective, and its application would be overly broad.[302]

Under the latter proposal, a mandatory fiduciary duty could be imposed in the context of LLCs and LPs.[303] However, there are many contentious issues here – whether the duty should be determined by federal or state law, what should be the precise scope of this duty and whether the duty should be mandatory, default or a mixture of both.[304] A detailed discussion of these issues is beyond the scope of this article. However, these issues clearly demonstrate that the solution may not be as straightforward as one may wish.

Under the classical theory, the existence of a fiduciary duty between the parties to a securities transaction is a prerequisite for the prohibition to attach.[305] The insider trading prohibition arises *as a consequence of* the existence of such duty.[306] In the case of uncorporate entities, the proposal

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[294]*Id*. at 1710-11.

[295]*See* Molk, *supra* note 287, at 1711.

[296]Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 575 (2012).

[297]*See* Molk, *supra* note 287, at 1697, 1709.

[298]*Id*. at 1698.

[299]*Id*. at 1734-35.

[300]*Id*.

[301]*See* Molk, supra note 287, at 1741.

[302]*Id*. at 1736.

[303]*Id*. at 1737.

[304]*Id*. at 1741.

[305]*See* Molk, *supra* note 287, at 1698-99.

[306]*Id*. at 1747-48.

is that a fiduciary duty be mandated into existence to expand the scope of the classical theory prohibition to LLCs and LPs.[307]

One of the major reasons why these uncorporate entities have grown in popularity is the governance flexibility that they provide.[308] Many states, in their own discretion, have chosen to afford wide latitude to such entities in their contractual ability to modify or eliminate entirely the mandatory fiduciary duties traditionally owed by company insiders.[309] Therefore, it is a policy determination afforded to the states that such flexibility needs to be given to these entities.[310]

Thus, this proposal seems to turn the whole issue on its head. Here, a fiduciary duty is sought to be retrofitted onto the existing legal framework governing these entities, solely for the purpose of expanding the scope of the insider trading prohibition.[311] This is at odds with the fundamental logic of the classical theory.[312]

I. *The Scope of the Theory – An Inescapable Dilemma*

It may have been the intention of Justice Powell to fashion the classical theory in order to articulate the U.S. insider trading prohibition in a way that is faithful to the language of Section 10(b).[313] However, it seems that this theory falls under its own weight. If the classical theory is to be strictly based on the law of deceit, its scope would be admittedly very restricted. It would apply only to face-to-face transactions in securities when the trader has a fiduciary (or similar) duty towards her counterparty.[314] Further, she must be a prospective buyer of such securities.[315] There should be no such restriction when she is the seller of securities. Finally, there must exist special facts that warrant the disclosure to the other party of material, non-public information that the fiduciary is aware of.[316] This would indeed catch an extremely small set of securities transactions. This would, in particular, completely leave out exchange-based transactions either in company shares or derivatives. It would also

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[307] *Id.*

[308] *Id.* at 1711-12.

[309] *See* Molk, *supra* note 287, at 1695.

[310] *Id.* at 1711-12.

[311] *Id.* at 1709-10.

[312] *See infra* Section VI.I.K for a similar argument regarding the STOCK Act and the misappropriation theory.

[313] Pritchard, *supra* note 256, at 18-19.

[314] *Id.* at 26.

[315] *Id.*

[316] *Id.* at 24.

exclude trading in the securities of LLCs and LPs where the mandatory fiduciary duties owed by company insiders are waived.

Therefore, if one faithfully follows the reasoning of the *Chiarella* Court in upholding the classical theory, it results in an extremely truncated insider trading prohibition. It is in fact hard to see how the theory addresses the basic policy objectives of securities law–protection of the interest of investors in securities and development of the securities market. With its complete exclusion of exchange-based transactions, it leaves out all those transactions where trading happens without any face-to-face negotiation between the prospective traders. In fact, the small subset of transactions that it covers can be simply described as those involving purchase of securities of a corporation or a general partnership (and possibly some LLCs and LPs) by a fiduciary in a face-to-face transaction wherein she is in possession of certain special facts whose non-disclosure to the other party would be unconscionable.

It seems that the burden of proof is surely on the advocates of the classical theory to explain as to why only this particular (and peculiar!) subset of transactions needs to be covered by the insider trading prohibition. In particular, it is unclear what is the precise nature of the investors' interest that is sought to be protected here is and why this interest is implicated only in the context of such specific transactions, and no others. It is further unclear as to how prohibiting transactions only in this specific context contributes to the development of the securities market.

In the context of this lack of clarity over the policy objective that such a truncated prohibition is intended to serve, the adoption of the classical theory does not seem to justify the severe civil or criminal liabilities that are part of the insider trading prohibition in the United States. Rather, under the classical theory, insider trading becomes a private dispute between the fiduciary (buyer) and her counterparty (seller) subject to the proof of the existence of any special facts that casts an obligation on the fiduciary to disclose any material, non-public information that she knows.[317] The appropriate remedy would be a private civil action by the counterparty under the general law of deceit against the fiduciary for damages or voiding of the contract or maybe even criminal prosecution. Again, whether every piece of material, non-public information can be treated as a special fact that must be disclosed is not clear.

As formulated, this kind of insider trading is indistinguishable from any other transaction wherein a fiduciary fails to disclose a fact to the other party who has placed her trust and confidence in the fiduciary and the fact is of such nature that its non-disclosure would amount to a material

[317] *See supra* Sections V.B-E.

omission on the fiduciary's part.[318] Further, the trader being a director or officer of the company, is only one source of the duty. But such a duty may arise in other ways as well. For example, A may have placed her trust in B for managing her investments and properties. In this case, B would be covered by the insider trading prohibition in respect of trading with A in the shares of all companies, whether or not she is a director or officer of those companies. Also, the same rule should apply whether B intends to transact with A based on a piece of material, non-public information with respect to a security or a piece of land. For example, B may buy a piece of land (as a pure investment) from A based on her access to non-public information that a major industrial township is to be located in that area which would drive up property prices. This is no different from B buying a company's shares from A based on a piece of positive non-public information about the company.

Therefore, the insider trading prohibition, as entailed by the classical theory, does not implicate any concerns that are specific to the securities market or the interests of investors *qua* investors.[319] This factor suggests that such insider trading should be a matter of private enforcement by the aggrieved party and does not warrant erecting an elaborate insider trading prohibition regime implemented through regulatory intervention and public enforcement tools.[320]

There is an inescapable dilemma here. If one simply accepts the boundaries of the insider trading prohibition as set out in *Chiarella*, the prohibition regime goes far beyond what is strictly warranted by the foundation of this theory – the existence of a pre-existing fiduciary relationship between the counterparties. Therefore, Justice Powell's claim to have secured the insider trading prohibition on the basis of deception and consequently on the plain language of Section 10(b) is simply unfounded.

On the other hand, if one considers the scope of the prohibition *as logically warranted* by the underlying classical theory and the notion of a pre-existing duty that it is based on, the prohibition regime is a truncated one that applies to an extremely small subset of all securities transactions. In particular, it leaves out all exchange-based transactions. Therefore, the policy objectives that it is intended to serve are totally unclear.

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[318] *See supra* Sections V.B-E.
[319] *See* Carlton & Fischel, *supra* 49, at 890.
[320] *Id.*

J. *Decoding the Motive Behind Chiarella*

At this stage, it would be instructive to speculate on the motives behind the approach of the *Chiarella* Court. Langevoort suggests that the chief motivating factor may have been to cut back on the SEC's authority to define the scope of the insider trading prohibition.[321] Of course, *contra* Langevoort,[322] our analysis suggested that the scope of the insider trading prohibition as enunciated in *Chiarella* was actually wider than that under the special relationship theory under *Cady, Roberts*, at least with respect to trading in company shares by the insiders.[323] However, the *Chiarella* Court may still have in mind the possibility that the SEC may expand the scope of the prohibition in future cases by invoking novel doctrinal principles. The Court probably wanted to stop the SEC in its tracks by making an authoritative pronouncement on the issue.

Another motive behind the Court's particular reading of the scope of the prohibition could be to roll back the all-encompassing equal access theory of *TGS*. While the *Chiarella* Court emphatically rejected the equal access theory, it purportedly did so solely on the basis of its textual analysis of Section 10(b), without offering any policy basis for the rejection.[324]

However, the Court's opinion in *Dirks* three years later (which was also authored by Justice Powell) went one step further by offering a policy justification for the rejection of the equal access theory.[325] In its view, market analysts perform a valuable function by "ferret[ing] out and analy[zing] information" by, among other things, questioning the company insiders.[326] This enables the analysts to form a judgment regarding the value of a particular security. Trading based on this analysis would then move the market prices closer to the intrinsic value resulting in an efficient market. Further, the *Dirks* Court believed that selective access of the analysts to material, non-public information is a necessary

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[321]Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 432 (2013) (discussing a fictional "Cary-Powell compromise").

[322]*Id.* at 430 (arguing that in certain respects, the special relationship theory in *Cady, Roberts* is wider than that in *Chiarella* as the former takes in its sweep both fiduciary breaches as well as the common law deceit). However, according to our analysis, the origin and scope of duty implicated in the two theories itself is conceptually distinct. The special relationship theory is predicated on the common-law duty that officers and directors have to the corporation itself not to mismanage corporate assets. The classical theory duty is based on a pre-existing or similar duty between the counterparties to the securities trade.

[323]*See supra* notes 254-255 and accompanying text.

[324]*Chiarella*, 455 U.S. at 231-32.

[325]*See Dirks*, 463 U.S. at 646.

[326]*Id.* at 658.

condition for this process to work.[327] Obviously, a strict equal access theory prohibition would foreclose such selective access. In the Court's view, the equal access theory therefore would have a chilling effect on analyst activity and an adverse impact on market efficiency.[328]

Viewed in this light, the *Chiarella* Court's move to depart from the law of deceit (as required by its attempt to base the prohibition on deception) is easy to understand. It brought exchange-based transactions within the scope of the insider trading prohibition simply because it is in the context of organized securities market that the concept of an efficient market is most relevant.[329] It is in the context of organized markets that market efficiency would lead to better price discovery and consequently more efficient allocation of capital. The fact that there is no reliance or causation element present here, and therefore the law of deceit is inapplicable, was simply beside the point.

This analysis also helps explain why the Court extended the prohibition even when the fiduciary is a seller of the securities and, therefore, may not have any pre-existing relationship with the buyer on the other side. The Court apparently regarded market analysts as the exclusive group who contribute to market efficiency by way of selectively accessing information and analyzing, as well as disseminating, it. Therefore, there was no justification for allowing persons other than market analysts (including fiduciaries) to sell securities based on their selective access to material, non-public information.

Thus, it can be argued that contrary to its claim of having based the prohibition on the text of Section 10(b), the *Chiarella* Court seems to have been driven by its objective of reaching a particular result, more specifically, reigning in SEC's authority to define the scope of the prohibition and firmly laying the equal access theory to rest, once and for all. The resulting prohibition regime however does gross violence to the Court's own deception-based analysis. Therefore, Nagy terms the analysis in *Chiarella* "the Supreme Court's fiduciary fictions."[330] Moreover, she also comments that this approach was followed simply to facilitate what the Court saw to be a desirable policy outcome.[331]

In today's context, the desirability of allowing market analysts selective access to information itself is questionable. In 2000, the SEC adopted Regulation Fair Disclosure (FD), which requires issuers to

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[327] *Id.* at 658-59.
[328] *See id.*
[329] *See Chiarella*, 455 U.S. at 222.
[330] Nagy, *supra* note 18, at 1337.
[331] *Id.* at 1339-40.

publicly disclose any material non-public information conveyed to market professionals and other specified people.[332] This regulation required that public disclosure must be simultaneous for intentional disclosures and prompt for unintentional disclosures.[333] Regulation FD clearly undercuts the basic policy premise behind the *Dirks* holding. Therefore, the only policy objective that could probably support (*Chiarella's* articulation of) the classical theory is no longer available.[334]

K. *The Takeaway*

To conclude, the classical theory stands on an extremely shaky foundation. If one takes the theory seriously and applies it strictly only in cases where there exists a fiduciary or similar duty between the counterparties, the scope of the prohibition becomes extremely narrow. Further, there is no intelligible reason which policy objective is served by picking out and prohibiting insider trading only in this particular subset of transactions. On the other hand, the *Chiarella* Court's "pragmatic" approach to expand the scope of the prohibition undercuts the very conceptual foundation of the theory. Further, the only plausible policy justification for this approach (selective analyst access to information) may no longer be valid, in the context of Regulation FD.

Most important, the distinction between face-to-face and exchange-based transactions is important not just from the perspective of the existence or otherwise of a fiduciary duty. It turns out to be crucial in determining the fundamental issue whether the counterparties suffer any loss at all. In this connection, the points made earlier in the context of the equal access theory are equally valid. If the counterparty was a time trader, she would have been on the other side of the trade anyway, regardless of the presence or absence of the fiduciary in the market. In this case, the presence of the fiduciary insider, if at all, would move the price in the right direction, making the counterparty better off than what she would have been otherwise. If the counterparty was a price trader and she was induced to come to the market as a result of a price change triggered by inside trading, she would be on the same side as the fiduciary and would still be a beneficiary. Thus, casting the counterparties as the victims of insider trading, whether under the equal access theory or the classical theory,

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[332] *See* Regulation FD, 17 C.F.R. 243 (2000).

[333] 17 C.F.R. § 243.100(a).

[334] The principles underlying Regulation FD have been part of the Indian insider trading prohibition as well since 2002. Currently, Regulation 8(1) read with Schedule A of the SEBI (Prohibition of Insider Trading) Regulations, 2015 delineate a code of practices and procedures for fair disclosure of unpublished price sensitive information.

seems to be an indefensible proposition. Consequently, giving such traders a right to recover damages from the insider trader in the absence of reliance, transaction causation and loss causation is perverse.[335]

The confusion over the proper scope of and the policy objective that the classical theory is intended to serve seems to have blurred the subtle, but significant, distinction between this theory and the special relationship theory. The special relationship theory is equivocal regarding the victims of insider trading and the nature of harm suffered.[336] The first prong of the theory (the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone) points to the company itself as the victim as a result of the violation by the insider of her duty not to mismanage corporate assets, of which confidential information is one.[337] The other prong (inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom she is dealing) seems to point to the counterparty as the victim.[338]

The classical theory does not suffer from this ambiguity.[339] Here, the trader owes a fiduciary or similar duty to the counterparty and the duty not to trade on material, non-public information without disclosure also runs to the same counterparty.[340]

Despite this, at times, U.S. courts seem to have misread the essence of this theory.[341] In Rajat Gupta's Sentencing Memorandum and Order,[342] Judge Rakoff seems to have conflated the classical theory under which Rajat Gupta was convicted with the special relationship theory.

In his order, Judge Rakoff cites the abuse of a position of trust by Mr. Gupta as "the heart of his offense."[343] Mr. Gupta was a board member of Goldman Sachs.[344] He was prosecuted and convicted for violating the insider trading prohibition by passing on confidential information that he learned during the course of Goldman Sachs board meetings to Mr. Raj Rajaratnam.[345] Mr. Rajaratnam traded on the basis of this information,

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[335]*See supra* Section IV.I.D.

[336]Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. BUS. L. J. 1225, 1229-30 (2017).

[337]*Id.*

[338]*Id.*

[339]Gubler, *supra* note 336, at 1256.

[340]*Id.*

[341]*Id.* at 1230.

[342]Sentencing Memorandum and Order of Rajat K. Gupta, United States v. Rajat Gupta, 904 F. Supp. 2d 349 (S.D.N.Y. 2012).

[343]*Id.* at *2.

[344]*Id.* at *11.

[345]*Id.* at *7.

realizing substantial gains for the funds he managed.[346] Judge Rakoff states:

> In the eye of the law, Gupta's crime was to breach his fiduciary duty of confidentiality to Goldman Sachs; or to put it another way, Goldman Sachs, not the marketplace, was the victim of Gupta's crimes as charged.[347][. . .] Mr. Gupta, well knowing his fiduciary responsibilities to Goldman Sachs, brazenly disclosed material non-public information to Mr. Rajaratnam at the very time, September and October 2008, when our financial institutions were in immense distress and most in need of stability, repose, and trust.[348]

However, this way of articulating the issue takes it in the direction of the special relationship theory. As *Chiarella* clearly sets out, under the classical theory, it is the existence of a pre-existing duty *between parties to the trade* that gives rise to the insider trading prohibition.[349] In this case, the genesis of Mr. Gupta's fiduciary duty surely was his board membership of Goldman Sachs (*modulo* the concerns expressed earlier regarding extending this duty in the context of exchange-based transactions).[350] However, the duty itself ran to the counterparties.

Judge Rakoff supports this position by pointing out that the U.S. Supreme Court has specifically rejected the equal access theory. He states:

> While insider trading may work a huge unfairness on innocent investors, Congress has never treated it as a fraud on investors, the SEC has explicitly opposed any such legislation, and the Supreme Court has rejected any attempt to extend coverage of the securities fraud laws on such a theory.[351]

However, the equal access theory treats the counterparties as victims, simply because they lacked access to the same information as the insider trader (or her tippees) had. The classical theory treats them as victims because the trader (or the tipper) had a fiduciary relationship with them *and* she violated it by trading on (or tipping) material, non-public

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[346]Gupta, *supra* note 342, at *2.
[347]*Id.* at *6.
[348]*Id.* at *11.
[349]*Chiarella*, 455 U.S. at 230.
[350]Gupta, *supra* note 342, at *6.
[351]*Id.*

information.[352] Therefore, notwithstanding the rejection of the equal access theory by the Supreme Court, it is still the counterparties who are victims of such trading.[353]

Therefore, according to Judge Rakoff, Mr. Gupta's "egregious breach of trust (to Goldman Sachs)" is the most determinative factor in deciding his sentencing, while monetary gains made by him, his tippees, or losses suffered by the counterparties are all irrelevant.[354] Therefore, according to him, the fact that the federal sentencing guidelines assign just two points to Mr. Gupta for his abuse of a position of trust, yet assign him no fewer than eighteen points for the monetary gains made by (his tippees) is "bizarre."[355]

Contrary to what he says, it is the other way around. The classical theory is all about a fiduciary's breach of duty to the counterparty and not to her company. Thus, an erroneous appreciation regarding the nature of the theory adopted can have consequences not just for determining the substantive scope of the prohibition, but even for determining the relevant factors for assessing the seriousness of the offense and the consequent punishment.

VI. THE MISAPPROPRIATION THEORY (*O'HAGAN*)

The U.S. government first advocated (a version of) the misappropriation theory in *Chiarella*.[356] The Court in the case declined to consider it since, according to the Court, it was not properly presented to the jury.[357] Therefore, the door to adopting this theory was formally kept open for the Circuit Courts to consider it. Following a Circuit split, the Supreme Court took up the issue and finally endorsed the theory in *United States v. O'Hagan*.[358] Justice Ginsburg delivered the opinion of the Court.[359]

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[352]*Id*. at *41.

[353]*Id*.

[354]Gupta, *supra* note 342, at *6.

[355]*Id*. at *2.

[356]*See Chiarella*, 455 U.S. at 222.

[357]*Id*. at 239 (Brennan, J., concurring) (stating that he could "find no instruction suggestion that one element of the offense was . . . misappropriation of that nonpublic information").

[358]United States v. O'Hagan, 521 U.S. 642 (1997).

[359]*Id*.

A. *Facts of the Case*

O'Hagan was a partner in the law firm of Dorsey & Whitney.[360] In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company.[361] Both Grand Met and Dorsey & Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans.[362] O'Hagan did no work on the Grand Met representation.[363] Dorsey & Whitney withdrew from representing Grand Met on September 9, 1988 and less than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.[364] On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock.[365] By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor.[366] In September 1988, O'Hagan also purchased some 5,000 shares of Pillsbury common stock, at a price just under $39 USD per share.[367] When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 USD per share[368]. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million USD.[369] He could not be prosecuted under the classical theory, as he had no pre-existing fiduciary relationship with the stockholders of Pillsbury.

O'Hagan was prosecuted for violation of Section 10(b) and Rule 10b-5.[370] The government brought charges against him, based on the misappropriation theory. He was convicted and was sentenced to a forty-one-month term of imprisonment.[371] A divided panel of the Court of Appeals for the Eighth Circuit reversed O'Hagan's conviction by rejecting the misappropriation theory.[372]

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[360] *Id*. at 647.
[361] *Id*.
[362] *O'Hagan*, 521 U.S. at 647.
[363] *Id*.
[364] *Id*.
[365] *Id*.
[366] *O'Hagan*, 521 U.S. at 647.
[367] *Id*. at 648.
[368] *Id*.
[369] *Id*.
[370] *O'Hagan*, 521 U.S. at 648.
[371] *Id*. at 649.
[372] *Id*.

The government's petition for rehearing by the same panel as well as an *en banc* hearing was denied. The case reached the Supreme Court.[373]

B. *The Background*

The theory basically holds that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary (or similar) duty to the source of the information is guilty of violating the insider trading prohibition read into Section 10(b) and Rule 10b–5 of the Exchange Act and the Rules respectively. Therefore, just as in the case of the special relationship theory and the classical theory, the misappropriation theory is also a duty-based theory of the insider trading prohibition.

While the special relationship theory and the classical theory are based on a person's duty to the company and the counterparty respectively, the misappropriation theory implicates the duty a person owes to the *source of information*. Combined with the Court's holding in *Chiarella*, classical and misappropriation theories became the twin pillars of the insider trading prohibition regime in the U.S.

Indeed, the *O'Hagan* Court saw these as complementary, essentially serving a single policy goal–each addressing efforts to capitalize on non-public information through the purchase or sale of securities.[374] While the classical theory targets such conduct by company insiders, the misappropriation theory targets the same conduct by the outsiders.[375]

C. *A Case for the Misappropriation Theory*

The misappropriation theory seems to avoid a fundamental problem that plagues the classical theory. While the classical theory is purportedly based on the duty between the counterparties, the very basis of this duty in the context of a large subset of securities transactions (i.e., exchange-based transactions) is questionable. This prompted the comment that the Supreme Court merely created a fiduciary fiction to support its analysis.[376]

The misappropriation theory does not suffer from this problem. Here, the duty is towards the source of information. The source of information and the person entrusted with such information are in a face-to-face relationship, and it is this duty that triggers the prohibition.

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[373] *Id.*
[374] *O'Hagan*, 521 U.S. at 655-56.
[375] *Id.* at 652-53.
[376] *See supra* note 333 and accompanying text.

Therefore, issues regarding the nature of duty between the counterparties in an exchange-based transaction seem to be irrelevant. On this count, this theory surely looks more coherent and plausible.[377]

Among the law scholars, Pritchard seems to have accepted this theory with open arms. He argues that while the classical theory is based on the law of deceit, the misappropriation theory is based on the law of agency.[378] But this seems problematic. As he himself admits, the common law of agency in the U.S. only precludes agents from using their principal's confidential information "in competition with or to the injury of the principal."[379] However, a person trading on confidential information entrusted to her by another person may or may not always have that effect and is a highly fact specific enquiry.

Similarly, Section 215 of the Indian Contract Act, 1872 also provides that when an agent deals, on his own account, in the business of agency without principal's consent, the principal may repudiate the transaction.[380] Trading in securities may or may not be the business for which the agency relationship has been entered into all cases. For example, a credit rating agency may outsource the job of data analysis to a third party, and such third party may trade in securities based on the confidential information entrusted to it. Such trading cannot, in any way, be treated as the business of agency, which is to provide the requisite data analysis to the rating agency. Even if it is held to be so, Section 216 authorizes the principal to claim from the agent any benefit which may have resulted to him from such transaction.[381] Thus, the credit rating agency should be entitled to claim the gains made out of such trading. No prohibition *per se* on such trading can be implied here. Therefore, this characterization of the misappropriation theory as having been based on the law of agency does not seem to be sound.

D. *The Heart of the Prohibition – Trading without Disclosure to the Source*

O'Hagan held that trading in the context of misappropriation of confidential information also amounts to deception in connection with the purchase or sale of a security.[382] It settled on "non-disclosure" as the

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[377]Langevoort, *supra* note 321, at 441.
[378]Pritchard, *supra* note 256, at 43-44.
[379]*Id.* at 44.
[380]Contract Act, 1872, § 215 (India).
[381]Contract Act, 1872, § 216 (India).
[382]*See O'Hagan*, 521 U.S. at 643.

determinative factor in establishing deception.[383] The Court held that a fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain, dupes or defrauds the principal.[384] In fact, during oral argument, the government accepted that if the trader discloses to the source of information her intention to trade (based on confidential information), there would be no deception and consequently the misappropriation theory would be inapplicable.[385]

Therefore, the misappropriation theory also comes with its "disclose-or-abstain" rule, but with a curious twist.[386] Here, the disclosure is to the source of information. Also, the disclosure is not of the information, since it is the source itself which entrusted the information in the first place and it is not a party to the trade anyway. The disclosure only pertains to the trader's intention to use the information for securities trading. In particular, the trader does not require any *authorization* from the source in order to trade. Therefore, there are difficulties in treating the misappropriation theory as a property rights argument. As Bainbridge remarks, the Court's authorized trading dictum is consistent with the property rights rationale of the prohibition.[387] The rest of this Section focuses on the misappropriation theory as enunciated in *O'Hagan*, with its nondisclosure-based deception.

E. *Two-faced Nature*

As stated, there are several problems with the misappropriation theory. While the *O'Hagan* Court held that since deception consists of undisclosed use of information by the trader, the fraud is consummated when, without disclosure to his principal, he uses the information to purchase or sell securities.[388] It further noted that under the misappropriation theory, the trader deceives the source of the information and simultaneously harms members of the investing public.[389] But this brings back the same problem discussed earlier in the context of the special relationship theory, thus it makes the theory two-faced. Since the trader deceives the source of the information, it is such source who is the "victim" of such deception. On the other side, the reference to "harm" to the

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[383] *See* Prakash, *supra* note 17, at 1493.

[384] *O'Hagan*, 521 U.S. at 653-54 (quoting brief for United States at 17).

[385] Pritchard, *supra* note 256, at 38.

[386] *See* Prakash, *supra* note 17, at 1495.

[387] Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1645 (1999).

[388] *O'Hagan*, 521 U.S. at 655-56.

[389] *Id.* at 656.

investing public implies that it is, after all, the investing public which is the harmed party.

The logical question to ask here would be regarding the precise nature of "harm" suffered by the investing public. On this issue, *O'Hagan* stated that the harm results because the counterparty is at an informational disadvantage vis-a-vis a misappropriator with material, non-public information and further such disadvantage stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.[390] This comment seems to indicate that the Court here conflated the misappropriation theory with the structural disparity theory of Justice Blackmun's dissent in *Chiarella*.[391]

Even leaving aside this issue, if the insider trading prohibition is to be aimed at preventing trading based on informational disadvantage that cannot be overcome with research or skill, the misappropriation theory is clearly under-inclusive. This is because the counterparty (or the entire marketplace) would suffer the same disadvantage if the trader traded on material, non-public information after disclosing to the source its intent to trade, or even with its blessings. The counterparty cannot overcome such disadvantage with research or skill. Thus, while the deception is that of the source of information, the harm results to the counterparty. The paradox here is that disclosure *to the source* of an intent to trade supposedly eliminates any harm *to the counterparty or the marketplace*. This makes the theory incoherent, to say the least.

F. *Resource Agnostic Theory – What Is Special About Information?*

Justice Thomas filed an opinion, concurring in the judgment in part and dissenting in part. He pointed out another anomaly in the theory.[392] He correctly noted that as per the Court, it is misappropriation without disclosure that initially supplies the necessary "deception" element.[393] Further, it is the use of the misappropriated information for securities trading that consummates the deception and establishes the necessary connection with securities trading.[394] In that case, there is no reason why the prohibition should not apply when the misappropriated resource is not material, non-public information, but something else, such as money. For example, an employee may embezzle money from her employer and use

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[390] *Id.* at 658-59.
[391] *See infra* Section VIII for the discussion of the structural disparity theory.
[392] *O'Hagan*, 521 U.S. at 681 (Thomas, J., concurring in part and dissenting in part).
[393] *Id.*
[394] *Id.*

it, without disclosure to the employer, to trade in securities. This transaction also contains the necessary "deception" element as well as the connection with securities trading.[395]

The Court's response to this issue was that while non-public information is "ordinarily" misappropriated for trading, money is not so misappropriated.[396] As Justice Thomas pointed out, information may be misappropriated for other purposes, such as selling it to a newspaper[397] or even to a competitor.

More to the point, this focus on "ordinary" purpose of misappropriation is inconsistent with the misappropriation theory. This is because the Court held that the deception is consummated when the information is actually used for trading *in a particular transaction*.[398] Thus, even if one accepts that money is not *ordinarily* misappropriated for securities trading, if a person actually misappropriates money and uses it for trading, without disclosure to the source of such money, the deception has arguably been consummated in that particular transaction.

This point gets further support from the fact that even if it is granted that material, non-public information is *ordinarily misappropriated* for securities trading, mere misappropriation of such information does not trigger the liability under the theory, unless and until the information is used for securities trading. Thus, the two prongs of deception (through non-disclosure) and securities trading are both *necessary and sufficient* to invoke the misappropriation theory. Therefore, this talk about *ordinary* use is incoherent. The theory logically prohibits the misappropriation of any resource for securities trading. In that case, calling this theory an *insider trading prohibition theory* itself would be a misnomer. Indeed, if an employee, without disclosure, uses the official telephone line to place a securities trade, the same would be prohibited under the misappropriation theory, as she converts, without disclosure, a resource entrusted to her for secret profit, and consummates the deception through her trade. If she openly discloses her intent to use the telephone, there is no deception and therefore no trading prohibition – an even more bizarre outcome!

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[395] *Id.*
[396] *O'Hagan,* 521 U.S. at 656 (majority opinion).
[397] *Id.* at 685 (Thomas, J., concurring in part and dissenting in part).
[398] *Id.*

G. *Misappropriation Theory and Enforcement Issues*

There have been other powerful criticisms of the theory as well. Haire explores the logical consequences of accepting the theory and argues that these consequences lead to absurdity.[399] Consequently, the theory should be rejected.

One, he implies that since the trader works the deception on the source (through non-disclosure), the defrauded party is the informational source, not the (counterparty) trader.[400] Thus, it is the source, and not the contemporaneous traders, who should have the right to recovery.[401]

Of course, as discussed earlier, *O'Hagan* also refers to "simultaneous harm" to the investing public.[402] This dichotomy only makes the problem worse. The source is deceived, but not harmed; while the investing public is harmed, but not deceived! As stated, neither should be able to have a right of recovery. The deceived party and the harmed party are distinct, often wholly disconnected with each other.

Haire further argues that the misappropriation theory forecloses the application of the doctrine of *respondeat superior*.[403] Under this doctrine, liability may be fastened on the employer of the trader if a true employment relationship existed between the trader and employer, and the trader was acting within the scope of her employment.[404] The *respondeat superior* doctrine may be justified on the consideration that it creates an incentive for the employers to adequately supervise their employees so as to prevent any violation of law.

However, by definition, the *respondeat superior* doctrine cannot be applied in the context of the misappropriation theory since an employee cannot be acting within the scope of her employment when she is defrauding her employer by using information (or any other official resource) without disclosure.[405]

Haire notes that private rights of action and *respondeat superior* liability have been important enforcement tools throughout much of the life of insider trading regulation.[406] However, if the misappropriation theory is to be taken seriously, these tools would simply be unavailable, making the enforcement of the prohibition more challenging. What Haire

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[399]Haire, *supra* note 112, at 1285.
[400]*Id.*
[401]*Id.*
[402]*O'Hagan*, 521 U.S. at 656.
[403]Haire, *supra* note 112, at 1286.
[404]*Id.*
[405]*Id.* at 1287.
[406]*Id.*

implies here is that these factors show that the misappropriation theory is untenable not just from the policy perspective, but from the enforcement perspective as well.[407]

Going forward, he hints that in future cases, the Supreme Court, faced with this two-sided nature of the theory (deception on the source and harm to the investing public) may actually focus on the latter.[408] This may lead to the evisceration of the duty model itself.[409] His forecast indeed turned out to be prescient. Lower courts seem to have subsequently disregarded the duty element deriving from the fiduciary principles – what Nagy calls the gradual demise of fiduciary principles.[410]

H. *Saikrishna Prakash on the Misappropriation Theory*

Prakash subjects the misappropriation theory to the most searching criticism, based on his close reading of *O'Hagan*.[411] In fact, his arguments go well beyond *O'Hagan* or the misappropriation theory. He argues that the U.S. insider trading prohibition regime has always been in a state of policy and doctrinal mess, or dysfunction as he emphatically highlights in the title of his article.[412] *O'Hagan* only highlights and accentuates this state of affairs. It is worth discussing his criticism in some detail.

Prakash concludes that contrary to popular, judicial (and even academic) perception, even under the classical theory, there never was any bar on a company director or officer to trade in her company shares without disclosing the material, non-public information she had access to, provided she disclosed her intent to trade on such information – what Prakash terms as candid insider trading.[413] If at all, *O'Hagan* merely confirms the position.[414] Thus, if the prevention of trading on such information was the policy goal, the regime makes a poor job of achieving it.[415]

On the other hand, he argues that the *O'Hagan* opinion has also worked a vast, unwitting, and wholly unwarranted expansion of the insider trading prohibition to reach deceptions of parties wholly outside of and unconnected to the securities markets and where material, non-public

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[407]Haire, *supra* note 112, at 1288.
[408]*Id.*
[409]*Id.*
[410]Nagy, *supra* note 18, at 1319.
[411]*See generally* Prakash, *supra* note 17.
[412]*Id.*
[413]*Id.* at 1495.
[414]*Id.* at 1493.
[415]Prakash, *supra* note 17, at 1526-27.

information is wholly superfluous.[416] In the following few paragraphs, these issues are discussed in detail.

1. Candid Insider Trading

On the first point, Prakash argues that "candid" insider trading has always been perfectly legal.[417] In the case of the classical theory, the origin of the insider trading prohibition is the fiduciary or similar duty that one party (usually a company insider) owes to the counterparty.[418] Silence on the part of the insider may be taken as an implicit representation by her as to any absence of knowledge on her part regarding the existence of any material, non-public information.[419] If she is actually aware of any such information, her silence then would amount to a misrepresentation and, therefore, deception.[420]

However, what if the fiduciary clearly indicates to the other party that she may possibly have access to such information, but would not disclose it, and the counterparty still enters into the transaction?[421] In this connection, Prakash relies on two U.S. Circuit Court cases (involving face-to-face transactions) where the insider bluntly told the counterparty that he/she would not reveal the entire information,[422] or even refused to answer a specific question asked.[423] Still, the respective counterparties went ahead with the transaction.[424] The courts ruled that there was no violation of the insider trading prohibition.[425] The counterparties could not have interpreted silence as the absence of any material non-public information; in fact, they were well aware that some such information may have existed which the insider was not willing to disclose.[426] Thus, there was no deception.[427]

Prakash argues that *O'Hagan* only provided a solid conceptual foundation for candid insider trading.[428]*O'Hagan* acknowledges that mere disclosure by a person to the source her intent to trade is enough to preclude any liability.[429] Thus, the "disclose-or-abstain" rule under neither

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[416]*Id.* at 1496.
[417]*Id*. at 1506-32.
[418]*Id*. at 1494-95.
[419]Prakash, *supra* note 17, at 1502.
[420]*Id*. at 1502.
[421]*Id*. at 1507-09.
[422]Jensen v. Kimble, 1 F.3d 1073, 1075 (10th Cir. 1993).
[423]McCormick v. Fund Am. Companies Inc., 26 F.3d 869, 874-75 (9th Cir. 1994).
[424]*McCormick*, 26 F.3d at 875; *Jenson*, 1 F.3d at 1075.
[425]*McCormick*, 26 F.3d at 884; *Jenson*, 1 F.3d at 1078-80.
[426]Prakash, *supra* note 17, at 1508.
[427]*Id*.
[428]*Id.* at 1507.
[429]*O'Hagan*, 521 U.S. at 653.

classical nor misappropriation theory refers to the disclosure of information.[430] It refers, respectively, to the disclosure to the counterparty of the intent to trade without necessarily disclosing all material, non-public information, or the disclosure to the source the intent to trade based on the information entrusted by the source.

How would classical candid insider trading work in the context of exchange-based transactions (if at all we bring in the fiduciary fiction in such cases)? Here, Prakash's response is less than satisfactory. Relying on the rules governing other forms of corporate disclosure, he suggests that announcing an "intent to trade securities using material, non-public information in a manner calculated to inform the securities markets generally and then wait[ing] until the market has had time to digest this" information is sufficient.[431] This seems problematic. The duty under the classical theory is specifically to the counterparty. So logically, the communication (of the trading intent) must also be specifically addressed to her. Of course, as seen earlier, this is exactly where the classical theory founders since there is no counterparty in the legal or substantive sense in an exchange-based (in particular in an order-based system) transaction.[432]

Prakash also suggests that the insiders can merely "contract out" of the insider trading prohibition by suitably amending the employment contract whereby the company explicitly authorizes them to engage in insider trading.[433] However, under the classical theory, the company is nowhere in the picture. Rather, it is the insider's fiduciary duty towards the counterparty which forms the basis of the prohibition. Here, Prakash seems to have conflated the classical theory with the special relationship theory. However, the general point that he makes regarding the validity of candid insider trading seems to be at least plausible.

2. Resource Agnosticism – Once Again

Prakash also notes the point that once we accept that the insider trading prohibition, whether under classical or misappropriation theory, is really about deception worked on a party and consummated by a securities trade, there is no reason to hold that the deception should be with respect to the misappropriation of material non-public information.[434] For example, a state government employee who knowingly and secretly

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[430]Prakash, *supra* note 17, at 1510-21
[431]*Id.* at 1520.
[432]*See supra* Section V.E.
[433]Prakash, *supra* note 17, at 1518-19.
[434]*Id*. at 1496

violates her state's policy against using government property for personal use by making a securities trade with a government computer would be guilty of "insider trading."[435] This is because she "[pretended] loyalty to the principal while secretly converting the principal's" resource for personal gain, which is the essence of the misappropriation theory.[436]

According to Prakash, even trading based on non-material, non-public information may be prohibited under the misappropriation theory in certain instances.[437] To modify the example given by Prakash, a law firm may have a policy prohibiting its employees from trading in the securities of any company if such company is a client of the firm. This rule may have been designed to avoid any potential conflicts of interest. Suppose a lawyer at the firm learns from sources within the firm that a particular corporate client has undisclosed plans to construct a new athletic facility for use by all employees. She may then buy the client company's shares without informing her firm, because she supposes that any company ought to be committed to the welfare of its employees as part of its corporate social responsibility, and she views the athletic facility as symbolic of such a commitment. In general, this non-public information would not be treated as material to the securities market because a reasonable investor would not consider this information significant in determining whether to buy, sell, or hold the relevant securities.

Prakash emphasizes that the materiality element is absolutely crucial for determining liability under either theory.[438] Now this seems to contradict what has been said in the last paragraph regarding trading based on non-material, non-public information. However, Prakash's point here is that we must see materiality in a different light – from the perspective of the deceived party.[439] Thus, in the case of the classical theory, it should be from the perspective of the counterparty.[440] In the case of the misappropriation theory, what matters is whether the deception was material from the perspective of the source of information. In the law firm example, the firm may have a zero-tolerance policy on its employees trading in client company securities. In this case, if the employee buys shares of the client company, it would be material deception.

More importantly, it would amount to deception regardless of whether the company's decision to build an athletic facility was material from the perspective of the securities market. Any employee trading in the

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[435] *Id.*
[436] *O'Hagan*, 521 U. S. at 653.
[437] Prakash, *supra* note 17, at 1547.
[438] *Id.* at 1541.
[439] *Id.* at 1544.
[440] *Id.*

shares of a client company without disclosure must face liability under the insider trading prohibition. Of course, if the employee discloses to the firm her intent to trade, it will not amount to deception and such employee would be immune from any enforcement action under the insider trading prohibition regime.

3. The Evisceration of the Duty Element

The most important point that Prakash makes is that it is totally superfluous to talk about the insider trading prohibition under the classical or the misappropriation theory (and we may even say the special relationship theory).[441] Any undisclosed breach of duty (of any variety) is enough to trigger a deception in connection with a securities trade. It is the securities trade that finally consummates the deception and brings the insider trading prohibition into play.[442]

Therefore, Prakash concludes that classical insider trading is a subset of misappropriation trading.[443] On this view, classical insider trading may be characterized as a special case where the duty runs to the counterparty to the trade (which happens to be the deceived party). This also probably reflects the remark in *O'Hagan* that the two theories are complementary to each other.[444] While the classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of non-public information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.[445] Under this subset characterization, the misappropriation theory can be said to complement the classical theory by expanding the scope of the insider trading prohibition so as to cover outside trading as well.

Further, Prakash argues that in turn, misappropriation trading is but a part of what he generally terms "Deceptive Trading."[446] This theory completely subsumes the entire gamut of the insider trading prohibition.[447] In particular, fiduciary breaches are not even necessary to establish deception.[448] Thus, there is a danger that the prosecutors may come up with

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[441] *See generally* Prakash, *supra* note 17, 1532-49
[442] *Id.* at 1538.
[443] *Id.* at 1547.
[444] *O'Hagan*, 521 U. S. at 651-53.
[445] *Id.*
[446] Prakash, *supra* note 17, at 1532-38.
[447] *Id.* at 1547-49.
[448] *Id.* at 1511.

novel ways of establishing deception, even in the absence of any fiduciary duty breach, to cast a wider net of the prohibition.

How realistic is this possibility? Prakash himself comments, tongue-in-cheek, that "skeptics may doubt that likelihood and may have good reasons to believe that the theory is nothing but the typical academic, pie-in-the-sky musings of a professor seeking tenure!"[449]

However, this concern was not entirely unfounded. In *O'Hagan*, the Supreme Court specifically posed the issue in terms of confidential information misappropriated in breach of a fiduciary or similar duty to the source of information.[450] In *United States v. Chestman*, the Second Circuit correctly held that that marriage by itself does not create such a relationship.[451] Thus, a person who receives non-public information from the spouse is not liable under the misappropriation theory solely on account of such marital relationship. The court emphasized that a fiduciary-like relationship involves dependency of one party on the other party and the entrustment of property to the other party to serve the ends of the relationship.[452] This surely was faithful to the plain reading of *O'Hagan*.

Later, lower courts often disregarded the fiduciary principles and held that the prohibition applies just on the basis of deceptive (or even wrongful) acquisition of information.[453]

SEC v. Dorozhko is one such case. Here, the defendant hacked into the computer system of Thomson Financial and stole confidential quarterly earnings reports on a company called IMS Health.[454] He then profitably traded in IMS Health shares on the basis of this non-public information.[455] He was clearly not liable either under the classical theory (no fiduciary relationship with IMS Health shareholders) or under the misappropriation theory (no fiduciary-like relationship with Thomson Financial). The SEC brought a civil enforcement action against him.[456] "[T]he District Court ruled that computer hacking was not 'deceptive' within the meaning of Section 10(b) as defined by the Supreme Court."[457] It "concluded that this behavior did not violate Section 10(b) without an accompanying breach of a fiduciary duty."[458]

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[449]*Id.* at 1527-28.
[450]*O'Hagan*, 521 U. S. at 647.
[451]United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991).
[452]*Id.* at 569.
[453]Nagy, *supra* note 18, at 1319.
[454]SEC v. Dorozhko, 574 F.3d 42, 44 (2d Cir. 2009).
[455]*Id.*
[456]*Id.* at 44-45.
[457]*Id.* at 45.
[458]*Dorozhko*, 574 F.3d at 45.

The Second Circuit reversed.[459] In its view, misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly "deceptive."[460] On the other hand, exploiting a weakness in an electronic code to gain unauthorized access may amount to mere theft, not deception.[461] Green and Schmid call it a bizarre outcome.[462] More important, this analysis completely does away with the need to establish the existence of any fiduciary or similar duty.

SEC v. Rocklage involved trading in the shares of a company by the brother-in-law of the company's CEO.[463] The brother-in-law obtained this information from his sister (the CEO's wife).[464] The wife initially concealed from her husband a prior agreement with her brother to tip him if she learned significant negative information about the company.[465] She also concealed that she did not intend to maintain the confidentiality that her husband had reasonably understood to bind her.[466] Shortly before she actually tipped her brother, however, she told her husband that she was going to give her brother the information.[467]

The Circuit Court ruled that her acquisition of information itself was deceptive.[468] It rejected the argument that the pre-tip disclosure eliminated any Section 10(b) liability.[469] It referred to the *O'Hagan* Court's observation that "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," but held it to be dicta.[470]

However, the *O'Hagan* Court agreed with the Government that a fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," is a misappropriator who "dupes" or defrauds the principal.[471] "[T]he fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."[472] It is the fiduciary's *use without disclosure*,

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[459]*Id.* at 43-44.
[460]*Id.*
[461]*Id.* at 51.
[462]Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 419 (2013).
[463]SEC v. Rocklage, 470 F.3d 1, 3 (1st Cir. 2009).
[464]*Id.*
[465]*Id.*
[466]*Id.*
[467]*Rocklage*, 470 F.3d at 3.
[468]*Id.* at 8.
[469]*Id.* at 10.
[470]*Id.* at 7 (quoting *O'Hagan*, 521 U. S. at 655).
[471]*O'Hagan*, 521 U.S. at 653-54 (quoting brief for United States at 17).
[472]*Id.* at 656.

rather than acquisition of information without disclosure, that the Court seems to focus on.

On its part, the SEC promulgated Rule 10b5-2, effectively "fiduciarizing" many non-fiduciary relationships.[473] These moves were clearly inconsistent with the plain language in *O'Hagan*. However, based on Prakash's three-layered taxonomy of the prohibition, it can be argued that *O'Hagan*, with its rather imprecise formulation of the theory with its focus on deception through non-disclosure culminating in a securities trade left the door open for such unforeseen expansion of the scope of the prohibition.

One case illustrates how far the SEC, or the government, can stretch the boundaries of fiduciary-like relationships with the help of this Rule. In *United States v. McGee*, the Third Circuit upheld the conviction of McGee who traded based on the material, non-public information he received from a co-participant in an Alcoholics Anonymous (AA) meeting.[474] The co-participant was working on an acquisition deal and due to a lot of stress, he "blurted out" the information to McGee.[475] The court relied on the general practice within AA that any confidences shared by a participant will not be violated by other members.[476] The court rejected the contention that Supreme Court precedent unequivocally requires the existence of a fiduciary duty.[477]

Now an open textured provision may possibly be valuable in certain contexts. Francis Miller stated:

> [I presume that] we would all be willing to admit that Congress did not expect, by virtue of this Fourteenth Amendment [of the US Constitution], to give to women the right of suffrage. But, if that be the case, it is far from being

[473] 17 C.F.R. § 240.10b5-2(b) (2000). The Rule provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading: When the person receiving the information agrees to maintain such information in confidence; when the persons involved in the communication have a history, pattern, or practice of sharing confidences that results in a reasonable expectation of confidentiality; or when the person receives such information from a spouse, parent, child or sibling, unless the person can show affirmatively, based on the particular facts and circumstances of that family relationship, that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential.

[474] United States v. McGee, 763 F.3d 304, 308 (3d Cir. 2014).

[475] *Id.* at 309.

[476] *Id.*

[477] *Id.* at 313.

the first time that men have builded better than they knew.[478]

However, this approach surely needs to be avoided in the context of the insider trading prohibition whose violation entails severe civil and criminal penalties and, moreover, whose policy and theoretical basis itself remains contested.

I. *O'Hagan Upholds SEC Rule 14e-3*

In 1980, immediately after *Chiarella*, the SEC adopted Rule 14e-3.[479] Rule 14e-3 was brought in under the authority of section 14(e) of the Exchange Act. This authorizes the SEC to define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative, in connection with any tender offer.[480]

SEC Rule 14e-3 prohibits trading on the basis of material, non-public information in the context of tender offers, when such information is directly or indirectly obtained from the acquiring corporation (called the offering person in this Rule), the target corporation or an insider (from either entity).[481] Therefore, in the limited context of tender offers, there was no need for the government to show any breach of duty to the counterparty (as under the classical theory) or the source of information (under the misappropriation theory).

The original intent behind bringing this Rule was to target the practice of warehousing. Warehousing refers to the practice whereby a person or company (or a group of persons and/or companies) accumulates,

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[478]Ben Glassman, *Dialogic Fidelity: The Fourteenth Amendment, Historical Meaning, and Appropriate Scrutiny for Sex Discrimination*, 18 HARV. BLACKLETTER L.J. 139, 171 (2002) (quoting SUFFRAGE CONFERRED BY THE FOURTEENTH AMENDMENT: WOMAN'S SUFFRAGE IN THE SUPREME COURT OF THE DISTRICT OF COLUMBIA, IN GENERAL TERM, 1871- SARA J. SPENCER VS. THE BOARD OF REGISTRATION, AND SARAH E. WEBSTER VS. THE JUDGES OF ELECTION- ARGUMENT FOR THE COUNSEL FOR THE PLAINTIFFS- WITH THE OPINIONS OF THE COURT 63 (1871)).

[479]17 C.F.R. § 240.14e-3 (1981).

[480]15 U.S.C. § 78n(e) (1934).

[481]17 C.F.R. § 240.14e-3 (1981). The rule reads, in part: It 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 (a) tender offer which information he knows or has reason to know is non-public and which he knows or has reason to know has been acquired directly or indirectly from (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

without public disclosure, a substantial block of shares in a company with a view either to making a takeover bid or to selling the block to someone else who then makes a bid.[482]

As the *Chiarella* Court noted, warehousing often happens when the offering person herself tips other traders regarding its impending non-public tender offer.[483] The Court noted that the SEC had acted to bar warehousing under its authority to regulate tender offers (by proposing Rule 14e-3).[484] The objective behind the practice of warehousing could be to put a large block of shares in friendly hands with the understanding that the shares would be tendered to the offering person once the tender offer is formally announced, making it more likely that the offer would be successful. In this case, the buying shareholder is really acting as a front for the offering person. This amounts to a deliberate attempt by the offering person to conceal her identity and intention. Under U.S. law, if the offering person herself openly bought shares, she would be required to disclose acquisitions made beyond the five percent threshold.[485]

Many jurisdictions require public disclosure of changes in substantial shareholding. The disclosure is intended to alert the marketplace to potential shifts in corporate control and to let market forces take effect thereafter.[486] This enables the company to defend itself against a potential hostile takeover.[487] It may also encourage other bidders to come to the market and make a competing tender offer.[488] With this, the shareholders would be able to evaluate the best offer on the table and act accordingly. Thus, the Rule was a prophylactic measure to ensure that the market for corporate control functions in a smooth and transparent manner. On this reading, the reach of the Rule is limited to only those cases where trading on non-public information regarding impending tender offers happens with the collusion of the offering person.

However, in later cases, the SEC seems to have applied this Rule effectively as an equal access theory in the tender offer context. The Rule was invoked in contexts other than warehousing and where the offering persons were not aware of trading on non-public information regarding their intended tender offer, nor was the trader's intention to buy a

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[482]Razeen Sappideen, *Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United Kingdom, United States and Australia*, 8 J. COMP. BUS. CAP. MKT. L. 281, 307 n.53 (1986).

[483]*Chiarella*, 445 U.S. at 234.

[484]*Id.* at 234 n.18.

[485]15 U.S.C. § 78m(d) (2012).

[486]Sappideen, *supra* note 482, at 287.

[487]*Id.*

[488]*Id.*

substantial block of shares with a view either to make a takeover bid or to sell the block to someone else who then makes a bid. *O'Hagan* was one such case where O'Hagan was charged under Rule14e-3 as well.[489]

O'Hagan challenged the breadth of this Rule. The Court framed the question in terms of whether the SEC exceeded its rulemaking authority by adopting this Rule, which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose.[490]

The Court upheld the application of this Rule in the non-warehousing context. It noted that Section 14(e) authorizes the SEC to prescribe measures that are reasonably designed to prevent any fraudulent practices in the tender offer context.[491] It accepted the government's argument that the Rule fulfils this prophylactic function, since in the case of a tender offer, trading on non-public information is often likely to involve a breach of duty.[492] At the same time, proving such breach may be difficult.[493] Thus, according to the Court, the purpose that Rule 14e-3 essentially serves is to dispense with the SEC's (or the government's) burden to prove a breach of duty in case of trading on material, non-public information in tender offer context.[494]

Here again, Justice Thomas saw this attempt to address "disparities in market information" to be invalid and affording a backdoor entry for the equal access theory and, therefore, a clear departure from *Chiarella*.[495]

Finally, the Court declined to address the issue whether it also reached cases where a breach of duty is clearly absent, such as warehousing.[496] But as the *Chiarella* Court noted, the original purpose behind proposing the Rule was precisely to bar warehousing.[497]

Thus, it seems that in *O'Hagan*, the Court effectively wrenched the Rule away from its original policy moorings and reinstated the equal access theory, at least in the context of tender offers.[498]

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[489]*O'Hagan*, 521 U.S. at 676.
[490]*Id*. at 647.
[491]*Id.* at 672-73.
[492]*Id*.
[493]*O'Hagan*, 521 U. S. at 674-75.
[494]*Id*. at 676.
[495]*Id.* at 698-99 (Thomas, J., concurring in in part and dissenting in part).
[496]*Id.* at 672 n.17 (majority opinion).
[497]*See Chiarella*, 445 U.S. at 234.
[498]This, again, is a truncated equal access theory. Disclosure by bidders of acquisitions of securities on the open market or otherwise was required only when beneficial ownership passed a five percent threshold. *See* Langevoort, *supra* note 219, at 844 ("The implication, of course, was that up to that point, issuers could buy stock secretly, even when they had private inside knowledge of their own plans and intentions.").

J. *Decoding the Motive Behind O'Hagan*

Coming back to the misappropriation theory as propounded by the *O'Hagan* Court, it seems that, just as in *Chiarella*, the Court in this case also fashioned this theory to arrive at a particular result. Justice Powell was the architect of the classical theory which afforded limited opportunity to the SEC to expand the scope of the prohibition and in particular seemed to insure against the entry of the equal access theory through the backdoor.

With Justice Powell's retirement, the Court seems to have grown sympathetic to the concern that the classical theory was inadequate to deal with what it termed as the "animating purpose" of the Exchange Act–to insure honest securities markets and thereby promote investor confidence.[499] One way to achieve this is by minimizing informational disparities because "investors likely would hesitate to venture their capital in a market where trading based on misappropriated non[-]public information is unchecked by law."[500] In particular, the classical theory did not prohibit trading on material, non-public information by those other than company insiders (and those who had another fiduciary relationship with the counterparty).[501] There was a seeming necessity to plug the loophole so that such "outsiders" were not able to exploit informational disparities and thereby defeat this "animating purpose." The misappropriation theory was supposed to do this job.

However, the misappropriation theory does a poor job of this. Maybe, investors would hesitate to venture their capital in a market where trading based on asymmetric access to information is unchecked by law. It has been argued that legalization of insider trading would result in reduced market liquidity, increase the cost of capital and have an adverse impact on the capital formation process in the economy.[502] There is no reason why the investors would be concerned whether the information was misappropriated or not. From the investors' perspective, if a trader trades on material, non-public information, it does not make any difference whether the trader had disclosed *to the source of information* her intent to so trade or not. If the former kind of trading erodes investor confidence, so does the latter one as well. By focusing on the disclosure, or otherwise on an intent to trade to the source, the issue of informational disparities is obscured.

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[499] *O'Hagan*, 521 U. S. at 658.
[500] *Id.*
[501] *Id.*
[502] Dent, *supra* note 54, at 259.

On the other side, the theory is over-inclusive, since it should logically cover cases where the use of material, non-public information is not even implicated. A person who misappropriates *any resource* in connection with securities trading is guilty of violating the prohibition – whether the resource at issue is money or official computer. Again, investors would be least concerned if the trader on the other side used her personal computer or an official computer to enter a trade. This fact becomes crucial in determining liability under the misappropriation theory.

Finally, as remarked earlier, even though the plain language in *O'Hagan* restricts the reach of the theory to deception due to a breach of a fiduciary duty, this focus on deception on the source coupled with a securities trade complicates the matter.[503] The SEC may well argue that its "fiduciarization" of familial relationships through the promulgation of Rule 10b5-2 is a logical extension of the *O'Hagan* theory. After all, a husband may tell his wife about an impending acquisition of his company, with the expectation that she would not use the information for trading in the company's shares. If, without disclosing her intent, she goes ahead and does just that, the husband has been deceived. Again, there is no clear sense in which such a prohibition addresses any genuine concerns of the investors or the securities markets in general.

The Court was clearly aware of the under-inclusive character of the theory in certain instances. It admitted that there is no prohibition on trading "when a person trading on the basis of non-public information has disclosed his trading plans to, or obtained authorization from, the principal—even though such conduct may affect the securities markets in the same manner" as undisclosed and therefore deceptive trading.[504]

In light of this comment, it may be puzzling why the Court still went ahead with its holding. Its response seems to be that while the misappropriation theory is surely under-inclusive, this is the best the Court can do within the boundaries of Section 10(b). The Court remarked that "the fact that [Section] 10(b) is only a partial antidote to the problems it was designed to alleviate does not call into question its prohibition of conduct that falls within its textual proscription."[505] In other words, an under-inclusive prohibition is still better than no prohibition at all. But the Court seems to have overlooked the fact that the theory is over-inclusive as well, in that it catches even that conduct which has no impact on the

[503] *O'Hagan*, 521 U. S. at 643.
[504] *Id.* at 659 n.9.
[505] *Id.*

securities markets (as where the misappropriated resource is something other than information).

The emphasis in *O'Hagan* on the problem of informational disparities strongly suggests that the Court was sympathetic to the equal access theory. The government definitely had that in mind when it supported the misappropriation theory as one that "protects the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed."[506] The natural question to ask is why the Court did not openly restore the theory straightaway? There are several possible answers to this question.

One, since *Chiarella* had clearly rejected the theory, the government could not have advocated that. Therefore, the government supported O'Hagan's prosecution based on the misappropriation theory, which was adequate in the context of the facts of the case.

Two, even if the equal access theory had been urged, the Court would have likely been reluctant to overrule *Chiarella*. There have been cases wherein the Court has overruled its earlier decisions. As the Supreme Court explained in *Planned Parenthood of Southeastern Pennsylvania v. Casey*, the rule of *stare decisis* is not an "inexorable command."[507] The Court may depart from an earlier ruling if it has proven to be intolerable simply in defying practical workability.[508] This was not definitely true of *Chiarella*. Further as the *Casey* Court remarked:

> [S]uch a decision is usually perceived (and perceived correctly) as, at the least, a statement that a prior decision was wrong. There is a limit to the amount of error that can plausibly be imputed to prior Court…. The legitimacy of the Court would fade with the frequency of its vacillation.[509]

On the other hand, since *Chiarella* had explicitly declined to consider the misappropriation theory, the issue was *res integra* and thus was open for the Court to consider.[510]

Finally, it is possible that even as a policy matter, the Court was unwilling to go all the way to fully restore the equal access theory, based

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[506]*Id.* at 653 (quoting Brief for United States at 14).

[507]Planned Parenthood of Southeastern Pennsylvania v. Casey, 505 U.S. 833, 854 (1992).

[508]*Id.* at 855 (citations omitted).

[509]*Id.* at 866.

[510]*Chiarella*, 445 U.S. at 243.

on its belief (*qua Dirks*) that selective informational access for market analysts is indeed a valuable tool for enhancing market efficiency.

Therefore, the Court's motive here may be to fashion a theory that goes a long way towards dealing with the perceived problem of informational disparities without endorsing the equal access theory. This is also discernible from the Court's willingness to uphold SEC Rule 14e-3, which virtually brought back the equal access theory in the limited context of tender offers.

K. *The STOCK Act and the Misappropriation Theory*

Members of the U.S. Congress are often privy to market moving information, such as pending legislative proposals that may benefit or harm particular companies or industries.[511] It was long suspected that Congress members frequently trade on such information.[512] This suspicion was strengthened when a study led by Alan J. Ziobrowski found that a group of senators outperformed the market by an average of twelve percent over a five-year period.[513]

On November 13, 2011, CBS aired a program on trading by Congress members on the basis of information that they obtained while discharging their official duty.[514] For example, in September 2008, Treasury and Federal Reserve officials briefed Congressional leaders about the impending financial meltdown.[515] After attending the meeting, Republican Congressman Bachus took positions in the options market in such a way that if the markets tumbled, the value of his portfolio would appreciate.[516] Further, it was claimed in the CBS program that such trading by Congress members does not run afoul the insider trading prohibition under Section 10(b) and Rule 10b-5.[517]

In 2012, Congress passed the Stop Trading on Congressional Knowledge (STOCK) Act.[518] The STOCK Act adds a new subsection to Section 21A of the Exchange Act that reads:

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[511]Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159, 164 (2014).

[512]*Id.*

[513]Alan J. Ziobrowski et al., *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661, 661-62 (2004).

[514]60 Minutes, *Congress: Trading Stock on Inside Information?*, CBS (Nov. 13, 2011), https://www.cbsnews.com/news/congress-trading-stock-on-inside-information/.

[515]*Id.*

[516]*Id.*

[517]*Id.*

[518]Stop Trading on Congressional Knowledge Act of 2012, Pub. L. No. 112-105, 126 Stat. 291.

> Solely for [the] purposes of the insider trading prohibitions arising under this [Act] . . . each Member of Congress or employee of Congress owes 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, non-public 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.[519]

Therefore, trading on such information by Congress members and employees amounts to deception on Congress, the United States Government, and the citizens of the United States and therefore, by implication, is covered by the misappropriation theory.[520]

Kim argues that the STOCK Act adds nothing to the insider trading prohibition landscape, as "[l]egislators, federal and state, are not statutorily exempted from federal insider trading law."[521] Similarly, Schroeder concludes that "[t]he STOCK Act was enacted to address a public relations problem, not a real legal problem."[522] "It 'closed' a non-existent loophole that supposedly exempted Congress and its staff from the federal securities laws."[523]

However, there is a more fundamental problem with the STOCK Act. Under the misappropriation theory, the insider trading prohibition is based on a *pre-existing* fiduciary-like duty between the trader and her source of information. It is this duty that prevents the recipient of information from improperly converting it and trading on it in the first place. Therefore, this duty must exist prior to and independent of any consideration of the misappropriation theory in the context of the insider trading prohibition. By asserting that such a duty exists solely for the purposes of the insider trading prohibitions arising under this Act, the STOCK Act turns this logic upside down.

In other words, such a duty may not exist for any other purpose but is legislated into existence specifically in the context of the insider trading prohibition. Now, either the members or the employees of Congress owe a fiduciary-like duty to Congress, the government and the U.S. citizens, or they do not. If they do, the duty is prior to any considerations related to

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[519] 15 U.S.C. § 78u-1(g)(1) (2012).

[520] *Id.*

[521] Sung Hui Kim, *The Last Temptation of Congress: Legislator Insider Trading and the Fiduciary Norm against Corruption*, 98 CORNELL L. REV. 845, 919 (2013).

[522] Schroeder, *supra* note 511, at 239.

[523] *Id.*

insider trading, and the insider trading prohibition is a result of such a duty. If they do not, the insider trading prohibition under the misappropriation theory simply does not arise. Asserting that such a duty exists *solely for the purposes of the insider trading prohibition* does violence to the very essence of the misappropriation theory.

L. *The Takeaway*

This theory is under-inclusive with respect to the Court's stated goal of minimizing informational disparities, since trading on MNPI is perfectly legitimate if the trader discloses to the source her intent to trade. It is also over-inclusive, as it is resource agnostic and reaches securities trading by misappropriating any resource whatsoever. Thus, calling it an insider trading prohibition itself may be a misnomer.

The two-faced nature of this theory is also troublesome. The deceived party is the source of information, while there is a simultaneous harm to the members of the investing public. The special relationship theory also suffers from this difficulty. The twin prongs there refer to the company on the one hand and the counterparties on the other. But it may be argued that both parties are at least connected to the securities market – the company as the issuer of securities, and the counterparties as investors.

Under the misappropriation theory, this is not necessarily so. For example, in *Carpenter v. United States*,[524] the (allegedly deceived) source of information was the Wall Street Journal. It is not clear why deception of such parties wholly unconnected to the securities market should be a concern of securities law. Arguably, the nature of this theory compels such bizarre reading.

This is most likely why, before the Supreme Court took up *O'Hagan*, it was predicted in some circles that the Court would finally reject it.[525]

Of course, as Prakash admits, this discussion and criticism applies to *O'Hagan's* particular formulation of the misappropriation theory.[526] There may be other, more coherent ways of framing the concept of misappropriation. However, no such alternatives are on the table – with one exception. It is the version advocated in the Chief Justice's dissent in

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[524]Carpenter v. United States, 484 U.S. 19, 19 (1987).

[525]Joseph J. Humke, *The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 851 (1997) (suggesting that the theory's "judicial demise is more probable than not").

[526]Prakash, *supra* note 17, at 1546.

Chiarella.[527] Therefore, we now turn to an analysis of this version of the misappropriation theory.

VII. THE MISAPPROPRIATION THEORY (THE CHIEF JUSTICE'S DISSENT IN *CHIARELLA*)

Chief Justice Burger's dissent in *Chiarella* is brief. Further, a considerable portion of his opinion is devoted to discussing whether the jury was indeed not instructed to consider the alternative theory advocated by the government.[528] In the end, he concludes otherwise and thus would confirm Chiarella's conviction.[529] Even then, this short opinion contains enough material to germinate a distinct theory.

The alternative theory that the government presented was, of course, the misappropriation theory of insider trading liability. The government argued that Chiarella "breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation."[530] "The breach of this duty is said to support a conviction under Section 10(b) for fraud perpetrated upon both the acquiring corporation and the sellers."[531]

A. *The Heart of the Prohibition – Trading without Authorization by the Source*

The Chief Justice was also emphatic in rejecting the equal access theory as a basis for the insider trading prohibition. He stated, "[a]s a general rule, neither party to an arm's length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation."[532]

Therefore, mere superior access to information does not invoke the "disclose-or-abstain" rule. He was, however, clearly in favor of going beyond the *pre-existing relationship between the parties* as the only basis for such a rule. In particular, according to him, the insider trading prohibition under Section 10(b) surely comes into play "when an informational advantage is obtained not by superior experience, foresight, or industry, but by some unlawful means."[533] Towards the end of his

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[527]*See infra* Section VII.
[528]*Chiarella*, 445 U.S. at 243-45 (Burger, C.J., dissenting).
[529]*Id.* at 245.
[530]*Id.* at 235 (majority opinion).
[531]*Id.* at 235-36 (quoting Brief for United States).
[532]*Chiarella*, 445 U.S. at 239-40 (Burger, C.J., dissenting).
[533]*Id.* at 240.

opinion, he remarked, "[Chiarella] misappropriated -- stole, to put it bluntly -- valuable non-public information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market."[534]

This reference to the "misappropriation" of information by Chiarella has led some commentators to believe that *O'Hagan* finally endorsed the misappropriation theory that was first propounded by the Chief Justice in *Chiarella*.[535]

However, while both theories are predicated on "misappropriation", each conceptualizes the issue in its own way.[536] As discussed in the preceding Section, the heart of misappropriation, and therefore deception under *O'Hagan*, is *non-disclosure*.[537] Thus, if a person openly discloses to the source of information, her intent to trade on the information entrusted, the deception is eliminated.[538] Subsequently, if this person trades on such information, there is no violation of the insider trading prohibition (even though the source may possibly have other legal remedies against such trader).[539]

On the other hand, the Chief Justice's analysis in *Chiarella* makes no reference to any disclosure.[540] Here, the issue turns on the way in which the informational advantage is obtained.[541] As the Chief Justice held that the insider trading liability arises "when an informational advantage is obtained not by superior experience, foresight, or industry, but by some unlawful means."[542]

It must be noted that this binary characterization (superior experience, foresight, or industry versus unlawful means) is not exhaustive.[543] For example, what would happen if the source of the information explicitly authorizes a person entrusted with that information to trade on its basis? Would such trading be prohibited under the Chief Justice's formulation of the prohibition? For example, assume that the acquiring corporations explicitly authorized Chiarella to trade in a few

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[534] *Id.* at 245.

[535] *See, e.g.*, Starkey De Soto, *"Well, Now I'm Screwed": The Ever-Expanding Liability for Outsider Trading*, 33 WHITTIER L. REV. 275, 281 (2011-2012) ("Chief Justice Berger's alternative theory of liability was finally adopted by the Supreme Court in 1997.").

[536] *Id.*

[537] *O'Hagan*, 521 U.S. at 654.

[538] *See supra* notes 477-80 and accompanying text.

[539] *See supra* notes 477-80 and accompanying text.

[540] *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

[541] *Id.*

[542] *Id.*

[543] *Id.*

(specified number of) shares,[544] and Chiarella bought shares well within that limit.[545] In this case, Chiarella would surely have the benefit of an informational advantage vis-à-vis his counterparties.[546] Moreover, such advantage would not be due to any "superior experience, foresight, or industry" on his part.[547] Rather, it would be the fortuitous consequence of his being employed by the printing press that printed the tender offer documents and the acquiring corporations' magnanimity in allowing him to trade in a few shares.[548] Under the Chief Justice's analysis, would such informational advantage be said to have been obtained by unlawful means?

The opinion does not contain any explicit discussion on this "unlawfully obtained" prong.[549] However, some of the examples that Chief Justice Burger discusses wherein, according to him, the informational advantage is not obtained by unlawful means, indicates that such authorized (by the information source) trading is not covered under his formulation of the theory.[550] For example, he states that his theory "would not impose a duty on a tender offeror to disclose its acquisition plans during the period in which it 'tests the water' prior to purchasing a full 5% of the target company's stock."[551] In this case, the acquirer itself is the "owner" of the information regarding its imminent acquisition move, and therefore is free to trade on its basis.[552]

Going further, the Chief Justice also states that warehousing in general would not be proscribed either.[553] Warehousing refers to the "practice whereby a person or company (or a group of persons and/or companies) accumulates, without public disclosure, a substantial block of shares in a company with a view either to making a takeover bid or to selling the block to someone else who then makes a bid."[554]

Further, as the *Chiarella* Court noted, warehousing often happens when the offering person herself tips other traders regarding its impending non-public tender offer.[555] The objective could be to put a large block of

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[544]The corporations might permit this if they figured out that trading in a few shares would not drive up the price and consequently the cost of acquisition.

[545]*Chiarella*, 445 U.S. at 224.

[546]*Id.*

[547]*Id.*

[548]*Id.*

[549]*Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

[550]*Id.*

[551]*Id.*

[552]*Id.*

[553]*Chiarella*, 445 U.S. at 242 (Burger, C.J., dissenting).

[554]Sappideen, *supra* note 482, at 307 n.53.

[555]*Chiarella*, 445 U.S. at 234.

shares in friendly hands with the understanding that the shares would be tendered to the offering person once the tender offer is formally announced, making it more likely that the offer would be successful. In this case, the buying shareholder is really acting as a front for the offering person.[556]

The point here is that since the offering person herself tips others, it cannot be termed as unlawful acquisition of information; and when such other persons trade on it, it cannot amount to misappropriation and hence not covered by this version of the misappropriation theory. This proposition gets further support from the Chief Justice's "blunt" reference to misappropriation as "stealing."[557] If the source of information specifically authorizes a person to trade on confidential information entrusted to her, by definition, it cannot be called stealing. Therefore, such trading cannot be said to be on the basis of misappropriated information.

The distinguishing feature in the two misappropriation versions can now be isolated. In the *O'Hagan* version, the heart of the prohibition lies in the trader's *non-disclosure* to the source of the information of her intent to trade on such information.[558] In the *Chiarella* version currently under discussion, it is trading on such information without such trading being *authorized* by the source.[559]

B. *Difficulties with the Theory*

Compared to *O'Hagan*, this version is surely more plausible as a basis for an insider trading prohibition based on *misappropriation*. This is because it is difficult to hold that mere disclosure of an intent to trade eliminates the element of misappropriation.[560] On the other hand, the concept of authorization seems to align closely with the issue of whether the trading was on misappropriated information.[561]

However, this fact by itself does not bring out any policy justification for adopting this theory.[562] The Chief Justice held that the antifraud provisions were designed in large measure to assure that dealing in securities is fair and without undue preferences or advantages among

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[556]Even though the practice of warehousing was legal when *Chiarella* was decided, the SEC had already proposed Rule 14e-3 when *Chiarella* was argued and decided. In fact, the Court made a reference to the (then) proposed Rule.

[557]*Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

[558]*O'Hagan*, 521 U.S. at 652.

[559]*See generally Chiarella*, 445 U.S. at 239-45 (Burger, C.J., dissenting).

[560]*Id.*

[561]*Id.*

[562]*Id.*

investors.[563] He further stated that an investor who purchases securities on the basis of misappropriated non-public information possesses just such an undue trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.[564]

This formulation is open to criticism in various ways. One, even if it assumed that such conduct serves no useful function, that is not a strong enough reason to prohibit it.[565] Particularly, with a regime of severe civil and criminal liabilities, unless it can be demonstrated that such conduct actually is harmful to the interest of investors or it adversely affects the development of the securities market in any manner.[566]

Of course, the Chief Justice also hints that profits made out of such trading amounts to unjust enrichment, at the expense of others.[567] At this point, it may again be asked "at the expense of which party?" If the trader unduly enriches herself, who is left poorer? In other words, who is conceptualized as the victim of such trading?

To answer this, the Chief Justice falls back upon the twin prongs in the special relationship theory of *Cady, Roberts*.[568] He notes that the SEC in that case relied upon two factors to impose a duty to disclose on corporate insiders: (1) Access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and (2) the unfairness inherent in trading on such information when it is inaccessible to those with whom one is dealing.[569] Thus, the trader's unjust enrichment happens at the expense of her counterparties since they do not have access to such information. The counterparties are the victims of such trading.

This formulation imports the same dichotomy and confusion inherent in the special relationship theory. The lack of authorization *from the source of information* to trade on such information and the lack of access *by the counterparties* to such information are two conceptually distinct issues.

Further, they are not necessarily co-extensive either. As discussed earlier, in *Chiarella*, if the acquiring corporations had authorized Chiarella to trade based on the confidential information and Chiarella traded on such

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[563]*Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting) (internal quotation marks omitted).

[564]*Id.*

[565]*Id.*

[566]*Id.*

[567]*Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting).

[568]*Id.*

[569]*Id.*

information, this would not fall afoul of the Chief Justice's theory.[570] But it is not at all clear how the purported unfairness *to the counterparties* is eliminated due to such authorized trading. Whether or not authorized by the corporations, such information was nonetheless inaccessible to Chiarella's counterparties resulting in an informational disadvantage to them.[571]

On the other side, if Chiarella disclosed to the counterparties (or indeed to the entire market) the confidential information regarding the impending tender offers, and the counterparties still went ahead with the trade, surely such trading is not unfair to them.[572] This is because they had access to the same information, and it is the lack of access to this information that results in unfairness. However, if the acquiring corporations did not authorize Chiarella's use of this information for trading, such trading would still attract liability under the Chief Justice's theory.[573] This is so because such unauthorized trading amounts to misappropriation and, therefore, is prohibited under this version of the misappropriation theory.

Exactly as in the case of the special relationship theory, the two prongs pull in opposite directions, making the theoretical framework incoherent. So long as the source of the information permits a person to trade on confidential information, the person can by all means enrich herself at the cost of the counterparties, who do not have access to that information. On the other side, a person may make full disclosure of the confidential information to the counterparty, thus clearly not implicating any unjust enrichment concerns. Still, such trading would be illegal, if not authorized by the source of information.

Therefore, if eliminating unjust enrichment arising out of a lack of symmetrical access to information is the purported goal, the theory is both under and over-inclusive. Just as in the case of the special relationship and the *O'Hagan* misappropriation theory, the two parties involved in the chain of trading transactions are distinct, wholly disconnected to each other. The source of information is deceived, but no way harmed by unauthorized trading, while the counterparty is harmed, but not deceived, due to its trading based on an informational disadvantage!

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[570] *Chiarella*, 445 U.S. at 222-23 (majority opinion).

[571] *Id.*

[572] *Id.*

[573] Indeed, if Chiarella had actually sought authorization to trade after disclosing the tender offer plans to the entire market, the corporations would have surely refused to authorize such trading, since a premature disclosure of their plans was likely to increase the cost of acquisition or even frustrate the plan.

Further, the points raised by Haire in the context of the *O'Hagan* misappropriation theory regarding who should have a right of recovery and the applicability of the principle of *respondeat superior* are equally relevant here.[574] Since the deceived party is not harmed here, and vice-versa, neither should have a right of recovery! Since trading without authorization from the source of information is the basis for the trading prohibition, the source itself is deceived and the principle of *respondeat superior* is clearly inapplicable. But as Haire notes, the private rights of action and *respondeat superior* liability have been important enforcement tools throughout much of the life of insider trading regulation, which become unavailable under the Chief Justice's theory.[575]

Similarly, as in the case of the *O'Hagan* misappropriation theory, adopting this theory logically necessitates that unauthorized use of *any resource* for the purpose of securities trading is prohibited.[576] An employee who steals money from the employer for trading, or uses an official computer for placing a trade, without authorization, is just as guilty of violating the prohibition. We just need to replace "undisclosed" with "unauthorized" and the conclusion follows exactly with the same chain of reasoning.[577]

The above-mentioned point also shows that as in the case of the *O'Hagan* misappropriation theory, the Chief Justice's theory may have nothing much to do with protecting the interest of investors or the regulation and the development of the securities markets. Actually, the prohibited conduct under this theory is about the unauthorized use of a resource. In that case, again, such conduct should be a matter of private enforcement by the source of information (for unauthorized use of confidential information) and does not warrant erecting an elaborate insider trading prohibition regime implemented through regulatory intervention and public enforcement tools.

Of course, there is a reference in the Chief Justice's dissent which seems to address a concern directly implicating the securities market.[578] The Chief Justice notes that a person obtaining an informational advantage by way of superior experience, foresight, or industry is not prohibited from trading on it under his theory.[579] He also notes that permitting a person to trade based on such information is justified as a policy stance.[580] The Chief

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[574]Haire, *supra* note 112, at 1286.
[575]*See supra* Section VI.I.G.
[576]*See supra* Section VI.F.
[577]*See supra* Section VI.I.F.
[578]*Chiarella*, 455 U.S. at 240 (Burger, C.J., dissenting).
[579]*Id.*
[580]*Id.*

Justice states that this rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting.[581] The Chief Justice's argument seems to be that permitting a person to use an informational advantage obtained through superior experience, foresight, or industry would incentivize market participants to secure and analyze information and further form a judgment as to the value of a security.[582] Such market participants may themselves trade or they may disseminate their analysis and judgment in the market.[583] Either way, the securities prices are nudged in the right direction, improving market efficiency.[584] Arguably, trading on information obtained unlawfully does not serve any useful purpose and needs to be prohibited.

However, as seen earlier, these two scenarios do not exhaust all possibilities. If the source of the information authorizes a person to trade on material, non-public information, such trading is legal under this theory. This is regardless of the fact that the trader may not have obtained the information through superior experience, foresight, or industry. Rather, it may have been handed over to her on a platter by the source – such as a tip about an upcoming tender offer by the offeror in the context of warehousing. If incentivizing "hard work, careful analysis, and astute forecasting" is the policy rationale behind this theory, trading by such tippee must be prohibited as well. But as the Chief Justice himself notes, it is not so prohibited under his theory.[585]

The Chief Justice further notes one such possibility – that the information might have been acquired by mere chance.[586] Trading on such information also serves no useful purpose. However, this arguably does not amount to misappropriation, further the source may well authorize the use of this information for trading, in which case trading on it would be legitimate.

Therefore, it seems that the Chief Justice's theory is a poor fit for the policy rationale it is claimed to have been based on.

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[581] *Id.*

[582] *Chiarella*, 455 U.S. at 240 (Burger, C.J., dissenting).

[583] *Id.*

[584] *See infra* Section IX. Here, the Chief Justice arguably anticipated *Dirks*. *Dirks* placed emphasis on the desirability of allowing selective access to information to market analysts to improve market efficiency. This may be the reason why the Chief Justice stopped short of advocating the equal access theory as it would kill any incentive for undertaking information search and analysis.

[585] *Chiarella*, 455 U.S. at 240 (Burger, C.J., dissenting).

[586] *Id.* (quoting Fraud Keeton, *Concealment and Non-Disclosure*, 15 TEXAS L. REV. 1, 25-26 (1936)).

Finally, exactly as in the case of the equal access theory, the talk about the trader being unjustly enriched at the expense of her counterparties is question begging. In this respect, the discussion regarding "time traders" and "price traders" is equally relevant here.[587] "Time traders" come to the market independent of the presence or otherwise of insider trading.[588] Now insider trading, if at all, moves the prices in the "right" direction. Therefore, if such traders are on the opposite side of the insider traders, they are actually able to buy/sell at a price closer to the "right" price and actually benefit. Such counterparties thus place no reliance on the presence or absence of any knowledge of material, non-public information on the part of their counterparty, nor are they harmed in any way and may actually benefit. On the other hand, price traders, if they interpret the signals correctly, would be on the same side as the insider trader.

C. *The Takeaway*

To sum up, this version of the misappropriation theory, with its two prongs pulling in opposite directions (authorization from the source legitimizing trading and supposed unfairness to the counterparty due to asymmetric access to information), is also incoherent. It also raises concerns regarding the non-availability of some of the important enforcement tools such as a private right of action and the theory of *respondeat superior*. The theory also implies that the unauthorized use of any resource (and not just material, non-public information) for securities trading is implicated and should logically be prohibited.

Further, the theory is a poor fit for its stated policy rationale (providing incentive for hard work, careful analysis, and astute forecasting) as it permits trading even in situations where such trading does not provide such incentive and thus does not seem to perform any useful function.

Finally, the theory seems to be based on an inchoate notion that the kind of trading prohibited by this theory amounts to the trader unjustly enriching herself at the expense of her counterparties. However, as in the case of the equal access theory, it is not clearly articulated what harm the counterparties suffer. On the other hand, it can be argued that they are not harmed, or possibly even benefitted.

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[587] *See supra* note 142 and accompanying text.
[588] *See supra* note 142 and accompanying text.

VIII. THE STRUCTURAL DISPARITY THEORY

Justice Blackmun, with whom Justice Marshall joined, wrote a brief dissent in *Chiarella* wherein he offered a sketch of his own theory of the insider trading prohibition and a policy basis for the same.[589]

At the outset, he made it clear that it was unnecessary to base Chiarella's conviction on the notion of misappropriation.[590] As per the Chief Justice's dissent, it was the fact that Chiarella misappropriated (or "stole") the information for securities trading which was the determinative factor in establishing his guilt.[591]

However, under Justice Blackmun's formulation, this fact was irrelevant.[592] According to him, even if Chiarella had obtained the blessing of his employer's principals before embarking on his profiteering scheme, he still would have been guilty of violating the prohibition.[593]

According to him, the essence of the violation rested on the fact that Chiarella had "access to confidential information that the honest investor, no matter how diligently he tried, could not [have] legally obtain[ed]".[594] Justice Blackmun characterized such impossibility to legally obtain such information as an issue of "structural disparity" in access to material information, which is a critical factor in establishing the "disclose-or-abstain" duty.[595]

In particular, he would hold that persons having access to confidential material information that is not legally available to others generally are prohibited form exploiting their structural informational advantage through trading in affected securities.[596]

A. *Distinguishing Structural Disparity from Equal Access*

It might seem that with this characterization Justice Blackmun sought to resurrect the equal access theory firmly rejected by the Court (and even the Chief Justice). Justice Blackmun in *Chiarella*, however, disavowed any such intention.[597] He emphatically stated that there is a significant conceptual distinction between equality of information and

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[589] *Chiarella*, 455 U.S. at 245 (Blackmun, J., dissenting).
[590] *Id.* at 245-46.
[591] *Id.* at 246.
[592] *Id.*
[593] *Chiarella*, 455 U.S. at 246 (Blackmun, J., dissenting).
[594] *Id.* at 247.
[595] *Id.* at 251.
[596] *Id.*
[597] *Chiarella*, 455 U.S. at 251 (Blackmun, J., dissenting).

equal access to information (what he respectively called parity of information and parity of access to material information).[598] According to him, the latter permits one to use, for securities trading, certain kinds of informational advantages, such as those obtained through diligence or acumen.[599] The former would foreclose that option.[600]

But this seems to be a mischaracterization. As discussed earlier, no one has really advocated an insider trading prohibition based on actual equality of information. Indeed, such a prohibition is simply unworkable in practice, as it would bring market trading to a near halt.[601] Let us consider the facts in *Texas Gulf Sulphur* ("TGS").[602] In the equal access theory adopted by the Second Circuit, it was illegal for company insiders (or indeed any other person) to buy TGS shares based on the material, non-public information regarding the discovery of a significant ore deposit.[603] However, once there was a public announcement, such information would no longer be non-public.[604] A person could then freely trade in TGS shares without having to worry whether the counterparty was *actually aware* of the fact that a significant deposit had been discovered.[605] It was enough that the information was in a public domain and that such counterparty had in-principle access to it.[606]

Thus, Justice Blackmun's attempt to disentangle the two theoretical strands seems to be futile. A theory based on actual equality of information in any case is a straw man, not to be considered seriously.

If this purported difference does not stand to scrutiny, does the structural disparity theory simply collapse into the equal access theory? While there is a significant overlap between the two, it can be argued that there may be subtle, important differences as well. Justice Blackmun's opinion is brief and sketchy, and it is well possible to interpret it so as to conclude that he effectively endorsed the equal access theory, without realizing it. It may be fruitful to consider whether it is possible to flesh out a different theory based on any points of distinction. This is because, as we have seen, the equal access theory is open to severe criticism both from the viewpoint of its policy foundations and enforcement implications. However, the points where the structural disparity theory diverges from

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[598] *Id.* at 252 n.2.
[599] *Id.*
[600] *Id.*
[601] *See supra* Section IV.I.B for the discussion of this point.
[602] *See Tex. Gulf Sulphur Co.*, 401 F.2d at 852.
[603] *Id.*
[604] *Id.* at 854.
[605] *Id.* at 863-64.
[606] *Tex. Gulf Sulphur Co.*, 401 F.2d at 849.

the equal access theory (if it does) could be crucial in responding to that criticism. In other words, the criticism directed at the equal access theory may not apply. With this objective, it is worthwhile to explore whether the structural disparity theory could possibly be distinguished from its lookalike equal access theory.

The Second Circuit fell back upon the two-pronged analysis in *Cady, Roberts* as the basis for its fashioning of the equal access theory.[607] What is important is that the second prong focuses on the "inherent unfairness" involved in one party trading based on material, non-public information that is unavailable to the other party.[608] This clearly casts the counterparty, who is the victim of such "unfairness."

Of course, Justice Blackmun also makes a reference to the "unfairness" prong in *Cady, Roberts*,[609] as well as the "justifiable expectation" of *TGS*.[610] But the purpose here seems to be more to rebut the Court's insistence that the existence of a fiduciary duty is a prerequisite for finding a violation of anti-fraud provisions. His focus on the structural disparity as the basis for the prohibition suggests that he probably considers the securities market itself as the victim of such trade. This could precisely be the point of difference between the structural disparity and the equal access theory.

This distinction could be crucial in certain situations. In India, SEBI constituted a High Level Committee to review the insider trading prohibition framework under the Chairpersonship of Mr. N K Sodhi.[611] In 2013, the Committee submitted its Report.[612] The Report adopted equal access as the baseline theory for its recommendations.[613] In that context, it recommended that it should be a valid defense available for a person charged with insider trading that no violation occurred since the counterparty also had access to the same unpublished price sensitive information.[614]

On several occasions, the information may not be unqualifiedly positive or otherwise. For example, a five percent year-on-year growth in corporate earnings may be perceived to be positive or negative depending on subjective expectations of different market participants. Therefore, two

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[607] *Id.* at 848, 854.

[608] *Id.* at 848.

[609] *Chiarella*, 445 U.S. at 249 (Blackmun, J., dissenting).

[610] *Id.* at 250.

[611] N. K. SODHI, REPORT OF THE HIGH LEVEL COMMITTEE TO REVIEW THE SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992 (2013), www.sebi.gov.in/cms/sebi_data/attachdocs/1386758945803.pdf [hereinafter Sodhi Report].

[612] *Id.*

[613] Patwardhan, *supra* note 29, at 67.

[614] *Sodhi Report*, *supra* note 611, at 11.

parties who have access to this (non-public) information may be on the opposite sides of the trade. Such trading is perfectly consistent with the equal access theory, as both parties had access to the same information and thus there was no unfairness.

The analysis would be different under the structural disparity argument. As Justice Blackmun put it, the heart of the matter is the fact that the trader had "access to confidential information that [any] honest investor [and not just the counterparties], no matter how diligently he tried, could not legally obtain."[615] Thus, two traders having illegally obtained the same information and trading on its basis with each other does nothing to eliminate the structural disparity and, therefore, is not permissible under this theory. In other words, the traders secured an unfair advantage not just over the counterparties, but over the entire market. Other traders had no way of legally accessing this information, analyzing it and using it for trading (based on their view of the value of the information). Further, trading on such information definitely affords an advantage to such trader as against the rest of the market, if not "a virtually riskless advantage" to such traders who had access to this information.[616] In this case, it is an implicit disadvantage for *all honest traders in the market* due to their inability to capitalize on this information, since they could not obtain it legally.[617]

B. *An Argument in Support of the Theory*

This theory surely stays clear of the oddities found in both versions of the misappropriation theory. Under both, whether trading on the basis of material, non-public information is prohibited or not depends upon whether the trader disclosed to the source of the information her intent to so trade (*O'Hagan* version) or obtained authorization from the source to trade (the Chief Justice in *Chiarella)*. The odd thing here is that this source may be wholly unconnected to the securities market (as the Wall Street Journal in *Carpenter*). The question as to how such non-disclosure/non-authorization becomes a relevant factor in determining harm to the investors or the securities market is left unanswered.

The structural disparity theory is much clearer on this. Disclosure to or authorization by the source to trade does not legitimize such trading.[618] Rather, the fact that the trader traded on information not legally obtainable

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[615] *Chiarella*, 445 U.S. at 247 (Blackmun, J., dissenting).
[616] *Id.* at 252.
[617] *Id*. at 247.
[618] *Id*.

by other market traders is the crucial factor, so there is at least a plausible connect with the core mandate of securities law.[619]

C. *Difficulties with the Theory*

However, the crucial issue here is the precise scope of the concept of "legally obtainable information" because it is this concept that acts as the separating line between legal and illegal conduct.[620] This may not have been much of an issue in *Chiarella*, since Chiarella himself conceded that he knew it was wrong, and he and his co-workers in the printshop were specifically warned by their employer that actions of this kind were improper and forbidden.[621]

However, in other cases, the issue may not be so easy to resolve. As Galeno notes, Justice Blackmun did not himself define "lawful unavailability" and he seemed to be using the concept very loosely.[622] Langevoort also notes this definitional problem. In his example, "many tips occur not because of any plot or scheme to obtain information, but because an insider [or even the company] gratuitously chooses to give it out[,] … [as there is no] business need for confidentiality."[623] "The [issue] here is selective dissemination or use *per se*, quite apart from whether others could have obtained the same information if they knew where to look."[624] We may rephrase Langevoort's formulation as "if they had the acumen to know where to look and were diligent enough to actually look for and find this information." Since Justice Blackman approves of trading on informational differences based on diligence and acumen, such trading should arguably be legal.[625]

Justice Blackmun implicitly accepts that his position is ambiguous. He remarks that "the concept of the 'insider' itself has been flexible; wherever confidential information has been abused, prophylaxis has followed." [626] However, rather than prophylactic, his approach seems to be more like "make-up-the-definition-as-you-go," which is clearly impermissible in the context of a penal statute.

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[619]*Chiarella*, 445 U.S. at 247 (Blackmun, J., dissenting).

[620]*Id.*

[621]*Id.* at 246.

[622]Maria T. Galeno, *Drawing the Line on Insiders and Outsiders for Rule 10b-5: Chiarella v. United States*, 4 HARV. J. L. & PUB. POL'Y 203, 231 n.90 (1981).

[623]Langevoort, *supra* note 246, at 50 n.202.

[624]*Id.*

[625]*Chiarella*, 445 U.S. at 252 n.2 (Blackmun, J., dissenting) (internal quotation marks omitted).

[626]*Id.* at 250.

In this connection, the "void for vagueness doctrine" has been well settled in the U.S. as well as in India. As Justice Sutherland observed in *Connaly v. General Construction Co.*,

> [T]he terms of a penal statute creating a new offense must be sufficiently explicit to inform those who are subject to it what conduct on their part will render them liable to its penalties … and a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law.[627]

The Supreme Court of India has also endorsed the doctrine.[628] Apart from this definitional vagueness and the constitutional issue arising out of that, the fundamental policy rationale of the theory is also open to criticism. Citing cases, Justice Blackmun states that the principle that "one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair" has been adopted in a broader array of contexts.[629]

As Langevoort notes, these cases largely deal with a seller of property who knows of defects that are not patent. "What the law really reflects is a concept of unilateral mistake of fact…."[630] He approves Justice Blackmun applying the concept in the context of securities trading as it involves material information regarding the value of the stock that is not lawfully available to the other party or to the marketplace as a whole.[631]

Contra Langevoort, it may be argued that such application is not justified. In the context of a property transaction, the defect pertains to that particular property, and the buyer is looking to buy that particular property that she can buy only from that particular seller. In the case of an exchange-based securities transaction, the buyer is looking to buy or sell a particular security from anyone who is willing to sell or buy it. She may end up trading the security either with a person in possession of illegally obtained material information or someone else. In an impersonal market, she pays or receives the same price in either case. Thus, she is no worse off simply because her trade happened to match with that of the person in possession of illegally obtained information.

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[627]Connally v. General Const. Co., 269 U.S. 385, 391 (1926) (internal citations omitted).
[628]*See, e.g.*, Kartar Singh v. State of Punjab, (1994) SCC (3) 569.
[629]*Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting).
[630]Langevoort, *supra* note 246, at 50 n.202.
[631]*Id.*

In this context, it would be helpful to recall the earlier discussion regarding the distinction between a solitary defect and a generic defect.[632] The latent defect in property is of the solitary variety, whereas material information (in the context of exchange-based transactions) is of generic nature.[633] The two cases are conceptually distinct, and so is the impact and victim analysis in both cases. This is precisely the reason why conceptualizing the counterparty as the victim under the equal access theory runs into a serious difficulty, at least in the context of impersonal trading.

However, drawing such an analogy may be inappropriate in any case for the simple reason that the structural disparity theory conceptualizes the entire marketplace as the harmed party, and not the counterparty *per se*. Thus, any duty under the "disclose-or-abstain" rule must logically run to the entire marketplace, and not just to the counterparty. As remarked above, even if both parties to the trade illegally obtain such information, trading on it would be illegal as other "honest investors" in the market could not have obtained it legally. But then the same principle can be extrapolated to the entire marketplace. Even if a person obtains information illegally and disseminates it widely, it would only mean that a large number of traders are now aware of it. This, however, does nothing to alter the basic fact that they too have not obtained it legally – in particular, through any diligence or acumen on their part.

This analysis indicates that unlike the special relationship or the classical theory, the rule of "disclose-or-abstain" would not apply here. Rather, it is the "always-abstain" rule. A person who illegally obtains material information is simply prohibited from trading. Therefore, Justice Blackmun's assertion that one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair[634] is not relevant in the context of his own propounded theory. There is no question of disclosure, it is a rule of an absolute trading prohibition based on illegally obtained information.

Murdock argues that the equal access theory in *TGS* also implies the "always-abstain" rule (or what he terms "abstain-until-disclosable" rule).[635] His argument is based on the Court's recognition that disclosure may be "forbidden by the legitimate corporate objective of acquiring options to

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[632]*See supra* Section IV.I.E.
[633]*See supra* Section IV.E.
[634]*See supra* note 622 and accompanying text.
[635]Murdock, *supra* note 70, at 1554.

purchase the land surrounding the exploration site."[636] In such a situation, "if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished."[637]

However, if the insider disclosed to the counterparty any MNPI she had access to, her burden under the equal access theory is arguably discharged, as there is no information asymmetry between the parties to the transaction. The corporation may, of course, have other remedies against the insider if it suffers any loss as a result of such premature disclosure.

The position is different in the case of the structural disparity theory. Here, it is the structural disparity in access to MNPI in the context of *the market as an institution* that cannot be remedied by disclosure to the counterparty.

This raises the question as to the harm suffered by the marketplace. A person may trade based on illegally obtained information (which would be illegal under the theory) or she may abstain from trading (as she would be required to, since abstention would be the only legitimate option). In either case, "honest investors" are unable to use that information, so no case can be made out that they have been harmed by the person's trading.

An argument may still be made that in the latter case (abstention), no one has been able to use and profit from such information; whereas in the former case, the person trading on illegally obtained information alone is able to reap profits while other traders are denied those profits. This surely is a perverse argument since no one can have a vested right to profit from an illegally obtained resource (information or otherwise) simply because certain other persons have so profited.

In fact, if the insider traded on material, non-public information, the same was at least partly incorporated in the market price, enhancing the efficacy of the price discovery mechanism of the securities market. This point was also discussed in the context of the equal access theory.[638] It, however, applies with greater force here as the focus of the structural disparity theory is the securities market, rather than the counterparty.

Therefore, it can be argued that the "harm to the marketplace" argument, as implicit in this theory is illusory. The core of this theory seems to be the notion that trading on illegally obtained information affords a riskless advantage to a select few and the value judgment that it therefore ought to be prohibited.

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[636] *Tex. Gulf Sulphur Co.*, 401 F.2d. at 848.
[637] *Id.*
[638] *See supra* Section IV.

D. *The Takeaway*

To conclude, the insider trading prohibition as entailed by the structural disparity theory fails to articulate any harm to investors in a convincing manner – either to individual investors or to the securities market. The core of this theory seems to be the notion that trading on illegally obtained information affords a riskless advantage to a select few and the value judgment that it therefore ought to be prohibited. Exactly as in the case of equal access theory, it is arguably based on the notion of "fairness." The economic cash value of this is, however, questionable.

IX. THE TWIST IN THE TIP

In the case of the equal access theory, the question as to under what conditions the person who communicates MNPI to another person and such other person trades on it is straightforward. If the tippee traded on the basis of material information that her counterparty did not have access to, such trading would be squarely prohibited under the theory.

On the other hand, in case of duty-based theories, a breach of a duty is needed to be established. This would not be a big obstacle in the case where the insider herself trades without disclosing the non-public information, since such trading *per se* would be in breach of her duty. In the case of the tippee trading, the issue is more complex. Here the insider does not herself trade, but only discloses the information to the tippee who trades on its basis.[639] The tippee would inherit the duty not to trade only derivatively from the insider.[640] That would happen only if the insider disclosed the information in breach of her duty.[641] Thus, the conditions under which the insider can be said to have breached her duty through such disclosure of information becomes the crucial issue here. *Dirks* presented a rather unusual set of facts to the Supreme Court to resolve this issue. While this case arose under the classical theory, due to the twists and turns in U.S. jurisprudence, it merits separate discussion.[642]

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[639] *See generally Dirks*, 463 U.S. at 656.

[640] *Id.* at 659.

[641] *Id.* at 647.

[642] *See supra* Section V for a critique of the classical theory. Here, we sidestep the issues raised there and discuss the tipping jurisprudence, as it has evolved in the context of the classical theory.

A. *Facts in Dirks*

Dirks was working as a securities analyst with a broker firm.[643] He received information from Secrist, a former officer of Equity Funding (EF) regarding fraudulent corporate practices in EF.[644] Dirks began investigating the issue, even by talking to several employees of EF.[645]He informed the results of his investigation to the SEC and the Wall Street Journal.[646] He also discussed the issue with some of his firm's clients, who liquidated their EF shareholdings of more than $16 million USD.[647] Once the fraud became public knowledge, the price of EF shares plunged.[648]

The SEC began an administrative action against Dirks for repeating the allegations of fraud to his clients, without disclosing the same publicly.[649] Recognizing Dirk's role in uncovering the fraud, the SEC only censured him.[650] The case finally reached the Supreme Court.

B. *Opinion of the Court*

Justice Powell delivered the opinion of the Court. He reiterated its rejection of the equal access theory and the endorsement of the classical theory in *Chiarella*.[651] Thus, the whole issue turned on whether Secrist breached his duty in revealing the fraud inside EF to Dirks. Dirks would be liable only if Secrist so breached his duty.

The SEC's position was that where tippees, regardless of their motivation or occupation, come into possession of material corporate information that they know is confidential and know, or should know, came from a corporate insider, they must either (1) publicly disclose that information or (2) refrain from trading.[652] The Court rejected this saying that it is rooted in the idea that the antifraud provisions require equal information among all traders.[653] So the Court saw it as the re-entry of the equal access theory through the backdoor.

The Court was particularly concerned about what it termed the adverse impact of such a general rule on the role of market analysts, which

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[643]*Dirks*, 463 U.S. at 646.
[644]*Id*. at 649.
[645]*Id*.
[646]*Id*. at 650.
[647]*Dirks*, 463 U.S. at 650.
[648]*Id*.
[649]*Id*.
[650]*Id*. at 646.
[651]*See Dirks*, 463 U.S. at 654-55.
[652]*Id.* at 651.
[653]*Id.* at 657.

the SEC recognized to be necessary for the preservation of a healthy market.[654] The analysts often "ferret out and analyze information" by, among other things, "questioning corporate officers and others who are insiders."[655] This information is then processed by the analysts to form a judgment regarding the value of company securities.[656] This, in turn, is disseminated to the market in the form of newsletters or otherwise. This facilitates informed trading by the market participants. This process would enhance the efficiency of the mechanism of price discovery. The Court said that it is the nature of such information that it cannot be simultaneously made available to the market in general.[657] Here, it is interesting to note that while the Court correctly cast the analysts in the special role of efficiency-enhancers through their research and analysis, it also held that selective access to information is the privilege that they must enjoy for performing this special role.[658] In such cases, the insider who discloses the information exclusively to the analysts does not breach any duty.[659]

This analysis only established a negative proposition, that an insider disclosing material information selectively to a few participants did not, *per se*, violate her duty. The question still remained as to under what condition she would be violating her duty. Identifying such conditions was required, since only in such cases, the tippee would be derivatively breaching her duty as well, by trading on such information.

The Court held that the issue turned on the purpose behind tipping.[660] It fell back upon the analysis in *Cady, Roberts* to say that a purpose of the securities laws was to eliminate use of inside information for personal advantage.[661] Therefore, an insider breached her duty by disclosing non-public information if she would personally benefit, directly or indirectly, from the disclosure.[662] The benefit here need not be an immediate pecuniary gain, but may be reputational benefit that will translate into future earnings.[663] The Court also held that a gift of the confidential information by the insider to a friend or relative also would constitute a

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[654] *Id*. at 657-58.
[655] *Dirks*, 463 U.S. at 658 (internal citations omitted).
[656] *Id*. at 658-59.
[657] *Id.* at 658-59.
[658] *Id*. at 660.
[659] *Dirks*, 463 U.S. at 660-61.
[660] *Id*.
[661] *Id.*
[662] *Id.* at 662.
[663] *Dirks*, 463 U.S. at 663.

breach of duty.[664] "The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[665]

The Court concluded that neither Secrist nor other EF employees interviewed by Dirks as part of his investigations violated their duty by disclosing confidential information to Dirks.[666] They did not receive any personal benefit, nor were they motivated by a desire to expose fraud. Thus, there was no derivative breach by Dirks in disclosing the information to his clients.[667] Dirks was not liable under Section 10(b) for violating the insider trading prohibition.[668]

C. *The Dissent*

Justice Blackmun filed a dissenting opinion where he disagreed with the Court both in terms of its analysis as well as the outcome.[669] Justice Blackmun held that Secrist violated his duty, as entailed by the classical theory, by transmitting material, non-public information to Dirks, and therefore was guilty of violating the insider trading prohibition.[670]

The dissent questioned the Court's view regarding the benign motivation behind and the useful purpose served by Dirks' investigations.[671] After learning of the fraud from Secrist, one of the first things that Dirks did was to draw up a list of clients with positions in EF.[672] The clients holding positions in EF were told the "hard story" – all the allegations.[673] Others were given vaguely worded details of fraud.[674] The dissent also disputed the position that Dirks derived no personal benefit.[675] Some of the clients directed their business to his employer due to the tip on EF, generating higher commission for the broker.[676] Dirks, as an employee, thus was benefitted indirectly.[677]

The dissent also discussed the practical difficulties that may arise in operationalizing the personal benefit test. It is hard to explain why the benefit Secrist obtained - the good feeling of exposing a fraud and his

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[664] *Id*. at 664.
[665] *Id.*
[666] *Id.* at 660.
[667] *Dirks*, 463 U.S. at 667.
[668] *Id.*
[669] *Id*. at 678-79 (Blackmun, J., dissenting).
[670] *Id*.
[671] *Dirks*, 463 U.S. at 669-70.
[672] *Id.*
[673] *Id*.
[674] *Id.* at 669-70.
[675] *Dirks*, 463 U.S. at 669-70.
[676] *Id*.
[677] *Id.* at 669 n.4.

enhanced reputation - is any different from the benefit to an insider who gives the information as a gift to a friend or relative. The distinction between pure altruism and self-interest has puzzled philosophers for centuries; there is no reason to believe that courts and administrative law judges will have an easier time with it.[678]

The dissent also pointed out that even if we accept the Court's view regarding the role played by the analysts in ferreting out corporate information, analyzing it, forming a judgment as to the value of corporate securities, and conveying it to the market; the analysis is inapt in this case.[679] The information received by Dirks here required no analysis using his expertise.[680]

Most importantly, the dissent challenged the fundamental proposition that either of the two factors (pecuniary benefit or disclosure as gift) is necessary to establish a breach of duty.[681] It pointed to the second prong in the *Cady, Roberts* analysis referred to by the *Chiarella* Court–the inherent unfairness to the shareholders.[682]

D. *Situating Dirks*

As the Court acknowledged, this case involved an unusual set of facts.[683] Probably, this was the decisive factor in the outcome of the case. Secrist was seen as a Good Samaritan who disclosed fraud within EF out of an altruistic motive. Obviously, such a motive would seem to be at odds with the breach of a legal duty.

The fact that Secrist made the disclosure to Dirks (a market analyst) also helped. The Court recognized the role of analysts as the gatekeepers of market efficiency. It further assumed that giving them selective access to corporate information is a necessary condition for the performance of their role.

Things have changed. In 2000, the SEC adopted Regulation Fair Disclosure (FD), which requires issuers to publicly disclose any material non-public information conveyed to market professionals and other specified people.[684] This regulation requires that public disclosure must be simultaneous for intentional disclosures and prompt for unintentional

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[678] *Id.* at 676 n.13.
[679] *See generally Dirks*, 463 U.S. at 669-71.
[680] *Id.* at 674 n.11.
[681] *Id.* at 671.
[682] *Id.* at 672 n.8.
[683] *Dirks,* 463 U.S. at 658 n.18 (majority opinion).
[684] 17 C.F.R. § 243.100(a) (2000).

disclosures.[685] Now, the regulation specifically provides that any failure to make a public disclosure shall not be deemed to be a violation of Rule 10b-5[686] (and therefore of the insider trading prohibition). Therefore, the *Dirks* holding technically remains intact.

At the same time, Regulation FD clearly undercuts the basic policy premise of that holding. Specifically, the Rule focused on corporate issuers and corporate officials as the source of such asymmetries, reasoning that if selective disclosures by corporate insiders could be prevented at the source, regulators would have less need to address trading by the recipients of that information.[687] Thus, the Regulation serves as a near total prohibition on tipping by the company or its officers, regardless of the existence of any personal benefit/gift enquiry as envisaged in *Dirks*.

Dirks represented a different era–an era that preceded the information superhighway of today. Also, it involved applying insider trading law to an unusual set of facts.[688] Coffee locates the decision in the post-Watergate zeitgeist.[689] The underlying notion was that just as the journalists played a crucial role in uncovering the Watergate scandal, financial analysts have an important role to play in uncovering financial frauds that often elude the slower moving government agencies.[690]

E. *The Aftermath*

Post *Dirks*, concerns arose regarding the failure of lower courts to require the government to clearly establish the personal benefit element, virtually making the test an empty shell.[691] The Second Circuit Court opinion in *Newman* changed the narrative.

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[685] *Id.*

[686] 17 C.F.R. § 243.102 (2000).

[687] *See* Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry, in* RESEARCH HANDBOOK ON INSIDER TRADING 112 (Stephen M. Bainbridge ed., 2013) (quoting Proposed Rule: Selective Disclosure and Insider Trading, SEC Release Nos. 33-7787, 34-42259, IC-24209 (Dec. 20, 1999), 64 Fed. Reg. 72574 (Dec. 28, 1999) ("We propose to use our authority to require full and fair disclosure from issuers…. We believe this approach would further the full and fair public disclosure of material information, and thereby promote fair dealing in the securities of covered issuers.")).

[688] *See* Joan MacLeod Heminway, *Willful Blindness, Plausible Deniability and Tippee Liability: SAC, Steven Cohen, and The Court's Opinion in Dirks*, 15 TRANSACTIONS: TENN. J. BUS. L. 47, 56 (2013).

[689] *See* John C. Coffee, Jr., *Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 289-90 (2013).

[690] *See id.*

[691] Joe Nocera, *On Insider Trading, There Ought to Be a La*w, BLOOMBERG: OPINION (Aug. 25, 2017), https://www.bloomberg.com/view/articles/2017-08-25/on-insider-trading-there-ought-to-be-a-law (arguing that over time, the definition of personal benefit became so watered down as to be rendered meaningless).

Unlike *Dirks*, *Newman* involved a chain of tippers and tippees.[692] The original tippers, who were company insiders for Dell and NVIDIA, separately disclosed MNPI to two financial analysts, who were acquaintances of the original tippers.[693] These two financial analysts then shared the information with other financial analysts, who in turn shared the information with their portfolio managers, Todd Newman and Anthony Chiasson.[694] Newman and Chiasson then traded on the information and each reaped millions in profits.[695] A jury found Newman and Chiasson guilty of insider trading based on the Government's argument that Newman and Chiasson, as sophisticated insiders, must have known that the information resulted from someone's breach of a fiduciary duty.[696]

However, the Second Circuit reversed the convictions. It held that in order to demonstrate personal benefit, there must be a "meaningfully close personal relationship" between the tipper and tippee.[697] Further, the personal benefit must be something "that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[698]

Arguably, the court in this case, went some way in clarifying the personal benefit test. While *Dirks* held that a gift of the confidential information by the insider to a friend or relative also would constitute a breach of duty, the Second Circuit was concerned that too wide a definition of friend or relative would render the test a nullity.[699] The "meaningfully close personal relationship" test is arguably devised to address this issue.

The second prong also aligns with *Dirks. Dirks* focused on a pecuniary gain or a reputational benefit that will translate into future earnings.[700] Thus, a tip must result in a pecuniary or similar valuable gain at some point of time. The Second Circuit emphasized that the gain must be objective, consequential, and of a pecuniary or similarly valuable nature, even though it may only be potential.[701]

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[692] *See* United States v. Newman, 773 F.3d 438, 443 (2d Cir. 2014).

[693] *Id.*

[694] *Id.*

[695] *Id.*

[696] *Newman*, 773 F.3d at 443-44.

[697] *Id.* at 452.

[698] *Id.*

[699] *Id.* (holding that if the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement would be a nullity).

[700] *Dirks*, 646 U.S. at 663.

[701] *Newman*, 773 F.3d at 452.

However, the Court here seems to have required the showing of a pecuniary or similarly valuable gain even in the context of a tip in the context of a meaningfully close relationship (its gloss of "tip to a friend or a trading relative" prong in *Dirks*). However, under *Dirks*, such tips are covered by the gift theory, with no burden to show a pecuniary benefit accruing to the tipper[702]. On this point, the court's holding is inconsistent with *Dirks*.

The Supreme Court denied certiorari in *Newman*.[703] Later, the Court did grant certiorari in the Ninth Circuit case *United States v. Salman*.[704] The case involved tipping MNPI to a trading relative. Writing for a unanimous Court,[705] Justice Alito found that Dirks "easily resolve[d]" the case.[706] The *Dirks* Court clearly held that a tipper breaches a fiduciary duty by making a gift to a friend or relative.[707] The Court "agree[d] with the Ninth Circuit" that any reading of Newman that required proof of a monetary benefit must be "inconsistent with *Dirks*."[708]

Finally, the Second Circuit again weighed on the issue in its two opinions in *Martoma I*[709] and *Martoma II*.[710] Martoma was a hedge fund manager.[711] He hired two doctors who were involved in the clinical trials of a drug for Alzheimer's disease.[712] He received MNPI regarding the final trial results to the effect that the drug was ineffective, and traded on this MNPI.[713] While Martoma appealed his conviction, the Second Circuit reversed *Newman* and the Supreme Court affirmed *Salman*.[714]

In *Martoma I*, the court correctly noted that the "meaningfully close relationship" analysis is irrelevant here, as Martoma paid the doctor for information in exchange of MNPI.[715] This is clearly a pecuniary gain, as per *Dirks*. The Court also read *Salman* to abrogate *Newman's* meaningfully close personal relationship requirement.[716] However, as noted above, this

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[702]*Dirks*, 646 U.S. at 663.

[703]Reed Harasimowicz, *Nothing New, Man! -- The Second Circuit's Clarification of Insider Trading Liability in* United States v. Newman *Comes at a Critical Juncture in the Evolution of Insider Trading*, 57 B.C.L. REV. 765, 785 (2016).

[704]United States v. Salman, 792 F.3d 1087 (9th Cir. 2015).

[705]Justice Gorsuch had not yet joined the Court at the time of the decision.

[706]*Salman*, 137 S. Ct. at 427.

[707]*Id.* (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

[708]*Id.* at 428.

[709]United States v. Martoma, 869 F.3d 58 (2d Cir. 2017).

[710]United States v. Martoma, 894 F.3d 64 (2d Cir. 2018).

[711]*Id.* at 64-65.

[712]*Id.*

[713]*Id.*

[714]*Martoma*, 869 F.3d at 64-65.

[715]*Id.* at 67.

[716]*Id.* at 69.

requirement clarifies *Dirks* as it provides a meaningful threshold for the government to invoke the gift theory. What *Salman* really abrogated was the requirement in *Newman* that even in the context of tipping a friend or a trading relative, proving a pecuniary benefit to the tipper is necessary.

Later, the Second Circuit withdrew *Martoma I* and issued an amended opinion *Martoma II*. The court focused on one specific sentence in *Dirks* to the effect that "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient."[717] It interpreted the comma to mean that an intention to benefit itself is enough to fasten liability, even in the absence of any relationship between the insider and the tippee.[718]

Thus, the "personal benefit" test has had a tortuous journey. The Supreme Court evolved the test in *Dirks* to establish the conditions under which the communication of MNPI by an insider would constitute a breach of duty, as required under the classical theory. In particular, the Court saw selective access to MNPI for the analysts as a necessary condition for them to perform their function. This, in turn, would enhance market efficiency. *Newman* arguably clarified *Dirks* by delineating the contours of an immediate or potential pecuniary gain as well as the gift theory, even though it overstepped *Dirks* in insisting on the showing of a pecuniary benefit even in the context of the gift theory. *Martoma I* was relatively straightforward as there was evidence of a pecuniary gain to the tipper, and the case could be resolved on this basis alone. Finally, *Martoma II* seems to have changed course and focused on the interpretation of one comma in a particular sentence in *Dirks* as the focus of its analysis.[719]

There are three open issues at this stage. One, in the backdrop of Regulation FD, one particular policy foundation for the test (legitimizing selective analyst access to MNPI) has been undercut. However, the test may still be useful in distinguishing, in other contexts, as to whether the disclosure was for a legitimate corporate purpose or if it amounted to a breach of duty. Such inquiry is crucial in any duty-based theory, as the tippee acquires the duty not to trade on MNPI only if the information was disclosed in breach of a duty. Fleshing out such contexts and then refining the test to address those becomes crucial.

Two, there is the question of whether the interpretation of the now infamous comma in *Dirks*, as set out in *Martoma II* is correct. The court

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[717] *Id.* at 74-75.

[718] *Martoma*, 894 F.3d at 74-75 ("The comma separating the 'intention to benefit' and 'relationship . . . suggesting a quid pro quo' phrases can be read to sever any connection between them.").

[719] *Id.*

itself acknowledged that the comma and the word "or" in the sentence were ambiguous.[720] In other words, the court accepted that it is also a reasonable interpretation that establishing a relationship between the insider and the recipient is necessary even in the context of "intent to benefit" situations.[721] Under this interpretation, the government's evidentiary burden goes up substantially. Clarifying this issue is crucial for the market participants, as the line between legal and illegal conduct would vary depending on the interpretation. Resolving this issue becomes crucial as it would provide adequate guidance to the market participants.

Three, there is no logical reason why the gift theory in *Dirks* is inapplicable in cases other than a tip to a friend or a trading relative.[722] For example, I happen to meet a stranger in a party. She reveals her financial difficulty. Moved by her story, I offer her a tip of MNPI so that she can trade on that. She does exactly that. Clearly, the tip here also resembles trading by me and gifting the proceeds to the stranger. There is no reason why the gift theory should not apply here, just because the tippee is not my friend or relative. In fact, in *Salman,* the government argued that "a gift of confidential information to anyone, not just a trading relative or friend, is enough to prove securities fraud."[723] This point exactly parallels what was discussed in the context of *O'Hagan*. While the plain language in that case focused on a fiduciary or similar duty, the Court's rather imprecise deception-based analysis of the misappropriation theory left scope for the lower Courts and the SEC to expand the reach of the theory, by bringing in other contexts such as deception on a family member.[724]

Thus, the "personal benefit" test arguably had, and will continue to have, a role to play in determining liability under the classical theory. What may be required is sharpening the test further. Unfortunately, as noted in the Introduction, it received rather casual treatment in both Bharara Report and ITPA.[725] The Report recommended eliminating the test altogether, despite acknowledging the role it plays.[726] In case of ITPA, it was added as an afterthought, as a last-minute amendment to the proposed Bill.[727]

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[720] *Id.* at 74.
[721] *Id.*
[722] *See Dirks*, 463 U.S. at 644.
[723] *Salman*, 137 S. Ct. at 426 (internal quotation marks omitted).
[724] *See supra* Section VI.I.H.
[725] *See supra* Section I.
[726] *See supra* note 39 and accompanying text.
[727] *See supra* note 40 and accompanying text.

X. TITLE 18 § 1348

In 2002, section 807 of the Sarbanes-Oxley Act (SOX) added a new Section 1348 under Title 18 to the U.S. Criminal Code.[728] While the legislative intention behind inserting this is not entirely clear, the U.S. Congress may have done it to significantly increase penalties in securities fraud cases and make it easier for prosecutors to prove such cases by eliminating the so-called "technical elements" as present in Section 10(b) and Rule 10b-5.[729]

On December 30, 2019, the Second Circuit issued an insider trading decision in *United States v. Blaszczak.*[730] The government charged several individuals in a tipping scheme involving confidential pre-decisional information of the Center for Medicare and Medicaid Services (CMS).[731] Blaszczak, a political intelligence consultant, received MNPI about prospective changes to Medicare reimbursement rates from a CMS employee.[732] Blaszczak then shared the information with individuals at two hedge fund clients, who in turn earned millions of dollars on trades in the securities of healthcare companies that would be impacted by the changes once they were announced publicly.[733] The defendants were charged with securities fraud under Section 10(b) of the Securities Exchange Act, as well as under section 1348.[734]

The district court instructed the jury with respect to the *Dirks* personal benefit test for the Section 10(b) charges, but not for Title 18

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[728]18 U.S.C. § 1348 ("Whoever knowingly executes, or attempts to execute, a scheme or artifice (1) to defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934; or (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934; shall be fined under this title, or imprisoned not more than twenty-five years, or both.").

[729]Stephen M. Bainbridge, *Regulating Insider Trading in the Post-fiduciary Duty Era: Equal Access or Property Rights?*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 80, 89 (2013) (quoting Kenneth M. Breen & Keith W. Miller, *Securities Fraud*, 32 Champion 49 (2009)).

[730]United States v. Blaszczak, 947 F.3d 19, 26 (2d Cir. 2019).

[731]*Id.* at 39.

[732]*Id.* at 42.

[733]*Id.* at 39.

[734]Brett Atanasio et al., *Insider Trading Law Alert: The Second Circuit Clears the Path for Insider Trading Convictions Absent a Dirks Personal Benefit*, JDSUPRA (Jan. 8, 2020), https://www.jdsupra.com/legalnews/insider-trading-law-alert-the-second-82209/.

charges.[735] The jury acquitted all defendants on the Section 10(b) charges, but convicted on the Title 18 charges.[736]

The Second Circuit upheld the convictions.[737] It held that the statutory purposes behind Title 18 differed from Section 10(b).[738] The court observed that the Sarbanes-Oxley Act of 2002 added a securities fraud provision to Title 18 of the criminal code "in large part to overcome the 'technical legal requirements' of the Title 15 fraud provisions."[739] Because of these different purposes between the two securities fraud statutes, the court declined to "graft" the personal benefit test from *Dirks* and Title 15 onto Title 18.[740]

After Blaszczak, the government's burden to prove "personal benefit" has been eliminated. This now may be the preferred provision for prosecution. The SEC is not authorized to pursue criminal charges for Title 18 securities fraud.[741] Thus, where proving personal benefit is difficult and the government chooses to prosecute only under Title 18, the SEC would not be able to bring a civil action for securities fraud.[742] This surely is an ironical result.

More importantly, the existence (and subsequent breach) of such a duty is not just a technical element. Rather, it is an integral part of the duty-based insider trading prohibition jurisprudence in the U.S. Both classical and *O'Hagan* misappropriation theories underlie the slogan "no duty, no violation."[743] By invoking Title 18 in the context of insider trading, it seems that the prosecutors and the lower courts have effectively dispensed with the duty element. Thus, the very foundation of the insider trading prohibition jurisprudence has been undercut.[744]

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[735] *Blaszczak*, 947 F.3d at 29.

[736] *Id.* at 26.

[737] *Id.*

[738] *Id.* at 35-36.

[739] *Blaszczak*, 947 F.3d at 36.

[740] *Id.* at 36-37.

[741] *See* Atanasio et al., *supra* note 734.

[742] *See id.*

[743] *See id.*

[744] There are some differences in coverage. Title 18 securities fraud applies only to securities of issuers "with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d))," while Section 10(b) applies to both registered and unregistered securities and securities-based swap agreements. *Compare* 18 U.S.C. § 1348(1)-(2), *with* 15 U.S.C. § 78(j). However, the above argument applies at least in the context of registered securities.

XI. SUMMARY AND CONCLUSION

The United States was the first legal jurisdiction to prohibit insider trading. Since the 1980s, there has been a worldwide trend towards prohibiting the practice. Insider trading is not defined anywhere in the United States law. The U.S. federal prohibition is judge-made. It has evolved through a series of judicial pronouncements. The U.S. prohibition has been termed a hodgepodge of theories, rules, and decisions; dysfunctional; inconsistent and obscure. To remedy this, there has been a flurry of recent activity to recommend, or enact, a statutory prohibition framework. In January 2020, the Bharara Task Force on Insider trading issued its report.[745] On December 5, 2019, the U.S. House of Representatives passed the Insider Trading Prohibition Act (ITPA).[746]

However, the controversy over the optimum nature and scope of the prohibition stems from a fundamental disagreement over whether insider trading should be prohibited and if so, what is the appropriate rationale behind the prohibition? The Indian prohibition regime is based on an explicit statutory framework. In spite of this, the evolution and the current state of insider trading law in India also underlie theoretical discontinuity and incoherence.

Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. This is evident from the treatment of "personal benefit" test – an essential element in tipping cases under U.S. jurisprudence – in the Bharara Report and ITPA.

Therefore, at this point in time, it is particularly imperative to attempt a nuanced analysis of the insider trading theories, as enunciated by the U.S. Courts over the years. In this article, we built upon and extended the existing commentary and critique of the three "big" judge-made theories – equal access, classical, and misappropriation. We identified three more theoretical strands in U.S. jurisprudence and offered a critique of these. The assessment was carried out based on two tests, from the angle of internal coherence as well as in terms of how well these theories respond to (1) the core mandate of securities law, (2) the protection of the interest of investors in securities, and (3) the development of the securities market.

Based on our analysis, we show that none of these theories provide a sound foundation for the insider trading prohibition regime in a way that

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[745] *See* Bharara Report, *supra* note 23.

[746] *See supra* note 26 and accompanying text.

addresses the core concerns of securities law. In addition, some of the theories lack internal coherence.

From the perspective of the connection with the securities market, the equal access theory is intuitively the most plausible. This is because it seeks to eliminate the "unfairness" involved when one party to a securities trade trades based on information that is not available to the other party. However, the theory addresses only formal equal access to information. Any attempt to ensure actual, substantive equal access is unworkable, as it would bring market trading to a near halt. Its application to trading on impersonal markets is open to criticism as there is no "counterparty" in any real sense, particularly on order-driven trading platforms. Most importantly, the "unfairness" argument seems to take for granted some inchoate notion of "harm" suffered by the assumed counterparty, whereas it can be shown that the counterparty, in fact, suffers no harm *as a result of insider trading*, and may even benefit.

Other victims, such as the ultimate buyer and seller in a chain of transactions or traders who trade on the same side as the insider trader have also been posited as victims of insider trading. These arguments are not convincing either, at least in the context of exchange-based, anonymous transactions.

The structural disparity theory is ambiguous both regarding the scope of the prohibition, as well as the purported victim of insider trading. Also, the theory logically implies the "always- abstain" rule. This does not square with Justice Blackmun's comment regarding a transaction without disclosure being inherently unfair.

One possible response to the problem of identifying "harm" to investors and predicating the prohibition on such harm is to base the prohibition on a pre-existing duty which casts an obligation on a person not to trade on material, non-public information without disclosure. The classical theory relies on a pre-existing fiduciary duty that a person has towards the counterparty. However, if this duty is to be taken seriously, the theory catches a very small subset of all securities transactions. In particular, transactions on an impersonal market are completely excluded. This theory also treats the counterparty as the victim – surely not as a counterparty, but as a victim of a breach of a fiduciary duty. Thus, the question regarding the precise harm suffered by such person plagues this theory as well.

Other duty-based theories have their own additional problems apart from identifying the harm to the investors (i.e., their two-faced nature). While the duty not to trade on material, non-public information arises from a person's relationship with one party, often totally unconnected to the securities market, the implicit victim of such trading is the counterparty or

the investors in general. This aspect introduces an irreconcilable contradiction in these duty-based theories. The special relationship theory and both versions of the misappropriation theory suffer from this flaw. For example, under *O'Hagan* misappropriation, the disclosure by the trader *to the source of information* of her intent to trade on such information legitimizes such trading. It is unclear how such disclosure eliminates the supposed unfairness to the counterparty or the investors. In the case of these theories, the deceived party and the harmed party are two distinct, unconnected entities. These theories also entail that there is nothing special about *information* and the reach of these theories should extend even where a person misuses or misappropriates any resource for securities trading. Thus, these theories do not strictly support an insider trading prohibition regime *per se.*

In *Dirks*, the Supreme Court fashioned the "personal benefit" test to distinguish between the disclosure of information for a legitimate corporate purpose from illegal tipping. The jurisprudence on this has had a tortuous journey, in the process leaving several open issues.

Finally, the recent Second Circuit decision regarding Title 18 insider trading prosecution seems to have undercut the very foundation of the duty-based insider trading prohibition jurisprudence in the U.S. by treating the "personal benefit" test as a mere technical requirement.

Therefore, we conclude that the insider trading prohibition theories evolved by the U.S. courts leave open a number of issues – in terms of their internal coherence, as well as their alignment with the mandate of securities law. Since the recent legislative initiatives seek to codify the existing law, or build upon that, these are unlikely to resolve such issues.

Of course, apart from the judge-made theories discussed in this article, legal scholars have proposed several theories to serve as the foundation of the insider trading prohibition. In a subsequent article, we intend to take up an assessment of those.