Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition

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Stephen M. Bainbridge*

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I. Introduction

Someone violates the federal insider trading prohibition only if his trading activity breached a fiduciary duty owed either to the investor with whom he trades or to the source of the information.1 From a securities law perspective, the federal prohibition thus is an empty shell. It has no force or substance until it has been filled with fiduciary duty concepts.

Despite the centrality of the fiduciary duty element to the federal prohibition, the fiduciary element has received relatively little attention from courts or commentators. On close examination, however, requiring a breach of fiduciary duty as a prerequisite for insider trading liability raises two interesting questions: What is the precise fiduciary duty at issue? Is the source of that duty federal or state law? Despite over a decade of experience

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1. This is true insofar as the core federal prohibition under Securities and Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5 (1993), is concerned. Breach of fiduciary duty is not required for liability to arise under the narrower provisions of SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (1993). See generally infra part II.
with the fiduciary duty requirement, neither of these questions has a clear and convincing answer.

The failure to resolve these issues has robbed the federal insider trading prohibition of coherence and predictability. Perhaps this lack of coherence was acceptable when insider trading was a low priority item for federal prosecutors, and the major penalty was disgorgement of profits. Today, however, insider trading is a major Securities and Exchange Commission (SEC or Commission) enforcement target and carries penalties that can only be described as draconian. Due process and simple fairness thus require that the fiduciary duty element be taken more seriously than it has been to date.

Perhaps the fiduciary duty requirement's substantive content is ignored because courts and commentators assume that there is a single fiduciary duty, applicable to all relevant market players, that proscribes the use of confidential information for personal gain. If so, this assumption's inherent invalidity was exposed by the SEC's enforcement effort directed at insider trading in corporate debt securities. Under state law, corporate officers and directors generally owe no fiduciary duties to debt securityholders. As a result, assuming state law provides the requisite fiduciary duty, one can plausibly argue that insider trading in debt securities is not unlawful. As this Article will demonstrate, similar state law arguments can be made in a variety of contexts, including the very core of the federal prohibition — its application to corporate officers and directors. This possibility has generated some critical commentary in the debt security context, but its full implications remain largely unexplored. This Article seeks to fill that gap.

Part II of this Article briefly traces the evolution of the current insider trading regime, with particular emphasis on the fiduciary duty element. Part III then explores the content of the fiduciary duty element. Part III argues

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that liability is premised not on the mere existence of a fiduciary relationship, but rather on the breach of a specific fiduciary duty—namely, the duty to refrain from self-dealing in confidential information owned by another party.

The inquiry then shifts to identifying the source of the requisite duty. As a preliminary matter, Part IV argues that the insider trading prohibition is a species of federal common law. Specifically, it is an example of interstitial lawmaking in which the courts are using common-law adjudicatory methods to flesh out Rule 10b-5's bare bones. Once this view of the prohibition is accepted, a choice of law question arises. In crafting a rule of decision for federal common-law cases, courts can either create a unique federal standard or incorporate state law into the federal rule. In the latter case, the cause of action remains federal, but the content of federal law is supplied by the incorporated state law principles. The decision to incorporate state law depends upon whether there are important federal interests that would be adversely affected by doing so. If so, the court will create a uniform federal standard, but if not, the court may incorporate state law.

In order to decide whether state fiduciary duties should be incorporated into the federal insider trading prohibition, we thus must ask two questions: Would incorporation adversely affect prosecution of insider trading under the federal securities laws and, if so, would any identifiable policy goal of those laws be frustrated thereby? Part V addresses the former concern, examining the implications of adopting state law fiduciary duty concepts as the rule of decision. It demonstrates that use of state law principles will at least complicate insider trading prosecutions and probably will substantially limit the prohibition's scope.

In light of that finding, Part VI then turns to the latter concern. Because a unique federal set of fiduciary duties applicable to insider trading is most easily justified if application of state law would frustrate an identifiable federal policy goal, Part VI examines the purported federal interests underlying the insider trading prohibition. As Part VI demonstrates, none of the commonly asserted federal policies requires creation of a unique set of federal fiduciary duties. Rather, the insider trading prohibition is justified solely by the need to protect property rights in valuable information.

Based on this analysis, Part VI argues that it is creation of a unique federal rule—not incorporation of state law principles—that would frustrate the policies of the securities laws. The Supreme Court has repeatedly made clear that the federal securities laws do not displace the much broader body of state corporate law. To the contrary, the Court has
specifically indicated that questions of fiduciary duty are governed by state law. If the fiduciary duty necessary for insider trading liability is supplied by federal law, a substantial tension thus would develop between the insider trading prohibition and the federalism policies of the securities laws. Incorporating state law fiduciary duties into the prohibition would resolve that tension. Moreover, state law fiduciary duties are generally consistent with the property rights rationale for regulating insider trading. Accordingly, incorporating state law fiduciary duties would advance the federalism policies of the federal securities laws, without frustrating any of the other policies thereof.

II. An Overview of the Law of Insider Trading

Generally speaking, insider trading is trading in securities while in possession of material nonpublic information. At present, there are three basic theories under which trading on inside information becomes unlawful. The disclose or abstain rule and the misappropriation theory were created by the courts under Section 10(b) of the Securities Exchange Act of 1934, as amended (Exchange Act) and Rule 10b-5 thereunder. Pursuant to its rule-making authority under Exchange Act Section 14(e), the SEC adopted Rule 14e-3 to proscribe insider trading involving information relating to tender offers. With the exception of Rule 14e-3, each of these theories requires that the transaction involve a breach of fiduciary duty.

6. Nonpublic information, for purposes of Rule 10b-5, takes two principal forms: "inside information" and "market information." Market information typically originates from nonissuer sources and involves events or circumstances concerning or affecting the price or market for the issuer's securities and does not concern the issuer's assets or earning power. This distinction is unimportant for our purposes because insider trading liability can be imposed on those who trade while in possession of either type. See Bainbridge, supra note 3, at 477 n.177 (citing authorities).

In theory, a distinction can be drawn between trading while in possession of material nonpublic information and trading on the basis of such information. See id. at 493-97. Such a distinction, however, turns out to be a most difficult one to draw in practice. For this reason, trading while in possession of material nonpublic information generally suffices for liability to arise under the federal securities laws (assuming the other elements of the offense are met). See United States v. Teicher, 987 F.2d 112, 120-21 (2d Cir.) (dictum), cert. denied, 114 S. Ct. 467 (1993).

A. The Disclose or Abstain Rule

The modern federal insider prohibition began taking form in SEC v. Texas Gulf Sulphur Co.11 TGS, as it is commonly known, rested on a policy of equality of access to information. Accordingly, under TGS and its progeny, virtually anyone that possessed material nonpublic information was required either to disclose it to the investment public before trading or abstain from trading in the affected company’s securities.12 If the would-be trader’s fiduciary duties precluded him from disclosing the information prior to trading, abstention was the only option.

In Chiarella v. United States13 and Dirks v. SEC,14 the Supreme Court rejected the equal access policy. Instead, the Court made clear that liability could be imposed only if the defendant was subject to a duty to disclose prior to trading. Inside traders thus were no longer liable merely because they had more information than other investors in the market place. Instead, a duty to disclose only arose where the inside traders breached a pre-existing fiduciary duty owed to the person with whom they traded.15

As we shall see, creation of this fiduciary duty element substantially narrowed the scope of the disclose or abstain rule.16 But the rule remains quite expansive in a number of respects. In particular, it is not limited to true insiders, such as officers, directors, and controlling shareholders, but picks up corporate outsiders in two important ways. Even in these situations, however, liability for insider trading under the disclose or abstain rule exists only where the trader — insider or outsider — violates a fiduciary duty owed to the person on the other side of the transaction.

First, the rule can pick up a wide variety of nominal outsiders whose relationship to the issuer is sufficiently close to justify treating them as "con-

11. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Prior to TGS, the federal prohibition was effectively limited to face-to-face and control transactions. See infra note 176 and accompanying text. Secondary market transactions were regulated only in SEC administrative proceedings. Id.
15. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," and no such duty arises "from the mere possession of nonpublic market information." Chiarella v. United States, 445 U.S. 222, 234-35 (1980). Thus, "there can be no duty to disclose where the person who has traded on [or tipped] inside information 'was not [the corporation’s] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'" Id. at 232; accord Dirks v. SEC, 463 U.S. 646, 653-55 (1983).
16. See infra part II.B.
structive insiders," but only in rather narrow circumstances. The outsider must obtain material nonpublic information from the issuer. The issuer must expect the outsider to keep the disclosed information confidential. Finally, the relationship must at least imply such a duty. If these conditions are met, the putative outsider will be deemed a "constructive insider" and subjected to the disclose or abstain rule in full measure. If these conditions are not met, however, the disclose or abstain rule simply does not apply. The critical issue thus remains the nature of the relationship between the parties.

Second, the rule also picks up outsiders that receive inside information from either true insiders or constructive insiders. There are a number of restrictions on tippee liability, however. Most important for present purposes, the tippee’s liability is derivative of the tipper’s, "arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty." As a result, the mere fact of a tip is not sufficient to result in liability. What is proscribed is not merely a breach of confidentiality by the insider, but rather a breach of the duty of loyalty imposed on all fiduciaries to avoid personally profiting from information entrusted to them.

Thus, looking at objective criteria, the courts must determine whether the insider personally will benefit, directly or indirectly, from his disclosure. So once again, a breach of fiduciary duty is essential for liability to be imposed: A tippee can be held liable only when the tipper has breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.

B. The Gap-Fillers

Chiarella created a variety of significant gaps in the insider trading prohibition’s coverage. Consider this standard law school hypothetical: A law firm is hired by Raider Corporation to represent it in connection with a planned takeover bid for Target Company. Alex Associate is one of the lawyers assigned to the project. Before Raider publicly discloses its intentions, Associate purchases a substantial block of Target stock. Under the disclose or abstain rule, he has not violated the insider trading prohibition. Whatever the scope of the duties he owed Raider, he owed no duty to the shareholders of Target. Accordingly, the requisite breach of fiduciary duty

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18. Id. at 659.
19. See id. at 662-64.
20. Id.
21. Id. at 660.
is not present in his transaction. Rule 14e-3 and the misappropriation theory were created to fill this gap.

1. Rule 14e-3

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

According to the SEC, Rule 14e-3 liability is not premised on breach of a fiduciary duty. In light of the well-established fiduciary duty requirement under Rule 10b-5, however, this interpretation of the rule may run afoul of *Schreiber v. Burlington Northern, Inc.*, in which the Supreme Court held that Exchange Act Sections 10(b) and 14(e) are *in pari materia.* In *United States v. Chestman,* however, the Second Circuit upheld Rule 14e-3 as a valid exercise of the SEC's rulemaking authority despite the absence of a fiduciary duty element.

Even assuming the SEC and the Second Circuit are correct on this point, however, the rule's scope is very limited. One prong of the rule (the prohibition on trading while in possession of material nonpublic information) does not apply until the offeror has taken substantial steps towards making the offer. More important, both prongs of the rule are limited to information relating to a tender offer. As a result, most types of inside information remain subject to the duty-based analysis of *Chiarella* and its progeny.

2. Misappropriation

The misappropriation theory grew out of then Chief Justice Burger's dissent in *Chiarella.* As an employee of a financial printer, Chiarella had access to tender offer documents being prepared for takeover bidders.

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22. 17 C.F.R. § 240.14e-3 (1993). In fact, Rule 14e-3 was pending at the time *Chiarella* was decided, *see* Chiarella v. United States, 445 U.S. 222, 234 n.18 (1980), almost as though the Commission knew that its attempts to reach warehousing of takeover securities under Rule 10b-5 were of questionable validity.


24. *Id.* § 240.14e-3(a).


Although Chiarella owed no duties to the investors with whom he traded, he did owe a duty of confidentiality to his employer and thereby to the bidders. Chief Justice Burger argued that Chiarella's misappropriation of material nonpublic information that had been entrusted to his employer constituted a breach of duty sufficient to justify imposing Rule 10b-5 liability. Although Justice Brennan and Justices Blackmun and Marshall supported the Chief Justice's argument, the majority declined to reach the misappropriation question because that theory of liability was not presented to the jury. The Second Circuit nevertheless adopted the misappropriation theory as a basis for inside trading liability in \textit{United States v. Newman} and followed it in a number of subsequent decisions.

Like the traditional disclose or abstain rule, the misappropriation theory requires a breach of fiduciary duty before trading on inside information becomes unlawful. The fiduciary relationship in question, however, is a quite different one. Under the misappropriation theory, the defendant need not owe a fiduciary duty to the investor with whom he trades. Nor must he owe a fiduciary duty to the issuer of the securities that were traded. Instead, the misappropriation theory applies when the inside trader violates a fiduciary duty owed to the source of the information. Had the misappropriation theory been available against Chiarella, for example, his conviction could have been upheld even though he owed no duties to those with whom he had traded. Instead, the breach of the duty he owed to Pandick Press would have sufficed.

\textbf{III. What Is the Requisite Fiduciary Duty?}

In neither \textit{Chiarella} nor \textit{Dirks} did the Supreme Court do a very good job of defining the fiduciary duty element. Nor have the lower courts subse-

\begin{itemize}
  \item 28. \textit{Id.} at 239 (Brennan, J., concurring).
  \item 29. \textit{Id.} at 245 (Blackmun, J., dissenting).
  \item 30. \textit{Id.} at 235-37. In his concurrence, Justice Stevens indicated that "respectable arguments could be made" for and against the misappropriation theory. \textit{Id.} at 238 (Stevens, J., concurring).
  \item 31. 664 F.2d 12 (2d Cir. 1981).
  \item 33. It is not unlawful, for example, to trade on the basis of inadvertently overheard information. SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984).
  \item 34. Carpenter, 791 F.2d at 1028-29.
\end{itemize}
Subsequently done much to flesh out the requirement. To the contrary, most
decisions treat the fiduciary duty element conclusorily at best. The SEC and
the lower courts seem to view the fiduciary duty element as a mere minor
inconvenience that should not stand in the way of expansive insider trading
liability. They have consistently sought to evade the spirit of the fiduciary
duty requirement, while complying with its letter. Consider, for example,
the creation of the misappropriation theory and Rule 14e-3 as a means of
recriminalizing the conduct legalized by Chiarella. The misappropriation
theory and Rule 14e-3 are best viewed as part of a SEC effort to revive the
TGS equal access to information rule while nominally remaining faithful to
the fiduciary duty requirement. Even a former SEC Commissioner admits
as much, acknowledging that the misappropriation theory can be seen as
"merely a pretext for enforcing equal opportunity in information."

This persistent refusal to take the fiduciary duty requirement seriously
is problematic in light of the centrality of the fiduciary duty requirement to
the Supreme Court's insider trading jurisprudence and the Court's explicit
rejection of the equal access policy. In view of the draconian sanctions
associated with insider trading liability, moreover, the failure to meaning-
fully define the scope and content of the fiduciary duty element raises im-
portant fairness and due process concerns. This Part outlines the framework
within which such a definition should evolve by exploring the nature of the
fiduciary duty at issue.

In the course of its Chiarella and Dirks opinions, the Supreme Court
frequently spoke of the need to show the existence of a "fiduciary relation-
ship" as a predicate to liability. Yet, surely that is not enough. As Justice

35. See supra part II.B.2.
36. Charles C. Cox & Kevin S. Fogarty, Bases of Insider Trading Law, 49 OHIO ST.
L.J. 353, 366 (1988). For a summary of the arguments that equal access to information is
not an appropriate basis for imposition of insider trading liability, see Stephen M. Bainbridge,
The Insider Trading Prohibition: A Legal and Economic Enigma, 38 U. FLA. L. REV. 35, 57-
59 (1986).
37. E.g., Dirks v. SEC, 463 U.S. 646, 654 (1983); Chiarella v. United States, 445
U.S. 222, 232 (1980). In United States v. Chestman, 947 F.2d 551 (2d Cir. 1991), the court
observed that the requisite relationship could be satisfied either by a fiduciary relationship or
a "similar relationship of trust and confidence." Id. at 568. So expanding the class of
relationships that can give rise to liability may lead to a results-oriented approach. If a court
wishes to impose liability, it need simply conclude that the relationship in question involves
trust and confidence, even though the relationship bears no resemblance to those in which
fiduciary-like duties are normally imposed. Accordingly, courts should be loath to use this
phraseology as a mechanism for expanding the scope of liability. The Chestman court was
sensitive to this possibility, holding that a relationship of trust and confidence must be "the
functional equivalent of a fiduciary relationship" before liability can be imposed. Id. Chest-
Frankfurter put it, albeit in a different context, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations?" In other words, it should not be enough to establish the existence of a fiduciary relationship. Before liability can be imposed one must also establish that the defendant violated a fiduciary duty arising out of the fiduciary relationship in question.

In any fiduciary relationship, a variety of duties may arise. Which is the duty whose violation triggers insider trading liability? Again, the Court was not very precise on this score. It spoke mainly of a duty to disclose before trading. While so describing the duty perhaps sufficed for purposes of applying the disclose or abstain rule to trading insiders, it created analytical problems when the insider tipped information rather than trading on it. The duty to disclose phraseology created even greater problems when the misappropriation theory was created. Given that Chiarella owed no fiduciary duties to the investors with whom he traded, for example, he plainly owed those investors no duty to disclose nonpublic information before trading.

Faced with these problems, some lower courts switched the inquiry to whether the defendant was subject to a duty of confidentiality.

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39. This conclusion is supported by the Supreme Court’s treatment of tippee liability. It is not enough to show that the tipper was party to a fiduciary relationship with the source of the information. As we have seen, there must also be a breach of the tipper’s fiduciary duty before tippee liability can result. That this requirement extends to insider trading liability generally seems reasonably clear from Dirks’s discussion of Chiarella. See Dirks, 463 U.S. at 653-54.
40. See, e.g., Dirks, 463 U.S. at 654; Chiarella, 445 U.S. at 235.
41. Even as to the disclose or abstain rule, however, attempting to create a duty to disclose independent of a duty not to self-deal is problematic. See infra part IV.
42. See, e.g., United States v. Libera, 989 F.2d 596 (2d Cir. 1993), cert. denied, 114 S. Ct. 467 (1993); United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986), aff’d on other grounds, 484 U.S. 19 (1987). Note that these cases arose in the employment context,
approach finds some support in Dirks's discussion of constructive insiders. Recall that under Dirks one becomes a constructive insider only where the outsider is expected to keep "nonpublic information confidential and the relationship at least" implies a duty to do so.\textsuperscript{43}

Using a duty of confidentiality as the requisite fiduciary duty, however, makes little sense in the insider trading context. Unlike most types of tangible property, the same piece of information can be used by more than one person at the same time; an insider's use of the information, moreover, does not necessarily lower its value to its owner. When an executive that has just negotiated a major contract for his employer thereafter inside trades in the employer's stock, for example, the value of the contract to the employer has not been lowered nor, absent some act of disclosure, has the executive violated his duty of confidentiality. Using nonpublic information for personal gain thus is not inconsistent with a duty of confidentiality, unless one's trades somehow reveal the information.

The fiduciary duty requirement therefore should be satisfied only by a duty to refrain from self-dealing in nonpublic information. This conclusion finds considerably greater support in Dirks than does the duty of confidentiality approach. The Court, for example, described the elements of an insider trading violation as: "(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."\textsuperscript{44} Another passage likewise describes insider trading liability as arising from "the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"\textsuperscript{45} Yet another noted that insiders are "forbidden by their fiduciary relationship from using undisclosed corporate information for their personal gain."\textsuperscript{46} The focus in each instance is on the duty to refrain from self-dealing.

The emphasis on self-dealing, rather than confidentiality, is confirmed by the result in Dirks. Secrist violated his duty of confidentiality by dis-
closing the information to Dirks. Yet, the fact of the tip alone did not suffice for liability to be imposed. Rather, as we have seen, the court held that liability could be imposed only if Secrist had made the tip for personal gain, in other words, only if the tip involved self-dealing. Hence, mere violation of the duty of confidentiality is not enough. Rather, a duty to disclose before trading arises only if trading would violate a duty to refrain from self-dealing in confidential information owed by the trader to the owner of that information.

IV. Federal or State? The Choice of Law Problem

Having identified the requisite fiduciary duty, a question remains: Whence comes that duty? Courts and commentators uniformly treat the Chiarella fiduciary duty as a species of federal law. True enough, in the sense that the underlying cause of action arises under federal law. But while the prohibition is tied to a federal statute and the regulations thereunder, there is nothing in either the text or legislative history of Exchange Act Section 10(b) or Rule 10b-5 to support the modern substantive definition of insider trading. Instead, it is wholly a judicial creation. Like the rest of modern Rule 10b-5 jurisprudence, the definition of insider trading is "a judicial oak which has grown from little more than a legislative acorn." The federal insider trading prohibition thus is best classified within the genus of federal common law. It is an example of interstitial lawmaking in which the courts are using common-law adjudicatory methods to flesh out the bare statutory bones.

This conclusion admittedly may run afoul of a series of recent Supreme Court decisions in which the Court adopted a narrower approach to interpreting Rule 10b-5, which purports to focus on the text of the rule and Section 10(b). Central Bank v. First Interstate Bank is perhaps the leading

47. See infra part VI.A.1.


49. Professor Theresa Gabaldon notes that federal courts have often borrowed state law to define the elements of the implied cause of action under Rule 10b-5. Theresa A. Gabaldon, State Answers to Federal Questions: The Common Law of Federal Securities Regulation, 20 J. CORP. L. 156, 160 (1994). As I do, she treats the insider trading prohibition as a species of federal common law in which courts should borrow state law. Id. at 198-99.

50. I shall not lengthen an already hefty article with an extended discourse on the merits
exemplar of this trend. In that case, the Court overruled a host of precedent imposing aiding and abetting liability under Rule 10b-5. In doing so, the Court held that the scope of conduct prohibited by Section 10(b) (and thus the rule) is controlled by the text of the statute.

The Fourth Circuit recently extended Central Bank's logic to the insider trading context. In United States v. Bryan, the Fourth Circuit rejected the misappropriation theory as a basis for insider trading liability under Rule 10b-5. Following Central Bank, the court held it could not expand "the concept of fraud in the securities context beyond what the words of the Act reasonably will bear." In turn, the court held that the statute imposes liability only where there has been "deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction." Because the misappropriation theory involves no such deception, but rather simply a breach of fiduciary duty owed to the source of the information, the theory could not stand.

Bryan's extension of Central Bank to the insider trading context, and consequent refusal to treat the prohibition as a species of federal common law, is problematic on several grounds. Although the Fourth Circuit was careful to opine that its decision left intact both the disclose or abstain theory of liability and tipping liability thereunder, arguably this is not the case. As we have seen, the duty at issue in tipping cases is not a duty to disclose, but rather, a duty to refrain from self-dealing in confidential information owed by the tipper to the source of the information. As such, tipping is subject to the same line of attack as the Bryan court invoked against the misappropriation theory.

of a purely textualist approach to interpreting the securities laws. Instead, it suffices here merely to point out some of the problems such an approach creates in the insider trading area and, further, to suggest that treating the insider trading prohibition as a species of federal common-law can be justified as being consistent with congressional intent. For a useful treatment of the legitimacy of using common-law adjudicatory methodologies in federal securities litigation, see generally id.

55. Id. at *50.
56. Id. at *50-51.
57. See id. (criticizing misappropriation theory on grounds that it converts Rule 10b-5 into "federal common law governing and protecting any and all trust relationships").
58. Id. at *59-60.
Even the basic disclose or abstain theory of liability is called into question by Bryan. Granted, insider trading in violation of the disclose or abstain rule involves an element of deception. By definition, the defendant has failed to disclose nonpublic information before trading. As suggested by my argument that the relevant fiduciary duty is one against self-dealing, however, the nondisclosure argument is not a very powerful explanation for insider trading liability. Persons subject to the disclose or abstain theory often are also subject to a duty of confidentiality, which precludes them from disclosing the information. As to them, the insider trading prohibition thus becomes a rule to abstain from trading, rather than a rule requiring disclosure or abstention. A former SEC Commissioner admits as much: "Unlike much securities regulation, the insider trading rules probably do not result in more information coming into the market: The ‘abstain or disclose’ rule for those entrusted with confidential information usually is observed by abstention." In other words, given that defendant had no right to disclose, it is the failure to abstain from trading, rather than the nondisclosure, which is the basis for imposing liability. It is for this reason that the fiduciary duty relevant to the disclose or abstain theory of liability is more accurately described as a duty to refrain from self-dealing in confidential information belonging to another than as a duty of confidentiality or disclosure.

Put another way, the nondisclosure argument is circular. As Chiarella made clear, and Dirks affirmed, not all failures to disclose are fraudulent. Rather, a nondisclosure is actionable only if the trader is subject to a duty to disclose. In turn, I contend, a duty to disclose exists only where the trader is subject to a fiduciary duty to refrain from self-dealing in confidential information. Absent such a fiduciary duty, insider trading simply is not fraudulent. Once again, this leaves the disclose or abstain rule subject to the same line of attack as was adopted by the Bryan court.

59. Cox & Fogarty, supra note 36, at 353.

60. The Bryan court appears to have realized that the conduct traditionally viewed as falling within the scope of the disclose or abstain theory of liability properly can be viewed as a theft of information, albeit without recognizing the implications of that point for the viability of the disclose or abstain theory. The court opined that "trading on the basis of misappropriated information" would give rise to liability where "a corporate executive trades in shares of his own company, without disclosure, on the basis of information entrusted to him solely for corporate purposes." Bryan, 1995 U.S. App. LEXIS 15893, at *29. In other words, liability arises where the executive, without disclosure, self-deals in confidential corporate information.

61. It is for this reason that insider trading does not implicate the federal policy of preventing fraud in securities transactions.
A further problem with Bryan is that the statute's and the rule's texts in fact provide little guidance as to the scope of insider trading liability. According to Central Bank, where the text does not resolve some aspect of the Rule 10b-5 cause of action, courts must "infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision of the 1934 Act."62 This presents the Court with what it admits to be an "awkward task."63 Justice Scalia has put it somewhat more colorfully: "We are imagining here."64 This process thus is known as imaginative reconstruction of congressional intent.

Central Bank somewhat constrained the imaginative process by requiring courts to "use the express causes of action in the securities acts as the primary model for the § 10(b) action."65 As applied to insider trading, however, this approach is not especially helpful. The short-swing profits cause of action under Section 16(b) of the Securities Exchange Act regulates insider trading only indirectly, does not seek to define insider trading, and does not involve questions of fiduciary duty. Section 20A provides an express private right of action for insider trading, but was not adopted until more than 50 years after Section 10(b) and, moreover, provides no substantive definition of insider trading. Section 21A creates a treble money civil penalty for insider trading, but suffers from the same flaws as Section 20A insofar as it might be used as a source of imaginatively reconstructing congressional intent with respect to Section 10(b).

Other evidence of congressional intent, however, suggests that Bryan's extension of Central Bank to the insider trading context negates that intent. The subject of congressional intent with respect to insider trading is described below in considerable detail.66 It suffices here to note the following points: There is good evidence that Congress in 1934 did not intend to regulate insider trading in any way other than through the short-swing profit provisions of Section 16(b). Since 1934, however, Congress has twice

62. Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1448 (1994) (quoting Musick, Peeler & Garrett v. Employers Ins., 113 S. Ct. 2773, 2090 (1993)). Although the court in Central Bank concluded that the text was dispositive, it nonetheless went on to consider how the 1934 Congress would have addressed the issue. Id. Considering congressional intent as it relates to insider trading regulation thus would be appropriate, even if one rejects the arguments made in the text as to the text's lack of clarity.


64. Id. at 360.

65. Central Bank, 114 S. Ct. at 1448.

66. See infra part VI.A.1.
amended the Act insofar as it relates to insider trading. Although the legislative history of both provisions expressly left the definitional problem to the courts, Congress on both occasions also expressly endorsed the misappropriation theory.

Under the so-called re-enactment doctrine, the courts will adhere to a judicial construction of a statute prevailing at the time Congress re-enacts the statute. As argued below, the misappropriation theory thus appears to have been validated by congressional action. At least insofar as the re-enactment doctrine applies to cases arising under Rule 10b-5, however, Central Bank places it in serious jeopardy. The Central Bank majority remarked that arguments based on the re-enactment doctrine "deserve little weight in the interpretive process." The Court also held that because "Congress has not reenacted the language of § 10(b) since 1934" the Court need not "determine whether the other conditions for applying the reenactment doctrine are present." Hence, even if Congress had intended that the 1984 and 1988 amendments expressly endorse the misappropriation theory, that action arguably would not be binding on the courts.

Extension of this aspect of Central Bank to the insider trading context would be just as flawed as Bryan's extension of its main holding. Rejecting the re-enactment doctrine as authority for the misappropriation theory simply because Section 10(b) has never been re-enacted ignores highly relevant congressional action elsewhere in the act and thus flouts the apparent congressional intent. If only the intent of the 1934 Congress is relevant, after all, the evidence suggests that Section 10(b) was not concerned with insider trading and the prohibition as a whole should be overturned. This would negate the subsequently adopted statutory penalties for insider trading because there no longer would be any underlying violation to which they could be applied, which is an anomalous result, at best. Even if the disclose or abstain theory survives Bryan, it still seems odd that penalties Congress adopted with the clear intent that they be applied to misappropriation of information should be rendered nugatory by the Fourth Circuit's rejection of the underlying cause of action. As I argue in Part VI.A.1 below in more detail, this anomaly is best avoided by treating Congress's failure to define insider trading as an invitation to the courts to develop such a definition through an on-going process of common-law adjudication.

67. Central Bank, 114 S. Ct. at 1452.
68. See infra part VI.A.1.
69. Central Bank, 114 S. Ct. at 1452.
70. Id.
Finally, Bryan's approach to interpreting Rule 10b-5 precludes one from taking into account the policy considerations developed in Part VI below. To be sure, Central Bank opined that policy considerations may not override the court's interpretation of the text and structure of the Act. There is an emerging school of thought, however, that Central Bank is merely one in a series of recent decisions in which the Court's interpretation of the Act's text and structure were driven by an overriding policy concern: namely, reducing the number of securities lawsuits. More charitably, we might refer to this as a desire to prevent excessive, vexatious, often frivolous securities litigation. If so, it is a project with which I generally have considerable sympathy.

71. Although the Bryan court recognized that Central Bank purportedly discourages recourse to policy considerations, it did consider certain policy arguments against the misappropriation theory. Chief among them were the anomalies inherent in the misappropriation theory, see United States v. Bryan, No. 94-5124, 1995 U.S. App. LEXIS 15893, at *51-59 (4th Cir. June 27, 1995), which are described in detail in Part VI.A.2.b.iii. The Bryan court ignored the possibility that these anomalies can be explained in a way that is consistent with a sound public policy towards insider trading. I develop such an explanation in Part VI.B.2 below.

72. Central Bank, 114 S. Ct. at 1453-54. The Court made an exception for cases in which policy considerations "show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." Id. at 1454. As argued above, insider trading becomes just such a case when the post-1934 congressional enactments are taken into account.

73. See Stephen M. Bainbridge, Securities Act Section 12(2) After the Gustafson Debacle, __ BUS. LAW. __ (forthcoming 1995).

74. Id. A word should be said to distinguish my critique of the Supreme Court's decision in Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995), from the argument being made here. In Gustafson, the Supreme Court substantially restricted the scope of liability under Securities Act § 12(2). In many respects, § 12(2) offers plaintiffs a more attractive remedy than does Rule 10b-5. If the Supreme Court had not restricted the class of transactions to which § 12(2) liability attaches, § 12(2) might well have displaced Rule 10b-5 as the principal vehicle for imposition of securities liability. Some commentators have argued that the Supreme Court could appropriately take into account the effect a broad interpretation of § 12(2) would have on Rule 10b-5 in the course of interpreting the former. See Bainbridge, supra note 73. This is too pragmatic an approach to statutory interpretation for my tastes. In this regard, I invoked the homely adage that "two wrongs don't make a right," to argue that the Supreme Court's institutionally illegitimate creation of the implied right of action should not be used thereafter to justify an incorrect interpretation of an express statutory right of action. Id. at n.120.

My current argument is not an attempt to "have my cake and eat it too." My argument against Gustafson is only that the cart should not be put before the horse: The mere fact that the Rule 10b-5 cause of action is on the books and, Central Bank notwithstanding, is likely to remain there for the foreseeable future should not control the interpretation of an express statutory provision. In contrast, the present context involves the quite different question of
cations developed below for retaining the federal insider trading prohibition and treating it as a species of federal common law outweigh the policy arguments for piecemeal cutbacks on the scope of Rule 10b-5.

In sum, if congressional intent is to be imaginatively reconstructed, one should conclude that the securities statutes instruct courts to treat the problem of defining insider trading as a common-law question. To be clear, my point is not that the definition of insider trading is federal common law. I acknowledge that the long tradition of so viewing the prohibition has been called into doubt by Central Bank. My point is only that the analytical methodologies applied by the Supreme Court to federal common-law issues provide an appropriate mechanism for giving content to the federal prohibition. This approach is consistent with the Supreme Court's 10b-5 jurisprudence, arguably even post-Central Bank, and also with both the most sensible reconstruction of congressional intent and sound public policy.

Once the problem is seen as one to be solved by application of federal common law, a choice of law question arises. Federal common law often is influenced by, and not infrequently incorporates, state law. In Burks v. Lasker, for example, a shareholder of a federally regulated investment company brought suit under the federal securities laws against the company's board of directors. The Supreme Court held that state law controls the board of directors' ability to use a special litigation committee to terminate the litigation. In Kamen v. Kemper Financial Services, Inc., the Court extended Burks, describing the federal law governing derivative suits brought under the Investment Company Act as a species of federal common law, and incorporating state law governing excusal of the demand requirement in such suits. Until quite recently, for another example, the federal courts applied state statutes of limitation to private party lawsuits under Rule 10b-5. Although the Supreme Court adopted a unique federal limitations period in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, the Court

how courts should interpret the Rule 10b-5 cause of action itself. Notwithstanding my doubts about the legitimacy of the creation of implied private rights of action, fuller explication of which is perhaps best left for another day, unless and until the Court overturns the Rule 10b-5 cause of action, it remains on the books and must be interpreted.

75. See infra part VI.A.1.
76. 441 U.S. 471 (1979).
indicated that it would continue to borrow state statutes of limitations in appropriate cases.  

In light of these precedents, the question is not whether state law is relevant to the task of defining insider trading, but rather the extent to which it should be incorporated into the federal prohibition. In particular, the question at hand is the extent to which state law fiduciary duty concepts should be incorporated into the fiduciary duty requirement established by Chiarella. In answering that question, courts have two options. First, they may create a unique rule of federal common law that applies uniformly throughout the nation. The courts could draw on state law by analogy in doing so, but the rule would remain wholly federal. Second, they may adopt state law as the federal rule. If this option is selected, the substantive content of the federal rule will vary depending on which state’s law controls.

Yet again, this is a question the Supreme Court failed to answer with clarity. On the one hand, the Dirks Court contended "that ‘[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.’ " If so, one would assume that the fiduciary duty arises out of federal law. As we shall see, however, this contention is at best an overstatement.

On the other hand, the Dirks Court also implied that the requisite duty arose out of state common law:

81. *Id.* at 355-58. To be sure, while both of these examples involve the use of state common law to fill the interstices of the federal securities laws, and thus suggest that state law could appropriately play a role in insider trading prohibition as well, neither directly addresses the use of state common law to define the elements of a federal claim. This too is possible, however. In DeSylva v. Ballentine, 351 U.S. 570 (1956), for example, the court looked to the state law definition of "children" for purposes of interpreting a federal statute.


83. *Id.*

84. *Id.* at 297.


86. The Court’s repeated references to a "Cady, Roberts duty" may also point towards a federal source for the requisite duty. There is at least the implication that *Cady, Roberts* created a federal duty to refrain from self-dealing in confidential information, which has become part of the overall bundle of fiduciary duties to which insiders are subject. See, e.g., *id.* at 662. This analysis, however, suffers from two flaws. First, it reads an awful lot into some vague passages of both *Dirks* and *Cady, Roberts*. Second, creation of such a duty is inconsistent with the Court’s holding in *Santa Fe*. See *infra* notes 288-97 and accompanying text.

87. See *infra* part VI.A.1.
In the seminal case of *In re Cady, Roberts & Co.*, the SEC recognized that the common law in some jurisdictions imposes on "corporate 'insiders,' particularly officers, directors, or controlling shareholders" an "affirmative duty of disclosure . . . when dealing in securities." The SEC found that . . . breach of this common law duty also established the elements of a Rule 10b-5 violation . . . .

In other words, the federal securities laws are violated only upon breach of this purported state common-law duty. This interpretation of *Dirks* also would seem to be supported by the misappropriation theory: The focus in most misappropriation cases is on violation of duties arising out of the employment relationship, which in turn implicates agency law and thus points towards a state law source for the requisite duty.

The lower courts have likewise failed to resolve this question, although cases consistent with both approaches exist. The Second Circuit's *Chestman* decision, for example, is compatible with the unique federal rule approach. The court considered whether a spousal relationship constituted a fiduciary relationship triggering *Chiarella*. It undertook a careful and exhaustive analysis, which is wholly irrelevant to the problem at hand, because the court failed to resolve the choice of law issue. Instead, the court created a generic fiduciary duty, which purports to take its "cues as to what is required

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89. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992); *see also* *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985) (drawing on state law fiduciary principles, as well as federal precedents, to determine whether familial relationship met fiduciary duty requirement); *Pengra*, *supra* note 5, at 1372-74 (urging courts to adopt federal fiduciary standard); *cf.* Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 277-78 (1981) (noting *Chiarella* may have federalized "the most advanced state the common law had reached in a handful of jurisdictions"). Professor Langevoort points out that an early line of cases created "an established principle of federal law under rule 10b-5 that insiders owe a fiduciary duty of disclosure when engaged in face-to-face purchases or sales with corporate shareholders." DONALD C. LANGEVOORT, INSIDER TRADING REGULATION 37 (1988). True enough, *see infra* note 129 (citing cases that applied special circumstances and fiduciary duty rules to face-to-face insider trading transactions), but these cases antedate not only *Chiarella*, but also *Santa Fe*. Moreover, they deal with face-to-face and control transactions, not secondary market transactions. *See infra* note 297. As we shall see, there is plenty of precedent from state common law for treating the latter differently. *See infra* part V.C. As such, the existence of this line of cases does not compel one to conclude that the duty in question is a federal one. To the contrary, the underlying rationale of this line of cases is contrary to *Chiarella* and *Dirks*. These cases impose liability on insiders to effect a purported congressional intent to assure equality of access to information. *See, e.g.*, *Cook v. Avien, Inc.*, 573 F.2d 685, 694 n.19 (1st Cir. 1978). As we have seen, however, *Chiarella* and *Dirks* rejected the equal access policy as a basis for imposing insider trading liability. *See supra* part II.A.
to create the requisite relationship from the securities fraud precedents and the common law."\(^{90}\) In so doing, the court relied extensively on state law fiduciary duty concepts.\(^{91}\) At the same time, however, the court gave not even a hint that state law was controlling. As such, under a Chestman-like approach, state law arguments are at most relevant but not dispositive.\(^{92}\)

\(^{90}\) Chestman, 947 F.2d at 568.

\(^{91}\) See id. at 568-70. A student commentator suggests that In re Worlds of Wonder Sec. Litig., [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689 (N.D. Cal. 1990), implicitly assumes that the fiduciary duty in question arises out of federal law. See Pengra, supra note 5, at 1373. Worlds of Wonder involved a private cause of action brought by holders of convertible debentures against insiders who had allegedly inside traded in the corporation's stock. The court recognized that Chiarella required it to find a fiduciary relationship between the debentureholders and the insiders. Worlds of Wonder, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 98,239. Analogizing convertible debentures to equity securities, the court found that the requisite duty existed in this context. Id. This conclusion is contrary to the vast majority of state law decisions, which decline to recognize fiduciary duties running to holders of convertible bonds. See, e.g., Simons v. Cogan, 549 A.2d 300 (Del. 1988); see also Broad v. Rockwell Int'l Corp., 642 F.2d 929 (5th Cir.), cert. denied, 454 U.S. 965 (1981) (any fiduciary duties running to holders of convertible bonds would be satisfied because insiders complied with terms of bond indenture). In view of the overwhelming mass of contrary state authority and the Worlds of Wonder court's failure to take cognizance of that body of precedent, the opinion is perhaps best read as yet another example of a judicial failure to recognize the problem at hand.

\(^{92}\) Some cases have reached results clearly in conflict with applicable state law. In SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983), for example, Lund and another businessman discussed a proposed joint venture between their respective companies. In those discussions, Lund received confidential information about the other's firm. Lund thereafter bought stock in the other's company. The court determined that by virtue of their close personal and professional relationship, and because of the business context of the discussion, Lund was a constructive insider of the issuer. Lund, 570 F. Supp. at 1401-03. In doing so, however, the court focused almost solely on the issuer's expectation of confidentiality. It failed to inquire into whether Lund had agreed to keep the information confidential. See Langevoort, supra note 89, at 92-94.

Lund is inconsistent with the leading state law decision. In Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), Morgan Stanley represented a company considering acquiring Olinkraft Corporation in a friendly merger. During exploratory negotiations Olinkraft gave Morgan confidential information. Morgan's client ultimately decided not to pursue the merger, but Morgan allegedly later passed the acquired information to another client planning a tender offer for Olinkraft. In addition, Morgan's arbitrage department made purchases of Olinkraft stock for its own account. The Second Circuit held that Morgan was not a fiduciary of Olinkraft: "Put bluntly, although, according to the complaint, Olinkraft's management placed its confidence in Morgan Stanley not to disclose the information, Morgan owed no duty to observe that confidence." Walton, 623 F.2d at 799.

Interestingly, a subsequent case from the same district as Lund affirmed the need for an affirmative assumption of the duty of confidentiality. See SEC v. Ingram, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,788 (C.D. Cal. 1988). In none of this, however,
In contrast, if the latter option is selected, state law fiduciary duty concepts would be determinative. While insider trading would remain a matter of federal law, the substantive definition of insider trading would be supplied by state law. Several cases appear to be consistent with this approach. In *United States v. Carpenter*, for example, the court held that:

> [B]ecause of [Winans's] duty of confidentiality to the *Journal*, defendants 
> ... [had a] corollary duty, which they breached, under section 10(b) and 
> rule 10b-5, to abstain from trading in securities on the basis of misappropriated information or to do so only upon making adequate disclosure to 
> those with whom they traded.\(^93\)

Put another way, Winans's federal duty to disclose arose under Section 10(b) only because he first violated his state law duty to the Wall Street Journal. Similarly, albeit in a noninsider trading case, the Seventh Circuit interpreted *Dirks* as holding that "the existence of a requirement to speak [under Rule 10b-5] . . . is itself based on state law . . . ."\(^94\)

How then should courts choose between these options? Unfortunately, the standards governing that choice are not particularly well-developed. The basic test, however, is the impact incorporation of state law would have on the relevant federal statutory policies. In *Lampf*, for example, the Court created a unique federal statute of limitations for implied federal rights of action because borrowing a state limitations rule would frustrate the purpose of the underlying federal statute.\(^95\) In *Burks*, the Court used state law to fill the interstices of a federal statute affecting the powers of directors because doing so did not permit acts prohibited by the federal statute and was otherwise not inconsistent with the statutory policy.\(^96\) In *Kamen v. Kemper Financial Services, Inc.*\(^97\), the Court reaffirmed what it termed "the basic teaching of *Burks v. Lasker*: Where a gap in the federal securities laws must be bridged by a rule that bears on the allocation of governing powers within the corporation, federal courts should incorporate state law into federal common law unless the particular state law in question is inconsistent with the policies

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underlying the federal statute. The bottom line then is whether there are important federal interests that would be adversely affected by adopting state law fiduciary duty principles as the federal rule of decision.

V. The Impact of Incorporation

In light of the preceding analysis, the first inquiry must be into the impact incorporation of state fiduciary duties would have on the federal insider trading prohibition. If state law is borrowed as the rule of decision, the federal prohibition will become little more than an empty shell waiting to be filled by state law fiduciary duties. Logically, the first inquiry in any insider trading case thus would be whether the defendant's conduct is proscribed by state law. If so, defendant's trades violate the federal prohibition, but if not, the trades do not violate the federal prohibition. This Part outlines the methodology such an inquiry would demand by examining three fiduciary relationships: corporate insiders to bondholders, outside corporate counsel to their clients, and corporate insiders to their corporation and their shareholders.

To be sure, an inquiry of the sort illustrated here is essentially unheard of in federal insider trading jurisprudence. The Supreme Court itself set the tone in Dirks. At best, the common-law duty to which Justice Powell pointed exists only in "some jurisdictions." With no analysis or citation of authority, however, Powell extrapolated from this common-law duty the


99. This interpretation is consistent with the test laid out in the leading case of United States v. Kimball Foods, 440 U.S. 715 (1979), in which the Supreme Court laid out the following criteria for deciding when state law should be incorporated into federal common-law rules:

Undoubtedly, federal programs that "by their nature are and must be uniform in character throughout the nation" necessitate formulation of controlling federal rules. Conversely, when there is little need for a nationally uniform body of law, state law may be incorporated as the federal rule of decision. Apart from considerations of uniformity, we must also determine whether application of state law would frustrate specific objectives of the federal programs. If so, we must fashion special rules solicitous of those federal interests. Finally, our choice-of-law inquiry must consider the extent to which application of a federal rule would disrupt commercial relationships predicated on state law.

Kimball Foods, 440 U.S. at 728-29. To be sure, Kimball Foods is not squarely on point because the occasion for creating federal common law arose in that case because the United States was a party to the litigation rather than because the claim arose under federal law. It does confirm, however, the importance of determining whether incorporating state law would adversely affect some federal policy.

100. Dirks v. SEC, 463 U.S. 646, 659 (1983); see generally infra part V.C.
rule that all "insiders [are] forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage." 101 In effect, Justice Powell and virtually every subsequent lower court decision implicitly assumed that there is a single set of fiduciary duties, found in all fiduciary relationships, which always includes a duty to refrain from self-dealing in nonpublic information belonging to another. 102

There are two problems with this assumption. The less important of the two is that it collapses the inquiry into the single question of whether inside traders have a fiduciary relationship with someone affected by their trades. As we have seen, however, the analysis cannot end there. One must go on to ask whether there has been a breach of the requisite duty.

The more important of the two problems is that the assumption is simply not true as a matter of state common law. Different types of fiduciary relationships impose different types of fiduciary duties. Different states impose different fiduciary duties on the same relationship. As a result, not all fiduciary relationships include a duty to refrain from self-dealing in nonpublic information belonging to another. If the federal prohibition must rely on state law fiduciary duty concepts, prosecuting insider trading thus becomes much more complex than it is under the current approach. Indeed, as we shall see, in many cases reliance on state law will free some potential defendants from liability. The impact of incorporation on the federal prohibition thus will be substantial.

A. Insiders and Bondholders

If insider trading liability under the disclose or abstain rule indeed requires a fiduciary relationship arising out of state law, then one may use material, nonpublic information with impunity when trading in debt securities. 103 In virtually all jurisdictions, corporate officers and directors owe no

101. Dirks, 463 U.S. at 659.

102. Justice Powell's treatment of this problem is especially frustrating in light of the lower court's handling of the issue. In the court of appeals, Dirks contended that his informants breached no fiduciary duty under applicable state law. The court of appeals questioned whether that was correct, but assumed it to be the case for purposes of reviewing the SEC's decision. Dirks v. SEC, 681 F.2d 824, 838 (D.C. Cir. 1982), rev'd, 463 U.S. 646 (1983). The court of appeals nevertheless rejected Dirks's argument, asserting that Chiarella "did not hold that breach of the [insiders'] fiduciary obligations was required to bring rule 10b-5 to bear on the case, nor did it hold that state fiduciary law was the sole source of the duty to disclose-or-refrain." Id. at 838-39. Unfortunately, in reversing the first half of that statement, Justice Powell simply ignored the second half.

103. Various alternative theories of liability may come into play in this context. In
fiduciary duties to bondholders. Instead, the bondholders’ rights are limited to the express terms of the contract and an implied covenant of good faith.\textsuperscript{104} Cases in a few jurisdictions purport to recognize fiduciary duties running to holders of debt securities, but the duties imposed in these cases usually are more accurately characterized as the very same implied covenant of good faith found in most other jurisdictions.\textsuperscript{105}

In particular, the misappropriation theory might apply. Suppose a corporate officer traded in the firm’s debt securities using material nonpublic information belonging to the corporation. As the argument would go, even though the officer owes no fiduciary duties to the bondholders, he owes fiduciary duties to the corporation. The violation of those duties would suffice for liability under the misappropriation theory. See Pitt & Groskaufmanis, supra note 5, at 242-45. One trouble with this argument is that it assumes that the officer owes duties to the corporation that are violated by insider trading. Such an assumption may not be warranted. See infra part V.C. In any case, the misappropriation theory would not reach trading by an issuer in its own debt securities, which would come under the disclose or abstain rule. Pitt & Groskaufmanis, supra note 5, at 245.


\textsuperscript{105} See, e.g., Broad v. Rockwell Int’l Corp., 642 F.2d 929 (5th Cir.), cert. denied, 454 U.S. 965 (1981); Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669 (S.D.N.Y. 1984), vacated, 754 F.2d 478 (2d Cir. 1985); Fox v. MGM Grand Hotels, Inc., 187 Cal. Rptr. 141 (Cal. Ct. App. 1982). A student commentator recently argued that a fiduciary duty running to bondholders should be recognized under Rule 10b-5. See Pengra, supra note 5, at 1374-77. Setting aside for the moment the commentator’s questionable argument for federalizing these fiduciary duties, the argument for creating fiduciary duties — federal or state — running to bondholders is extremely weak. Bond issuances are repeat transactions. Where parties expect to have repeated transactions, the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating party in future transactions. The issuer’s management has a strong self-interest in the corporation’s cost of capital (i.e., avoiding takeovers, maximizing personal wealth, avoiding firm failure). Management therefore will be slow to do anything that unnecessarily increases their cost of capital. But if they abuse their current bondholders, that will come back to haunt them the next time they want to use the bond market to raise capital. If investors care about protection from insider trading, management therefore will provide it.

In addition, negotiations between the issuer and the underwriters that market the debt securities will produce efficient levels of protection. Because the bond market is dominated by a small number of institutional investors, the relationship between underwriters and bondholders is another example of the repeat transaction phenomenon. Underwriters will not sully their reputations with bondholders for the sake of one issuer. Moreover, in a firm commitment underwriting, the underwriters buy the securities from the issuer. If the indenture does not provide adequate levels of protection, the underwriters will be unable to sell the bonds.

Finally, if the risk of insider trading is unsystematic in nature, portfolio theory suggests that bondholders can eliminate it by holding a diversified portfolio. Even if insider trading is characterized as a systematic risk, the bond market is dominated by highly sophisticated institutions, which are fully capable of pricing the bonds in light of the indenture’s terms. As such, the pricing mechanism (assuming the market to be efficient) will provide a rate of
The distinction between this implied covenant and a fiduciary duty is an important one for our purposes. An implied covenant of good faith arises from the express terms of a contract and is used to fulfill the parties' mutual intent. In contrast, a fiduciary duty has little to do with the parties' intent. Instead, courts use fiduciary duties to protect the interests of the duty's beneficiary. In other words, while a fiduciary duty requires the party subject to the duty to put the interests of the beneficiary of the duty ahead of his own, an implied duty of good faith merely requires him to respect their bargain.

A two-step move thus will be required if lower courts are to impose liability under the disclose or abstain rule on those who inside trade in debt securities. First, the clear holdings of Chiarella and Dirks must be set aside so that the requisite relationship can be expanded to include purely contractual arrangements and the requisite duty expanded to include mere contractual covenants. Second, the implied covenant of good faith must be interpreted as barring self-dealing in nonpublic information by corporate agents.

The first move raises serious institutional legitimacy concerns. In Chiarella, a majority of the justices indicated varying degrees of receptivity to the misappropriation theory. One might therefore argue that the lower courts' creation of the misappropriation theory was institutionally justifiable because they did so at the apparent invitation of the Supreme Court. But the Court has never invited lower courts to eliminate altogether the fiduciary duty requirement.

The second move is equally problematic. Even assuming that the implied covenant of good faith controls the conduct of corporate agents, the covenant should not be deemed to bar self-dealing in nonpublic information. The leading Met Life decision indicates that a covenant of good faith will be implied only when necessary to ensure that neither side deprives the other side of the fruits of the agreement. The fruits of the agreement are limited to regular payment of interest and ultimate repayment of principal. Because insider trading rarely will affect either of these fruits, the covenant does not preclude it.

Delaware Chancellor Allen set out a more expansive standard in Oak Industries, which held that an implied covenant of good faith is always

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108. Id. at 1518.
present in corporate debt relationships. This implied covenant is breached when it is clear from the express terms of the indenture trust that the parties would have prohibited the challenged act had they thought to negotiate about it. Allen's standard is thus a bit broader, seemingly extending the covenant to conduct that does not directly threaten either the repayment of principal or regular payment of interest. In particular, Allen's analysis allows the implied covenant of good faith to address matters that affect the market price of the bonds. This requires, however, that there be express terms addressing such matters because only then could one draw the necessary inference that the parties would have proscribed the conduct in question had they bargained over the issue. Given the increasingly bare bones nature of indenture trust agreements, it seems unlikely that the language necessary for the covenant to bar insider trading by corporate officers will be present in very many cases.

In sum, the disclose or abstain rule should not apply to insider trading in debt securities. The requisite breach of duty by definition cannot be found because there simply is no fiduciary relationship between the corporation's agents and its bondholders.

B. Corporate Counsel

The Second Circuit treats the attorney-client relationship as a "hornbook" fiduciary relationship. Not surprisingly, lawyers that trade on confidential client information routinely incur insider trading liability without any meaningful analysis of whether their conduct violated their fiduciary duties. As I have argued elsewhere, however, one can construct

110. Id. at 880.

Professionals other than lawyers also have been subjected to liability without serious analysis. In United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990), the court determined that a psychiatrist violated the prohibition by trading on information learned from a patient. In determining that the requisite breach of fiduciary duty had occurred, the court relied in large measure on the Hippocratic Oath. In relevant part, the Oath reads: "Whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even apart therefrom, which ought not to be noised abroad, I will keep silence thereon, counting such things to be as sacred secrets." Id. at 272. While the Oath thus imposes a duty of
a perfectly plausible argument that insider trading by lawyers does not violate their fiduciary duties to their clients.  

To make a long argument as concise as possible, let us assume that a lawyer’s state law fiduciary obligations with respect to confidential client information are accurately stated by the American Law Institute’s Restatement of the Law Governing Lawyers. Unless the client expressly forbids self-dealing in confidential client information, insider trading violates the Restatement’s standard only if harm to the client results or is reasonably likely to result from the lawyer’s trading activity. Because insider trading often neither harms nor even threatens to harm clients, it frequently will be permitted by the Restatement’s provisions on client confidentiality.  

Indeed, the drafters admit as much, offering the following illustration:  

Lawyer represents Client, a multi-national corporation whose stock is traded on several national stock exchanges. In an otherwise legal transaction, Lawyer makes a $5,000 purchase of Client’s stock as a personal investment. In part, Lawyer is motivated by a favorable impression of Client’s management. Lawyer’s impression is based in part on confidential client information that Lawyer has gained through the course of representing Client.

For those of us trained as securities lawyers, this seems like a classic case of insider trading for which Lawyer should expect both securities law and disciplinary sanctions. The drafters, however, conclude that "Lawyer’s use of the confidential client information does not violate" the rules regulating confidential client information.

In view of this analysis, Lawyer also has not violated the federal insider trading prohibition. Because the law governing lawyers fails to proscribe Lawyer’s trading, the requisite breach of fiduciary duty simply is not present. Once again, reliance on state law fiduciary duty concepts thus

115. Bainbridge, supra note 113, at 8-16.
116. RESTATEMENT, supra note 114, at § 111 illus. 2.
117. Id.
118. Again, one might fall back on the misappropriation theory as a source of liability. In its classic form, the misappropriation theory was intended to capture cases in which the insider traded in the securities of a corporation with whom he had no fiduciary relationship. If a lawyer representing the bidder in an acquisition bought target stock, for example, the
precludes federal prosecution.

C. Corporate Officers and Directors

If there is any one group that everyone, excepting only a few academic opponents of the prohibition, agrees ought to be captured by the insider trading prohibition, it is surely true insiders — corporate directors and senior managers. Yet, recall the move that Justice Powell was obliged to make in Dirks. He simply asserted that the fiduciary duties of all corporate insiders forbid them from self-dealing in nonpublic information belonging to the corporation. The sole basis for this assertion ever mentioned in the opinion is the SEC's Cady, Roberts decision, which in turn was supported only by a purported common-law duty found in "some jurisdictions." Given the importance Dirks lays on the fiduciary duty element, Justice Powell's failure to provide any meaningful analysis or justification of this alleged rule is disturbing at best. In fact, on close examination, his reliance on Cady, Roberts disclose or abstain rule would not apply because the lawyer owes no fiduciary duties to the non-client target or its shareholders, but the misappropriation theory would apply. See, e.g., United States v. Elliott, 711 F. Supp. 425 (N.D. Ill. 1989); see also SEC v. Singer, 786 F. Supp. 1158 (S.D.N.Y. 1992) (lawyer used confidential client information to trade in stock of non-client corporation). The misappropriation theory, however, readily can be extended to cases in which the lawyer traded in the client's stock. See, e.g., United States v. Teicher, 987 F.2d 112, 117 (2d Cir. 1993), cert. denied, 114 S. Ct. 467 (1993) (investment bank employee charged with misappropriating information relating to client's forthcoming merger).

The sticking point, however, remains the requirement of a breach of fiduciary duty. Here we might usefully distinguish between solo practitioners and members of a law firm. In the former case, it will be necessary to show that the lawyer owed a fiduciary duty to the client. This will require a constructive insider analysis similar to that used under the disclose or abstain rule. As such, the solo practitioner can plausibly argue that his use of confidential client information did not breach any fiduciary duty. In the more common and important case of a lawyer working within a law firm, the logic of the misappropriation theory suggests that liability could be imposed even if the law firm owed no relevant fiduciary duty to the client, and thus would itself be free to trade, so long as the trading lawyer owes fiduciary duties to the law firm. Many law firms now subject their employees to explicit contractual obligations to refrain from trading in client stock. MARC I. STEINBERG, CORPORATE AND SECURITIES MALPRACTICE 93-94 (1992). At least one court has imposed liability under the misappropriation theory for violation of such a contractually based duty. United States v. Carpenter, 791 F.2d 1024, 1033-34 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987) (newspaper policy sufficed to impose liability on employee). This approach, however, creates the same institutional competence problems associated with extending insider trading liability to trading in debt securities. Alternatively, one might look to agency law to find the requisite fiduciary duty. This too is problematic, however, because one can make a plausible argument that insider trading is not a violation of the agent's fiduciary duty to the principal. See infra notes 154-58 and accompanying text.

and the supposed common-law duty proves an unusually thin rope upon which to hang the draconian penalties for violating the federal insider trading prohibition.

Consider first the fiduciary duty required for liability under the disclose or abstain rule. Are officers and directors subject to a fiduciary duty running to shareholders to refrain from self-dealing in nonpublic information belonging to the corporation? As a matter of state law, the answer is far from clear.

State common-law insider trading rules saw their most active period of development during the first three decades of this century. During that period three approaches to the insider trading problem emerged: The insider had no duty to refrain from self-dealing in nonpublic information belonging to the firm and thus could buy freely regardless of any informational advantage; the insider had no duty in the absence of "special circumstances" or "special facts" justifying the imposition of a duty; or the insider had a fiduciary duty to the shareholders and was required either to disclose any relevant inside information or to forgo trading.120

Prior to 1890 it was treatise law that "[t]he doctrine that officers and directors are trustees of the stockholders . . . does not extend to their private dealings with stockholders or others, though in such dealings they take advantage of knowledge gained through their official position."121 Because liability in such transactions could arise only from actual fraud, the dispositive question was whether the defendant said or did anything "to divert or prevent, and which did divert or prevent, the plaintiff from looking into, or making inquiry, or further inquiries, as to the affairs or condition of the company and its prospects for dividends."122

120. See generally Adolf Berle, Publicity of Accounts and Directors' Purchases of Stock, 25 Mich. L. Rev. 827 (1927); Beverly Lake, The Use for Personal Profit of Knowledge Gained While a Director, 9 Miss. L.J. 427 (1937); Clarence D. Laylin, The Duty of a Director Purchasing Shares of Stock, 27 Yale L.J. 731 (1918); Harold R. Smith, Purchase of Shares of a Corporation by a Director from a Shareholder, 19 Mich. L. Rev. 698 (1921); Robert Walker, The Duty of Disclosure by a Director Purchasing Stock from His Stockholders, 32 Yale L.J. 637 (1923); H.L. Wilgus, Purchase of Shares of a Corporation by a Director from a Shareholder, 8 Mich. L. Rev. 267 (1910). For a careful examination of the state common-law rules, which concludes that state courts were striving throughout the relevant time period to find ways of sanctioning insider trading, see Douglas M. Branson, Choosing the Appropriate Default Rule — Insider Trading Under State Law, __ Ala. L. Rev. __ (forthcoming).

121. Wilgus, supra note 120, at 267 (quoting 21 THE AMERICAN AND ENGLISH ENCYCLOPEDIA OF LAW 898 (2d ed. 1902)).

122. Carpenter v. Danforth, 52 Barb. 581, 589 (N.Y. App. Div. 1868); Wilgus, supra note 120, at 272-74 (discussing Carpenter); see also Grant v. Attrill, 11 F. 469 (S.D.N.Y. 1882)
After 1900, some courts continued to reject any fiduciary duty on the part of corporate officers and directors in their private dealings with shareholders, but the trend was toward the special circumstances rule and, to a lesser extent, the fiduciary duty rule. Although the former would prove more widely accepted than the latter, it was the latter that was first adopted by the courts. In 1903, for example, the Georgia Supreme Court adopted a fiduciary duty rule, holding that "where the director obtains the information giving added value to the stock by virtue of his official position, he holds the information in trust for the benefit of [the shareholders]." Similarly, in 1904, the Kansas Supreme Court approved the notion that a director had a duty to all shareholders to disclose material information about the corporation.

In 1909, the United States Supreme Court introduced the special circumstances rule in *Strong v. Repide*. In *Strong*, a director purchased shares from a stockholder at less than one-tenth of their potential value. In doing so, the director concealed both his identity and the imminent announcement of a profitable contract. The Court held that under such...
"special circumstances" the stockholder was entitled to recession or damages for fraud.\textsuperscript{127}

After \textit{Strong}, the trend was clearly towards the special circumstances rule. By 1937 one commentator, in fact, argued that the special circumstances rule had become the majority, or at least the plurality, rule and that the fiduciary duty rule had been adopted in a substantial minority of jurisdictions.\textsuperscript{128} Both rules continued to gather adherents thereafter.\textsuperscript{129}

While the special circumstances rule and the minority rule now probably represent the majority view, the no duty rule retains some adherents even amongst the modern decisions.\textsuperscript{130} In some states, the fiduciary duty necessary to make insider trading a violation of the federal securities laws thus is still absent. Even in those states where the special circumstances or fiduciary duty rules have been adopted, moreover, state law will often fail to supply the requisite duty because both rules are more limited in application than in doctrine.\textsuperscript{131} In particular, both rules applied only to face-to-face transactions.\textsuperscript{132} For our purposes, cases dealing with impersonal transactions conducted on secondary trading markets are far more relevant. The uniform state law approach in the secondary market context remained a no duty rule.

The leading stock exchange case is \textit{Goodwin v. Agassiz}.\textsuperscript{133} The defendants were directors and senior officers of a mining corporation. A geologist

\textsuperscript{127} Id. at 434-35. Larry Mitchell argues that the special circumstances rule was not based on fiduciary duty principles. \textit{Lawrence E. Mitchell, The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back, 52 Albany L. Rev. 775, 795-99 (1987)}. As Professor Mitchell concedes, however, the Supreme Court has consistently interpreted the special circumstances rule as arising out of fiduciary principles. \textit{Id. at 798 n.96}.

\textsuperscript{128} Lake, \textit{supra} note 120, at 448-49.

\textsuperscript{129} See, e.g., \textit{Broffe v. Horton}, 172 F.2d 489 (2d Cir. 1943) (diversity case); \textit{Childs v. RIC Group, Inc.}, 331 F. Supp. 1078, 1081 (N.D. Ga. 1970) (diversity case), aff'd, 447 F.2d 1407 (5th Cir. 1971); \textit{Hobart v. Hobart Estate Co.}, 159 P.2d 958 (Cal. 1945). An early line of federal cases arising under Rule 10b-5 applied the special circumstances and, more often, the fiduciary duty rules to face-to-face insider trading transactions. \textit{See, e.g., Kohler v. Kohler Co.} 319 F.2d 634 (7th Cir. 1963); \textit{Speed v. Transamerica Corp.}, 99 F. Supp. 808 (D. Del. 1951).


\textsuperscript{133} 186 N.E. 659 (Mass. 1933).
came up with a theory suggesting that there might be substantial copper deposits in northern Michigan. The company thought the theory had merit and began securing mineral rights options on the relevant tracts of land. Meanwhile, the defendants started buying shares on the market. The plaintiff was a former stockholder who had sold his shares on the market. The shares apparently had been bought by the defendants although, of course, neither side knew of the other's identity. Plaintiff later sued, arguing that he would not have sold if the geologist's theory had been disclosed.

The court rejected plaintiff's argument, holding that the defendants had no duty to disclose nonpublic information before trading in the firm's securities. That the trades took place on an impersonal secondary trading market was the central rationale of the court's holding. In the court's view, honest directors would be put in a difficult position if they were required to disclose everything they then knew about the corporation before trading in its stock.

Although it is now of considerable antiquity, at least by corporate law standards, Goodwin apparently remains the prevailing state law view. At least insofar as trading on secondary markets is concerned, the SEC thus seriously erred when it asserted in Cady, Roberts that the common law imposed fiduciary duties on corporate insiders that trade with shareholders. As we have seen, the law varied substantially from state to state, and even in the jurisdictions where the requisite duty existed, it was arguably limited to face-to-face transactions involving unusual fact situations. Justice Powell's treatment of the Cady, Roberts duty as the basis for imposing federal insider trading liability was thus something of a stretch.

Assuming state law imposes no duty running from insiders to shareholders when trading on secondary trading markets, insiders could still be held liable under the misappropriation theory if their trades violate a duty owed to the corporation to refrain from self-dealing in nonpublic corporate information. Here too, however, there is a perfectly respectable argument that insider trading by senior officers and managers is not a violation of their fiduciary duties to the corporation.

135. Id.
136. See generally 3A FLETCHER CYC CORP § 1168.1 (perm. ed. 1986). This is subject to the caveat, however, that many states in which the rule currently exists by virtue of cases decided long ago might not follow the rule if a case arose today. See infra note 162 and accompanying text.
Diamond v. Oreamuno is the leading case holding that insider trading violates the insider's fiduciary duties. In Diamond, the company's earnings were plummeting and the defendants used their advance knowledge of that fact to bail out of the stock. Once the decline in earnings was made public, the market price of the shares dropped by over half.

Plaintiff shareholder brought a derivative suit alleging that defendants had breached their fiduciary duties to the corporation. Although the court held that a corporate officer or director may not use nonpublic corporate information to personally profit by trading in the firm's securities, its rationale for that result is quite sparse. Stripped to its essentials, the analysis relied on three purportedly analogous doctrines: the insider trading prohibition under the federal securities law, the Delaware Chancery Court's decision in Brophy v. City Services Co., and the agency law rule that a person that acquires special knowledge or information by virtue of a confidential or fiduciary relationship may not exploit that information to make a personal profit. None of the three, however, provides a very convincing justification for Diamond's holding.

At the time Diamond was decided, the federal insider trading prohibition consisted of the short-swing profit rule under Exchange Act Section 16(b) and Rule 10b-5 as interpreted by the TGS and Cady, Roberts decisions. Neither had anything to do with the problem at hand. TGS was driven by concerns about access to information rather than breach of duty. Section 16(b) is a strict liability rule, as to which questions of fiduciary duty are simply irrelevant. So long as defendant's trades fall within the statutory six-month period and fall outside the various exemptions created by the SEC and the courts, the defendant loses even if his trades breached no duty to the corporation or its shareholders.

Brophy also offers little support for Diamond. In the first place, like Diamond, it relied on agency law concepts. As we shall see in a mo-

138. 70 A.2d 5 (Del. Ch. 1949).
140. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-52 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). A further complication is caused by the double liability that Diamond now permits because disgorgement actions will sound under both state and federal law. See Freeman v. Decio, 584 F.2d 186, 195 (7th Cir. 1978).
ment, agency law arguably does not support the *Diamond* result, although it may support *Brophy*’s.

In the second, *Brophy* is factually distinguishable from *Diamond*. The information on which the insider traded was the knowledge that the corporation was about to begin a stock repurchase program.\(^{143}\) In a sense, the insider was competing with the corporation, which agency and corporate law proscribe.\(^{144}\) Moreover, while the court did not require a showing of corporate injury, the insider’s conduct in fact directly threatened the corporation’s interests. If his purchases caused a rise in the stock price, the corporation would be injured by having to pay more for its own purchases.\(^{145}\)

In contrast, the *Diamond* insiders’ conduct involved neither competition with the corporation nor a direct threat of harm to it.\(^{146}\) The court made two moves to evade this problem. First, it asserted that proof of injury was not necessary in order for a breach of duty to be found.\(^{147}\) As we shall see, this is a plausible position, but also one that has not found uniform acceptance. Second, the court inferred that the corporation might have suffered some harm as a result of the defendants’ conduct, even though the complaint failed to allege any such harm. In particular, the court surmised that the defendants’ conduct might have injured the corporation’s reputation.\(^{148}\) As I have argued elsewhere, however, this is not a very likely source of corporate injury.\(^{149}\) This second move therefore is even less convincing then the first. As a result, *Diamond* does not necessarily follow from *Brophy*.

Finally, agency law constituted the third leg of *Diamond*’s supporting tripod. Like the other legs, however, it is at best problematic. According

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143. *Id.* at 7.

144. *Cf.* Conant, *supra* note 131, at 65 (insider’s conduct "was a breach of a confidential relation by an employee").

145. Freeman v. Decio, 584 F.2d 186, 194 (7th Cir. 1978). Admittedly, absent some leak, a single insider’s purchases are unlikely to have a significant price effect. *See* Bainbridge, *supra* note 113, at 10-11.

146. *See* Freeman, 584 F.2d at 194. The information in question related to a historical fact. As such, it simply was not information the firm could use. In particular, the only imaginable firm use for this information would be if the firm itself were to buy or sell its securities before announcing the decline in earnings. *As the Freeman court pointed out, the corporation could not lawfully trade in that manner.* *Id.*


148. *Id.*

to the Restatement of Agency, the principal-agent relationship is a fiduciary one with respect to matters within the scope of the agency relationship. More to the point for present purposes, Section 388 of the Agency Restatement imposes a duty on agents to account for profits made in connection with transactions conducted on the principal's behalf. The comments to that section further expand this duty's scope, requiring the agent to account for any profits made by the use of confidential information even if the principal is not harmed by the agent's use of the information.

Because the law of agency therefore appears to provide the requisite fiduciary duty, establishing the existence of an agency relationship also is generally assumed to suffice for imposing insider trading liability under the post-Chiarella federal prohibition.

One can plausibly argue, however, that the apparent bar on insider trading created by agency law is not as strict as it first appears. The broad prohibition of self-dealing in confidential information appears solely in the comments to Sections 388 and 395. In contrast, the black letter text of Section 388 speaks only of profits made "in connection with transactions conducted by [the agent] on behalf of the principal." One must stretch the phrases "in connection with" and "on behalf of" pretty far in order to reach insider trading profits. Similarly, Section 395, which speaks directly to the issue of self-dealing in confidential information, only prohibits the use of confidential information for personal gain "in competition with or to the injury of the principal." Arguably, agency law thus tracks the law governing lawyers in requiring an injury to the principal before a breach of fiduciary duty can be found.

This argument is supported by Freeman v. Decio, the leading case rejecting Diamond's approach. In Freeman, the court noted both Diamond and the position expressed in the comments to Sections 388 and 395, but nonetheless held that corporate officers and directors could not be held liable for insider trading as a matter of state corporate law without a show-
ing that the corporation was injured by their conduct. Under *Freeman*, insider trading by corporate insiders thus does not constitute a breach of duty absent a showing of injury to the corporation. As such, if incorporated into the federal prohibition, *Freeman* would provide an important escape valve for insiders.

Admittedly, the insiders’ state law arguments are not as strong in this context as they are vis-a-vis bondholders. As to the insiders’ duties to shareholders, the leading cases are now of considerable antiquity. More important, the trend in the case law was towards imposing fiduciary duties on insiders. Indeed, even *Goodwin* plausibly can be read as an application of the special circumstances, rather than the no duty, rule to secondary trading markets. Finally, the American Law Institute’s (ALI) corporate governance project opines that a duty to refrain from self-dealing in confidential corporate information exists in both face-to-face and stock exchange transactions. All of which suggests that some state courts might recognize such a duty if the issue arose today.

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157. *Freeman* v. Decio, 584 F.2d 186, 192-95 (7th Cir. 1978).

158. *Accord* Schein v. Chasen, 313 So. 2d 739 (Fla. 1975). Moreover, the duty in question is not the type of duty required by *Dirks*. See *Freeman*, 584 F.2d at 194 (suggesting that duty in question was more akin to duty of care than to duty of loyalty).

159. Professor Loss suggests that the "evolution of the common law toward the 'minority' view [the fiduciary duty rule] was aborted by the on-slaught of Rule 10b-5." LEWIS LOSs, FUNDAMENTALS OF SECURITIES REGULATION 820 (1983). If so, judicial adoption of this Article’s thesis can be expected to renew the development of state law, which may lead to a renewed evolution towards the no-duty rule. Indeed, Professor Branson suggests that such a trend is already visible. DOUGLAS M. BRANSON, CORPORATE GOVERNANCE 506-07 (1993); Branson, supra note 120. For a good discussion of the current state of the case law, along with a holding "that a director, who solicits a shareholder to purchase his stock and fails to disclose information not known to the shareholder that bears upon the potential increase in the value of the shares, shall be liable to the shareholder," see *Bailey v. Vaughn*, 359 S.E.2d 599, 605 (W.Va. 1987).

160. For example, the court’s analysis of the type of information in question concluded that the theory was "at most a hope." *Goodwin* v. Agassiz, 186 N.E. 659, 661 (Mass. 1933). Further, the court said that "in the circumstances" there was no affirmative duty to disclose. *Id*.

161. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.04(a) (Proposed Final Draft 1992) [hereinafter ALI PRINCIPLES]. Given the controversy that surrounded the ALI project, it is still too early to tell whether it will be regarded as authoritative on this and other corporate law issues. In any case, it is at least amusing that the only citation of support offered by the Reporter for the proposition that this duty extends to secondary market transactions is a "but see" cite to *Goodwin*. See *id*. at 377.

162. Cf. *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 375 (2d Cir. 1980)
At the very least, however, the insider's state law argument deserves to be taken seriously.

A similar situation prevails with respect to the insider's duties to the corporation. Although Diamond has not won universal acceptance, as illustrated by Freeman, the ALI's corporate governance project adopted the Diamond approach. Indeed, there is a perfectly plausible argument that Diamond was correctly decided. The Freeman court conceded that if all confidential information relating to the firm is treated as a corporate asset, then one need not show an injury to the corporation in order for the insider's trades to constitute a breach of duty. The court said, however, that doing so would put the cart before the horse. In its view, one should first ask whether there was any potential loss to the corporation before deciding whether to treat the information in question as a firm asset. In fact, however, there is a strong argument for treating all nonpublic information to which insiders become privy by virtue of their position as a firm asset. Nevertheless, the insider's state law argument must be taken seriously so long as Freeman remains on the books.

D. Summary

The central lesson of the analysis in this section should now be apparent. To the extent the federal insider trading prohibition depends upon state law fiduciary duty concepts, the prohibition's scope becomes substantially narrower than is usually assumed. Many classes of inside traders that now routinely suffer draconian penalties should escape liability. At a minimum, insider trading prosecutions become more complex. One must establish that the defendant was subject to the requisite fiduciary duty under applicable state law and that the defendant's conduct breached that duty.

To be sure, such an inquiry is not undertaken in current insider trading prosecutions. Why not? Perhaps in their mad rush to judgment, courts have simply ignored the complexity of the analysis mandated by Chiarella and Dirks. Alternatively, perhaps the requisite fiduciary duty is to be found somewhere other than in state law. The next section considers these possibilities.

(repeating no liability rule as applied by New Jersey state courts, albeit subject to caveat that New Jersey might no longer follow rule).

163. Id. at 361.

164. Freeman v. Decio, 584 F.2d 186, 193 (7th Cir. 1978).

165. See infra part VI.B.2.
VI. Should a Uniform Federal Rule Be Created?

Part II demonstrated that the history of the insider trading prohibition since TGS has been one of expansion and contraction. Aided and abetted by the lower federal courts, the SEC has consistently sought to expand the prohibition's scope. The Supreme Court twice called a halt to this process. On both occasions, however, the SEC and the lower courts found ways of complying with the letter of the Supreme Court's holdings, while evading their spirit.

This unwillingness to accept restrictions on the federal prohibition's scope may go a long way towards explaining the failure to give state law arguments the serious attention they deserve. As the preceding Part demonstrated, looking to state law for the requisite fiduciary duty makes the prohibition more complex and fragile than proponents of an expansive prohibition might like. But so what? The question is whether the state law rules just recounted have any role in the federal prohibition and, if so, what role they should be given.

The possible contraction and complication of the federal prohibition argues for creation of a unique federal rule only if incorporation of state law would frustrate some identifiable policy goal of the federal securities laws. Exploring this remaining issue is the task to which this Part is addressed.

A. The Traditional Justification for the Federal Prohibition

In order to determine whether incorporation of state fiduciary duties would frustrate important federal policies, such that a unique federal fiduciary duty should be created, we first must identify the reason insider trading is a matter of federal regulatory concern. As we shall see, none of the standard securities law policy arguments can justify the federal prohibition.166 Given that the prohibition itself cannot be justified on these grounds, it follows that any effect incorporating state law might have on these policies cannot justify creation of a unique federal fiduciary standard.

1. Congressional Intent

Recall that Justice Powell asserted in Dirks that "[a] significant purpose of the Exchange Act was to eliminate the idea that use of inside information
for personal advantage was a normal emolument of corporate office.\textsuperscript{167} This claim might be used to justify creating a uniform federal rule.\textsuperscript{168} As the argument would run, Congress established eliminating insider trading as an important federal policy, which would be undermined if the prohibition was forced to rely upon the vagaries of state law. This argument, however, proves too much.

Careful examination of the legislative history demonstrates that regulating insider trading was not one of the original purposes of the Exchange Act.\textsuperscript{168} Neither Section 10(b) nor Rule 10b-5 explicitly regulates insider trading or prohibits nondisclosure of inside information in insider trades. Instead, Congress addressed insider trading in Section 16(b), which permits the issuer of affected securities to recover insider short-swing profits.\textsuperscript{169} Section 16(b) imposes quite limited restrictions on insider trading. It does not reach transactions occurring more than six months apart, nor does it apply to persons other than those named in the statute or to transactions in securities not registered under Section 12.\textsuperscript{170} Given that Congress could have struck at insider trading both more directly and forcefully, and given that Congress chose not to do so, there is no statutory authority for the creation of a more sweeping

\begin{itemize}
\item 168. See generally Bainbridge, supra note 3, at 459-62; Michael P. Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. Rev. 1, 55-69 (1980); Frank H. Easterbrook, Insider Trading Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 317-20. The argument that neither Section 10(b) nor Rule 10b-5 originally prohibited insider trading, once made chiefly by academic opponents of the prohibition, has come to be recognized even by certain segments of the popular press. For example, as The Economist observed:
\begin{quote}
There was no attempt by the 1934 legislators to outlaw insider trading by stockbrokers, other insiders (and outsiders) who came into possession of privileged information. It was not until 1942 that the commission tackled the problem. It promulgated the so-called rule 10b-5 under the section of the 1934 act which allowed it to lay down rules to protect the public. But again, there was no specific mention of insider trading. The rule simply forbid securities trading based on fraudulent activity. It was to be left to the courts to decide what was and was not fraudulent.
\end{quote}
\item 170. Id.
\item 171. The first version of § 16 (§ 15 in draft) permitted corporate recovery of both insider and tippee short-swing profits and prohibited the tipping of confidential information by insiders. Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 9-10 (1934)
\end{itemize}
prohibition under Section 10(b).

To be sure, Section 10(b) is often described as a "catchall" intended to capture various types of securities fraud not expressly covered by more specific provisions of the Exchange Act.\textsuperscript{172} What the SEC catches under Section 10(b), however, must not only be fraud, but also within the scope of the authority delegated to it by Congress.\textsuperscript{173} Nothing in the legislative history suggests that Congress intended Section 10(b) to create a sweeping prohibition of insider trading.\textsuperscript{174} To the contrary, Section 10(b) received minimal attention during the hearings on the 1934 Act and was apparently seen simply as a grant of authority to the SEC to prohibit manipulative devices not covered by Section 9.\textsuperscript{175}

Indeed, if Congress intended in 1934 that the SEC use Section 10(b) to craft a sweeping prohibition on insider trading, the Commission was quite dilatory in doing so. Section 10(b) is not self-executing. It merely proscribes such fraudulent or manipulative devices as the SEC may prohibit by rule. Rule 10b-5, the foundation on which the modern insider trading prohibition rests, was not promulgated until 1942. Nor did the Commission


\textsuperscript{173} See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976) ("The rulemaking power granted to an administrative agency . . . is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'"); cf. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC Rule 19c-4 as exceeding scope of SEC's authority under Exchange Act Sections 14(a) and 19(c)).

\textsuperscript{174} See Dooley, supra note 168, at 55-59; Easterbrook, supra note 168, at 319. There is an oft-quoted passage in one of the Senate reports relating to the Exchange Act, which is usually read as indicating a congressional intent to proscribe insider trading. See S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934), quoted in House TSA Report, supra note 167, at 3, reprinted in 1984 U.S.C.C.A.N. at 2276. ("Among the most vicious practices unearthed at the hearings . . . was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities."). Dooley has demonstrated that this passage does not deal with insider trading as we understand the term today, but rather with manipulation. See Dooley, supra note 168, at 56 n.235.

\textsuperscript{175} See Dooley, supra note 168, at 59; Stock Exchange Regulation Hearing, supra note 171, at 115 (testimony of Thomas G. Corcoran, Reconstruction Finance Corp.) Corcoran described the predecessor to Section 10(b) as a prohibition on the invention of "any other cunning devices." Id.
FIDUCIARY DUTIES

begin using Rule 10b-5 to regulate insider trading on stock exchanges until the *Cady, Roberts* decision in 1961.\(^{176}\) Even in *Cady, Roberts*’s wake there were those who thought it did not presage general application of Rule 10b-5 to insider trading.\(^{177}\) As we now know, that short-lived expectation died with *SEC v. Texas Gulf Sulphur Co.*\(^{178}\) The point remains, however, that the federal insider trading prohibition is a relatively recent administrative and judicial creation lacking any significant statutory basis: "In regulating insider trading under rule 10b-5 the lower federal courts and the SEC have been operating without benefit of support from the legislative history of the 1934 Act or from the language of section 10(b). In plainer words, they have exceeded their authority."\(^{179}\)

Since Professor Dooley wrote those "plainer words," of course, Congress has twice amended the Exchange Act for the specific purpose of enhancing the penalties associated with insider trading.\(^{180}\) In so doing, it has

\(^{176}\) In re *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Dooley argues that prior to *Cady, Roberts*, the SEC apparently did not view Rule 10b-5 as governing insider trading, citing among other things a lengthy article on insider trading coauthored by then SEC Chairman Cook that does not even mention Rule 10b-5. See Dooley, supra note 168, at 61 (citing Donald C. Cook & Myer Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 612 (1953)). This appears to be true, insofar as insider trading on public secondary markets is concerned. The handful of Rule 10b-5 decisions cited as precedent by *Cady, Roberts* uniformly involved face-to-face transactions or control transactions. See, e.g., *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (omissions in connection with what amounted to tender offer); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (sale of control negotiated face to face); *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943) (same). As such, they do not support extension of Rule 10b-5 or Section 10(b) to modern insider trading violations on impersonal stock exchanges. Interestingly, in a pre-*TGS* case arising under Rule 10b-5, the Seventh Circuit applied the special circumstances rule to a face-to-face transaction, which confirms that there was no general bar on insider trading prior to *TGS*. See *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963).

\(^{177}\) See, e.g., *Recent Decision*, 48 Va. L. Rev. 398, 403-04 (1962) ("[I]n view of the limited resources of the Commission, the unfortunate existence of more positive and reprehensible forms of fraud, and the inherent problems concerning proof and evidence adhering to any controversy involving a breach of duty of disclosure, there is little prospect of excessive litigation evolving pursuant to [*Cady, Roberts*]."). But see Comment, *Broker Silence and Rule 10b-5: Expanding the Duty to Disclose*, 71 Yale L.J. 736, 747 (1962) ("While the SEC confined itself to a holding on the narrow situation in the present case, it is likely that the [*Cady, Roberts*] decision is a warning that it will move in the direction of expanding the scope of liability.").


\(^{179}\) Dooley, supra note 168, at 59.

consistently encouraged vigorous SEC enforcement of the federal insider trading prohibition.\textsuperscript{181} This sort of ex post facto indication of legislative intent is usually viewed skeptically.\textsuperscript{182} In this instance, however, the recent amendments appear to be an authoritative congressional endorsement of the insider trading prohibition. It is therefore worth taking a close look at what those amendments did and, more important, what they did not do.

Where Congress has revised a statute without reversing prior on-point judicial holdings, that failure has been taken as evidence of congressional approval of those holdings.\textsuperscript{183} On neither of the occasions on which it has amended the Exchange Act to address insider trading did Congress see fit to reverse either Rule 14e-3 or the misappropriation theory. To the contrary, the legislative history of both acts is replete with statements of congressional approval of those theories.\textsuperscript{184} Indeed, Section 2 of the 1988 Insider Trading and Securities Enforcement Act provides a congressional finding that the SEC's rules "governing trading while in possession of material, nonpublic information are, as required by the Act, necessary and appropriate in the public interest and for the protection of investors."\textsuperscript{185} The House Report further states that "[t]hese findings are intended as an expression of congressional support for these regulations."\textsuperscript{185}

On the substantive level, the 1988 Act overruled Moss v. Morgan, \textit{Stanley, Inc.},\textsuperscript{187} in which the Second Circuit had held that private parties did not have standing to sue under the misappropriation theory. The 1988 Act

\begin{footnotesize}
\textsuperscript{184} E.g., H.R. Rep. No. 910, supra note 181, at 10, 26; H.R. Rep. No. 355, 98th Cong., 1st Sess. 4-5 (1983). In 1987, Congress considered proposals to statutorily define insider trading. Rosenbaum & Bainbridge, supra note 2, at 233. At that time, the SEC argued that a definition was not needed. \textit{Id.} SEC General Counsel Daniel L. Goelzer, however, told the Senate Securities Subcommittee that if \textit{Carpenter} invalidated the misappropriation theory, the SEC would have "a desperate need" for legislation re-establishing it. \textit{Id.} at 231 n.21. The Supreme Court's failure to do so probably explains the 1987 bill's demise, which further buttresses the sense of congressional approval of the present regime.
\end{footnotesize}
expressly created a private party cause of action for insider trading cases. Because a private party cause of action existed as to all other types of insider trading violations, Congress's action amounts to an express legislative endorsement of the misappropriation theory.

In light of this evidence of congressional support, Rule 14e-3 and the misappropriation theory ought to be immune from legal challenge, Bryan notwithstanding. One nevertheless should not read too much into the 1984 and 1988 amendments. While both acts treat insider trading as a matter of federal concern, neither addresses the substantive definition of insider trading in any meaningful way. At most, all Congress did in these acts was to endorse the misappropriation and Rule 14e-3 theories of liability. Other than purporting to resolve any doubts as to their validity, both acts left the task of defining insider trading to the courts.

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189. Larry Mitchell argues that the 1988 Act's standing provisions implicitly overruled Chiarella. Mitchell, supra note 127, at 838. Professor Mitchell is undoubtedly correct in arguing that the 1988 Act's standing provisions at least illustrate, and at worst exacerbate, the doctrinal incoherence of the modern federal insider trading prohibition. See id. at 777-78. Nevertheless, Professor Mitchell's argument that the 1988 Act has substantive implications for the definition of insider trading is unpersuasive for two reasons: First, it directly conflicts with the clearly stated congressional intent to avoid defining or even affecting the substantive definition. Second, it is unsupported by subsequent judicial opinions. Professor Mitchell's argument is based on a distinction between regulation of conduct and effects. Id. at 785-89. He asserts that the 1988 Act implicitly endorses an effects-based regulatory scheme, which thereby returns the law to its pre-Chiarella state. Id. at 838. Subsequent cases, however, continue to apply a conduct-based definition of insider trading. E.g., United States v. Chestman, 947 F.2d 551 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992).

190. Bainbridge, supra note 3, at 472-73; Stuart J. Kraswell, An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988, 45 Bus. Law. 145, 157-58 (1989). Congress did so mainly because insider trading is difficult to define with precision. Congress also was concerned that even if a clear statutory definition could be devised, inside traders would find ways of evading it. Bainbridge, supra note 3, at 472-73; Kraswell, supra, at 150-51. Accordingly, Congress deliberately left the definition of insider trading as vague and unconstrained as possible. In light of the draconian penalties associated with insider trading after the 1984 and 1988 acts, however, this decision raises troubling vagueness concerns. As Jonathan Macey bluntly put it, "opposition to a clear, fixed definition for the crime of insider trading constitutes nothing less than a naked power grab by the SEC, a move obviously at odds with the most elemental notions of justice and fair play." JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 64 (1991). Or as Ed Kitch put it, somewhat less bluntly, "[t]he fact that the agency finds it more comfortable to avoid the discipline of defining the offense before bringing the charge is no reason for eschewing the increased fairness and deterrent efficacy that would flow from the exercise." Edmund W. Kitch, A Federal Vision of the Federal Securities Laws, 70 Va. L. Rev. 857, 861 (1984).
Even if the 1984 and 1988 acts should be seen as a congressional endorsement of the then-existing judicial definition of insider trading, moreover, consider what those acts endorsed: An incoherent body of law in which state law fiduciary duty principles arguably had some role, but whose role had not been clearly defined. As such, Congress's action in amending the statute need not be read as foreclosing the use of state law fiduciary duties as the rule of decision. Indeed, it is noteworthy that courts which have addressed the fiduciary duty question since the 1984 and 1988 acts have continued to make at least referential use of state law rules. The definitional problem thus remains a matter of federal common law. Defining insider trading, moreover, remains a matter as to which state fiduciary duty principles may be looked to as the rule of decision.

2. Federal Securities Law Policy and Insider Trading

In the absence of specific congressional guidance, the definition of insider trading should be determined by reference to the broader policy goals of the federal securities laws. To pose the question somewhat differently, do the general purposes of the securities laws require a uniform federal rule of decision? Commentators have put forth various rationales for regulating insider trading. Only three, however, are directly related to the purposes of the securities laws: protection of the mandatory disclosure system, protection of investors, and maintaining public confidence in the securities market. None of these goals is advanced by regulating insider trading, just as none would be frustrated by deregulating insider trading. A fortiori, none stands as a bar to incorporation of state law fiduciary duties.

a. Insider Trading and the Mandatory Disclosure System

Mandatory disclosure is arguably the central purpose of the federal securities laws. Both the Securities Act and the Exchange Act are based on a policy of mandating disclosure by issuers and others. The Securities Act creates a transactional disclosure regime, which is applicable only when a firm is actually selling securities. In contrast, the 1934 Exchange Act.

191. See supra notes 89-94 and accompanying text.
192. See generally Bainbridge, supra note 36, at 49-63.
193. Professor Thel contends that the "fundamental purpose of the [Exchange] Act" is "to protect the public's interest in the integrity of security prices." Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385, 392 (1990). Even if this is the true purpose of the Act, insider trading is not implicated by it. See infra part VI.A.2.b.
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creates a periodic disclosure regime, which requires on-going, regular, disclosures.¹⁹⁴

Neither Act requires a firm to disclose all nonpublic information relating to the firm.¹⁹⁵ Instead, when premature disclosure would harm the firm's interests, the firm is generally free to refrain from disclosing such information.¹⁹⁶ Even proponents of the mandatory disclosure system acknowledge that it is appropriate to strike this balance between "investors' needs for disclosure [and] management's legitimate need for secrecy."¹⁹⁷

According to Professor Roberta Karmel, the federal insider trading prohibition is necessary to the effective working of the mandatory disclosure system. She posits that the prohibition ensures "that confidentiality is not abused and utilized for the personal and secret profit of corporate managers and employees or persons associated with a bidder in a tender offer."¹⁹⁸ Many reputable corporate law scholars, of course, doubt whether mandatory disclosure is a sound policy.¹⁹⁹ If the mandatory disclosure system ought to be done away with, Karmel's argument collapses at the starting gate. For present purposes, however, I take the mandatory disclosure system as a given and limit my inquiry to whether a prohibition of insider trading is necessary to protect the mandatory disclosure system from abuse.

Karmel offers several different rationales for her claim that an insider trading prohibition is a necessary supplement to the mandatory disclosure system. At one point in the analysis, she opines that such a prohibition is necessary "to preserve the fairness, honesty and integrity of the public securities markets."²⁰⁰ This argument adds little, if anything, to the claims that an insider trading prohibition is necessary to protect investors and preserve public confidence in the integrity of the markets. Because those claims are wrong, as the following sections demonstrate, this prong of Karmel's argument falls with them.

¹⁹⁶. Id. at 170.
¹⁹⁷. Id.
¹⁹⁸. Id. at 170-71.
At another point in the analysis, Karmel asserts that an insider trading prohibition is necessary to prevent managers from reaping "secret" profits. In the first place, absent a violation of fiduciary duty, secret profits are wholly unproblematic. In the second place, what does taking of secret profits have to do with the mandatory disclosure regime? Mandatory disclosure is intended to get material information to investors in a timely fashion. If managers profit from nonpublic information, but their trading activities do not affect the timing of disclosure, investors will receive information at the same time as they would have received it in the absence of insider trading. As such, so long as the timing of disclosure is not affected, the mandatory disclosure regime’s principal goal is unaffected by insider trading.

The insider trading prohibition thus is relevant to the mandatory disclosure regime only insofar as it affects managers’ incentives to manipulate the timing of disclosure. From this perspective, Karmel’s argument fails on both explanatory and justificatory grounds. True, unwarranted delays in disclosing corporate information result in social costs. Despite the strong bias in the federal securities laws towards prompt disclosure of material developments, there are many circumstances in which the firm is permitted to delay disclosure, such as when it could be preempted by competitors or otherwise would be unable to take advantage of the development. This type of delay reduces market efficiency, but is justified because prompt disclosure in such circumstances would reduce the firm’s incentive to produce socially valuable information. The resulting loss of market efficiency, however, requires that the delay be no longer than necessary for the firm to capture the development’s value.

While insider trading poses some risk of causing this sort of delay, the risk is undoubtedly quite minimal. The available empirical evidence suggests that measurable delay attributable to insider trading is rare. This

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201. Id. at 170-71.
202. Michael Dooley points out that insider trading can be treated as a compensation question, which may lead to disclosure problems. Insider compensation is one of the many items of mandatory disclosure under the SEC’s regulations. Failure to disclose insider trading profits thus might be treated as a material omission, which would give rise to a claim for fraud. DOOLEY, supra note 132, at IV-221. This does not necessitate a prohibition of insider trading, however, just enforcement (or, at most, expansion) of the Exchange Act’s existing rules on disclosure of insider trading profits.
203. See Karmel, supra note 195, at 171 ("information must be made publicly available to investors as soon as its dissemination will no longer do more harm than good to shareholders . . . .").
205. Dooley’s 1980 survey of the 37 reported insider trading decisions between 1966 and
finding is not particularly surprising. Given the rapidity with which securities transactions can be conducted in modern secondary trading markets, an insider need at most delay disclosure long enough for a five-minute telephone conversation with his stockbroker. Even if the insider wished to cover his tracks by trading through an elaborate network of offshore shell corporations, very little delay is entailed once the network is up and running. Delay also often will be readily detectible by the insider's supervisors.

In fact, insider trading seems more likely to create incentives for insiders to prematurely disclose information than to delay its disclosure. Suppose the firm enters into merger negotiations with a potential acquirer. An insider with power to affect the timing of disclosure trades on that information. Having made his purchase, the insider has an incentive to cause disclosure of the firm's plans as soon as possible. Absent leaks, the merger will have no price effect until it is disclosed to the market, at which time there usually is a strong positive effect. Once the information is disclosed the insider will be able to reap substantial profits, but until disclosure takes place he bears a variety of firm-specific and market risks. The deal, the stock market, or both may collapse at any time. Early disclosure enables him to minimize those risks by selling out as soon as the price jumps in response to the announcement. While premature disclosure threatens the firm's interests, that threat has little to do with the mandatory disclosure system. Instead, it is properly treated as a breach of the insider's fiduciary duty.

Finally, if the concern really is ensuring timely disclosure, the insider trading prohibition sweeps far too broadly. As we have seen, the prohibition encompasses a host of actors both within and outside the firm. In contrast, only a few actors are likely to have the power to affect the timing of disclosure. A much narrower prohibition thus would suffice if this were the true reason for regulating insider trading. Indeed, if this were the real concern, one need not proscribe insider trading at all. Instead, one could strike at the problem much more directly by proscribing failing to disclose material information in the absence of a legitimate corporate reason for doing so.

1980 found but a single case in which disclosure was delayed. Dooley, supra note 168, at 34.

206. Cf. Bainbridge, supra note 113, at 9-10 (arguing that few lawyers are in position to affect timing of disclosure). More junior executives and outsiders could affect the timing of disclosure by delaying transmission of information to their superiors. Upon close examination, however, this concern is overstated. Id.
b. Investor Protection and Maintenance of Confidence in the Markets

The purposes of the Securities Exchange Act generally and Section 10(b) in particular are usually said to be the protection of investors and the maintenance of public confidence in the securities markets through the imposition of disclosure requirements and prohibitions of fraud. If so, the insider trading prohibition seems quite out of place in the federal securities laws. Neither policy justifies a ban on insider trading, nor can either policy explain the state of the law.

i. Investor Protection

The goal of investor protection implicitly assumes that the regulated conduct harms investors. This is simply not true with respect to insider trading. See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) ("The fundamental purpose of the 1934 Act is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor."); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974); In re Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

207. The Supreme Court has sometimes stated a more expansive version of the investor protection purpose of the securities laws, claiming that they are intended to protect "the investing public and the national economy through the promotion of 'a high standard of business ethics . . . in every facet of the securities industry.'" Bateman Eichler, Hill Richards, Inc. v. Bemer, 472 U.S. 299, 315 (1985). Some scholars question whether insider trading is necessarily unethical. See, e.g., Easterbrook & Fischel, supra note 199, at 261-62; Jonathan R. Macey, Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm, 11 HARV. J.L. & PUB. POL'Y. 785 (1988). Others, however, regard insider trading as falling short of ethical standards. See Bainbridge, supra note 113, at 39-40; Dooley, supra note 168, at 55. But even if insider trading is inconsistent with a high standard of business ethics, many unethical practices in fact lie outside the scope of the securities laws. Indeed, the Court has observed of insider trading itself that:

Depending on the circumstances, and even when permitted by law, one's trading on material nonpublic information is behavior that may fall below ethical standards of conduct. But in a statutory area of the law such as securities regulation, where legal principles of general application must be applied, there may be "significant distinctions between actual legal obligations and ethical ideals."

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trading. Insider trading is said to harm the investor in two principal ways. Some contend that the investor's trades are made at the "wrong price." A more sophisticated argument is that the investor is induced to make a bad purchase or sale. Neither proves convincing on close examination.

An investor that trades in a security contemporaneously with insiders having access to material nonpublic information likely will allege injury in that he sold at the wrong price; that is, a price that does not reflect the undisclosed information. If a firm's stock currently sells at $10 per share, but after disclosure of the new information will sell at $15, a shareholder who sells at the current price thus will claim a $5 loss. The investor's claim, however, is fundamentally flawed. It is purely fortuitous that an insider was on the other side of the transaction. The gain corresponding to shareholder's "loss" is reaped not just by inside traders, but by all contemporaneous purchasers whether they had access to the undisclosed information or not.

To be sure, the investor might not have sold if he had had the same information as the insider, but even so, the rules governing insider trading are not the source of his problem. Irrespective of whether insiders are permitted to inside trade or not, the investor will not have the same access to information as the insider. In the former case, the insider will not disclose before trading. In the latter, assuming perfect deterrence, the insider will not trade, but the information will still remain confidential.

Unless immediate disclosure of material information is to be required, a step the law has been unwilling to take, there will always be winners and losers in this situation. Surely then it makes little sense to claim that the shareholder is injured when his shares are bought by an insider, but not when they are bought by an outsider without access to information. To the extent the selling shareholder is injured, his injury is correctly attributed to the rules allowing corporate nondisclosure of material information, not to insider trading.

The more sophisticated argument is that the price effects of insider trading induce shareholders to make poorly advised transactions, but this argument too is flawed. In the first instance, insider trading rarely

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209. As we shall see, disparities in access to information are a major contributor to the perception of unfairness associated with insider trading. See infra note 223 and accompanying text. A sense of unfairness, however, is not the same as an actual injury.

210. The flip side of the inducement argument is that insider trading may preempt investors from making beneficial trades. Professor Wang argues that:

Instead of inducing opposite trade transactions, an inside trade may preempt trades of the same type. When an inside trade directly or indirectly changes a specialist/market-maker's inventory, the new pattern of quotations may either
produces the sort of price effects necessary to induce shareholders to trade. The stock of any given corporation "represents only a particular combination of expected return and systematic risk, for which there is a vast number of substitutes." The correct measure for the supply of securities thus is not simply the total of the firm's outstanding securities, but the vastly larger number of securities with a similar combination of risk and return. Supply and demand effects caused by insider trading therefore cannot have a significant price effect.

Gilson and Kraakman argue that the price effect of insider trading is an example of what they call the "derivatively informed trading mechanism" of market efficiency. Derivatively informed trading affects market prices through a two-step mechanism. First, those possessing material nonpublic information begin trading. Their trading has only a small price effect. Next, the market gradually reacts, provided there is leakage or tipping of the information, observation of insider trades by otherwise uninformed traders, or following of price fluctuations by uninformed traders. The problem is that while derivatively informed trading can affect price, the effects occur slowly and sporadically. Given the inefficiency of derivatively informed trading, price or volume changes resulting from insider trading thus will only rarely be of sufficient magnitude to induce investors to trade.

induce new transactions or ones that would otherwise have occurred. For example, if an inside trade increases a market-maker's inventory, he may lower his price quotations to encourage purchases from him and deter sales to him. If an inside trade decreases the market-maker's inventory, he may increase his prices to encourage sales to him and deter purchases from him.

William Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets, 54 S. Cal. L. Rev. 1217, 1236 (1981). This is a sophisticated argument, but is likely to be important only when the market for the corporation's shares is unusually thin or the insider's trades are usually large. Only in those instances is the price or volume effect of insider trading likely to have the effect Wang suggests.

212. See id.; see also Easterbrook, supra note 168, at 335-37.
213. Gilson & Kraakman, supra note 211, at 630.
214. Id. at 572-79.
215. Id. at 631.
216. The empirical evidence tends to support this view. Early market studies indicated that insider trading had an insignificant empirical effect on price in most cases. See Roy A. Schotland, Unsafe at Any Price, 53 Va. L. Rev. 1425, 1443 (1967) (citing studies). A more recent study found that while insider transactions were followed by a strong price effect, such transactions were only rarely based on exploitation of nonpublic information. Dan Givoly & Dan Palmon, Insider Trading and the Exploitation of Inside Information: Some Empirical
Assuming for the sake of argument that insider trading produces noticeable price effects, however, and further assuming that some investors are misled by those effects, the inducement argument is further flawed because many transactions would have taken place regardless of the price changes resulting from insider trading. Those investors benefitted from insider trading because they purchased at a price closer to the "correct" price—the price that would prevail if the information were disclosed. In any case, it is hard to tell how the inducement argument plays out when investors are examined as a class. For any given number that decide to sell because of a price rise, another group of investors may decide to defer a planned sale in anticipation of further increases.

ii. Maintaining Confidence in the Markets

In the absence of a credible investor injury story, the protection of investors goal of the federal securities laws does not justify a uniform federal fiduciary standard. The lack of investor injury also undercuts the related goal of maintaining investor confidence in the integrity of the securities markets. If investors are not injured by insider trading, why should insider trading affect their confidence in the securities markets?

There is no denying that many, if not most, investors are angered by insider trading. A Business Week poll, for example, found that 52% of

Evidence, 58 J. Bus. 69 (1985). Finally, the SEC's chief economist has reached the debatable conclusion that pre-announcement price and volume run-ups in takeovers are most likely attributable to factors other than insider trading. See Rosenbaum & Bainbridge, supra note 2, at 235.

On the other hand, a more recent study of insider trading cases brought by the SEC during the 1980s found that insider trading led to quick price changes. Lisa Meulbroek, An Empirical Analysis of Illegal Insider Trading, 47 J. Fin. 1661 (1992). The author attributes this result in part to the increase in trading volume resulting from insider trading, which in turn is detected by market professionals who then begin trading. Id. at 1695. It is worth noting, however, that many of the SEC's insider trading cases during the relevant period resulted from computer analysis of stock market activity. See Securities Regulation Issues, Hearings Before the Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce, 100th Cong., 1st Sess. 89-96 (1987). As such, despite the author's attempt to control for selection biases, it seems likely that the study remains inherently biased towards cases in which insider trading produced noticeable volume effects, which in turn suggests that it may not be a reliable predictor of whether insider trading generally has significant price effects.


219. As Professor Coffee pointedly observed, "No contemporary observer can mistake
the respondents wanted insider trading to remain unlawful.\textsuperscript{220} As I have argued elsewhere, this anger can damage the reputation of particular firms.\textsuperscript{221} If so, perhaps the same feelings also could affect investors' confidence in the markets.

In order to determine whether investor anger over insider trading in fact undermines their confidence in the markets, one must first identify the source of that anger. A Harris poll found that 55\% of the respondents said they would inside trade if given the opportunity.\textsuperscript{222} Of those who said they would not trade, 34\% said they would not do so only because they would be afraid the tip was incorrect. Only 35\% said they would refrain from trading because insider trading is wrong. Here then lies one of the paradoxes of insider trading. Most people want insider trading to remain illegal, but most people (apparently including at least some of the former) are willing to participate if given the chance to do so on the basis of accurate information. This paradox is central to evaluating arguments based on confidence in the market. Investors that are willing to inside trade if given the opportunity obviously have no confidence in the integrity of the market in the first instance. Any anger they feel over insider trading therefore has nothing to do with a loss of confidence in the integrity of the market, but instead arises principally from envy of the insider's greater access to information.\textsuperscript{223}

The loss of confidence argument is further undercut by the stock market's performance since the insider trading scandals of the mid-1980s. The enormous publicity given those scandals put all investors on notice that insider trading is a common securities violation. If any investors believe that the SEC's enforcement actions drove insider trading out of the markets, they are beyond "mere legal help."\textsuperscript{224} At the same time, however, the years since

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\textsuperscript{220} LANGEVOORT, supra note 89, at 8 n.8. This is, of course, something short of an overwhelming majority. Hence, at the outset, one must be careful not to overstate the extent to which investors are angered by insider trading.

\textsuperscript{221} Bainbridge, supra note 113, at 14-16.

\textsuperscript{222} DOOLEY, supra note 132, at IV-256.

\textsuperscript{223} "Under any 'game' theory of the market, a player is likely to consider unfair any advantage gained by his competitors that he not only does not have, but that he cannot obtain." J. A. C. Hetherington, Insider Trading and the Logic of the Law, 1967 Wis. L. Rev. 720, 721.

\textsuperscript{224} Cf. Dooley, supra note 168, at 35 ("If there are any [sophisticated investors] who are still unaware that otherwise unexplained market movements may be caused by insider trading they are beyond merely legal help.").
the scandals have been one of the stock market’s most robust periods. One can but conclude that insider trading does not seriously threaten the confidence of investors in the securities markets.

iii. The Anomalies

The preceding sections demonstrated that the investor protection and confidence in the market rationales do not justify an insider trading prohibition. These rationales prove equally unconvincing from an explanatory perspective. Under current law, investors’ rights vary widely depending on the identity of the trader, the nature of the inside information, and the source of that information. If investor protection or confidence in the market were the real issues, the relevance of such factors would be hard to justify. As such, neither policy necessitates creation of a unique federal fiduciary duty.

Consider United States v. Carpenter, the leading misappropriation case. R. Foster Winans wrote the Wall Street Journal’s "Heard on the Street" column, a daily report on various stocks that is said to affect the price of the stocks discussed. Journal policy expressly treated the column’s contents prior to publication as confidential information belonging to the newspaper. Despite that rule, Winans agreed to provide several co-conspirators with prepublication information as to the timing and contents of future columns. His fellow conspirators then traded in those stocks based on the expected impact of the column on the stocks’ prices, sharing the profits.

Winans and his co-conspirators were convicted of securities, mail, and wire fraud for their participation in this scheme. In affirming their convictions, the Second Circuit held that Winans’s breach of his fiduciary duty to the Wall Street Journal satisfied the standards laid down by the

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225. Near the end of 1985, the Dow Jones Industrial Average stood at 1550. N.Y. TIMES, Dec. 11, 1985, at D7. As of this writing, the Dow stands at almost three times that level.

226. The experience of other countries confirms this conclusion, although one of course must be cautious in using such evidence in light of cultural and historical differences. For example, Japan only recently began regulating insider trading and its rules are not enforced. Hong Kong has repealed its insider trading prohibition. Both have vigorous and highly liquid stock markets. See Macey, supra note 190, at 44. Macey also convincingly argues that regulating insider trading may in fact do more harm to investor confidence than would deregulating it. Id. at 42-44.


Supreme Court in *Chiarella* and *Dirks.* From either an investor protection or confidence in the market perspective, however, this outcome seems bizarre at best. For example, any duties Winans owed in this situation ran to an entity that had neither issued the securities in question nor even participated in stock market transactions. What Winans’s breach of his duties to the Wall Street Journal has to do with the federal securities laws is thus not immediately apparent.

The incongruity of the misappropriation theory becomes even more apparent when one considers that its logic suggests that the Wall Street Journal could lawfully trade on the same information used by Winans. If we are really concerned with protecting investors and maintaining their confidence in the market’s integrity, the inside trader’s identity ought to be irrelevant. From the investors’ point of view, insider trading is a matter of concern only because they have traded with someone who used their superior access to information to profit at the investor’s expense. As such, it would not appear to matter whether it is Winans or the Journal on the opposite side of the transaction. Both have greater access to the relevant information than do investors.

The logic of the misappropriation theory also suggests that Winans would not have been liable if the Wall Street Journal had authorized his trades. In that instance, his trades would not have constituted an improper conversion of nonpublic information and the essential breach of fiduciary

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229. On certiorari, the Supreme Court affirmed the convictions on securities, mail, and wire fraud. Carpenter v. United States, 484 U.S. 19 (1987). Because the Court affirmed the securities fraud convictions by an evenly divided four-four vote, the decision did not address the validity of the misappropriation theory. Rosenbaum & Bainbridge, *supra* note 2, at 232.

230. Rosenbaum & Bainbridge, *supra* note 2, at 242 n.85. In Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.), cert. denied, 423 U.S. 1025 (1975), the Ninth Circuit held that a newspaper columnist had a duty to disclose his financial stake in the impact of his columns. As the *Carpenter* court implicitly acknowledged, however, *Zweig* probably did not survive *Chiarella.* *Carpenter,* 791 F.2d at 1034.

231. See Rosenbaum & Bainbridge, *supra* note 2, at 242 n.85 (criticizing this result); cf. *Carpenter,* 791 F.2d at 1033 (recognizing this interpretation’s possibility, but declining to rule on its validity).

232. See *supra* note 223 and accompanying text.

233. Whether the owner of nonpublic information could authorize someone else to use it for trading purposes is an interesting open issue under the misappropriation theory. See Langevoort, *supra* note 89, at 194-95. If the deciding court adheres to the misappropriation theory’s internal logic, authorized trading should not result in liability. The requisite conversion of information simply is not present. If courts are simply using the misappropriation theory to comply with the letter of the *Chiarella-Dirks* framework while closing the loopholes it creates, however, they will find a way to punish authorized trading.
duty would not be present. Again, however, from an investor's perspective, it would not seem to matter whether Winans's trades were authorized or not.

Finally, conduct that should be lawful under the misappropriation theory is clearly proscribed by Rule 14e-3. A takeover bidder may not authorize others to trade on information about a pending tender offer, for example, even though such trading might aid the bidder by putting stock in friendly hands.234 If the acquisition is to take place by means other than a tender offer, however, Rule 14e-3 will not apply and the misappropriation theory should not either. From an investor's perspective, however, the form of the acquisition seems just as irrelevant as the identity of the inside trader.

As the saying goes, this is no way to run a railroad. Yet these anomalies only begin to scratch the surface. A host of other oddities and incongruities have crept into the federal insider trading prohibition in the years since Chiarella.235 All of them are a direct result of Chiarella's imposition of a fiduciary duty requirement. None of them are easily explicable from either an investor protection or a confidence in the market rationale.

B. Devolution Versus Incorporation

As the preceding section demonstrated, insider trading significantly implicates none of the principal purposes of the federal securities laws and, therefore, it cannot be said that important federal policies would be frustrated if state law were incorporated into the prohibition. Indeed, to the contrary, the analysis to this point undoubtedly appears to be more an argument for devolving responsibility for insider trading back to the states, than one for incorporating state fiduciary duties into the federal prohibition. Much of the analysis that follows, moreover, will buttress that impression. There are, however, good reasons for thinking that the latter course is preferable. First, political reality: Although the modern insider trading prohibition was created by courts, Congress has brought insider trading within the statutory scope of the securities laws. Accordingly, while courts remain free to define insider trading, they are no longer free to do away with the federal prohibition itself. Major reform, such as devolution, thus must come from Congress. But one can tell a fairly straightforward public choice story about insider trading, which reveals that a federal prohibition has strong interest group support, while there simply is no proreform constituency. Second, one can also tell a fairly convincing story that outlines a

234. Rosenbaum & Bainbridge, supra note 2, at 236-37.
235. For a catalog of some of the more troubling anomalies, see id. at 241-45.
public-regarding rationale for treating enforcement of the insider trading prohibition as a matter for the federal Securities and Exchange Commission. As such, both political reality and sound public policy argue for retaining a federal common-law prohibition of insider trading, but incorporating state fiduciary duties as the rule of decision.

1. The Public Choice Story

This Part relies on the well-established economic model of regulation in which rules are sold by regulators and bought by the beneficiaries of the regulation. Into that model we can plug slightly different, but wholly compatible, stories about insider trading told by two prominent scholars. One explains why the SEC wanted to sell insider trading regulation, while the other explains to whom it has been sold. By putting these stories together, we obtain a complete answer to the question of why insider trading became a matter of federal concern and, more important for present purposes, is likely to remain a federal concern.

a. The Sellers' Story

In 1980, Professor Michael Dooley explained the federal insider trading prohibition as the culmination of two distinct trends in the securities laws. First, as do all government agencies, the Commission desired to enlarge its jurisdiction and enhance its prestige. According to one widely accepted theory of bureaucratic behavior, administrators can maximize their salaries, power, and reputation by maximizing the size of their agency's budget. A vigorous enforcement program directed at a highly visible and unpopular law violation is surely an effective means of attracting political support for larger budgets. Given the substantial media attention directed towards insider trading prosecutions, and the public taste for prohibiting insider trading, it provided a very attractive subject for such a program.

Second, during the prohibition's formative years, there was a major effort to federalize corporation law. In order to maintain its budgetary priority over competing agencies, the SEC wanted to play a major role in

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federalizing matters previously within the state domain.\footnote{240} According to Dooley, regulating insider trading was an ideal target for federalization.\footnote{241} Rapid expansion of the federal insider trading prohibition purportedly demonstrated the superiority of federal securities law over state corporate law. Because the states had shown little interest in insider trading for years, federal regulation demonstrated the modernity, flexibility, and innovativeness of the securities laws.\footnote{242} The SEC's prominent role in attacking insider trading thus placed it in the vanguard of the movement to federalize corporate law and ensured that the Commission would have a leading role in any system of federal corporations law.\footnote{243}

\footnote{240} In the seminal \textit{Cady, Roberts} decision, the Commission acknowledged and embraced the federalization process: "The securities acts may be said to have generated a wholly new and far-reaching body of Federal corporation law." \textit{In re Cady, Roberts \& Co.}, 40 S.E.C. 907, 910 (1961). In addition, during the late 1970s the Commission considered imposing a variety of corporate governance rules, which would have essentially superseded state corporation law in many respects. \textit{See} Stephen M. Bainbridge, \textit{The Short Life and Resurrection of SEC Rule 19c-4}, 69 WASH. U. L.Q. 565, 603 n.176 (1991).

\footnote{241} Dooley, \textit{supra} note 168, at 62.

\footnote{242} \textit{Id.}

\footnote{243} \textit{Id.} While Dooley's argument explains the Commission's interest in federalizing corporate law, an interesting question is why the courts cooperated with the SEC. According to a leading theory of judicial behavior, "judges seek to impose their personal preferences and values on society." \textit{Richard A. Posner, Economic Analysis of Law} 534 (1992). If so, the effort to federalize corporate law becomes easy to understand. First, during the 1960s and '70s, it was conventional wisdom among the legal elites — from which federal judges tend to be selected — that state corporate law was fundamentally flawed. \textit{See} Stephen M. Bainbridge, \textit{Independent Directors and the ALI Corporate Governance Project}, 61 GEO. WASH. L. REV. 1034, 1045 (1993). This would be reflected in the tenor of their decisions defining the boundaries between state and federal law. Second, creating a federal common law of corporations would substantially increase the amount of corporate litigation within the federal court system, giving federal judges many more opportunities to impose their personal views on business corporations. Again, the unpopularity of insider trading and the states' hands-off approach made it a logical candidate for early federalization.

I find this vision of the judicial role unappealing from a normative perspective and unpersuasive from an explanatory perspective. As I have argued elsewhere, judges properly should seek to, and in fact do, enforce not their personal preferences but rather those policies and moral norms that have substantial support in the community. \textit{Stephen M. Bainbridge, Social Propositions and Common Law Adjudication}, 1990 U. ILL. L. REV. 231. Judicial cooperation with the SEC's federalization program, however, is explicable from this perspective as well. In light of the conventional wisdom that state corporate law was seriously flawed and that insider trading was undesirable, judges seeking to faithfully enforce those policy and moral norms having substantial community support would have supported federalizing insider trading law. The lingering effects of the conventional wisdom probably go far to explain the continuing willingness of the lower courts to support an expansive federal insider trading prohibition. From this perspective, efforts to reform the prohibition will
We can test Dooley's argument by asking whether it explains subsequent events. Consider, for example, the SEC's devotion of significant enforcement resources to insider trading during the 1980s. During the 1980s, the SEC embarked upon a limited program of deregulating the securities markets. Among other things, the Commission adopted a safe harbor for projections and other soft data, the shelf registration rule, the integrated disclosure system, and expanded the exemptions from registration under the Securities Act. The deregulatory trend motivated one long-time critic of the SEC to compliment the Commission for being "well on the road toward a sensible disclosure system with much of the dead wood, idiosyncracies, overregulation, and overdrafting eliminated." At about the same time, however, the SEC adopted a vigorous enforcement campaign against insider trading. Not only did the number of cases increase substantially, but the Commission adopted a "big bang" approach under which it focused on high visibility cases that would produce substantial publicity. In part this may have been due to an increase in the frequency of insider trading, but Dooley's analysis nicely explains the Commission's renewed interest in insider trading as being motivated by a desire to preserve its budget during an era of deregulation and spending restraint.

Dooley's argument also explains the SEC's continuing attachment to the equal access approach to insider trading. The equal access policy generates an expansive prohibition that federalizes a broad range of conduct otherwise succeed only if judges become convinced that the conventional wisdom is in error.


249. Bainbridge, supra note 3, at 466-67.

250. Id.

251. This hypothesis also nicely explains the big bang enforcement policy. Dooley points out that TGS could have been prosecuted as a violation of the proxy rules, while "the government could have avoided the insider trading complications in Carpenter by charging Winans with fraudulent misrepresentation .... One assumes that insider trading charges make better newspaper copy and thus generate bigger headlines than indictments for misrepresentation." DOOLEY, supra note 132, at IV-221 n.f.
left to state corporate law, while also warranting a highly active enforcement program. As such, the Commission’s use of Rule 14e-3 and the misappropriation theory to evade Chiarella and Dirks makes perfect sense. By these devices, the Commission restored much of the prohibition’s pre-Chiarella breadth and thereby ensured that its budget-justifying enforcement program would continue unimpeded.

b. The Buyers’ Story

If Dooley’s account is correct, as it seems to be, the record of insider trading prosecutions is quite curious. In the years prior to Chiarella, the SEC was a willing supplier of insider trading regulation, but insider trading prosecutions were quite rare.\(^{252}\) After Chiarella, however, the number of insider trading prosecutions increased substantially.\(^{253}\) As we have seen, Dooley’s thesis can be extended to the post-Chiarella era. We are thus not surprised that the SEC remained ready to supply insider trading regulation. But where did the demand for regulation come from?

In 1991, Professor Jonathan R. Macey published a short monograph on insider trading, from which one can extract an answer to this question.\(^{254}\) His analysis applies public choice theory to the insider trading problem. A basic tenet of public choice analysis is that well-defined, politically influential interest groups use their influence with lawmakers to obtain legal rules that benefit themselves at the expense of larger, more diffuse groups.\(^{255}\) Macey argues that the post-Chiarella insider trading rules have been supported and driven in large part by market professionals, a cohesive and politically powerful interest group, which the post-Chiarella regime effectively insulates from insider trading liability.\(^{256}\)

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252. Id. at IV-234.
253. Id. at IV-237.
256. See MACEY, supra note 190, at 17-18. Macey argues that Rule 14e-3, which is so strikingly different than the rest of the federal insider trading prohibition, is designed to protect the interests of target managers, another well-defined and politically powerful interest group. Id. Rule 14e-3 prohibits the practice of warehousing takeover securities, which hostile bidders otherwise could use to put target company securities into friendly hands before commencing a bid. Id. at 19-20. As an alternative to Macey’s market professional argument, one might extend his analysis of Rule 14e-3 to the entirety of the insider trading prohibition. No one disputes that managers of large corporations have a good deal of political influence
The post-Chiarella prohibition strongly supports Macey's thesis. Only insiders and quasi-insiders such as lawyers and investment bankers have a greater degree of access to nonpublic information that might affect a firm's stock price than do market professionals. By basing insider trading liability on breach of fiduciary duty, and positing that the requisite fiduciary duty exists with respect to insiders and quasi-insiders but not with respect to market professionals, the prohibition protects the latter's ability to profit from new information about a firm.

Market professionals benefit in a variety of ways from the present ban. When an insider trades on an impersonal secondary market, the insider takes advantage of the fact that the market maker's or specialist's bid-ask prices do not reflect the value of the inside information. Because market makers and specialists cannot distinguish insiders from noninsiders, they cannot protect themselves from being taken advantage of in this way. When trading with insiders, the market maker or specialist thus will always be on the wrong side of the transaction. If insider trading is prohibited, however, the market professionals are no longer exposed to this risk.

Professional securities traders likewise profit from the fiduciary-duty-based insider trading prohibition. Because professional investors are often active traders, they are highly sensitive to the transaction costs of trading in securities. Prominent among these costs is the specialist's and market-maker's bid-ask spread. If a ban on insider trading lowers the

257. See DOOLEY, supra note 132, at IV-254 to -255; MACEY, supra note 190, at 13-15.

258. DOOLEY, supra note 132, at IV-255.

259. Institutional investors also fall within the classes of market professionals that benefit from the insider trading rules. Like the investment banking community, institutional investors are an important SEC constituency. They also constitute a well-defined and relatively cohesive interest group that is well-positioned to capture the SEC's regulatory agenda. From this perspective, it is significant that institutional investors are one of the principal consumers of advice from professional market analysts. MACEY, supra note 190, at 13. They thus stand to benefit from any informational advantage the insider trading prohibition gives to the professional market analysts that supply them with information.
risks faced by specialists and market-makers, some portion of the resulting gains should be passed on to professional traders in the form of narrower bid-ask spreads.260

Circumstantial evidence for Macey's thesis is provided by comparing pre- and post-Chiarella enforcement patterns. As we have seen, the frequency of insider trading prosecutions rose dramatically after Chiarella. Strikingly, however, in the years immediately prior to Chiarella, those enforcement proceedings that did take place often targeted market professionals.261 After Chiarella, market professionals were rarely charged.262

As we did with Dooley's argument, we can also test Macey's hypothesis by asking whether it explains subsequent developments. Consider, for example, the problem of selective disclosure. When analysts receive information from corporate insiders, which is not made available to the public at large, the SEC has taken the position that the disclosure constitutes a tip that gives rise to liability under Dirks's tipping rules for both the insider and the analyst.263 At first blush, this seems inconsistent with Macey's thesis. But if specialists and market makers are the subclass of market professionals with the greatest political influence with the SEC on this issue, as seems at least possible,264 an answer to this puzzle emerges. Just as the insider trading prohibition allows specialists to trade without fear of doing business with insiders with superior information, the SEC's pursuit of selective disclosure to analysts ensures that the specialist or market maker need not fear the possibility of doing business with clients of an analyst that has superior information.

261. DOOLEY, supra note 132, at IV-234.
262. Id. at IV-237.
263. Id. at IV-254.
264. Many market makers and specialists are controlled by full-service securities firms, which also employ market analysts. In attempting to identify which subclass of market professionals has the most political power at the SEC, these firms seem the most likely candidates. The question thus becomes whether these firms are likely to prefer rules that favor the market making or the analysis side of their business. Dooley suggests that rules against selective disclosure "may diminish the potential returns to individual firms from trading and advising customers, [but] the industry as a whole may gain from decreased costs in competing for genuinely new information." Id. at IV-254. If so, fully integrated firms should prefer the market making side of their business. As such, their influence with the SEC will be used on behalf of that part of their business rather than their market analysis business.
2. A Public-Regarding Story

Dooley's and Macey's arguments do not tell a very appealing story. Taken together, they demonstrate that the insider trading prohibition advances no important federal policy. Instead, the prohibition is driven largely by the venal interests of bureaucrats and the entities they supposedly regulate. It is nevertheless possible to identify a public-regarding justification for the federal insider trading prohibition; namely, protection of property rights in valuable information. As the only public-regarding justification for regulating insider trading, however, the protection of property rights rationale strongly argues for using state law fiduciary duty concepts to supply the fiduciary duty element of the federal prohibition.265

a. The Property Rights Rationale for Regulating Insider Trading

There is an emerging consensus that the federal insider trading prohibition is most easily justified as a means of protecting property rights in information.266 There are essentially two ways of creating property rights in information: allow the owner to enter into transactions without disclosing the information or prohibit others from using the information. In effect, the federal insider trading prohibition vests a property right of the latter type in the owner of nonpublic information.

265. Some commentators argue that courts should simply enforce the bargain struck by legislators and special interests. See, e.g., Frank H. Easterbrook, The Court and the Economic System, 98 HARV. L. REV. 4 (1984). Professor Macey has persuasively argued against this approach. Jonathan R. Macey, Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model, 86 COLUM. L. REV. 223 (1986). Even if the former view prevails, however, it is singularly inapt in the present context. While Dooley's and Macey's arguments permit us to describe a coherent bargain, the bargain might be said to exist at judicial sufferance. As we have seen, neither Congress nor the SEC has attempted to define insider trading. To the contrary, Congress has expressly left the definitional issue to the courts. See supra part VI.A.1. In so doing, Congress knew that courts might modify the definition of insider trading in ways that narrowed the prohibition's scope. Because Congress nevertheless failed to restrict the courts' ability to do so, even judges adopting Easterbrook's view should not regard themselves as bound to any particular definition of insider trading.

At first blush, the insider trading prohibition admittedly does not look very much like most property rights. To be sure, enforcement of the insider trading prohibition differs rather dramatically from enforcement of, say, trespassing laws. The existence of property rights in a variety of intangibles, including information, however, is well-established. Trademarks, copyrights, and patents are but a few of the better known examples of this phenomenon. There are striking doctrinal parallels between insider trading and these other types of property rights in information. Using another’s trade secret, for example, is actionable only if taking the trade secret involved a breach of fiduciary duty, misrepresentation, or theft.267 As Dooley observes, this is "an equally apt summary of the law of insider trading after Chiarella and Dirks."268

In context, moreover, even the insider trading prohibition’s enforcement mechanisms are not inconsistent with a property rights analysis. Where public policy argues for giving someone a property right, but the costs of enforcing such a right would be excessive, the state often uses its regulatory powers as a substitute for granting a property right.269 Insider trading poses just such a situation. Private enforcement of the insider trading laws is rare and usually parasitic on public enforcement proceedings.270 Indeed, the very nature of insider trading makes public regulation essential precisely because private enforcement is almost impossible.271 The insider trading prohibition’s regulatory nature thus need not preclude a property-rights-based analysis.

Such an analysis has both justificatory and explanatory power. From a justificatory perspective, the rationale for prohibiting insider trading is precisely the same as the rationale for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce socially valuable information. As the theory goes, the readily appropriable nature of information makes it difficult for the developer of a new idea to recoup the sunk costs incurred in developing it.272 If an inventor develops a better mousetrap, for example, he cannot profit on that invention without selling

268. DOOLEY, supra note 132, at IV-181.
269. POSNER, supra note 243, at 36.
270. Dooley, supra note 168, at 15-17.
272. See generally ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS ch. 4 at 44-48, ch. 5 at 11-29 (2d ed. draft materials quoted by permission of authors); POSNER, supra note 243, at 38-45.
mousetraps and thereby making the new design available to potential competitors. Assuming both the inventor and his competitors incur roughly equivalent marginal costs to produce and market the trap, the competitors will be able to set a market price at which the inventor likely will be unable to earn a return on his sunk costs. Ex post, the rational inventor should ignore his sunk costs and go on producing the improved mousetrap. Ex ante, however, the inventor will anticipate that he will be unable to generate positive returns on his up-front costs and therefore will be deterred from developing socially valuable information. Accordingly, society provides incentives for inventive activity by using the patent system to give inventors a property right in new ideas. By preventing competitors from appropriating the idea, the patent allows the inventor to charge monopolistic prices for the improved mousetrap, thereby recouping his sunk costs. Trademark, copyright, and trade secret law all are justified on similar grounds.

Granted, this argument may not provide quite as compelling a justification for the insider trading prohibition as it does for the patent system. A property right in information should be created when necessary to prevent someone other than the developer of socially valuable information from appropriating its value before the developer can recoup his sunk costs. Insider trading, however, often does not affect an idea's value to the corporation and probably never entirely eliminates its value. Legalizing insider trading thus would have a much smaller impact on the corporation's incentive to develop new information than would, say, legalizing patent infringement.

The property rights approach nevertheless has considerable justificatory power. Consider the prototypical insider trading transaction, in which an insider trades in her employer's stock on the basis of information learned solely because of her position with the firm. There is no avoiding the necessity of assigning the property right to either the corporation or the inside trader. A rule allowing insider trading assigns the property right to the insider, while a rule prohibiting insider trading assigns it to the corporation.

From the corporation's perspective, we have seen that legalizing insider trading would have a relatively small effect on the firm's incentives to develop new information. In some cases, however, insider trading will harm the corporation's interests and thus adversely affect its incentives in this

273. An alternative approach is to ask whether the parties, if they had bargained over the issue, would have assigned the property right to the corporation or the inside trader. For an argument that the property right would be assigned to the corporation in the lawyer-corporate-client context, see Bainbridge, supra note 113, at 27-34.
This argues for assigning the property right to the corporation, rather than the insider. In particular, it is at this point that the court went awry in *Freeman v. Decio*. As we saw above, the *Freeman* court required a showing of actual injury from insider trading before the information in question is treated as a corporate asset. Such a case-by-case inquiry requires litigation of various issues not readily susceptible of proof and, moreover, runs counter to the general thrust of property rights analysis. In general, creation of a property right with respect to a particular asset is not dependent upon there being a measurable loss of value resulting from the asset's use by someone else. Indeed, creation of a property right is appropriate even if any loss in value is entirely subjective because subjective valuations are difficult to measure for purposes of awarding damages and because the possible loss of subjective values presumably would affect the corporation's incentives to cause its agents to develop new information.

As with other property rights, the law therefore should simply assume (although the assumption will sometimes be wrong) that protection of the corporation's interest maximizes the social incentives for the production of valuable new information.

Because the relative rarity of cases in which harm occurs to the corporation somewhat weakens the argument for assigning it the property right, however, the critical issue may be whether one can justify assigning the property right to the insider in our prototypical transaction. On close examination, the argument for assigning the property right to the insider is even weaker than the argument for assigning it to the corporation. Some

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274. The question of whether insider trading harms the affected corporation is often confused with the question of whether it harms investors or the capital markets. These are distinct inquiries, however. As the preceding sections indicate, I am skeptical that insider trading adversely affects markets or investors. In some cases, however, it may adversely affect the affected corporation. Such cases, of course, are likely to be rare. See Bainbridge, *supra* note 113, at 8-16.

275. 584 F.2d 186 (7th Cir. 1978).

276. See *supra* notes 156-58 and accompanying text.

277. I am indebted to Jeff Stake and Tom Ulen for their insights with respect to this aspect of the problem.

278. Note that this analysis is not intended as an argument for a mandatory rule against insider trading. As noted below, the mandatory nature of the present insider trading prohibition seems odd in light of the property rights rationale. See *infra* note 282. It may be that the most efficient rule would be a default rule against insider trading, which the parties could vary by agreement amongst themselves, but that is a question beyond the scope of this article. For an argument that mandatory prohibitions of insider trading may be justifiable in some cases, however, see Bainbridge, *supra* note 113, at 36-39 (arguing for mandatory prohibition of insider trading by lawyers).
have argued that legalized insider trading would be an appropriate compensation scheme. In other words, we might allow insiders to inside trade in order to give them greater incentives to develop new information. This argument fails, however, because insider trading is a remarkably inefficient compensation scheme. Even assuming that the change in stock price that results once the information is released accurately measures the value of the innovation, the insider’s trading profits are not correlated to the value of the information. This is so because his trading profits are limited not by the value of the information, but by the amount of shares the insider can purchase, which in turn depends mainly upon his ex ante wealth or access to credit. A second objection to the compensation argument is the difficulty of restricting trading to those who produced the information. The costs of producing information normally are much greater than the costs of distributing it. Thus, many firm employees may trade on the information without having contributed to its production. The third objection to insider trading as compensation is based on its contingent nature. If insider trading were legalized, the corporation would treat the right to inside trade as part of the manager’s compensation package. Because the manager’s trading returns cannot be measured ex ante, however, the corporation cannot ensure that the manager’s compensation is commensurate with the value of his services.279 The economic theory of property rights in information thus cannot justify assigning the property right to insiders rather than to the corporation. Because there is no avoiding the necessity of assigning the property right to the information in question to one of the relevant parties, the argument for assigning it to the corporation therefore should prevail.280

The explanatory power of the property rights approach is nicely illustrated by considering the implications of the Supreme Court’s insider trading jurisprudence. After Dirks, market analysts were essentially exempt from insider trading liability with respect to nonpublic information they

279. Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 VA. L. REV. 117, 150 (1982). Moreover, the manager himself may prefer a less uncertain compensation package. Because managers are risk adverse, they "would prefer the certainty of a $100,000 salary to a salary of $50,000 and a 10 percent change of a bonus of $500,000" from insider trading. The manager will value the "bonus" at 50,000 dollars, but if he collects it will cost the shareholders the full $500,000. Thus, both the shareholders and the manager could gain by exchanging a guaranteed bonus for the manager’s agreement not to trade on inside information. Easterbrook, supra note 168, at 332.

280. The argument in favor of assigning the property right to the corporation becomes even stronger when we move outside the prototypical situation to cases covered by the misappropriation theory. There is no plausible justification for assigning the property right to those who steal information.
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develop because they usually owe no fiduciary duty to the firms they research. *Dirks* thus essentially assigns the property right to such information to the market analyst rather than to the affected corporation. This is justifiable from an economic perspective because market analysts expend considerable resources to develop valuable information about firms. If the information produced by market research is socially valuable, the *Dirks* rule makes sense because it encourages this activity.\(^{281}\)

In addition, many of the prohibition's doctrinal oddities make sense if protection of property rights is the true policy goal.\(^{282}\) Consider, for example, the apparent incongruity that Winans could be held liable for trading on information about the Wall Street Journal's "Heard on the Street," but the Journal could have lawfully traded on the same information. As we saw in the preceding section, this result makes no sense from a traditional securities law perspective. From a property rights perspective, however, the result in *Carpenter* makes perfect sense: Because the information belonged to the Journal, it should be free to use the information as it saw fit, while Winans's use of the same information amounted to a theft of property owned by the Journal.

b. The Federalism Policies of the Securities Laws

If one accepts protection of property rights as the rationale for regulating insider trading, it becomes quite difficult to discern any compelling federal interest in doing so. The property rights rationale makes it obvious that the federal insider trading prohibition has nothing to do with disclosure or fraud. Instead, like the trade secrets rules, the insider trading prohibition is mainly concerned with preventing employees and other fiduciaries from using information belonging to the corporation for personal gain. As such, the prohibition is unrelated to the traditional purposes of the securities laws. Indeed, the prohibition is arguably inconsistent with the federalism policies of those laws.

281. *See Macey, supra* note 266, at 36.

282. To be sure, not all aspects of the federal prohibition can be so explained. For example, because property rights generally include some element of transferability, it may seem curious that federal law at least in some circumstances does not allow the owner of nonpublic information to authorize others to use it for their own personal gain. *See, e.g.*, 17 C.F.R. § 240.14e-3(d) (1992) (tender offeror may not divulge its takeover plans to anyone likely to trade in target stock). This does not undermine the general validity of the property rights justification. Rather, if protection of property rights is taken as a valid public-regarding policy basis for the prohibition, it gives us a basis for criticizing departures from that norm.
As we have seen, the federal insider trading prohibition originated as part of an effort by the SEC and some courts to federalize corporate law. Most of this effort's progeny were slain by a series of decisions in which the Court created significant federalism limitations on the scope of the federal securities laws. As I have argued elsewhere, the legislative history of the Exchange Act demonstrates that Congress intended to leave regulation of corporate governance to the states.\textsuperscript{283} Consistent with this clear congressional intent, the Supreme Court has routinely rejected efforts to create a federal law of corporations.\textsuperscript{284} To the contrary, because "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law,"\textsuperscript{285} the Court has consistently reaffirmed that:

\textit{It . . . is an accepted part of the business landscape in this country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares.}\textsuperscript{286}

Of particular relevance to the present problem is the Court's recognition that state law governs the rights and duties of corporate directors:

As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. "Corporations are creatures of state law" and it is state law which is the font of corporate directors' powers.\textsuperscript{287}

Oddly, given these decisions, the insider trading prohibition has nevertheless survived. It does so, however, only at the cost of substantial doctrinal tension.

Interpreting \textit{Chiarella} and \textit{Dirks} as creating a unique federal fiduciary duty proscribing insider trading would further compound this doctrinal tension by bringing the prohibition squarely into conflict with the Supreme Court's decision in \textit{Santa Fe Industries, Inc. v. Green},\textsuperscript{288} in which the Supreme Court held that Rule 10b-5 is concerned with disclosure and fraud, not with fiduciary duties. Prior to \textit{Santa Fe}, the lower federal courts had given Rule 10b-5 an increasingly expansive interpretation.\textsuperscript{289} \textit{Santa Fe} was

\begin{itemize}
\item \textsuperscript{283} Bainbridge, \textit{supra} note 240, at 593-616.
\item \textsuperscript{284} Id. at 613-16.
\item \textsuperscript{285} Id. at 613-16.
\item \textsuperscript{286} Id. at 613-16.
\item \textsuperscript{287} Id. at 91; see also id. at 89 ("No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations.").
\item \textsuperscript{288} Burks v. Lasker, 441 U.S. 471, 478 (1979) (citations omitted).
\item \textsuperscript{289} See Kitch, \textit{supra} note 190, at 863-66.
\end{itemize}
one of a series of cases in which the Supreme Court applied the brakes to this process. Santa Fe attempted to freeze out minority shareholders of one of its subsidiaries by means of a statutory short-form merger. The plaintiffs had a state law remedy available in the statutory appraisal rights provision, but chose to seek redress under Rule 10b-5. The plaintiffs claimed that the merger violated Rule 10b-5 because it was effected without prior notice to the minority shareholders and was done without any legitimate business purpose. They also claimed that their shares had been fraudulently under-valued.

The Supreme Court held that the plaintiffs had not stated a cause of action under Rule 10b-5. For present purposes, Santa Fe's main importance derives from its refusal to allow a Rule 10b-5 cause of action for breaches of fiduciary duty. The Court was concerned that a decision in favor of the plaintiffs would result in federalizing much of state corporate law — in many cases overriding well-established state policies of corporate regulation. This concern was well-founded, for if the Court gave these plaintiffs a federal cause of action, it could not meaningfully justify denying a federal claim in any breach of fiduciary duty case. The Court simply refused to give Rule 10b-5 such an expansive reach.

While its holding is not squarely on point, the rationale of Santa Fe is directly applicable to the problem at hand. The Court held, for example, that Rule 10b-5 did not reach claims "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary." This is of course the very essence of the complaint made in insider trading cases. The court also held that extension of Rule 10b-5 to breaches of fiduciary duty was unjustified in light of the state law remedies available to plaintiffs. As we have seen, insider trading plaintiffs likewise have state law remedies available to them. Granted, those remedies vary from state to state and are likely to prove unavailing in many cases, but the same was true of the state law remedy at issue in Santa Fe. Finally, the court expressed reluctance "to federalize the substantial portion of the law of corporations that deals with

291. Id. at 470-71. The Court rested its holding on several bases. First, Section 10(b) and Rule 10b-5 were only intended to reach deception and manipulation. Neither was present on these facts. Id. at 471-77. Second, the implied private right of action under Rule 10b-5 should not be extended to cases that do not involve deception or manipulation. Id. at 477-80.
292. See id. at 478-79.
293. Id. at 479.
294. Id. at 477.
295. Id. at 478.
transactions in securities, particularly where established state policies of corporate regulation would be overridden. In view of the state law standards discussed in Part V, of course, this is precisely what the federal insider trading prohibition did.

To be sure, none of the Supreme Court's decisions squarely forbid either federalizing the insider trading prohibition or creating a unique federal fiduciary rule applicable to insider trading. At the very least, however, Santa Fe and its ilk require one to ask why insider trading should be singled out for special treatment. Given that all other corporate fiduciary duties have been left to state law, what justifies creating a federal fiduciary duty against insider trading?

Repealing the federal prohibition in fact would be the simplest means of resolving the tension between Chiarella and Santa Fe. The simplest ap-

296. Id. at 479.

297. In Central Bank v. First Interstate Bank, the Supreme Court reaffirmed what it called the holding of Santa Fe that Section 10(b) does not reach mere breaches of fiduciary duty. Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446 (1994). In United States v. Bryan, the Fourth Circuit relied on Santa Fe and Central Bank in holding the misappropriation theory invalid on grounds that it involves merely a breach of fiduciary duty. United States v. Bryan, No. 94-5124, 1995 U.S. App. LEXIS 15893, at *37, 50-51 (4th Cir. June 27, 1995). The court opined that the only alternative to doing so "would be the effective federalization of [fiduciary] relationships historically regulated by the states," which it held would violate Santa Fe. Id. at *55. The court thus ignored the possibility proposed here of treating the insider trading prohibition as a species of federal common law, with incorporation of state law as the rule of decision.

Setting Bryan aside, the lower courts have generally treated Santa Fe as something to be evaded, rather than followed. Some courts have permitted 10b-5 causes of action to lie where the nondisclosure led plaintiffs to forego pursuing an available state law remedy. See, e.g., Healey v. Catalyst Recovery, 616 F.2d 641 (3d Cir. 1980); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978). This approach has been subjected to substantial criticism. See, e.g., Healey v. Catalyst Recovery, 616 F.2d 641, 651-61 (3d Cir. 1980) (Aldisert, J., dissenting); RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 1052-54 (7th ed. 1992). It allows litigants to end-run Santa Fe by pointing to a non-disclosure or misrepresentation even though the bulk of their case goes to breach of fiduciary duty. While it might be argued that liability is being imposed because of the nondisclosure of the breach, rather than the breach itself, it has been held that failure to disclose a breach of duty is not actionable under Rule 10b-5. Biesenbach v. Guenther, 588 F.2d 400 (3d Cir. 1978); In re Sears, Roebuck & Co. Sec. Litig., 792 F. Supp. 977 (E.D. Pa. 1992); Merritt v. Colonial Foods, Inc., 499 F. Supp. 910, 913-14 (D. Del. 1980). In any case, the lower court approach imposes liability for failing to disclose information relevant not to making investment decisions, the concern of the securities laws, but to making state law litigation decisions, a matter wholly outside the scope of the securities laws. Finally, and most troublingly, the lower court's chosen escape device ignores the thrust of Santa Fe by giving no deference to the strong policy reasons laid out by the Supreme Court for refraining from intruding federal law into a sphere traditionally left for state law.
approach, however, is not always the best. As the following section explains, there are good and sufficient reasons to retain a federal prohibition of insider trading. None of those reasons, however, necessitates the creation of a unique federal fiduciary duty against insider trading. Nor do any of them resolve the doctrinal tension between Chiarella and Santa Fe. Rather, that tension is best resolved by adopting state law standards as the requisite fiduciary duty. This approach strikes an appropriate balance between the federalism concerns expressed by Santa Fe and the policies that favor federalizing the prohibition.

The Court's decision in Burks v. Lasker.²⁹⁸ is especially supportive of this approach. In Burks, the Court applied state law governing termination of derivative litigation to a case arising under the federal Investment Company Act.²⁹⁹ Although the cause of action clearly arose under federal law, the Court applied state law because state law "is the font of corporate directors' powers" and because application of state law did not pose a "significant threat to any identifiable federal policy or interest."³⁰⁰ Burks thus strongly argues in favor of using state law to supply the fiduciary duty element of the federal insider trading prohibition. State law is the "font" of corporate fiduciary duties, while we have seen that incorporation of state law poses no threat to "any identifiable federal policy or interest."

Although the Supreme Court's decision in DeSylva v. Ballentine³⁰¹ arose outside the securities law area, it is also quite instructive. In that case the Supreme Court considered what familial relationships were encompassed by the term "children" as used in a federal statute. The Court looked to state law for a definition of the term."³⁰² It did so in large measure because there is no federal law of domestic relations:

The scope of a federal right is, of course, a federal question, but that does not mean that its content is not to be determined by state, rather than federal law. This is especially true where a statute deals with a familial relationship; there is no federal law of domestic relations, which is primarily a matter of state concern.³⁰³

From this perspective, DeSylva is an especially apt precedent for the insider trading prohibition. Just as there was no general body of federal domestic relations law, Santa Fe teaches that there is no general federal law of fiduciary duty. Just as the Court incorporated state law in DeSylva, it thus should incorporate state law here.

³⁰³. Id. at 580.
c. The Comparative Advantage Argument

Despite Santa Fe, treating the problem of insider trading as a matter of federal law and, in particular, preserving a primary enforcement role for the Commission, is readily justifiable. As we have seen, the property rights approach argues in favor of granting owners of information legal protection against insider trading. While a rule against insider trading thus is socially desirable, the costs of such a rule still must be taken into account. Those costs can be broken down into three basic categories. Primary costs are the injuries suffered by the owner of information used to inside trade. Secondary costs are those incurred by the owner to deter and detect insider trading. Tertiary costs are those incurred by society in operating the judicial system in which enforcement of the rule takes place.

The difficulties associated with detecting and successfully prosecuting insider trading make these costs very high. By one estimate, fewer than one in five cases of insider trading is successfully prosecuted, and in retrospect that estimate probably is too high by several orders of magnitude. It is often very difficult to tell when insider trading is taking place, and even when insider trading is suspected it is very difficult to identify the responsible party if many people had access to the information. Finally, even when insider trading is detected, it often can be difficult to build a persuasive case against the inside trader.

Rational actors will take these factors into account when deciding whether to inside trade. In economic terms, deterrence can be reduced to a simple equation. A rational actor will be deterred only when the expected sanction associated with an offense exceeds the expected benefit. The expected sanction, in turn, is a function of the nominal sanction and the probability of conviction. Because the latter factor is quite small, insider trading is difficult to deter.

If the SEC has a comparative advantage vis-a-vis private parties in enforcing insider trading rules, society can reduce the total cost associated with regulating insider trading by allocating responsibility for doing so to the Commission. That secondary costs will be lower follows a fortiori from the Commission's comparative advantage. Primary costs also will be lower because the Commission's comparative advantage will result in greater deterrence for the same expenditure of resources.

304. Bainbridge, supra note 3, at 489-90.
305. According to another estimate, insider trading is the most common securities law violation, but also is one of the most rarely prosecuted. Dooley, supra note 168, at 7-9. But see Branson, supra note 89, at 294 (finding "no credible evidence that insider trading is ubiquitous or even widespread").
That the Commission has a comparative advantage is fairly easy to demonstrate.\textsuperscript{306} Virtually all private party insider trading lawsuits are parasitic on SEC enforcement efforts, which is to say that the private party suit was brought only after the SEC’s proceeding became publicly known.\textsuperscript{307} This condition holds because the police powers available to the Commission, but not to private parties, are essential to detecting insider trading.\textsuperscript{308} Informants, computer monitoring of stock transactions, and reporting of unusual activity by self-regulatory organizations or market professionals are the usual ways in which insider trading cases come to light.\textsuperscript{309} As a practical matter, these techniques are available only to public law enforcement agencies. In particular, they are most readily available to the SEC.

Unlike private parties, who cannot compel discovery until a nonfrivolous case has been filed, the Commission can impound trading records and compel testimony simply because its suspicions are aroused.\textsuperscript{310} As the agency charged with regulating broker-dealers and self-regulatory organizations, the Commission also is uniquely positioned to extract cooperation from securities professionals in conducting investigations.\textsuperscript{311} Finally, the SEC is statutorily authorized to pay bounties to informants, which is particularly important in light of

\textsuperscript{306} Professor Romano questions whether "the difficulty of enforcing an insider trading prohibition is significantly lessened when shifted to the public sector." ROMANO, supra note 199, at 103. She cites two studies that conclude that public enforcement efforts have not deterred insider trading. \textit{Id.} These studies, however, do not answer the real question. The issue is not whether public enforcement deters insider trading, but whether it is more effective in doing so than a regime of purely private enforcement. The study by Professor Dooley, for example, which Romano cites as finding that public enforcement is "ineffective," \textit{Id.}, also concludes that private enforcement is wholly parasitic on public enforcement. Dooley, supra note 168, at 20.

For a detailed analysis of the Commission’s comparative advantages vis-a-vis private parties in detecting insider trading, albeit one that is skeptical of the efficacy of the Commission’s efforts, see DOOLEY, supra note 132, at IV-224 to -242.

\textsuperscript{307} Dooley, supra note 168, at 20.

\textsuperscript{308} \textit{Id.}


\textsuperscript{310} Dooley, supra note 168, at 20.

\textsuperscript{311} \textit{Id.}
the key role informants played in breaking most of the big insider trading cases of the 1980s.\textsuperscript{312}

Internationalization of the securities markets is yet another reason for believing the SEC has a comparative advantage in detecting and prosecuting insider trading. Sophisticated insider trading schemes often make use of off-shore entities or even off-shore markets. The difficulties inherent in extra-territorial investigations and litigation, especially in countries with strong bank secrecy laws, probably would preclude private parties from dealing effectively with insider trading involving off-shore activities. In contrast, the SEC has developed memoranda of understanding with a number of key foreign nations, which provide for reciprocal assistance in prosecuting insider trading and other securities law violations.\textsuperscript{313} The SEC's ability to investigate international insider trading cases was further enhanced by the 1988 act, which included provisions designed to encourage foreign governments to cooperate with SEC investigations.\textsuperscript{314}

Despite the SEC's demonstrable comparative advantage, it is worth considering one further argument against the federal prohibition. Jonathan Macey concedes that insider trading is difficult to detect. He further concedes that centralized monitoring of insider trading by the SEC and the self-regulatory organizations within the securities industry may be more efficient than private party efforts to detect insider trading. He nevertheless draws a distinction between SEC monitoring of insider trading and a federal prohibition of insider trading. Macey contends that the SEC should monitor insider trading but refer detected cases to the affected corporation for private prosecution.\textsuperscript{315}

Macey's argument is an interesting and sophisticated one, but there are counter-points. First, we know from experience with the present legal regime that SEC monitoring detects only a small percentage of insider trading cases. Private party enforcement of insider trading rules, even supplemented by law enforcement monitoring, thus is unlikely to provide an adequate deterrence. Because the probability of detection is quite low, and the potential gains are quite high, the nominal sanction must be quite high in order to deter insider trading. This is the basic economic rationale behind

\begin{itemize}
\item \textsuperscript{312} See Kraswell, \textit{supra} note 190, at 164-66.
\item \textsuperscript{313} \textit{Id.} at 172-73.
\item \textsuperscript{314} \textit{Id.} at 171.
\item \textsuperscript{315} \textit{MAC\EY,} \textit{supra} note 190, at 40-41. For quite different reasons, Professor Branson had earlier proposed a similar regime under which the SEC's enforcement activities would be confined "to oversight, with self-regulation by those entities having proprietary rights in the information." \textit{Branson,} \textit{supra} note 89, at 302.
\end{itemize}
the draconian penalties imposed on insider trading by the federal securities
laws. They combine public law enforcement, which enhances the
probability of detection, with onerous criminal and civil sanctions, which
maximize the nominal sanction. In contrast, the sanction presently available
in private party litigation is limited to actual damages or disgorgement of
actual profits. While that sanction could be increased, perhaps by creation
of the same sort of treble money remedy that exists under the antitrust laws,
it may well be the case that criminal sanctions are needed for effective deter-
rence.

Because insider trading is difficult to prosecute even when detected,
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.

In any case, the notion of creating a regime in which public agencies
detect wrongdoing, but then leave enforcement to private parties strikes me
as odd. Such regimes are rare, at best. Instead, where enforcement or other
costs are such that private enforcement of property rights is difficult, the law
typically uses the state’s regulatory powers as a substitute for creating a
property right. Insider trading, in fact, is a classic example of a regula-
tory regime that acts as a substitute for private property rights.

This analysis answers the question posed in the preceding section;
namely, why insider trading is an appropriate matter of federal concern in
light of the Supreme Court’s consistent holdings that fiduciary duties are a
matter for state law. It is solely because of the SEC’s comparative advantage
in detecting and prosecuting insider trading that it is appropriately treated
differently than other breaches of corporate fiduciary duty. Other duty of

316. Bainbridge, supra note 3, at 488-91.
318. See Frank H. Easterbrook, Insider Trading as an Agency Problem, in
Principals and Agents: The Structure of Business 81 (J. Pratt & R. Zeckhauser eds.,
1985). Professor Romano identifies “a practical weakness with this explanation. . Until the
1980s, cases seeking criminal penalties for insider trading, rather than civil sanctions, were
unheard of.” Romano, supra note 199, at 102. This is not as serious an objection, however,
as it may seem at first blush. Recall that prior to Chiarella, key interest groups were at risk
of being charged with insider trading. See supra notes 261-62 and accompanying text. Their
exposure may have discouraged vigorous enforcement of the insider trading laws, which
would have protected all potential subjects of criminal enforcement.
319. See supra note 269 and accompanying text.
loyalty questions, such as usurpation of corporate opportunities and interested directors transactions, are appropriately left to private party enforcement under state corporate law because they are both rare and comparatively easy to detect and prosecute. In a public corporation, opportunities to inside trade are likely to be much more common than are opportunities for self-dealing transactions with the corporation. Insider trading is also easier to hide. In contrast to insider trading, which is conducted on impersonal stock exchanges and lends itself to secrecy, transacting with the corporation necessarily takes place in the open. Nor is it easy to usurp a corporate opportunity without that fact coming to light. Only the much greater likelihood of insider trading, coupled with the degree of difficulty associated with detecting and prosecuting it, justifies treating it as an exception to the Santa Fe rule.

This leads us to the second counter-point to Macey’s argument, which is that insofar as it is intended as a proposal for law reform, it ignores the implications of his own analysis of the politics of insider trading. If Dooley and Macey are correct, repealing the federal prohibition is politically impracticable. There is no organized constituency that favors doing so, while attempting to do so would generate strong interest group opposition. Doing so, moreover, would run counter to the institutional interests of the SEC and Congress. If politics is the art of the possible, so too is law reform. At best, critics of the prohibition can hope only for judicial tinkering at the margins of how insider trading is defined.

Incorporation of state law as the basis for the requisite fiduciary duty is precisely the sort of marginal change that ought to be sought by proponents of reforming the prohibition. Doing so is politically practical (at least in comparison to repealing the prohibition), doctrinally sound, and theoretically justifiable. Incorporating state law is thus preferable both to proposals to create a unique federal fiduciary duty applicable to insider trading or to repeal the federal prohibition.

3. A Modest Proposal for Reform

In sum, regulation of insider trading is a matter of federal concern not because it implicates important federal policies, but simply because regulating insider trading is an important societal goal and the federal government is able to accomplish that goal more efficiently than are states or private parties. But while efficiency of enforcement justifies a federal prohibition of insider trading, it does not justify creating a unique federal definition of insider trading. To be sure, if we adopt state law fiduciary duty principles as the rule of decision, there will be cases in which an enforce-
ment proceeding is derailed because the defendant's conduct violated no fiduciary duty under applicable state law. But so what? This is true whenever state standards are incorporated into federal common law. Even if a uniform federal rule were adopted, moreover, there would still be cases falling outside its scope.

It is also important to note that while insider trading cases are often brought by the federal government and arise under federal statute, insider trading does not directly affect the rights of the United States or threaten to impose liability on it. Rather, as the breach of fiduciary duty requirement itself suggests, insider trading mainly implicates the rights and obligations of private parties. Courts are more likely to impose uniform national rules in the former case than in the latter.

The bottom line, however, is whether application of state law would frustrate the accomplishment of federal policies. The key point here is the absence of any public-regarding federal policies at stake in regulating insider trading. To the contrary, incorporating state law is the approach most consistent with the policies of the federal securities laws. Creation of the federal insider trading prohibition involved federalizing an area traditionally regulated by the states. As we have seen, this easily might have proved the first wedge in federalizing the entire body of state corporate law. *Santa Fe* blunted that threat, but the insider trading prohibition still lingers on the federal stage.

The federalism policies reflected in *Santa Fe* are deeply imbedded in the Supreme Court's securities jurisprudence, as reflected by *Burks* and other cases. Clearly establishing state law as the rule of decision would go a long

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320. In the analogous context of borrowing state statutes of limitations for application to implied federal rights of action, the Supreme Court has indicated that a uniform federal rule is appropriate if the use of state rules would result in forum shopping. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston*, 501 U.S. 350, 357 (1991). In this context, the risk of forum shopping is minimal. Long-standing choice-of-law rules direct that questions of breaches of fiduciary duty by corporate officers and directors are governed by the law of the state of incorporation. RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 309 (1969). Similar choice-of-law rules governing misconduct by agents would apply to misappropriation cases. Hence, for most insider trading cases, forum shopping is not a concern.

In *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977), the Supreme Court observed that "Federal Courts applying a 'federal fiduciary principle' under rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system." *Santa Fe Indus.*, 430 U.S. at 479. This is consistent with *Lampf*’s holding that a unique federal common-law rule should be created when a uniform federal standard is required. The basic thesis of this article, of course, is that insider trading should not be governed by a "federal fiduciary principle," but by state fiduciary principles.

way towards reconciling the prohibition and *Santa Fe*. Recall that incorporation of state law is appropriate when there is no body of applicable federal law upon which to draw. Because *Santa Fe* precluded the development of a general body of federal fiduciary law, this principle is especially apt in the present context.

More important, by incorporating state law courts would minimize the extent to which the federal insider trading prohibition intrudes on the state’s legitimate zone of regulatory authority over fiduciary duties. As such, if frustration of federal policy is the basic test, state law should be incorporated. Doing so would advance the federalism policies of the securities laws, without adversely affecting any other policy goals of those laws.

State law fiduciary duty principles still would be the appropriate rule of decision, however, even if *Santa Fe* had never been decided. In light of the property rights rationale for regulating insider trading, the prohibition should extend only to cases in which property rights are threatened. As we have seen, federal insider trading jurisprudence in some areas has failed to draw the distinctions required by a property rights approach. In contrast, as the debate between the *Diamond* and *Freeman* courts demonstrates, adoption of state law fiduciary duties as the rule of decision will force courts to ask the right questions because those duties are defined by reference to whether the agent’s conduct threatens the principal’s property rights in information. Indeed, the very diversity and multiplicity of state law fiduciary duty rules will force courts to ask whether liability is appropriate in a particular case, in contrast to the present single federal fiduciary standard under which courts all too often fail to engage in any meaningful analysis of whether the prohibition ought to extend to the case at bar.

In sum, it is appropriate for insider trading to be regulated by the federal government. There is no reason, however, for that regulation to take the form of a unique nationwide rule of federal common law. Instead, the fiduciary duty element required by the federal definition of insider trading should be supplied solely by state corporate law.

**VII. Conclusion**

This Article was intended to answer a question posed in my prior work on insider trading by lawyers; namely, to what extent are state law fiduciary duties relevant to the federal insider trading prohibition?322 In studying that question, one inevitably concludes that the emperor has no clothes. Courts have systematically turned a blind eye to the myriad of doctrinal problems

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inherent in the current prohibition. In this Article, I offer the emperor at least a fig leaf. Instead of proposing repeal of the prohibition, which seems politically impractical and unwarranted as a matter of policy, I have proposed a mechanism for rationalizing the prohibition and thereby assuaging the doctrinal conflicts that beset it.

Insider trading is not defined in the federal securities statutes. Instead, its definition has evolved through a process of common-law adjudication. At the core of the resulting rule is a requirement that the alleged inside trade constitute a breach of the trader's fiduciary duty to refrain from self-dealing in confidential information. Once the substantive definition of insider trading is viewed as a species of federal common law, the question arises whether federal courts should incorporate state law as the rule of decision or create a unique federal standard. This Article has demonstrated that the insider trading prohibition can be justified only as a mechanism for protecting property rights in information. As such, the prohibition has relatively little to do with the traditional securities regulation concerns of disclosure and fraud. To the contrary, insider trading became a matter of federal concern because of the SEC's self-interest and that of some of its regulatory constituents. To be sure, the exigencies of detecting and prosecuting insider trading warrant a continuing federal regulatory role. Because there is no significant federal policy interest at stake, however, there is no reason to create a unique federal rule defining insider trading. Instead, courts should adopt state law fiduciary duty principles as the rule of decision.

Granted, reliance on state law will complicate insider trading prosecutions. But no more so than in any other case where state standards are incorporated into federal common law. In any case, there are affirmative reasons to adopt state law as the rule of decision. By acknowledging that insider trading is primarily a matter for state law, like all other questions of fiduciary duty, this approach accords proper deference to the states' position as the primary regulator of corporate governance questions. Finally, because state law fiduciary duty rules are designed to protect property rights, looking to them to define insider trading will more clearly tie the prohibition to the rationale for regulating insider trading.