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# Trading in Substitute Securities: Liability Under Rule 10b-5

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## I. Introduction

A trade in a substitute security occurs when a trader with inside information, typically an employee, trades—not in the securities of the company that is the subject and source of the information—but in the securities of another company whose stock would be affected if such inside information were to become public. The main piece of academic literature on this topic is Ian Ayres and Joe Bankman's article, *Substitutes for Insider Trading*.[1] This Article builds on that work by providing a more in-depth analysis of liability for insider trading on substitute securities under Rule 10b-5 promulgated under the Securities Exchange Act of 1934.[2] In contrast to Ayres and Bankman,[3] this Article concludes that trading in substitute securities is presumptively illegal under the misappropriation theory pursuant to Rule 10b-5. While Ayres and Bankman argue that a possible-harm standard may apply to trades in substitute securities, such a standard is supported by neither background state law nor federal precedent. Instead, a fiduciary-sourced default rule should apply, which requires only the use of confidential information for private benefit to establish liability. Moreover, even if the possible-harm standard were to apply, most

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1 Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 STAN. L. REV. 235 (2001).

2 17 C.F.R. § 240.10b-5 (2016) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").

3 Ayres and Bankman largely fail to state explicitly whether the insider trading is theoretically illegal, stating that "case law in this area is ambiguous," Ayres & Bankman, *supra* note 1, at 256, and that "[m]ost counsel would caution employees in the possession of material nonpublic information not to trade in substitute stocks," *id.* at 259. Other commentators have expressly concluded that substitute trading is not illegal. *See* Brian Bloch, *Substitute Trading Eludes Market Abuse Rules*, GLOBAL RISK REGULATOR (Sept. 4, 2015), https://www.globalriskregulator.com/Regions/Europe/Substitute-trading-eludes-market-abuse-rules ("Mark Astarita, a partner at US securities defence attorneys [firm] Sallah Astarita & Cox, emphasises that substitute trading is not inherently illegal.").

trades in substitute securities could result in a possible harm to the source of the information by way of reputational damage.

## II. An Overview of Trading in Substitute Securities

In short, a trade in a substitute security occurs when an insider of one company ("A Corp.") who has inside information about A Corp., beneficially trades not in the stock of A Corp., but in the stock of another company ("B Corp.").[4] This trade is advantaged because the inside information from A Corp. correlates to the performance of the stock of B Corp. There are four main types of companies that are likely to have stock prices that are correlated with any given company's stock price: that company's suppliers of goods or services, customers of goods or services, manufacturers or providers of competing goods or services (competitors), and manufacturers or providers of complimentary goods or services (complementors).[5] Trading in substitute securities may be accomplished directly through the purchase or short sale of stock of a substitute company, indirectly by trading in derivatives of a substitute company, or in indexes of the industry generally.[6]

The direction of correlation between two linked companies is dependent on the type of information. For example, when Kodak entered the instant camera market, the shares of Polaroid, the only extant competitor, fell by 12.7%.[7] This negative correlation is the expected result of a zero-sum game between substitute products.[8] However, if Kodak subsequently beat analyst estimates as a result of an increase in general market demand for instant cameras, the share price of both Kodak and Polaroid would also likely increase. This information provided by Kodak would be incorporated into the share price of both companies.[9] Thus, Kodak and Polaroid may also be positively correlated, depending on the nature of the information.

The trading in substitute securities has the potential to achieve high, short-term returns. Ayres and Bankman analyzed a set of hypothetical substitute-security transactions, based on a 1998 Intel earnings announcement and the correlative effect on other companies and the Philadelphia Semiconductor Index.[10] A substitute-security trade directly on shares of the index would allow the hypothetical Intel insider (or Intel itself) to achieve a 6.0% to 7.3% two-week

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[4] A notable example of substitute trading in practice is the conduct of Jay Gould in the nineteenth century: "When forming new telegraph companies to compete against the incumbent Western Union, [Jay Gould] consistently sold short Western Union stock. And this same maxim—sell thy rival's stock short before entering—was used against Gould when a new steamship line began competing against his Pacific Mall company." Ayres & Bankman, *supra* note 1, at 243.

[5] *See id.* at 241. Additionally, there might be two companies with correlated stock prices even though they are not in the same industry and do not share a specified relationship. *See, e.g.*, Evan Gatev et al., *Pairs Trading: Performance of a Relative-Value Arbitrage Rule*, 19(3) REV. FIN. STUDIES 797, 806–08 (2006) (finding that excess returns can be achieved through pairs trading with stocks that "do not necessarily belong to the same broad industry categories").

[6] *See* Ayres & Bankman, *supra* note 1, at 247, 251.

[7] *See id.* at 242. Indeed, in that very case, there were options trading for four months prior to the announcement that bet on a fall in Polaroid stock—potentially indicating a trade in substitute securities. *Id.*

[8] For another example, see Ian Ayres and Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313, 316 (2002) ("[A] biotech firm which knows it has just patented a particular gene may have a profitable opportunity to trade its rivals' shares short.").

[9] *Cf.* Ayres & Bankman, *supra* note 1, at 243–46.

[10] *See id.* at 248–49.

return (354.2% to 523.5% annualized).[11] In addition, a hypothetical set of option purchases in correlated companies would have produced a two-week return of 21.1% (14,277.5% annualized).[12]

## III. Legality of Trading in Substitute Securities Under Rule 10b-5

### *A. Employees and Other Insiders*

The first and most common[13] form of trading in substitute securities is trading by an employee or other insider of the source of the information. A brief set of scenarios will help guide the analysis in this section:

> *Scenario 1: X is an employee of A Corp. and is in possession of information indicating that A Corp. is getting ready to manufacture Widget M that directly competes with Widget N manufactured by B Corp. Using that information, X short sells the stock of B Corp. Subsequently, A Corp. announces that it is selling Widget M. The share price of A Corp. climbs while the share price of B Corp. falls. X makes a sizeable profit.*
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> *Scenario 2: Same facts as Scenario 1, except X buys the shares of a supplier, C Corp., with which A Corp. currently has a contract and expects to order a significant number of critical components to manufacture Widget M. On announcement, the share price of C Corp. rises significantly.*
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> *Scenario 3: Same facts as Scenario 2, except X buys a controlling interest in C Corp.*

#### 1. Liability under the Traditional "Equal Access" Theory

Although explicitly overruled,[14] the equal access theory derived from the Securities and Exchange Commission (SEC) administrative action *Cady, Roberts & Co.*[15] is still useful to determine the theoretical and policy limitations of insider trading liability. While *Cady, Roberts* was narrowly considering the trading of the stock of the source company,[16] it explicitly required

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[11] *See id.*

[12] *See id.* at 250–51. For a more detailed analysis of the correlation and profit possible between two substitute firms, see Robert G. Hansen & John R. Lott, *Profiting from Induced Changes in Competitors' Market Values: The Case of Entry and Entry Deterrence*, 43 J. INDUS. ECON. 261 (1995); Hui Huang, *Substitute Trading and the Effectiveness of Insider Trading Regulations* (Oct. 2006) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=829425.

[13] Ayres & Bankman, *supra* note 1, at 251 ("The much higher rate of return per dollar invested may make substitute trading more attractive to employees than employers. It is not surprising, therefore, that we find that currently, informationally informed substitute trading is carried out by employees rather than employers.").

[14] *See* Chiarella v. United States, 445 U.S. 222, 233 (1980) ("We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."); *id.* at 235 ("We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.").

[15] 40 S.E.C. 907, 912 (1961).

[16] *See id.* at 909. Ayres and Bankman conclude that the duty to disclose was traditionally extended only to corporate insiders, thereby implying that the duty to disclose extended only to the corporation itself and that trading

only that there was a "relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose" and "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[17] The resulting fundamental premise of the theory is that "anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[18]

Applying this theory to each of the scenarios above (and indeed the scenarios detailed below in Part III.B.3 as well), X could be found liable for trading in substitute securities. As a preliminary matter, the information on which the insider trades would be material under prevailing law[19]: a reasonable investor in either the supplier or the competitor would likely consider information concerning A Corp.'s intention to enter the widgets industry as important in a potential transaction.[20] Furthermore, X possesses the information only by virtue of his position as an insider and exploits that corporate information to the unfair disadvantage of the holders of the substitute security. Therefore, the failure to disclose the inside information to X's counterparty would constitute a fraud under the equal access theory of Rule 10b-5.

Of course, the SEC would not be able to resort to this theory today.[21] Nevertheless, it shows the potential outer limits of what the SEC may consider is, or should be, a violation of Rule 10b-5. Furthermore, it serves as a guidepost toward which the misappropriation theory appears to be headed.[22]

#### 2. Liability under a "Classical" Fiduciary Duty Theory

The fiduciary duty theory originates in *Chiarella v. United States*.[23] In that case, the defendant used information he gleaned from a hostile bidder to trade on the stock of the target firm. After overruling the equal access theory, the Court set a new standard for fraud under Rule 10b-5: "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[24] This duty to disclose must arise "from a relationship of trust and confidence

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substitute securities would therefore not be wrongful under the equal access theory. *See* Ayres & Bankman, *supra* note 1, at 252–54. However, the SEC in *Cady, Roberts* did not narrowly define to whom the duty was owed and implied that it was owed to any counterpart to the transaction. *See Cady, Roberts*, 40 S.E.C. at 911. Indeed, if the duty to disclose were solely derivative of the duty of loyalty to the corporation, it seems possible that the duty might only extend to the purchase of securities and not to the sale—the insider would not have a prior fiduciary relationship to a purchaser who was not an existing shareholder. In any case, how *Cady, Roberts* was subsequently interpreted is more in line with extending a duty to disclose based on mere possession of information. *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

[17] *Cady, Roberts,* 40 S.E.C. at 912.

[18] *Tex. Gulf*, 401 F.2d at 848.

[19] Materiality is defined as "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988) (quoting TSC Indus. v. Northway, 426 U.S. 438, 449 (1976)).

[20] In each of the other theories below, the information will continue to be material.

[21] The equal access theory was overruled in Chiarella v. United States, 445 U.S. 222, 235 (1980).

[22] *See infra* Part III.A.3.

[23] 445 U.S. 222 (1980).

[24] *Id.* at 235.

between parties to a transaction."[25]

In application to the facts of Scenario 1, it appears likely that X cannot be found liable under the theory announced in *Chiarella*. There is no relationship between X and B Corp. or between X and the counterparty to the short sale. As such, X has no duty to disclose. The existence of a relationship of trust and confidence between A Corp. and the supplier in Scenarios 2 and 3 appears to invoke the temporary insider doctrine.[26] However, in all scenarios, X obtained the confidential information through the fiduciary relationship with his employer, and not from any relationship with the supplier. Therefore, even if the corporate supply contract were to be attributed to X, it was not a breach of any relationship with the supplier to use the distinct corporate information for his own personal benefit.[27] Consequently, the doctrine does not provide any additional support for the liability of X in either scenario.

3. Liability under the Misappropriation Theory

In general, "[t]he 'misappropriation theory' hold[s] that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[28] In *United States v. O'Hagan*, the lawyer-defendant obtained information pertaining to that company's tender offer and traded in the securities of the target firm.[29] This violated the duties of confidentiality he owed to both his law firm and to the client with whom he was working.[30]

In applying the misappropriation theory to trades in substitute securities, the primary question is whether X's trading on a competitor's stock, as in Scenario 1, is a breach of a duty owed by X to the source of the information, namely A Corp. Of course, if X's employment contract were to explicitly allow or disallow trading in substitute securities, that would govern whether there was misappropriation.[31] In the probable likelihood that there is no explicit contract provision,[32] Ayres and Bankman lay out two theories that could govern default law: the fiduciary-sourced default rule and the possible-harm standard.[33] In the fiduciary-sourced default rule, the insider can never trade without permission from the source of the information.[34] If this

[25] *Id.* at 230.

[26] *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."); *see also* Ayres & Bankman, *supra* note 1, at 253–54.

[27] On the other hand, it is possible to imagine that X may have been internally compartmentalized from the plans of A Corp. and in fact may have received the information by reason of the company's relationship with the supplier. If that were so, ignoring for the moment the difficulty of distinguishing the two events in practice, it would be possible for X to be treated as a corporate insider of the substitute firm.

[28] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[29] *Id.* at 647–48 (detailing the defendant's purchase of call options in the target's stock).

[30] *Id.* at 653.

[31] Ayres & Bankman, *supra* note 1, at 255–56.

[32] *See id.* at 259 ("Most companies, however, have no express limitations.").

[33] *See id.* at 256.

[34] *Id.* at 256; *cf. O'Hagan*, 521 U.S. at 655 (noting that absent a "deception" of the source of the information,

rule is applied to these three scenarios, X would be liable for insider trading because he would have a duty to disclose to his employer or to abstain from using the corporate information for private benefit. In contrast, in the possible-harm standard, the insider would be prohibited from trading in substitute securities only when such trades are likely to cause harm to the source of the information.[35]

However, the possible-harm standard is not supported by background state law on the fiduciary duty of loyalty, whereas the fiduciary-sourced default rule is well supported by precedent.[36] Consequently, a fiduciary-sourced default rule should be applied to trading in substitute securities. Since trading in substitute securities necessarily involves the use of inside information for private benefit, it violates the insider's duty of loyalty and runs afoul of Rule 10b-5. Moreover, even if the possible-harm standard did apply, many cases of trading in substitute securities may result in a possible harm because the corporation could possibly suffer reputational harm in current or future relationships.[37] Therefore, trading in substitute securities is presumptively illegal under Rule 10b-5.

#### i. The Fiduciary-Sourced Default Rule Should Apply

The content of the fiduciary duties under the misappropriation theory of Rule 10b-5 may be derived from three sources of background law: state agency law, state contract law, or federal common law. In each case, the possible-harm standard is not supported and the fiduciary-sourced default rule should be applied in its place.

The possible-harm standard is not supported by state law on the fiduciary duty of loyalty because state law does not require a harm to the principal in order for the agent to be liable. In general, "[a]n agent has a duty not to acquire a material benefit from a third party . . . through the agent's use of the agent's position."[38] To recover from the agent, "it is not necessary that the principal show that the agent's acquisition of a material benefit harmed the principal."[39] The lack of a requirement for possible harm also draws support from early state law cases on insider trading: "[i]n equity, when the breach of a confidential relation by an employee is relied on and an accounting for any resulting profits is sought, loss to the corporation need not be charged in the complaint."[40] Thus, if the fiduciary duties under the misappropriation theory of Rule 10b-5

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which is precluded by full disclosure, there can be no liability under the misappropriation theory).

[35] Ayres & Bankman, *supra* note 1, at 256.

[36] *See infra* Part III.A.3.i.

[37] *See infra* Part III.A.3.ii.

[38] RESTATEMENT (THIRD) OF AGENCY, § 8.02 (AM. LAW INST. 2006). Additionally, the agent has a duty not to use property of the principal or communicate confidential information for the agent's own purposes. *Id.* § 8.05. While not a direct disclosure of information, trading in substitute securities does communicate the effects of such confidential information by affecting the price of the substitute security. *See* Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 179–80 (2005) (suggesting that trading in substitute securities, at some level, communicates to the management of the substitute firm the presence of nonmarket information that materially affects the value of the company). Even if trading in substitute securities does not directly breach the agent's duty not to disclose confidential information, one can conceptualize insider information as property of the company that the agent cannot use for personal gain.

[39] RESTATEMENT (THIRD) OF AGENCY, § 8.02 cmt. b (AM. LAW INST. 2006).

[40] Brophy v. Cities Serv. Co., 70 A.2d 5, 8 (Del. Ch. 1949); *see also, e.g.*, Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969) ("[A] corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation."). The

are derived from state law, there would be no requirement for a possible harm to the source of the confidential information.

Principally, Ayres and Bankman draw support for the possible-harm standard under a contract theory of implied terms: if the parties were to draft a contract, they would likely limit breaches of duty to situations in which the corporation was harmed.[41] While this supposition may be generally supported from a business perspective, the employer's and employee's understanding of the relationship does not control the interpretation of rights and duties of the parties in that relationship.[42] Typically, state law fiduciary duties apply by default and the employer-principal must explicitly consent to waive the duty of loyalty of the employee-agent with respect to a specific transaction or class of transactions.[43] Thus, while employers might be able to waive the duty of loyalty conflict prospectively, where the employment contract is silent on the issue of trading in substitute securities, state law on fiduciary duties would apply. Since such state law does not require a possible harm to the principal, it seems probable that a court would not ordinarily imply consent to use or disclose information for personal benefit where no harm to the principal would result.

The final source of fiduciary duties under the misappropriation theory is from federal case law itself. Significantly, given that recent cases are generally silent on the source of the law governing such duties,[44] perhaps the duty on which all insider trading is now based is not derivative of any state law claim but exists as an independent duty under federal common law.[45] With respect to trading in substitute securities, it is notable that the primary cases involving

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Supreme Court cited *Diamond* favorably in a violation of mail and wire fraud statutes where the defendant had "fraudulently misappropriated 'property[.]'" Carpenter v. United States, 484 U.S. 19, 24, 27–28 (1987). On the other hand, at least under Delaware law, a self-dealing transaction with a controlling shareholder will only trigger the strenuous analysis of entire fairness if the fiduciary receives something to the "exclusion of, and detriment to," those with which he stands in a fiduciary relationship. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). While not directly applicable, the doctrine does lend some credibility to the possible-harm limitation on the misappropriation theory, at least with respect to insiders who are not legal agents of corporations. Notably, however, the net effect of both a state law incorporation and a possible-harm standard would be such that directors might have a lower risk of Rule 10b-5 liability than employees or other insiders. This split seems particularly unlikely from a policy perspective given that directors may have equal ability and opportunity to misappropriate corporate information.

[41] Ayres & Bankman, *supra* note 1, at 256.

[42] RESTATEMENT (THIRD) OF AGENCY, § 1.02 (AM. LAW INST. 2006) ("Whether a relationship is characterized as agency in an agreement between parties or in the context of industry or popular usage is not controlling."); *see also id.* § 8.06 cmt. b ("Common-law agency does not accord effect to all manifestations of assent by a principal that purport to eliminate or otherwise affect the fiduciary duties owed by an agent. This is so for two distinct reasons: (1) the law, and not the parties, determines whether a particular relationship is one of agency as defined in § 1.01; and (2) the law imposes restrictions on the efficacy of a principal's manifestations of assent in the interest of safeguarding the principal's intention in creating a relationship of common-law agency.").

[43] *Id.* § 8.06.

[44] *See, e.g.*, Salman v. United States, 137 S. Ct. 420, 422 (2016); United States v. O'Hagan, 521 U.S. 642, 643 (1997); Dirks v. SEC, 463 U.S. 646, 646–47 (1983). *O'Hagan* mentions state law only as a backdrop in the event an insider discloses to the source of the information. 521 U.S. at 655.

[45] *See* Stephen Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1190–91 (1995) ("What is the precise fiduciary duty at issue? Is the source of that duty federal or state law? Despite over a decade of experience with the fiduciary duty requirement, neither of these questions has a clear and convincing answer."). *But see* Nolfi v. Ohio Kentucky Oil Corp., 675 F.3d 538, 549 (6th Cir. 2012) (incorporating state law for a Rule 10b-5 claim).

misappropriation concern tender offers or other similar transactions.[46] In these cases, such a trade risks an increase in the market price of the target firm, which directly harms the attempted acquisition or damages an outside firm's reputation by breaching confidentiality.[47]

However, in *O'Hagan*, the Court implicitly suggested that the fraud was completed with the harm on the counter-party to the transaction, irrespective of the harm to the source of the information:

> The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. [*See* Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101, 120 (1984) ("A fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons . . . .").] A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.[48]

This suggests that the misappropriation theory requires only a breach of the duty of confidentiality and that whether harm is done to the source of the information is irrelevant.[49] Therefore, the possible-harm standard is not applicable, and mere disclosure for a private benefit suffices—the fiduciary-sourced default.

Additionally, the case law regarding tippee liability supports the federal common law theory that does not require possible harm. In particular, the Supreme Court has defined an insider's breach of duty as requiring only the disclosure of confidential corporate information for a personal benefit.[50] It follows that if disclosing information for personal benefit would constitute an insider's breach, then the insider directly using that inside information for a personal benefit would likewise constitute a breach of the insider's duties.[51] Such a duty does not, or at least does

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[46] *See, e.g.*, *O'Hagan*, 521 U.S. at 642; United States v. Cusimano, 123 F.3d 83, 85 (2d Cir. 1997). Ayres and Bankman cite several enforcement actions against insiders trading in stocks of suppliers, although each case involved an express contractual prohibition on trading on inside information. *See* Ayres & Bankman, *supra* note 1, at 257; *see also, e.g.*, United States v. Bryan, 58 F.3d 933, 938 (4th Cir. 1995).

[47] Ayres & Bankman, *supra* note 1, at 257.

[48] *O'Hagan*, 521 U.S. at 656.

[49] On the other hand, a rule where the insider breaches a duty to the source of information merely by trading on that information comes close to the equal access theory expressly overruled in *Chiarella v. United States*. 445 U.S. 222 (1980); *see also O'Hagan*, 521 U.S. at 690–91 (Scalia, J., dissenting) ("Even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of the source of the information. Moreover, as we have repeatedly held, use of nonpublic information to trade is not itself a violation of § 10(b). *E.g.*, [*Chiarella*, 445 U.S. at 232–33]. Rather, it is the use of fraud 'in connection with' a securities transaction that is forbidden. Where the relevant element of fraud has no impact on the integrity of the subsequent transactions as distinct from the nonfraudulent element of using nonpublic information, one can reasonably question whether the fraud was used in connection with a securities transaction.").

[50] *See* Dirks v. SEC, 463 U.S. 646, 663 (1983) ("[T]he initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.").

[51] In fact, the insider may not even have to "use" the information; under current Second Circuit precedent, the government need only show that the "defendant[] purchased or sold securities while knowingly in possession of the

not explicitly, address the question of harm to the company and therefore would support the fiduciary-sourced default rule.

Overall, while the possible-harm standard may be a rational and justifiable private standard to limit the application of the misappropriation theory to trades in substitute securities, the standard appears to have weak justification in current case law on Rule 10b-5 as well as in agency law generally. Consequently, the fiduciary-sourced default rule is more likely to be applied to trading in substitute securities, and thus, under the misappropriation theory, an insider must always abstain from trading in substitute securities unless he discloses the matter to the source of the information. At least in this context, it appears that the conception of Rule 10b-5 liability has largely returned to the equal access theory—albeit that the target of the disclosure may not be a party to the transaction.

ii. Trading in Substitute Securities May Cause Possible Harm to the Source of the Information

While the possible-harm standard is not supported by state or federal law, if it did apply to trading in substitute securities, it is feasible that every trade in substitute securities could result in a possible harm to the source of the information. In application to the scenarios laid out above, it appears likely that the corporation suffered no immediate or direct harm in Scenario 1, because A Corp. has no direct relationship with the party harmed by the trading in substitute securities. On the other hand, if the possible harm were reputational damage from the breach of confidentiality as indicated by Ayers and Bankman,[52] then the similar breach of confidentiality by X in Scenario 1 would violate the possible-harm standard to the extent that it affected any future relationships with A Corp. It appears likely that at least in some circumstances, the mere private use of corporate information, even when trading in a completely unrelated company, may cause enough of a reputational damage that customers or suppliers would only be willing to engage with the source on less favorable terms. Essentially, A Corp. would be required to buy insurance against the possibility that its insiders would again use inside information to the detriment of shareholders. As much as a car accident will increase car insurance rates, incidences of trading in substitute securities will raise insider trading insurance rates. Since a literal reading of a *possible*-harm standard would include all possibilities, no matter how remote, and the trading in substitute securities could raise costs for the source of the information, the insider could be liable in Scenario 1 for trading in substitute securities.[53]

In Scenario 2, there is a much higher risk that the transaction would affect the relationship between A Corp. and C Corp. There, the previous owners of C Corp. suffer a definitive harm, just as the previous owners of B Corp. suffered a definitive harm in Scenario 1. Unlike in Scenario 1, in Scenario 2, A Corp. and C Corp. have an ongoing relationship.

material nonpublic information." United States v. Rajaratnam, 719 F.3d 139, 159 (2d Cir. 2013) (quoting United States v. Teicher, 987 F.2d 112, 119 (2d Cir. 1993)). This would imply that deriving personal benefit in a securities transaction while knowingly possessing material information would constitute a breach of fiduciary duty; there would be no requirement to prove that the inside information was used or relied upon by the insider.

[52] Ayres & Bankman, *supra* note 1, at 257.

[53] Given this analysis, a possible-harm standard without a cognizable limitation would all but merge with the fiduciary-sourced default rule. A reasonable limitation would be a "plausible possible-harm standard," where the remoteness of the harm would be taken into consideration.

Therefore, the possibility of reputational damage affecting relations, as discussed in application to Scenario 1, is likely to be less remote and hence has a higher risk of immediate harm. Moreover, there might be a retaliatory element as C Corp. may seek to directly recover or inflict harm on A Corp.

Scenario 3 presents a clearer example of a situation in which A Corp. is likely harmed by the trade in substitute securities, as the transaction more clearly seems to be a conversion of the corporate information, and the relationship between A Corp. and C Corp. is likely to be substantially altered, if not impaired. The reputational harms, as discussed in the application to Scenarios 1 and 2, are also possible in this case because X would not immediately control the board of C Corp., which might decide to alter relations with A Corp., possibly to A Corp.'s detriment. Moreover, X might subsequently use his inside knowledge to direct changes in the relationship between A Corp. and C Corp., which have at least the potential to harm A Corp. This is especially true where A Corp.'s information indicates reliance on C Corp. and C Corp.'s market power, or when, by virtue of X's control, C Corp. waits to sign a long-term supply contract until after the product's announcement. However, an issue with this directive theory is whether the fraud is "in connection with the purchase or sale of any security." In *Chadbourne & Parke LLP v. Troice*, the Court stated, "[a] fraudulent misrepresentation or omission is not made 'in connection with' such a 'purchase or sale of a covered security' unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'"[54] Arguably, the harm in directing the company could be considered disconnected from the omission in the securities transaction. However, the prior owners would not have sold had they known the information that X possessed. At the time of sale there was at least a possibility that X would exploit the information on which the transaction was based to garner additional profits. Thus, by a possible-harm standard, it appears probable that X would breach his fiduciary duties to A Corp. by purchasing C Corp. stock when, at the time of sale, the exploited information could subsequently cause harm to A Corp.

Additionally, Scenario 3 may present a breach of duty under the doctrine of corporate opportunity.[55] However, the reach of corporate opportunity will likely be limited to situations in which companies have a practice of trading in stock substitutes.[56] Nevertheless, in such a case, the expropriation of a corporate opportunity could potentially serve as the basis of 10b-5 liability under the possible-harm standard, where the company is so engaged.

While the possible-harm standard likely would not govern trades in substitute securities, in each of the scenarios analyzed here, some possible harm is at least conceivable. Thus, even under the possible-harm standard, trading in substitute securities is presumptively illegal.

### *B. Tippees of Inside Information*

Even in cases in which there is a transaction where the trader of securities is not an insider but received the inside information as a tippee, there still should be liability under the misappropriation theory. The formative case on tippee liability is *Dirks v. SEC*,[57] which held that

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[54] 134 S. Ct. 1058, 1066 (2014) (interpreting 15 U.S.C. § 78bb(f)(1)(A) (2014)); *see also id.* at 1069–71 (applying the interpretation to Rule 10b-5).

[55] *See, e.g.*, Broz v. Cellular Info. Sys., 673 A.2d 148 (Del. 1996).

[56] *See* Ayres & Bankman, *supra* note 1, at 257.

[57] 463 U.S. 646 (1983).

a tippee is liable under 10b-5 when the tipper breaches his duty by disclosing information for personal benefit and the tippee knows or should know of the tipper's breach.[58] Two scenarios will guide the analysis here:

> *Scenario 4: The same general facts as Scenario 1, but X sells to Outsider Y the information that A Corp. is going to manufacture Widget M. Y then short sells the stock of B Corp. and makes a tidy profit.*
>
> *Scenario 5: Like Scenario 4, but X sells to Y his advice that Y should short sell the stock of B Corp. without giving any information about why he believes that is a profitable investment.*

In Scenario 4, X breached a duty to his employer by directly disclosing confidential information for personal benefit.[59] It can be inferred that Y, in purchasing information, also directly knew that X was breaching his fiduciary duty. The major remaining question is whether Y can avoid liability by trading in substitute securities. While *Dirks* was decided under the classical theory provided by *Chiarella*, the Second Circuit has held that the doctrine applies equally under the misappropriation theory.[60] Therefore, Y inherits X's fiduciary duty to disclose and breaches that duty under the misappropriation theory by trading in substitute securities.

Scenario 5 raises another issue: whether X breached any duty by disclosing, not the insider information directly, but the correlative information itself. Arguably, this is a disclosure of information that is not per se confidential. However, X could be considered to have breached a duty to A Corp. because X misappropriated confidential information for his own personal, private benefit. In addition, while the case was focused on personal benefit, not trades in substitute securities, *Salman v. United States*[61] suggests that a tipper cannot do by tipping what he could not do directly.[62] Therefore, so long as Y understands that X is still breaching a duty to A Corp. by disclosing the proposed substitute trade, Y would be liable.

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[58] *Id.* at 660; *see also* Salman v. United States, 137 S. Ct. 420, 423 (2016) ("The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty, and the tippee may commit securities fraud by trading in disregard of that knowledge. In [*Dirks*, 463 U.S.], this Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or 'makes a gift of confidential information to a trading relative or friend.'" (quoting *Dirks*, 463 U.S. at 664)).

[59] Personal benefit, in this simplified scenario, is directly obtained through pecuniary gain. *Dirks* explicitly provided a wider definition of any "direct or indirect personal benefit." 463 U.S. at 663; *see also Salman*, 137 S. Ct. at 427–28.

[60] SEC v. Obus, 693 F.3d 276, 285–86 (2d Cir. 2012) ("The Supreme Court's tipping liability doctrine was developed in a classical case, Dirks, but the same analysis governs in a misappropriation case." (citing United States v. Falcone, 257 F.3d 226, 233 (2d Cir. 2001))).

[61] 137 S. Ct.

[62] *Cf. id.* at 427–28 ("[The tipper] would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to [the tippee]. . . . It is obvious that [the tipper] would personally benefit in that situation. But [the tipper] effectively achieved the same result by disclosing the information to [tippee], and allowing him to trade on it. Dirks appropriately prohibits that approach, as well. . . . Dirks specifies that when a tipper gives inside information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds." (citations omitted)).

### C. *Liability of the Corporation Itself*

While the corporation itself may be liable for trading on inside information,[63] there appears to be no recognized theory on how the corporation, as an outsider, could be liable for trading in substitute securities.[64] Most importantly, except by contract[65] or control,[66] the misappropriation theory would not apply to corporate trading. Given the limited scope for liability and the significant availability of short-term profits, it is surprising that companies do not engage in the practice more frequently.[67]

## IV. Conclusion

Trading in substitute securities involves the holder of inside information trading in the securities of a firm that is not the source of the information. This Article concludes that such trading is illegal under Rule 10b-5. Under the misappropriation theory, a trader can violate Rule 10b-5 by breaching a duty to the source of the information. Employees or other insiders with a fiduciary relationship to the source breach their fiduciary duty when they use corporate information for personal gain. Therefore, an insider who uses corporate information to trade in substitute securities for personal gain breaches a duty to corporate source of that information and runs afoul of Rule 10b-5. Correspondingly, a tippee who receives that information from an insider with knowledge of the insider's breach can inherit the breach and violate Rule 10b-5.

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[63] *See* Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45, 70–72 (2005). The corporation may also be criminally liable under Rule 10b-5 for the conduct of its employees. *See, e.g.*, United States v. S.A.C. Capital Advisors, L.P., No. 13 Civ. 5182 (RJS), 2013 U.S. Dist. LEXIS 160216 (S.D.N.Y. Nov. 5, 2013). For a more detailed discussion of the use of direct corporate trading as a substitute for individual officer inside trading, see Jesse M. Fried, *Insider Trading Via the Corporation*, 162 U. PA. L. REV. 801 (2014).

[64] Ayres & Bankman, *supra* note 1, at 259. Ayres and Bankman note that a former chief economist of the SEC stated the following regarding corporate liability for trading in substitute securities: "All [eight securities lawyers] said that 1) it is legal to trade rivals' stock; 2) even at its most imperious, the SEC has never suggested that this is illegal; and 3) they had never heard of such a case being brought, or even episodes of such trading questioned." *Id.* (quoting Robert G. Hansen & John R. Lott, Jr., *Profiting from Induced Changes in Competitors' Market Values: The Case of Entry and Entry Deterrence*, 43 J. INDUS. ECON. 261, 273 n.16 (1995)).

[65] Ayres and Bankman note that a company (L) can be deemed a temporary insider of another company (M) through contract, such that trading by L on the stock of M based on information obtained through the contract would constitute a claim under classical fiduciary duty theory. *See* Ayres & Bankman, *supra* note 1, at 259 n.68. Likewise, using that information to trade in a third company's stock could violate L's contractually-created duty to M under the misappropriation theory, such that L would be liable under Rule 10b-5 for a trade in substitute securities.

[66] Misappropriation would apply as follows: As the controlling person of another company (SubCo), ParCo would be subject to fiduciary duties in its management of another company. *See, e.g.*, Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." (citations omitted)). If the directors of ParCo used confidential information derived from their control of SubCo for the benefit of ParCo and ParCo's shareholders (in connection with a transaction in securities), ParCo could be liable under 10b-5 for misappropriating information in violation of a duty to ParCo. Thus, in the case of *Weinberger v. UOP*, 457 A.2d 701 (Del. 1981), where directors used subsidiary information to prepare a feasibility study for the parent in connection with a merger agreement, the controlling-shareholder company could be subject to 10b-5 liability under the misappropriation theory.

[67] *See* Ian Ayres & Barry Nalebuff, *Don't Sell Us Short*, FORBES (Feb. 2, 2004 12:00 AM), http://www.forbes.com/forbes/2004/0202/057.html (exploring why corporations do not engage in substitute trading, and suggesting that it is because it seems "distasteful" or "unsportsmanlike").

However, as a corporation does not owe a duty to itself, it is not subject to enforcement under the misappropriation theory of Rule 10b-5—at least concerning its own information.

Like traditional insider trading, the debate over whether prohibiting trading in substitute securities is economically efficient is largely unresolved.[68] However, considering that trading in substitute securities is presumptively illegal, as well as the general lack of enforcement actions in this area, the overall costs of trading in substitute securities may not justify diverting scarce resources from the enforcement of other areas of the law. Even if enforcement itself may not be socially efficient, certain policy reforms, such as increased disclosure requirements, may be socially optimal because they generally deter inefficient trading.[69]

[68] In general, the arguments for and against a prohibition on trading in substitute securities largely tracks the arguments for and against insider trading more generally: whether the efficiency benefits from insider trading (principally, more accurate pricing) outweigh the efficiency costs (namely, management incentives and inefficient compensation). Ayres & Bankman, *supra* note 1, at 267–69. For an example of when trading in substitute securities would provide pricing information, see Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 179–180 (2005). A primary distinction, however, is that in the context of substitute securities trading, most of the costs and benefits are borne by the shareholders of the correlated company and not by the company that is the source of the information. *See* Ayres & Bankman, *supra* note 1, at 275 (noting that the losses to shareholders are of another firm, as are the benefits from accurate pricing). Due, in larger part, to inefficiencies in accurately compensating employees who have the right to trade in substitute securities, Ayres and Bankman conclude that trading in substitute securities is more likely than not to be economically inefficient and therefore should be prohibited. *See id.* at 279. However, Ayres and Bankman may have failed to fully consider the effects that prohibiting trading in substitute securities might have on the incentives of market participants. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 24–25 (2006) (finding that prohibiting trading in substitute securities decreases incentives for individuals to undertake activities that are both socially productive and that produce tradable information).

[69] Ayres & Bankman propose numerous disclosure requirements for the company including identification of core substitutes (suppliers, customers, rivals, and quantitative correlates), whether the firm granted or denied permission to employees to trade, disclosure of substitute trades under Rule 16b, and disclosure of the implicit value of stock trading as executive compensation. *See* Ayres & Bankman, *supra* note 1, at 285–90.