University of California, Los Angeles
School of Law
Law & Economics Research Paper Series

An Overview of US Insider Trading Law: Lessons for the EU?

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Research Paper No. 05-5

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Abstract: This brief essay was prepared for a forthcoming symposium on Directive 2003/6/EC of the European Parliament and of the Council, which *inter alia* mandates a uniform regulatory regime for insider trading among EU member states. In this essay, I review the evolution of insider trading law in the United States for the benefit of EU observers in connection with the on-going process of member state implementation of the Directive.

Although legal liability for insider trading in the United States is based on the federal securities regulation statutes, most notably Rule 10b-5 under the Securities Exchange Act of 1934, the prohibition of insider trading in fact exists almost independently of the relevant statutes. Instead, the law of insider trading has evolved through a series of judicial opinions in a process more closely resembling common law adjudication rather than statutory interpretation.

Taken together, the statutes and case law provide a comprehensive scheme of insider trading regulation upon which EU member states usefully may draw in implementing the Directive. As the essay explains, however, the ad hoc process by which U.S. law evolved has created a number of doctrinal problems that the member states would do well to avoid.

JEL Classification: K22, G30, G38

Keywords: Insider trading

An Overview of US Insider Trading Law: Lessons for the EU?

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The prohibition of insider trading originally evolved in the United States as a matter of the state law fiduciary duties of corporate directors and officers. Even after securities regulation became a matter principally of Federal concern following the adoption of the Securities Act of 1933 and the Securities Exchange Act of 1934, federal law continued to largely ignore insider trading until the late 1960s. In the last four decades, however, a complex federal prohibition of insider trading has emerged as a central feature of modern U.S. securities regulation.

Although the modern insider trading prohibition technically is grounded in the federal securities regulation statutes, most notably Rule 10b-5 promulgated by the Securities and Exchange Commission (SEC) pursuant to the authority granted it by Section 10(b) of the Securities Exchange Act, the prohibition in fact evolved through a series of judicial decisions in a process more closely akin to common law adjudication rather than statutory interpretation.

Taken together, the statutes and case law provide a comprehensive scheme of insider trading regulation upon which EU member states usefully may draw in implementing Directive 2003/6/EC on insider dealing. As this Essay explains, however, the ad hoc process by which U.S. law evolved has created a number of doctrinal problems that the member states would do well to avoid.

I. Origins of the Federal Prohibition

Change is one of the key distinguishing characteristics of the federal insider trading prohibition. Although the prohibition is only about three decades old, already it has seen more shifts in doctrine than most corporate law rules have seen in the last century. In particular, there has been a steady pattern in which new theories of liability have emerged. We shall see two very important cases in which the Supreme Court restricted the scope of the traditional disclose or abstain rule. In response to those cases, the SEC and the lower courts developed two new theories on which liability could be imposed. Unfortunately, this process has been rather ad hoc, which has left the doctrine with a number of problems and curious gaps.

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A. The Statutory Background

The core of the modern federal insider trading prohibition derives its statutory authority from § 10(b) of the Exchange Act, which provides in pertinent part that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered …, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. …[1]

Notice two things about this text. First, it is not self executing. Until the SEC exercises the rulemaking authority vested on it by the statute, § 10(b) does nothing.

The second point to be noticed is that nothing in § 10(b) explicitly proscribes insider trading. To the extent the 1934 Congress addressed insider trading, it did so not through § 10(b), but rather through § 16(b), which permits the issuer of affected securities to recover insider short-swing profits.[2] 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 § 12.

If Congress intended in 1934 that the SEC use § 10(b) to craft a sweeping prohibition on insider trading, the SEC was quite dilatory in doing so. Rule 10b-5, the foundation on which the modern insider trading prohibition rests, was not promulgated until 1942, eight years after Congress passed the Exchange Act. The Rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[3]

Note that, as with § 10(b) itself, the rule on its face does not prohibit (or even speak to) insider trading. Nor was Rule 10b-5 initially used against insider trading on public secondary trading markets. Instead, the initial Rule 10b-5 cases were limited to face-to-

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[1] 15 U.S.C. § 78j(b).

[2] 15 U.S.C. § 78p(b).

[3] 17 CFR § 240.10b-5.

face and/or control transactions.[4] Not until 1961 did the SEC finally conclude that insider trading on an impersonal stock exchange violated Rule 10b-5.[5] In sum, the modern prohibition is a creature of SEC administrative actions and judicial opinions, only loosely tied to the statutory language and its legislative history.

B. The Disclose or Abstain Rule

The modern federal insider prohibition began taking form in *SEC v. Texas Gulf Sulphur Co*.[6] The *TGS* opinion rested on a policy of equality of access to information. The court contended that the federal insider trading prohibition was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material information." Put another way, the majority thought Congress intended "that all members of the investing public should be subject to identical market risks." Accordingly, under *TGS* and its progeny, virtually anyone who possessed material nonpublic information was required either to disclose it before trading or abstain from trading in the affected company's securities. 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. US*,[7] the United States 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. In turn, the requisite duty to disclose arises out of a fiduciary relationship between the inside trader and the persons with whom he trades. *Chiarella* thus made clear that the disclose or abstain rule is not triggered merely because the trader possesses material nonpublic information. When a securities fraud action 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 information.

C. Tipping

Chiarella substantially limited the scope of the insider trading prohibition. As such, it posed the question whether anyone other than classical insiders such as directors, officers, and perhaps large shareholders could be held liable for dealing on the basis of insider information. In *Dirks v. SEC*,[8] the Supreme Court confirmed that the prohibition

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[4] See, e.g., Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) (omissions in connection with what amounted to tender offer).

[5] In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[6] 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

[7] 445 U.S. 222 (1980).

[8] Dirks v. SEC, 463 U.S. 646 (1983).

extended beyond classical insiders and began fleshing out the rules applicable to them. The court began by reaffirming its rejection of the equal access standard:

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on 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." Not to require such a fiduciary relationship, we recognized, would "[depart] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."

The court then explained that the prohibition applied not only when such a person traded but also when such a person tipped inside information to someone who then trades.

The court held that a tippee's liability is derivative of that of the tipper, "arising from [the tippee's] role as a participant after the fact in the insider's breach of a fiduciary duty." A tippee therefore can be held liable only when the tipper breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.

What *Dirks* proscribes thus is not merely a breach of confidentiality by the insider, but rather the breach of a fiduciary duty of loyalty to refrain from profiting on information entrusted to the tipper. Looking at objective criteria, courts must determine whether the insider-tipper personally benefited, directly or indirectly, from his disclosure. The most obvious case is the *quid pro quo* setting, in which the tipper gets some form of pecuniary gain. Nonpecuniary gain can also qualify, however. Suppose a corporate CEO discloses information to a wealthy investor not for any legitimate corporate purpose, but solely to enhance his own reputation. *Dirks* would find a personal benefit on those facts. Finally, *Dirks* indicated that liability could be imposed where the tip is a gift, because it is analogous to the situation in which the tipper trades on the basis of the information and then gives the tippee the profits.

Because *Dirks* requires that the tipper receive some personal benefit, it did not prohibit corporate insiders from selectively disclosing information to certain analysts so long as there was a corporate purpose for doing so. In 2000, the SEC adopted Regulation FD to create a noninsider trading-based mechanism for restricting selective disclosure. If someone acting on behalf of a public corporation discloses material nonpublic information to securities market professionals or "holders of the issuer's securities who may well trade on the basis of the information," the issuer must also disclose that information to the public. Where the issuer intentionally provides such disclosure, it must simultaneously disclose the information in a manner designed to convey it to the general public. Hence, for example, if the issuer holds a briefing for selected analysts, it must simultaneously announce the same information through, say, a press release to "a widely disseminated news or wire service." The SEC encouraged issuers to make use of the Internet and other new information technologies, such as by webcasting conference calls with analysts. Where the disclosure was not intentional, as where a corporate officer "let something slip," the issuer must make public disclosure "promptly" after a senior officer learns of the disclosure.

D. The Misappropriation Theory and Rule 14e-3

Dirks did not resolve the significant question posed by *Chiarella*; namely, to what extent does the insider trading prohibition apply where the defendant traded on the basis of market information derived from sources other than the issuer. The classic case is where an insider of a takeover bidder trades in stock of the target company on the basis of information about the bidder's plans. Such a person is not one in whom the shareholders of the target have placed their trust and confidence. Accordingly, under *Chiarella* no liability should arise. (Indeed, *Chiarella* involved just such facts.)

Rule 14e-3 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. This provision (Rule 14e-3(d)(1)) does not prohibit the bidder from buying target shares or from telling its legal and financial advisers about its plans. Instead, it prohibits tipping of information to persons who are likely to buy target shares for their own account. Rule 14e-3 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.

Unlike both the disclose or abstain rule and the misappropriation theory under Rule 10b-5, Rule 14e-3 liability is not premised on breach of a fiduciary duty. There is no need for a showing that the trading party or tipper was subject to any duty of confidentiality, and no need to show that a tipper personally benefited from the tip.

Misappropriation. In response to the set-backs it suffered in *Chiarella* and *Dirks*, the SEC began advocating a new theory of insider trading liability: the misappropriation theory. Unlike Rule 14e-3, the SEC did not intend for the misappropriation theory to be limited to tender offer cases (although many misappropriation decisions have in fact involved takeovers). Accordingly, the Commission posited misappropriation as a new theory of liability under Rule 10b-5.

In *US v. O'Hagan*,[9] the Supreme Court endorsed the misappropriation theory as a valid basis for insider trading liability. A fiduciary's undisclosed use of information belonging to his principal, without disclosure of such use to the principal, for personal gain constitutes fraud in connection with the purchase or sale of a security and thus violates Rule 10b-5.

The court acknowledged that misappropriators have no disclosure obligation running to the persons with whom they trade. Instead, it grounded liability under the

[9] 521 U.S. 642 (1997).

misappropriation theory on deception of the source of the information: the theory addresses the use of "confidential information for securities trading purposes, in breach of a duty owed to the source of the information." Under this theory, "a fiduciary's undisclosed, self serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information." So defined, the majority held, the misappropriation theory satisfies § 10(b)'s requirement that there be a "deceptive device or contrivance" used "in connection with" a securities transaction.

In many respects, *O'Hagan* posed more new questions than it answered old ones. For example, is there liability for so-called brazen misappropriators? Because the *O'Hagan* majority made clear that disclosure to the source of the information is all that is required under Rule 10b-5, ifa brazen misappropriator discloses his trading plans to the source, and then trades on that information, Rule 10b-5 is not violated, even if the source of the information refused permission to trade and objected vigorously.

Would there be liability for authorized trading? Suppose a proxy contest insurgent authorized an arbitrageur to trade in a target company's stock on the basis of material nonpublic information about the prospective insurgent's intentions. The *O'Hagan* majority at least implicitly validated such transactions. It approvingly quoted, for example, the statement of the government's counsel that "to satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent." Hence, assuming such consent is forthcoming, the arbitrageur would escape Rule 10b-5 liability. Note that Rule 14e-3 would not apply because the transaction is a proxy contest rather than a tender offer.

These and the various other doctrinal questions that pervade the insider trading prohibition are a direct consequence of the ad hoc process of common law adjudication by which the prohibition has evolved in the US. Directive 2003/6/EC gives the EU;s member states a valuable opportunity to avoid these problems by writing on a more-or-less blank slate.

II. Elements of the Modern Prohibition

Inside versus market information: Nonpublic information, for purposes of Rule 10b-5, takes two principal forms: "inside information" and "market information." Inside information typically comes from internal corporate sources and involves events or developments affecting the issuer's assets or earnings. Market information typically originates from sources other than the issuer 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. Under US law, the use of either sort is prohibited.

Materiality: Liability arises only with respect to trading on the basis of material information. Materiality is defined for this purpose as whether there is a substantial likelihood that a reasonable investor would consider the omitted fact important in deciding whether to buy or sell securities.[10]

Nonpublic Information: When can insiders trade? Insiders may not trade whenever they are in possession of material nonpublic information. When the information in question is disclosed, insiders may trade but only after the information in question has been effectively made public. The information must have been widely disseminated and public investors must have an opportunity to act on it. At a minimum, insiders therefore must wait until the news could reasonably be expected to appear over the major business news wire services.

Who is an insider? The term insider trading is something of a misnomer. To be sure, the modern federal insider trading prohibition proscribes a corporation's officers and directors from trading on the basis of material nonpublic information about their firm, but it also casts a far broader net.

At common law, the insider trading prohibition focused on corporate officers and directors. The short-swing profit insider trading restrictions provided by §16(b) similarly are limited to officers, directors, and shareholders owning more than 10 percent of the company's stock. In the seminal *Texas Gulf Sulphur* decision, some of the defendants were middle managers and field workers. The court had little difficulty finding that such mid-level corporate employees were insiders for purposes of § 10(b). Subsequent courts have agreed that employees and agents are covered just as are directors and officers.

In *Dirks*, the Supreme Court made clear that the prohibition also extends to a variety of nominal outsiders whose relationship to the issuer is sufficiently close to justify treating them as "constructive insiders." The Court offered as examples: "an underwriter, accountant, lawyer or consultant working for the corporation." More generally, the court held that an outsider becomes a constructive insider where he obtains material nonpublic information from the issuer with an expectation on the part of the corporation that the outsider will keep the disclosed information confidential and the relationship at least implies such a duty.

Possession or use? The SEC long has argued that trading while in knowing possession of material nonpublic information satisfies Rule 10b-5's scienter requirement. In *United States v. Teicher*,[11] the Second Circuit agreed, albeit in a passage that appears

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[10] Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

[11] 987 F.2d 112 (2d Cir. 1993). See generally Allan Horwich, Possession Versus Use: Is there a Causation Element in the Prohibition on Insider Trading? 52 Bus. Law. 1235 (1997); Donna M. Nagy, The "Possession vs. Use" Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden, 67 U. Cin. L. Rev. 1129 (1999).

to be dictum. In *SEC v. Adler*,[12] however, the Eleventh Circuit rejected *Teicher* in favor of a use standard. Under *Adler*, "when an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade—i.e., that the information was not used."

In an attempt to resolve the dispute, the SEC adopted Rule 10b5-1, which states that Rule 10b-5's prohibition of insider trading is violated whenever someone trades "on the basis of" material nonpublic information. Because one is deemed, subject to certain narrow exceptions, to have traded "on the basis of" material nonpublic information if one was aware of such information at the time of the trade, Rule 10b5-1 formally rejects the *Adler* position. In practice, however, the difference between *Adler* and Rule 10b5-1 may prove insignificant. While *Adler* created a presumption of use when the insider was aware of material nonpublic information, Rule 10b5-1 provides affirmative defenses for insiders who trade pursuant to a pre-existing plan, contract, or instructions. As a result, the two approaches should lead to comparable outcomes in most cases.

Is there liability for trading in debt securities? One of the areas in which the Supreme Court's failure adequately to specify the source and nature of the fiduciary obligation underlying the disclose or abstain rule has proven especially problematic is insider trading in debt securities. Yet, the prohibition's application to debt securities has received surprisingly little judicial attention. One court has held that insider trading in convertible debentures violates Rule 10b-5,[13] but this case is clearly distinguishable from nonconvertible debt securities. As to the latter, there is still no definitive resolution.

III. Remedies and Penalties

Under Exchange Act § 32(a), a willful violation of Rule 10b-5 or 14e-3 is a felony that can be punished by both fines and jail time. Although the SEC has no authority to prosecute criminal actions against inside traders, it is authorized by Exchange Act §21(d)(1) to ask the Justice Department to initiate a criminal prosecution. In addition, the Justice Department may bring such a prosecution on its own initiative.

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[12] 137 F.3d 1325 (11th Cir. 1998). The Ninth Circuit subsequently agreed with *Adler* that proof of use, not mere possession, is required. The Ninth Circuit further held that in criminal cases no presumption of use should be drawn from the fact of possession—the government must affirmatively prove use of nonpublic information. United States v. Smith, 155 F.3d 1051 (9th Cir. 1998).

[13] In re Worlds of Wonder Securities Litigation, [1990-1991 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,689 (N.D.Cal. 1990).

Most insider trading litigation, however, consists of civil actions brought by the SEC.[14] Under Exchange Act §21(d), the SEC may seek a permanent or temporary injunction whenever "it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation" of the Act or any rules promulgated thereunder. "Once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the court possesses the necessary power to fashion an appropriate remedy."[15] Thus, in addition to or in place of injunctive relief, the SEC may seek disgorgement of profits, correction of misleading statements, disclosure of material information, or other special remedies. Of these, disgorgement of profits to the government is the most commonly used enforcement tool.

Finally, among other remedies and sanctions, the Insider Trading Sanctions Act of 1984 created a civil monetary penalty of up to three times the profit gained or loss avoided by a person who violates Rules 10b-5 or 14e-3 "by purchasing or selling a security while in the possession of material nonpublic information." An action to impose such a penalty may be brought in addition to or in lieu of any other actions that the SEC or Justice Department is entitled to bring.

IV. Conclusion

Because of the space limitations imposed on this essay, the analysis herein necessarily touched only briefly on some of the most prominent foibles and gaps that have been created in the US insider trading law by the ad hoc process of common law adjudication by which the prohibition has evolved.[16] It is to be hoped that the EU's member states will take advantage of the opportunity provided by Directive 2003/6 to adopt the best aspects of US law, while avoiding the worst of our foibles and gaps.

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[14] Although it has long been clear that persons who traded contemporaneously with an inside trader have a private cause of action under Rule 10b-5 (and perhaps Rule 14e-3), and may also have state law claims, private party litigation against inside traders has been rare and usually parasitic on SEC enforcement actions.

[15] SEC v. Manor Nursing Centers, 458 F.2d 1082, 1103 (2d Cir. 1972). The SEC may also punish insider trading by regulated market professionals through administrative proceedings. Under §15(b)(4) of the 1934 Act, the SEC may censure, limit the activities of, suspend, or revoke the registration of a broker or dealer who willfully violates the insider trading prohibition. Similar sanctions may be imposed on those associated with the broker or dealer in such activities. The SEC may issue a report of its investigation of the incident even if it decides not to pursue judicial or administrative proceedings, which may lead to private litigation.

[16] For a more detailed treatment of the various idiosyncrasies of US insider trading law, see Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice between Property Rights and Securities Fraud*, 52 SMU LAW REVIEW 1589 (1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=142296.