“FINE DISTINCTIONS” IN THE CONTEMPORARY LAW OF INSIDER TRADING

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The law of insider trading is evolving in a way that reflects a fundamental conflict between a vision of the prohibition as a moralistic response to greed on the part of the privileged—especially when they occupy roles as fiduciaries—and a vision of the prohibition as akin to more conventional securities fraud. This Article traces this conflict back to Cady, Roberts, and then examines some contemporary issues that reflect this tension, especially the emergence of a theory of “reckless tipping.”

I. INTRODUCTION

Fifty years after Cady, Roberts’s claim that the law of insider trading should never be circumscribed “by fine distinctions and rigid classifications,”¹ that body of law is still mutating. To be sure, we now have a stable framework of three distinct legal theories—the classical theory, the misappropriation theory, and Rule 14e-3—each of which is well understood as to its basic elements.² Most insider trading cases handed down in any given year say nothing particularly new about the state of the law, but rather simply apply familiar principles to sometimes challenging facts.³ However, every so often we do discover something new about the core conceptions of insider trading.

Although I would like to concentrate mainly on this contemporary case law in this Article, doctrinal history is an essential starting point.¹ By all accounts, William Cary, then Chairman of the Securities and Exchange Commission (“SEC”), wanted to promote a wide scope to Rule 10b-5, which would include fiduciary breaches (i.e., constructive fraud), as well as classical common law deceit, and thus help build a federal body of corporate law that would supplement, if not supplant, the meager efforts of state courts and legislatures.⁵ He thought it unnecessary to answer

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² See generally 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION chs. 3, 6, 7 (2012 ed.).

³ Materiality questions tend to be the hardest, but the courts—both in insider trading cases and fraud cases generally under Rule 10b-5—have, by and large, resisted any effort to take cases away from the factfinder, who is expected to apply a highly general standard of what a reasonable investor would likely consider important. See generally id. ch. 5. Some scholars have criticized this approach. See Joan MacLeod Heminway, Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading, 72 LA. L. REV. 999 (2012).


⁵ Cady, Roberts, 40 S.E.C. at 910. Cary later offered useful commentary on his own thinking. See William L. Cary et al., Insider Trading in Stocks, 21 BUS. LAW. 1009 (1966). While this is generally viewed as the driving force behind the duty to abstain or disclose, the more specific history of concern at the SEC about brokerage firms using inside information to compete for customer favor and order flow at a time of fixed commissions is also worth noting. See generally Stanislav Dolgopolov, Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets, 4 J.L. ECON. & POL’Y 311 (2008). Stanislav Dolgopolov specifically points to evidence that the SEC staff in the New York regional office had determined to charge Cady, Roberts and its involved partners with a 10b-5 violation for insider trading before Cary came to the Commission,
the hard questions posed by common law courts that had struggled with how open-market purchases or sales become deceptive simply by virtue of the trader’s informational advantage resulting from some privileged position of access. 6 Rather, Cary believed that federal corporation law should be more ambitious than that, ignoring fine distinctions and avoiding rigid classifications. This expansive impulse, however, thrived only for a short while; within twenty years, its premise—that there is a free-floating federal fiduciary obligation discoverable within Rule 10b-5—was soundly rejected as a matter of principle. In celebration of the perceived virtues of state-law primacy that Cary instead found so disturbing, the Supreme Court said that fraud under Rule 10b-5 means real deception, nothing less. 7

That left insider trading law in an awkward place, because no one has ever been able to articulate a robust theory of harmful marketplace deception arising from insider trading. The insider’s order is anonymous, communicating nothing except the fact of a trade, inducing no one else to take the other side except as an independent choice to offer liquidity. So where is the detrimental reliance? On whom, or what? There may be very good economic policy arguments to prohibit it anyway—though these are still highly contested 8—but preventing open-market deception is not the fundamental point of any of them.

So how or why did the insider trading prohibition survive the retrenchment that happened to so many other elements of Rule 10b-5? The Supreme Court’s decision in Chiarella v. United States in 1980 cut back on the law’s scope, but still sustained the fiction of insider trading as actionable deception. 9 The core of insider trading regulation was left standing. We might call this a fictional “Cary-Powell compromise,” because Justice Powell was the moving intellectual force on the Court in reconceptualizing insider trading. 10 He cited Cady, Roberts repeatedly and with apparent favor in both Chiarella and its follow-on, Dirks v. SEC, 11 even as he was otherwise doing so much pruning. Powell’s two opinions joined with Cary’s view in promoting the fiduciary’s duty of affirmative disclosure as the crucial explanation for how insider trading can be thought of as deceptive, without mentioning the lingering irony of depending so much on purely constructive fraud. 12 The later-developing misappropriation theory, which the Court finally adopted in 1997 13—long after Justice Powell had retired—was a significant modification to this

8 I leave to elsewhere the never-ending debate among both lawyers and economists about whether and why insider trading is good or bad for the stock markets, stimulated initially by the work of Henry Manne. See generally Stephen Clark, Insider Trading and Financial Economics: Where Do We Go from Here?, 16 STAN. J.L. BUS. & FIN. 43 (2010); 18 LANGEVOORT, supra note 2, §§ 1:2–1:6.
10 See A.C. Pritchard, Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws, 52 DUKE L.J. 841, 931–34 (2003) (discussing Powell’s thinking, drawn from his private papers and other sources). The fiduciary emphasis reflected Powell’s deep-seated respect for the fiduciary obligation, coupled with the idea that using this, rather than some more expansive line of demarcation, would dissuade the SEC and prosecutors from pursuing a parity of information campaign.
compromise and even more accommodating in accepting fiduciary faithlessness as deception, pushing the law back further in Cary’s direction. As I argued in an earlier essay on Cady, Roberts, this strange and intellectually ungainly judicial commitment to assertive insider trading regulation—even by some fairly conservative judges—shows how powerful a totemic symbol the prohibition of insider trading has become in branding the American securities markets as supposedly open and fair, and American securities regulation as the investors’ champion. Insider trading regulation had already taken on an expressive value far beyond its economic importance, which judges were reluctant to undercut.\(^{15}\)

However, this commitment is hardly unconditional. From the beginning, Wall Street has tried to label the SEC’s campaign against insider trading as an unrealistic and ill-conceived effort to achieve “parity of information” in securities markets, taking away the incentive for information discovery crucial to market efficiency. That was always a bit of a hyperbole; from Cady, Roberts on, the effort was always to define a category describing the illegitimate use of confidential information separate and distinct from proper uses. But legitimacy is in the eye of the beholder, and it is possible to think that it is never fair to take advantage of secrets that belong to others without their clear-cut permission. If that drives the enforcement philosophy, we edge closer to parity of information, even if we never reach it.\(^{16}\) Chiarella chose the fiduciary principle as a line of demarcation, here based on the idea that it was naturally wrongful for fiduciaries—or their confederates—to secretly enrich themselves.

My argument is that the Supreme Court embraced the continuing existence of the “abstain or disclose” rule and tolerated constructive fraud, notwithstanding its newfound commitment to federalism, because it accepted the central premise on which the expressive function of insider trading regulation is based: manifestations of greed and lack of self-restraint among the privileged, especially fiduciaries or those closely related to fiduciaries, threaten to undermine the official identity of the public markets as open and fair. The law thus grants an entitlement to public traders that the marketplace pool will not be polluted by those kinds of insiders. But enough time may have passed that we may have lost sight of the compromise associated with this fiction and started acting as if insider trading really is the worst kind of deceit. The result is pressure on the doctrine to expand, using anything plausible in the 10b-5 toolkit.

Others have also noted this expansionism; Donna Nagy has described it as the gradual “demise” of fiduciary principles in the law of insider trading.\(^{17}\) My aim here is to tie the concern more clearly to the uneasy deceptiveness of insider trading, first using somewhat familiar examples such as the debate over whether possession or use is required for liability, and the supposed overreach of Rule 10b5-2. Each of these settings brings us back to the centrality of intent, reminding us that the Cary-Powell compromise has in mind a form of intentionality that is closely tied to greed and opportunism, making insider trading a sui generis form of securities

\(^{15}\) The courts’ tolerance was no doubt also bolstered by the fact that, earlier case law notwithstanding, novel insider trading cases are almost always posed in SEC enforcement actions or criminal prosecutions, not in the private securities class actions in which so many judges seem to have lost faith. See 18 LANGEVOORT, supra note 2, § 9:1. It is difficult to predict how insider trading law would have fared had the first case to come up to the Supreme Court been one of whether and how much other investors could recover in class action suits claiming open market insider trading.

\(^{16}\) The classic quest to define the illegitimate use of inside information was undertaken by Victor Brudney. See Victor Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322 (1979).

That takes us to the most jarring recent development in insider trading law—the emergence of recklessness as an alternative basis for liability. I finish with consideration of insider trading without a fiduciary breach, and a brief conclusion.

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