

THE MISAPPROPRIATION THEORY OF INSIDER TRADING: A LEGAL, ECONOMIC, AND ETHICAL ANALYSIS

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I. INTRODUCTION

During the past decade, allegations of illegal behavior, abuses of power, and lapses in ethics have spurred criticism of the way financial markets are regulated. Insider trading has been among the most visible of the illegal practices.¹ The notoriety of many insider trading cases has prompted numerous responses from practicing lawyers, journalists, and scholars who variously argue that insider trading should be legalized,² that it should be prohibited or defined more specifically,³ that the Securities and Exchange Commission (SEC) has overstepped its bounds and must be curtailed,⁴ and that insider trading laws should be expanded to cover a wider range of abusive

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1. Forty-six people were indicted for insider trading between 1984 and 1988. 134 CONG. REC. H7470 (daily ed. Sept. 13, 1988) (statement of Rep. Eckhart).

2. See Henry G. Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. Nov.-Dec. 1966, at 113. For discussion of the merits on both sides of this argument, compare Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982) (proposing a rationale for prohibiting insider trading based on its possible adverse effects on internal decision making in large corporations) with Jerome B. Baesel & Garry R. Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. FIN. & QUANTITATIVE ANALYSIS 553 (1979) (discussing the profitability of insider trading); Dan Givoly & Dan Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence*, 58 J. BUS. 69 (1985) (presenting evidence that profit from trades by insiders may result from publicity surrounding the trades themselves, rather than from disclosure of specific news regarding the corporation); Saul Levmore, *In Defense of the Regulation of Insider Trading*, 11 HARV. J.L. & PUB. POL'Y 101 (1988) (stressing the economic dangers of insider trading); and Stephen H. Penman, *Insider Trading and the Dissemination of Firms' Forecast Information*, 55 J. BUS. 479 (1982) (suggesting that corporate insiders time their trades relative to public disclosure of their firms' prospective profitability).

3. See Michele Galen, *Insider Trading: To Squelch It, First Define It*, BUS. WEEK, May 21, 1990, at 146; Harry Pitt & Karl Groskaufmanis, *2nd Circuit's Recent Insider-Trading Decision Invites Legislative Fix*, LEGAL TIMES, May 21, 1990, at 25.

4. See Bruce Fein & William Reynolds, *It's Time for Courts to Rein in the SEC*, LEGAL TIMES, July 2, 1990, at 20.

practices.⁵

The courts have reacted to insider trading cases by devising the misappropriation theory. According to this theory, one who trades in the securities markets on the basis of material, non-public information that he has "misappropriated" in breach of a fiduciary duty of trust or confidence has committed fraud under Rule 10b-5, promulgated by authority of Section 10(b) of the Securities Exchange Act of 1934.⁶ Underlying this theory are assumptions of law and economics that emphasize individual transactions rather than market operations, and property rather than social contract theory. In this paper I examine the validity of these assumptions. I argue that the misappropriation theory, as it has evolved historically, is a theoretically unsound tool for accomplishing the purposes of the 1934 Act.⁷ I also contend that the theory fails to support the intended goals of existing securities laws and encourages an economic infrastructure that is neither optimally efficient nor morally justifiable.⁸ Misappropriation theory should be abandoned in favor of a wider prohibition of all trades made by persons possessing material information unavailable to the general public.

II. THE HISTORY OF INSIDER TRADING REGULATION AND THE DEVELOPMENT OF MISAPPROPRIATION THEORY

Even before the enactment of the Securities and Exchange Act of 1934, courts sporadically applied the common law tort of fraud to securities transactions, presaging more concerted Depression-era efforts.⁹ Under common law, fraud is the intentional misrepresentation of a material fact upon which the plaintiff justifiably relies to his detriment.¹⁰ While this defini-

5. See Steven R. Salbu, *A Legal and Economic Analysis of Insider Trading*, 8 BUS. & PROF. ETHICS J. 2 (1990).

6. See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C.) [hereinafter "1934 Act"]; *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983). See *infra* text accompanying notes 20-42.

7. See Salbu, *supra* note 5, asserting that misappropriation theory was invented as an ineffective expedient to force a fit between the goals of market protection and the anti-fraud gravamen of the language in Rule 10b-5.

8. See Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 118 (1982) (discussing efficiency and fairness as goals of insider trading proscription).

9. These efforts are discussed in detail in ROBERT L. HEILBRONER, *THE MAKING OF ECONOMIC SOCIETY*, 134-65 (8th ed. 1989).

10. See RESTATEMENT (SECOND) OF TORTS § 525 (1977).

tion typically encompasses cases in which misrepresentation is expressed verbally or implied by an affirmative act,¹¹ fraud can also be inferred from silence, using a "special facts" justification under which a special relationship creates a duty to speak and a concomitant inference of fraud in the instance of silence.¹² The development of liability for insider trading is largely a function of this jurisprudence of tacit fraud.

When dealing with insider trading cases, the early Twentieth Century courts adhered strictly to the common-law requirements of fraud, recognizing a cause of action only when a silent trade was made despite a clearly identified duty to speak.¹³ These common-law cases received statutory and administrative support when the 1934 Act was adopted.

In enacting the Securities Exchange Act of 1934, Congress intended "to protect the investing public and honest business."¹⁴ Congress passed the 1934 Act under pressure from popular opinion that blamed the Great Depression on unfairness, manipulation, and abuse in financial markets.¹⁵ Congress demonstrated little concern with the defrauding of individual investors and their isolated injuries; rather, Congress focused on the perceived systemic effect—the crash of the stock market.¹⁶ With the intent of protecting the future integrity of securities markets, Congress passed Section 10(b) of the 1934 Act. That section, as originally adopted, forbids a person to "use or employ, in connection with the purchase or sale of any security, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the

11. See, e.g., *Steinberg v. Chicago Medical Sch.*, 371 N.E.2d 634 (Ill. 1977).

12. See *Strong v. Repide*, 213 U.S. 419 (1909). *Strong* created the common-law nexus between a special relationship and the inference of misrepresentation from silent trading. In essence, the trade itself can be considered a fraudulent transaction if a duty to disclose is inferable from the "special facts" of the case. See *id.* at 431-33.

13. See *Strong*, 213 U.S. at 431-33.

14. S. REP. NO. 47, 73rd Cong., 1st Sess. (1934), reprinted in 2 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 17 (1973). See also 77 CONG. REC. 937 (1933) (quoting President Roosevelt regarding the purpose of the Securities Act of 1933, stating, "It should give impetus to honest dealing in securities and thereby bring back public confidence"). Roosevelt's more elaborate commentary on the 1934 Act is contained in 78 CONG. REC. 2264 (1934) (message from President Roosevelt), reprinted in 4 J.S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 5 (1973).

15. See *supra* note 14 for the legislative history of the 1934 Act.

16. See *id.*

public interest or for the protection of investors."¹⁷

To implement the goals of Section 10(b), the SEC promulgated Rule 10b-5 in 1942. The Rule states,

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, (1) to employ any device, scheme, or artifice to defraud; (2) to 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 light of the circumstances under which they were made, not misleading; or (3) to 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].¹⁸

Early decisions under the 1934 Act applied its restrictions broadly.¹⁹ These cases implicitly presumed that trading on information not publicly accessible was patently unfair and thus within the general intent of the 1934 Act.²⁰ While focusing on the anti-fraud provisions of Rule 10b-5 promulgated under the Act,²¹ the courts failed to scrutinize fact patterns for evidence of the particular elements of fraud. Misrepresentation was imputed to silent trades despite the absence of a special relationship from which a duty to speak might be inferred.²² The courts liberally imputed liability by emphasizing fairness and market integrity over the technical requirements of fraud.²³

17. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b)).

18. Rule 10b-5, Employment of Manipulative and Deceptive Devices, Exchange Release No. 3230, 7 Fed. Reg. 3804 (1942) (codified at 17 C.F.R. § 240.10b-5 (1991)).

19. See, e.g., Securities and Exch. Comm'n v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). These decisions implicitly applied the industry's existing standards. Under the New York Stock Exchange's 1914 listing agreement amendments, companies were required to disclose actions that related to dividends and interest. The requirement was a reaction to trading that occurred upon inside knowledge that Goodyear Rubber Company was planning to issue dividends several months later. See Howard C. Westwood & Edward G. Howard, *Self-Government in the Securities Business*, 17 LAW & CONTEMP. PROBS. 518, 524 (1952).

20. See, e.g., Texas Gulf Sulphur Co., 401 F.2d at 851-52.

21. See *supra* note 19 and accompanying text.

22. The Securities and Exchange Commission construed Rule 10b-5 broadly in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The Commission stated that the Rule broadly restricts the trading practices of "any person," and declined to require corporate insider status as a prerequisite to the Rule's application, asserting that the Rule was meant to ameliorate the inherent unfairness that exists when information not available to the public is used by one party to a market transaction. See *id.* at 911-12.

23. See, e.g., Texas Gulf Sulphur Co., 401 F.2d at 851-52. This decision stated that anyone who possesses inside information must either disclose the information to the

The first court decisions to apply the misappropriation theory, however, revived the rigorous common-law requirement that all elements of fraud be proven in the prosecution of insider trading cases. In particular, courts applying the misappropriation theory required the plaintiff to prove intentional misrepresentation, express or implied by breach of a duty to disclose, and justifiable reliance on the part of the ostensibly defrauded party.

In *Chiarella v. United States*,²⁴ for example, the Supreme Court held that nondisclosure can be fraudulent only if a duty to speak exists.²⁵ The defendant Chiarella was an employee in a printing plant who received information by reading printing jobs that related to tender offers of various corporations.²⁶ The Court held that because Chiarella was not a corporate insider and had no prior relationship with the corporations, he was under no duty either to disclose the information or to refrain from trading.²⁷ The doctrine which evolved from *Chiarella* was subsequently labelled "misappropriation theory" because the duty to disclose or refrain from trading was triggered only if the trade could be viewed as theft or misappropriation from an entity to which the trader owed some fiduciary duty.²⁸

public or refrain from trading the securities involved. *See id.* at 848. The case contains the broadest interpretation of the intent and scope of Rule 10b-5 to date. The opinion suggests that non-public information, regardless of its derivation and the status of its holder, renders an unfair advantage when the holder trades on the information. This advantage was considered sufficient in itself to qualify any trading thereunder as fraudulent. *See also* *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir. 1974) (holding that the defendants owed a duty, not only to the purchasers of the actual shares sold, but to all persons who purchased stock in the open market without knowledge of the material inside information during the relevant period).

24. 445 U.S. 222 (1980).

25. *See id.* at 235.

26. *See id.* at 224.

27. *See id.* at 232-33.

28. *See also* *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) (holding that the defendant's use of confidential information that had been misappropriated by the employees of an investment banking company constituted a violation of 10b-5), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983).

In response to *Chiarella*, the SEC promulgated Rule 14e-3 pursuant to authority conferred under Section 14(e) of the 1934 Act. *See* 17 C.F.R. § 240.14e-3 (1991). The rule prohibits fraud "in connection with tender offers," and applies to those who derive non-public information, directly or indirectly, from a target company or offering company. *See id.* Although the language of 14e-3 appears to eliminate the misappropriation requirement, questions remain regarding the different standards of 14e-3 and 10b-5. *See United States v. Chestman*, 903 F.2d 75, 83 (2d Cir. 1990) (stating that, unlike 10b-5, the duty imposed by Rule 14e-3 to disclose or abstain from trading, in the context of a tender offer, does not require a fiduciary duty or confidential relationship), *vacated in part*, 60 U.S.L.W. 2245 (2d Cir. Oct. 7, 1991) (en banc). Even if courts decide that 14e-3 actions do not require a showing of misappropriation, it is unlikely that courts will

The courts did not apply the misappropriation theory in a constrained manner. In *Dirks v. Securities and Exchange Commission*,²⁹ for example, the Supreme Court applied the misappropriation theory to information derived from tips. *Dirks* created a duty on the part of a tippee, derived from the duty of a tipper, either to disclose non-public information or refrain from trading. Under *Dirks*, if a tippee receives inside information from someone who has a fiduciary relationship to the shareholders of the relevant corporation, this relationship will be imputed to the tippee himself. This derivative duty is limited to instances in which *scienter* can be proven to exist on the parts of both the tipper and the tippee.³⁰

After *Dirks*, a California Federal District Court found in *Securities and Exchange Commission v. Lund*³¹ that persons who are not insiders in the traditional sense can develop fiduciary duties to shareholders of a corporation by virtue of being "temporary insiders."³² Lund had received information from a friend and business associate who was a corporate insider; as a "temporary insider," he was found liable under Rule 10b-5 for trading on non-public material information received within the context of a special relationship.³³

extend this approach beyond circumstances involving tender offers. The history of 14e-3, nevertheless, implies that it would be logical and consistent to eliminate the misappropriation theory in instances other than tender offer cases. The SEC's rationale for adoption of the rule is "unfair disparities in market information and market disruption." Tender Offers, Exchange Act Release No. 17,120, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980). This explanation could apply with equal merit to cases beyond tender offers.

29. 463 U.S. 646 (1983).

30. The Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.), addresses the issue of tipper and tippee liability. While the 1988 Act does not overrule the basic substantive principle regarding tippers and tippees as stated in *Dirks*, "[T]he Committee intends that a person who 'controls' a tipper and otherwise meets the standards for imposition of a penalty should be liable for profits made by indirect tippees in a situation in which the tipper may communicate to one person, who does not trade and therefore receives no direct profits, but who acts as a conduit and passes on the information to other who do trade." The Insider Trading and Securities Fraud Enforcement Act of 1988, H.R. REP. No. 3055, 100th Cong., 2d Sess. 19-20 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6056-57.

31. 570 F. Supp. 1397 (C.D. Cal. 1983).

32. See *id.* at 1403.

33. See *id.* Criteria for finding the requisite breach of a relationship of trust and confidence were later outlined in *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). The District Court stated that a fiduciary or confidential relationship requires "trust as the basis of obligation and corresponding reliance or security." 601 F. Supp. at 712. This definition encompasses both "technical" fiduciary relationships and informal alliances wherein one person trusts and relies upon another, such trust being either unilateral or mutual.

The Second Circuit Court of Appeals has discerned a different philosophy underlying the 1934 Act. In 1984, the Second Circuit decided *Securities and Exchange Commission v. Materia*,³⁴ a case similar to *Chiarella* in that the defendant, a copyreader for a financial printer, traded on information regarding proposed tender offers that he discovered through his job.³⁵ In an earlier case, the Second Circuit had recognized that a fiduciary duty to refrain from trading on inside information was required for liability under *Chiarella*.³⁶ Such a duty was found to exist because corporate clients of the printer would be harmed by the defendant's trading, which would in turn damage the company's reputation and precipitate a loss of business. The *Materia* decision implied that fraud perpetrated on an entity that is neither the buyer nor the seller of the securities in question comes under the umbrella of Rule 10b-5.

Analogous reasoning was applied the following year in *Securities and Exchange Commission v. Musella*,³⁷ wherein tippees received non-public information from an employee of a law firm that represented the acquiring companies in tender offers.³⁸ The court in *Musella* noted that under the *Chiarella* rationale, an individual could conceivably circumvent liability by obtaining non-public information from the acquiring company rather than the target company.³⁹ In an earlier case, the Second Circuit had rejected this result as nonsensical, emphasizing the fundamental unfairness involved in trading on improperly obtained information regardless of the source.⁴⁰ Under the court's analysis, a tippee who trades is liable if she knew or should have known that the tipper obtained the information through the tipper's breach of fiduciary duty to its law-firm employer, regardless of which side that employer happens to represent.⁴¹

While the Second Circuit and the Supreme Court were attempting to clarify the parameters of misappropriation theory and their interpretations of the 1934 Act and its Rules, Con-

34. 745 F.2d 197 (2d Cir. 1984).

35. See *id.* at 203.

36. See *id.* at 202.

37. 578 F. Supp. 425 (S.D.N.Y. 1984).

38. See *id.* at 434-35.

39. See *id.* at 436.

40. See *id.* at 438.

41. See *id.* at 439 (citing *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983)).

gress passed the Insider Trading Sanctions Act of 1984 (ITSA).⁴² ITSA augmented the 1934 Act, authorizing the SEC to seek civil penalties from those who purchased or sold securities using material non-public information, or who "tipped" others whose transactions occurred on a national securities exchange or through a broker or dealer.⁴³ The intent of the ITSA was to increase the reach of the 1934 Act and strengthen its enforcement.⁴⁴ The Second Circuit, in its effort to strengthen the regulatory reach of 10b-5, interpreted the intent of ITSA broadly.⁴⁵

In *Moss v. Morgan Stanley Inc.*,⁴⁶ the Second Circuit also upheld the dismissal of a complaint that alleged illegal behavior that did not fit the technical requirements of misappropriation theory because no fiduciary relationship existed between buyer and seller.⁴⁷ *Moss* concerned an employee who misappropriated information from his employer when he purchased shares of the target company's stock from unwitting shareholders—termed "contemporaneous traders"—prior to the announcement of a tender offer.⁴⁸ A seller sued, alleging that the employee had a duty to inform sellers of the pending tender offer, but the court held that there was no such "duty of disclosure."⁴⁹

Congress overruled the holding in *Moss* by adopting the In-

42. Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered sections of 15 U.S.C.) [hereinafter ITSA].

43. *See id.*

44. *See Eichler v. Berner*, 472 U.S. 299, 313 n.23 (1985) (discussing the purposes of the ITSA and interpreting the relationship between the ITSA and Section 10(b) of the 1934 Act).

45. *See, e.g., United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987). The Second Circuit stated:

In enacting [the ITSA], Congress noted that the intent of the 1934 Act was to condemn all manipulative or deceptive trading 'whether the information about a corporation or its securities originates from inside or outside the corporation.' . . . Clearly, Congress has understood its predecessors to have delineated illegal conduct along the lines not simply of relationships to corporations and duties arising thereunder. . . . Rather, Congress apparently has sought to proscribe as well trading on material non-public information obtained not through skill but through a variety of 'deceptive' practices, unlawful acts which we term 'misappropriation.'

Id. at 1030-31 (citations omitted).

46. 719 F.2d 5 (2d Cir. 1983), *cert. denied sub nom. Moss v. Newman*, 465 U.S. 1025 (1984).

47. *See id.* at 14.

48. *See id.* at 8.

49. *See id.* at 13-15 (citing *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983)).

sider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).⁵⁰ ITSFEA was intended to strengthen the enforcement framework of existing insider trading laws⁵¹ and create private insider trading liability to contemporaneous traders.⁵² The House Committee report accompanying the legislation stated that *Moss* was "inconsistent with the remedial purposes of the Exchange Act."⁵³ The report further stated that "the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material non-public information is unlawful."⁵⁴

Congress's extension of insider trading prohibitions was motivated by other cases as well. Wide publicity had surrounded *United States v. Carpenter*,⁵⁵ which involved R. Foster Winans, the former author of the "Heard on the Street" column of *The Wall Street Journal*.⁵⁶ Winans gave stockbrokers at Kidder Peabody the content and publication dates of his columns before they were actually published.⁵⁷ The District Court determined that when these columns were published, they had an impact on the financial markets.⁵⁸ The Second Circuit Court of Appeals determined that the acts of Winans and his tippees constituted misappropriation from *The Wall Street Journal*; the use of the material in subsequent trading by the tippees satisfied the "in connection with the sale or purchase of securities" requirement of 10b-5.⁵⁹ Consistent with its holding in *Materia*, the Second Circuit found misappropriation through breach of a fiduciary duty to disclose or refrain from trading, based on Winans's em-

50. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C.) [hereinafter ITSFEA]. See HOUSE COMM. ON ENERGY AND COMMERCE, H.R. REP. No. 910, 100th Cong., 2d Sess. 1, 13-15 (1988), reprinted in 1988 U.S.C.C.A.N. 6043 [hereinafter H.R. REP. No. 910].

51. *Id.* at 7.

52. Pub. L. No. 100-704, § 20A(a), 102 Stat. 4677, 4680 (1988):

Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

53. H.R. REP. No. 910, *supra* note 50, at 26-27.

54. *Id.*

55. 484 U.S. 19 (1987).

56. See *id.* at 22.

57. See *id.* at 23.

58. *United States v. Winans*, 612 F. Supp. 827, 830 (S.D.N.Y. 1985).

59. *United States v. Carpenter*, 791 F.2d 1024, 1031-32 (2d Cir. 1986), *aff'g* *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985).

ployee relationship. The fact that *The Wall Street Journal* and its parent company, Dow Jones, did not themselves trade in securities did not deter the Court from finding a 10b-5 violation.⁶⁰ The Second Circuit decision in *Winans* supports the implication in *Materia* that defrauding an entity other than a buyer or seller of the relevant securities can be a violation of Rule 10b-5.⁶¹

These cases demonstrate the tension that has long existed between the Second Circuit and the United States Supreme Court in their interpretations of the original 1934 Act and Rule 10b-5.⁶² Second Circuit cases tend to apply the rule as a means of ensuring the integrity of securities markets,⁶³ echoing the apparent intent of the original 1934 Act,⁶⁴ while Supreme Court decisions limit the scope of the Rule to wrongful acts under a more precise reading of its anti-fraud provisions.⁶⁵ Decisions of these courts have clashed precisely because of a disparity in interpretation of the philosophy underlying the 1934 Act.

60. *See id.*

61. The appeal of the *Winans* case and related tippee cases in *United States v. Carpenter*, 484 U.S. 19, 24 (1987), resulted in a conviction for mail fraud and a 4-4 stalemate on the insider trading issue. Because the court reached a majority decision only on the mail fraud issue, the effect of *Carpenter* on misappropriation theory is unclear. Scholars have suggested conflicting interpretations of the 4-4 decision in *Carpenter*. Compare Anne P. Donovan, *Supreme Court Upholds Conviction of Former Business Writer Winans*, INVESTOR'S DAILY, Nov. 17, 1987, at 1 (quoting Alan Bromberg, who said, "it states pretty strongly that the misappropriation theory is a fairly dubious proposition") with Sherry R. Sontag, *Misappropriation Theory in Limbo: An SEC Victory—or Not?*, NAT'L L.J., Dec. 7, 1987, at 3, 10 (quoting SEC Commissioner Grundfest as stating that the decision in *Carpenter* left misappropriation theory "alive and well"). The 4-4 split in *Carpenter* on the insider trading issues indicates that the Supreme Court lacks consensus regarding this important question.

62. These two varying approaches to reading Rule 10b-5 are characterized as "effect" versus "conduct" in Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 778-822 (1988).

63. Second Circuit cases built on the far-reaching decision of *Securities and Exch. Comm'n v. Texas Gulf Sulphur Co.*, in which the court indicated that its crucial concern was protection of the market mechanism, stating, "Whether predicated on traditional fiduciary concepts, or on the 'special facts' doctrine, the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." 401 F.2d 833, 848 (2d Cir. 1968) (citations omitted), *cert. denied*, 394 U.S. 976 (1969).

64. The SEC responded to *Chiarella* by passing Rule 14e-3, which eliminated the requirement of misappropriation under limited circumstances. *See supra* text accompanying note 28.

65. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court required proof of scienter in private claims. *See id.* at 193. The decision suggests that Section 10(b) of the 1934 Act intended to remedy culpable conduct rather than repair market failures or imperfections. The Court's emphasis on manipulation and deception created the foundation for its holding in *Chiarella*, limiting the application of the Act and its rules to infractions against individuals rather than the market.

The legal, economic, and historical context of the 1934 Act and Rule 10b-5 lend considerable support to the Second Circuit's assumption that market integrity is the underlying purpose of Section 10(b) and Rule 10b-5. The remainder of this analysis is devoted to demonstrating that fairness and overall market integrity should prevail in the development of effective insider trading laws. The individual transactional level of analysis encompassed in the misappropriation theory supports these goals inadequately. The legal, economic, and ethical discussions that follow explain why.

III. THE SHORTCOMINGS OF MISAPPROPRIATION THEORY

A. *The Microeconomic Focus of Misappropriation Theory*

The misappropriation theory inadequately serves the economic function of Rule 10b-5: the maintenance of market integrity. In limiting its restriction to trades made on misappropriated non-public information, the theory prohibits only one category of imbalanced market transactions. Transactions in which parties have disparate access to information that has been legitimately obtained by the advantaged party are permitted under the theory. Economic theory suggests that this disparity itself is inefficient and may result in market failures. In particular, misappropriation theory cannot insure market integrity because the focus on particular transactions fails to address the issue of information asymmetry.⁶⁶

Efficient market operation is disturbed by imperfections in

66. The efficient capital market theory is the model for analysis of this question. This theory suggests that pricing of securities will most closely approach equilibrium when information is allowed to flow freely and when buyers and sellers are encouraged by their confidence in the marketplace to participate therein. See Christopher P. Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). On the basis of the efficient capital market theory, some scholars have suggested that prohibition of insider trading is bad policy because, *inter alia*, any mandate to refrain from trading on the basis of true information impedes the assimilation of such information into the market pricing mechanism. Others have responded that perceptions of unfairness in the market discourage participation and thereby hinder efficiency. See generally HENRY GIRARD MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35 (1986); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

market structure.⁶⁷ Under conditions of perfect competition, prices and the supply of goods are self-regulating. Perfect competition is a function of the number of players in the market and their relative degree of power; the registration of consumer preferences through market transactions at fully known market prices; the relevant prices known to each producer who strives to maximize profits; and equal access to the market.⁶⁸ Adam Smith first discussed these characteristics in describing the kind of atomistic competition in which the invisible hand operates precisely because no single player has the ability to overwhelm its dynamics through the use of unusual or extraordinary market power.⁶⁹

Commentators have noted the potential distortions created by information asymmetry in capital markets. Information asymmetry can create a disparity of power between and among buyers and sellers. Asymmetry increases the risk assumed by the inferior party, creating a warping effect on utility functions and subsequent consumer behavior. This results in a form of market failure wherein the supply of securities may not be efficiently allocated.⁷⁰ For example, stock prices of takeover target firms have been observed to increase significantly during the eight-week period before the first public announcement of impending consolidation.⁷¹ Such pre-tender price run-ups have been attributed to legitimate information searches,⁷² to exploitation of information leakage,⁷³ or both, suggesting that

67. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 44-52 (1988).

68. These components of market efficiency are discussed in EDWIN MANSFIELD & NARIMAN BEHRAVESH, *ECONOMICS USA* 31-53 (1986).

69. See ADAM SMITH, *THE WEALTH OF NATIONS* 72-81 (R.H. Campbell et al. eds., Liberty Press 1981) (1776). Although Smith disfavored the interference of government in the marketplace through mercantilist policy, he recognized the necessity of regulation that protects the integrity of market structure. See *id.* at 628-31.

70. For a discussion of the efficient allocation of resources under conditions of optimal information quality in a free marketplace, see WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 430-45 (2d ed. 1982) (observing that information is filtered through the free market mechanism to determine output selection, production planning, and distribution).

71. See In-Mu Haw et al., *Market Manifestation of Non-public Information Prior to Mergers: The Effect of Ownership Structure*, 65 *ACCT. REV.* 432, 446 (1990).

72. See J. Kimball Dietrich & Eric Sorensen, *An Application of Logit Analysis to Prediction of Merger Targets*, 12 *J. BUS. RES.* 393 (1984) (documenting the limited ability to distinguish between takeover targets and non-takeover targets during the 12-month period prior to takeover).

73. See Krishna G. Palepu, *Predicting Takeover Targets*, 8 *J. ACCT. & ECON.* 3, 31-32 (1986).

market structure disparities exist routinely and that behavior in the marketplace incorporates any existing advantage.

Unconstrained opportunism based on information asymmetry almost inevitably causes market failure.⁷⁴ Even in the absence of a stock market crash, information asymmetry is likely to squeeze smaller shareholders from stock market participation when they discover that they cannot achieve normal returns in an environment of windfall profits realized by unfairly advantaged traders.⁷⁵

Misappropriation theory misses the mark in its attempts to rectify information asymmetry. Misappropriation addresses a single transaction, prohibiting theft of information from its owner. The theory may discourage future capitalization on stolen information. Yet acquiring and trading upon non-public information without a breach of a fiduciary duty is not misappropriation and will not trigger 10b-5 liability. The key element of information asymmetry—unequal access to information—is only addressed by misappropriation theory when a fiduciary duty exists. Unfortunately, information asymmetry often exists without any breach of fiduciary duty.

B. *Private Actions and the ITSFEA*

The theoretical impetus for the development of misappropriation theory can be traced to the creation of private actions under the 1934 Act.⁷⁶ When insider trading claims were being pursued by the SEC or by state bodies, the original 10(b) function of market maintenance was clear and unchallenged. The development of private compensation for insider trading made it necessary to focus on individualized injuries, hence the temptation to shift from a macro-level to a micro-level analysis.⁷⁷ Misappropriation theory has functioned as a rickety bridge between the purpose of Rule 10b-5 and the creation of private claims. Ironically, in casting a wider net of liability through pri-

74. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 490-92 (1970).

75. See *id.*

76. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

77. See Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398 (1974).

vate actions, the judiciary fettered itself with a technical requirement ill-fitted to the purposes of Rule 10b-5.

The courts and Congress have attempted to reconcile misappropriation theory with the goal of market integrity. The attempted match has been clumsy, and the forced fit consistently reveals that the adoption of misappropriation theory for this purpose has been a mistake. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,⁷⁸ the Second Circuit held that contemporaneous traders could recover damages in private actions.⁷⁹ The court failed, however, to explain how a cause of action based on fraud could be maintained without a relationship on which to base a duty or without privity on which to base a contractual obligation. The Sixth Circuit attempted to provide the missing link, suggesting that difficulties in tracing causality between purchases and sales in securities markets require the recognition of surrogate plaintiffs.⁸⁰ Accordingly, contemporaneous traders, even those whose purchases or sales do not rely on the insider's behavior, act as "stand-ins" for those parties who have been directly and individually defrauded, but who presumably either were unaware of this fraud or could not prove the fraud because of market complexities.⁸¹

The creation of these surrogate private claims has resulted in theoretical inconsistencies in applying Rule 10b-5. The compensatory purpose of a private cause of action is not advanced by granting compensation to a "stand-in" on grounds that the real victim is too difficult to trace.⁸² The proper justification for the granting of surrogate status to contemporaneous traders is to achieve 10b-5's goal of deterrence.⁸³

Here is where confusion reigns: Have private actions under 10b-5 been created to compensate victims of fraud, or to deter future insider trading abuses? Victim compensation focuses on

78. 495 F.2d 228 (2d Cir. 1974).

79. *See id.* at 238.

80. *See* *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

81. *See id.* at 320-22.

82. Analogous situations in other areas of law demonstrate the inappropriateness of surrogate liability in our legal system. If X injures Y in an automobile crash and Y wanders from the scene under the spell of amnesia, never to surface again, can Z, who was injured in a similar accident wherein the tortfeasor left the scene and cannot be located, have a cause of action against X as a "stand-in"? Such a policy would require an extreme departure from basic common law tenets of causality in cases of injury claims.

83. *See* 542 F.2d at 326 n.11.

individual transactions and normally requires a showing of duty, breach, injury, and causality or reliance. In contrast, the deterrence of insider trading is a market-wide objective within the larger macroeconomic environment. It is a public policy goal that traditionally falls under the aegis of state enforcement and police power. The normally compensatory private cause of action is perhaps being stretched to cover public policy purposes, resulting in an overinclusive compensatory effect that grants damages to plaintiffs who have not been injured by the actions of the defendant. At the same time, however, the deterrent effect is underinclusive, because liability under misappropriation theory requires theft of information. No deterrence is accomplished when trading is done on unavailable but legitimately obtained information, despite possible detriment to the market.

The Second Circuit in *Moss v. Morgan Stanley Inc.*⁸⁴ implicitly recognized the inconsistency between the misappropriation theory and optimal protection of market efficiency. The court had two choices: (1) to stretch the interpretation of fraud to overlook the essential requirements of causality, reliance, and a special relationship from which to infer fraud from silence, thereby providing the protection of market efficiency intended in Rule 10b-5; or (2) to require with the usual rigor that the plaintiff prove the essential elements of fraud, thereby allowing trades on publicly unavailable information based on the technicality that the information was obtained without breaching some fiduciary duty. Neither option is satisfying because the misappropriation requirement is so poorly adapted to the problems that result from insider trading. The Second Circuit chose the former option in *Moss*, leaving in its wake greater public dissatisfaction with legal loopholes that allow both inequities and inefficiencies to permeate the market.⁸⁵

The ITSFEA was largely a response to this growing outcry. In granting a statutory cause of action to contemporaneous traders and thus overruling *Moss*, Congress again had two op-

84. See 719 F.2d 5 (2d Cir. 1983), cert. denied sub nom. *Moss v. Newman*, 465 U.S. 1025 (1984).

85. Public distress regarding insider trading abuses peaked in the mid and late 1980s. See, e.g., *Insider Trading*, THE ECONOMIST, Nov. 22, 1986, at 77-78; James B. Stewart, *Street Bombshell: Inside-Trading Scandal Implicates High Aides at Goldman, Kidder*, WALL ST. J., Feb. 13, 1987, at A1; *Wall Street Scam: Making Millions with your Money*, TIME, Dec. 1, 1986, 48-56.

tions: (1) to select the alternative that the Second Circuit rejected in *Moss*; or (2) to abandon the misappropriation theory and create by statute some alternative with fewer theoretical inconsistencies.⁸⁶ Congress unfortunately forfeited its opportunity to abandon the misappropriation theory and thereby resolve its otherwise irreconcilable conflicts with the larger purposes of the 1934 Act.⁸⁷ Instead, Congress left misappropriation theory intact. The legislative history notes correctly that the denial of claims by contemporaneous traders is "inconsistent with the remedial purposes of the Exchange Act," insisting in the same breath that "misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful."⁸⁸ Thus in explaining section 20A of the ITSFEA, Congress perpetuated the inconsistency between contemporaneous trader standing and misappropriation theory. The law appears to have reverted to its status in *Shapiro*,⁸⁹ wherein the prohibition against outsiders' trading on publicly unavailable information is limited to instances of stolen information.

Consistency between securities law and its policy goals requires consistency in underlying economic assumptions. One crucial assumption pertains to the appropriate level of economic analysis, given the relationship between individual transactions and the impersonal market. Although a finding of "transactional causality" was originally necessary to establish the element of causation in fraud,⁹⁰ the ITSFEA retreated from this position.⁹¹ The abandonment of the transactional causation requirement was procedurally necessary to create the cause of action; it is virtually impossible for a private plaintiff trading in the stock exchange to establish either privity with a particular defendant or causality of the trade by any trader's particular transaction. Thus, in creating contemporaneous

86. See *infra* Section IV.

87. See *supra* note 14.

88. See H.R. REP. NO. 910, *supra* note 50, at 26-27.

89. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2d Cir. 1974).

90. "Transactional causality" means that the actual trade on insider information caused the victim to buy or sell. Transactional causality requires the establishment of both a buyer-seller relationship between the parties and an inference of reliance by the victim upon the silent misrepresentation of the alleged perpetrator. See, e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

91. See Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465, 483 (1990).

claims, Congress recognized the futility of transactional analysis in the achievement of larger, macroeconomic goals within an impersonal marketplace.

A complete understanding and acceptance of market principles compels the conclusion that Congress and the courts have done only half the job. Assuming that 10b-5 is intended to protect buyers and sellers who enter transactions under conditions of anonymity and of trust in basic macro-market principles, the source of an inside information advantage is as irrelevant as the technical requirements of micro-transactional privity, causality and reliance.

C. *Ethical Systems and Constructs of the Insider Trading Prohibition*

Apart from economic considerations, assumptions regarding ethical systems underlie the application of misappropriation theory.⁹² Most relevant here is a distinction between property-based and contract-based theories; the nature of insider trading recommends the application of a contract-based system. Unfortunately, the current application of misappropriation theory is part of an ethical system built on a property construct. The property-based system underlying applications of misappropriation theory violates many normal ethical and legal expectations. As a result, court decisions that use misappropriation theory have often caused a public outcry. Describing the two fundamental ethical approaches to insider trading in terms of property and contract allows us to examine the ethical assumptions behind the dominant models of legal decisions and connect the ethical constructs to traditional legal conceptions.

Property theories have been applied to the ethical issues regarding insider trading to question the validity of any prohibition at all,⁹³ to analyze the elements of infringement,⁹⁴ or to

92. Numerous articles focus on the ethical side of insider trading questions. See, e.g., Robert W. McGee & Walter E. Block, *Information, Privilege, Opportunity and Insider Trading*, 10 N. ILL. U. L. REV. 1 (1989); Roman Tomasic & Brendan Pentony, *Insider Trading and Business Ethics*, 13 LEGAL STUD. F. 151 (1989).

93. See Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933 (1985), reprinted in *ECONOMIC LIBERTIES AND THE JUDICIARY* 317-27 (James A. Dorn and Henry G. Manne eds., 1987).

94. See Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79 (1987).

discuss the nature of misappropriation of information.⁹⁵ All of these applications suggest that the crucial problem with insider trading is the just distribution of asset ownership among individuals. Property theories refer either explicitly or implicitly to Locke's concept of distributive justice in accordance with his theory of acquisition, which states that property rights naturally vest in unowned objects when one mixes one's labor with those objects.⁹⁶ Property rights in information are created when information is developed in the course of one's labor. Property interests created by managerial labor are thus viewed as emolument or compensation. It follows that insider trading is justified,⁹⁷ and shareholders should be permitted to authorize insider trading as one compensation option, because such authorization essentially mitigates the misappropriation of property through the vehicle of consent.⁹⁸ The current conceptualization of insider trading found in misappropriation theory is built on a rights-based property framework.⁹⁹

Contract theory would analyze insider trading differently.¹⁰⁰ Both the micro-level scrutiny of agreements among individuals and the macro-level examination of social contracts provide an ethical framework for the examination of a wide variety of practices involving non-public information. While contracts among individuals protect the property rights discussed above, social contracts support and legitimize institutions such as the markets themselves.¹⁰¹ In essence, individual contract analysis supports an ethical position based on property rights, the contracts

95. See John W. Bagby, *The Evolving Controversy Over Insider Trading*, 24 AM. BUS. L.J. 571 (1987).

96. See JOHN LOCKE, TWO TREATISES OF GOVERNMENT 287-302 (Peter Laslett ed., student ed. 1988) (1698).

97. See Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 876-78 (1983); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 322.

98. See Nicholas L. Georgakopoulos, *Classical and Cross Insider Trading: Variations on the Theme of Rule 10b-5*, 28 AM. BUS. L.J. 109, 131 (1990); Bill Shaw, *Shareholder Authorized Inside Trading: A Legal and Moral Analysis*, 9 J. BUS. ETHICS 913, 920-21 (1990).

99. The legislative history of the ITSFEA sheds light on this property-rights orientation. It states that "individuals have a duty not to 'misappropriate' information from their employers or otherwise in breach of fiduciary or other relationship of trust and confidence, and commit securities fraud when they trade in possession of misappropriated information or tip others who trade." H.R. REP. No. 910, *supra* note 51, at 10.

100. See Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

101. See generally SOCIAL CONTRACT: ESSAYS BY LOCKE, HUME, AND ROUSSEAU (Ernest Barker ed., 1960).

simply being vehicles for orderly property transactions.¹⁰² Social contract theory distinguishes itself from the property-based ethical system in several ways: (i) its level of analysis is social rather than individual; (ii) its scope goes beyond the essentially economic concerns of property ownership by focusing on norms, values, processes and procedures, institutions and social organization; and (iii) its primary concern is voluntary consensus regarding the social elements in (ii) above.¹⁰³

The social contract approach to ethical questions fits the "market integrity" version of insider trading proscription, as the property orientation is compatible with a "misappropriation" orientation.¹⁰⁴ Market integrity relies upon a consensus of systemic fairness, information availability, and symmetry.¹⁰⁵ Ideally, these qualities should be incorporated into an institution such as the New York Stock Exchange through social consensus with respect to norms, values, processes, and procedures which are the subject matter of the social contract. From an ethical vantage founded in social contract theory, trades made using non-public information obtained without misappropriation do in fact defraud the market because the above assumptions regarding information dispersement are part of the social pact.

Systems of ethics based on property and on social contract¹⁰⁶

102. This refers to more traditional, classical contract theory pertaining to individuals, as contained in U.C.C. Article 2: Sale of Goods. Whereas social contract is typically categorized under political philosophy or economy, classical contract theory traditionally falls under positive conceptions of law.

103. See Thomas W. Dunfee, *Business Ethics and Extant Social Contracts*, 1 BUS. ETHICS Q. 23 (1991) (discussing social contract as a significant source of ethical norms in business practices).

104. David Gauthier suggests that rational order "requires that rationality be conceived as related instrumentally to the satisfaction of individual interests." DAVID P. GAUTHIER, *MORAL DEALING: CONTRACT, ETHICS, AND REASON* 342 (1990). Both rights and laws derived from rational analysis determine human relationships (and, implicitly, contractual agreements). This connection between the rational discernment of rights and consensus among people is the source of the nexus between contract and morality.

105. "Market integrity" is used here to refer to the maintenance of a set of broadly-accepted rules and norms that support the effective and efficient functioning of a free marketplace within a capitalist framework. Systemic unfairness in the availability of information within securities markets reduces investor confidence, thereby discouraging participation in and undermining vital capital markets. For a discussion of the relationship between insider trading and the behavior of investors, see Spencer Derek Klein, Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988). See also MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 167 (1982) (stating that social stability requires "a basic core of value judgments that are unthinkingly accepted by the great bulk of its members," and that one such value central to American capitalism is that payment should be in accordance with production).

106. Yet another alternative would be a rights based system of ethics which presup-

are both legitimate, assuming the existence of sets of moral rights regarding both the distribution of resources and the maintenance of the social order.¹⁰⁷ Given the two perspectives, both broadly incorporated into American public policy, the question becomes which system is the appropriate model for addressing insider trading.

Recall that the historical context of the Securities Acts of the 1930s indicates that the problems were considered systemic rather than individual and that the abuses to be addressed were market abuses rather than micro-level thefts.¹⁰⁸ The original intent of the 1934 Act was to repair markets riddled by manipulation and structural inefficiency. The goal is no less valid today, and the macro-level nature of the problem compels the conclusion that a social contract perspective should be applied to the ethical analysis of the issue.

In addition, the enforcement vacuum exists in the social system area, not in the area of property conversion.¹⁰⁹ Common

poses some natural or rational order in the world apart from the voluntary, consensual arrangements of humans. Natural laws such as Adam Smith's ostensible natural market laws can be derived through the application of reason, through which we can discover nature as opposed to convention. See THOMAS HOBBS, *LEVIATHAN: OR THE MATTER, FORME, AND POWER OF A COMMONWEALTH, ECCLESIASTICALL AND CIVIL* 84 (Michael Oakeshott ed., Basil Blackwell 1957) (1651). While Hobbes's view of human nature presupposed the rational pursuit of individual human interests, Kantian rationalism recognized within the sphere of ethics a requirement that humans treat one another as ends in themselves rather than mere means. IMMANUEL KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* (H.J. Paton trans., Harper & Row 1964) (1762). Ethical analysis of insider trading lends itself more to social contract than natural law theory because markets as developed in the West are cultural creations based on a constellation of accepted assumptions. It would be extraordinarily difficult, as well as ethnocentric, to make any reasonably objective claims regarding the natural status of Western markets. For this reason the analysis herein is restricted to ethical systems based on human arrangements rather than some concept of cosmic rightness.

107. The confluence of Locke's property-based theory of acquisition and Rousseau's idea of a social contract as components of a free, well-ordered society suggest that both property and social contract play important roles in moral philosophy. See generally LOCKE, *supra* note 97; J. ROUSSEAU, *THE SOCIAL CONTRACT* (Maurice Cranston trans., Penguin Books 1979) (1762). The natural tension between individual and society does place the two structures somewhat at odds, however, as acquisitive impulses are tempered by the constraining effects of social contract as a moral medium. The conflicting directions of these two constructs is the premise behind the pragmatism of enlightened self-interest. 2 ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 121-24 (Francis Bowen ed., Alfred A. Knopf, Inc. 1987) (1838). Rawls's theory of justice implicitly recognizes the legitimacy of both property and social contract as sources of morality within the arena of distributive justice. JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

108. See *supra* note 14 and accompanying text.

109. See John C. Coffee, Jr., *Hush!: The Criminal Status of Confidential Information after McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 AM. CRIM. L. REV. 121, 138-152 (1988) (suggesting that the criminalization of employee disclosure of confidential information or trade secrets has converted a civil wrong into a criminal

law is able to compensate misappropriation of property and discourage its future occurrence. No analogous body of common law exists to protect the market's integrity should the 1934 Act be disqualified from this broader task. Assuming that both property and social contract can be legitimate bases for the creation of ethical constructs, we should select the option which addresses an unmet ethical challenge. The social contract approach comes closer to meeting the original and continuing need for regulation than the property approach, and it fills a real gap by defining the social consensus for market behavior. No such gap exists in the common law's handling of individual property violations.

If we accept the arguments favoring social contract analysis, the misappropriation theory is unequal to the ethical challenges presented by insider trading. Widely-held assumptions of fairness, market integrity, and information symmetry support the assertion that trading on publicly unavailable information is unethical, regardless of the source of that information, based solely on the consensus of the market's participants. The unfair advantage exercised in all such trades is unethical according to our society's conception of the rules of fair markets.

Social contract is more appropriate than property analysis in tying traditional legal concepts to the realm of ethics. An examination of the existing social contract suggests a basic consensus that marketplaces should be maintained as fair and efficient, subject to the limitation that information be widely available if it is to be used in trading. Apart from this description of the existing social contract, ethical analysis requires a normative examination: What should the social contract be under the various approaches to ethical decisionmaking?¹¹⁰ Although the social contract is legally supportable by virtue of the consent implicit therein, it is possible that the contract could be improved if it were altered. Under each theory of ethical analysis discussed below, the social contract requires broader prohibition of insider trading than exists under the misappropriation theory.

offense and has raised "compliance costs" by causing citizens to "desist from socially desirable behavior").

110. See Patricia H. Werhane, *The Ethics of Insider Trading*, 8 J. BUS. ETHICS 841, 841 (1989) (giving ethical justification for the principle that "no one should profit from exploitation of important information not available to the public") (quoting George F. Will, *Keep Your Eye on Giuliani*, NEWSWEEK, Mar. 2, 1987, at 84).

Various theories of distributive justice undermine the wisdom of maintaining the misappropriation theory. Distributive justice theories are concerned with the *fair* allocation of scarce resources within society (and for our purposes, in accordance with the social contract discussed earlier.)¹¹¹ These theories typically define justice in terms of liberty and equality,¹¹² or as the absence of illegitimate state coercion.¹¹³ The misappropriation theory is deficient under either alternative.

John Rawls's egalitarian version is built on two fundamental principles that he argues would form the social contract of persons who were able to transcend their own subjective, personal interests: (1) individual liberty should be maximized so long as it is compatible with the basic liberties of others; and (2) once basic liberties are ensured, unequal distribution of social goods should exist only if they benefit each person in the society.¹¹⁴ Misappropriation theory leaves a "moral gap" wherein neither of these basic principles is satisfied. That gap consists of trades made by non-insiders based on legally acquired but non-public information. The existing freedom to trade of those fortuitously endowed with non-misappropriated secrets is not compatible with the basic liberties of others. Such trades deny the less privileged person the ability to compete fairly and to participate in an equitable marketplace. Furthermore, the unequal distribution of goods that results from these trades does not benefit everyone; rather, skewed distribution results in unearned and gratuitous windfalls benefitting the secret-holders at the expense of traders on the other side of such market transactions. Because these effects exist, the misappropriation theory is ethically underinclusive under Rawls's criteria of distributive justice.

Robert Nozick's libertarian approach to distributive justice prescribes minimizing the government coercion that impinges upon individual entitlements or rights.¹¹⁵ Subsumed within this notion is an assumption that it is unjust to stifle individual economic rights by imposing patterns of ostensibly equitable dis-

111. See generally OTTO A. BIRD, *THE IDEA OF JUSTICE* (1967); MURRAY N. ROTHBARD, *THE ETHICS OF LIBERTY* (1983). An early bibliography of the theories of justice can be found in 1 *THE GREAT IDEAS: A SYNTOPICON* 850-79 (R. Hutchins ed., 1952).

112. See RAWLS, *supra* note 107.

113. See ROBERT NOZICK, *ANARCHY, STATE AND UTOPIA* (1974).

114. See RAWLS, *supra* note 107, at 60.

115. See NOZICK, *supra* note 113.

tribution. Accordingly, state power is just only when exercised granting due respect to the basic property rights of acquisition and transfer.¹¹⁶ Under this test, regulation of insider trading can be ethically justified only to the extent that it protects basic individual property rights. The misappropriation theory fails this test for legitimate government intervention. The theory's "gap" results in underinclusive application of the anti-fraud provisions of Rule 10b-5,¹¹⁷ encouraging the illegitimate acquisition and transfer of property. Nozick defines acquisition legitimacy in Lockean terms requiring the mixing of property with labor. He defines transfer legitimacy in terms of a sale's voluntary nature.¹¹⁸ Implicit in these definitions are two assumptions: that original rights to resources depend upon some legitimate basis of earning through labor, and that the voluntary transfers that follow must comport with the basic legal and ethical norms of the marketplace.¹¹⁹ Trades that fall within the misappropriation theory gap fail Nozick's test of legitimacy. Wealth is gained in such trades without risk or effort and at the expense of non-privileged market participants. Title to property obtained without the investment of labor and through illegitimate misappropriation from the entire market mechanism is tainted under the libertarian analysis of distributive justice.

Under utilitarian analysis, the normative questions regarding the content of the social contract should be answered according to a social cost-benefit analysis.¹²⁰ Whereas neoclassical economic theory presumes rational behavior based on individual utility preference functions,¹²¹ normative philosophy requires that the accounting of utility be social rather than

116. *See id.* at 149-231.

117. *See supra* notes 66-75 and accompanying text.

118. *See* NOZICK, *supra* note 113, at 149-163.

119. Nozick states that

[n]ot all actual situations are generated in accordance with the two principles of justice in holdings: the principle of justice in acquisition and the principle of justice in transfer. Some people steal from others, or defraud them, or enslave them, seizing their product and preventing them from living as they choose, or forcibly exclude others from competing in exchanges. None of these are permissible modes of transition from one situation to another.

Id. at 152.

120. *See generally* JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (Charles Warren Everett ed., 1970) (1789); RICHARD B. BRANDT, A THEORY OF THE GOOD AND THE RIGHT (1979); HENRY SIDGWICK, OUTLINES OF THE HISTORY OF ETHICS FOR ENGLISH READERS (New York, MacMillan 1886); J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANISM: FOR AND AGAINST (1973).

121. *See generally* MANSFIELD & BEHAVESH *supra* note 68, at 315-319.

individual.¹²² Thus utilitarianism is often discussed in terms of achieving the greatest good for the greatest number.¹²³ The public welfare is calculated by ordering social costs and benefits of all action choices and deriving net scores for each, seeking social utility maximization in making the final ethical selection.¹²⁴

Under utilitarian analysis, the optimal social contract with respect to insider trading should maximize net social good. Applying the misappropriation theory and thereby allowing trades based on legitimately derived, non-public information results in a net social loss. The benefits achieved consist of windfall profits to persons lucky enough to possess the non-public information. Those who trade with this "winner" incur a loss equivalent to the winner's gain. It is not surprising that the net result is a zero-sum game, at least in regard to the particular transactions themselves, because nothing of value has been produced. This is precisely why the winner's profit is considered a windfall.¹²⁵

Because the transaction results in a wash between the buyer and the seller, calculation of the public utility of the trades must be based on their secondary effects. While it has been suggested that all trades add to the information base of the market pricing mechanism and therefore make the markets more efficient,¹²⁶ the tendency of these gains to be offset by inefficiencies of information asymmetry has already been noted herein.¹²⁷ As stated earlier, the potential benefits of allowing any trading whatsoever on non-public information are countered by equally weighty disadvantages.¹²⁸ What remain are so-

122. See Alasdair MacIntyre, *Utilitarianism and Cost-Benefit Analysis: An Essay on the Relevance of Moral Philosophy to Bureaucratic Theory*, in *VALUES IN THE ELECTRIC POWER INDUSTRY* 217 (Kenneth Sayer ed., 1977) (discussing the basic distinction between social and individual levels of analysis).

123. Jeremy Bentham created the first widely published iteration of this idea, which he called the "greatest happiness principle." BENTHAM, *supra* note 120, at 1.

124. See HENRY SIDGWICK, *METHODS OF ETHICS* (London, MacMillan 1874) (discussing the methodology thus simplified in more elaborate detail).

125. Robert Reich describes the exorbitant profits of financial dealings in the 1980s as one aspect of "paper entrepreneurialism," the creation of wealth by the manipulation of symbols. This occurs during an exchange of securities, and particularly by risk-free speculation of those whose privilege, such as non-public information, places them in a no-lose situation. See ROBERT B. REICH, *THE NEXT AMERICAN FRONTIER* 140-172 (1983).

126. See Manne, *supra* note 2, at 111-16.

127. See *supra* notes 70-75 and accompanying text.

128. See *supra* notes 66-75 and accompanying text.

cial losses that result from the trades: the growing public perception that the market favors those with non-public information and the resulting generic tendency to abandon the market gradually or to exit *en masse* in the event of a rash of highly publicized incidents. In addition, the temptation to make large profits without producing goods or services for public consumption is both a drain of business talent from the productive marketplace and a cost to businesses that indirectly subsidize these windfalls without any value added to their products or services.¹²⁹ The growth of "paper entrepreneurialism"¹³⁰ and these inefficiencies for American business exact a cost in terms of global competitiveness as well as the rising trade deficit.¹³¹ Permitting any trading on the basis of non-public information results in a net loss to society, even if the information was derived legitimately and has not been misappropriated. From a utilitarian standpoint, the social contract should eliminate the misappropriation requirement from the prohibition of fraud contained in the 1934 Act.

Whereas utilitarian analysis determines ethical outcomes based on social cost and benefit, rights theory suggests that individuals have certain entitlements¹³² that can never ethically be denied.¹³³ A common criticism of utilitarian models is their capacity for reaching outrageous results which few would condone as morally sound.¹³⁴ Kant posed this problem as the treating of humans as mere means rather than as ends in themselves.¹³⁵ He suggested that rights be formulated applying a "categorical imperative" to cases in which "I ought never to act except in such a way that I can also will that my maxim should

129. See REICH, *supra* note 125, at 140-72.

130. *Id.*

131. See Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., July-Aug. 1980, at 66; Charles W.A. Hill et al., *Declining U.S. Competitiveness: Reflections on a Crisis*, ACAD. MGMT. EXEC., Feb. 1988, at 51.

132. To the extent that Nozick's theory of distributive justice concerns entitlements, there is some overlap between distributive justice models and rights models. They are discussed individually here not to suggest that these categories are mutually exclusive, but to catalogue the major approaches to ethical analysis and examine the misappropriation theory under each.

133. See, generally, SAMUEL STOLJAR, *AN ANALYSIS OF RIGHTS* (1984); ALAN R. WHITE, *RIGHTS* (1984); H.J. McCloskey, *Rights*, 15 PHIL. Q. 115 (1965).

134. See, e.g., TOM L. BEAUCHAMP & NORMAN E. BOWIE, *ETHICAL THEORY AND BUSINESS* 32-33 (3d ed. 1988) (discussing the "unjust consequences" that can result from the utilitarian calculation of the ostensible greatest good).

135. See generally KANT, *supra* note 106.

become a universal law."¹³⁶

The source and the legitimacy of particular rights are usually attributed to some form of natural law.¹³⁷ Enlightened thinking of the Eighteenth Century initially deduced scientific laws and later deduced laws of political philosophy and economy.¹³⁸ The concept of the social contract itself developed from the age of reason. To give content to that contract, economic laws of the marketplace became a significant source of human rights.¹³⁹ The catalog of rights embodied in the Bill of Rights¹⁴⁰ were derived from an effort to protect existing economic interests.¹⁴¹ These rights were viewed as fundamental and natural endowments. The freedoms contained within the Bill of Rights, combined with those of an unfettered marketplace, form much of the essential classical liberalism that sprang from the conceptions of natural law.

Classical liberalism presumes the existence of fundamental rights. Those rights that directly relate to the normative criteria for markets and behavior include individual freedom; localization of market decision processes at individual rather than group levels whenever possible; and the restriction of both business and government to those activities mandated under the extant social contract.¹⁴² While such market characteristics typically form the foundation for arguments against government interference, classical liberal ideology supports regulation to the degree that it is necessary to protect these rights by supporting the free market infrastructure.¹⁴³ The central tenets of market rights theorists can be protected only when the marketplace and its rules are established and protected as equitable. To the extent that non-level playing fields characterize securities markets, the rights of individuals both to trade freely

136. KANT, *supra* note 106, at 69, 70.

137. See, e.g., RICHARD TUCK, *NATURAL RIGHTS THEORIES* (1979) (discussing the historic development of rights theory and the relevance of natural law).

138. See H.L.A. Hart, *Are There Any Natural Rights?*, 64 *PHIL. REV.* 175 (1955) (discussing the reasoning of natural law theories).

139. See generally SMITH, *supra* note 69.

140. U.S. CONST. amend. I-X.

141. See CHARLES A. BEARD, *AN ECONOMIC INTERPRETATION OF THE CONSTITUTION OF THE UNITED STATES* 16-18 (1986).

142. The most prominent modern proponent of these ideals of classical liberalism is Milton Friedman. See, e.g., FRIEDMAN, *supra* note 105.

143. Even Adam Smith, the classical proponent of a laissez-faire policy that relies on the invisible hand to regulate markets, believed that government intervention was necessary to protect market mechanisms from anti-competitive behavior. See *supra* note 69.

and to make informed decisions are impaired. The anti-fraud provisions of 10b-5 are consistent with these principles if they protect the optimally competitive market infrastructure that forms the foundation of individual freedoms and rights.

Not all rights theories are grounded in economics. Ronald Dworkin suggests that legal questions of policy can be addressed using economic criteria, but that legal questions of principle cannot.¹⁴⁴ To determine the latter by utility might also entail an insupportable abrogation of rights.¹⁴⁵ The crucial question of principle with respect to trading on non-public information is one that Dworkin addresses: the principle of equality, particularly equal treatment¹⁴⁶ and equal concern and respect.¹⁴⁷ Related to equality is the ethical goal of fairness,¹⁴⁸ defined as like (or equal) treatment of like (or equal) cases.¹⁴⁹

The limited scope of the misappropriation theory impedes the ends of equality and fairness. By allowing trades in a marketplace characterized by unequal access to information, application of the theory denies equal treatment, concern and respect to those lacking access. The normal trader (as opposed to the trader privileged with non-public information) is thus treated as inferior by the marketplace in which the rules are implicitly a by-product of the social contract. The effect is unfair as well because like traders¹⁵⁰ are not given like opportunities in the marketplace. Because the rules of the marketplace, including Rule 10b-5, are part of the general social contract, these rules should foster fairness and equality if they are to be ethical under Dworkin's conception of rights. Fairness and equality as defined herein include equal access to information in all market transactions.¹⁵¹

144. See RONALD DWORKIN, *A MATTER OF PRINCIPLE* (1985); RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* (1978).

145. See DWORKIN, *TAKING RIGHTS SERIOUSLY*, *supra* note 144, at 94-100.

146. See *id.* at 227.

147. See *id.* at 180, 272.

148. See John Rawls, *Justice as Fairness*, 67 *PHIL. REV.* 164 (1958).

149. See RAWLS, *supra* note 107, at 108-114 (discussing the definition of fairness).

150. "Like traders" for our purposes should be defined as all who enter the marketplace voluntarily. To define "like traders" according to the degree of information to which they have access would render the phrase ineffectual for the analysis at hand.

151. This is not to suggest that equal possession of information is mandated, but simply that equal access to information is necessary in a fair marketplace. As long as the information is in the public domain, any player can do the research to get that information and any advantage thereby conferred. Thus Locke's contention that property rights should reflect effort mingled with object is consistent with the "rights" approach. See LOCKE, *supra* note 96, at 287-302. Fairness and equality of treatment require

Because its approach is compensation of tort or punishment of criminal conversion rather than equality of access in the marketplace, the misappropriation theory fails to protect the rights of all buyers and sellers. In limiting its purview to trades on misappropriated information, it allows all other inequitable trades based on non-public information. To be ethically consistent under a rights analysis, Rule 10b-5 should prohibit all market transactions involving non-public information, not just those derived from a misappropriation.

IV. DISMANTLING MISAPPROPRIATION THEORY BY REASSESSING THE ELEMENT OF FRAUD IN RULE 10b-5

Misappropriation theory is a poorly-fashioned attempt to effect the purposes of Rule 10b-5 within the gravamen of fraud. Although Congress's attempt through the ITSFEA to improve the workings of the Rule was largely ineffective, both the Second Circuit and the United States Supreme Court have an opportunity to approach more closely the intended public policy goals of the Rule by changing the way in which they analyze its fraud requirement. This can be done by enlarging the "special circumstances" under which fraud is inferred from silent trading, and by expanding the application of the "fraud on the market" theory.

A. "*Special circumstances*" under which fraud is inferred from silent trading.

The general rule under common law is that there is no duty to disclose information to the other party in a transaction.¹⁵² Exceptions to the rule provide ample opportunity for both the legislature and the judiciary to improve the workings of 10b-5. These exceptions include the following:

(i) *A statute or regulation requiring disclosure.* Calamari and Perillo suggest that "[t]he number of such statutes perhaps attests

only that the players start at the same point and have an equal opportunity to compete on a level field.

152. This doctrine dates back to *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817), in which a defendant purchased tobacco from plaintiff at a very low price under conditions of an export blockade during the War of 1812. Defendant knew that the Treaty of Ghent had been signed and made the purchase without disclosing this information, which was not yet generally dispersed in New Orleans, to the plaintiff seller. *See id.* at 185-86. When the plaintiff sought to void the sale, the Court denied the remedy, holding that the buyer was not bound by duty to communicate to the seller its intelligence of the extrinsic circumstances. *See id.* at 195.

to the inadequacy of common law disclosure rules.”¹⁵³ The SEC has statutory authority to define fraud in the context of tender offers;¹⁵⁴ Congress had the option in ITSFEA or any other legislation to create a duty similar to the one created in *Securities and Exchange Commission v. Texas Gulf Sulphur*,¹⁵⁵ requiring all holders of information not publicly available to disclose the information or refrain from trading. Had Congress opted to create such a duty on the part of all market participants, contemporaneous trader liability would be achieved without the need for awkward legal fictions like those supplied under the surrogate plaintiff theory.¹⁵⁶ Additionally, traders would be restricted from injuring the overall market regardless of whether such acts could be traced to a micro-level incidence of misappropriation, thus fostering the original policy intent of 10b-5.

(ii) *A duty to disclose results when one party is operating under a material mistake of which the other party is aware.*¹⁵⁷ Neither buyer nor seller is allowed under the common law of contract to take advantage of a unilateral mistake of fact of which the buyer or seller has knowledge. From this principle the courts can reasonably infer a duty on the part of a trader to disclose any publicly unavailable information, regardless of the source of that information, or else refrain from trading. Misappropriation is not necessary to create a duty to inform because the person holding inside information knows that virtually all other market participants are operating under unilateral mistake when dealing with the advantaged person. Congress could have created liability to contemporaneous traders in the ITSFEA without leaving misappropriation theory intact. Although Congress did not exercise this option, judicial reform of the interpretation of Rule 10b-5 is still possible. Courts can uphold liability to con-

153. JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS*, 288 (2d ed. 1977). Among the statutes the authors discuss in this regard are the Securities Act, the Truth-in-Lending Act, The Interstate Land Sales Full Disclosure Act, and The Truth-in-Negotiation Act.

154. Section 14e of the 1934 Act gives the SEC the right to define “fraudulent, deceptive, or manipulative acts or practices” only with respect to tender offers. 15 U.S.C. § 78n(e) (1988). The issue of the extent of the SEC’s power under 14e remains unresolved. *See, e.g., United States v. Chestman*, 903 F.2d 75 (2d Cir. 1990). Although the SEC’s definitional authority under the express provisions of 14e only extends to tender offers, SEC authority to define fraud might be extended by analogy to 10b, or, alternatively, granted to the SEC by Congress.

155. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

156. *See Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

157. *See Davis v. Reisinger*, 105 N.Y.S. 603 (N.Y. App. Div. 1907).

temporaneous traders while replacing the problematic misappropriation theory with a more workable interpretation of the 10b-5 fraud requirement.

B. *Expanding the Application of "Fraud on the Market" Theory.*

Fraud on the market theory, first applied in *Basic Inc. v. Levinson*,¹⁵⁸ provides a conceptual framework that could prohibit all trading on information not publicly available while still complying with the fraud requirement of 10b-5. The theory of fraud on the market is based on the presumption of an efficient capital market in which material misrepresentations made to the general public will affect the market price of stocks, and consequently, individual buying and purchasing decisions as well. The Supreme Court adopted a very limited version of fraud on the market theory, using the concept only as rebuttable evidence to prove that a particular individual did in fact make a personal purchase or sale decision based on public misrepresentation.

Despite its limited application in *Basic*, fraud on the market is a viable theory for bringing insider trading decisions closer to the original intent of the 1934 Act. To the extent that markets are efficient, all express misrepresentations and all withholding of information divert prices from their most accurate approach to equilibrium, which would exist if all accurate information and only accurate information were assimilated. An efficient market demands that market speculation should occur with minimal information asymmetry. If information is unbalanced, investment behavior will be perceived as unfair, public confidence in financial markets will be eroded, and participation in the markets will suffer to the detriment of the larger economy. If the law were to infer from any trade a representation that the trade is being made using only publicly held information, then

158. 485 U.S. 224 (1988). In *Basic*, the defendant and Combustion Engineering, Inc., were involved in over two years of merger negotiations. *See id.* at 227-28. When Basic executives were questioned about abnormal activity in the trading of the company's shares, they responded that they were "unaware of any present or pending [corporate] developments which would account for the high volume of trading and price fluctuations in recent months." *Id.* at 228. The issue facing the court was whether this statement qualified as 10b-5 fraud—particularly, whether it met the requirements of materiality and reliance, given that the statement was not made in the process of any sale or purchase of securities. The court held that a violation of 10b-5 could be based on a rebuttable presumption that deception in impersonal transactions injures investors by perpetrating a "fraud on the market." *See id.* at 250.

any trade made on non-public information would constitute a misrepresentation tantamount to fraud on the market. All investors can be presumed to rely on this information in their basic assumption that markets will be maintained to be fair and efficient. This broad conceptualization of the *Basic* doctrine would accurately label any trade made with non-public information as fraudulent. It would simultaneously align more closely the purposes and the actual application of Rule 10b-5.

V. CONCLUSION

Misappropriation theory is unsound under legal, economic, and ethical analysis. The judiciary developed the theory to interpret Rule 10b-5 in an attempt to be consistent with its original goal of preserving market integrity. The forced reconciliation of misappropriation theory with market integrity yields undesirable results. Application of the theory allows trading that creates windfall profits and market inefficiencies. Apart from its economic dysfunction, the misappropriation theory cannot withstand scrutiny under traditional approaches to normative philosophy.

Although recent Congressional efforts to improve the definition and enforcement of insider trading proscription have not resolved these problems, the courts have the power to reunite the intended functions and the manifest effects of the 1934 Act by interpreting its anti-fraud provisions more broadly. By creating new duties or expanding the interpretation of old duties, the courts can prohibit trading on information not publicly available, regardless of the source of that information. To do so would be legally, economically, and ethically sound.

