CONCEPTS AND INSIGHTS SERIES

Insider Trading Law and Policy

Stephen M. Bainbridge

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INSIDER TRADING LAW AND POLICY

by

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As always, for Helen

PREFACE

Insider trading likely is one of the most common forms of securities fraud, yet it remains one of the most controversial aspects of securities regulation among legal (and economic) scholars. This text provides a comprehensive overview of both the law of insider trading and the contested economic analysis thereof. It adopts a historical approach to the doctrinal aspects of insider trading, beginning with turn of the 20th Century state common law, and tracing the prohibition's evolution up to the most recent U.S. Supreme Court decisions under Rule 10b–5. The text then reviews the debate between those scholars favoring deregulation of insider trading, allowing corporations to set their own insider trading policies by contract, and those who contends that the property right to inside information should be assigned to the corporation without the right of contractual reassignment.

In preparing this text, I sought to produce a readable text, with a style I hope is simple, direct, and reader-friendly. Even when dealing with complicated economic or financial issues, I tried to make them readily accessible to legal audiences. Hence, this text is neither an encyclopedia nor a traditional hornbook. You will find no stultifying discussions of minutiae (I hope) or lengthy string citations of decades-old cases (or, at least, not very many). My goal is to hit the highpoints—the topics most likely to be covered in a law school course.

Stephen M. Bainbridge

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ABOUT THE AUTHOR

Stephen Bainbridge is the William D. Warren Distinguished Professor of Law at UCLA School of Law, where he currently teaches Business Associations, Advanced Corporation Law and a seminar on corporate governance. In past years, he has also taught Corporate Finance, Securities Regulation, Mergers and Acquisitions, and Unincorporated Business Associations. Professor Bainbridge previously taught at the University of Illinois Law School (1988–1996). He has also taught at Harvard Law School as the Joseph Flom Visiting Professor of Law and Business (2000–2001), at La Trobe University in Melbourne (2005 and 2007) and at Aoyama Gakuin University in Tokyo (1999).

Professor Bainbridge is a prolific scholar, whose work covers a variety of subjects, but with a strong emphasis on the law and economics of public corporations. He has written over 75 law review articles which have appeared in such leading journals as the Harvard Law Review, Virginia Law Review, Northwestern University Law Review, Cornell Law Review, Stanford Law Review and Vanderbilt Law Review. Bainbridge's most recent books include: Corporate Governance After the Financial Crisis (2012); Business Associations: Cases and Materials on Agency, Partnerships, and Corporations (8th ed. 2012) (with Klein and Ramseyer); Agency, Partnerships, and Limited Liability Entities: Cases and Materials on Unincorporated Business Associations (3d ed. 2012) (with Klein and Ramseyer); Mergers and Acquisitions (3d ed. 2012); The New Corporate Governance in Theory and Practice (2008).

In 2008, Bainbridge received the UCLA School of Law's Rutter Award for Excellence in Teaching. In 1990, the graduating class of the University of Illinois College of Law voted him "Professor of the Year."

In 2008, 2011, and 2012, Professor Bainbridge was named by the National Association of Corporate Directors' Directorship magazine to its list of the 100 most influential people in the field of corporate governance.

INSIDER TRADING LAW AND POLICY

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Chapter 1

INTRODUCTION

The term insider trading is something of a misnomer. It conjures up images of corporate directors or officers using secret information to buy stock from (or sell it to) unsuspecting investors. To be sure, the modern federal insider trading prohibition proscribes a corporation's officers and directors from trading on the basis of material nonpublic information about their firm, but it also casts a far broader net. Consider the following people who have been convicted of illegal insider trading over the years:

- A partner in a law firm representing the acquiring company in a hostile takeover bid who traded in target company stock.
- A Wall Street Journal columnist who traded prior to publication of his column in the stock of companies he wrote about.
- A psychiatrist who traded on the basis of information learned from a patient.
- A financial printer who traded in the stock of companies about which he was preparing disclosure documents.

As you can see, the insider trading laws thus capture a wide range of individuals who trade in a corporation's stock on the basis of material information unknown by the investing public at large.

Insider trading is covered by a number of legal regimes, of which no less than 5 are important for our purposes:

- The disclose or abstain rule under § 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Securities and Exchange Commission (SEC) Rule 10b–5 thereunder is principally concerned with classic insiders such as corporate officers and directors.[1] It provides that § 10(b)

[1] The Securities and Exchange Commission (Commission or SEC) is an independent agency created by Congress in the Exchange Act to enforce the various federal securities laws. Congress gave the SEC power to supplement the securities statutes with various rules and regulations, among which are rules 10b–5 and 14e–3 governing insider trading. Congress also gave the SEC power to investigate alleged violations of the securities laws and to bring civil actions against suspected violators. The SEC's Division of Enforcement handles most insider trading actions, which is the litigation arm of the SEC. See generally Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance (2d ed. 2003) (describing organization of the SEC and its functions). The SEC may only bring civil actions, but if "the SEC suspects someone of criminal violations . . . it has discretion to prepare a formal referral to the Department of Justice," which "has sole jurisdiction to institute criminal proceedings under the Exchange Act." Brian J. Carr, Note, Culpable Intent Required for All

and Rule 10b–5 are violated when a corporate insider trades the corporation's stock on the basis of material nonpublic information with shareholders of the corporation without disclosing such information prior to the transaction.

- The misappropriation theory under § 10(b) and Rule 10b–5 deals mainly with persons outside the company in whose stock they traded. It provides that § 10(b) and Rule 10b–5 are violated when a corporate outsider trades in breach of a duty to disclose owed not to the persons with whom the outsider trades, but rather to the source of the information.
- SEC Rule 14e–3 under Exchange Act § 14(e) is limited to insider trading in connection with a tender offer. It prohibits specified insiders and other affiliates of both the bidder and the target from divulging confidential information about a tender offer. It also, subject to narrow exceptions set forth in the Rule, prohibits any person who possesses material information relating to a tender offer by another person from trading in the target company's stock once the bidder has commenced a tender offer or has taken substantial steps towards commencement of the offer.
- Section 16(b) of the Exchange Act prohibits corporate directors, officers, and shareholders owning more than 10% of the firm's stock from earning "short swing profits" by buying and selling stock in a six month period.
- State corporate law principally targets corporate officers and directors who buy stock from shareholders of their company in face-to-face transactions.

All five regulatory schemes are discussed in the chapters that follow, but our attention will focus mainly on the federal prohibition under SEC Rule 10b–5.

At the beginning of the 1900s, state corporate law was the only legal regime regulating insider trading. At that time, as is still true in some states, corporate law allowed insider trading. Federal securities law, especially Rule 10b–5, however, has largely superseded the state common law of insider trading. To be sure, the state rules are still on the books and are still used in a few cases that fall through the cracks of the federal regulatory scheme, but federal law offers regulators and plaintiffs so many procedural and substantive advantages that it has become the dominant legal regime in this area. The most important feature of federal law,

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Criminal Insider Trading Convictions After United States v. O'Hagan, 40 B.C. L. Rev. 1187, 1191 (1999).

however, may be that it put a cop on the beat. State law relied on firms and shareholders to detect and prosecute insider trading. Under federal law, the SEC and the Justice Department can prosecute inside traders, which has substantially increased the likelihood it will be detected and successfully prosecuted.

A truly significant distinguishing feature of the federal insider trading prohibition has been change. Although the prohibition is only about four decades old, it has seen more shifts in doctrine than most corporate law rules have seen in the last century. Exploring this rich history is a useful exercise—in many respects you cannot understand today's issues without the historical background—but is also is fraught with danger: you must draw clear distinctions between what was the law and what is the law.

One point requiring particular attention is the evolution of new theories on which insider trading liability can be based. We shall see two very important cases in which the Supreme Court restricted the scope of the traditional disclose or abstain rule. In response to those cases, the SEC and the lower courts developed two new theories on which liability could be imposed. As we move through this material, pay close attention to which theory is being discussed at any given moment and consider how that theory differs from the others.

A. A Quick Overview

Under current federal law, there are three basic theories under which trading on inside information becomes unlawful.[2] The disclose or abstain rule and the misappropriation theory were created by the courts under Section 10(b) of the Exchange Act and Rule 10b–5 thereunder. Pursuant to its rule-making authority under Exchange Act Section 14(e), the SEC adopted Rule 14e–3 to proscribe insider trading involving information relating to tender offers.

1. The Disclose or abstain rule

The modern federal insider prohibition began taking form in *SEC v. Texas Gulf Sulphur Co.*[3] The prohibition, as laid out in that opinion, rested on a policy of equality of access to information. Accordingly, under *Texas Gulf Sulphur* and its progeny, virtually anyone who possessed material nonpublic information was required either to disclose it before trading or abstain from trading in the

[2] Although insider trading originally was governed in the United States by state corporate law, and those state laws remain on the books, federal law has long since supplanted state law in this area. See infra Chapter 2. Insider trading may also violate other federal statutes, such as the mail and wire fraud laws, which are beyond the scope of this text.

[3] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

affected company's securities. If the would-be trader's fiduciary duties precluded him from disclosing the information prior to trading, abstention was the only option.

In *Chiarella v. United States*,[4] and *Dirks v. SEC*,[5] the United States Supreme Court rejected the equal access policy. Instead, the Court made clear that liability could be imposed only if the defendant was subject to a duty to disclose prior to trading. Inside traders thus were no longer liable merely because they had more information than other investors in the market place. Instead, a duty to disclose only arose where the inside traders breached a pre-existing fiduciary duty owed to the person with whom they traded.[6]

Creation of this fiduciary duty element substantially narrowed the scope of the disclose or abstain rule. But the rule remains quite expansive in a number of respects. In particular, it is not limited to true insiders, such as officers, directors, and controlling shareholders, but picks up corporate outsiders in two important ways. Even in these situations, however, liability for insider trading under the disclose or abstain rule can only be found where the trader—insider or outsider—violates a fiduciary duty owed to the issuer or the person on the other side of the transaction.

The rule can pick up a wide variety of nominal outsiders whose relationship with the issuer is sufficiently close to the issuer of the affected securities to justify treating them as "constructive insiders," for example, but only in rather narrow circumstances. The outsider must obtain material nonpublic information from the issuer. The issuer must expect the outsider to keep the disclosed information confidential. Finally, the relationship must at least imply such a duty. If these conditions are met, the putative outsider will be deemed a "constructive insider" and subject to the disclose or abstain rule in full measure.[7] If these conditions are not met, however, the disclose or abstain rule simply does not apply. The critical issue thus remains the nature of the relationship between the parties.

The rule also picks up outsiders who receive inside information from either true insiders or constructive insiders. There are a number of restrictions on tippee liability, however. Most important for present purposes, the tippee's liability is derivative of the tipper's, "arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."[8] As a result, the mere fact of a

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[4] 445 U.S. 222 (1980).

[5] 463 U.S. 646 (1983).

[6] *Chiarella*, 445 U.S. at 232; *Dirks*, 463 U.S. at 653–55.

[7] See *Dirks*, 463 U.S. at 655 n.14.

[8] Id. at 659.

tip is not sufficient to result in liability. What is proscribed is not merely a breach of confidentiality by the insider, but rather a breach of the duty of loyalty imposed on all fiduciaries to avoid personally profiting from information entrusted to them.[9] Thus, looking at objective criteria, the courts must determine whether the insider personally will benefit, directly or indirectly, from his disclosure. So once again, a breach of fiduciary duty is essential for liability to be imposed: a tippee can be held liable only when the tipper has breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.

Chiarella created a variety of significant gaps in the insider trading prohibition's coverage. Rule 14e–3 and the misappropriation theory were created to fill some of those gaps.

2. Rule 14e–3

Rule 14e–3 prohibits insiders of the bidder and target from divulging confidential information about a tender offer to persons who are likely to violate the rule by trading on the basis of that information. The rule also, with certain narrow and well-defined exceptions, prohibits any person who possesses material information relating to a tender offer by another person from trading in target company securities if the bidder has commenced or has taken substantial steps towards commencement of the bid.

Note that the Rule's scope is very limited. One prong of the Rule (the prohibition on trading while in possession of material nonpublic information) is not triggered until the offeror has taken substantial steps towards making the offer. More important, both prongs of the rule are limited to information relating to a tender offer. As a result, most types of inside information remain subject to the duty-based analysis of Chiarella and its progeny.

3. Misappropriation

Like the traditional disclose or abstain rule, the misappropriation theory requires a breach of fiduciary duty before trading on inside information becomes unlawful. It is not unlawful, for example, for an outsider to trade on the basis of inadvertently overheard information.[10] The fiduciary relationship in question, however, is a quite different one. Under the misappropriation theory, the defendant need not owe a fiduciary duty to the investor with whom he trades. Nor does he have to owe a fiduciary duty to the issuer of the securities that were traded. Instead, the

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[9] See id. at 662–64.

[10] SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984).

misappropriation theory applies when the inside trader violates a fiduciary duty owed to the source of the information. The Supreme Court validated the misappropriation theory in *U.S. v. O'Hagan*.[11]

B. The Policy Debate

Insider trading is one of the most common violations of the federal securities laws. It is certainly the violation that has most clearly captured the public's imagination. Indeed, what other corporate or securities law doctrine provided the plot line of a major motion picture, as insider trading did in Oliver Stone's Wall Street (1987)? Yet, insider trading also remains one of the most controversial aspects of securities law. Courts and regulators typically justify the prohibition on fairness or other equity grounds. Is insider trading clearly unfair, however? People who trade with an insider who has access to nonpublic information probably feel they were cheated. According to one poll, however, well over half of all Americans would trade on inside information if given the chance. Whether insider trading is unfair thus depends on the eye of the beholder.

Many leading corporate law scholars contend that the legality of insider trading should turn not on fairness considerations, but rather on issues of economic efficiency. Some of these commentators believe that the prohibition cannot be justified on efficiency grounds, while others have offered various economic justifications for the prohibition.

Although virtually no one seriously believes that the federal insider trading prohibition is likely to be repealed any time soon, the academic policy debate nevertheless rewards study. Understanding the policy issues at stake can help inform the way in which unresolved aspects of the prohibition are settled. For law students, a review of the policy debate also has considerable instrumental value. The insider trading debate cannot be understood without considering the so-called "law and economics" school of jurisprudence. Many corporate law teachers are practitioners of law and economics, while even those who are not often feel compelled to introduce their students to this mode of legal reasoning. Insider trading is one of the widely-used vehicles for introducing law and economics to corporate law students. Accordingly, we shall devote some attention to developing the economic tools necessary to understanding the debate, as well as the policy debate itself.

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[11] 521 U.S. 642 (1997).