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Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies

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Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies

Law Working Paper N°. 204/2013
March 2013

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Abstract

The current law on insider trading is arbitrary and unrationalized in its limited scope in a number of respects. For example, if a thief breaks into your office, opens your files, learns material, nonpublic information, and trades on that information, he has not breached a fiduciary duty and is presumably exempt from insider trading liability. But drawing a line that can convict only the fiduciary and not the thief seems morally incoherent. Nor is it doctrinally necessary.

The basic methodology handed down by the Supreme Court in SEC v. Dirks and United States v. O'Hagan dictates (i) that a violation of the insider trading prohibition requires conduct that is 'deceptive' (the term used in Section 10(b) of the Securities Exchange Act of 1934), and (ii) that trading that amounts to an undisclosed breach of a fiduciary duty is 'deceptive.' This formula illustrates, but does not exhaust, the types of duties whose undisclosed breach might also be deemed deceptive and in violation of Rule 10b-5. Many forms of theft or misappropriation of confidential business information could be deemed sufficiently deceptive to violate Rule 10b-5. More generally (and more controversially), the common law on finders of lost property might be used to justify a duty barring recipients from trading on information that has been inadvertently released or released to them without lawful authorization. Still, current law has stopped short of generally prohibiting the computer hacker and other misappropriators who make no false representation.

This article surveys possible means by which to rationalize current law and submits that the SEC can and should expand the boundaries of insider trading by promulgating administrative rules paralleling and extending the rules it issued in 2000 (namely, Rules 10b5-1 and 10b5-2). Specific examples are suggested.

At the same time, this article acknowledges that the goal of reform should not be to achieve parity of information and that there are costs in attempting to extend the boundaries of insider trading to reach all instances of inadvertent release. Deception, it argues, should be the key, both for doctrinal and policy reasons.

Keywords: Insider trading, deception, deceptive device, Section 10(b), Rule 10b-5, agent, fiduciary

JEL Classifications: A13, D63, D73, G18, H39, K42

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Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies

by John C. Coffee, Jr.*

Introduction

Inherently, the common law is path dependent. As a result, as the twig is bent, so grows the tree. Once a legal doctrine has developed beyond its infancy, its future trajectory is largely confined within boundaries established by the limited plasticity of common law concepts. Gaps may be filled in; some critical terms may be marginally reinterpreted; but radical change is unlikely. In this light, both because the law of insider trading is largely judge made,[1] and because it is well past its early formative period,[2] it seems particularly subject to these constraints.[3]

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[1] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (aptly describing Rule 10b-5 as "a judicial oak which has grown from little more than a legislative acorn"). However, Rule 10b-5 has also grown through administrative rulemaking as well, and this article will suggest that the most sensible way to fill in gaps in the law is through SEC rule-making. Rules 10b5-1 and 10b5-2 are the leading examples of such administrative gap filling, and they define important fact patterns that today fall within Rule 10b-5 (but did not always). *See* 17 C.F.R. § 240.10b5-1 (2013); 17 C.F.R. § 240.10b5-2 (2013). Both rules were clearly intended to reverse judicial decisions that had construed Rule 10b-5 narrowly. *Compare* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc) (deeming relationship of husband and wife not to be a fiduciary relationship), *with* Rule 10b5-2(b)(3), § 240.10b5-2(b)(3) (declaring spouses to owe a "duty of trust or confidence" to each other the breach of which can violate Rule 10b-5).

[2] More than fifty years have passed since the SEC's decision in *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), in which then SEC Chair William Cary first provided a substantive definition to the insider trading prohibition, formulating the "disclose or abstain" standard for insiders.

[3] In both *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 165 (2008) and *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011), the Court emphasized in decisions construing Rule 10b-5 (which is the source of authority for the insider trading prohibition) that "[c]oncerns with the judicial creation of a private cause of action

That said, common law concepts are nonetheless malleable and have the potential for expansion. In the case of insider trading law, duties can be derived from the common law that would trigger an obligation to disclose or abstain from trading, but no article has yet seriously explored these possibilities. This introduction will survey some of these possibilities, but its goal is not to urge the maximum expansion of the insider trading prohibition. Rather, it seeks to evaluate the tools at hand.

At the outset, it must also be recognized that the scope of the insider trading prohibition has recently expanded, as the result of decisions that appear to relax older doctrinal constraints. In net effect, these liberalizing decisions have shifted the balance of advantage in securities enforcement litigation in favor of the Government. This expansion in the law has largely occurred along two distinct axes: (1) additional duties have been recognized whose breach violates Rule 10b-5;[4] and (2) deception not involving a breach of duty has also been found to violate Rule 10b-5.[5]

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caution against its expansion." In short, judge made law must be construed to give it "narrow dimensions." *Stoneridge*, 552 U.S. at 167. Still, if the Court's concern is with the problems it perceives with private causes of action, expanding the insider trading prohibition, itself, should not heighten this concern, because insider trading is seldom enforced through private litigation, but instead through criminal and SEC enforcement.

[4] A leading example is *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), which accepted in principle that a legal duty can arise by contract whose breach would violate Rule 10b-5. Defendant had claimed that only fiduciary breaches recognized under state law could support a violation of Rule 10b-5. Conservative law professors have long argued the thesis that only such a state law-grounded violation could support a Rule 10b-5 violation. *See* Stephen A. Bainbridge, *Incorporating State Law Fiduciary Duties Into The Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1267 n.320 (1995). But Rule 10b5-2 today recognizes that a "duty of trust or confidence" can be grounded on a contract or an agreement "to maintain information in confidence." *See* Rule 10b5-2(b)(1), § 240.10b5-2(b)(1). Decisions to date have largely upheld the rule. *See* SEC v. Yun, 327 F.3d 1263, 1273 (11th Cir. 2003) (recognizing that "a breach of an agreement to maintain business confidences would also suffice" to support insider trading liability); SEC v. Lyon, 529 F. Supp. 2d 444, 452–53 (S.D.N.Y. 2008). However, in *SEC v. Cuban*, 634 F. Supp. 2d at 729–731, the Court drew a tortured distinction between agreeing to

The specifics of these decisions are carefully analyzed by Professor Donald Langevoort and Stephen Crimmins in their excellent contributions to this symposium, but this article will use this recent expansion as a jumping-off point to ask: How much more doctrinal evolution is possible, without legislation, in the foreseeable future? More specifically, how could the law evolve over the next decade? Is it possible that the law could expand to the point that anyone who acquires and trades on material nonpublic information would violate Rule 10b-5?

This article has both descriptive and normative intentions. Initially, it will first map the gaps in existing insider trading law; then, it will consider how far the law could be expanded, without legislation, through administrative rulemaking. Its model for reform is the SEC's successful effort in 2000 to extend the boundaries of Rule 10b-5 through the promulgation of Rules 10b5-1 and 10b5-2.[6] Motivating this inquiry is a premise that needs to be explicitly stated at the outset: the current reach of the insider trading prohibition is both arbitrary and incomplete. Egregious cases of informational

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maintain confidentiality and agreeing not to trade. In its view, Rule 10b5-2(b)(1) improperly "attempts to predicate misappropriation theory on a mere confidentiality agreement lacking a non-use component." *Id*. at 730–731. This distinction between agreeing to maintain confidentiality and agreeing not to trade was, however, viewed skeptically by the Fifth Circuit, which reversed and remanded. *See* SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010). In *United States v. Whitman*, No. 12-CR-125, 2012 U.S. Dist. LEXIS 163138, at *14–*16 (S.D.N.Y. Nov. 14, 2012), the district court went well beyond *Cuban* and held that Rule 10b-5 is not grounded on state law theories of fiduciary duty, but rather on federal common law. To the extent that federal law controls, SEC rules could do much more to generalize or expand the scope of the insider trading prohibition.

[5] *See* SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (discussed *infra* at notes 7, 27–28, and 50–59 and accompanying text).

[6] These rules were adopted in 2000 along with Regulation FD, which selectively bars selective disclosure. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 7881, 73 S.E.C. Docket 3 (Aug. 15, 2000), *available at* http://www.sec.gov/rules/final/33-7881.htm.

misuse are not covered, while less culpable instances of abuse are criminalized. For the long-term, the scope of the insider trading prohibition needs to be better rationalized.

To understand this contention, it is useful to begin our mapping of the current outer boundaries on insider trading law with three recent decisions. First, in *SEC v. Dorozhko*,[7] the Second Circuit opened the door to the prosecution of persons who trade on material nonpublic information, even when they do not breach a fiduciary (or similar confidential) relationship, at least so long as they obtain the material nonpublic information through "deception." Immediately, questions arise as to how far this minimal requirement of deception can be stretched. Could even overhearing an extended conversation (say, in an elevator ride or in a bar) be deemed deceptive if the others have incorrectly assumed that the defendant is part of their group and the defendant omits to disclose the truth?

Second, in *SEC v. Obus*,[8] the Second Circuit appears to have relaxed the former requirement that tipper and tippee must be part of a de facto conspiracy in which the tipper was deliberately providing the material information to benefit the tippee (either (1) in return for an economic benefit conferred by the tippee on the tipper, or (2) as a gift by

[7] *Dorozhko*, 574 F.3d 42. In *Dorozhko*, the defendant appears to have hacked into a secure server at Thomson Financial Inc. to gain access to the soon-to-be released, but still confidential, third quarter earnings of IMS Health, Inc. (which had hired Thomson Financial "to provide investor relations and web-hosting services" for it). *Id*. at 44. Learning that the third quarter results were highly unfavorable for IMS, the defendant then purchased "put" options on IMS that would very shortly expire, thus implying that the options would soon be worthless if IMS's stock price did not fall quickly. On these facts, the defendant had no connection to IMS or Thomson Financial and clearly owed no fiduciary duty to either. Nonetheless, the Second Circuit panel found that to the extent the defendant had "deceptively" gained access to material, nonpublic information, he had violated Rule 10b-5. It remanded to the district court to determine whether the computer hacking on its actual facts had "involved a fraudulent misrepresentation that was 'deceptive' within the ordinary meaning of Section 10(b)." *Id*. at 51.
[8] SEC v. Obus, 693 F.3d 276 (2d Cir. 2012).

the tipper to the tippee).[9] Today, under *Obus*, it may be possible for the tippee to "recklessly" violate Rule 10b-5, even without paying any benefit to the tipper, at least if the tippee has "reason to know" that the tipper breached its duty in communicating the information.[10] Again, countless variations on this fact pattern can be proposed: for example, suppose that one member of a live-in couple tells the other what he or she is working on around the clock at the office and thereby divulges material nonpublic information, because he or she is under stress and wants sympathy. At the bottom of this slippery slope lies the simply negligent leakage of information: i.e., the loose-lipped law firm associate in the crowded elevator who carelessly divulges the name of the target company. The concept of deception cannot be reasonably stretched to reach all these possible cases of unintentional tipping, but prosecutors and regulators are motivated to strain to find deception because, under existing law, the liability of the tippee is

[9] These are the standards specified in *Dirks v. SEC*, which said that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders." 463 U.S. 646, 662 (1983). The Court further recognized that a fiduciary breach occurred "when an insider makes a gift of confidential information to a trading relative or friend." *Id*. at 664.

[10] In *Obus*, the Second Circuit summarized the law on tippee liability under Rule 10b-5, as follows:

> "Tippee liability requires that (1) the tipper breached a duty by tipping confidential information; (2) the tippee knew or had reason to know that the tipper improperly obtained the information (i.e., that the information was obtained through the tipper's breach); and (3) the tippee, while in knowing possession of the material, nonpublic information, used the information by trading or by tipping for his own benefit."

693 F.3d at 289.

Nothing is said in this passage that requires that the tippee pay a benefit to the tipper, even though the Court in the same paragraph required that such a benefit be paid to the tipper to establish tipper liability. Seemingly, a distinction has been drawn here between tipper and tippee liability. There may well be policy justifications for such a distinction, but the decision is silent on this point and does not express them.

derivative of the liability of the tipper. Under *Dirks*, unless the tipper has breached some duty, the tippee who profits cannot be held to account.[11]

Finally, several decisions have recognized that state law definitions of fiduciary duty do no control or exhaust the field. Most notably, in *SEC v. Cuban*,[12] the court recognized that a duty to keep information confidential can arise either by contract or based on other relationships that do not give rise to traditional fiduciary duties. In its view, a breach of a contractual duty provides an even "stronger footing for imposing liability for deceptive conduct than does the existence of a fiduciary or similar relationship of confidence."[13]

Once we move beyond state law-defined fiduciary duties as the exclusive source of duties that can trigger a Rule 10b-5 violation, then the next question becomes: How many other duties can similarly be postulated whose breach should violate Rule 10b-5? This introduction will survey several potential such duties, in part because their discovery could simplify insider trading enforcement and in part because their recognition would make the insider trading prohibition more consistent and equitable. But the recognition of these additional duties also exposes those who have legitimately gained informational

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[11] *See Dirks*, 463 U.S. at 659. ("Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty").

[12] *Cuban*, 634 F. Supp. 2d 713, 729–731 (N.D. Texas 2009), *rev'd on other grounds*, 620 F.3d 551 (5th Cir. 2010). *Cuban* was, of course, analyzing SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2013), which defendant had challenged as beyond the scope of the SEC's authority. For an equally important, if less noticed, decision, *see* United States v. Whitman, No. 12-CR-125, 2012 U.S. Dist. LEXIS 163138, at *14–*16 (S.D.N.Y. Nov. 14, 2012) (finding federal law to control the issue of who qualifies as a fiduciary for purposes of insider trading liability). *See also infra* note 64.

[13] *Cuban*, 634 F. Supp. 2d at 725 (explaining that a contract can capture the defendant's "obligation with greater acuity than does a duty that flows more generally from the nature of the parties' relationship.")..

advantages to potential prosecution and may create a trap for the unwary with very uncertain boundaries. Balancing the costs and benefits of any extension is therefore essential. Accordingly, the aim of this overview is more to map the possibilities than to argue for any definitive position. Part I will begin by seeking to identify where the major gaps exist in contemporary law. Part II will then turn to conceivable doctrinal answers that could be used to plug these gaps and will consider possible SEC rules to implement such duties. Finally, Part III will conclude with an evaluation of these possibilities.

Part I: Gaps in the Law

Twenty years ago, in *Dirks v. SEC*,[14] the Supreme Court grafted a "breach of duty" precondition onto insider trading law. Essentially, the Court ruled that it was the breach of a fiduciary or similar duty that made the use of an informational advantage deceptive and thus within the scope of Rule 10b-5's prohibition. Doctrinally, this step was necessary because Rule 10b-5 necessarily rests on Section 10(b) of the Securities Exchange Act, which grants authority to the SEC to adopt rules proscribing the use of "any manipulative or deceptive device or contrivance."[15] Deception thus becomes an indispensable element.[16] Although *Dirks* clearly establishes that the failure to disclose a breach of fiduciary duty before trading is deceptive, it does not hold that this one example

[14] 463 U.S. at 647–648.
[15] 15 U.S.C.A. § 78j(b) (West 2012).
[16] In principle, the Government could alternatively seek to prove a Rule 10b-5 violation by showing that conduct was "manipulative." But "manipulation" and "manipulative" are terms of art that the Supreme Court has long narrowly construed to exclusively cover practices "intended to mislead investors by artificially affecting market activity." Santa Fe Indus. v. Green, 430 U.S. 462, 476 (1977). Hence, neither "contrivance" nor "manipulative" in Section 10(b) add much, if anything, to its coverage.

of deception exhausts the field. Other forms of deception that do not involve a fiduciary breach remain possible.

In all likelihood, *Dirks* was a product both of its time and a post-Watergate zeitgeist. The defendant analyst (Ray Dirks), who received material information from an insider at Equity Funding, seemed more a hero than a villain to most observers, but not to the tone deaf SEC (which may have been embarrassed by the fact that Ray Dirks, and not it, had uncovered the epic fraud at Equity Funding). The Court in *Dirks* elaborately strove to find ways to protect the securities analyst from potential prosecution any time it passed on information to institutional clients. Motivating this desire was probably the sense that only with such insulation could securities analysts uncover and expose dangerous frauds, which seemed to elude bureaucratic, slower-moving regulators.[17]

The *Dirks* decision also resonated with the dominant post-Watergate sensibility of its era. The defendant securities analyst had played a socially desirable role that was functionally equivalent to the role of the Washington Post journalists (Woodward and Bernstein) who had uncovered Watergate years earlier. Because the SEC's broad theory of liability would have chilled analysts' incentive to investigate, the Court seemed motivated to resist the SEC's theory. Today, securities analysts less often resemble heroes and often look more like highly conflicted gatekeepers, particularly after the burst of the IPO Bubble in 2000 and the resulting Global Settlement in 2003. That settlement, engineered by then New York Attorney General Eliot Spitzer with the major investment banks, reflected a consensus that securities analysts were involved in marketing activities

[17] *Dirks* tends to glorify the role of the securities analyst, defining that role as "to 'ferret out and analyze information'" and describing such a role as "necessary to the preservation of a healthy market." 463 U.S. at 658.

for their investment bank employers that left them highly conflicted.[18] If *Dirks* had instead been decided today, analysts might have received a considerably less deferential treatment from the Court.

Because law is path dependant, *Dirks* will continue to shape the development of contemporary law. But, after *Dorozhko*, alternative forms of deception may be accepted as a substitute for the fiduciary breach that *Dirks* placed at stage center. How far can these substitute theories be stretched? To answer, it is useful to survey the most obvious categories of misconduct that seem today to fall outside the scope of the existing insider trading prohibition, as defined by *Dirks* and *O'Hagan*. These include:

A. Careless Tipper/Corrupt Tippee

In *SEC v. Yun*,[19] a senior corporate officer and his wife were in the process of divorce. She called her divorce attorney from her office at a real estate brokerage firm to pass on facts that she had just learned from her husband, indicating that stock and options he owned in his employer were about to decline in value. The purpose of the call was to adjust the valuation of his assets for the purpose of the divorce settlement. The negative news that she disclosed was overheard by another real estate broker in the office, who quickly sold the company's stock short and profited. The SEC sued the non-trading wife, as well as her co-worker, probably because it realized it needed to show a breach by the tipper to hold the tippee liable. Thus, the SEC alleged that the wife had "recklessly"

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[18] For a brief description of this settlement, which also involved the NASD, the NYSE and most state securities commissioners, *see* JOHN C. COFFEE, JR. AND HILLARY A. SALE, SECURITIES REGULATION: CASES AND MATERIALS (12th ed. 2012) at 111–112. Several FINRA rules were also adopted to curb analyst conflicts by precluding analysts from participating in certain marketing activities, but some of these rules have been subsequently preempted by the JOBS Act. *Id.* at 112.

[19] SEC v. Yun, 327 F.3d 1263, (11th Cir. 2003).

tipped her co-worker. In all likelihood, the SEC believed that the wife had tipped her colleague knowingly and deliberately as part of a longstanding pattern of sharing real estate commissions, but it was uncertain that it had sufficient evidence to prove this contention. Although the district court accepted the SEC's theory of "reckless" tipping, the Eleventh Circuit reversed, finding that the "recklessness" charge unfairly prejudiced the defendant and that such conduct by the tipper, when unmotivated by any expected benefit from the tippee, was beyond the scope of Rule 10b-5.

Although the SEC lost Round One in *Yun*, it may have scored a comeback victory more recently in *Obus*.[20] There, an employee of GE Capital, which was considering financing an acquisition of a target company, called a college friend who worked at a hedge fund that owned a large stake in that target company. Apparently as the result of this conversation, the hedge fund increased its stake in the target. The defendant GE employee attempted to justify this contact as a means of gaining information about the target for his employer. No evidence suggested that the defendant GE employee expected or received any personal benefit from tipping his college friend (although it is arguable that their college friendship might have inclined the GE employee to make a gift to his friend).

Sidestepping these factual issues, the Second Circuit found that the defendant GE employee could be liable as a tipper if he acted "recklessly" in communicating the information to his college friend in violation of GE's policies. The Second Circuit panel gave a "hypothetical" example of a person on a train who knowingly discusses material,

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[20] 693 F.3d 276.

nonpublic information in the presence of a friend who he expects will trade on it.[21] Although it seems doubtful that the facts in *Obus* would suffice to show a "willful" violation (as is required in the Second Circuit in the case of a criminal prosecution[22]), the bottom line seems to be that the SEC, at least in the Second Circuit, can go forward by alleging that a friend "recklessly" enabled another friend to trade. Although the cases are thus divided, the "gift" or economic benefit requirement in *Dirks* seems to have become attenuated.[23]

At least for the present, *Obus* seems limited to the context of communications among friends. It would seemingly *not* apply to the garrulous associate who discusses material nonpublic information in the elevator (unless possibly if the elevator was filled with his friends). Closer cases can, however, be imagined. For example, how should the law treat the more opportunistic conduct of the bartender in a Wall Street club who carefully listens to the conversation of two increasingly tipsy investment bankers? No intention to make a gift is apparent here, nor is there any clear breach of fiduciary duty, as presumably the club lacks policies regarding information that its employees learn from customers. Finally, it is unlikely that the relationship between the bartender and his customers would rise to the level that it could be said that the parties had "a history,

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[21] *Id.* at 287.

[22] Section 32(a) of the Securities Exchange Act criminalizes "willful" violations of the rules or regulations adopted under that Act (including Rule 10b-5). *See* 15 U.S.C.A. § 78ff(a) (West 2012). Courts in the Second Circuit have interpreted this language to require "specific intent to defraud." *See* United States v. Cassese, 428 F.3d 92, 98 (2d Cir. 2006); United States v. Whitman, No. 12-CR-125, 2012 U.S. Dist. LEXIS 163138, at *23–*28. (S.D.N.Y. Nov. 14, 2012).

[23] Most of us have college friends that we dearly like, but we would not make multi-million dollar gifts to these persons when such a gift could result in career-ending reputational damage to ourselves or (after *Obus*) criminal liability. Nonetheless, any passage of such information to a friend, after *Obus*, may be viewed by regulators as a "gift" that satisfies the *Dirks* standard.

pattern or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality."[24] If that were the case, then Rule 10b5-2 would prohibit trading on those facts,[25] but most tips among acquaintances will not involve facts satisfying this standard. In short, the bartender today can listen carefully to his tipsy customer and trade.

Consider next one last case where the relationship is even more predatory: assume that a cab driver waits outside the offices of a well known Manhattan law firm late at night, hoping to pick up "M&A" lawyers who then discuss pending transactions on their cell phones on the drive home. Assume further that the cab driver has done this repeatedly and profited handsomely. Still, no fiduciary or other confidential relationship is present here. Nor, at least on these facts, is the cab driver breaching any instructions given, or expectations held, by his own employer. At most, there is a weak agency relationship here between the cab driver and his client that might come under the outer wings of the Restatement of Agency.[26]

Comparatively, the behavior in both the foregoing bartender and taxi driver hypotheticals is more opportunistic and predatory than the case of the loose-lipped associate who is simply overheard in an elevator. Thus, it may then seem arbitrary to draw a line that holds liable the defendant in *Obus* who arguably made a gift (but for no personal benefit) but finds no liability in the cases of more predatory defendants, who

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[24] See Rule 10b5-2(b)(2), 17 C.F.R. § 240, 10b5-2(b)(2) (2013).

[25] *Id.*

[26] *See* RESTATEMENT (SECOND) OF AGENCY, § 388 cmt. C (2012) (discussed *infra* at notes 57–59 and accompanying text).

have stalked and stolen from their "victims," as in the last two examples of the bartender and taxi driver.

B. Non-deceptive "Theft" of Business Information

Dorozhko extends the law of insider trading significantly, but it recognizes that some element of deception must still be present for a defendant to violate Rule 10b-5. Thus, it drew a questionable line between a person who misappropriates material information through an affirmative misrepresentation and one who steals the same information and trades without disclosure. Specifically, it found that a computer hacker who misrepresents his identity to gain access to the information does violate Rule 10b-5, but it also suggested that a hacker who penetrates computer security without a misrepresentation and then fails to disclose that he is trading based on the "possession of nonpublic market information" does not.[27] Understandable as this distinction may have been in light of the existing case law, it is neither morally self-evident nor compelled by the language of Rule 10b-5, as will be later discussed. Sunday school instructors will never teach their pupils that the former hacker has done evil, but the latter hacker who steals without a misrepresentation has not. Only doctrine-obsessed (but morally myopic) lawyers can be satisfied with such a line.

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[27] *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (stating that "[i]t is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft. Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b-5.") (emphasis added). The court then remanded for a determination on this issue. The above quoted language suggests that a "mere theft" without an affirmative misrepresentation is not "deceptive" and thus not within the scope of Section 10(b) or Rule 10b-5. This article suggests that this analysis is too glib, as much theft is deceptive.

To be sure, artful prosecutors can potentially describe much behavior as deceptive. Defendants can be alleged to have "stealthily snuck" into an investment banker's office late at night to read his files, or they can "furtively glance" over another's shoulder on a train to read a memorandum he is studying. It may also be deceptive for a private party to illegally wire tap another's phone or to focus powerful microphones on such a person to overhear conversations. But stealing someone's briefcase at gunpoint still seems robbery, and not fraud. In short, *Dorozhko* can be pushed, but only so far.

C. "Warehousing" and Selective Disclosure.

In *United States v. O'Hagan*,[28] the majority of the Supreme Court postponed for another day whether "warehousing"—"the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced"[29]—violated the federal securities laws. Today, such behavior would clearly violate Rule 14e-3 if a takeover bid is already being structured and is later announced,[30] and it could sometimes violate Regulation FD, which seeks to restrict selective disclosure.[31] Still, Regulation FD has numerous exceptions and applies only to reporting companies.[32] Further, *O'Hagan* expressly states that one may use material nonpublic information obtained as the result of a breach of a fiduciary duty if one first discloses to the source that one is about to breach one's fiduciary duty by

[28] United States v. O'Hagan, 521 U.S. 642 (1997).
[29] *Id.* at 673 n.17 (internal quotation marks omitted).
[30] *See* Rule 14e-3, 17 C.F.R. § 240.14e-3 (2013). Technically, the rule is only applicable if a person has already taken "a substantial step or steps to commence . . . a tender offer." *See id.* § 240.14e-3(a).
[31] *See* Regulation FD, 17 C.F.R. §§ 243.100–.103 (2013).
[32] *See* Rule 101(b), 17 C.F.R. § 243.101(b) (defining "issuer" to include only reporting companies).

trading on that information.[33] The Court's rationale is that an open and disclosed fiduciary breach is not deceptive.

To be sure, there is a distinct possibility in "warehousing" cases that the corporate officer who deliberately tips arbitrageurs is breaching his fiduciary duty to his acquiring corporation. But this is hardly self-evident when the intention behind his tipping is to increase the acquirer's prospects of success. As in *Obus*, much may depend on whether the acquiring corporation has policies that forbid such disclosure, and these policies can be amended to create exceptions when a bidder wishes to engage in such conduct (and can avoid the reach of Rule 14e-3).

In summary, gaps and loopholes exist in current law that permit the misuse of material, nonpublic information and have no strong efficiency justification. The aspirational "abstain or disclose" rule of *Cady Roberts* has not then been fully implemented. To be sure, the overall significance of these gaps can be debated (as, realistically, bartenders and cab drivers do not trade with the same volume or frequency as hedge funds). Nonetheless, given these gaps, the next question becomes: Are there legal theories that could preclude such conduct that are within the potential reach of existing legal doctrine?

Part II. <u>Potential Theories</u>

Herein, we will examine potential theories that could close the foregoing gaps without legislation, but this section does not consider the costs, wisdom, or practicality of such an effort.

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[33] 521 U.S. at 655 ("[I]f the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . . .").

A. Fraud on the Market. One of the curious features of existing insider trading law is that it has largely ignored the "fraud on the market" doctrine and the significance of market efficiency. Again, this seems the product of path dependency. *Dirks* was decided in 1983,[34] five years before the Supreme Court in 1988 accepted the "fraud on the market" doctrine in *Basic Inc. v. Levinson*.[35] In *Dirks*, the Court redefined insider trading liability to rest it on a "property rights" foundation under which the corporation became the victim, injured by the insider leaking information belonging to it.[36] Later, in endorsing misappropriation theory in *United States v. O'Hagan*,[37] the Court simply extended this same theory to the source of the material information, at least when the tippee "feign[ed] fidelity" to that source.[38] In all likelihood, the Court was motivated to adopt this "property rights" interpretation because the corporation seemed a clearer victim than its investors. Particularly when the investors are not already shareholders in the company at the time they purchase, the doctrinal problems are substantial: How are such persons legally injured in the absence of any demonstrated detrimental reliance on their part or any obvious duty owed to them, as non-shareholders? In contrast, when confidential business information is released without the corporation's authorization, the injury to the corporation seems more obvious (and, early on, *Texas Gulf Sulphur* gave a graphic illustration of this problem).[39]

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[34] 463 U.S. 646.
[35] Basic Inc. v. Levinson, 485 U.S. 224 (1988).
[36] *See* Dirks, 463 U.S. 646.
[37] 521 U.S. 642.
[38] *Id.* at 655.
[39] *See* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Texas Gulf Sulphur ("TGS") discovered extraordinary mineral and precious metal deposits in Timmins, Ontario. *Id.* at 843–44. TGS then suspended drilling in part to buy the surrounding land. *Id.* But heavy trading in its

Still, a few years after *Dirks*, in *Basic*, the Court did focus on this issue of individual reliance and decided that there was an injury to the individual investor when material information is concealed or omitted.[40] Misleading statements or omissions do defraud investors, it concluded, "even if the purchasers do not directly rely on the misstatements,"[41] because in essence the investor relies instead on the integrity of the market price.[42] Logically, if this theory works for purposes of a garden-variety securities fraud action, then it should work as well in insider trading cases, which equally rest on Rule 10b-5. Hence, *Basic* provides a plausible basis for viewing the trading counterparty as a victim of insider trading. In both contexts, the investor who buys an overvalued stock is relying on the accuracy of the market price. The defendant in both cases knows the stock is mispriced.

Still, the problem with such a theory is that it may prove too much. Conceivably, it might overbroadly require corporations to inform the market on a daily, or even hourly, basis of all material developments. As *Basic* itself recognized, this would go too far. But *Basic* also solved this problem by further holding that: "Silence, absent a duty to disclose, is not misleading under Rule 10b-5."[43] This rule protects the corporation that remains silent, but not the insider who wishes to trade. Once the issue is framed so that there

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securities by its management drove up its stock price, started rumors of a major discovery, and may have alerted the market to the significance of TGS's ore strike. *Id.* at 851. If this trading made it more costly for TGS to acquire the surrounding land, there is an obvious corporate injury on these facts.

[40] 485 U.S. 224.

[41] *Id.* at 241–42.

[42] *Id.* at 245 (courts may utilize a presumption that persons who trade "had done so in reliance on the integrity of the price set by the market").

[43] *Id.* at 239 n.17.

must be a requisite duty to disclose, the corporate insider is caught because, as an insider, he or she has a fiduciary duty to disclose before trading.

Still, the individuals in our foregoing hypotheticals—the bartender, the cab driver, and the person who overhears material information in the elevator—are not fiduciaries. To find their conduct deceptive, some other undisclosed breach of a duty must be postulated. That is, in the case of a tippee who is not part of a conspiracy with the tipper in which some benefit is exchanged, we must find some other duty that has been breached in order to be able to characterize this tippee's conduct as deceptive and therefore in violation of Rule 10b-5. Some may broadly assert that all tippees have a duty to disclose before trading, but the doctrinal foundation for such a rule seems weak, because such a tippee and its counterparty are legal strangers to each other who trade in anonymous markets. For liability to be imposed on the non-fiduciary, some duty must be postulated that obligates such a tippee to disclose or abstain. But, as next discussed, finding such a separate and distinct duty is not an insurmountable obstacle.

B. The Duty to Hold Lost or Stolen Information in Confidence

As just discussed, it can be argued that other contemporaneous traders do rely on the accuracy of the market price and so those trading on the opposite side are injured when defendants trade knowing that the price is inaccurate. Indeed, *Basic* appears to say exactly this, but it also recognizes that silence should not be actionable unless some specific duty to disclose is triggered.[44] In *O'Hagan*, the tippee "feign[ed] fidelity" to his source to gain the information, and that was held "deceptive."[45]

[44] *See supra* note 40 and accompanying text.
[45] 521 U.S. at 652.

As a result, under the logic of these cases, if a tippee has neither misappropriated the information from the source nor provided some benefit to the tipper (or received a gift from the tipper), then Rule 10b-5 seemingly permits the non-fiduciary tippee to trade. After all, this was exactly the status of Ray Dirks, who neither paid his tipper anything nor "feigned fidelity" to the source of the information. Still, if the tippee both trades <u>and</u> breaches some distinct duty in so doing, nothing in *Dirks* insulates him from liability.

That brings us to the harder part: What is the duty that the tippee might breach when the tippee is not a fiduciary (or the tippee of a fiduciary) but has come into possession of material nonpublic information? Here, the suggested answer is best stated in two parts: First, when the information is stolen (but taken without deception), the law could be viewed as imposing a constructive trust on such stolen property that holds the thief accountable for his ill-gotten profits.[46] Second, even when the information is leaked

[46] As a technical matter, the appropriate remedy may be an equitable accounting, rather than a constructive trust. *See* Newby v. Enron Corp., 188 F. Supp. 2d 684, 706 (S.D. Tex. 2002) (distinguishing remedies); 1 GEORGE E. PALMER, THE LAW OF RESTITUTION § 2.11 (1978) (arguing that a fiduciary is accountable for profits without regard to injury to principal); RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958). Nonetheless, courts often prefer to use the phrase "constructive trust." *See, e.g.*, United States v. Reed, 601 F. Supp. 685, 700 (S.D.N.Y. 1985), *rev'd on other grounds* 773 F.2d 477 (2d Cir. 1985); Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969).

Semantics aside, the law has long recognized that a thief or a knowing receiver of stolen goods is subject to an equitable accounting or constructive trust. *See* Lightfoot v. Davis, 91 N.E. 582 (N.Y. 1910); Fur & Wool Trading Co. v. Fox, 156 N.E. 670 (N.Y. 1927); *see also*, Comment, *The Thief as Constructive Trustee*, 37 YALE L.J. 654 (1928). Also, the common law has traditionally favored the original owner of stolen property even over a "good faith" purchaser from the thief. For a modern such case, see O'Keefe v. Snyder, 416 A.2d 862 (N.J. 1980). In this case, the artist Georgia O'Keefe was held entitled to recover a painting by her that she either lost or had stolen from a good faith purchaser from the intermediate possessor. *Id.* The court noted that if the painting had been stolen, plaintiff O'Keefe would have been entitled to recover if she sued within the statute of limitations. *Id.* at 867. For an overview of these rules on good faith purchasers of stolen property, see Saul Levmore, *Variety and Uniformity in the Treatment of the* inadvertently (as in the overheard conversation in the elevator), the law could treat the recipient of the information as a "finder" who has come into possession of lost property (and therefore has an obligation to act as a bailee to protect this property by not tipping or trading on it).[47]

This latter claim about lost property requires an explanation of complex common law principles that have frankly never been applied to the context of insider trading. At common law (and by statute in many jurisdictions), one who finds lost property (say, a diamond ring left by mistake in a washroom) is typically under a duty to restore it to the true owner.[48] Although this body of law on "finders" and lost property is hyper-technical,[49] the finder is essentially in the position of a bailee of the lost property, accountable to the true owner.[50]

Good Faith Purchaser, 16 J. LEGAL STUD. 43 (1987). This article, however, does not address the "good faith purchaser" but only the tippee who is aware of an unauthorized release. *Id.*

[47] For recent summaries of the law applicable to finders, see Anne M. Payne, *Rights and Obligations of Finders, Owners and Former Owners*, 1 AM. JUR. 2D, ABANDONED, LOST, AND UNCLAIMED PROPERTY § 27 (2013) ("The finder of lost property holds it as a bailee for the true owner; as to all others, the finder's rights are tantamount to ownership . . . ."). *Cf.* Hurley v. City of Niagara Falls, 289 N.Y.S.2d 889 (App. Div. 1968), *aff'd*, 254 N.E.2d 917 (N.Y. 1969). Thus, the thrust of this analogy is to treat the recipients of inadvertent releases of material nonpublic information as bailees.

[48] For example, see, e.g., N.Y. PERS. PROP. LAW §§ 252–54 (McKinney 2013) (requiring a finder to deliver any item of personal property with a value over twenty dollars to the police within ten days and awarding such property to the finder after the expiration of a period ranging from three months to three years, depending on its value).

[49] The law on finders in the United States has been described as "a state-by-state hodgepodge of common law, modern statutes, and haphazard local regulations." *See* Mark D. West, *Losers: Recovering Lost Property in Japan and the United States*, 37 LAW & SOC'Y REV. 369, 396–97 (2003). More than one third of the states have enacted legislation requiring a finder to deliver lost property to public authorities for a prescribed period before the finder can claim ownership. *Id.* at 397. However, these statutes have generally been narrowly construed. *See, e.g.*, Saritejdiam, Inc. v. Excess Ins. Co., 971 F.2d 910 (2d Cir. 1992).

Little of this complexity and confusion in the law of lost property is relevant to this article. Typically, the litigated dispute is between the owner of the location on which the lost property was found and the finder. Their relative rights to the property may turn on whether the property was "lost" or only "mislaid"—a distinction most commentators find hopelessly

The premise here is that a person who overhears material nonpublic information (such as in a public elevator) is functionally equivalent to a "finder" who discovers lost property, at least when the informational recipient knows that the release of the information has not been authorized. Once that condition is satisfied, it follows that the tippee/finder's duty is to hold the information as a bailee and not profit from its conversion.

Viewed intuitively, this asserted duty is probably easiest to accept when the information has been obtained deliberately by someone who is "stalking" the source of the information (as in our earlier cases involving the bartender and the cabdriver). Here, equitable considerations dictate that the law should impose a constructive trust on the "stolen" property to prevent these more predatory actors from realizing an ill-gotten gain. In any event, the relevant point here is that, once a duty to hold lost property for the true owner is recognized, then that duty would functionally play the same role as a fiduciary duty in the *Dirks* case: trading on this information in violation of this duty to return or restore can be viewed as just as "deceptive" as trading in violation of a fiduciary duty in *Dirks*.

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indeterminate. *See* R. H. Helmholz, *Equitable Division and the Law of Finders*, 52 FORDHAM L. REV. 313, 315, 317–21 (1983); Leanna Izuel, *Property Owners' Constructive Possession of Treasure Trove: Rethinking The Finders Keepers Rule*, 38 UCLA L. REV. 1659 (1991); David Riesman, Jr., *Possession and the Law of Finders*, 52 HARV. L. REV. 1105, 1121 (1939). None of this complexity need concern us over the range of cases here considered.

[50] The principle that the original owner has superior title to the finder (who in turn has superior title to all others) dates back nearly three hundred years to Armory v. Delamirie, (1722) 93 Eng. Rep. 664 (K.B.). In that case, a chimney sweep found a jewel, amidst the ashes, while cleaning a chimney. *Id.* The decision held that he was entitled to keep the jewel against all others, except "the rightful owner." *Id.*

To illustrate this, let us return to the case of the person who escapes liability under *Dorozhko* because he is simply a thief who has stolen property (for example, a briefcase containing material, nonpublic information). If this thief were to sell this briefcase and its contents, the common law would likely subject his ill-gotten gains to a constructive or implied trust.[51] Even the good faith purchaser of the property would often have to restore it to the true owner. By analogy, such a trust might also be imposed on the proceeds from the misuse of stolen information.

To be sure, this analogy extends legal principles applicable to tangible personal property to intellectual property, and that is a doctrinal leap. Still, the Supreme Court has not hesitated to say that a corporation is entitled to "exclusive possession" of its confidential business information.[52] The net effect of this doctrinal extension is that a tippee who has not participated in any breach of fiduciary duty, but who has either "stolen" information or simply knowingly received "lost" information, may not trade on it (at least without disclosure to the source). Any undisclosed breach would be deceptive and thus within the scope of Rule 10b-5.

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[51] The law of equity makes some technical distinction between the "conscious wrongdoer" and the "innocent wrongdoer," and the person who trades on information that was not stolen, but whose release was not authorized, may fall into the latter category and be subject therefore to a "resulting trust," not a "constructive trust." *See* Henry Monaghan, *Constructive Trust And Equitable Lien: Status of The Conscious And Innocent Wrongdoer in Equity*, 38 U. DET. L.J. 10 (1960).

[52] *See* Carpenter v. United States, 484 U.S. 19, 26 (1987) (quoting 3 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 857.1, at 260 (rev. ed. 1986) to the effect that "Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy").

Concededly, few courts, if any, would be willing to go this far on their own. But they might be induced to accept and enforce SEC rules articulating such a duty. Such a rule would specify the duty of a tippee who becomes aware of material nonpublic information that such tippee knows was not intended to be (and has not otherwise been) publicly released. A line would necessarily need to be drawn in such a rule between information that was truly "lost" and information that was "abandoned" through reckless mishandling. In my view, the earlier bartender and cab driver hypotheticals would fall on the unlawful side of this line, and such recipients should be barred from trading on such information.

More difficult, to be sure, is the case of merely "lost" information, such as the information overheard in the elevator where the recipient is not stalking the victim. But at common law, even in this case, the superior property right in "lost" property still remains with the owner (i.e., the corporate issuer), unless it "abandoned" the property.

How could such a legal rule be feasibly implemented? Imagine an SEC Rule (let us call it proposed Rule 10b5-3), which might be captioned "Duty Not to Trade on In advertent or Unauthorized Releases of Material Information." It might read:

<u>Proposed Rule 10b5-3</u>

> (a) Whenever a person receives or obtains material nonpublic information from a source that owns or has the right to control the release of such information and such recipient either (a) knows that the release of such information has not been lawfully authorized by the party entitled to possession or control over such information, or (b) is aware of a reasonable possibility that such release was not lawfully authorized, such person may not (i) purchase or sell any security, or any security-based swap agreement, whose value is likely to be affected by such information, or (ii) communicate such information to other

> persons under circumstances which make it reasonably foreseeable that they will trade on such information, until in each case such information has been publicly released.
>
> (b) As used in this rule, a release of information is not 'lawfully authorized,' if, the release is, without limitation, (i) inadvertent or by mistake; (ii) the result of a trick, subterfuge, false representation, or other misappropriation; (iii) intended as a gift, favor or other benefit, either from or to the information recipient; or (iv) for a specific, limited purpose to a customer, supplier, lender, business associate, or agent of any thereof, but was not intended to be generally disseminated.

The foregoing rule is drafted so that it would apply to material information that has been released either as the result of a misappropriation or a mistake; the information could concern either the actual corporate issuer having possession of the information or a third party (such as the target company that the corporate issuer intended to acquire at a premium). The proposed rule would thus bar the "finder" of such information from either trading or tipping others, but only until the information was publicly released. Still, the rule would not bar the recipient from communicating the information to regulators or the press (as in *Dirks*). Also, it would not apply to the person who discovers information through his own research or efforts (where there was neither a misappropriation nor a mistaken release).[53] Finally, the proposed rule should not apply to the person who simply hears a rumor (because such person does not "know," or have reason to believe, that the information's release has not been "lawfully authorized").

[53] Hence, if I wish to observe the size of the crowds at various outlets of a chain or department store to estimate its holiday sales, I may trade on this information. The proposed rule would also not apply if the information is not acquired from a source that has possession or control rights over it. Thus, if I observe a major airline plane crash, even though this information is both material and still nonpublic, I could trade on such information, without violating this proposed rule.

Negligence is insufficient for liability; rather, some awareness is required to establish scienter.

The feasibility of this proposed rule must be considered in light of recent technological innovations, most notably the advent of social media. Would this rule mean that information released in a "tweet" or on Facebook would bar those receiving it from trading? The answer is no, because the term "publicly released" would be broadly interpreted to include the release of information on social media and widely followed websites. Any contrary rule would sweep overbroadly.

Would such a rule be upheld by the courts? Would it sweep too broadly, creating undesirable uncertainty and criminalizing mere negligence? Would its costs outweigh its benefits? These questions will be deferred temporarily.

C. Codifying Dorozhko

Although the Second Circuit said in *Dorozhko* that deception is sufficient without a breach of fiduciary duty, the SEC has not yet spoken to this issue, and the *Dorozhko* decision defined deception narrowly to require a false representation.[54] In principle, if the SEC were to endorse *Dorozhko*, or some variant of it, the SEC's position should merit *Chevron* deference.[55] Moreover, given its expertise, the SEC would be the appropriate body to attempt to define what "deception" might mean in this special context of trading markets. Thus, consider the following proposed rule that the SEC could adopt (let us call this proposed Rule 10b5-4):

[54] *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009); *supra* note 27 and accompanying text.
[55] *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984) (holding that an agency's interpretation of its statute is entitled to deference when not inconsistent with clear Congressional intent).

Proposed Rule 10b5-4

> For the purposes of Section 10(b) of the Securities Act of 1933 and Section 17(a) of the Securities Act of 1933, and the antifraud rules thereunder, the terms 'deceptive,' 'deceit' and 'artifice to defraud' shall be deemed, without limitation, to include the following conduct when done in connection with the purchase or sale of a security or a security-based swap agreement:
>
> (1) misrepresenting one's identity or purpose in obtaining, or attempting to obtain, access to information that the actor is aware is likely to be material and nonpublic;
>
> (2) taking, emailing, reproducing, photocopying, or otherwise misappropriating business records or other confidential information, or disseminating such records or information to persons not authorized to receive such information, through either an affirmative misrepresentation or by means of a covert act or subterfuge, when one knows, or is recklessly indifferent to the prospect, that such records or information are likely to contain material, nonpublic information that the lawful owner of the information has not authorized for contemporaneous public release;
>
> [(3) failing to disclose one's identity, employment, status, conflict of interest, or other relevant information when one knows that such disclosure would likely cause another person not to reveal, or to cease to reveal, information that is material and nonpublic.]

This language deliberately expands *Dorozhko* to the limits of its logic, but it does *not* reach simple negligence. It would cover theft through deception (but not armed robbery), to the extent that the actor knows (or is recklessly aware) that he or she is likely misappropriating material nonpublic information. In its view, the individual who opens another's briefcase or desk drawer to discover confidential information has engaged in a "covert act or subterfuge" that is sufficient to satisfy Rule 10b-5's deception requirement. The third and final bracketed clause reaches the furthest (and may be more vulnerable) in requiring the disclosure of one's identity or conflict when one is hearing an extended conversation, but it would not cover overhearing the ten-second remark in an elevator. It is included mainly for discussion purposes.

In all cases, this proposed rule would be violated only if the defendant trades or causes others to do so on an approximately contemporaneous basis;[56] no violation results from simply misappropriating information unless there is a trade "in connection with such" misappropriation. In overview, this route is probably the simplest, most direct path to the end of reaching cases that do not involve a breach of fiduciary duty, but it depends on *Dorozhko* remaining good law.

In response to this proposal, some may question whether the SEC can effectively rewrite *Dorozhko* and eliminate its seeming requirement of a false representation. One answer, of course, is that this is exactly what the SEC did in adopting Rule 10b5-2, which overrode the Second Circuit's earlier *en banc* holding in *United States v. Chestman*[57] that husbands and wives were not fiduciaries to each other.[58] Today, Rule 10b5-2 expressly provides that they owe each other a duty of trust or confidence.[59] *Chevron* deference enabled the SEC to make new law in defining the scope of fiduciary relationships, and it even more clearly entitles the SEC to define the meaning of "deception" and "deceptive."[60]

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[56] The standards with respect to the "in connection with" requirement are set forth in SEC v. Zandford, 535 U.S. 813 (2002), which held a broker to have violated Rule 10b-5 when the broker stole funds from his client's discretionary trading account. Although the issue in that case was the "in connection with" requirement, the Court had no difficulty in finding theft to violate Rule 10b-5.

[57] 947 F.2d 551 (2d Cir. 1991).

[58] *Id*. at 568–71.

[59] *See* Rule 10b5-2(b)(3), 17 C.F.R. § 240.10b5-2(b)(3) (2013).

[60] Because "deceptive device" is expressly used in Section 10(b) of the Securities Exchange Act, it seems even more within the logical scope of the SEC's *Chevron* authority than does the issue of

Equally important, the *Dorozhko* court appears to construe the term deception overly narrowly. Looking to the definitions of "deception" and "deceive" in Webster's International Dictionary's 1934 edition (the year of passage for the Securities Exchange Act), the panel emphasized that Webster's defined "deceive" to mean "to cause to believe the false, or to disbelieve the true."[61] But, as the panel noted but did not discuss, this same edition of Webster's also defined the term to mean "to impose upon; to deal treacherously with; cheat."[62] Reading another's mail, opening their desk drawers, or hacking their computer (by any means) is cheating and amounts to "treacherous" behavior. Or, at least, the SEC could safely so rule.

D. <u>The Restatement of Agency</u>

Section 388 of the Restatement (Second) of Agency has long stated a broad theory of an agent's duty to protect and keep confidential information that it learns from its principal. Specifically, Comment c to that Section states:

> c. <u>Use of confidential information</u>. An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal.[63]

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which relatives constitute fiduciaries (the issue addressed by Rule 10b5-2). Nor does state law tend to vary on this question of what is "deceptive." Finally, *Dorozhko* does not expressly hold that conduct not involving a false representation is always insufficient to satisfy the "deceptive device" standard, but only suggests that such a line is likely on its facts. *See* 574 F.3d 42.

[61] 574 F.3d at 50. (citing WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934) at 679). The Supreme Court has also looked to the 1934 edition of Webster's to understand the meaning of words in the 1934 Act. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976).

[62] *Id.* at 50.

[63] *See* RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958) (citation omitted). Section 395 then forbids the agent to tip others. *See id.* § 395.

The commentary to this section specifically applies this rule to the context of insider trading, and the New York Court of Appeals relied on this language in *Diamond v. Oreamuno* over forty years ago.[64]

Under Section 388, no fiduciary breach or act of deception is necessary. It is sufficient that the agent acquire the "confidential information in the course of his . . . duties."[65] Thus, in terms of our earlier hypotheticals, if a cab driver is considered an agent to his passenger, then under Section 388, he may not profit, as agent, from confidential information received from the passenger, as his principal.

Of course, in any realistic case, issues could arise both as to whether the cab driver was an agent (as opposed to an independent contractor[66]) or whether he knew the information was confidential. Still, Section 388 reaches well beyond the narrower definition of fiduciary and covers all agents. Thus, in cases involving "stalking" of the

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[64] 248 N.E. 2d 910 (N.Y. 1969). The Court added that profits made by the agent in stock transactions based on such inside information "are held in constructive trust for the principal." *Id.* at 914 (internal quotation marks omitted). *See also* United States v. Reed, 601 F. Supp. 685, 700 (S.D.N.Y. 1985) (imposing constructive trust on stock trading profits based on inside information), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). Not all courts have followed *Diamond*. *See* Freeman v. Decio, 584 F.2d 186, 192 (7th Cir. 1978). But those that have not have chiefly relied on the fact that federal insider trading law already supplies an adequate remedy. That is not an answer when federal law stops short. Finally, this article does not propose that state courts take any step, but only that, in determining the scope of the federal remedy, courts should consider the classic law of agency.

[65] RESTATEMENT (SECOND) OF AGENCY§ 388 cmt. c (1958).

[66] The definition of agent is set forth in Section 1 of the Restatement (Second) of Agency, and covers any relationship that "results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control and consent by the other so to act." This broad language might reach the cab driver, but probably not the bartender in our earlier hypotheticals. To the extent that the passenger can instruct the cab driver what route to take, the cab driver is arguably "subject to his control" and thus resembles an agent. The bartender (like the soda jerk) is simply selling a product (alcoholic beverages), although when James Bond asks for his Beefeater's martini to be shaken and not stirred, (and the bartender agrees), this may take the bartender a small step closer to being an agent.

victim (as in our earlier taxi driver hypothetical), prosecutors have at their disposal both a potential "deception" theory under *Dorozhko* and an agency theory under Section 388.

E. Willful Violations of Regulation FD

Regulation FD prohibits "reporting companies" from making selective disclosure, subject to certain exceptions.[67] Thus, by itself, it would probably preclude the practice of "warehousing" if the tipper was a senior executive of a reporting company.

But the penalties for such a violation are likely to be far more modest than those for insider trading, and Regulation FD expressly provides that a failure to comply with it does not violate Rule 10b-5.[68] Still, one potential theory has not yet been pursued: a "willful" violation of any SEC rule is a criminal offense under both the Securities Act of 1933 and the Securities Exchange Act of 1934.[69] Thus, a corporate officer of a "reporting company" who "willfully" tips arbitrageurs about an impending transaction in violation of Regulation FD is seemingly subject to criminal prosecution. Although the JOBS Act exempts many issuers from becoming reporting companies, this is a theory of liability that could already apply to most listed companies, but it has not yet been utilized by prosecutors.

Part III. An Evaluation

To this point, it has been argued that some common law doctrines have sufficient plasticity that they can be manipulated to reach desired results: Specifically, they could

[67] *See* Regulation FD, 17 C.F.R. § 243.100 et seq. (2013).
[68] *See* Rule 102, 17 C.F.R. § 243.102 (2013). This also likely means that there is no private cause of action for a violation of Regulation FD.
[69] *See* Section 24 of the Securities Act of 1933, 15 U.S.C.A. § 77x (West 2012), and Section 32 of the Securities Exchange Act of 1934, 15 U.S.C.A § 78ff (West 2012). For a recent analysis of the requirement of "willfulness" under these provisions, *see* United States v. Whitman, No. 12-CR-125, 2012 U.S. Dist. LEXIS 163138 (S.D.N.Y. Nov. 14, 2012).

enable the SEC to describe many forms of misbehavior as "deceptive," even though they involve neither a false representation nor a fiduciary breach. But, the issue remains: How desirable is it to push the law to the outer boundaries of "deception"? The following considerations bear on this question:

1. Overcriminalization. Do we really want to reach the person who is provided a valuable tip unintentionally? Opinions will vary. Some will argue that the temptation to trade on such information will often be irresistible and that the persons who violate the proposed rule will not have knowledge of the applicable law, thus trapping unwary (even if somewhat culpable) ordinary laymen. But the primary rule here proposed (Rule 10b5-4) does not make equivocal conduct actionable. Under it, the tippee must stalk the victim, using either a covert means or subterfuge to obtain the information or misrepresenting the tippee's identity or purpose. This is not morally neutral conduct, and those who engage in it are entitled to little empathy.

In contrast, proposed Rule 10b5-3, which applies to those who come into possession of "lost" information, does sweep more broadly and can be asserted to potentially criminalize fairly equivocal conduct. Even this rule, however, would be limited by a broad interpretation of the concept of "public release," so that information on social media or widely followed websites would be considered to be in the public domain and freely usable.

2. The Impact on Market Efficiency. Arguably, *Dirks* may be at least partially explained by the Court's fear that the SEC's proposed theory of liability would chill securities analysts and thereby prevent the detection of some frauds. Certainly, it is implausible that Ray Dirks would have travelled from the East Coast to Los Angeles to

investigate Equity Funding at first hand if he had not seen the prospect of profit (for himself and his clients).

Indeed, the *Dirks* case dramatically underscores the social value in the early detection of fraud. Not only was the overvaluation in the market price of Equity Funding corrected (which admittedly helps some investors (i.e., purchasers) and hurts other (i.e., sellers)), but non-shareholders also benefitted: the prospective purchasers of Equity Funding's insurance were protected from investing their retirement savings in a worthless product. If analysts are chilled, the social injury might be considerable and extend beyond investors to a variety of third parties.

Thus, most securities law scholars and practitioners have resisted a parity-of-information approach to defining the scope of the insider trading prohibition because it would dull market efficiency by chilling the incentive to search for new information. Proposed Rule 10b5-3 does not go anywhere near adopting a parity of information approach. Research could still fuel trading, even when it developed material new information. But the tippee who learns new nonpublic, material information that is owned or controlled by another would no longer be protected, even though he owes no duty to that source.[70] Under proposed Rule 10b5-3, he would be made a "finder" who could not trade on such information. As a result, proposed Rule 10b5-3 would largely swallow up most of the terrain now covered by Regulation FD, but it would extend even further. Some uncertainty would likely surround the loose edges of this rule, including in

[70] SEC v. Obus, 693 F.3d 276, 289 (2d Cir. 2012), may have already gone substantially this far by seemingly eliminating the need to show that the tippee paid an economic benefit to the tipper, but it remains still unclear what the Court actually meant in *Obus*. *See supra* note 10 and accompanying text.

cases where analysts have arguably pieced together a “mosaic” of information from multiple sources. To say the least, such a rule would be resisted by analysts and others within the financial services industry.

Still, these concerns about uncertainty and the soft edges of the rule apply much more to proposed Rule 10b5-3 than to proposed Rule 10b5-4. The latter rule requires some “covert act” of deception or an affirmative misrepresentation. It aims at prohibiting stealth, theft and misappropriation, not simply mistaken or unauthorized release. Valuable as analysts may be, they are not entitled to steal information. *Dorozhko*’s unwillingness to cover “mere theft” of information seems anomalous and unjustified (at least on public policy grounds), and proposed Rule 10b5-4 responds to its shortfall. But Rule 10b5-4 (unlike Rule 10b5-3) does not restrict the analyst who simply stumbles across new information. Thus, it leaves largely in place the protective shield that *Dirks* erected around analysts. In contrast, Rule 10b5-3 would largely remove that shield. Thus, the case for proposed Rule 10b5-4 is again much simpler than that for proposed Rule 10b5-3.

3. <u>Federalism</u>. Although several decisions have found that the duty to disclose should be determined by federal (and not state) law, federalizing a duty not to trade on “lost” information pushes the SEC’s power to make new law to its limit. No term actually in the 1934 Act would be construed by proposed Rule 10b5-3, and thus the claim that the SEC is entitled to *Chevron* deference is weakened. Moreover, the actual law on “finders” and lost property varies widely among the states and was never truly applied to information (as opposed to personal property). Finally, although the theory outlined in proposed Rule 10b5-3 applies only when the person trading on the “lost”

information trades in an efficient market (and thus deprives other investors of their right to rely on the accuracy of the market price), it is far from clear that courts would regard such behavior as adequately “deceptive” to fall within Rule 10b-5’s prohibition.

For all these reasons, the far simpler approach would be for the SEC to define “deceptive” to include stealing information or acquiring it by trick or ruse (as proposed Rule 10b5-4 would do). Such a rule has a better chance of receiving *Chevron* deference, and its premise that theft of information is generally deceptive eliminates the strange distinction that *Dorozhko* has seemingly erected between fraud and theft. Historically, the draftsmen of the Securities Exchange Act of 1934 explained the intent of Section 10(b) to Congress, saying that it was meant to be a “catch all” provision that essentially declared:

> “Thou shalt not devise any other cunning devices.”[71]

More recently, the Court has said in a case also involving simple theft that Section 10(b) “should be ‘construed not technically and restrictively, but flexibly to achieve its remedial purposes.’”[72] Stealing information by any trick, ruse, invasion of privacy, or simple theft—however novel the means—is at bottom just another “cunning device,” which should be within the scope of Rule 10b-5, at least if the SEC would so indicate.

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[71] This is the famous statement of Thomas G. Corcoran to the House Committee on Interstate and Foreign Commerce. Mr. Corcoran (also known as “Tommy the Cork”) was one of the principal draftsmen of the Securities Exchange Act and a protégé of Justice Felix Frankfurter (who also influenced the legislation). *See Stock Exchange Regulation Hearings on H.R. 7852 and H.R. 8720 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 115 (1934) (internal quotation marks omitted).

[72] SEC v. Zandford, 535 U.S. 813, 819 (2002). The Court also emphasized that “any distinction between omissions and misrepresentation is illusory in the context” of a theft by a broker owing a fiduciary duty. *Id.* at 823. This rejection of technical distinction may continue in other cases involving similarly egregious misbehavior.

This suggested intermediate position would leave unchanged the status of the tippee who simply overhears information innocently,[73] but that "gap" does not—today at least—threaten the integrity of the market. This does not mean that the SEC could not at some future point also seek to restrict the use of "lost" information. But change best comes incrementally. The first step should be to generalize the outcome in *Dorozhko*, but without its strange requirement of a false representation.

Is it realistic to think the SEC might take such a step? That is harder to predict. The SEC is undoubtedly overworked and underfunded and has much on its plate. Moreover, the agency appears anxious that rules proposed by it might be rejected by the D.C. Circuit on cost/benefit or related grounds.[74] But rules relating to insider trading are less likely to be challenged by industry groups, and the Commission is in a safer position when it promulgates anti-fraud rules against insider trading than when it seeks to regulate corporate governance. Although the SEC moves slowly, it should move ultimately in the general direction here outlined.

CONCLUSION

Above all, this article has argued that the process of defining insider trading has not been completed. Gaps remain, and new ones will likely arise again in the future. The

[73] It can be argued that such tippees are already exposed to liability under the Second Circuit's standard for tippee liability in SEC v. Obus, 693 F.3d 276, 298 (2d Cir. 2012). *See supra* notes 8–11 and accompanying text. To the extent that *Obus* is read literally, a case may exist for a safe harbor rule protecting analysts and others where no benefit or payment is exchanged by them for information. In essence, this would only restore the *Dirk* standard from erosion.

[74] In Business Roundtable v. SEC, 647 F.3d 1144, 1156 (D.C. Cir. 2011), the D.C. Court of Appeals invalidated the SEC's newly adopted Rule 14a-11 for failure to adequately consider the potential costs and benefits of the rule.

SEC can fill these gaps, and doctrinal means are available by which the SEC could extend the reach of Rule 10b-5.

Closer questions surround the various tools that the SEC could use. For the short run, the simplest course would be for the SEC to define by rule that deception by trick, ruse, or subterfuge violates Section 10(b) and Rule 10b-5, even if no affirmative misrepresentation is made. This is justifiable both in terms of Section 10(b)'s original purpose of serving as the flexible "catchall" remedy to bar all other "cunning devices"[75] and Webster's 1934 definition of "deceive" to include "cheating" and dealing "treacherously" with another.[76] For the longer run, the ability of the non-fiduciary to trade on material, nonpublic information that has been inadvertently released or selectively distributed raises more difficult problems, but ones that also merit closer scrutiny and constraint.

This process may never end. Predictably, new "cunning devices" will surface from time to time, as fraud evolves and mutates. Voluminous as the writing has been about insider trading, this point has been largely missed: Rule 10b-5 was intended to evolve to keep pace with the ingenuity of fraudsters. It still can—if the SEC will only exercise its authority.

[75] *See supra* note 66 and accompanying text.
[76] *See supra* note 58 and accompanying text.

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