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Insider Trading

Insider-trading law has been shaped by competing institutional forces and theoretical perspectives. While the Securities and Exchange Commission (SEC) and federal prosecutors have pushed for broad theories of liability rooted in the value of equal access to information, the courts have implemented a narrower framework predicated on fiduciary duty and fraud. Congress, however, has not weighed in on this back-and-forth. Despite the attention insider trading attracts, legislators have not enacted a statutory definition for the offense. Its elements are instead the product of judicial decisionmaking, with SEC rules supplementing the core prohibition. Nevertheless, recent Congresses have shown increasing interest in insider trading, featuring several bills that would codify the elements of the offense and fill perceived gaps in existing doctrine. This In Focus provides an overview of insider-trading law and recent efforts at legislative reform.

The Evolution of Insider-Trading Law

Origins

The modern insider-trading prohibition is grounded in Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5. Those provisions impose broad prohibitions of fraud in connection with securities transactions, but do not explicitly mention insider trading. Nevertheless, the courts and regulators have constructed a complex legal regime on top of this modest textual foundation.

The story begins in 1961, when the SEC first deployed Rule 10b-5 to tackle open-market trading on the basis of inside information. In that year, the Commission settled an administrative enforcement action against a brokerage-firm partner who sold shares of the Curtiss-Wright Corporation after learning of an impending dividend cut from one of the corporation's directors. The enforcement action—*In re Cady, Roberts & Co.*—marked the SEC's first articulation of what became known as the "disclose or abstain" rule, under which persons with special access to a corporation's material nonpublic information must either disclose such information or abstain from trading the corporation's securities.

While *Cady, Roberts* represented a notable expansion of Rule 10b-5, the Second Circuit accepted the SEC's position seven years later in *SEC v. Texas Gulf Sulphur Co*. The case offers a common insider-trading fact pattern: after a mining company discovered promising mineral deposits—but before it announced the discovery—several insiders bought the company's shares and options to acquire its shares. The Second Circuit embraced the SEC's view that this conduct violated Rule 10b-5. In doing so, the court articulated a broad theory of insider-trading liability premised on the notion that all investors should have equal access to material information about the securities they trade. Although the defendants in *Texas Gulf* were insiders, the court's opinion did not limit the "disclose or abstain" rule to a corporation's officers, directors, and agents. Instead, the Second Circuit explained that the requirement applied to *anyone* in possession of material nonpublic information—regardless of their relationship to the securities issuer.

The Supreme Court Alters the Approach

The equal-access gloss on Rule 10b-5 did not last. In 1980, the Supreme Court rejected that theory in *Chiarella v. United States*. The case involved an employee of a financial printer that prepared tender-offer documents for acquirers. Based on information in these documents, the employee identified firms that were being targeted for acquisition and purchased their shares before the bids were announced. The employee thus clearly traded on the basis of material nonpublic information. Nevertheless, he was not an insider of the targeted firms, nor did his employer—which served the acquirers—have any special relationship with them. In *Chiarella*, the Court reversed the employee's insider-trading conviction based on the absence of such a relationship. According to the Court, a trader's failure to disclose a material fact is fraudulent—and therefore violates Rule 10b-5—only if the trader has a duty to disclose the fact. There is no such duty, however, absent a "fiduciary or other similar relation of trust and confidence." While the Court acknowledged that corporate *insiders* owe fiduciary duties to buyers and sellers of their companies' shares, it concluded that the defendant in *Chiarella* had no such relationship with the shareholders of the targeted firms. The Court therefore reversed the defendant's conviction because the trial court's jury instructions improperly allowed for a conviction without a finding of the requisite relationship.

In rejecting the equal-access model from *Texas Gulf*, *Chiarella* sets forth the basic contours of what has been called the **"classical" theory of insider-trading liability**, under which corporate insiders who trade on material nonpublic information violate Rule 10b-5 by breaching a duty to their *counterparties* (buyers or sellers). The decision explicitly declined to consider an alternative theory, under which persons who trade on material nonpublic information can violate Rule 10b-5 by breaching a duty to the *source of the information* (in *Chiarella*, the acquirers that had retained the defendant's printing firm). This **"misappropriation" theory** would remain in limbo until the Supreme Court embraced it in its 1997 decision in *United States v. O'Hagan*. In that case, a partner at a law firm representing an acquirer in a takeover bid purchased shares in the targeted firm before the transaction was publicly announced. Like the defendant in *Chiarella*, the lawyer owed no fiduciary duties to his counterparties (the target's shareholders), and therefore could not be liable under the classical theory. Nevertheless, the Court concluded that the attorney had violated Rule 10b-5 by misappropriating confidential information from the acquiring company that had retained his law firm. The Court explained that the attorney's undisclosed misappropriation of his principal's information fell squarely within Rule 10b-5's prohibition because it defrauded his principal of the exclusive use of that information.

"Tippee" Liability

Rule 10b-5 is not limited to corporate insiders and persons who directly misappropriate nonpublic information. Rather, much of the ambiguity in insider-trading law involves the circumstances in which defendants can be liable for trading on the basis of a "tip" from such persons. The Supreme Court's decision in *Dirks v. SEC* remains the seminal case on "tippee" liability. In *Dirks*, a former insider at a financial conglomerate had leaked information about corporate fraud to a securities analyst. The analyst then passed the information to clients, who ultimately traded on it. The Court rejected the SEC's argument that the analyst had violated Rule 10b-5 by relaying the information, reasoning that tippees are liable for insider trading only if they know or should know that their tippers violated a fiduciary duty or similar obligation by disclosing the information. For such a violation to occur, the Court explained, the tipper must seek to *personally benefit* from the disclosure. Because the tipper in *Dirks* was motivated by a desire to expose corporate fraud rather than by the prospect of pecuniary or reputational benefits, the Court concluded that there had been no breach of a duty—and therefore no violation of Rule 10b-5 by the tippee.

Dirks's "personal benefit" requirement has bedeviled the courts. In *Dirks* itself, the Supreme Court explained that the standard could be satisfied with evidence suggesting a *quid pro quo*, or a "gift" of nonpublic information to "a trading relative or friend." In the latter circumstance, the Court reasoned, a tip resembles trading by the insider or misappropriator himself, followed by a gift of the profits to the tippee. Later decisions have complicated this inquiry. In 2014, the Second Circuit adopted a restrictive view of the "personal benefit" test in *United States v. Newman*, where it held that tippee liability requires proof of a "meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." This language stands in some tension with *Dirks*'s recognition that a tipper can personally benefit from a gift of information to a relative or friend. The Supreme Court partially clarified the law in its 2016 decision in *Salman v. United States*, where it rejected *Newman*'s conclusion that the personal-benefit test requires a tipper and tippee to have exchanged something of "pecuniary or similarly valuable nature." Even so, the status and scope of *Newman*'s "meaningfully close personal relationship" requirement remain unsettled.

SEC Rules

The SEC has responded to the Supreme Court's fraud-based insider-trading doctrine with a series of rules designed to patch perceived holes in the case law.

SEC Rule 14e-3 prohibits trading on material nonpublic information related to tender offers when (1) the information is derived from the offering person, issuer of the securities sought by the offer, or an insider of the issuer, and (2) the bidder has taken substantial steps to commence the offer. The SEC adopted the rule six months after the Supreme Court's *Chiarella* decision in 1980, at the onset of a decade marked by an explosion in corporate takeovers.

SEC Rule 10b5-1 defines the circumstances in which a purchase or sale of securities constitutes trading "on the basis of" material nonpublic information. The rule adopts a broad conception of this standard, defining "on the basis of" to include mere awareness of such information. Rule 10b5-1 also sets forth affirmative defenses for insiders who trade pursuant to a preexisting contract, instruction, or written plan. In response to allegations that corporate executives regularly abuse Rule 10b5-1 trading plans, SEC Chair Gary Gensler and some Members of Congress have expressed interest in revisiting the rule.

SEC Rule 10b5-2 provides a nonexclusive list of the circumstances in which a person has a "duty of trust or confidence" for purposes of the misappropriation theory of insider-trading liability. The rule departs from a strict fiduciary model, providing that such a duty exists whenever (1) a person agrees to maintain information in confidence; (2) two people have a pattern or practice of sharing confidences, such that the recipient of the information should know that the other person has an expectation of confidentiality; or (3) someone receives information from a spouse, parent, child, or sibling, provided that the defendant does not affirmatively demonstrate the absence of an expectation of confidentiality.

Proposed Legislation

Recent Congresses have featured several pieces of insider-trading legislation. **H.R. 2655, the Insider Trading Prohibition Act (ITPA) (117th Cong.)**—which the House has passed—would retain the current fraud-based regime but broaden it in certain respects. Among other things, the bill would fill an oft-criticized gap in the law by prohibiting trading on the basis of information that is obtained by various illegal methods, even where there is no breach of a fiduciary duty or similar obligation. In the 114th Congress, **H.R. 1173, the Ban Insider Trading Act (BITA)**, would have adopted a similar change and expressly dispensed with the personal-benefit requirement for tippee liability. **S. 702, the Stop Illegal Insider Trading Act (114th Cong.)**, would have gone further than either the ITPA or the BITA and replaced the current fraud-based regime with an equal-access model prohibiting *any* trading on the basis of material nonpublic information. Finally, **S. 2211 and H.R. 1528, the Promoting Transparent Standards for Corporate Insiders Act (117th Cong.)**, would direct the SEC to study possible revisions to Rule 10b5-1.

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