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THE INSIDER TRADING PROHIBITION THEORIES IN THE LITERATURE-A CRITIQUE

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ABSTRACT

The regulation of insider trading is a comparatively recent phenomenon in most of the jurisdictions around the world. The United States was the first legal jurisdiction to prohibit insider trading. Insider trading is defined nowhere in the United States federal law. The prohibition has been read into the general anti-fraud provisions of the federal securities law. Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. This state of affairs is at least partly attributable to the fact that there is a fundamental disagreement over the necessity of insider trading prohibition. Arguments have been advanced in support of legalizing insider trading. On the other side, a number of arguments in favor of prohibiting insider trading have been advanced as well. In view of this, it is important to clarify the policy and theoretical basis of the prohibition. Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. As a first step, it is imperative to attempt a nuanced analysis of the current insider trading theories, as enunciated by the U.S. Courts as well as those proposed by legal scholars. This article is a sequel to my earlier article wherein I offered a critique of the judge-made insider trading prohibition theories in the United States. As promised there, I come back here to offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars. In the final article in this three-part series, I plan to propose a new theory of insider trading prohibition that I argue aligns better with the mandate of securities law and also avoids certain problems associated with the other theories.

INTRODUCTION

The regulation of insider trading is a comparatively recent phenomenon in most jurisdictions around the world. Before the 1980s, most countries left insider trading virtually unregulated. Today, the vast majority of countries have insider trading laws on the books.[1] The United States was the first jurisdiction to enact insider trading regulation.[2] The term insider trading is not defined anywhere in the United States law. The prohibition on insider trading has been read into the general anti-fraud provisions of the securities law — Section 10(b) of the Securities Exchange Act of 1934[3] (Exchange Act) and Rule 10b-5[4] thereunder. This has been done through a series of judicial pronouncements.

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

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

[3] 15 U.S.C. § 78j(b). Section 10(b) makes it unlawful for any person, directly or indirectly, "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 public interest or for the protection of investors."

[4] 17 C.F.R. § 240.10b-5. Rule 10b-5 provides that: it shall be unlawful for any person, directly or indirectly, to employ any device, scheme, or artifice to defraud ... or ... 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.

Bainbridge argues that the Exchange Act and its legislative history suggest that the statute was not intended to prohibit the use of inside information, but only the use of manipulative devices such as market pools.[5] Rather, it is the later courts that have interpreted Section 10(b) — a general anti-fraud provision—so as to include a prohibition on insider trading. As he points out, Section 10(b) received minimal attention during the hearings on the Exchange Act and was apparently seen simply as a grant of authority to the SEC to prohibit manipulative devices not covered by Section 9 of the Exchange Act.[6] Interestingly, even the U.S. Congress contended that the elimination of insider trading abuses was one of the goals of the Exchange Act.[7]

Several commentators have been critical of the evolution of the U.S. prohibition entirely through judicial pronouncements. Prakash terms the United States insider trading regime dysfunctional.[8] Nagy argues that a hodgepodge of theories, rules, and decisions form the basis of today's insider trading law in the United States.[9] According to Preet Bharara — former U.S. Attorney for the Southern District of New York — insider trading laws have for too long lacked clarity, generated confusion, and failed to keep up with the times. This lack of clarity and certainty, in this important area of law and our securities markets, has benefited no one.[10]

This state of affairs is at least partly attributable to the fact that there is a fundamental disagreement over the very necessity of insider trading prohibition. Arguments have been advanced in support of legalizing insider trading. It has been argued that insider trading acts as an effective compensation scheme for a company's executives.[11] The other argument advanced in favor of legalization is that the effect of insider trading will always be to move a share's price towards the level correctly reflecting all the real facts about the company.[12]

On the other side, arguments in favor of prohibiting insider trading have been advanced. These include the adverse impact of insider trading on market liquidity, the increase in the cost of capital for companies, and possibly the extinction of public stock markets[13]. Another family of arguments focuses on the harm caused to the company itself.[14]

In view of this, it is important to clarify the policy and theoretical basis of the prohibition. Unless a well thought out theoretical foundation for the prohibition is in place, the enactment of a statutory framework may amount to little more than a hasty, knee-jerk legislative solution. As a

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[5] Stephen Bainbridge, *A Critique of the Insider Trading Sanctions Act of 1984*, 71 VA. L. REV. 455, 459 (1985).
[6] *Id.* at 460.
[7] *See id.* at 459.
[8] Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).
[9] Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1365 (2009).
[10] *Bharara Task Force on Insider Trading Publishes Report: Recommending Reforms to Insider Trading Law*, BUSINESSWIRE (Jan. 27, 2020), https://www.businesswire.com/news/home/20200127005079/en/Bharara-Task-Force-Insider-Trading-Publishes-Report.
[11] *See* Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 936 (1985).
[12] *Id.* at 935.
[13] *See generally* George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster*, 38 DEL. J. CORP. L. 247 (2013).
[14] *See, e.g.*, Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1055 (1982).

first step, it is imperative to attempt a nuanced analysis of the current insider trading theories as enunciated by U.S. Courts, as well as those proposed by legal scholars.

This article is a sequel to my earlier article wherein I offered a critique of the judge-made insider trading prohibition theories in the United States.[15] As promised there, I come back here to offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars.

The plan of the article is as follows. In the following Section, I offer a critique of the Property Rights Theory which has been fairly influential in recent years. In Section III, I take up the discussion of the Deception-Based Theory that conceptualizes wrongful insider trading in terms of deceptive acquisition of information. In Section IV, I discuss the fraud on the market theory in the context of its proposed application to insider trading. Section V focuses on another variant of the fraud-based approach to insider trading–the Contractual Fraud Theory. In Section VI, I analyse the Corruption Theory, which treats insider trading as a form of private corruption. In Sections VII and VIII, I consider two recent novel approaches–prohibition predicated on the duty to hold lost or stolen information in confidence and insider trading as an agency law issue.[16] The final Section summarizes the discussion and concludes.

The analysis focuses on assessing the internal coherence and the alignment of these theories with the mandate of securities law–to protect the interests of investors in securities and to promote the development and regulation of the securities market.[17] Dooley also suggests that the rationale (or demand, as he terms it) for insider trading prohibition determines the legitimacy of the substantive prohibition. Thus, either the investors or the securities market, if not both, must be the primary beneficiaries of insider trading regulation to justify the existence of the regulation.[18]

I. THE PROPERTY RIGHTS THEORY

In *United States v. O'Hagan*, the U.S. Supreme Court recognized that a company's confidential information qualifies as property to which the company has a right of exclusive use.[19] This formulation might suggest a property rights-based theory for the insider trading prohibition.

However, the *O'Hagan* Court finally settled on the non-disclosure of the intent to trade as the determinative factor in establishing deception and, therefore, the insider trading prohibition. In

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[15] Mangesh Patwardhan, *To Legislate or Not to Legislate: Judging the Judge-Made Insider Trading Prohibition Theories in the United States*, 45 DEL. J. CORP. L. 323 (2021). In the interest of brevity, I cite this source rather liberally in the current article, so that I do not have to repeat the arguments made there.

[16] Another approach discussed in the literature is the Unjust Enrichment Theory. I do not discuss it here. The unjust argument approach is implicit in the version of the misappropriation theory enunciated by the Chief Justice's dissent in *Chiarella v. United States*. I discussed his theory in my earlier article. Patwardhan, *supra* note 15, at 401-09.

[17] The Securities and Exchange Board of India Act, 1992 (SEBI Act) explicitly states that the object of the Act is to provide for the establishment of SEBI to carry out these two functions. The US Supreme Court articulated "insuring honest securities markets and thereby promoting investor confidence" as the "animating purpose" behind the Exchange Act. United States v. O'Hagan, 521 U.S. 642, 658 (1997).

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

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

fact, during oral arguments, the Government accepted that so long as the trader tells the source her intent to trade on the basis of material non-public information (MNPI), there is no deception and therefore no prohibition on trading on such information.[20] This is the reason why this version of the misappropriation theory cannot be reconciled with the property rights theory.

The other version, the Chief Justice's dissent in *Chiarella v. United States* implicitly treats unauthorized trading as the source of the prohibition.[21] This surely seems to align more closely with the property rights theory. However, even here, though non-authorization by the source of the information is relied on to establish deception, this theory does not cast such source as the victim of such trading. Rather, the Chief Justice's focus is to ensure that dealing in securities is fair and without undue preferences or advantages among investors.[22] Further, he holds that trading on such unauthorized information amounts to the trader enriching herself at the expense of others,[23] and here he surely does not mean that such trading is at the expense of the source, but rather the counterparty. Thus, after a detour through deception on the source, he ultimately treats the counterparty as the harmed party.

Thus, any attempt to interpret either version of the misappropriation theory in property rights terms leads to unsatisfactory results. A full-fledged property rights theory would recognize the source of the information as the party holding rights over the information and harmed as a result of a person trading on such information. Indeed, such a position has been advocated.

A. Insider Trading and Property Rights in Corporate Information

Several legal scholars have attempted to support an insider trading prohibition regime based on the property rights argument.[24] However, in recent times, the strongest proponent of this line of thinking is Bainbridge.[25] He states that reviving the old equal access standard makes no policy sense.[26] If one steps back and evaluates insider trading from first principles, what immediately jumps out is that we are really dealing with property rights in information.[27]

He further explains that there are two ways of creating such rights. One, the law may allow the owner to enter into transactions without disclosing the information. Two, the law may prohibit others from using the information.[28] The federal insider trading prohibition operates as the latter version of property rights.[29] He comments that property rights in intangibles such as patents,

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[20] *See* Adam C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B. U. L. REV. 13, 38 (1998).
[21] Patwardhan, *supra* note 15, at 404.
[22] Chiarella v. United States, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting) (citations and internal quotation marks omitted).
[23] *Id.*
[24] *See, e.g.*, Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information,* 9 J. LEGAL STUD. 683, 719 (1980); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights,* 48 OHIO ST. L. J. 79 (1987).
[25] *See, e.g.*, Stephen M. Bainbridge, *Regulating Insider Trading in the Post-fiduciary Duty Era: Equal Access or Property Rights?*, *in* RESEARCH HANDBOOK ON INSIDER TRADING 80 (Stephen M. Bainbridge ed., 2013).
[26] *Id.* at 91.
[27] *Id.*
[28] *Id.*
[29] *See id.*

copyrights, and trademarks are a well-established phenomenon–rights in information are just another such instance. There are doctrinal parallels between these as well. Under U.S. law, using another's trade secret is actionable only if it involved a breach of fiduciary duty, misrepresentation, or theft.[30]

That raises the obvious question of whether public enforcement should have any role in protecting such a private property right. Bainbridge's response is that even though the right is private in character, the cost of enforcing this right is excessive. Therefore, it makes sense for the state to use its regulatory power to enforce it.[31]

B. Incentivizing the Creation of Corporate Information–Assessing the Policy Rationale

Bainbridge argues that insider trading may harm the employer in some circumstances. It could injure the firm if it creates incentives for managers to delay the transmission of information to superiors.[32] It might adversely interfere with corporate plans (e.g. when managers of a potential acquirer start buying up shares of the target, making the acquisition more expensive).[33] Managers may elect to follow policies that increase the fluctuations in the price of the firm's stock.[34]

These concerns may well be justified. However, these arguments do not support an absolute prohibition on insider trading with its civil and criminal penalties. Private enforcement by the corporation itself appears to be a more appropriate option in this case.

Bainbridge candidly admits that whether insider trading harms the company is not dispositive.[35] There is no avoiding the necessity of assigning property rights in information, either to the corporation or the insider. A rule allowing insider trading assigns a property interest to the insider, while a rule prohibiting insider trading assigns it to the corporation.[36] As with other property rights, the law should simply assume (even though the assumption will sometimes be wrong) that assigning the property right to agent-produced information to the firm maximizes the social incentives for the production of valuable new information.[37]

However, contrary to his claim, this argument is not akin to the one in the context of other intellectual property rights such as patents. Even in the absence of an insider trading prohibition, companies would still produce much of the information either because it is in their interests (e.g. new product development) or because it is mandated by law (preparing and disseminating financial information). Thus, the assignment of property rights in such information to the company is not a necessary condition for creating this information in the first place.

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30 *See id.*
31*See Id*.
32 *Id.* at 92.
33 *See id.*
34 *Id.* at 93.
35 *Id.* at 94.
36 *Id.*
37 *Id.* at 95.

Private enforcement of the insider trading laws are rare and usually parasitic on public enforcement proceedings.[38] This fact itself may indicate that insider trading is usually not a concern to companies and is not perceived to be against their interests, at least in a large number of cases.

SEC v. Obus[39] is squarely on the point. "There, an analyst for GE Capital, Strickland, was helping to develop the financing of a possible acquisition of a company called SunSource. Strickland called a friend who worked at a hedge fund that held a large equity stake in SunSource. Among other things, the conversation included the fact that the client [GE Capital] was planning the acquisition. The hedge fund later acquired more SunSource stock."[40] Now, according to the property rights theory, the relevant information regarding the impending acquisition should be assigned to GE Capital. Any other person would be barred from using this information for securities trading or tipping others. This is based on the consideration that the use of such information harms the company.

An Indian case, *Rakesh Agarwal v. SEBI*[41] is another relevant example. In that case, Rakesh Agarwal, who was the Managing Director of ABS Ltd. ,a takeover target company, traded in the shares of his company based on this non-public information. However, it was nobody's contention that such trading harmed the company. Mr. Agarwal was under a contractual obligation on his part to enable the acquirer to acquire 20% shares in the open offer. The response to the public offer was lukewarm. There was a distinct possibility that the acquirer might not be able to acquire 20%, causing the whole transaction to fall through. There was a general agreement that ABS stood to benefit significantly by the proposed takeover, a contention not disputed by the Securities and Exchange Board of India (SEBI), either. Thus, Mr. Agarwal's purchases of his company's shares smoothened the acquisition process. Therefore, the assumption that "trading by the insiders based on non-public information always harms the company" seems to be too simplistic.

Indeed, the "defendants [in *Obus*] argued that the phone call was meant to serve the client's interest, which would preclude a finding of misappropriation."[42] As Langevoort notes, this could be true from a number of different perspectives—"Strickland might have been trying to get helpful information about SunSource from the hedge fund manager, and/or trying to use his connection to curry favour with a large shareholder that could be used to smooth along the acquisition."[43] In fact, "GE Capital did investigate and chose not to sanction Strickland, suggesting that it did not feel particularly deceived by his behaviour."[44]

Therefore, while Strickland did *use* the information regarding the acquisition, it may have been in the interests of GE Capital. That still leaves the question as to whether the hedge fund could be said to have injured GE Capital by infringing its property rights by trading on this

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[38] *Id.* at 91.
[39] Securities and Exchange Commission v. Obus, 693 F.3d 276 (2nd Cir. 2012).
[40] Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 449 (2013). This case was brought under the misappropriation theory, but the analysis here would carry over, with even greater force, to the discussion under the property rights theory.
[41] 2004 49 SCL 351 SAT (India).
[42] Langevoort, *supra* note 40, at 449.
[43] *Id.* at 449.
[44] *Id.* at 455.

information. Here, the answer turns on the specific factual matrix of the case. If the hedge fund's acquisition of further stock increased the cost of acquisition, it surely would injure GE Capital. On the other hand, by taking the hedge fund (which already was a big investor in SunSource) into confidence regarding the acquisition deal, it could have become easier for GE Capital to carry out the acquisition. In this case, the hedge fund buying more stock arguably benefitted GE Capital even further since the hedge fund would offer a larger block of stock when GE Capital commenced the tender offer. This is precisely what happens in the context of warehousing. "Warehousing refers to the practice whereby a person or company (or a group of persons and/or companies) accumulates, without public disclosure, a substantial block of shares in a company with a view either to making a takeover bid or to selling the block to someone else who then makes a bid."[45]

Therefore, neither Strickland's tipping (if one may call it that) nor the hedge fund's buying shares based on this information have hurt or benefitted GE Capital. Thus, even in the seemingly simple case where a third party trades in the shares of a potential target based on information received from the acquirer, it does not necessarily harm the acquirer (as one would normally assume since it is supposed to increase the cost of acquisition).

Under the property rights theory with its mandatory prohibition rule as advocated by Bainbridge and other scholars, such trading would be prohibited. It seems perverse to prohibit the use of a resource even when such use benefits its owner and does not harm anybody else.[46]

C. Property Rights Theory and Path Dependence

In an earlier article, Bainbridge argues the same position, but through the lens of the historical evolution of the U.S. insider trading prohibition. He frames the issue in terms of the concept of path dependence.[47] Path dependence claims that inefficient local equilibria can persist over time. Initial conditions, which may be determined by chance or other non-economic forces (such as political interests), direct the system down a particular path. Subsequent deviations from that path may be precluded as too costly, even if there are more desirable or efficient alternatives available.[48]

At the outset, Bainbridge is careful to point out that he uses the concept of "path dependence [as] a pedagogically useful metaphor."[49] According to him, "the insider trading prohibition ought to be viewed as a means of protecting property rights in information, rather than as a means of preventing securities fraud."[50] He argues that there was nothing inevitable about

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[45] Razeen Sappideen, *Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United Kingdom, United States and Australia*, 8 J. COMP. BUS. CAP. MKT. L. 281, 307 n. 53 (1986).
[46] This "no harm" argument flows from the fact that the property rights theory, unlike both versions of the misappropriation theory, conceptualizes the issue exclusively in terms of the harm to the source of information. In fact, Bainbridge criticizes the equal access theory as one that makes no policy sense. *See* Bainbridge, *supra* note 25, at 91.
[47] *See* Stephen M. Bainbridge, *Insider Trading Regulation: the Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999).
[48] *Id.*
[49] *Id.* at 1590.
[50] *Id.* at 1591.

insider trading being treated as a species of securities fraud.[51] He states that "insider trading ought to be regarded as a property rights problem rather than as a securities fraud issue, but that the prohibition's path dependent evolution suggests the need for doctrinal compromise in order to resolve the resulting tensions. Unfortunately, the *O'Hagan* majority muffed the opportunity to craft just such a compromise."[52]

Of course, this fact of path dependence by itself should not be determinative in deciding the future course of the insider trading prohibition in other jurisdictions. For instance, unlike in the U.S., there is an explicit prohibition in India against insider trading written into the SEBI Act and the Regulations made thereunder. Therefore, Bainbridge may well be correct that insider trading has nothing much to do with the interest of the investors or the securities market but is all about property rights in information. In that case, a better option would be for the Indian legislature to omit the insider trading prohibition provisions from SEBI Act and leave it to the sources of such information to pursue a private remedy for the infringement of their property rights and subject to any proof of any injury arising out of such infringement. Thus, the insider trading prohibition would simply cease to be a securities law issue and SEBI would have no jurisdiction over monitoring and enforcing the prohibition.

In Bainbridge's analysis, however, this is not the end of the matter. He argues that "the Securities and Exchange Commission (SEC) has a demonstrable comparative advantage in detecting and prosecuting insider trading."[53] "Insider trading is an activity that is hard to detect and difficult to prosecute" successfully.[54] "It is difficult to tell whether insider trading is taking place"—and if so, who is doing it—if many people have access to MNPI.[55] Thus, even if a company wanted to protect its property rights in information, it would have neither the wherewithal nor the resources for enforcing such protection.

Today, the regulators around the world carry out computer based surveillance of the securities markets and use sophisticated algorithms to flag any suspicious activity, including insider trading.[56] Company insiders and other persons buying or selling shares above a prescribed threshold are required to report their trading activity to the stock exchanges.[57] The regulators can compel discovery to aid their investigation.[58] Informants, computer monitoring of stock transactions, and reporting of unusual activity by either self-regulatory organizations or market professionals, or both, are the usual ways in which insider trading cases come to light. As a

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[51] *Id.* at 1590.
[52] *Id.* at 1592.
[53] *Id.* at 1591.
[54] *Id.* at 1623.
[55] *Id*.
[56] *See, e.g.,* Securities and Exchange Board of India, Annual Report 2013-14, 177 (2014) for a discussion of the initiatives taken by SEBI in this regard.
[57] In India, provisions regarding this are contained in Regulation 9(1) and 9(2) r/w Schedule B (Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders) of SEBI (Prohibition of Insider Trading) Regulations, 2015.
[58] Securities and Exchange Board of India Act, 1992, § 11, 8-9 (codified as amended by Securities Laws (Amendment) Act, 2014)) explaining that in India, Clauses (i), (ia), and (ib) of Section 11(2) of SEBI Act confer power on SEBI to call for information and records from various parties (including other authorities within or outside India) in the course of any investigation or enquiry.

practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC.[59]

Allocating prosecutorial responsibility to the SEC may also be justified on institutional expertise grounds. The Commission's enforcement staff will handle many more insider trading cases than will counsel representing private corporations. As such, they will develop greater expertise in handling such prosecutions, which further enhances the Commission's competitive advantage in dealing with insider trading.[60]

However, even if the securities regulator has a comparative advantage and is so uniquely placed to enforce the prohibition, its enforcement actions ultimately benefit the private entities in protecting their enforcement rights. Thus, while the regulator may help the companies detect insider trading based on their proprietary information, the regulator ought to recover the cost of such enforcement from the companies as they are the beneficiaries of this (under the property rights theory). Since it may not be possible to determine the exact benefit derived by a particular company due to prevention of such trading in the first place, such recovery could be by way of a fee, say imposed on all listed companies in proportion to their market capitalization.[61] Further, a company should be free to opt out of this regime (and avoid paying the fees) if, in its view, it is not harmed by insider trading in its securities.

This is important because developing sophisticated algorithms and implementing those for constant monitoring requires considerable resources in terms of money as well as expertise. There is also an opportunity cost involved. Resources spent on the enforcement of the insider trading prohibition reduce what is available for enforcement of other “core” securities law issues such prevention of market manipulation. In the context of the increasing complexity of the securities markets and the consequent higher vulnerability to securities fraud, it is even questionable whether the securities regulators should devote any resources for the enforcement of the insider trading prohibition, which the property rights theory treats as not related to any of the core concerns related to the securities market. This point would remain valid notwithstanding any comparative advantage that the regulator may have.

This point is even more significant when the information does not belong to the company but to a third party totally unconnected to the securities market, as in *Carpenter v. United States*. There, the information pertained to the contents of the daily column published in the *Wall Street Journal* titled “Heard on the Street” that contained recommendations regarding stock market trading.[62] It is not clear why the securities regulator should spend resources in monitoring any

[59] Bainbridge, *supra* note 47, at 1624.
[60] *Id.*
[61] As the Indian Supreme Court held in Municipal Corporation of Baroda v. Babubhai, AIR 1989 SC 2091 (1989), in regard to fees there is, and must always be, a correlation between the fee collected and the service intended to be rendered. However, the element of *quid pro quo* in the strict sense is not always a *sine qua non* for a fee. The imposition of a fee as suggested above fits the description. Thus, it would qualify as a fee and not as a tax. Thus, it would not attract Article 265 of the Constitution of India, which provides that no tax shall be levied or collected except by authority of law. In particular, SEBI may impose such a fee in exercise of its function under Section 11(2)(k) of SEBI Act.
[62] Carpenter v. United States, 484 U.S. 19 (1987).

violation of a *newspaper's property rights in its unpublished material*, even though the material may be connected to the securities market.

D. The Harm Fiction

There have been other related criticisms of the property rights theory as well. Fisch also contends that this theory simply does not justify government intervention. If inside information is corporate property, the company should be free to allocate it, by contract, just as it can do so in case of other forms of property. In particular, the company should be able to authorize its directors or officers to trade on the basis of inside information.[63] According to Fisch, this means that the government must defer to the company's decision to contractually allocate that property.[64]

Dooley recognizes that the law generally has permitted one who has developed valuable information to benefit by withholding it when contracting with others.[65] A fiduciary is forbidden to benefit personally from developing valuable information, not because it would be unfair in an abstract sense but because the agency costs of such behavior exceed any realizable social benefits derived from increased incentives to develop the information.[66] The parties themselves could avoid this problem by drafting elaborate agreements that require information sharing and then engage in extensive monitoring and bonding activities. The resulting transaction costs, however, will likely prove excessive.[67] Efficiency can be enhanced at less cost by a legal rule that vests the property right to valuable information in the firm.[68]

The firm will be harmed if the discoverer either organizes a rival business to exploit the information or remains in the firm but attempts to drive out his partners. Although the first strategy can be pursued in any size organization, the second is feasible only in a firm with relatively few members or shareholders.[69]

Because insiders in publicly held corporations cannot exclude all outsiders from sharing in the benefits of new information, their purchase of additional shares does not conflict with the overall interests of the corporation or its outside shareholders.[70] Therefore, the efficiency considerations that are relevant in the context of mandatory disclosure in case of agencies, partnerships, or closely held companies simply do not apply in the case of publicly held companies. Under common law, no fiduciary standards were imposed on directors and officers while trading on an impersonal exchange.[71]

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[63] Jill Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 225 (1991) (footnote omitted).
[64] *Id.* at 225.
[65] Dooley, *supra* note 18, at 63.
[66] *Id.* at 64.
[67] *Id.* at 65.
[68] *Id.*
[69] *Id.* at 66.
[70] *Id.*
[71] Dooley, *supra* note 18, at 66.

This is exactly the problem that was noted in my analysis elsewhere of the classical theory. The *Chiarella* Court simply invented a "disclose-or-abstain" duty in the context of market-based transactions–a fiduciary fiction.[72]

Dooley's analysis gives a new angle to the issue in the context of the property rights theory–what may be termed as "harm fiction." It is true that unauthorized use of information can, in certain other settings (such as agency or partnership), be harmful to a party who produces that information, and therefore the law prohibits such use. This principle is then sought to be generalized even to impersonal, market-based transactions, even when no such harm is implicated. This is exactly parallel to the case where one starts from the fact that fiduciary relationships exist in certain personal, face-to-face situations and then simply extrapolates these to market-based transactions in order to justify the classical theory.[73]

E. Insider Trading as Private Corruption and Property Rights Theory[74]

Kim conceptualizes insider trading as private corruption–the use of an entrusted position for self-regarding gain.[75] She notes certain problems with the property rights argument.

One of the core features of property is that the owner enjoys a right to exclusive possession generally as against the world.[76] The existence of any fiduciary or similar duty of trust or confidence is irrelevant. However, this fact is crucial in establishing liability under the current U.S. insider trading law.[77]

This criticism seems to be off the mark. This anomaly only says that the current U.S. law is not actually based on the property rights theory, notwithstanding the *O'Hagan* Court's (rather fleeting) reference to property rights. It says nothing about the desirability of adopting the property rights theory.

However, there is another point that can be made in this respect. Taking the right to exclude seriously undermines the entire mandatory disclosure regime in the U.S. and several other jurisdictions. The legal framework in these jurisdictions requires that listed companies disclose financial and other information about their operations to the market.[78] But by treating corporate information as property, companies should be free to decide whether and to what extent they would disclose such information. This is clearly against the spirit of the current disclosure-based regime that makes such disclosures mandatory as a mechanism to ensure market efficiency and to detect and prevent fraud. In this context, Justice Brandeis's famous remark that publicity is justly

[72] *See* Patwardhan, *supra* note 15, at 361-63.
[73] *See id.* at 363.
[74] *See infra* Section V for a detailed discussion of the corruption theory.
[75] Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014).
[76] *Id.* at 977.
[77] *See id.* at 978 (discussing the hypothetical example of the ninja trader).
[78] SEBI Regulations (Listing Obligations and Disclosure Requirements), 2015 (dealing with market disclosures by an entity which has listed, on a recognised stock exchange, certain designated securities issued by it or issued under schemes managed by it).

commended as a remedy for social and industrial diseases is often quoted. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.[79]

The second point that Kim makes is concerning the general alienability of property. Here, Kim accepts that not all property rights are fully alienable; examples include contested commodities (such as organs and babies), negative externalities (such as pollution or overharvesting), and fundamental rights. Additionally, Kim remarks that the right to use inside information about the firm in securities transactions does not fall in any of those domains.[80]

At this point, it may be argued that Kim is merely begging the question (since it needs to be argued why it does not obviously fall in the same category). However, the point here is that alienability is a general feature of property rights, and a departure from this can be made only if a compelling policy interest justifies otherwise. No such compelling argument has been given (except the purported corporate harm which cannot be accepted as a universally true proposition), and thus any insider trading prohibition regime based on property rights must permit alienability.

Kim gives the example wherein the Chief Executive Officer (CEO) of a company may negotiate the right to use inside information for trading, instead of another perquisite such as a company-provided car. Both involve a private exchange of property for services.[81] So long as the shareholders are satisfied that such exchanges are not abusive, they should be free to permit either. However, the property rights theory of the insider trading prohibition would forbid the former while permitting the later. Thus, it does not take corporate property rights in information seriously.

F. Informational-Egalitarianism v. Informational-Propertarianism

Krawiec argues that it is the “nature of information itself” that creates the policy and doctrinal puzzles of the insider trading prohibition.[82] Krawiec frames the distinction between the equal access theory and the property rights theory as the tension between two approaches–"informational-egalitarian" and "informational-propertarianism."[83]

Krawiec argues against the standard property rights theory and offers another proposal on the issue, which is a variant of the standard property rights theory. There are three strands of this argument. First, it displays a certain scepticism toward intellectual property as a means to optimal information production and dissemination. Then, it considers challenges to the argument that use and production are necessarily maximized in a system of private property rights, particularly in the context of information.[84] The arguments here delve deep into economic theory and go far beyond the specific issue of insider trading and cover other intellectual property rights as well.

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[79] Louis D. Brandeis, *Chapter V: What Publicity Can Do*, *in* OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT (1914), https://louisville.edu/law/library/special-collections/the-louis-d.-brandeis-collection/other-peoples-money-chapter-v.
[80] Kim, *supra* note 75, at 979 (footnotes omitted).
[81] *See id.* at 980.
[82] Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 445 (2001).
[83] *Id.* at 447.
[84] *Id.* at 481.

Second (the third point in order of analysis), Krawiec argues that traditionally, the American legal system has been reluctant in recognizing property rights in information. This should, at the very least, cause a more careful consideration of the assertion that issuers are deserving of an exclusive property right in information about themselves.[85]

Finally, Krawiec points to the crucial fact about information–that it has multiple uses. Therefore, it is not at all obvious that companies need any extra incentive to produce information about themselves. The possibility of multiple profitable uses for the same information may provide sufficient incentives for information production, obviating the need for an endowment of property rights in information creators.[86]

Companies always develop new products or technologies and build efficient business structures, say through mergers and acquisitions, so they can operate a successful enterprise.[87] They would not stop engaging in these activities, thereby producing new information, just because people privy to this undisclosed information may also use it for securities trading. This undercuts the policy argument offered in favour of the property rights theory–that it provides an economic incentive to produce socially valuable information.

Krawiec then offers a “middle ground” to avoid the problems of both "informational-egalitarian" and "informational-propertarianism."[88]

Krawiec also identifies the need to encourage the dissemination of valuable inside information to the marketplace as the key issue. While an “always disclose” rule would achieve this, it is impracticable.[89] On the other side, permitting insider trading would create “perverse incentives” for the insiders, thus the Bainbridge “corporate harm” arguments are repeated.[90]

Krawiec advocates the privatization of the “outsider” insider trading regime. This regime would permit trading on non-public information by corporate outsiders, defined as those persons who are neither employees nor constructive insiders of the issuer and who did not receive their information in a tip from the issuer's employees or constructive insiders.[91] Prohibiting (actual or constructive) insiders from trading on inside information is aimed at avoiding the perverse incentives problem.

Corporate insiders and constructive insiders are those who have assumed a fiduciary duty to the corporation and its shareholders and who often control the corporation's information flow to the outside world.[92]

[85] *Id.* at 490.
[86] *Id.* at 488 (footnote omitted).
[87] *Id.* at 489.
[88] *Id.* at 493.
[89] *Id.* at 495.
[90] *Id.* at 496.
[91] *Id.* at 498.
[92] *Id.*

The other "true" outsiders would be free to trade on any inside information that they may get access to, subject to any confidentiality agreements they may have signed with the company. However, the burden of enforcing such agreements would be shifted from the SEC to the private parties and state courts. The SEC's monitoring expertise could also be employed to assist companies with enforcing private contracts regarding the use of valuable corporate information.[93]

He concludes that a nonexclusive property right in corporate outsiders who possess inside information may strike the most appropriate balance between incentives and access–a difficult balancing act, but one that is performed with some measure of success in connection with other types of intellectual property.[94]

However, as Krawiec himself admits, insiders will attempt to evade the federal limitations on insider trading by trading through or tipping friends and family members and then arguing that these illegal trades and tips are actually misappropriations, which are governed by state contract law.[95] Some of the more egregious instances could be prevented by allowing the Commission to bring enforcement actions when it believes that an insider has attempted to disguise her trades in this manner, but the burden of proof would be on the government to show that what appears to be outsider trading is, in fact, disguised insider trading.[96]

In practice, it could be challenging for the Regulator to discharge this burden, since it is the friends and family members of the insider who would be involved in the tipping and trading scheme.

On the other hand, instances of "true" outsiders getting access to inside information would, by definition, be rather rare. Thus, it is not at all clear whether such a regime would advance Krawiec's avowed policy goal of the dissemination of valuable inside information to the marketplace. On the contrary, it may leave a loophole for the insiders to trade on non-public information through their friends and family members in the guise of legal "outsider" insider trading.

G. Property And… Other Valid Principles

Douglas accepts that his analysis does not support the claim that the U.S. insider trading doctrine is a property doctrine or that a property rationale is sufficient for explaining past cases or deciding future cases. However, the analysis does support the conclusion that it would be a mistake to treat certain non-property doctrines as completely unrelated to property doctrine.[97] He terms this "Property And… Other Valid Principles."[98]

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[93] *See id.* at 498.
[94] *Id.* at 502.
[95] *Id.* at 499.
[96] *Id.*
[97] Kevin R. Douglas, *Missing the Role of Property in the Regulation of Insider Trading*, 69 CATH. U. L. REV. 209, 233 (2020).
[98] *Id.* at 239.

He notes that insider trading law departs from the standard property rights doctrine.[99] The insider trading doctrine is more analogous to an inalienability rule or a vice law than a property rule.[100] It prohibits certain information owners from using their information for securities trading and bars these owners from licensing third parties to do the same. These restrictions contradict the common and long-standing expectation that property owners have a right to partially alienate their property for consideration.[101] According to him, apart from property rights, valid competing principles are also motivating the doctrine. Most legal regimes contain general rules and exceptions to those rules.[102]

Some exceptions are authorized by an overarching policy objective that also justifies the general rule. Other exceptions to general rules are authorized by a competing government interest that is given explicit priority in a specific context.[103] According to Douglas, fairness and investor confidence are two obvious candidates for the additional principles in insider trading law that compete with property doctrine.[104]

The first principle is about an equal-information conception of fairness.[105] In that context, he mentions the two-pronged test explaining liability for insider trading found in *Cady, Roberts*, and *Chiarella*, "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) *the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure.*"[106]

However, I have argued elsewhere that this two-pronged test actually makes the underlying theory ambiguous and dichotomous. Further, the impersonal nature of today's securities markets fundamentally alters the victim analysis. In the context of impersonal markets, the counterparties are not harmed by insider trading and may actually benefit. This is so regardless of whether such counterparties are time traders or price traders.[107]

The second candidate for an additional principle animating this area of law is the investor confidence or market integrity rationale offered by the Court in *O'Hagan*.[108] In *O'Hagan,* the Court states that imposing liability under the misappropriation theory is in line with the "animating purpose of the Exchange Act: to ensure honest securities markets and thereby promoting investor confidence."[109]

O'Hagan acknowledges that some information asymmetries are inevitable in securities markets.[110] It is unclear how the average investor would determine which kind of information

[99] *Id.* at 211.
[100] *Id.* at 237.
[101] *Id.*
[102] *Id.* at 239.
[103] Douglas, at 239 (footnote omitted).
[104] *Id.* at 240.
[105] *Id.*
[106] *Id.* (quoting *Chiarella*, 445 U.S. at 227).
[107] *See* Patwardhan, *supra* note 15, at 346-47 for an elaboration of this point.
[108] Douglas, *supra* note 97, at 241 (quoting *O'Hagan*, 521 U.S. at 658).
[109] *Id.* (quoting *O'Hagan*, 521 U.S. at 658).
[110] *Id.*

advantages (if any) are being used by his counterparties in the marketplace. This epistemic challenge may explain how the pursuit of some version of investor confidence through the prohibition of some information asymmetries might cause departures from long-standing property principles. If investors would find it difficult to differentiate between counterparties with acceptable and unacceptable information advantages, then it may be equally difficult for courts and enforcement officials to do so. Therefore, to the extent that insider trading doctrine departs from the common elements of a property regime, the difficulty of precisely differentiating between acceptable and unacceptable information advantages may have caused the development of conflicts in the doctrine.[111]

O'Hagan held that since deception consists of undisclosed use of information by the trader, the fraud is consummated when, without disclosure to his principal, he uses the information to purchase or sell securities.[112] Further, *O'Hagan* states that the harm results because the counterparty is at an informational disadvantage vis-a-vis a one who misappropriates material non-public information, and, further, such disadvantage stems from contrivance, not luck. It is a disadvantage that cannot be overcome with research or skill.[113]

However, if the insider trading prohibition is aiming at preventing trading based on informational disadvantage that cannot be overcome with research or skill, the misappropriation theory is clearly underinclusive. This is because the counterparty (or the entire marketplace) would suffer the same disadvantage if the trader traded on MNPI after disclosing to the source its intent to trade, or even with its blessings. Further, the counterparty cannot overcome such disadvantage with research or skill. Thus, while the deception is that of the source of information, the harm results to the counterparty. The paradox here is that disclosure *to the source* of an intent to trade supposedly eliminates any harm *to the counterparty or the marketplace.* This makes the theory incoherent, to say the least.[114]

Therefore, if it is the difficulty of precisely differentiating between acceptable and unacceptable information advantages that may cause the development of conflicts in the doctrine, the property and other valid doctrines approach does not seem to be of any help in clarifying the law in light of a competing government interest. As *O'Hagan* demonstrates, this approach can actually misalign the prohibition regime with the underlying policy rationale and obscure the core focus of insider trading law.

Douglas also argues that we do not have to choose only one of the property doctrines and fairness.[115] If common law nondisclosure and trade secret doctrines can contain property principles and fairness principles, it may be possible for the insider trading doctrine to contain equal-information principles and investor confidence principles while simultaneously being motivated by property principles.[116]

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[111] *Id.* (footnote omitted).
[112] *O'Hagan*, 521 U.S. at 655.
[113] *Id.* at 658.
[114] Patwardhan, *supra* note 15, at 381.
[115] Douglas, *supra* note 97, at 242.
[116] *Id.*

Under common law, nondisclosure is viewed as analogous to an affirmative misrepresentation only in exceptional cases, including when the non-disclosing party has information that "the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[117] This is the language that the *Chiarella* Court seized upon to impose liability under the classical theory.[118] However, in the context of impersonal markets, the concept of counterparty is meaningless–not just as a matter of legal form, but even as a matter of substance. Therefore, it is a stretch to extend the common law nondisclosure duty to the securities transactions executed on impersonal markets.[119]

Douglas notes that defining fairness as the protection of some party's property rights is a common aspect of American law, especially in the area of trade secrets.[120] In applying Texas's trade secret law, the Fifth Circuit Court of Appeals described the principle in the following manner:

> That the cost of devising the secret and the value the secret provides are criteria in the legal formulation of a trade secret shows the equitable underpinnings of this area of the law. It seems only fair that one should be able to keep and enjoy the fruits of his labour. If a businessman has worked hard, has used his imagination, and has taken bold steps to gain an advantage over his competitors, he should be able to profit from his efforts. Because a commercial advantage can vanish once the competition learns of it, the law should protect the businessman's efforts to keep his achievements secret. As is discussed below, this is an area of law in which simple fairness still plays a large role.[121]

This analogy is again clearly inapplicable in the context of insider trading. In trade secrets law, the fairness principle is invoked to justify assigning property rights to the person who developed the particular property. This is held to be a fair outcome for such holder of property rights. The objective here is to incentivize the production of such intellectual property. As already discussed, this rationale is inapplicable in the context of insider trading, as the corporates will produce valuable business information for enhancing corporate value anyway, regardless of whether someone else may also use it for trading in the securities of the corporation.[122] Further, according to the proposal under discussion, it is not fairness to the holder of property rights in the information (the corporate) that animates the fairness principle. Rather, the insider trading prohibition is justified on the ground that it is fair *to third parties*, i.e. the traders in the securities markets or the investors in general.

Of course, Douglas does not offer his theory as a normative proposal. His theory is aiming at the explanation of the developing positive law. He notes the need for legal reform. The call for legal reform might be satisfied by bringing the doctrine into greater harmony with the expected features of a property regime. Alternatively, reformers can *clearly* authorize a departure from the expectations of a property regime.[123]

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[117] *Id.* at 224 (quoting RESTATEMENT (SECOND) OF TORTS § 551 (AM. L. INST. 1977)).
[118] *See Chiarella*, 445 U.S. at 228.
[119] *See* Patwardhan, *supra* note 15, at 364 for an elaboration of this point.
[120] Douglas, *supra* note 97, at 232.
[121] Metallurgical Indus. Inc. v. Fourtek, Inc., 790 F.2d 1195, 1201 (5th Cir. 1986).
[122] *See supra* text accompanying Section I.B.
[123] Douglas, *supra* note 97, at 242 (footnote omitted).

As the discussion in this subsection shows, the rationale for bringing in other principles such as common law nondisclosure and fairness are inapposite in the context of insider trading law. Furthermore, by comingling other legal principles with property rights, courts seem to reach bizarre results that are out of tune with their proffered justification for prohibiting insider trading.

H. The Takeaway

To conclude the assessment of the property rights theory, it must be said that this is not two-faced, unlike the special relationship and misappropriation theories.[124] It is based on the notion that information is basically property, and property rights in corporate information must be assigned to the company itself as a mandatory rule. Further, this right is inalienable. Any trading based on such corporate information then amounts to a violation of this inalienable property right and is prohibited. Some proponents of this theory openly admit that the origin of the prohibition in securities law was a historical accident, and the underlying rationale for the prohibition has nothing much to do with the core concerns of securities law.

However, the policy arguments offered in support of this theory are weak. It can be argued that in a large number of cases, trading on corporate information does not harm the company or may even benefit it. Thus, companies should be free to alienate this right by permitting others to trade on such corporate information if it is in the company's interests. Also, companies would anyway produce valuable information for furthering their business interests, independent of any assignment to them of property rights in corporate information.

Further, the argument for extending this principle, even in a case of third parties who are unconnected to the securities markets (such as newspapers), is even weaker. Finally, there seems to be no reason why the SEC (or other securities regulators) should spend considerable resources on monitoring the insider trading prohibition, especially if it is not connected to the core mandate of securities law and does not implicate the interest of investors or the development of the securities markets. This is true regardless of any comparative advantage that the securities regulators may have in this regard.

II. DECEPTION-BASED THEORY

In an earlier article, I discussed Saikrishna Prakash's critique of the misappropriation theory discussed by the *O'Hagan* Court.[125] Prakash argues that the *O'Hagan* Court unwittingly adopts a Deceptive Trading Theory.[126] Misappropriation is not necessary because *any* deception triggered by a securities transaction is enough.[127] Haire also predicted the ultimate evisceration of the duty model itself.[128]

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[124] *See* Patwardhan, *supra* note 15, at 336-38 & 380-81.
[125] *See id.* (citation omitted).
[126] Prakash, *supra* note 8, at 1533.
[127] *Id.* at 1539.
[128] M. Breen Haire, *The Uneasy Doctrinal Compromise of the Misappropriation Theory of Insider Trading Liability*, 73 N.Y.U. L. REV. 1251, 1288 (1998).

This prediction turned out to be accurate. The lower courts, while paying lip service to the binding holding in *O'Hagan*, began predicating insider trading liability on mere wrongful acquisition of information, even in the absence of any fiduciary-like duty.[129] The SEC promulgated Rule 10b5-2 to effectively expand the scope of the prohibition even where no fiduciary or similar duty was at issue.[130]

Nagy also notes this trend–what she calls the gradual demise of fiduciary principles.[131] The *O'Hagan* Court remarked that because Section 10(b) is only a partial antidote to the problems it was designed to alleviate, it does not call into question its prohibition of conduct that falls within its textual proscription.[132]

However, in the backdrop of the Court's (unwitting) adoption of a Deceptive Trading Theory, the Court's pessimism may have been unwarranted. One way to add a modicum of clarity and consistency to the law of insider trading would be for courts to embrace a new theory premised on the deceptive acquisition of confidential information. This new theory of insider trading liability under Rule 10b-5 could function as a third alternative to the classical and misappropriation approaches.[133] This approach would expand liability even where there is no pre-existing duty between the trader and her source, but the acquisition of information involves deception.

Nagy discusses a few such examples. These involve a person hacking into a computer to obtain information for securities trading, a friend who "dupes" another into revealing MNPI that she then uses in a securities transaction,[134] and a person who tricks another into leaving a business meeting in order to access confidential file folders left on the table.[135] In such cases, there would be no liability under *O'Hagan,* but such acts are deceptive and therefore trading on the basis of such information would be prohibited under the theory currently being discussed.

Coffee offers a similar proposal. In fact, he goes further and proposes that the SEC frame a rule (what he terms Rule 10b5-4) to define such non-duty based deception.[136]

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[129] *See* Patwardhan, *supra* note 15, at 389-91 for a brief discussion of these cases.
[130] *Id.* (discussing Rule 10b5-2).
[131] *See* Nagy, *supra* note 9, at 1321.
[132] *O'Hagan*, 521 U.S. at 659 n.9.
[133] Nagy, *supra* note9, at 1369.
[134] *Id.* at 1371.
[135] *Id.* at 1372.
[136]John C. Coffee, Jr., *Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 306 (2013). The proposed Rule reads: For the purposes of Section 10(b) of the Securities Exchange Act of 1934, Section 17(a) of the Securities Act of 1933, and the antifraud rules thereunder, the terms "deceptive,' "deceit,' and "artifice to defraud' shall be deemed, without limitation, to include the following conduct when done in connection with the purchase or sale of a security or a security-based swap agreement: (1) misrepresenting one's identity or purpose in obtaining or attempting to obtain access to information that the actor is aware is likely to be material and non-public; (2) taking, emailing, reproducing, photocopying, or otherwise misappropriating business records or other confidential information, or disseminating such records or information to persons not authorized to receive such information, through either an affirmative misrepresentation or by means of a covert act or subterfuge, when one knows, or is recklessly indifferent to the prospect, that such records or information are likely to contain material non-public information that the lawful owner of the information has not authorized for contemporaneous public release; (3) failing to disclose one's identity, employment, status, conflict of interest, or other

One advantage that this theory offers is, as remarked earlier, it expands the reach of the insider trading prohibition, as compared to the *O'Hagan* misappropriation theory, which Nagy's examples bear out.

However, it still does not cover all cases where the information may have been acquired without any deception. An example is where a trader obtains confidential information through outright theft, but the theft is accomplished without any act of deception.[137]

How does this theory compare with the Chief Justice's preferred theory in his dissent in *Chiarella*? "Deceptive acquisition of information" is a narrower term than "misappropriation" in the Chief Justice's dissent.[138] For example, trading on information acquired through theft would be prohibited under the latter but not the former. Thus, this theory seems to be in between *O'Hagan* "misappropriation" and the "misappropriation" per the Chief Justice's dissent. If prohibiting trading on wrongfully obtained information is the policy goal, the Chief Justice's dissent in *Chiarella* offers a more expansive framework.

This theory inherits the same dichotomy inherent in the two misappropriation versions—maybe because it sits between them! As Nagy candidly admits, the sources of the information—and not securities investors—are deceived by the defendant's conduct. Yet, it is insider trading's impact on the securities market and the confidence of investors that provides the rationale for the prohibition.[139]

This fact makes the theory incoherent. In this regard, Prakash's criticism of *O'Hagan* misappropriation is relevant here as well. It reaches deceptions of parties wholly outside of and unconnected to the securities markets.[140]

This dichotomy leads to bizarre results. As Coffee notes, his formulation requires the disclosure of one's identity or conflict when one is hearing an extended conversation (regarding MNPI), but it would not cover overhearing the ten-second remark in an elevator.[141]

Similarly, if a trader "tricks" another person into letting her use the computer of such person and makes a trade through such computer, such trading is prohibited. In other words, deception need not be in the context of material non-public information but can be in the context of any resource.[142] This resource, agnostic nature of the theory implies that calling it an insider trading prohibition theory may be a misnomer! Further, if she outright steals the computer—in full view of its owner—and uses it for placing a trade, such trading is not prohibited, since the computer was not acquired through deception!

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relevant information when one knows that such disclosure would likely cause another person not to reveal, or to cease to reveal, information that is material and non-public.

[137] Nagy, *supra* note 9, at 1372.

[138] The version of the misappropriation theory offered by the Chief Justice prohibits trading on MNPI without authorization from the source. *See* Patwardhan, *supra* note 15, at 401-04.

[139] *Id.*

[140] Prakash, *supra* note 8, at 1496.

[141] Coffee, *supra* note 136, at 307.

[142] *See* Prakash, *supra* note 8, at 1496 for a discussion of the same issue in the context of the misappropriation theory.

In both cases, the respective distinction is totally irrelevant from the investors' point of view. Still, the issue of legality or otherwise of securities trading in each context is crucially dependent on just such distinctions. Again, the total disconnect of this theory with the core mandate of securities law (and even with the underlying policy objective that is sought to be achieved) can be clearly seen.

Therefore, this theory suffers from the same incoherence and policy flaws as both versions of "misappropriation." In addition, it is narrower than the Chief Justice's version of "misappropriation" in *Chiarella* that makes it an even less desirable candidate as a foundation for the insider trading prohibition.

In all fairness, it must be said that scholarly support for this theory may be motivated by the fact that, at least as of now, the insider trading prohibition regime in the U.S. must necessarily be based on some concept of "deception." This is because of the textual requirement of Section 10(b) of the SEA, into which the prohibition has been read. Thus, predicating an insider trading prohibition on deception—defined in the widest possible manner—may be the best option that does not warrant recourse to any legislative initiative by the U.S. Congress.

In that sense, both the Chief Justice's version of misappropriation as well as the structural disparity theories[143] go "outside the line" of Section 10b-5, unless of course one can point to another set of persons who are deceived. However, as discussed earlier, the argument that the counterparty or even the entire market is deceived by the insider trader is not sustainable in the context of an impersonal, exchange-based transaction.

Thus, based on the above discussion, it can be concluded that the deception-based theory to the insider trading prohibition is incoherent and a poor fit, even to its own purported policy justification.

III. FRAUD ON THE MARKET

Coffee offers yet another proposal to provide a foundation for the insider trading prohibition. The theory that he offers here is known as fraud on the market (FOTM). According to him, one of the curious features of existing insider trading law is that it has largely ignored FOTM doctrine and the significance of market efficiency. He attributes it to path dependency.[144]

In particular, the economic foundation of FOTM is the efficient market hypothesis (EMH). EMH says that in an efficient market the price of a security reflects certain available information.[145] The upshot is that a particular investor may not have access to all such information or may not

[143] *See* Patwardhan, *supra* note 15, at 401-09 & 410-18.
[144] Coffee, *supra* note 136, at 297. Nagy advocates what she terms "fraud on investors" theory. *See* Nagy, *supra* note 9, at 1373. Despite the similarity in the nomenclature, Nagy takes the Chief Justice Burger's dissent in *Chiarella* as the starting point. In a latter article, Nagy terms it "fraud on contemporaneous traders." *See* Donna M. Nagy, *Salman v. United States: Insider Trading's Tipping Point?*, 69 STAN. L. REV. ONLINE 28, 35 (2016).
[145] EMH actually posits different degrees of efficiency. This distinction will be discussed shortly.

bother to read or understand it. However, when she decides to buy or sell a security at the price set by the market, it is as if she has done it on the basis of this information.

A. FOTM in Securities Class Action Suits

FOTM was first advocated in the context of granting a class certification in case of class action suits pertaining to securities fraud. The U.S. Supreme Court first endorsed it in *Basic Inc. v. Levinson*.[146] In a later case, the Court declined to overrule *Basic*.[147]

The problem that FOTM sought to address was that of proving reliance in case of a securities fraud class action, where the securities trading happens in an impersonal market. This is because "in face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor."[148] Thus, it can be inquired whether there was any material misrepresentation–or nondisclosure in the face of a duty to speak by one party–and whether the counterparty relied on the same.

In case of an impersonal market, the counterparties do not know each other and there is no element of reliance. Further, the price is not mutually negotiated but the trade happens at the price set by the market. Thus, the typical case of a face-to-face transaction wherein a person, based on the representations made to her, forms a judgement as to the value of the security is simply inapplicable here.

For a private right of action to succeed, the plaintiffs need to prove reliance, transaction causation, and loss causation.[149] Proving reliance in such cases could be difficult as the plaintiffs will have to prove that they were aware of such misrepresentations and actually relied on these. As *Basic* put it, "reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."[150] However, in an impersonal market, there are no direct representations either from one party to the trade or the issuer of the securities to the counterparty. The information is disclosed to the market as a whole. The counterparty buys shares based on the price set by the market.

FOTM provides a way out. As the *Basic* Court put it:

> [In case of a market-based transaction], the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.[151]

[146] Basic Inc. v. Levinson, 485 U.S. 224 (1988).
[147] Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014).
[148] *Basic*, 485 U.S. at 244.
[149] Amgen v. Connecticut Retirement Plans and Trust Funds, 568 U.S. 455, 460 (2013) (quoting Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 37 (2011)).
[150] *Basic*, 485 U.S. at 243.
[151] *Id.* at 244 (quoting *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

The Court further added that, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price."[152]

The Court further wrote:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business…. Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements…. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.[153]

Thus, FOTM creates a rebuttable presumption of reliance.[154] Thus, in case of corporate misstatements, all those who purchased the company's shares between the time the misstatement was made and it came to light are presumed to have relied on the same. This is presumed to have happened through their reliance on the integrity of the market price, which was actually distorted due to the misrepresentations.

Coffee argues that if FOTM works for other securities fraud action, it should work for insider trading as well. *Basic* provides a plausible basis for viewing the trading counterparty as a victim of insider trading. In both contexts, the investor who buys an overvalued stock is relying on the accuracy of the market price. The defendant in both cases knows the stock is mispriced.[155]

B. Difficulties with FOTM

However, it can be argued that FOTM cannot serve as a sound foundation for the insider trading prohibition. First, FOTM in itself is a contested theory. Justice White was clearly apprehensive about "embrac[ing] novel constructions of a statute based on contemporary microeconomic theory" with "no staff economists, no experts schooled in the [EMH]," and "no ability to test the validity of empirical market studies."[156] Recent empirical research has cast doubts on the validity of the EMH.[157] Doubts regarding the EMH spill over to FOTM and further extend to its application to insider trading.

Second, there is no unanimity in academic literature whether the application of FOTM as a general proposition is valid. In developed markets, which are apparently efficient, reliance should be presumed from the materiality of the deception. But because it is at best uncertain whether undeveloped markets are efficient, FOTM theory should not be applied to them in any form.[158] If this is correct, in an FOTM-based insider trading prohibition framework, insider trading would be

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[152] *Id.* at 247.
[153] *Id.* at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (1986)).
[154] *See id.* at 245.
[155] Coffee, *supra* note 136, at 298.
[156] *Basic*, 485 U.S. at 253 (White, J., concurring in the judgment in part and dissenting in part).
[157] *See, e.g.*, Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 175 (2009) (stating that doubts about the strength and pervasiveness of market efficiency are much greater today than they were in the mid-1980s).
[158] Note, *The-Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1161 (1982).

prohibited or otherwise, depending on the degree of development and consequently the efficiency of the market.

Macey questions whether we can conclude that FOTM theory is socially desirable merely because it is *coherent*. He discusses a hypothetical example to argue that imposing liability for a certain sort of incomplete disclosure, particularly in the absence of a showing of reliance on any actual misstatements by the defendant, provides a strong disincentive to disclose at all. Thus, the fraud on the market theory, by penalizing those firms that choose to disclose corporate news, ultimately may make the markets less efficient. [159]

This example, of course, does not directly carry over to insider trading. However, the underlying lesson of this example is that in certain cases, the issue of full disclosure needs to be balanced against legitimate corporate interests.

C. FOTM and Insider Trading

More importantly, even if it is assumed that the application of EMH and FOTM in other areas of securities law is universally valid, its application to insider trading raises other specific issues. To see this, it is necessary to look at the structure of the EMH in greater detail.

EMH does not look at efficiency in all or nothing terms. It identifies three forms of market efficiency. The weak form of the EMH says that market prices impound all historical price data; therefore, no investor can earn an above-market return by trading on such information.[160]

The "semi-strong" version posits the same, but with respect to all publicly available information,[161] of which historical price data is a proper subset. Finally, the strong form posits it with respect to *all* information, whether publicly available or not.[162]

In *Basic*, the Court specifically seems to have adopted FOTM based on the semi-strong version of the EMH. This is clear from its remarks regarding "the market performing the valuation process and informing the investor that *given all the information available to it*, the value of the stock is worth the market price."[163] In other words, the market vouches for the integrity of the price *only with reference to publicly available information*.

This fact implies that FOTM in this form is inapplicable to insider trading. By definition, insider trading implies that a person trades, based on nonpublic information that is available to them, but not to the market. Thus, even if the said information is not reflected in the market price, it says nothing about the integrity of the market price in the semi-strong sense. So, long as the

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[159] Jonathan R. Macey, *The Fraud on the Market Theory: Some Preliminary Issues*, 74 CORNELL L. REV. 923, 924 (1988-1989).
[160] *See* Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 463 (2006).
[161] *See, e.g.*, Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 640 n. 24 (2003) (citing Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FINANCE 383, 388 (1970)).
[162] Dunbar & Heller, *supra* note 160, at 463-64.
[163] *See supra* note 151 (emphasis added).

market price reflects all publicly available information, the market is efficient in the semi-strong sense. There has been no distortion of the market process.

This point will be clearer if the example above is contrasted with another situation. Assume a company makes financial misstatements by way of reporting inflated revenue and profits. Such misstatements "pollute" the mix of information that is publicly available. If the company had stated its accurate revenue and profit figures, the market would have placed a lower price on company securities (as the semi-strong version implies). Thus, these financial misstatements have distorted the valuation process in a clear sense.

On the other hand, whether the insider traded on such information or abstained from trading, there is no change in the information mix that is publicly available. Thus, the market price would be the same in either case. Thus, the insider's trading on such information in no way affects the integrity of the price as set by the market in the semi-strong sense. Thus, the very basis of FOTM as fleshed out in *Basic* is inapposite in this case. An investor who traded in that security would have paid or received the same price in either case.

One may argue here that the insider's non-disclosure deprives the market of this information, and therefore the mix of publicly available information is reduced. However, this seems to be circular logic. The insider's duty to disclose is predicated on the assumption that applying FOTM in the insider trading context is valid. On the other hand, the application of FOTM to insider trading seems to be predicated on the assumption that the insider has a duty to disclose.

Another potential counterpoint to this analysis could be to argue that *Basic* set too low a threshold by focusing on semi-strong efficiency. One could instead advocate FOTM based on strong form efficiency. Thus, whether the market sets the price in an integrity preserving way would be a function of not just the information that is publicly available, but all information that is material from the viewpoint of assessing the security's value.

The obvious problem with this proposal is that the market, by definition, cannot impound information that is not available to it. The only way to ensure strong form efficiency is to require the companies to disclose information to the market on a daily, or even hourly, basis. If this is done, the semi-strong version effectively is collapsed into the strong version, as there is no material information that is not publicly available. There are genuine business considerations why all information cannot be instantly disclosed to the market.[164] Therefore, the focus of *Basic* on semi-strong efficiency is well justified.

In fact, it can be argued that permitting insider trading is possibly the only way to go beyond semi-strong efficiency. If the insiders trade in large quantities, or if their trades trigger derivative trading by the outsiders who infer the existence of material, nonpublic information,such trading would result in the market indirectly incorporating such information in the market, without actual

[164] Other "external" information such as an impending change in government policy, or a Court judgment that will be soon delivered also impact the price of a security. By definition, such information may stay nonpublic for an extended period of time. This is another reason why there will be an irreconcilable gap between all material information and what is publicly available, at a given point of time. If such a gap did not exist, there would be no opportunity for insider trading, and no point in writing this article!

disclosure of that information. Thus, the market could actually go in the direction of strong efficiency, at least to some extent. In the process, the integrity of the valuation process would improve. Investors who trade at such price cannot be said to have been harmed in any way. Thus, FOTM actually seems to justify legalizing insider trading.

Korsmo challenges the received wisdom on the link between market efficiency and FOTM. According to him, "it is possible to accept market efficiency and reject the FOTM theory, or to reject market efficiency and accept the FOTM theory."[165] He argues that, "the logic of the FOTM rests not on market efficiency, but on the structure of impersonal securities markets."[166] Apart from the fact that prices in such markets are set by impersonal market mechanisms, the other important feature is that securities are typically not being purchased for any form of personal consumption, instead of or in addition to for investment and resale.[167]

How are these facts relevant to FOTM? Korsmo provides an example to elucidate the point:

> Assume a buyer is willing to buy a used car that is being offered for $10,000. The seller falsely represents that the car's tires are brand new, when they are actually old and in need of replacing, which will cost $500. The buyer would be willing to pay up to $11,000 for the car if it had new tires, but would value it at $10,500 if she knew the truth about the tires. The buyer pays $10,000 for the car. The buyer cannot be said to have been harmed by the misrepresentation, because the buyer is in the same position he would have been in had he known the truth, or had the misrepresentation never been made. Either way, the buyer would have paid $10,000 for a car with old tires.[168]

Thus, the buyer did not rely on the misstatement, as he would have bought the car at $10,000 anyway, even in the absence of such misrepresentation. In other words, she would pay the same price, with or without misrepresentation.

Next, Korsmo discusses an analogous example:

> The issuer of a security that is trading at $9,500 makes a misrepresentation that causes the market price to rise to $10,000. The buyer believes the security is mispriced, and is really worth $11,000. Even if the buyer knew the truth, she would be willing to pay up to $10,500 for it. She therefore buys the security for $10,000. Just like in the previous example, the buyer would have still been willing to pay $10,000 even if she had known the truth. [169]

Korsmo's insight here is that:

> The buyer is *not* in the same position she would have been in absent the misrepresentation. If the misrepresentation had not been made, she may still have been *willing* to pay $10,000,

[165] Charles R. Korsmo, *Market Efficiency and Fraud on the Market: The Danger of Halliburton*, 18 LEWIS & CLARK L. REV. 827 (2014).
[166] *Id*. at 868.
[167] *Id.* at 868.
[168] *Id.* at 868-69.
[169] *Id.* at 869.

> but she would not, in fact, have paid $10,000—she would have paid $9,500. Thus, even if she knew the truth, and even if she did not rely on the market price as reflecting the "true value" of the security, the buyer has still been harmed by the misrepresentation.[170]

Now we can add a twist to the tale. Suppose, as in the example above, the security initially trades at $9,500 and the price rises to $10,000 after the issuer's misrepresentation. Certain insiders, aware of the misrepresentation, start selling company shares. As a result of their trading (and maybe triggered trading), the price declines to $9,950. While the investor suffered harm as a result of corporate misstatements, insider trading in company shares actually reduced her loss (as she could buy at $9,950 instead of $10,000). Thus, insider trading, if at all has any price effect, it moves the price in the "right" direction.

Therefore, whether we analyze FOTM from the viewpoint of reliance or pure market structure, its application to insider trading is unjustified. In fact, FOTM seems to provide an argument in support of the legalization of insider trading.

D. Corporate Misstatements v. Trader Misrepresentations

There is one important difference between the typical corporate misstatement examples discussed and insider trading. Market misstatements originate from the issuer who is not a party to the securities trade in the secondary market. In the context of FOTM, insider trading is implicitly treated as a misrepresentation to the effect that the insider is not aware of any material, nonpublic information. Here, the purported misrepresentation originates from a party to the trade. Does this difference possibly account for the conclusion that the application of FOTM in the corporate misstatement context does not carry over to insider trading?

This question must be answered in the negative. To see this, it is necessary to consider a misrepresentation that originates from a trader. Circular trading refers to the practice wherein a group of traders sell securities to each other in a circular fashion. This is usually done through synchronized trading. The traders with prior understanding enter orders in such a way that their orders will definitely, or in all likelihood, match with each other.[171]

In India, synchronization *per se* is not illegal. However, if done to artificially raise or depress the price of a security, it distorts price integrity and becomes a manipulative and deceptive devise, prohibited under Section 12A of SEBI Act.[172] In effect, such trading amounts to a misrepresentation that such trades are genuine trades, based on the trader's assessment of the price, and therefore the market price that is set as a result of such trades is integrity preserving. However, the mix of publicly available information here is clearly "polluted" as the market knows about the higher price (and possibly higher volume), without knowing that these have been achieved by creating a false market, rather than through a genuine interplay of market demand and supply forces.

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[170] *Id.*
[171] SUMIT AGARWAL & ROBIN J. BABY, A LEGAL COMMENTARY ON SEBI ACT, 1992 285 (2011).
[172] *Id.* at 286.

In Korsmo's example, instead of corporate misstatements, if circular trades are distorted in order to raise the price to $10,000, the net effect for the investor is the same. She ends up paying $500 more than the price the market would have set in the absence of the distortion (due to misstatements or circular trades). This is because in either case, the market price moves away from what it would be if accurate information was known to the market. On the other hand, insider trading results in at least a partial incorporation of non-public information in the price.

E. Davis on the Fraud on the Market Theory

Davis argues in support of adopting FOTM theory in insider trading law.[173] He argues that, "the injuries the law should seek to prevent are the deception on the counterparty and the inevitable loss in investor confidence."[174] He notes that the question of "whether the counterparty actually suffers any injury at all, however, has been a controversial question."[175] After considering arguments on both sides, he states that "the sounder conclusion is that the counterparty is injured and that such injury requires a robust insider trading law."[176]

According to him:

> The question remains how to redirect the focus of insider trading law away from a breach of fiduciary duty to the source and toward a breach of duty to the counterparty. One obstacle to this refocusing is the lack of a direct interaction between parties trading in impersonal, computerized markets.[177]

In essence, his argument hinges on combining the disclose-or-abstain duty with FOTM. *In re Cady, Roberts & Co.* the SEC first enunciated the disclose-or-abstain duty. The SEC stated:

> We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[178]

I have argued elsewhere that the SEC's articulation of the insider trading prohibition is ambiguous and dichotomous, making the theory two-faced.[179] The SEC enunciated two factors inherent in the theory. The fact that the insider had a relationship with the company that gave her access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a

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[173] Kenneth R. Davis, *Insider Trading Flaw: Toward a Fraud-on-the-Market Theory and Beyond*, 66 AM. U. L. REV. 51 (2017).
[174] *Id.* at 70.
[175] *Id.*
[176] *Id.* at 73.
[177] *Id.* at 77.
[178] *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961) (footnote omitted).
[179] *See* Patwardhan, *supra* note 15, at 336-38.

party takes advantage of such information knowing it is unavailable to those with whom he is dealing. [180]

This two-faced nature of the theory is the source of the dichotomy. The first factor seems to indicate that the concerned information is essentially treated as a corporate resource. This resource has been entrusted to the insider in order to discharge her corporate duties and it should not be used for the personal benefit of anyone.[181] Thus, this factor implies that insider trading is basically wrongful conversion of a corporate resource (in this case information) for obtaining a personal gain. Thus, the company itself is the victim of such trading.[182]

The SEC seems to have implicitly accepted this when it held that the counterparties do not have any private right of action against the inside traders due to the lack of privity between them. At the same time, it held that this fact does not absolve an insider from responsibility for fraudulent conduct.[183] However, the second factor seems to pull the theory in the opposite direction. The reference to the "inherent unfairness" raises the question "unfair to whom"? Since the supposed unfairness arises because one party has information that the other party does not have access to, the conclusion here is that it is unfair to the counterparty.[184]

Therefore, if an insider trades on MNPI after disclosing the same to the counterparty, the unfairness is arguably eliminated, as the counterparty now has access to this information. Of course, the source may have other legal remedies available to it for wrongful conversion of this information. On the other hand, such trading may well be beneficial to the source of information[185] and so the source may authorize the insider to trade on such information. Such trading, without the disclosure of the information to the counterparty, is not an improper conversion of a corporate resource, but nonetheless is clearly unfair to the counterparty. While the duty not to trade on MNPI runs to the source, such trading is held to be unfair to the counterparty. The interests of these two parties are often not coextensive. Therefore, adopting the SEC disclose-or-abstain theory is problematic.

Further, the lack of a direct interaction between parties trading in impersonal, computerized markets is not just an obstacle to be overcome. The impersonal nature of today's securities markets fundamentally alters the victim analysis. I demonstrate elsewhere that in the context of impersonal markets, the counterparties are not harmed by insider trading and in fact may actually benefit. This is the case, regardless of whether such counterparties are time traders or price traders.[186]

In the context of insider trading, ordinary investors believe that corporate insiders have an advantage that renders trading securities a game of Russian roulette. When investor distrust of the

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[180] *In re Cady,Roberts*, at 912 (footnote omitted).
[181] Patwardhan, *supra* note 15, at 336.
[182] *Id.* at 336-37.
[183] *In re Cady, Roberts*, at 915.
[184] Patwardhan, *supra* note 15, at 337 (footnote omitted).
[185] *See supra* Section I.B for a discussion of relevant caselaw.
[186] *See* Patwardhan, *supra* note 15, at 346-47.

securities markets swells, their willingness to invest falters, trading volume sinks, stock prices fall, and fewer new issues come to market. [187] This policy basis speaks more to the market-wide harms of insider trading,[188] rather than any fraud on the counterparty or other traders in the market. FOTM seems to be beside the point here. FOTM basically serves to dispense with the need to prove actual reliance by the counterparty on any material misstatements (or material nondisclosure) by the trader in an impersonal market, in order to establish deception. If the objective behind prohibiting insider trading is to prevent the market harms of insider trading, it is unrelated to the issues whether certain traders, such as employees of a corporation, have a fiduciary duty to the counterparty and whether FOTM allows us to invoke this duty and establish deception even in the context of impersonal markets. Thus, prohibiting insider trading to prevent any adverse impact on market liquidity, access to capital, and the cost of capital may well be justified independent of the validity of FOTM.

Finally, Davis concedes that his theory reaches only those cases where the trade occurred in a market efficient at disseminating material information.[189] Thus, trading on MNPI is not prohibited in markets that are not efficient, at least under FOTM theory. However, Langevoort argues that because market efficiency is not a binary, yes-or-no question, one cannot sensibly argue in every case that material information affects market prices.[190] Therefore, whether insider trading liability attaches in a particular case would turn on the difficult question as to whether the particular trade was executed on an efficient market. It is unclear if the judiciary is equipped to take this call.

F. The Takeaway

To conclude, basing the insider trading prohibition on FOTM seems to be unsatisfactory. Even in other areas of securities law, the wisdom of endorsing FOTM by judicial fiat has been questioned, in the absence of any economic expertise on the part of the judges. Recent research has cast doubts on the validity of FOTM. Further, its endorsement as a matter of universal application may not be socially or economically desirable.

The application of FOTM to insider trading raises its own specific concerns. The semi-strong version of FOTM, relied on in *Basic*, is inapplicable to insider trading, as the latter implicates information that is not publicly available. More important, corporate misstatements or circular trading "pollute" the mix of publicly available information and consequently the integrity of the market price. If at all, insider trading results in at least a partial incorporation of nonpublic information and thus helps the market to go in the direction of strong efficiency, albeit in a small way. Thus, FOTM seems to justify legalization of insider trading.

This conclusion is not at all surprising. If the investors do rely on the presence of insider trading, they do it by reading the signals correctly. For example, if a company is a potential takeover target, and persons privy to this information start buying company shares, the price would

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[187] Davis, *supra* note 173, at 73.
[188] For example, Dent argues that the prevalence of insider trading implies that persons other than the insiders would always have an informational disadvantage and thus would be reluctant to trade, reducing liquidity and increasing the cost of capital for companies. Ultimately, this would lead to the extinction of public stock markets. Dent, *supra* note 13, at 263-64.
[189] Davis, *supra* note 173, at 55.
[190] Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 167–68 (2009).

go up. Those who detect this sudden price rise are likely to read it as indicating the presence of some nonpublic positive information and so they too would be on the buy side. Mere interjection of FOTM and the consequent indirect reliance does not change the fact that if the investors do place any reliance on the insiders' trades, it is in the "right" manner and therefore cannot be said to have been harmed.

IV. CONTRACTUAL FRAUD THEORY

Zachary Gubler has developed another fraud-based theory of the insider trading prohibition.[191] He notes the problems with explaining the prohibition under traditional views of fraud. Perhaps for this reason, many commentators view insider trading law's roots in fraud as hardly more than a quirk of history.[192] He offers an alternative account – what he terms the contractual fraud theory.

A. The Theory Explained

Under this theory:

> Insider trading liability arises whenever the trading breaches a duty to report — either explicit or implied by a court — a violation of an underlying covenant — whether contractual or fiduciary-based — that prohibits insider trading in the first place. This failure to report constitutes fraud pursuant to Rule 10b-5 and should therefore give rise to the fraud-like, extra compensatory damages provided for by the rule.[193]

The rationale that he offers is that insider trading is extremely costly to detect for parties wishing to protect their information from any impermissible use – the "costly detection problem."[194] A firm that hires a consultant to provide strategic advice regarding a potential merger may want to protect its merger-related information against impermissible uses by the consultant, including insider trading. It may do so relying on either fiduciary duty law or contract law.[195]

This is an archetypal case of the costly detection problem as detecting a breach of duty by the consultant, in the context of insider trading, is very costly. To overcome this problem, the firm may contractually require the consultant to report a breach of the underlying duty – by way of inserting a "Reporting Covenant."[196]

The consultant will have an incentive to report the violation only if the breach of the Reporting Covenant is subject to extra-compensatory damages.[197] However, at common law, courts are extremely reluctant to allow contracting parties to "contract for fraud liability"; that is

[191] Zachary J. Gubler, *Insider Trading as Fraud*, 98 N.C.L. REV. 533 (2020).
[192] *Id.* at 536.
[193] *Id.* at 565.
[194] *Id.*
[195] *Id.* at 538 (footnotes omitted).
[196] *Id.* at 539 (footnotes omitted).
[197] *Id.*.

to say to enforce the breach of a contractual disclosure obligation through extra-compensatory (in other words fraud) damages.[198]

Under the contractual fraud theory, "parties can *explicitly* contract for fraud liability for insider trading through the use of a Reporting Covenant."[199] Further, "courts can–in certain circumstances–find that parties have contracted for fraud liability *implicitly* under Rule 10b-5."[200] The court should ask "whether the parties themselves would have opted into the Rule 10b-5 regime if they had explicitly addressed this issue."[201]

Gubler argues that his theory offers several advantages. First, it is "more respectful of the fraud-based nature of Rule 10b-5's text than alternative theories of insider trading."[202] Further, "it actually explains the law as it has been received."[203] In particular, the contractual fraud theory helps untangle that "riddle, wrapped in a mystery".[204] In other words, the contractual fraud theory seems to do a good job of explaining the law "as it is"–at least in the context of the insider trading prohibition regime in the United States. Going beyond the explanatory power of this theory, Gubler argues that his theory responds to potentially significant welfare implications of insider trading–public as well as private welfare.[205]

B. Public-Welfare Maximizing View

Gubler argues that courts or the SEC ought to take a public-welfare maximizing view in determining whether a contract contains an implicit provision for fraud liability.[206] They could decide whether to find an implied Reporting Covenant in these contracts, and therefore effectively decide whether Rule 10b-5 applies, based on considerations about the *public* costs and benefits of insider trading.[207]

He provides a quick summary of the social costs and benefits of insider trading, as discussed in the literature. Insider trading may "create the perception, if not the reality, that the market is 'rigged' and only serves to benefit the well-placed and the well-heeled of corporate America."[208] "A decrease in market integrity is feared to lead to a decrease in market participation, which would result in lower liquidity."[209]

[198] *Id.* at 539-40.
[199] *Id.* at 540.
[200] *Id.*
[201] *Id.*
[202] *Id.*
[203] *Id.*
[204] *Id.* at 540-41 (footnotes omitted).
[205] *Id.* at 568.
[206] *Id.* at 569.
[207] *Id.* at 578.
[208] *Id.* at 578-79 (footnote omitted).
[209] *Id.* at 578-79 (footnote omitted).

"Balanced against this cost, there is the possibility that insider trading might result in markets that are more informationally and allocatively efficient."[210] Market efficiency is important since it is correlated with greater gross domestic product and societal wealth more generally.[211]

Gubler considers the possible objection to the argument "that judicial or regulatory decisionmakers might interpret contracts in light of public, not private, considerations."[212] "This suggestion might seem eccentric, but it is not unprecedented."[213] "After all, it is well established in contract law that courts can refuse to enforce contracts for public policy reasons."[214]

There are two points that can be argued against this. It is one thing for courts to refuse to put their stamp of approval on contracts that are against public policy. Courts reading an implicit Reporting Covenant into a private contract to further the public policy objectives of prohibiting insider trading seems to go much further.

In the context of considering a private-welfare maximizing view, discussed in the following subsection, Gubler suggests that whether the contract should be interpreted as containing an implicit provision triggering Rule 10b-5 liability for insider trading would turn on a hypothetical bargaining analysis.[215] This is a standard way of deciding contract interpretation questions. The hypothetical bargain analysis asks what the parties themselves were likely to have decided had they considered this issue at the time of contracting.[216] This, in turn, depends on two factors: the difficulty of detecting the underlying breach and the availability of alternative means for enforcing compliance.[217]

This seems to create a puzzle for the contractual fraud theory. Assume that in a particular context of potential insider trading, the contracting parties themselves do not see any private-welfare maximizing benefit in incorporating the Reporting Covenant. Thus, the bargaining analysis would not permit courts or the SEC read such an implicit covenant. They may still determine that there is a public-welfare maximization angle involved here and read such a Covenant into the contract anyway. This clearly goes beyond, and actually contradicts, the intentions of the contracting parties. If the SEC makes a determination that public welfare is indeed implicated in a particular case and reads the Reporting Covenant in the contract, the defaulting party would be liable to pay the other party extra-compensatory damages for the breach of the Reporting Covenant. Since the contracting parties themselves do not see any private-welfare maximizing benefit in incorporating such a Covenant (as the hypothetical bargaining analysis shows), it results in unjust enrichment of the collecting party.

Gubler also states that given the nature of the public-welfare maximizing determination, it does not seem like an inquiry that is naturally suited for the judiciary. It seems more appropriately

[210] *Id.* at 579.
[211] *Id.*
[212] *Id*. at 579.
[213] *Id*.
[214] *Id.* at 579-80.
[215] *Id*. at 569.
[216] *Id.* at 569-70 (footnote omitted).
[217] *See Id.* at 570.

allocated to the province of expert regulators, such as the SEC.[218] Gubler suggests that insider trading liability is not private-welfare maximizing for arm's-length contracts.[219] The SEC could take a public-welfare maximizing approach to the problem, in which case it would focus on the public costs and benefits posed by insider trading.[220] The SEC has brought Rule 10b5-2. It does not draw any distinction between different types of contractual relationships, let alone whether they are arm's length or otherwise. Rather, it simply provides that a confidentiality agreement (whether express or implied) is sufficient for liability.[221]

This does not mean that there are no constraints on what the SEC can do here. At a minimum, parties must have entered into a contractual relationship subject to a confidentiality agreement, which is what Rule 10b5-2 requires. Thus, while the rule is valid, it is bordering the limit of the SEC's authority under the contractual fraud theory.[222]

The question that one may ask at this point is why the SEC's determination of the public costs of insider trading should be circumscribed by the contractual fraud theory. The SEC, as an expert regulator, may well determine that insider trading has social costs that outweigh any social benefits, even beyond what the contractual fraud theory can accept. In particular, the SEC may well determine that any trading on unequal access to information is socially undesirable. The perception of unfairness will persist so long as such trading happens. The fiduciary or contractual relationship between the contracting parties is simply irrelevant.

In fact, the SEC seems to be sympathetic to such equal access argument. I have argued elsewhere that the SEC Rule 14e-3[223] was aimed at proscribing the practice of warehousing. The Rule was a prophylactic measure to ensure that the market for corporate control functions in a smooth and transparent manner. On this reading, the reach of the Rule is limited to only those cases where trading on nonpublic information regarding impending tender offers happens with the collusion of the offering person.[224]

In later cases, the SEC seems to have applied this Rule effectively as an equal access theory in the tender offer context. The Rule was invoked in contexts other than warehousing and where the offering persons were not aware of trading on nonpublic information regarding their intended tender offer; additionally, the trader's intention was not to buy a substantial block of shares with a

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[218] *Id.* at 580.
[219] *See infra* Section IV.C.
[220] Gubler, *supra* note 191, at 590.
[221] *Id.*.
[222] *Id.*
[223] 17 C.F.R. § 240.14e-3 (2019). The rule reads, in part: It shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to (a) tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.
[224] *See* Patwardhan, *supra* note 15, at 392-93.

view either to making a takeover bid or to selling the block to someone else who then makes a bid.[225]

The SEC adopted Regulation Fair Disclosure (Regulation FD) in 2000. It requires issuers to publicly disclose any MNPI conveyed to market professionals and other specified people. This regulation requires that public disclosure must be simultaneous for intentional disclosures and prompt for unintentional disclosures.[226] Now the regulation specifically provides that any failure to make a public disclosure shall not be deemed to be a violation of Rule 10b-5 (and therefore of the insider trading prohibition).[227] This seems to be designed to ensure that there is no head-on conflict with the Supreme Court's rejection of the prohibition based on equal access consideration.[228]

At the same time, Regulation FD clearly undercuts the holding in *Chiarella* and *Dirks*. The Rule focuses on corporate issuers and corporate officials as the source of such asymmetries. If selective disclosures by corporate insiders could be prevented at the source, regulators would have less need to address trading by the recipients of that information. In effect, this seems to be an indirect (or alternate) approach to addressing information asymmetry.[229]

The SEC has also contested the "personal benefit" test evolved by the Supreme Court in the context of tipping cases. In *Dirks*, the Court held that the insider is guilty of violating the prohibition only if she discloses MNPI in breach of her duty. In turn, this depends on whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.230 Absent personal gain and breach by the insider, there has been no breach of duty to stockholders nor a derivative breach.[231]

The SEC advocated a more expansive test. According to it, "(w)here `tippees' –regardless of their motivation or occupation—come into possession of material `corporate information that they know is confidential and know or should know came from a corporate insider[*sic*]' they must either publicly disclose that information or refrain from trading."[232]

The upshot here is that if an expert regulator such as the SEC is better equipped to assess whether prohibiting insider trading in a particular context is desirable from a public-welfare perspective. It should be permissible for it to take a call on this, directly based on considerations related to public costs and benefits of such trading. There is no reason why the choice must be

[225] *Id.* at 393-94.
[226] 17 C.F.R. § 243.100(a).
[227] 17 C.F.R. § 243.102.
[228] *See* Chiarella v. United States, 445 U.S. 222 (1980); Dirks v. SEC, 463 U.S. 646 (1983).
[229] Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry, in* RESEARCH HANDBOOK ON INSIDER TRADING 112 (Stephen M. Bainbridge ed., 2013) (quoting Proposed Rule: Selective Disclosure and Insider Trading, SEC Release Nos. 33-7787, 34-42259, IC-24209 (Dec. 20, 1999), 64 Fed. Reg. 72574 (Dec. 28, 1999) ("We propose to use our authority to require full and fair disclosure from issuers . . . We believe this approach would further the full and fair public disclosure of material information, and thereby promote fair dealing in the securities of covered issuers.")).
[230] 463 U.S. 646, 663 (1983).
[231] *Id.* at 662.
[232] *Id.* at 651 (quoting 21 S. E. C. Docket 1401, 1407 (1981)).

constrained by any outer limits set by the contractual fraud theory. If this is correct, the contractual fraud theory seems to become superfluous in the context of public-welfare considerations.

C. Private-Welfare Maximizing View and the Proposed Default Rule

In the context of private-welfare maximization analysis, the question is under what circumstances should courts (or the SEC) infer an implicit Reporting Covenant in a relationship, whether contractual or fiduciary.

From a private-welfare maximizing view, there are two relevant factors: the difficulty of detecting the underlying breach and the availability of alternative means for enforcing compliance. The more costly it is to detect the underlying breach, while the alternative means cost less, the more likely contracting parties will choose to enforce prohibitions via Rule 10b-5.[233] Here, courts should employ a hypothetical bargaining analysis.[234]

Gubler compares the case of the Chief Marketing Officer (CMO) of the firm with that of its supplier. He argues that if a firm has sensitive information that does not need to be used for insider trading, it is easier to refuse to share or delay information with the supplier..[235] In contrast, the firm is hiring the CMO's knowledge and expertise for a variety of unspecified, and multifaceted problems that will persist over an undetermined period of time. In that context, it will be difficult to control the flow of information to the CMO.[236] Therefore, he advocates that courts should adopt default rules reflecting this result—that is to say, a default Reporting Covenant in intrafirm relationships, but not in arm's-length ones. In fact, this is what the Supreme Court essentially did in *O'Hagan*.[237]

He argues that although private parties could contract around the rule the Court announced in *O'Hagan*, they rarely do. This is evidence that this is in fact the private-welfare maximizing result.[238]

There may be a simpler explanation. Parties – O'Hagan and his law firm – may not have this possibility on their mind that O'Hagan may trade based on nonpublic information that is obtained from the law firm. The firm may be injured by such trading, and yet the firm may have difficulty discovering his trade when they entered into the contract. Consequently, the issue of whether O'Hagan should be permitted to trade on this information and the disclosure of such trading may not have been addressed in the contract.

Going beyond this hypothetical musing, one may offer more concrete evidence. If the employee trades on nonpublic information and the firm is injured as a result of such trading, the firm would be in a position to recover by compensatory remedies. However, it may be costly for the employer to detect such breach. The point of the Reporting Covenant is to make non-disclose

[233] Gubler, *supra* note 191, at 570.
[234] *See supra* note 217 and accompanying text.
[235] Gubler, *supra* note 191, at 571.
[236] *Id.*
[237] *Id.* at 575.
[238] *Id.*

itself actionable by permitting the employer to seek extra-compensatory damages, in addition to the compensation for the loss suffered. This incentivizes the employee to actually report the underlying breach.[239]

This implies that once the government (or the SEC) initiates an action against an employee inside trader--can be read into the contract as a default rule--becomes aware of the underlying breach and also that of the Reporting Covenant. Since courts have not yet accepted the contractual fraud theory, the employer would not be able to claim extra-compensatory damages for the latter breach. However, it would certainly be entitled to recover compensatory damages, in case it suffers a loss as a result of such trading. Because this rarely happens, firms do not think they are harmed by their employees' insider trading. In this situation, there is no question of their intention to incorporate the Reporting Covenant.[240]

Also-- notwithstanding the scholarly disagreement over the costs and benefits of insider trading-- the practice has definitely earned a bad name in public perception. It has been suggested that our society's contempt for all forms of insider trading can be traced (at least in part) to moralism rather than morality. For example, one plausible explanation for our society's general contempt for insider trading is that it often reflects the vice of greed in such traders.[241] In this context, no firm would risk a severe loss to its reputation by incorporating a clause to permit the employees to contract around *O'Hagan* and by implication condoning the vice of greed.

D. Contractual Fraud Theory and Fiduciary Relationships

Gubler notes certain federalism concerns. If Rule 10b-5 is really about property, (fiduciary duty law or unjust enrichment), there is a concern about what effect incorporating these common law categories into federal law might have on the common law itself.[242] Liability under *O'Hagan* would attach not only to traditional fiduciary relationships but also to other fiduciary-like relationships as well. Moreover, the court would have to determine which obligations apply to such fiduciary-like relationships. Thus, the federalization of fiduciary duty law would likely affect not only the domain but also the content of fiduciary duty law. As a consequence, federal securities law would drive these determinations.[243]

These concerns seem to be equally at play where the contractual fraud theory is predicated on a fiduciary duty. Federal courts would need to make the determination as to the existence and the contours of such a duty in the context of insider trading. Thus, federalization of fiduciary duty law again looms large. As an alternative, federal courts could look at the relevant state law, in order to determine the content of fiduciary duty law that should apply in a particular case. This would lead to insider trading law being even more incoherent and unpredictable than what it already is.

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[239] *See Id.* at 567.
[240] *See supra* Section I.B for a discussion of cases where trading or tipping was probably in the interest of the issuer.
[241] John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 48 (2014).
[242] Gubler, *supra* note 191, at 562.
[243] *Id.* at 562 (footnotes omitted).

Molk flags the issue of non-corporate insider trading. He notes that in the United States, for insider trading liability to attach, fiduciary duties are required between either insiders and their trading partners or between insiders and their provider of information.[244] In the last few years, new types of entities such as limited liability companies (LLCs) and limited partnerships (LPs) have emerged as the entities of choice.[245] "These alternative entities now dwarf the rate of new corporate formations."[246]

Many states grant these entities "the power for complete elimination of core insiders' state law fiduciary duties."[247] "Publicly traded LLCs span a variety of industries."[248] A few such prominent LLCs are TravelCenters, MGM Growth Properties, and Enterprise Product Partners.[249] The last-mentioned LLC has a market capitalization of $63 billion.[250] Almost half—49%—publicly traded Delaware LLCs and LPs waived all three fiduciary duties of loyalty, care, and good faith.[251]

The contractual fraud theory predicated on fiduciary duty law is clearly inapplicable here. It may be possible to retrofit an implied contractual duty with its Reporting Covenant in the specific context of insider trading. However, this seems to run counter to the very rationale behind permitting such entities. One of the major reasons why these non-corporate entities have grown in popularity is the governance flexibility that they provide.[252] The law often grants these alternative entities "wide latitude to such entities in their contractual ability to modify or eliminate entirely the mandatory fiduciary duties traditionally owed by company insiders."[253] Thus, it is a policy determination that such flexibility needs to be given to these entities. Bargaining analysis here would suggest that the contracting parties would have decided against incorporating any Reporting Covenant, making the contractual fraud theory inapplicable as a matter of contractual relationships as well. The alternative—simply postulating such a default rule by fiat—gain runs afoul of federalism concerns.

A. Fit With the Existing Law

Gubler claims that his theory does a better job in explaining the current state of the law.[254] He takes certain classes of persons who trade on non-public information and shows that the

[244] Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693 (2020).
[245] *Id.* at 1694 (quoting Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010)).
[246] *Id.*
[247] *Id.* at 1709.
[248] *Id.* at 1710-11.
[249] *Id*. at 1711.
[250] *Id.*
[251] *Id.* at 1713 (quoting Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 575 (2012)).
[252] *See id.* at 1711-12.
[253] *Id.* at 1695.
[254] Gubler, *supra* note 191, at 542.

contractual fraud theory agrees with Supreme Court jurisprudence in terms of whether such persons are covered under the U.S. federal insider trading prohibition.[255]

Beyond this, it is important to see whether the theory squares up with the other aspects of U.S. insider trading law. The theory views the breach of the Reporting Covenant in *fraud-like* terms that gives rise to non-compensatory damages.[256] "After all, the failure to disclose information while under an obligation to do so sounds a lot like classic fraudulent concealment, which, as a species of fraud, triggers non-compensatory damages."[257] In effect, the theory permits courts to give effect to an explicit Reporting Covenant or infer one implicitly based on bargaining analysis to enable a contracting party to seek extra-compensatory damages.

Under the contractual fraud theory, Rule 10b-5 allows parties to contract for extra-compensatory damages for a particular instance of the costly detection problem: insider trading.[258] In addition to the criminal penalties for insider trading, the civil penalties include treble damages.[259] In effect, Gubler treats the civil penalties as extra-compensatory damages. "Rule 10b-5 allows the contracting parties to have such contract provisions enforced by public enforcement authorities, another feature that helps address the costly detection problem by making it more likely that such breaches will be detected."[260]

At this point, it is worthwhile to repeat the objections raised against public enforcement of the insider trading prohibitions in the context of the property rights theory.[261] Even if the securities regulator has a comparative advantage and so uniquely placed to enforce the prohibition (due to the costly detection problem), its enforcement actions ultimately benefit the private entities in protecting their enforcement rights. Thus, while the regulator may help the companies detect insider trading based on their proprietary information, the regulator ought to recover the cost of such enforcement from the companies as they are the beneficiaries of this. Since it may not be possible to determine the exact benefit derived by a particular company due to prevention of such trading in the first place, such recovery could be by way of a fee imposed on all listed companies in proportion to their market capitalization. Further, a company should be free to opt out of this regime—and avoid paying the fees—if, in its view, it is not harmed by insider trading in its securities.

Moreover, under the contractual fraud theory it would be more logical for the regulator to pass on the information regarding any insider trading to the source of the information and leave it to such source to seek compensatory and extra-compensatory damages for the underlying breach and the breach of the Reporting Covenant respectively. Once the regulatory oversight brings to light the underlying breach, the costly detection problem has been overcome. It should then be left to the contracting parties themselves to recover damages for the underlying breach as well as that

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[255] *See id*. at 591-93 (discussing different scenarios).
[256] *See id.* at 565.
[257] *Id.* at 567 (quoting RESTATEMENT (SECOND) OF TORTS § 551(1)–(2)(a) (AM. LAW INST. 1977)).
[258] *See id.* at 568.
[259] *Id.* at 568 n. 228 (quoting Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1278 (1984)).
[260] *Id.* at 568.
[261] *See supra* Section I.C.

of the Reporting Covenant. This is true in a pure private-welfare maximization context as it is a party to the contract that is harmed by the breach.

One may support public enforcement of insider trading law all the way down when a public-welfare maximization concern is at play; however, this position can be supported independent of the plausibility of the contractual fraud theory. In fact, as discussed above, the contractual fraud theory arguably becomes superfluous in this context.[262]

Finally, Section 20A of the Securities Exchange Act (SEA) grants a private right of action to the contemporaneous traders against the inside trader. Thus, such traders may sue the insider trader for damages.[263] Under the contractual fraud theory, in the context of private-welfare argument, it should logically be the source of information who should have a right of recovery (and also the right to seek extra-compensatory damages for the breach of the Reporting Covenant). In the context of the public-welfare argument, since it focuses on the market harms of insider trading, it would be logical to grant the right of recovery to the regulator on behalf of the securities market and credit any recovery to a common fund.[264]

Finally, it is difficult to square the criminal penalties provided under insider trading law with the contractual fraud theory. This theory essentially departs from common law by permitting the parties to contract for fraud liability in the context of insider trading and allows the defrauded party to seek extra-compensatory damages for the breach of the Reporting Covenant. Criminal penalties are at odds with the scheme of this theory.

E. The Takeaway

To sum up, the contracting fraud theory plausibly explains certain specific aspects of current U.S. law. However, it seems that the theory becomes rather superfluous in the context of its public- welfare maximization rationale. In the context of private-welfare argument, it is not tenable to support the argument that the judiciary may read a default Reporting Covenant in intrafirm relationships as a general rule. The theory also raises federalization concerns in the context of the exact scope of fiduciary relationships and the newly emerged non-corporate entities. Finally, the framework of civil and criminal penalties under the current law in the United States is at odds with the underlying logic of the contractual fraud theory.

V. CORRUPTION THEORY

Kim offers a new theory of insider trading law—that insider trading should be viewed as a form of private corruption.[265] She begins with the definition of public corruption in the political

[262] *See supra* Section IV.B.
[263] Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 166 (1989).
[264] *See* Securities and Exchange Board of India Act, 1992, §11(5). The SEBI Act provides that any recovery made on account of disgorgement shall be credited to the Investor Protection and Education Fund established by SEBI and such amount shall be utilized by SEBI in accordance with the regulations made under SEBI Act.
[265] Kim, *supra* note 75, at 951.

science and political economy literatures as the "use of public office for private gain."[266] She further defines private gain as "personal gain that is supererogatory—neither part of the explicit compensation allocated to the public official nor *culturally* viewed as an acceptable or unavoidable perquisite of the role."[267]

Building on this, she defines private corruption as the use of one's entrusted position for self-regarding gain.[268] In analogy with private gain, the term self-regarding gain refers to gain that is supererogatory—neither part of the explicit compensation allocated to the individual, nor culturally viewed as an acceptable or unavoidable perquisite of the role.[269]

Kim identifies three costs of private corruption and applies those to insider trading. First, there is the temptation cost.[270] Insider trading may distort managerial incentives and thereby misallocate corporate financial resources. Managers may be tempted not to enhance corporate value, but to reap self-regarding gains generated by inside trades.[271]

Second, there are distraction costs. Insider trading opportunities will consume at least some of the manager's time that would otherwise be devoted to promoting the corporate interest. In order to take advantage of these opportunities, the corporate insider trader will have to research, plan, and execute his insider trading strategies.[272]

Finally, there are legitimacy costs.[273] If investors come to see the securities markets as a rigged game—one that seems by design to systematically disadvantage ordinary investors—they could respond by discounting the amount that they are willing to pay for all securities, thereby raising the cost of capital. But without knowing the volume and frequency of insider trading, setting the proper discount would be nearly impossible. The perception of rampant insider trading might also discourage investors from trading as much or as often, or may even catalyze exit en masse. Either response would weaken the depth and liquidity of securities markets, which would decrease market efficiency.[274]

It should be noted that Kim accepts the role that culture plays in the notion of corruption. According to her, it is true that relying on cultural views is precarious because they are shifting, vague, contradictory, and hard to measure. Given such difficulties, it is tempting to define "private gain" more narrowly, for example, as gain that breaches some formal rule or law. But this alternative definition would buy clarity at the cost of accuracy because corruption undeniably incorporates a cultural dimension.[275]

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[266] *Id.* at 952.
[267] *Id.* at 953 (footnote omitted).
[268] *Id.* at 957 (footnote omitted).
[269] *Id.* at 956.
[270] *Id.* at 961.
[271] *Id.* at 962.
[272] *Id.* at 964 (footnote omitted).
[273] *Id.*
[274] *Id.* at 967 (footnotes omitted).
[275] *Id.* at 953 (footnotes omitted).

This implies that the issues of whether, and which forms of, insider trading must be prohibited vary from culture to culture. In fact, she cites empirical evidence in behavioural finance that connects corruption more generally to insider trading.[276] In a survey, subjects were asked to read and evaluate various vignettes describing activity ranging from clearly illegal under federal insider trading law to clearly innocent. Strong correlations were found between the high levels of perceived public sector corruption in the country and the tendency to view insider trading as acceptable. The more corrupt that citizens judged their country, the less objectionable were the inside trades and vice versa.[277]

Going by Kim's definition of private corruption, the logical implication is that in those jurisdictions where insider trading is deemed to be acceptable, it does not amount to private corruption. Therefore, the private corruption theory does not support an insider trading prohibition in such jurisdictions.

If this is correct, the recent global trend towards the adoption of insider trading laws may be explained by regulatory ritualism.[278] Anderson discusses how ritualism may have played out in the arena of insider trading as well as human rights law.[279]

I have argued elsewhere that the Indian prohibition regime is beset with serious doctrinal discontinuity and incoherence.[280] Huang argues that for the Chinese insider trading prohibition to be effective, it is necessary to clarify and streamline its theoretical basis.[281] This may be because of the fact that countries such as India and China have imported the concept of the insider trading prohibition from the United States without paying close attention to the desirability of such a prohibition and the contours of the prohibition regime as suited to their specific situation.

Guttentag discusses the recent Chris Collins story. He attempts to make sense of Collins' seemingly inexplicable behavior by turning to the work of criminologists to identify distinctive features of the crime of insider trading.[282] Even the desire to pursue one's own self-interest is a product of cultural factors rather than simply an innate feature of human nature.[283] Recognizing the socially constructed nature of motivation raises the possibility that someone engaging in insider trading, perhaps in providing a tip, might be motivated more by a desire to enhance their reputation and social standing than the hope of receiving a pecuniary gain from the tip.[284]

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[276] *Id.* at 960 (footnote omitted).
[277] *Id.* at 960 (footnotes omitted).
[278] ANDERSON, *supra* note 1, at 137.
[279] *See generally Id.* at 133-37.
[280] Mangesh Patwardhan, *The Insider Trading Prohibition in India– In Search of a Doctrine*, 14(2) INT'L & COMP. CORP. L.J. 38 (2020).
[281] Hui Huang, *The Regulation of Insider Trading in China: Law and Enforcement, in* RESEARCH HANDBOOK ON INSIDER TRADING 303, 316 (Stephen M. Bainbridge ed., 2013).
[282] Michael D. Guttentag, *"Huh?" Insider Trading: The Chris Collins Story*, 15 TENN. J.L. & POL'Y 95, 95-96 (2020).
[283] *Id.* at 107 (quoting James William Coleman, *Motivation and Opportunity: Understanding the Causes of White-Collar Crime, in* WHITECOLLAR CRIME: CLASSIC AND CONTEMPORARY VIEWS 360, 363 (Gilbert Geis et al. eds., 3d ed. 1995) [hereinafter, Coleman, *Motivation and Opportunity*]).
[284] *Id.* at 107-8.

Further, the necessity of neutralizing ethical constraints is an element of motivation for committing a white-collar crime. Neutralization of ethical concerns is important because white-collar criminals are likely to accept many aspects of the existing social order as valid. One of the common neutralization techniques is believing that ill-gotten gains are actually earned or deserved.[285]

In terms of motivation, there are several rationalizations that can be surmised from the record that Collins may have relied on to neutralize ethical concerns.[286] Collins viewed himself as something of a savio rof Innate. At one point he stated that "[w]ithout me, [Innate] would have gone down."[287] Collins might have believed that because of his central role in ensuring Innate could run a clinical trial on a potential treatment for SPMS that he was entitled to a privileged position when the time came for sharing losses resulting from the failed clinical trial.[288] While Collins may have relied on this as a rationalization technique, it may well be seen as an acceptable behaviour in another culture.

The upshot here is that each jurisdiction ought to begin from first principles and determine whether insider trading should be prohibited in the first place, and if so, what should be the scope and contours of its prohibition regime in the backdrop of its own specific cultural milieu. In that case, it is not possible to offer a general, universal argument in support of enacting the prohibition and its scope.

There also seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading—viewed as a form of private corruption—at least in the case of temptation costs and distraction costs. In the case of legitimacy costs, whether the perception of rampant insider trading actually discourages investors from trading as much or as often—with the consequent adverse impact on liquidity and the cost of capital—may be at least partially determined by whether insider trading is perceived to be culturally acceptable.

However, the other two costs seem to be culturally agnostic. The distortion of managerial incentives and the diversion of managerial time, in the context of insider trading opportunities, would happen regardless of whether insider trading is deemed to be acceptable in that particular culture.

As for temptation costs, Kim argues that managers can accelerate receipt of revenue, change depreciation strategy, or alter dividend payments in an attempt to affect share prices and insider returns. Alternatively, they may direct the company to pursue projects that are easier to conceal from public scrutiny or structure transactions in such a manner as to exploit informational advantages in trading stock. They may push the firm into riskier projects or manipulate the timing and content of information release in a manner that will generate more price volatility than

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[285] *Id.* at 108 (quoting Coleman, *Motivation and Opportunity*, *supra* note 283, at 368).
[286] *Id.* at 113
[287] *Id.* (quoting Transcript of Interview of Representative Collins, Review No. 17-3509_Exhibits-Final Redacted_Part 1, at 16 (2017)).
[288] *Id.*

otherwise.[289] Insider trading opportunities also have distraction costs as these will consume at least some of the manager's time that would otherwise be devoted to promoting the corporate interest.[290] These concerns, if valid, would be clearly relevant regardless of the cultural attitude to insider trading.

Kim cites international evidence for temptation and distraction costs. One such study found that more stringent insider trading laws and enforcement were positively associated with higher corporate values for the sample firms. This finding is consistent with the hypothesis that stricter insider trading regimes help reduce the controlling shareholder's incentive to divert corporate value through insider trading.[291] The implication here is that a prohibition on insider trading, predicated on these two costs, can in fact be supported independent of whether insider trading is seen as a self-regarding gain in a particular culture and therefore independent of the corruption theory itself.

Kim considers some hard cases and analyses those through the lens of the corruption theory. One such case is *SEC v. Dorozhko*.[292] Here, the question presented was whether a hacker's infiltration of a company's server and his subsequent trading on the extracted financial information violated federal insider trading law.[293] Kim suggests that under the corruption theory, Dorozhko would not be liable for insider trading.[294] She notes that it might be helpful to go beyond the primary question of asking whether the act fits the formal analytic definition of corruption to a secondary exploration of whether the act generates those costs tightly associated with corruption: temptation, distraction, and legitimacy costs.[295]

Under the primary definitional analysis, hacking and trading does not fit the definition of corruption. A secondary analysis employing corruption's signature costs does not give a strong reason to revise this initial judgment. Accordingly, under the corruption theory, the Second Circuit's opinion in Dorozhko goes too far in classifying hacking and trading as a violation of federal insider trading laws.[296]

Another case is *SEC v. Cuban*.[297] According to SEC allegations, in 2004 the CEO of Mamma.com contacted Mark Cuban, who held 6.3 percent of Mamma.com's outstanding shares, to invite him to participate in a forthcoming PIPE financing.[298] After first obtaining Cuban's promise to keep such information confidential, the CEO disclosed the details of the proposed

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[289] Kim, *supra* note 75, at 962 (footnotes omitted).
[290] *Id.* at 964.
[291] *Id.* at 968 (footnote omitted).
[292] SEC v. Dorozhko, 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (*Dorozhko I*), *vacated*, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (*Dorozhko II*).
[293] *Dorozhko II*, 574 F.3d at 42.
[294] Kim, *supra* note 75, at 998.
[295] *Id.* at 998-99.
[296] *Id.* at 1000.
[297] SEC v. Cuban (*Cuban I*), 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, SEC v. Cuban (*Cuban II*), 620 F.3d 551 (5th Cir. 2010).
[298] Kim, *supra* note 75, at 1000-01 (footnote omitted). A PIPE (private investment in public equity) transaction is a private placement followed shortly by a registered offering that enables PIPE investors to resell their shares to the public.

transaction. Cuban immediately protested on the ground that the financing would dilute the value of his existing shares. He added: "Well, now I'm screwed. I can't sell." But he dumped all of his shares before the PIPE deal was publicly announced and avoided a loss of more than $750,000.[299] Again, based on the secondary analysis, Kim concludes that it is neither to identify any temptation or distraction costs nor any overwhelming concerns regarding legitimacy costs.[300]

The implication here is that for deciding a case based on the corruption theory, it is imperative for the judiciary to go beyond the mere formal definition of corruption and engage in a secondary analysis regarding any concerns present in that particular case with reference to temptation, distraction, and legitimacy costs and attach liability only if these are overwhelmingly present.

As Kim mentions, we have relied on the judiciary to adapt the law forward with each case through acts of interpretation, extension, and innovation. But without an adequate theory of what is wrong with insider trading, that common-law-like development has reached a crisis with circuits on the cusp of explicit disagreement and some courts initiating a soft rebellion against what appeared to be doctrinal orthodoxy.[301] It is unclear whether the judiciary is well-equipped to engage in the kind of secondary analysis that is required by the corruption theory of the three costs of insider trading on a case-to-case basis. As a result, we may see even more disagreement among different courts and greater uncertainty surrounding insider trading law.

To sum up, under the corruption theory the question of whether insider trading must be prohibited and, if so, what should be the contours of the prohibition becomes a culture-specific issue. It is not possible to offer a universal argument in support of enacting the prohibition and its precise scope. This lends support to the view that the enactment of insider trading prohibition in several jurisdictions may be nothing more than an exercise in regulatory ritualism. Further, there seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading, viewed as a form of private corruption, at least in the case of temptation and distraction costs. The adverse impact of these two, the distortion of managerial incentives and the diversion of managerial time, is arguably culturally agnostic. The implication is that a prohibition on insider trading, predicated on these two costs, can in fact be supported without an appeal to the corruption theory, making the theory superfluous. Finally, courts would need to go beyond the formal definition of corruption and engage in a secondary analysis on a case-by-case basis to determine if significant concerns regarding one or more of the three costs of corruption are implicated. This would arguably engender even more disagreement among different courts and greater uncertainty surrounding insider trading law.

VI. DUTY TO HOLD LOST OR STOLEN INFORMATION IN CONFIDENCE

Coffee explores yet another proposal. He considers the question as to what is the duty that the tippee might breach when the tippee is not a fiduciary (or the tippee of a fiduciary) but has

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[299] *Id.* at 1001 (footnote omitted).
[300] *See generally id.* at 1002.
[301] *Id.* at 1008.

come into possession of material non-public information. Coffee's proposal here seeks to cover two specific cases.[302]

First, when the information is stolen, but taken without deception, the law could be viewed as imposing a constructive trust on such stolen property that holds the thief accountable for his ill-gotten profits.[303] For instance, if a thief who steals a briefcase with documents that contain material, non-public information were to sell this briefcase and its contents, the common law would likely subject his ill-gotten gains to a constructive or implied trust.[304]

When the information has been obtained deliberately by someone who is "stalking" the source of the information, equitable considerations dictate that the law should impose a constructive trust on the stolen property to prevent these more predatory actors from realizing an ill-gotten gain. [305] One such example is a cab driver who waits outside the offices of a well-known Manhattan law firm late at night, hoping to pick up mergers and acquisitions lawyers who then discuss pending transactions on their cell phones on the drive home. Further, the cab driver has done this repeatedly and profited handsomely.[306]

Additionally, even when the information is leaked inadvertently, as in the overheard conversation in the elevator, the law could treat the recipient of the information as a "finder" who has come into possession of lost property and therefore has an obligation to act as a bailee to protect this property by not tipping or trading on it.[307] Similarly, the cab driver may simply happen to drive a mergers and acquisitions lawyer who discusses a pending transaction on her cell phone. In either case, the information has clearly not been stolen.

Coffee acknowledges that few courts could be willing to go so far on their own. But they might be induced to accept and enforce SEC rules articulating such a duty.[308] He terms his proposed rule "Rule 10b5-3."[309]

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[302] Coffee, *supra* note 136, at 300.
[303] *Id.* Coffee notes in the footnote that as a technical matter, the appropriate remedy may be an equitable accounting, rather than a constructive trust. *Id.* at 300 n. 46.
[304] *Id.* at 302-3.
[305] *See id.* at 302.
[306] *Id.* at 293.
[307] *Id.* at 300-01.
[308] *Id.* at 303.
[309] *Id.* at 304. It is captioned "Duty Not to Trade on Inadvertent or Unauthorized Releases of Material Information." It reads: (a) Whenever a person receives or obtains material nonpublic information from a source that owns or has the right to control the release of such information and such recipient either (i) knows that the release of such information has not been lawfully authorized by the party entitled to possession or control over such information, or (ii) is aware of a reasonable possibility that such release was not lawfully authorized, such person may not (1) purchase or sell any security, or any security-based swap agreement, whose value is likely to be affected by such information, or (2) communicate such information to other persons under circumstances which make it reasonably foreseeable that they will trade on such information, until in each case such information has been publicly released. (b) As used in this rule, the phrase "lawfully authorized," when used with respect to the release of information, shall not include, without limitation, information that is released (i) inadvertently or by mistake; (ii) as the result of a trick, subterfuge, false representation, or other misappropriation; (iii) as a gift, favor or other benefit, either from or to the information recipient; or (iv) for a specific, limited purpose to a customer, supplier, lender, business associate, or agent of any thereof, but was not intended to be generally released.

This is surely a novel approach, as it covers cases where the recipient of the information has no pre-existing duty of trust and confidence to the source of the information, nor does she employ any deception in gaining access to such information.

However, if the fact that such information was stolen or found is to be taken as the basis for an insider trading prohibition, objections can be raised against the proposal. First, as Coffee himself states, at common law and by statute in many jurisdictions, one who finds lost property (like a diamond ring left by mistake in a washroom) is typically under a duty to restore it to the true owner.[310] Even a good faith purchaser of the stolen property would often have to restore it to the true owner.[311] In case of non-public information, it is not even clear what restoring such property to the true owner means.

In the alternative, the remedy of equitable accounting may be invoked.[312] In that case, the thief or the finder would have an obligation to account for any profits made by trading on such information to the principal.

Coffee points out that in *Carpenter v. United States*, the US Supreme Court held that confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit and which a court of equity will protect through the injunctive process or other appropriate remedy.[313]

Therefore, the corporation should be fully entitled to benefit from any material, non-public information in its possession. This consideration also shows that any framework based on stolen or found information cannot lead to an insider trading prohibition. The owner of the information would be fully entitled to use it for securities trading and keep any profits she makes.

Coffee further states that his proposed Rule would bar the finder of such information from either trading or tipping others, but only until the information was publicly released.[314]

This argument raises another issue. The issue here is whether mere authorized release of the information may be equated with the authorization to trade on it. If I display my gold chain openly at Marine Drive in Mumbai or Times Square in New York it can hardly be inferred that I have now permitted others to take it and walk away.[315] Release of information is just that, others are now aware of it in the same way they would be aware of my gold chain. The owner of the

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[310] *Id.* at 301.
[311] *Id.* at 303.
[312] *See supra* note 303.
[313] Carpenter v. United States, 484 U.S. 19, 26 (1987) (quoting 3 William Meade Fletcher et al., Fletcher Cyclopedia of the Law of Private Corporations § 857.10 (rev. ed. 1986)).
[314] Coffee, *supra* note 136, at 305. Even though he does not mention "thief," the same rule would be applicable, since his proposed Rule and its prohibition on trading only turns on whether the release of information is "lawfully authorized." Thus, once the information is lawfully released, the person who earlier "stole" it would be entitled to trade on it as well, as the information gets "unstolen."
[315] Presumably, mere display would not be tantamount to "abandoning" it, as under Coffee's formulation here, such abandonment of information would amount to authorizing others to trade on it. *See infra* note 317 and accompanying text. For example, I could openly announce that this display is meant to flaunt my possession and I intend to keep my ownership of the chain intact!

information should similarly be able to release the information without intending to authorize anyone to trade on it.

Thus, the fundamental flaw of this theory seems to be that it just cannot be connected to the real issue of insider trading, which is prohibiting trading on material non-public information. In the case of information not lawfully authorized to be released, any person who steals or finds it is not prohibited from trading on it. She must restore it or account for the profits made out of such trading to the true owner. Further, the owner of the information would be fully entitled to derive a benefit by trading on that. Even after the information is lawfully released, the release itself cannot be held to constitute an authorization for others to trade on it unless it is argued that such release itself constitutes the owner abandoning her exclusive right over such information, which usually is not the case.

This fundamental flaw derives from the fact this theory has a basic disconnect with the core mandate of securities law which focuses on the development of the securities market and prevention of harm to the investors or the marketplace. This proposal is essentially a variation on the property rights theory discussed above.[316] It focuses on the manner in which a person acquired information from the source of such information. As is to be expected, there is no reason why focusing on this inquiry should have any connection with the totally distinct issue of the impact of the acquirer trading on such information in the marketplace. This is because the source of the information, the investors in general, and the counterparty in particular are often distinct and unconnected entities.

Two examples may help elucidate this point further. First, Coffee states that a "line would necessarily need to be drawn in such a rule between information that was truly 'lost' and information that was 'abandoned' through reckless mishandling."[317] Such distinctions would be totally irrelevant to the counterparty, to the trade, or the investors in general. It makes no difference to them whether the material non-public information was stolen or found by the trader or abandoned by the owner. But the scope and the coverage of the rule crucially depends on such distinction.

Second, in *O'Hagan*, Justice Thomas noted that the SEC's "construction of the relevant language in § 10(b), and the incoherence of that construction, becomes evident as the majority attempts to describe why the fraudulent theft of information falls under the Commission's misappropriation theory, but the fraudulent theft of money does not."[318] The logic of that argument carries over here as well with even greater force. If a person steals or finds money and then uses it for securities trading, she is accountable to the owner of that money for any profits made. As we have seen, exactly the same is true if the person steals or finds material non-public information and uses it for trading.

Therefore, in this case, it can be seen even more clearly that this theory is agnostic in terms of the precise nature of the resource that is involved. In fact, it can be stated as a general principle

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[316] *See supra* Section I.
[317] Coffee, *supra* note 136, at 303.
[318] *United States v. O'Hagan*, 521 U.S. 642, 681 (Thomas, J., concurring in the judgment in part and dissenting in part).

that a thief or finder of any resource is liable to the owner of the resource to account for any profits or gains the thief or finder makes from using the resource for securities trading.

Thus, any insider trading prohibition based on this theory is two-faced and ambiguous. It purportedly addresses an issue, trading on material non-public information, perceived to be harmful to the investors, the securities markets, or both. At the same time, it seeks to address it by focusing on an entirely different inquiry – the purported rights of the owner of such information and the remedies available to such owner in the event of a violation of her rights.

Finally, this theory also undercuts the rationale for the public enforcement of the insider trading prohibition. This objection is the same as raised in the context of the property rights theory. At the very least, the securities regulator should recover the cost of such enforcement from its beneficiaries. Even better, the securities regulator should completely stay out of the enforcement of an insider trading prohibition (if it is to be based on this theory) and leave the issue of protecting against the misuse of stolen or found information to owners of such information. The resources this frees can be productively employed to address other issues related to the core concerns of securities regulation.[319]

To sum up, the attempt to predicate the insider trading prohibition on the fact that trading took place on stolen or lost information leads to incoherent results. Further, such a prohibition does not square with the core mandate of securities law. There is no reason why such a prohibition should be located in securities law, nor does it offer any rationale for its public enforcement by the securities regulator.

VII. INSIDER TRADING AS AN AGENCY LAW ISSUE

Coffee offers one final proposal as a basis for the insider trading prohibition. This is the law of agency. For this, he relies on the Restatement (Second) of the law of Agency.

Comment C to Section 388 of the Restatement (Second) of the law of Agency reads:

> Use of confidential information. An agent who acquires confidential information in the course of his employment or in violation of his duties has a duty . . . to account for any profits made by the use of such information, although this does not harm the principal.[320]

Further, the commentary to this section specifically applies this rule to the context of insider trading.[321] Under Section 388, no fiduciary breach or act of deception is necessary. It is sufficient that the agent acquires the "confidential information in the course of his . . . duties." Thus, "if a cab driver is considered an agent to his passenger, then . . . he may not profit, as agent, from confidential information received from the passenger, as principal."[322] This is regardless of

[319] *See supra* Section I.C.
[320] *See* RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958) (citation omitted). Section 395 then forbids the agent to tip others. *See id.* § 395; *see also* RESTATEMENT (THIRD) OF AGENCY § 8.05 cmt. c (2006) (using same language).
[321] Coffee, *supra* note 136, at 309.
[322] *Id.* at 310 (footnote omitted).

whether the driver had any fiduciary duty towards the passengers or whether the passengers were harmed by her trading.

However, as Coffee himself mentions, "issues could arise both as to whether the cab driver was an agent (as opposed to an independent contractor) or whether he knew the information was confidential."[323] However, he says that, at least in the case of the stalker driver, the prosecutors have another theory, based on agency law, at their disposal.[324]

This seems to be problematic. Whether the driver happened to get mergers and acquisitions lawyers as his passengers or he stalked them by purposely waiting outside their office cannot have any bearing on whether the lawyer is their agent or not. In either case, the service he is required to perform and the consideration for it are the same. His stalking only shows that he had an ulterior motive which is more about his intentions rather than the nature of the relationship itself.

Again, notwithstanding the application of this Ssection to insider trading, the pertinent issue is whether an insider trading prohibition can actually be read into that. Again, this Ssection only provides for the agent accounting for any profits made out of the use of such information. Therefore, the principal would be entitled to the profits made by such agent. In fact, Coffee approvingly quotes the New York Court of Appeals opinion in *Diamond v. Oreamuno*.[325] However, the court there also noted that profits made by the agent in stock transactions based on such inside information "are held in constructive trust for the principal."[326]

Therefore, in the cab driver example the driver would be required to account for the profits made to the mergers and acquisitions lawyers, who are his principals. The lawyers themselves would probably be treated as agents of their employer, who in turn would be the agent of the acquiring, or target, company that hired it.

Similarly, Section 215 of the Indian Contract Act, 1872, also provides that when an agent deals on his own account in the business of agency without the principal's consent, the principal may repudiate the transaction. Trading in securities may or may not be the business for which the agency relationship has been entered into all cases. Section 216 authorizes the principal to claim from the agent any benefit which may have resulted to him from such transaction.[327]

Thus, in both jurisdictions, it is the prevention of harm to the principal or equitable considerations (such as depriving the agent of any gains that he may make by use of such confidential information and handing these over to the principal) that underlie this legal position. The provisions are focused on maintaining the integrity of the agency relationship and nothing much to do with the concerns related to the securities market.

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[323] *Id.* (footnote omitted).
[324] *Id.* (footnote omitted).
[325] *Diamond v.* Oreamuno, 248 N.E.2d 910 (N.Y. 1969).
[326] *Id.* at 914.
[327] Since Comment c to Section 388 of the Restatement (Second) of the law of Agency in the US specifically speaks to the use of confidential information, unlike in the case of *O'Hagan* misappropriation or the proposal based on the duty to hold lost or stolen information in confidence, it does not carry over to the use of other resources such as money or computer. However, the Indian version of the prohibition based on the law of agency would so carry over, in which case the same objection voiced by Justice Thomas in *O'Hagan* would apply.

As such, this theory has a basic disconnect with securities law. If the driver trades on such information and accounts for the profits made to her immediate principal or the ultimate principal in the chain, it makes no difference to the counterparty, to the trade, or the investors in the market. This is yet another instance where the law aimed at protecting the interests of one entity, the principal in an agency relationship, is sought to be retrofitted to securities law whose basic mandate is to facilitate the development of securities markets and protect the interests of the investors. Again, the principal and the investors are two distinct parties, wholly unconnected to each other. This again results in a poor doctrinal fit.

Finally, this raises the issue whether the principal can authorize her agent to trade on such information and allow her to keep the profits. To take one example, if the takeover target is the ultimate principal and it is interested in fending off the offer from the acquiring company, it may even be benefitted if persons privy to the takeover attempt trade the company's shares and drive up the price. In that case, it may actually contract with its agents to so trade and permit them to keep the profits. The profits that the agents keep are simply the consideration they receive for performing the service.

The same is true with warehousing, where the acquiring company as the principal may tip off a few persons to buy the shares of the target company. Such persons may make a profit when they ultimately tender their shares to the acquirer. The acquirer may allow them to retain the profit as consideration for the services rendered by them.[328]

Thus, the accounting of profits argument does not imply a prohibition on trading based on confidential information acquired from the principal. If such trading benefits the principal in any way, profits made on such trading can in fact be used as a compensation to the agent for the services provided.

In this view, Manne's argument that managerial insider trading can act as an effective compensation scheme also comes into play. Manne argued in favour of this as a tool to encourage managerial innovation that would ultimately create value for the shareholders.[329]

Viewing insider trading as an agency law issue adds another gloss to this argument. Jensen and Meckling, in their seminal paper, gave an economic analysis of the agency relationship. They observed that the agent will not always act in the best interests of the principal. The principal can limit divergences from her interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, the owner has an incentive to minimize managerial costs so as to maximize her own wealth.[330]

Applied in the context of a company, this implies that the company as the principal would seek to establish a mechanism so as to make sure that the managers act in the best interests of the company. This could be done by seeking to align the managers' interests with those of the

[328] *See supra* note 45 and accompanying text.
[329] *See* Manne, *supra* note 11, at 936.
[330] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

shareholders. Permitting the managers to trade on confidential information that creates value for the company could be one such incentive. This would also be efficient in terms of minimizing managerial cost, as the managers' reward from insider trading comes from the market and not from the company.

Of course, a number of objections can be raised against holding that insider trading is an effective managerial compensation scheme. Kripke notes the "attribution problem" in this context. It is not easy to allocate corporate success between different causes, such as pure luck and genuine entrepreneurial initiative by an executive or a group of executives. Even if that could somehow be done, determining the amount of optimal reward would still be challenging.[331]

Even leaving aside the problem mentioned above, it would be difficult to ensure that only those executives who are innovators would be able to reap the benefits by way of insider trading in proportion to their contribution to the enhanced value. Typically, in a modern organization, information flows through multiple levels and many more employees unrelated to the innovation often come into possession of such information. Therefore, this problem is real.

Finally, if insider trading occurs in the context of a new product being developed or the company winning a major lawsuit, the enhancement in the corporate value may at least plausibly be attributed to the product development team or the legal team respectively. Quite often, insider trading occurs in the context of inside information which is not generated as a result of any innovation by the information generator. To take one example, the chief financial officer (CFO) of a company would know that the quarterly profits of the company are far above the market estimates. There is no plausible reason to attribute the same to the CFO. In that context, it is hard to see why the CFO should be entitled to use this information to her advantage by engaging in insider trading activity.

Those objections are fairly robust and persuasive. Thus, the focus of this analysis is not to support Manne's argument. However, if insider trading is seen as an agency issue, it could lend some respectability to the argument that companies should be free to opt out of the insider trading prohibition regime.

For example, a company may argue that it can put in place a monitoring mechanism so as to avoid the problems associated with permitting the managers to trade on confidential information, while keeping the upside-alignment of their interests with those of their principal-shareholders. This could be a powerful argument since it purportedly shows that such insider trading actually benefits the shareholders of the company.

To sum up, framing insider trading as an agency law issue does not imply a prohibition on insider trading, only the requirement that the agent must account for any profits made to the principal. Since the duty to account for profits is based on preventing harm to the principal, or on equitable considerations, the principal should be free to authorize such trading if it does not harm or benefit her. In particular, the profits made by the agent on such trading can be used as a

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[331] *See* Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 946 (1985).

compensation to the agent for the services rendered. It also seems to lend respectability to Manne's argument for treating insider trading as an effective managerial compensation scheme.

Again, a major problem with this proposal is its basic disconnect with the securities market. The focus of the rule, to maintain the integrity of the agency relationship, and the concerns of securities law, development of the market and protection of the investors' interest, are totally distinct. Further, the two constituencies are wholly unconnected to each other and do not necessarily have co-extensive interests.

VIII. SUMMARY AND CONCLUSION

The unsettled state of insider trading law is partly attributable to the fact that there is a fundamental disagreement over the necessity of and the appropriate rationale behind the insider trading prohibition. In view of this, it is important to offer a sound theoretical foundation for the prohibition. As the first step, it is imperative to attempt a nuanced analysis of the insider trading theories as enunciated by the US Courts and legal scholars. In an earlier article, I offered a critique of the judge-made insider trading prohibition theories in the United States. Here, I offer a critique of the major strands of the insider trading prohibition theories proposed by legal scholars.

There is an influential school of thought that treats insider trading as essentially a property rights issue. The basic policy justification for casting the issue in this way is that giving the companies property rights in their proprietary information would encourage them to produce socially valuable information. However, this argument is rather weak as the companies anyway produce such information to further their business interests. The fact that someone else may also use it for insider trading is not a real deterrent factor. This theory also implies that the companies should be able to trade based on the information that they own, or authorize others to trade on it if it is in their interest. The adoption of this theory would also undercut the current disclosure-based regime in securities law, as presumably the companies should be able to decide whether and to what extent they wish to disclose information to the market. This theory also implies that the insider trading prohibition is basically a matter of private enforcement by the companies whose property rights have been infringed.

Another approach is to base the prohibition on the deceptive acquisition of information. The problem here is that the issue whether the trader traded on non-public information that was acquired from the source through deception or elsewhere is totally distinct and often irrelevant from the investors' point of view. This implies that this approach has a basic disconnect with the core concern of securities law.

FOTM seemingly resolves the "lack of reliance" challenge in the context of impersonal markets. However, it also fails for the same reason as the equal access theory–the absence of any demonstrable harm to the counterparties or even a demonstrable gain. In fact, insider trading arguably helps the market go beyond semi-strong efficiency. Thus, FOTM seems to actually support legalization of insider trading.

A variant of the fraud-based approach–the contracting fraud theory–plausibly explains certain specific aspects of current U.S. law. However, it seems that the theory becomes rather

superfluous in the context of its public-welfare maximization rationale. In the context of the private-welfare argument, it is not plausible to support the argument that the courts may read a default Reporting Covenant in intrafirm relationships as a general rule. The theory also raises federalization concerns in the context of the exact scope of fiduciary relationships and the newly emerged noncorporate entities. Finally, the framework of civil and criminal penalties under the current law in the United States is at odds with the underlying logic of the contractual fraud theory.

The corruption theory treats insider trading as a form of corruption. Under this, the question whether insider trading must be prohibited and, if so, what should be the contours of the prohibition becomes a culture-specific issue. It is not possible to offer a general, universal argument in support of enacting the prohibition and its precise scope. This lends support to the view that the enactment of insider trading prohibition in several jurisdictions may be nothing more than an exercise in regulatory ritualism. Further, there seems to be some tension between the cultural dimension present in the corruption theory and the analysis of the economic costs of insider trading–viewed as a form of private corruption–at least in the case of temptation and distraction costs. The adverse impact of these two–the distortion of managerial incentives and the diversion of managerial time–is arguably culturally agnostic. The implication is that a prohibition on insider trading, predicated on these two costs, can in fact be supported without an appeal to the corruption theory, making the theory superfluous. Finally, proposals based on the duty to hold stolen or lost information and agency law do not imply any prohibition on trading based on material, non-public information. They merely imply that the trader becomes accountable to the owner/principal for the profits made on such trading. Further, this again casts the issue as one for private enforcement.

At this stage, there are two options available. One can accept that, contrary to the current dominant view, there is really nothing wrongful about insider trading. Therefore, the proponents of legalization of insider trading are right.

The other option is to explore whether it is possible to articulate a policy rationale for prohibiting insider trading that avoids the problems with the existing theories and the policy rationales that underlie these theories. If so, the next task would be to craft a theory that seeks to effectuate the offered rationale. I intend to take this up in the final article in this three-part series.