SOCIAL NORMS AND INSIDER TRADING

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INTRODUCTION

Insider trading is a somewhat misleading term. To the extent that the phrase is supposed to connote improper and unethical trading, it is both overinclusive and underinclusive. The term *insider trading* is overinclusive because not all trading by corporate insiders is improper or unethical. After all, insiders often trade while not in possession of any valuable or material information about the company whose shares they are trading. The term *insider trading* is underinclusive because it frequently is the case that trading by outsiders, i.e., those who have no connection with the company whose shares are being traded, is improper and unethical. A clear example of such trading is trading by government officials and legislators on the basis of nonpublic information obtained in the course of their official duties.[1]

The point of this Article is to establish the proposition that the goal of regulating what is known as insider trading should properly be understood as serving the function of promoting the generalized concept of social trust. This is not the only function served by insider trading law, but it may be the most important. In addition, the laws

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1. John W. Goodell & Toan Luu Duc Huynh, *Did Congress Trade Ahead? Considering the Reaction of U.S. Industries to COVID-19*, FIN. RSCH. LETTERS, Oct. 2020, at 1, 1, https://doi.org/10.1016/j.frl.2020.101578 [https://perma.cc/US56-Z3NU].

against insider trading protect corporations' property rights in information and police certain breaches of fiduciary duty.

As Francis Fukuyama argued most forcefully,[2] social trust—which refers to the ability of members of a society to trust one another and to engage in cooperative behavior based on that trust—is the most important cultural factor affecting a nation's prosperity. Trust, in other words, is a prerequisite to economic prosperity. Insider trading (whether or not such trading is done by insiders) undermines social trust and, in so doing, threatens the economy.

In this Article, I argue that improper and unethical trading, whether or not such trading is done by insiders, undermines social trust and should be prohibited and criminalized for that very reason. The most prominent justification for regulating insider trading is that such regulation is a way to protect companies' property rights in information.[3] Under this approach, insider trading is prohibited because it involves theft or embezzlement.[4] Other scholars, however, disagree with the property rights approach to insider trading and argue that such trading should be prohibited because it is "unfair" rather than because doing so protects property rights in information.[5]

While both the property rights approach and the fairness approach to insider trading regulation have merit, both have proved somewhat difficult to operationalize in practice. In this Article, I argue that supplementing these approaches with the understanding that insider trading regulation benefits society by reinforcing the importance of trust in society can reduce some of the doctrinal confusion that plagues this area of the law.

Following this Introduction, Section I of this Article discusses the role of social trust in economic development, particularly as it relates to insider trading. Section II follows with a discussion of the current law of insider trading. Here I connect the well-known personal benefit test[6] to the concept of social trust by arguing that the

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2. FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 23–32 (1995). For another seminal work in this field, see generally ROBERT PUTNAM, MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY (1993).

3. Karen E. Woody, *The New Insider Trading*, 52 ARIZ. ST. L.J. 594, 597 (2020).

4. *Id.*

5. *See* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 113 (1998); Patricia H. Werhane, *The Indefensibility of Insider Trading*, 10 J. BUS. ETHICS 729, 729 (1991).

6. The personal benefit test was created by the Supreme Court in Dirks v. SEC, 463 U.S. 646, 646 (1983) (describing the personal benefit test, which

strongest justification for the personal benefit test is that it reinforces the role of insider trading law in fostering social trust among securities market participants. A conclusion follows.

I. SOCIAL TRUST

The essence of Fukuyama's argument is that the most pervasive cultural influence on a nation's prosperity and ability to compete in international markets is the level of trust or cooperative behavior based on shared social norms.[7] High-trust societies outperform low-trust societies.[8] It is easy to see why: As Ali Ahmed pointed out:

> In low-trust societies, trusting relationships are limited to the members of the family or ethnic group. State intervention is often the only way to build large-scale industries, and inefficient public administration, political corruption, and fragmented party systems are common. In contrast, high-trust societies have a strong sense of societal trust and communal solidarity, advanced large-scale enterprises, and professional management. Low-trust societies need to negotiate and often litigate rules and regulations, whereas high-trust societies are able to develop innovative organizations and hold down the cost of doing business. In a nutshell, Fukuyama postulated that higher the level of trust in a country the less corrupt, the more developed and the wealthier its economy will be.[9]

A distinctive feature of high-trust societies is that they have low levels of corruption relative to low-trust societies. Another distinctive feature of high-trust societies is that they are prosperous. This, of course, is no coincidence. As Kenneth Arrow observed half a century ago in the context of explaining why truthfulness is important in economic life, "[v]irtually every commercial transaction has within itself an element of trust, certainly any transaction

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determines whether a "tipper" who provides material nonpublic public information to a "tippee" who trades on such information, breaches her fiduciary duties under SEC Rule 10b-5 by evaluating whether the tippee provided such information in exchange for a "personal benefit." Absent the receipt of some kind of personal benefit by a tipper, a tippee who receives material, nonpublic information and trades on it is not liable for violating SEC Rule 10b-5).

7. Ali M. Ahmed & Osvaldo Salas, *Trust in India and Sweden: An Experimental Examination of the Fukuyama Conjecture*, 42 J. CROSS-CULTURAL RSCH. 420, 420 (2008).

8. Stephen Knack & Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation*, 112 Q.J. ECON. 1251, 1252–55 (1997) (examining the relationship between trust and economic performance across 29 countries and found a strong and significant relationship between economic growth and trust).

9. Ahmed & Salas, *supra* note 7, at 420–21.

conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence."[10]

It is easy to see how certain economic activities require trust:

> Trust-sensitive transactions include those in which goods and services are provided in exchange for future payment, employment contracts in which managers rely on employees to accomplish tasks that are difficult to monitor, and investments and savings decisions that rely on assurances by governments or banks that they will not expropriate these assets.[11]

High-trust societies have numerous advantages over low-trust societies:

> Individuals in higher-trust societies spend less to protect themselves from being exploited in economic transactions. Written contracts are less likely to be needed, and they do not have to specify every possible contingency. Litigation may be less frequent. Individuals in high-trust societies are also likely to divert fewer resources to protecting themselves—through tax payments, bribes, or private security services and equipment—from unlawful (criminal) violations of their property rights. Low trust can also discourage innovation. If entrepreneurs must devote more time to monitoring possible malfeasance by partners, employees, and suppliers, they have less time to devote to innovation in new products or processes.
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> Societies characterized by high levels of trust are also less dependent on formal institutions to enforce agreements. Informal credit markets dependent on strong interpersonal trust can facilitate investment where there is no well-developed formal system of financial intermediation, or where lack of assets limits access to bank credit. Interpersonal trust can also provide an imperfect substitute for government-backed property rights or contract enforcement where governments are unable or unwilling to provide them.
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> . . . [T]rust also triggers investment and other economic activity.[12]

One challenge in analyzing the role of social trust in economic development is understanding the role played by law in fostering social trust. The problem is that law is both a complement to, and a substitute for, high levels of social trust. It is easy to see this problem in the context of concerns about insider trading. On the one hand, one might think that law is unnecessary in a high-trust society due to the very fact that people are trustworthy and, therefore, presumably can be trusted to act ethically and in conformity with prevailing societal norms of right and wrong. On the other hand, one might

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10. Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFFS. 343, 357 (1972).

11. Knack & Keefer, *supra* note 8, at 1252.

12. *Id.* at 1252–53.

think that the legal system will reflect and reinforce the high ethical standards of a high-trust society.[13] One might even think that formal rules against insider trading are unnecessary in a high-trust society because, in such a society, those in possession of nonpublic information will be deterred from exploiting that information by fear of being ostracized and shunned if found out.

Some researchers have found a positive correlation between government regulation and economic growth in general and the growth of markets in particular.[14] Other researchers have found substantial growth in high-trust economies despite the absence of significant government regulation.[15] It seems plausible that the law has the potential both to supplement social trust and to undermine public trust. For example, absent legal regulation, it would be possible for opportunistic insiders to exploit the high levels of trust that exist in an economy by freely engaging in insider trading despite the existence of social norms against it. At best, regulation should echo and reinforce existing social norms in high-trust economies.

An interesting phenomenon identified by Bruce Carlin, Florin Dorobantu, and S. Viswanathan, is "that public trust and government enforcement systems are substitutes in economies where social capital is valuable."[16] This is because in high-trust societies where social capital is valuable, "[a]s the government limits the potential loss from opportunism . . . the value of becoming trustworthy decreases which results in a lower overall trust level."[17] Put simply, people have less incentive to develop reputations for being trustworthy to the extent that government regulation requires everybody to be trustworthy.[18] Other research has shown that insider trading laws benefit the economy. In particular, Utpal Bhattacharya and Hazem Daouk conducted a study of 103 countries with stock

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13. Bruce Ian Carlin, Florin Dorobant & S. Viswanathan, *Public Trust, the Law, and Financial Investment*, 92 J. FIN. ECON. 321, 323 (2009).

14. *See* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleife, *What Works in Securities Laws?*, 61 J. FIN. 1, 20–22 (2006); Rafael La Porta et al., *Trust in Large Organizations*, 87 AM. ECON. REV. 333, 336 (1997); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152 (1998); Edward Glaeser, Simon Johnson & Andrei Shleifer, *Coase Versus the Coasians*, 116 Q.J. ECON. 853, 853 (2001).

15. *See* Knack & Keefer, *supra* note 8, at 1284; Franklin Allen et al., *Law, Finance, and Economic Growth in China*, 77 J. FIN. ECON. 57, 59, 97 (2005).

16. Carlin, Dorobant & Viswanathan, *supra* note 13, at 328.

17. *Id.*

18. JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 254 (2013).

markets and found insider trading laws to exist in 87 of them.[19] Of the 87 countries with insider trading laws, only 38 had experienced actual prosecutions for insider trading.[20] Bhattacharya and Daouk found "that the cost of equity in a country, after controlling for a number of other variables, does not change after the introduction of insider trading laws but decreases significantly after the first prosecution."[21]

The reason why the cost of equity capital is lower in legal regimes in which there is enforcement of insider trading law is straightforward. Market makers, who provide liquidity to stock market participants by providing continuous bid and offer quotes to buy and sell shares, systematically lose money when trading against insiders who have superior information. This is because insiders with superior information will only sell shares at the bid price when they know that the actual value of the shares in question is below the bid price. And they will only buy shares when they know that the offered price is lower than the actual value of the shares. Of course, these market makers trade on anonymous markets, and they do not know which of their counterparties has inside information and which does not. In order to stay in business, market makers (liquidity providers) must make up for their anticipated losses to insiders. The way that the market makers do this is by reducing their bid price and increasing their offer price to all traders in anticipation of their expected losses to the subset of the trading population comprised of insiders.[22] To put it simply, as insider trading as a percentage of the total trading population increases, the transaction costs of trading stock, as expressed in the magnitude of the bid-asked spread, go up. In related work, Laura Beny has found that more stringent insider trading laws are generally associated with more dispersed equity ownership, greater stock price accuracy, and greater stock market liquidity, controlling for various economic, legal, and institutional factors.[23]

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19. Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 77 (2002).

20. *Id.*

21. *Id.* at 75.

22. Michael J. Brennan & Avanidhar Subrahmanyam, *Market Microstructure and Asset Pricing: On the Compensation for Illiquidity in Stock Returns*, 41 J. FIN. ECON. 441, 441–42 (1996).

23. Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 280–81 (2007).

Thus, it appears to be the case that insider trading laws serve a valuable role in promoting healthy capital markets and economic development. This makes sense. While it may be theoretically appealing to consider insider trading regulation unnecessary in a high-trust society, in practice the reality of modern capital markets provides a clear role for law. Specifically, modern securities markets are characterized by anonymous trading. Stock exchanges around the world, including London (LSE), Toronto (TSX), and New York (NYSE and Nasdaq), offer anonymous trading.[24] In addition, trading through electronic communications networks (ECNs), which offer trading through dark pools and trading through inter-dealer brokers who facilitate trades on behalf of institutional clients, is anonymous.[25] With these anonymous trading opportunities available, it is not uncommon for high-profile investors to execute trades by entering orders that are visible in an order book that does not reveal the identity of such investors.[26] These orders and trades are anonymous in that the identity of the trades is not known to the trader's counterparty. Of course, the identities are transparent for purposes of clearing and settlement, and regulators have access to trade information.[27]

There are bona fide reasons for allowing anonymous trading. Specifically, trading by sophisticated investors, particularly when such investors trade in large blocks of shares, can have a significant price impact on the security being traded. Investors who want to purchase large blocks of shares do not want to drive up the price of the shares they are purchasing before they have fully executed their purchasing strategy. Likewise, investors who want to sell large blocks of shares do not want to drive down the price of the shares they are purchasing until they have completed their sales. To reduce the price impact of their trading, traders often will avoid placing a single large order to buy or sell stock and will instead place several smaller orders to purchase or sell shares. If trading were not anonymous, other traders, observing the initial trades, would move in to trade ahead of the first investor, thereby driving up their trading costs. In other words, anonymous trading helps traders who have invested valuable resources in developing a trading strategy to

24. Cory Mitchell, *Anonymous Trading: What it is, How it Works, Example*, INVESTOPEDIA (Apr. 21, 2022), https://www.investopedia.com/terms/a/anonymoustrading.asp [https://perma.cc/37YL-VTCW].

25. *Id.*

26. *Id.*

27. *Id.*

protect their property rights in that trading strategy by inhibiting the ability of other traders to free ride on the opportunities created by that research.

In addition to being anonymous, securities trading in U.S. equities is open to investors from around the world. There are no U.S. laws that prohibit non-U.S. citizens from investing in the stock market. Not only do many U.S. investment firms market to international clients, but the Securities and Exchange Commission (SEC) and the federal government encourage foreign investment in U.S. equity and debt markets for the obvious reason that such investments fund American businesses that create jobs and foster economic growth.[28] Several brokerage firms, including TD Ameritrade, Interactive Brokers, Charles Schwab International, and Zacks Trade, offer accounts to non-U.S. residents.[29]

The reality of both anonymous trading and borderless trading is significant to the analysis, here, of the interplay between law and social norms in the regulation of insider trading. The point is that localized concepts of trust are inapplicable under these conditions. Government regulation is necessary. In particular, government regulation of insider trading can and should reflect and reinforce the prevailing social norms of the legal system that adopts such regulation. I argue that insider trading laws reflect and instantiate prevailing social norms. High-trust societies should have strong insider trading laws firmly in place, and such laws should be vigorously enforced. Thus, it is no surprise that the countries with the strongest capital markets have the strongest laws regulating insider trading.[30]

In high-trust societies, strong, vigorously enforced insider trading laws reinforce the important social norms that incentivize robust markets. In the following section of this Article, I review salient features of current U.S. insider trading laws. I argue that one of the primary consequences of insider trading regulation is that it promotes social trust by inculcating a communitarian spirit of "we're all in this together" among the population of traders in the stock of a particular company.

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28. Geoff Williams, *Can Non-U.S. Residents Open U.S. Brokerage Accounts to Trade Stocks?*, MYBANKTRACKER (Sept. 6, 2023), https://www.mybanktracker.com/blog/investing/non-us-resident-brokerage-accounts-309858 [https://perma.cc/WCT3-GCQX].

29. *Id.*

30. Beny, *supra* note 23, at 240.

II. Insider Trading Law

Examples of the way in which insider trading law can promote communitarian social norms can be found with reference to the jurisprudence that has developed in the classic insider trading cases of *In re Cady, Roberts & Co*.,[31] *SEC v. Texas Gulf Sulphur Co.*,[32] and *Chiarella v. United States*.[33]

A. *In re Cady, Roberts & Co.*

In re Cady, Roberts & Co. is the case that is said to have built the foundation on which the modern law of insider trading rests.[34] The decision in *In re Cady, Roberts* is of particular importance because it established that exchange-based insider trading could involve federal securities fraud, despite the fact that earlier cases, particularly *Goodwin v. Agassiz*,[35] had held that "open-market insider trading was not actionable as common law fraud."[36] As developed in the previous section of this Article, insider trading law plays a particularly important role in anonymous trading markets. In such markets, traders cannot rely on their own reputations for probity to reassure their trading partners that they are acting ethically. Accordingly, market participants need laws to reassure them that they are not being exploited.

The fact that *In re Cady, Roberts* involved a selling shareholder is important. The case arose out of sales of stock by customers of the stock trading firm Cady, Roberts & Co. Cheever Cowdin was a partner in the firm and a director of the Curtiss-Wright Corporation. In his capacity as a director, Cowdin learned that Curtis-Wright was going to reduce its dividend payout to its shareholders. Cowdin informed one Robert Gintel, one of his colleagues at Cady, Roberts & Co., of the impending cut in the Curtiss-Wright dividend. Expecting that Curtis-Wright's shares would drop when the dividend cut was announced, Gintel arranged for Cady, Roberts & Co.

31. In re Cady, Roberts & Co., Exchange Act Release No. 34-6668, 1961 WL 60638, at *3, *7 (Nov. 8, 1961).

32. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

33. Chiarella v. United States, 445 U.S. 222, 245 (1980).

34. *See In re Cady, Roberts & Co.*, 1961 WL 60638, at *1; Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 Colum. L. Rev. 1319, 1319 (1999).

35. Goodwin v. Agassiz, 186 N.E. 659, 660–61 (Mass. 1933).

36. Langevoort, *supra* note 34, at 1319.

customers who owned Curtiss-Wright stock to sell their shares in advance of the announcement, thereby avoiding significant losses.[37]

In holding that Gintel violated SEC Rule 10b-5, the SEC articulated the rule that an insider or other person in possession of material, nonpublic information must either disclose that information to the public or abstain from trading altogether.[38] Because the illicit trading in *In re Cady, Roberts* involved selling shares rather than buying shares, one cannot plausibly argue that the trading harmed the existing shareholder population of Curtiss-Wright. In fact, the trading benefitted a subset of Curtiss-Wright's existing shareholder population because it enabled those shareholders to exit their positions in the company before the price of the shares plummeted in the wake of the announcement of the dividend cut.

It is not easy to justify the outcome in *In re Cady, Roberts* on economic grounds. One might argue that potential investors will reduce the price they are willing to pay for shares to compensate for the risk that material, negative inside information is being withheld from them that makes the shares worth less than the market price. The problem with this analysis is that the drop in the value of the shares was not caused by the insider trading. Rather, the drop in the price of the shares was caused by the fact that the Curtiss-Wright Corporation reduced its dividend payment. Thus, Curtiss-Wright's purchasers would have experienced losses regardless of whether insider trading had occurred. Significantly, there was no allegation in *In re Cady, Roberts* that those who instigated the sales of Curtiss-Wright stock made any misstatements or misrepresentations. Alternatively, it is conceivable that Cady, Roberts & Co. offered a discount on the price of the Curtis-Wright stock it was selling and that this discount caused or induced potential investors to make purchases of the stock that they otherwise would not have made.

While this theory of harm is plausible, there was no allegation that the insider trading in *In re Cady, Roberts* actually induced trading by any particular party. At the same time, it may well be the case that the stock exchange specialists responsible for trading Curtiss-Wright stock had recorded limit orders from customers who wished to purchase Curtiss-Wright shares when the price declined to a particular level. The insider trading could have caused a price decline that triggered purchases of shares from these limit orders. However, these same limit orders to purchase Curtiss-Wright shares

37. *In re Cady, Roberts & Co.*, 1961 WL 60638, at *2.
38. *Id.* at *5.

would have been triggered by the decline in share price that followed the announcement of the dividend cut.

Moreover, to the extent that the insider trading in *In re Cady, Roberts* harmed one cohort of the Curtiss-Wright trading population, it concomitantly benefitted another cohort. Specifically, just as the insider trading in *In re Cady, Roberts* harmed those who were induced to trade by the insiders' trading, it benefitted those investors who were not induced to trade. This latter group of price insensitive traders consisted of those whose trading was not based on an informed view of the value of securities relative to their prices but on external factors, particularly changing demands for savings and liquidity over the course of the trader's life cycle.[39] To the extent that insider trading drives down the price of a company's shares, such trading actually benefits those traders because it allows them to purchase shares that they would have purchased anyway at a lower price than would have otherwise been available in the absence of insider trading.

Thus, regulating insider trading appears to benefit a certain cohort of traders—i.e., those traders who would not have traded "but for" the insiders trading—at the expense of another cohort of traders—i.e., those who would have traded regardless of the trading by the insiders. While the outcome of the *In re Cady, Roberts* case "feels right," it is difficult to justify the strong anti-insider trading position on consequentialist grounds. Rather, as Donald Langevoort presciently has observed in the context of insider trading, "[t]here is reason to believe that people will often refuse to engage in a transaction that they perceive as unfair to them, even if they would be better off financially by going forward than by refusing to deal."[40]

In other words, prohibiting insider trading that is intuitively perceived to be unfair creates valuable social capital by reinforcing generalized notions among market participants that they can trust the market environment in which they operate. As Professor Langevoort observed some years ago:

> [T]he deep belief that insider trading is a wrong that needs legal remedy—the feeling that actually motivates the resource-heavy enforcement

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39. *See* David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 316–17, 331 (1987).

40. Langevoort, *supra* note 34, at 1327; Daniel Kahneman, Jack L. Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Markets*, 76 AM. ECON. REV. 728, 728 (1986); Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 83 AM. ECON. REV. 1281, 1281 (1993).

> agenda—derives from the more fundamental attitude that economic power and status demand a strong dose of self-restraint and accountability. Left alone, the feeling goes, market norms too easily create subcultures that glorify and rationalize selfishness. Because the riches from insider trading can be so great and the opportunity to "pull it off" otherwise so simple for those with special access to sensitive information, insider trading poses *the* quintessential temptation in a larger company to pursue self-interest rather than stay in role as habitually virtuous fiduciary. Responding to this quintessence, securities law has drawn a very visible and symbolically important line. There is a natural tie here to the desire to promote investor confidence, but also a good dose of the belief in the expressive function of the law generally—the idea that both law and society are better off if the law systematically expresses certain virtues.[41]

To Professor Langevoort's convincing account of the "virtue signaling" benefits of tough insider trading law, I would add the regulation of insider trading also serves the function of reflecting and reinforcing social norms that are important to economic development and human flourishing. If this analysis is correct, then the rampant insider trading by members of Congress should be viewed as particularly problematic for society. A study by the New York Times found that 183 current senators or representatives, or 35% of Congress, reported a trade of a stock or another financial asset by themselves or an immediate family member between 2019 and 2021.[42] Of these politicians, more than half sat on congressional committees that had the potential to give them information into the companies whose shares they reported buying or selling.[43]

Some of the instances of congressional insider trading seem particularly egregious. As the New York Times reported, Senator Tommy Tuberville, Republican of Alabama and a member of the agriculture committee, "regularly reported" that, while his committee had been discussing cattle markets, he bought futures contracts whose value were linked to cattle prices.[44] Representative Bob Gibbs, an Ohio Republican on the House Oversight Committee, reportedly bought shares of AbbVie, a pharmaceutical company, during the time the committee was investigating AbbVie and five rivals over high drug prices.[45] The New York Times also found

41. Langevoort, *supra* note 34, at 1328.

42. Kate Kelly, Adam Playford & Alicia Parlapiano, *Stock Trades Reported by Nearly a Fifth of Congress Show Possible Conflicts*, N.Y TIMES (Sept. 13, 2022), https://www.nytimes.com/interactive/2022/09/13/us/politics/congress-stock-trading-investigation.html [https://perma.cc/BQ6V-K7FB].

43. *Id.*

44. *Id.*

45. *Id.*

"[t]he timing of one trade by the wife of Representative Alan Lowenthal, Democrat of California" to be "especially striking."[46] That trade was the sale of Boeing shares on March 5, 2020, a scant "one day before a House committee on which he sits released damaging findings on the company's handling of its 737 Max jet, which was involved in two fatal crashes."[47]

All in all, the New York Times reported that there were more than 3,700 trades reported by lawmakers from both parties that "posed potential conflicts" for the members of Congress.[48] While members of Congress are not prohibited from trading in stocks and other securities and financial instruments, the law ostensibly prohibits members of Congress from trading on inside information and requires them to disclose all significant trades made by themselves or their immediate families.[49]

It is far from clear whether the law adequately deters insider trading by members of Congress. The relevant statute, the "Stop Trading on Congressional Knowledge Act,"[50] provides that the securities laws' provisions related to insider trading apply to members of Congress and their employees. Furthermore, the statute makes it clear that these members and staffers owe a fiduciary duty which arises from their relationship of trust and confidence with Congress itself, regarding material, nonpublic information obtained by virtue of their positions. However, it appears that insider trading

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46. *Id.*

47. *Id.*

48. *Id.*

49. Title I of the Ethics in Government Act of 1978 (EIGA) requires members, officers, certain employees of the U.S. House of Representatives and related offices, and candidates for the House of Representatives to file Financial Disclosure Statements (FD Statements or Statements) with the Clerk of the House of Representatives. *See* 5 U.S.C. app. §§ 101–111. In addition, Representative Louise McIntosh Slaughter's Stop Trading on Congressional Knowledge Act (STOCK Act) amended the EIGA to add a requirement for Members, officers, and certain employees of the House to report certain securities transactions over $1,000 within 30 days of notice of the transaction, but in no case later than 45 days after the transaction. *See generally* Stop Trading on Congressional Knowledge (STOCK) Act of 2012, Pub. L. No. 112-105, 126 Stat. 291. These STOCK Act filings are known as Periodic Transaction Reports (PTRs). *See* H. COMM. ON ETHICS, 117TH CONG., INSTRUCTION GUIDE: FINANCIAL DISCLOSURE STATEMENTS AND PERIODIC TRANSACTION REPORTS 1 (2021). In addition, House Rule 26 provides that Title I of the EIGA shall be deemed to be a rule of the House with regard to House Members, officers, and employees. *See* H.R. DOC. NO. 115-177, at 1005 (2019). The Committee on Ethics (Committee) administers the EIGA for the House. *See id.* at 463.

50. STOCK Act § 4.

by members of Congress remains a significant problem, with the New York Times reporting "that 44 of the 50 members of Congress who were most active in the markets bought or sold securities in companies over which their committee assignments could give them some degree of knowledge or influence."[51]

Certain, specific examples of securities trading by members of Congress seem particularly egregious. As reported in the Los Angeles Times, in 2020, North Carolina Republican Richard M. Burr sold stock in what the FBI described as "well-timed stock sales" in 2020 during the early days of the Covid-19 pandemic.[52] Burr sold 95% of his Individual Retirement Account (IRA) holdings and 58% of the holdings in the IRA account of his wife, shortly before the stock market experienced a "dramatic and substantial downturn," as reported in an affidavit of FBI agent Brandon Merriman.[53] This affidavit characterized the stock sales as "suspicious."[54] The Department of Justice has investigated other politicians, including California Democrat Dianne Feinstein, for violations of insider trading laws.[55]

Similar instances of what appears to be insider trading on congressional knowledge occurred in connection with the 2008 financial crisis.[56] In one famous case, Spencer Bachus, the chairman of the House Financial Services Committee, along with several other members of Congress, received a private briefing on conditions in the capital markets from top government officials, including Ben Bernanke, the Chairman of the Board of Governors of the Federal Reserve System, and Hank Paulson, the Secretary of the Treasury.[57] This briefing took place on September 18, 2008. The very next day, Congressman Bachus placed large bets that the stock market would fall, both by establishing a short position and by purchasing shares in

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51. Kelly, Playford & Parlapiano, *supra* note 42.

52. Sarah D. Wire, *Justice Department Seized Sen. Burr's Phone Over "Well-Timed Stock Sales,"* L.A. TIMES (Sept. 7, 2022, 6:54 PM), https://www.latimes.com/politics/story/2022-09-06/justice-department-seized-senators-phone-over-well-timed-stock-sales [https://perma.cc/UCS3-35W8].

53. *Id.*

54. *Id.*

55. *Id.*

56. Tamara Keith, *Rep. Bachus Investigated for Insider Trading*, NPR (Feb. 10, 2012, 3:00 PM), https://www.npr.org/2012/02/10/146709359/rep-bachus-investigated-for-insider-trading [https://perma.cc/X6FN-4DEU].

57. PETER SCHWEIZER, THROW THEM ALL OUT: HOW POLITICIANS AND THEIR FRIENDS GET RICH OFF INSIDER STOCK TIPS, LAND DEALS, AND CRONYISM THAT WOULD SEND THE REST OF US TO PRISON 24, 28 (2011).

a highly leveraged short fund that would generate significant gains when the stock market dropped in value.[58] Other members of Congress also traded. Among those trading were Senators John Kerry, Dick Durbin, and Sheldon Whitehouse, and Representatives Jim Moran and Shelly Moore Capito.[59]

The details of Bachus's trading are chillingly recounted:

> On the evening of September 18, at 7 p.m., Bachus received [a] private briefing for congressional leaders by Hank Paulson and Federal Reserve Bank Chairman Ben Bernanke about the current state of the economy. They sat around a long table in the office of Nancy Pelosi, then the Speaker of the House. These briefings were secretive. Often, cell phones and Blackberrys had to be surrendered outside the room to avoid leaks.
>
> What Bachus and his colleagues heard behind closed doors was stunning. As Paulson recounts, "Ben [Bernanke] emphasized how the financial crisis could spill into the real economy. As stocks dropped perhaps a further 20 percent, General Motors would go bankrupt, and unemployment would rise . . . if we did nothing." The members of Congress around the table were, in Paulson's words, "ashen-faced."
>
> Bernanke continued, "It is a matter of days before there is a meltdown in the global financial system." Bachus was among those who spoke. According to Paulson, he suggested recapitalizing the banks by buying shares.
>
> The meeting broke up. The next day, September 19, Congressman Bachus bought contract options on Proshares Ultra-Short QQQ, an index fund that seeks results that are 200% of the inverse of the Nasdaq 100 index. In other words, he was shorting the market. It was an inexpensive way to bet that the market would fall. He bought options for $7,846 on a day when the Dow Jones Industrial Average opened at 8,604. A few days later, on September 23, after the market had indeed fallen, he sold the options for over $13,000 and nearly doubled his money.[60]

The investigation of Congressman Bachus's insider trading was the first of its kind.[61] The Office of Congressional Ethics conducted the investigation and ultimately concluded that the Congressman did

58. Keith, *supra* note 56.

59. SCHWEIZER, *supra* note 57, at 33–34.

60. David Weigel, *Spencer Bachus, Rogue Trader*, SLATE (Nov. 14, 2011, 10:30 AM), https://slate.com/news-and-politics/2011/11/spencer-bachus-rogue-trader.html [https://perma.cc/7DXW-XJ6M].

61. *Id.*; *see also* Scott Higham, *Ethics Office Clears Bachus of Insider Trading*, WASH. POST (Apr. 30, 2012, 7:21 PM) https://www.washingtonpost.com/investigations/ethics-office-clears-bachus-of-insider-trading/2012/04/30/gIQAVwvZsT_story.html [https://perma.cc/TS9U-GUCZ] (describing the investigation as "the first of its kind involving a member of Congress").

not violate any insider trading rules.[62] The exoneration of Congressman Bachus was disappointing but not surprising. As one veteran Wall Street reporter observed, "[y]ou cannot read the description of the personal stock trading allegedly conducted by Rep. Spencer Bachus and other members of Congress during the financial crisis and conclude anything other than the following: Our government is completely corrupt."[63] Congress has a very weak record of investigating its own members.[64] As a consequence, there is a widespread consensus that insider trading and other unethical behavior "may be widespread on Capitol Hill."[65]

Moreover, it may well be the case that the trading by Representative Bachus was perfectly legal.[66] Bachus's defenders argued that the Congressman was merely "[a]ttending a briefing on the declining economy and what to do about it," which was "unrelated to specific companies (or classes of companies)," and that this sort of activity "cannot create 'insider trading' liability."[67] The claim appears to be that there could be no legal jeopardy for Congressman Bachus because "[i]n the meeting of policymakers to consider responses to our economic meltdown, no one discussed information related to any specific company (or class of companies) that was useful to someone seeking to obtain an advantage in connection with securities transactions."[68]

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62. Mike Zapler, *Bachus Cleared After Insider Trading Probe*, POLITICO (Apr. 30, 2012, 9:57 PM), https://www.politico.com/blogs/on-congress/2012/04/bachus-cleared-after-insider-trading-probe-122119 [https://perma.cc/3XBH-5P2Q].

63. Henry Blodget, *The Congress Insider Trading Scandal is Outrageous: Rep. Spencer Bachus Should Resign in Disgrace*, BUS. INSIDER (Nov. 14, 2011, 1:19 PM), https://www.businessinsider.com/the-congress-insider-trading-scandal-is-a-disgrace-rep-spencer-bachus-should-resign-immediately-2011-11 [https://perma.cc/MJ2M-YEVC].

64. Danielle Caputo & Kedric Payne, *Senator Coons' Ethics Committee Hits New High of Dismissed Cases*, CLC (Feb. 1, 2023), https://campaignlegal.org/update/senator-coons-ethics-committee-hits-new-high-dismissed-cases [https://perma.cc/68BK-8U4H]. Part of the problem may stem from the fact that Congress engages in self-regulation of its own ethical lapses. *See* Theresa A. Gabaldon, *The Self-Regulation of Congressional Ethics: Substance and Structure*, 48 ADMIN. L. REV. 39, 45–46 (1996).

65. Boldget, *supra* note 63.

66. Roderick M. Hills & Harvey Pitt, *Viewpoint: The Politics of Congressional Ethics*, BIRMINGHAM NEWS (Mar. 4, 2012, 8:43 AM), https://www.al.com/birmingham-news-commentary/2012/03/our_view_the_politics_of_congr.html [https://perma.cc/RVA4-KSS9].

67. *Id.*

68. *Id.*

The problem with this defense is that most, if not all, observers are firmly of the opinion that "the current de facto exemption of Congress from the draconian penalties for insider trading it has imposed on everybody else is fundamentally unfair[.]"[69] It is difficult to imagine how receiving information at a private briefing from the Chairman of the nation's central bank that "[i]t is a matter of days before there is a meltdown in the global financial system" would not be a breach of the misappropriation theory.[70] After all, "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."[71]

As Justice Ginsburg observed in the seminal case adopting the so-called "misappropriation theory" of insider trading liability, "the deception essential to the misappropriation theory involves feigning fidelity to the source of information."[72] It is difficult to see how members of Congress should not be subject to insider trading liability under the misappropriation theory.[73] Any doubts about this were clarified by the STOCK Act, which specifically provides that:

> [S]olely for purposes of the insider trading prohibitions arising under [the Securities Exchange Act of 1934] and Rule 10b-5 thereunder, each Member of Congress or employee of Congress owes a duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.[74]

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69. Steve Bainbridge, *Why is Eric Cantor Delaying Passage of the STOCK Act and Its Ban on Congressional Insider Trading?*, PROFESSORBAINBRIDGE.COM (Dec. 8, 2011), https://www.professorbainbridge.com/professorbainbridgecom/2011/12/why-is-eric-cantor-delaying-passage-of-the-stock-act-and-its-ban-on-congressional-insider-trading.html [https://perma.cc/C42P-3YZM].

70. Weigel, *supra* note 60.

71. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

72. *Id.* at 655.

73. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1315 (2009).

74. 15 U.S.C. § 78u-1(g)(1). The STOCK Act imposes the same duty of trust and confidence on executive branch employees, judicial officers, and judicial employees. 15 U.S.C. § 78u-1(h)(1). The Act also requires that public officials report their securities trades. 5 U.S.C. app. § 103.

However, the passage of the STOCK Act appears to have done little to curb insider trading.[75] Examples of trading in by politicians on information about the Covid epidemic seem particularly egregious.[76] As Andrew Krueger recently observed in an excellent essay about congressional insider trading: "Although falling trust in government began in the mid-1960s and must be attributed to many factors, a belief that members of Congress ('Members') exploit their access to confidential information in order to enrich themselves certainly cannot help alleviate this distrust."[77] Thus, just as the robust enforcement of insider trading restrictions in the private sector helps to build trust and create social capital, the lax enforcement of insider trading by government officials erodes social trust.[78]

The lack of trust in government is a significant problem. There is no doubt that "America is experiencing a lack of trust in major institutions—particularly the federal government."[79] Recent survey research shows that fully 56% of respondents do not trust the federal government to do what is right. Fifty-three percent believe the federal government has a negative impact on the U.S. Sixty-seven percent do not think that the federal government is transparent, and 65% believe that the federal government does not listen to the public.[80] Because the legitimacy of democracies relies on trust, these results are concerning.[81] And to the extent that the apparently rampant insider trading by elected officials contributes to the lack of trust in government, there is a strong argument that regulation of trading by government officials should be significantly enhanced and augmented.[82]

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75. Andrew Krueger, *The STOCK Act Ten Years Later: The Need for a New Congressional Insider Trading Regulatory Scheme*, 100 WASH. U.L. REV. 545, 557 (2022).

76. *Id.*

77. *Id.* at 545.

78. There is some evidence that the STOCK Act had some influence on politician's use of non-public macroeconomic information in their trading. *See* Serkan Karadas, Minh Tam Tammy Schlosky & Joshua Hall, *Did Politicians Use Non-Public Macroeconomic Information in Their Stock Trades? Evidence from the STOCK Act of 2012*, 14 J. RISK & FIN. MGMT. (SPECIAL ISSUE) 1 (2021).

79. Paul Hitlin & Nadzeya Shutava, *Trust in Government: A Close Look at Public Perceptions of the Federal Government and its Employees*, P'SHIP PUB. SERV. 4 (Mar. 23, 2023), https://ourpublicservice.org/wp-content/uploads/2022/03/Trust-in-Government.pdf [https://perma.cc/8VK5-6XKE].

80. *Id.*

81. *Id.* at 7.

82. *See* Krueger, *supra* note 75, at 567 ("In a time of record-level distrust in government, a regulatory scheme which prevents members of Congress from

B. *SEC v. Texas Gulf Sulphur Co.*

The *In re Cady, Roberts* case, discussed in the previous section, involved insider trading where the insiders were trading with counterparties who were not investors in the corporation prior to the trading. In contrast, *SEC v. Texas Gulf Sulphur Co.* is what is known as a "classical" case of insider trading because it involved trading by corporate insiders who were, of course, fiduciaries in shares of their own company.[83] The SEC complaint alleged that Texas Gulf Sulphur (the Company) began exploratory drilling in Timmins, Ontario, Canada, on November 8, 1963.[84] Shortly after the drilling began, the Company's field geologist, defendant Kenneth Darke, examined the geological evidence generated by the exploratory drilling and found the results to be extremely promising and "impressive."[85] These results were communicated to other Texas Gulf Sulphur officers, directors, and employees, along with an admonition to maintain absolute secrecy.[86] As corporate lawyers have explained the facts:

> In an effort to acquire additional mineral rights in the area before any one else discovered the strike, the drill rig was removed from the drilling area and a worthless core was left in the drill hole. However, the complaint continues, while such acquisitions were being made and the findings were being assayed (tested), certain of the defendants began purchasing either calls on or shares of Texas Gulf. It is alleged that each of these defendants (many of whom neither owned shares of Texas Gulf in November 1963 nor had ever purchased calls thereon) had knowledge at the time of their purchases of the "material facts concerning the results of . . . [the] drilling . . . which facts were not generally known by the investing public," and which defendants failed to disclose to the sellers of the shares they purchased.[87]

The geologist Darke recommended that his brother, certain friends, and others purchase Texas Gulf stock.[88] In addition to the insider trading, two other sorts of related wrongdoing occurred in *Texas Gulf Sulphur*. First, the positive information about the mineral discovery allegedly was intentionally concealed from a majority of

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exploiting their access to material nonpublic information could help chip away at this distrust.").

83. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839–42 (2d Cir. 1968).

84. W. McNeil Kennedy & Herbert S. Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057, 1059 (1965).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

the directors by certain officers of the Company.[89] These directors, who had not been informed of the discovery, were persuaded to grant options to purchase Texas Gulf Sulphur shares to two directors who were aware of the discovery.[90]

Second, "[t]he Company itself . . . released an allegedly false and misleading statement to the press on April 12, 1964, minimizing the results of its drilling and characterizing the rumors about the strike as being exaggerated and without factual basis."[91] After the press release was published, shares of Texas Gulf Sulphur stock declined slightly.[92] A few days later, on April 16, 1964, officers of the Company conveyed accurate information concerning the strike to the board of directors and released that information to the press.[93]

In the period between the November 1963 discovery of the minerals and the April 16, 1964, press release, the price of Texas Gulf Sulphur shares doubled from $17.00 per share to $34.00 per share.[94] By the time the SEC filed its complaint, Texas Gulf Sulphur stock was trading at prices in excess of $70.00 per share.[95]

While some of the rhetoric in the Second Circuit's opinion is a bit over the top, the holding seems sound. The holding is based on the improbable notion that "all investors trading on impersonal exchanges have relatively equal access to material information."[96] The Second Circuit opined that:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[97]

The case established the ideal of "equal access to information" as a policy goal of insider trading law, emphasizing that "all investors trading on impersonal exchanges have relatively equal access to material information" and that "all members of the investing public should be subject to identical market risks."[98]

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89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.* at 1059–60.
95. *Id.* at 1060.
96. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).
97. *Id.*
98. *Id.* at 848, 852.

This broad notion that investors have a right to expect "equal access to information" for trading purposes was later explicitly rejected in *Chiarella v. United States*,[99] which pointedly refused to recognize a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.[100] *Texas Gulf Sulphur*, therefore, "poses a substantial question as to whether Rule 10b-5 should be employed as a vehicle to regulate intra-corporate affairs and the fiduciary and disclosure duties of officers and employees to their companies."[101]

Scholars have emphasized the transformation of insider trading law after *Texas Gulf Sulphur* "from being an absolute bar on trading while in possession of inside information to becoming a more complicated question regarding fiduciary duty and personal benefit."[102] Another controversial aspect of *Texas Gulf Sulphur* is the extent to which the opinion injects federal securities regulation into the realm of corporate governance, a field traditionally left to state regulation. There is no question that *Texas Gulf Sulphur* implicates corporate governance in important ways. In my view, this is both inevitable and justifiable.

The core problem with the insider trading in *Texas Gulf Sulphur*, and the reason why the opinion is deeply relevant to corporate governance, is that the trading harmed the shareholders of the company in direct and profound ways that would undermine investor confidence if left unchecked. The point is quite simple. Texas Gulf Sulphur was in the business of exploring for minerals. If the company was successful in locating and securing rights to such minerals, the shareholders would win. If the company failed to locate and secure such rights, shareholders would lose. The trading by the insiders in *Texas Gulf Sulphur* placed the ordinary "outsider" shareholders of the Company in a no-win situation. If the Company succeeded in its quest to secure valuable mineral rights, insiders would swoop in before any announcement of such a result could be made and buy the shares at what would be revealed to be bargain-basement prices once the information was revealed. If the Company

99. Chiarella v. United States, 445 U.S. 222, 233 (1980).

100. Donald C. Langevoort, *From* Texas Gulf Sulphur *to* Chiarella*: A Tale of Two Duties*, 71 SMU L. REV. 835, 838 (2018).

101. Kennedy & Wander, *supra* note 84, at 1072.

102. Woody, *supra* note 3, at 604; *see also* James D. Cox, *Seeking an Objective for Regulating Insider Trading Through* Texas Gulf Sulphur, 71 SMU L. REV. 697, 699–700 (2018) (discussing how, after *Texas Gulf Sulphur*, the logic went "[f]rom the clarity of parity of information to the mist of fiduciary duty").

failed in its efforts to secure mineral rights, insiders simply could refrain from purchasing shares and even dump their existing shares on unsuspecting outside investors. Absent legal intervention, rational investors, anticipating this sort of behavior by insiders, would decline to invest or would significantly discount the price at which they are willing to invest.

The same analysis applies to the issuance of stock options to certain insiders by Texas Gulf Sulphur. The purchase of those options, at a steep discount to their actual value, allowed the purchasing insiders to dilute the share ownership of the existing shareholder population. Thus, in *Texas Gulf Sulphur*, issues of corporate governance and issues of insider trading neatly overlap.

The Second Circuit, in its *Texas Gulf Sulphur* opinion, is clear that the insider trading laws have important implications for corporate governance. The court observed that

> it would seem elementary that the Commission ***has a duty to police management so as to prevent corporate practices which are reasonably likely fraudulently to injure investors.*** And, of course, as we have already emphasized, a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation.[103]

And turning to the false press release that the Company issued, the Second Circuit was clear that even in the absence of insider trading or of a wrongful purpose in making a false disclosure,

> the Commission has been charged by Congress with the responsibility of ***policing all misleading corporate statements*** from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another.[104]

In other words, "the Commission has a duty to ***police management*** so as to prevent corporate practices which are reasonably likely to fraudulently injure investors."[105] In a nutshell, the Second Circuit's opinion in *Texas Gulf Sulphur* is all about creating social capital by creating a trading environment characterized by trust and integrity.

103. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861 (2d Cir. 1968) (emphasis added).
104. *Id.* (emphasis added).
105. *Id.* (emphasis added).

C. *Chiarella v. United States*

As Donna Nagy has observed,

> *Chiarella v. United States* occupies a special place in history. It was the first prosecution under the federal securities laws for the crime of insider trading. And the U.S. Supreme Court's iconic holding—regarding the circumstances under which insider trading constitutes securities fraud—not only profoundly changed the law in 1980 but also continues to define insider trading's contours right up to the present day.[106]

The facts of *Chiarella* are striking. Vincent Chiarella worked as a financial printer for Pandick Press and, in the course of his employment, was involved in printing disclosure documents related to merger and acquisition transactions contemplated by his employer's clients.[107] Despite the fact that the names of the companies involved in these deals were encoded in the documents he prepared, Chiarella deduced the names of companies that were about to be acquired at a substantial premium to market.[108] He then bought shares in these target companies before the deals were announced.[109]

The Supreme Court's opinion in *Chiarella* is important because it categorically rejected the notion that insider liability could arise merely due to asymmetric information between parties to a securities transaction. This so-called "equal access to information" approach to insider trading law is incredibly broad because it results in liability for those trading with an informational advantage relative to their counterparty regardless of how they obtained the information. As Frank Easterbrook, who was at the time in the Department of Justice and involved in the government's case against Chiarella, observed, "if you didn't have a rule that people could trade on different amounts of information, there's no incentive to collect the information. If there's no incentive to collect the information, markets won't be efficient."[110] In other words, "you can't have an equal information rule and still have informationally efficient [capital] markets."[111]

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106. Donna M. Nagy, Chiarella v. United States *and Its Indelible Impact on Insider Trading Law*, 15 TENN. J.L. & POL'Y 6, 7 (2020).

107. *Id.* at 7–8.

108. *Id.* at 8.

109. *Id.*

110. Kenneth Durr, *Interview with Frank Easterbrook*, SEC HIST. SOC'Y ORAL HIST. PROJECT, 13–14 (Jan. 13, 2011), https://www.sechistorical.org/collection/oral-histories/20110113_Easterbrook_Frank_T.pdf [https://perma.cc/MY9L-H344].

111. *Id.* at 15.

Ultimately, in the wake of *Chiarella*, the dividing line between legal and illegal trading boiled down to an analysis of property rights in information.[112] This property rights approach to insider trading law led to the current understanding that illegal insider trading often involves the misappropriation of property rights in information. Another way of analyzing Chiarella's behavior that is fully consistent with the property rights approach is that insider trading liability should arise where a trader violates a duty to disclose arises from a relationship of trust and confidence between the parties to a transaction.[113] Such liability does not arise from the "mere possession of nonpublic market information."[114]

Thus, *Chiarella* and its progeny explicitly introduce the concept of trust as a critical component of insider trading law. The key point here, from the perspective of this Article, is that there is an important distinction between insider trading law that promotes trust and insider trading law that promotes fairness. In particular, securities trading that some might view as unfair to a counterparty may not involve any breach of trust. Stock market professionals, including arbitrageurs, brokers, portfolio managers, and securities researchers, many of whom work for investment banks and hedge funds, have a systematic advantage over their trading counterparties. As David Haddock and I previously have observed:

> [M]arket professionals . . . devote their careers to acquiring information about a firm, an industry, a group of firms or industries and to developing skills for evaluating information they obtain. Under present law, market professionals, insiders, owe no fiduciary duty to the firms they study; their employment carries with it no implied responsibility to look after firms' interests. Moreover, because he actually works in the exchanges in closely allied firms, a market professional can execute the trade firm's stock more promptly than even a firm's insiders, and he beaten by an insider only when the latter's acquisition of information quicker.[115]

These market professionals have a systematic advantage when trading against uninformed outsiders who have neither the skills and expertise nor the access to highly efficient trading platforms to compete in the quest to find undervalued or overvalued securities to

112. *Id.*

113. Woody, *supra* note 3, at 605.

114. Chiarella v. United States, 445 U.S. 222, 235 (1980) ("[A] duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.").

115. David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 318 (1987).

trade for arbitrage profits. These "[m]arket professionals invest resources in order to develop an ability to obtain early information about firms, to quickly assimilate that information, and to execute speedy stock market transactions before other traders have drained the information of its value."[116] These market professionals have an advantage over outsiders because they discover valuable information before the outsiders do. These market professionals systematically outperform the outsiders they trade against.[117]

Those who view trading on the basis of an informational advantage over one's counterparty as "unfair" have much to lament about the current state of the law of insider trading. Current law does not generally attempt to ban all trading on the basis of an informational advantage. Rather, it only attempts to ban insider trading in which the purportedly "unfair" informational advantage involves a breach of trust.

CONCLUSION

Laws that encourage and reinforce social trust are not necessarily "fair." Fostering social trust and achieving fairness are distinct regulatory goals. In the context of insider trading, fairness consists of prohibiting trading where one trader has an informational advantage over her trading counterparty in order to achieve some version of equality among traders. On the other hand, social trust in this context requires prohibiting trading that undermines people's trust in the integrity of the trading environment in which they are transacting. The important distinction between the "fairness" approach to insider trading regulation and the "social trust" approach to insider trading regulation is that traders can trade on the basis of informational advantages over their counterparties and still trade in ways that promote the ideals of social trust that are important to fostering successful free market economies. In contrast, fairness goals cannot be achieved unless trading on the basis of such informational advantages is banned.

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116. *Id.*
117. *Id.* at 319.