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Insider Trading Examined Through the Lens of a Finnis Framework

Morality and Rule 10b-5

Amar A. Shah

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Insider Trading -- A Legislative Background

I. Introduction

“Greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures, the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, knowledge, has marked the upward surge of mankind and greed, you mark my words, will not only save Teldar Paper, but that other malfunctioning corporation called the U.S.A.”¹ These words were uttered by the infamous Gordon Gekko in the 1987 motion picture *Wall Street* which illustrated an environment that insider trading regulation was meant to remedy. Greed can, in short, make one do whatever it takes to get whatever one seeks. But that greed, when seen not at an individual level, but on a market wide level has the capacity to wreak havoc on the economy.

One of the biggest issues with insider trading is that it disrupts economic efficiency in terms of information availability.² In an efficient market, the stock price of a given company will be an accurate reflection of its true underlying value.³ In turn, the accurate reflection gives investors the tools to make a wise investment decision⁴. On the contrary, if the stock price given is an inaccurate reflection of the true underlying value of the security, investors in turn will not be able to make an informed decision when deciding what investments to invest in.⁵ Thus an inefficient use of capital results.

Inaccurate stock prices also create societal costs. “When companies raise capital at inaccurate prices, existing shareholders derive gains to the extent that new investors overpay for

¹ *Memorable Quotes For Wall Street*, IMDB.com, <http://www.imdb.com/title/tt0094291/quotes> (last visited March 12, 2012).

² Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 593 (1984).

³ Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 Duke L.J. 977, 1006 (1992).

⁴ *Id.*

⁵ *Id.*

their shares, and suffer losses to the extent that new investors underpay.”⁶ This disparity between market value and actual value results in an inefficient allocation of capital and furthermore a decrease in the quality of projects funded by organizations.⁷

“If by issuing overpriced securities a corporation will obtain benefits for existing shareholders that exceed the losses from a project, the company will proceed to raise capital for an unprofitable project. Likewise, a corporation will refrain from issuing securities for a profitable project if the losses from selling those shares at a bargain price will exceed the project's profits.”⁸

On the contrary, when stock prices accurately reflect the underlying value of a security, “new investors pay exactly what the shares are worth and are able to evaluate their investment decisions on the merits.”⁹ This is the only way to preserve the efficient use of capital in the marketplace.¹⁰

Aside from economic inefficiencies, insider trading also carries with it an inherent sense of unfairness.¹¹ This unfairness has more or less fueled the rules and regulations that have come about through legislative as well as judicial action. The history of securities regulation can be traced to the 1933 Securities Act and the Securities Exchange Act of 1934 which were passed during the Great Depression.

“The Securities Act aims to protect purchasers of newly offered securities by requiring issuers to disclose information about their business, property, management, financial attributes, outlook and risk potential. The **Exchange Act** encompasses a series of regulations applying primarily to issuers and previously outstanding securities trading in secondary markets such as the NYSE and the NASDAQ. The **Exchange Act** seeks to ensure the integrity of the market through its antifraud and antimanipulation provisions.”¹²

⁶ *Id.*

⁷ Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 Duke L.J. 977, 1006 (1992).

⁸ Jonn R. Beeson, *Rounding The Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1090-1091 (1996).

⁹ Jonn R. Beeson, *Rounding The Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1090-1091 (1996).

¹⁰ Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 Duke L.J. 977, 1006 (1992).

¹¹ Jonn R. Beeson, *Rounding The Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1097 (1996).

¹² 50 N.J. Prac., Business Law Deskbook § 29:2 (2011-2012 ed.)

Although both acts seek to level the playing field amongst investors of all kinds, neither act outlaws the practice of insider trading. While mentioned in sections 16(b)¹³, 20(a)¹⁴ and 21(a)¹⁵ of the Exchange Act, the courts and the Securities and Exchange Commission have agreed that insider trading is encompassed within Rule 10b-5 in section 10(b) of the Exchange Act.¹⁶

Rule 10b-5,¹⁷ “promulgated by the SEC in 1942 as an exercise of the rulemaking power granted by section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”),” is the “basic federal antifraud provision used to regulate the securities markets.”¹⁸ The legislative history for Rule 10b-5 is limited and thus the Courts have mainly been the driving force in developing the scope of liability that the rule intends to impose.¹⁹

¹³ Section 16(b) requires statutory insiders (directors, officers and 10% shareholders of the corporation) to disgorge any profits earned through short-term trading which is a period of six months. Insider Trading and Securities Fraud Enforcement Act of 1988 s 16(b), 15 U.S.C. s 78p(b) (1994).

Regarding short term swing profits, liability is not based on the use of inside information but rather the timing of that use. A trade conducted within six months of another trade is a violation and in turn any profits reaped must be disgorged. On the other hand, an insider whose trades are separated by more than the statutory six-month period does not violate section 16 even if that trade was based on inside information. Insider Trading and Securities Fraud Enforcement Act of 1988 s 16(b), 15 U.S.C. s 78p(b) (1994).

¹⁴ “Section 20A provides private rights of action based on contemporaneous trading between an insider and another trader.” Insider Trading and Securities Fraud Enforcement Act of 1988 s 20A, 15 U.S.C. s 78t-1 (1994).

¹⁵ Section 21A provides the SEC with the authority to bring an action for civil penalties against anyone who engages in insider trading. Insider Trading and Securities Fraud Enforcement Act of 1988 s 20A, 15 U.S.C. s 78u-1(a)(1)(A) (1994). Similar to “section 20A, section 21A does not make insider trading illegal nor does it explicitly define insider trading. Instead, section 21A merely addresses the SEC’s ability to impose civil penalties on inside traders.” See Beeson, *supra* note 8, at 1102.

¹⁶ See Beeson, *supra* note 8, at 1104.

¹⁷ Rule 10b-5 of the Security and Exchange Act states: “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.” 17 C.F.R. s 240.10b-5 (1995).

¹⁸ Donald C. Langevoort, *Fraud and Deception By Securities Professionals*, 61 Tex. L. Rev. 1247, 1292 (1983)

¹⁹ See Beeson, *supra* note 8, at 1107

II. The Classical Insider Theory

Judicial interpretation regarding 10b-5 has drastically broadened its reach in terms of culpability over time. Originally, the basis for liability under Rule 10b-5 was founded upon common law notions of fraud which focused on a duty to speak which came about through certain fiduciary duties. The fiduciary relationships mainly arose within the context of traditional insiders who were directors, officers, and controlling shareholders.²⁰ Hence at common law,

“silence regarding facts that were not available to another party was not considered fraud unless the first party had a duty to speak that arose out of a special relationship or unless other special facts were present. Accordingly, courts traditionally required a breach of a fiduciary duty or similar relationship before liability for trading on the basis of material nonpublic information would attach. Strict adherence to such a requirement, however, would allow outsiders who have no fiduciary duty or relationship of trust that extends to the corporation to trade in the market on material nonpublic information.”²¹

The traditional definition of a corporate insider within 10b-5 was first expanded in the decision of *In Re Cady, Roberts & Co.* (“*Cady*”).

“On November 25, 1959, the Board of the Curtiss-Wright Corporation met to set the fourth-quarter dividend for the year. During the first three quarters the Board had declared a \$0.625 dividend, but decided that the fourth-quarter dividend should be reduced to \$0.375. At approximately 11:00 a.m., the Board approved disclosure of the dividend to the New York Stock Exchange, but there was a delay in transmitting the information due to a typing problem. The announcement did not appear on the Dow Jones ticker tape until 11:48 a.m. and was not delivered to the Exchange until 12:29 p.m. During a recess of the Board meeting, and prior to Dow Jones's receipt of the information, J. Cheever Cowdin, a Curtiss-Wright director, notified Robert Gintel, a broker at Cady, Roberts & Co., that the Board had cut the dividend. Prior to the dissemination of the news to the public, Gintel sold 7000 shares of Curtiss-Wright Stock.”²²

If applying the common law notions of Rule 10b-5 in terms of traditional fiduciary relationships which give rise to a duty to speak, Gintel in this instance would escape liability—he would not be considered an insider (director, officer, or controlling shareholder) and thus would not be held liable for his actions of trading on nonpublic material information. The Court saw the discrepancy and found Gintel to have violated 10b-5 even though he was not considered a traditional insider per the common law understanding. The court stated:

²⁰ Exchange Act s 16(b), 15 U.S.C. s 78p(a) (1994).

²¹ See *Beeson*, supra note 8, at 1083-1084

²² See *id.* at 1110.

“We have already noted that anti-fraud provisions are phrased in terms of “any person” and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation”.²³

As a result the court adopted the “disclose or abstain rule”

which based an individual's duty to disclose material nonpublic information prior to trading on two elements: (1) a relationship between the trader and the inside source of the information such that the information is intended only for a corporate purpose and not for the insider's own benefit; and (2) the inherent unfairness of the trader taking advantage of that information knowing that it is unavailable to others in the market.²⁴

Based upon the rule adopted, liability under Rule 10b-5 could be established when an investor learns of material nonpublic information, intended not for his benefit but for a corporate purpose, and trades based upon that information before disclosure. Liability thereby would ensue even if the investor was not a statutory insider. Thus in this instance Gintel would be held in violation of the disclose or abstain rule adopted.²⁵

Cady not only introduced an attempt by the court to expand the interpretation of 10b-5 to encompass more wrongdoers within its breath, but it also infused a fairness element into the rule which the court deemed inherent within Rule 10b-5's spirit. “The fairness theory of *Cady* finds its rationale in the goal of achieving a sense of integrity and fairness in the market which is not possible if the system tolerates transactions in which one party has inside information unavailable to the other.”²⁶

The disclose or abstain rule adopted in *Cady* was further expanded in *SEC v. Texas Gulf Sulphur Co.* In *SEC v. Texas Gulf Sulphur*, Texas Gulf Sulphur (“TGS”), a mining company, had been conducting geophysical surveys in eastern Canada for a number of years.²⁷ In November of 1963, a test hole, K-55-1, produced indications of very high concentrations of

²³ See *Beeson*, supra note 8, at 1111.

²⁴ See *Id.*

²⁵ See *Id.*

²⁶ See *Id.*

²⁷ Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 843 (2d Cir. 1968).

copper, zinc, and silver.²⁸ It was ultimately determined that the area had one of the largest copper and zinc deposits in North America.²⁹ The geological team involved in the expedition was told, by the company President, to keep the results of the core deposits confidential from all others in the corporation as well as the public.³⁰ Before TGS released the news of the strike to the public, various employees including the four geological team members along with the President and Executive Vice President had bought TGS stock and call options based upon their successful findings.³¹ After the findings were released to the public, TGS's stock price more than tripled.³² In turn, each of the employees who had bought stock in the company heavily profited from their investments.

To determine liability, the Court used the “disclose or abstain rule” established in *Cady* and applied it to “anyone in possession of material information.”³³ Therefore, “if a trader in possession of material inside information is precluded from disclosure due to a corporate confidence or simply chooses not to disclose, he must abstain from trading.”³⁴ The Court's declaration has the effect of including anyone within a firm with material inside information within the confines of Rule 10b-5. For example, an insider would now include a janitor who finds a sensitive document in a garbage can and decides to trade upon the information obtained. In *TGS*, the court applied the classical insider definition to not only the President and Executive Vice President, but also to the four geologists who were part of the team and who had bought

²⁸ See *Id.*

²⁹ See *Id.* at 850.

³⁰ See *Id.* at 843

³¹ See *Id.* at 844

³² See *Id.* at 847

³³ See *Id.* at 848

³⁴ See *Beeson*, *supra* note 8, at 1112

call options before the news was public knowledge. The disclose or abstain rule as introduced in *Cady* was now applied and broadened through the holding in *TGS*.³⁵

III. The Evolution of the Classical Insider Theory

The early cases interpreting Rule 10b-5 such as *Cady* and *TGS* provided a foundation on which later Courts could build a framework for a comprehensive insider trading theory.³⁶

Chiarella v. United States “provided the first girder in this framework.” Vincent Chiarella was employed by Pandick Press, a financial printing company.³⁷ Through his employment, he had access to confidential information regarding tender offers which was nonpublic

information.³⁸ Pandick Press’ core competency was printing financial documents for its clients.

Usually, offering companies would bring documents to Pandick for printing in preparation of disclosure to the public.³⁹ Chiarella was in charge of conducting the printing. For tender offers,

the offering company blanked out the target corporations for confidentiality purposes.⁴⁰ Despite

their efforts, Chiarella was able to determine the identities of the target corporations before they

were publicly disclosed.⁴¹ In five instances, Chiarella made trades in the stock of the target

corporation, without disclosure, before the news of the tender offer or merger was announced.⁴²

As a result of his trades, Chiarella was able to obtain in excess of \$30,000 in profits.⁴³

As Chiarella was in no way related to the target corporations which he was able to decipher, Chiarella would be considered an outsider trading on nonpublic material information.

He had no relationship with the target company as he was hired by the acquiring company.

³⁵ See *Beeson*, supra note 8, at 1112

³⁶ See *Id.* at 1116.

³⁷ *Chiarella v. U. S.*, 445 U.S. 222, 224 (1980).

³⁸ See *Id.*

³⁹ See *Id.*

⁴⁰ See *Id.*

⁴¹ See *Id.*

⁴² See *Id.*

⁴³ See *Id.*

Hence no special relationship or duty under any legal theory arose between the target company and Chiarella. The Supreme Court, adhering to a traditional notion of insider trading, held that “when an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.”⁴⁴ Because Chiarella had no special relationship with the target corporations in terms of historical dealings, his trading upon the nonpublic information without disclosure did not constitute fraud.⁴⁵

The Court also deemed the classical insider theory per *TGS* inapplicable as Chiarella was not an employee of the company upon which he traded upon.

“Furthermore, the Court narrowly defined the analysis of *Cady* to require a breach of a fiduciary duty or similar relationship of trust and confidence by a person in whom the sellers had placed their trust and confidence to support liability. Therefore, one with no defined duty has no duty to disclose or abstain from trading material nonpublic information.”⁴⁶

Based upon this limitation introduced by the court, there appeared to be an inherent gap within 10b-5. The fact that Chiarella was able to escape liability did not sit well with many.

IV. The Tipper/Tippee Theory

The inherent fairness in trading emphasized in *Cady* was being circumvented by the fiduciary duty requirement. This void was eventually addressed in *SEC v. Dirks* where the Court added tipper/tippee liability when construing Rule 10b-5.

Raymond Dirks was an officer of Delafield Childs, Inc., a New York registered broker-dealer firm serving institutional investors.⁴⁷ In early 1973, Ronald Secrist was fired from his job as an officer at Bankers National, a New Jersey life insurance company.⁴⁸ Four years earlier, Bankers National had been acquired by Equity Funding of America, a diversified company

⁴⁴ See *Chiarella*, supra note 37, at 235.

⁴⁵ See *Id.* at 242.

⁴⁶ See *Beeson*, supra note 8, at 1119.

⁴⁷ *Dirks v. S.E.C.*, 463 U.S. 646, 646 (1983).

⁴⁸ See *Id.*

selling primarily life insurance and mutual funds.⁴⁹ Shortly after being fired, Secrist called Dirks to inform him that Equity Funding had vastly overstated its assets as a result of several fraudulent corporate practices.⁵⁰ He investigated the allegations and came to the conclusion that fraud was being perpetrated at Equity Funding.⁵¹ Dirks discussed the investigation and his findings with anyone who asked.⁵² As a result of speaking with Dirks, several investors quickly began selling their investments in Equity Funding stock, before the New York Stock Exchange halted trading on Equity Funding.⁵³ The SEC eventually found that fraud was being perpetrated. Nevertheless, the SEC charged and convicted Dirks of violations of the antifraud provisions of the securities laws for disclosing information from his investigation to investors.⁵⁴

The Supreme Court in *Dirks* began by reaffirming the *Chiarella* holding, which limited the scope of Rule 10b-5 to instances involving the breach of a fiduciary duty or other special relationship of trust and confidence. The court stated there is no duty to disclose when the person who traded, “was not the corporation’s agent, . . . was not a fiduciary, or was not a person in whom the sellers . . . had placed their trust and confidence.”⁵⁵ The Court then broadened liability for recipients of material nonpublic information by including tippees who receive information improperly or for a confidential purpose.⁵⁶ To determine whether a tippee has obtained information improperly, the Court adopted a two prong test.⁵⁷

⁴⁹ See *Dirks*, supra note 46, at 646.

⁵⁰ *Dirks*, 463 U.S. at 649

⁵¹ See *Id.*

⁵² See *Id.*

⁵³ *Dirks*, 463 U.S. at 646

⁵⁴ See *Id.*

⁵⁵ *Dirks*, 463 U.S. at 654

⁵⁶ *Dirks*, 463 U.S. at 660

⁵⁷ See *Id.*

First, the insider (i.e. Tipper) must have breached a fiduciary duty to the shareholders in disclosing the information to the tippee.⁵⁸ This disclosure is considered a breach of fiduciary duty when the tipper makes the disclosure for a direct, or indirect, personal benefit.⁵⁹ This personal benefit includes either “pecuniary gain or a reputational benefit that will translate into future earnings.”⁶⁰ Second, the tippee will be subject to a duty to disclose or abstain only if he is aware, or reasonably should be aware, of the insider's breach.⁶¹ Because of the awareness requirement, the Tippee’s liability is derivative of the tipper’s liability. If the Tipper is found not to be liable, then the tippee is automatically exonerated from liability.

The Court held that because Secrist had not given Dirks the information for pecuniary gain, but merely to expose the fraud occurring at Equity Funding, he didn’t meet the first prong of the newly adopted test.⁶² Because tippee liability is derivative of the tipper’s liability, the court concluded that Dirks did not inherit a fiduciary duty since Secrist did not receive any personal benefit from divulging the information.

Through the *Dirks* court, 10b-5’s scope expanded to “tippees who facilitate a fraud after an insider’s breach.”⁶³ The court in *Dirks* further expanded liability to an additional group of tippees known as “constructive insiders.” These are insiders who have received information for a corporate purpose.

“Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”⁶⁴

⁵⁸ See *Dirks*, supra note 55, at 650.

⁵⁹ See *Id.*

⁶⁰ See *Id.*

⁶¹ See *Id.*

⁶² *Dirks*, 463 U.S. at 666.

⁶³ See *Beeson*, supra note 8, at 1122.

⁶⁴ *Dirks*, 463 U.S. at 655 n.14.

Through its interpretation of “constructive insiders,” the court again sought to “expand liability beyond traditional corporate insiders and include those who technically do not inherit a fiduciary duty since none truly exists between the constructive insiders and the corporate shareholders.”⁶⁵

V. The Misappropriation Theory

Up to this point, based upon all of the case law discussed, the court has based insider trading regulation on determining whether a fiduciary relationship was owed and whether that relationship was violated in a particular scenario. This structure has been expanded and constricted, but the court’s central concern in all of the cases was focused on the insider who owed a fiduciary duty to a source. What the courts have not addressed is the trading of nonpublic material information by outsiders who do not breach a duty to the corporation in which they trade.⁶⁶ The inherent unfairness of a trader who takes advantage of this nonpublic information, a major concern in *Cady*, thus was the driving force for a new legal theory in insider trading regulation—the misappropriation theory⁶⁷.

The misappropriation theory was introduced to remedy the perception of injustice resulting from a “failure of the securities laws to encompass all trading on material nonpublic information.”⁶⁸ The theory gained headway through the decision in *SEC v. Materia* which posed similar facts as those in *Chiarella* discussed above. In *SEC v. Materia*, Materia was employed by a financial printer but was a “copyholder” who read drafts of prospectuses and other financial documents aloud to a proofreader who would then check the drafts against the copy obtained

⁶⁵ See *Beeson*, supra note 8, at 1122.

⁶⁶ See *Id.* at 1124.

⁶⁷ See *Id.*

⁶⁸ Ronald F. Kidd, *Insider Trading: The Misappropriation Theory Versus an “Access to Information” Perspective*, 18 Del. J. Corp. L. 101, 117 (1993).

from the client.⁶⁹ In cases involving tender offers, the names of the target companies were omitted.⁷⁰ Nevertheless, Materia was able to make out four tender offer targets based upon his knowledge in the field and the general business environment.⁷¹ Using this information, Materia purchased stock in the target companies before the tender offers were publicly disclosed.⁷² Within days of the public announcements, he sold his holdings for significant gains.⁷³

Applying the fiduciary duty requirement proclaimed in *Chiarella* or *Dirk's* constructive insider theory in this matter, Materia would escape liability. *Chiarella* reasoned that 10b-5 is only applicable to an insider who owes a fiduciary duty.⁷⁴ Furthermore, using *Dirk's* constructive insider theory, an outsider who is hired by a company and learns of material nonpublic information will be considered only a fiduciary to the hiring corporation's shareholders.⁷⁵ In either case though, a fiduciary relationship is not established between the outsider and the shareholders of the target corporation within a tender offer situation. Hence, an inherent unfairness results if the outsider is freely able to trade upon information which involves a target corporation. The court stated that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5."⁷⁶ The court stated that by Materia misappropriating information from his employer, he "perpetrated a fraud" which gave rise to a duty to refrain from trading.⁷⁷

⁶⁹ *SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984).

⁷⁰ *Materia*, 745 F.2d at 199.

⁷¹ *See Id.*

⁷² *See Id.*

⁷³ *See Id.*

⁷⁴ *See Chiarella*, supra note 37, at 235

⁷⁵ *Dirks*, 463 U.S. at 655 n.14.

⁷⁶ *Materia*, 745 F.2d at 203.

⁷⁷ *Materia*, 745 F.2d at 202.

The misappropriation theory was again applied in *United States v. O'Hagan*. O'Hagan was a partner in the law firm of Dorsey & Whitney.⁷⁸ Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company.⁷⁹ O'Hagan did no work on the Grand Met representation but was told of the proposed tender offer by a junior partner on the account.⁸⁰ Upon learning of the tender offer, O'Hagan bought 2500 call options for Pillsbury, the target corporation.⁸¹ A month later, Grand Met publicly announced its offer to buyout Pillsbury.⁸² O'Hagan exercised his options and made a profit of 4.3 million dollars.⁸³ The court explained that the

"misappropriation theory holds that a person commits fraud in connection with a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates 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. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary turned trader's deception of those who entrusted him with access to confidential information."⁸⁴

Thus if A owes a special duty of trust or confidence to the "source" of the information and uses the information to trade without disclosure, A is deemed a misappropriator. A nexus of the relationship between A's duty to the source and the corporation whose stock is traded need not be established.⁸⁵ In this situation, O'Hagan owed a special duty to the law firm which employed him. The law firm in this case is the source of the information.⁸⁶ When O'Hagan secretly took

⁷⁸ *U.S. v. O'Hagan*, 521 U.S. 642, 647 (1997).

⁷⁹ *O'Hagan*, 521 U.S. at 647.

⁸⁰ *See Id.*

⁸¹ *See Id.*

⁸² *See Id.*

⁸³ *See Id.*

⁸⁴ *O'Hagan*, 521 U.S. at 652.

⁸⁵ 2 James D. Cox, *Treatise on the Law of Corporations* § 12:10 (3d ed. 2011).

⁸⁶ *O'Hagan*, 521 U.S. at 685

the information of the tender offer and purchased call options, he breached his fiduciary duty to the source of the information.⁸⁷ Hence he misappropriated the information.⁸⁸

The courts have struggled in determining how to define the “special duty of trust or confidence to a source of the information” when applying the misappropriation theory.

In *United States v. Chestman* the court broadly expanded the fiduciary relationship to not only employment relationships, but any relationship based on “trust and confidence.”⁸⁹ Ira Waldbaum was the controlling shareholder of a large supermarket chain named Waldbaum, Inc.⁹⁰ Ira told his sister, Shirley Witkin, three of his children, and a nephew that he had agreed to sell the corporation to Great Atlantic and Pacific Tea Company, Inc. (“A & P”), but cautioned them to keep the news confidential.⁹¹ Shirley Witkin in turn told her daughter, who then told her husband, Keith Loeb.⁹² Loeb then told Robert Chestman who was a broker who traded on the nonpublic information about the tender offer.⁹³

The court explained that Chestman's convictions under Rule 10b-5 could not be sustained unless “(1) Keith Loeb breached a duty owed to the Waldbaum family or Susan Loeb based on a fiduciary or similar relationship of trust and confidence, and (2) Chestman knew that Loeb had done so.”⁹⁴ The court found that a familial relationship is not dispositive of the trust and confidence requirement.⁹⁵ Instead more facts have to be presented to show that the relationship was one based on trust and confidence.⁹⁶ The court found that this was not shown and hence

⁸⁷ *See Id.*

⁸⁸ *See Id.*

⁸⁹ *See Beeson*, supra note 8, at 1132.

⁹⁰ *United States v. Chestman*, 947 F.2d 551, 555 (2d Cir. 1991).

⁹¹ *See Id.*

⁹² *See Id.*

⁹³ *See Id.*

⁹⁴ *Chestman*, 947 F.2d at 564.

⁹⁵ *Chestman*, 947 F.2d at 568.

⁹⁶ *See Id.*

held that the Loeb or Chestman were not liable for trading on nonpublic information. Based upon its holding, the court implicitly declared

“that where any fiduciary relationship existed, the misappropriation theory could be applied. Accordingly, under the misappropriation theory after Chestman there was no requirement that (1) the ‘buyer or seller of securities be defrauded’ or (2) the fiduciary duty be limited to the ‘confined sphere of fiduciary/shareholder relations.’”⁹⁷

The expansive fiduciary relationships for misappropriation purposes was exemplified further in *United States v. Willis* where a breach in a doctor patient relationship was grounds to hold the trader (the doctor) liable as a misappropriator.⁹⁸ Sanford I. Weill was CEO of Shearson Loeb Rhodes but had eventually sold his controlling interest to the American Express Company and in turn became its President.⁹⁹ He later expressed interest in becoming CEO of BankAmerica and successfully secured an investment from Shearson in the amount of 1 billion dollars if he became CEO.¹⁰⁰ Weill would occasionally tell his wife, Joan Weill of these endeavors.¹⁰¹ At the time, Joan Weill was seeing a psychiatrist, Robert Willis.¹⁰² Mrs. Weill told Dr. Willis both about her husband's efforts to become CEO of BankAmerica and about the investment.¹⁰³ Upon hearing this, and prior to the information becoming public, Dr. Willis purchased 13,000 shares of BankAmerica.¹⁰⁴ After a public announcement was made of Weill's desire to be CEO, Dr. Willis sold his shares at a profit of \$27, 475.¹⁰⁵

The court held that the relationship between Mrs. Weill and her psychiatrist was a special relationship of trust and confidence and consequently was a “sufficient predicate upon which to

⁹⁷ See *Beeson*, supra note 8, at 1131.

⁹⁸ *United States v. Willis*, 737 F. Supp. 269, 272 (S.D.N.Y. 1990).

⁹⁹ *Willis*, 737 F. Supp. at 270.

¹⁰⁰ See *Id.*

¹⁰¹ See *Id.*

¹⁰² *Willis*, 737 F. Supp. at 271.

¹⁰³ See *Id.*

¹⁰⁴ See *Id.*

¹⁰⁵ See *Id.*

find a misappropriation theory of liability.”¹⁰⁶ The court stated that “[i]t is difficult to imagine a relationship that requires a higher degree of trust and confidence than the traditional relationship of physician and patient.”¹⁰⁷ The court also declared that a requirement for damages on the part of the party who suffered the misappropriation, although probative, is not required for liability to attach¹⁰⁸; “the one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5.”¹⁰⁹

Based upon the development of the misappropriation theory, it is clear that the Courts have implemented a case by case analysis in determining whether a special relationship of trust or confidence existed to implicate the misappropriation theory. One of the biggest criticisms for the misappropriation theory was that there lies no bright line rule for determining the special relationship of trust and confidence.¹¹⁰ The Securities and Exchange Commission clarified the law by adopting 10b-5-2.

10b-5-2 provides “a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading under Section 10(b) of the [Exchange] Act and Rule 10b-5,”¹¹¹ but it does specify three situations where trust and confidence always exist. The first relates to situations involving confidentiality agreements, either written or oral. “This reflects the common-sense notion ... that reasonable expectations of confidentiality, and corresponding duties, can be created by an agreement between two parties.”¹¹² Accordingly, to honor reasonable expectations, the misappropriation theory will always apply to these situations. The second situation arises “whenever the person

¹⁰⁶ See *Beeson*, supra note 8, at 1133

¹⁰⁷ *Willis*, 737 F. Supp. at 272.

¹⁰⁸ *Willis*, 737 F. Supp. at 274.

¹⁰⁹ *Willis*, 737 F. Supp. at 274-275.

¹¹⁰ See *Beeson*, supra note 8, at 1137

¹¹¹ 17 C.F.R. § 240.10b5-2 (2009).

¹¹² 5C Disclosure & Remedies Under the Sec. Laws § 12:128.

communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality.”¹¹³ Finally the third situation where a special relationship of trust and confidence is recognized is “whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling.”¹¹⁴ As a result of these provisions, the Commission has made it more efficient for the courts to determine the special relationship requirement when applying the misappropriation theory.

Through the above discussion of the legislative history of 10b-5, it can be seen that the statute has evolved significantly from the early days of *Cady* through the later days of *O’Hagan*. Insider trading is a continuing problem which demands continuing monitoring. The numerous theories (i.e. classical insider theory, constructive insider theory, tipper/tippee liability, and the misappropriation theory) that have been applied in interpreting and applying 10(b)(5) show society’s evolution in terms of its moral growth.

A Moral Critique of Insider Trading Regulation

Conducting a moral analysis on Rule 10b-5 requires an initial selection of a particular moral theory. The moral theory selected will inevitably generate a result as to the moral implications of a particular statute. Some of the more popular theories include Relativism, Positivism, and Realism. Relativism is premised on the idea that there are no universal or absolute truths. Because society is filled with unique cultures that exist all around the world, relativists believe that truth depends upon culture and thus is ever changing with society.

¹¹³ See *Id.*

¹¹⁴ 5C Disclosure & Remedies Under the Sec. Laws § 12:128.

Positivism is premised on the narrow idea that truth is composed of a set of rules. Its central idea is that “law and morals are separate and distinct realms.” The positivists view law as a “science and individual laws as the data or social facts whose validity depended only upon their existence and not their merit. Whether a law was moral or immoral is not within the province of jurisprudence.”¹¹⁵ Realism rejects the positivists’ premise of there being an “aggregation of rules” and instead proclaims that the “rules are indeterminate until interpreted by a judge or other legal decision maker.”¹¹⁶ On the contrary natural law is premised on the idea that law and morality are interconnected. “The common thread of natural law theories is the belief that reason is the essence of law and the establishment of justice its primary function. The ultimate justification of a law is the extent to which it fosters both individual good and the common good.”¹¹⁷ Natural Law theorist, John Finnis’ Natural Law Natural Rights argues for “a morality that is the product of the deep structure of practical thinking or moral thought.”¹¹⁸ In the following section, Finnis’ moral analysis framework will be applied to Rule 10b-5, in particular the misappropriation theory, which regulates insider trading.

In his opening John Finnis proclaims,

“There are human goods that can be secured only through the institutions of human law, and requirements of practical reasonableness that only those institutions can satisfy. It is the object of this book to identify those goods, and those requirements of practical reasonableness, and thus to show how and on what conditions such institutions are justified and the ways in which they can be (and often are) defective.”¹¹⁹

Hence the first question to ask when doing a Finnis moral analysis is whether, in this scenario, Rule 10b-5 promotes the good. The first step in answering this question is to determine what values are implicated by the statute. In terms of these values, Finnis lays out seven fundamental,

¹¹⁵ Michael P. Ambrosio, A Moral Appraisal of Legal Education: A Plea for a Return to Forgotten Truths, 22 Seton Hall. L. Rev. 1177, 1191 (1992).

¹¹⁶ See Ambrosio, *supra* note 115, at 1192.

¹¹⁷ See Ambrosio, *supra* note 115, at 1190.

¹¹⁸ See Ambrosio, *supra* note 115, at 1218.

¹¹⁹ John Finnis, *Natural Law & Natural Rights* 3 (Oxford University Press, 2nd ed. 2011).

basic universal goods. These goods are life, knowledge, play, aesthetic experience, friendship, religion, and practical reason.¹²⁰ Finnis explains that each of these goods are “intrinsic goods each worth having for their own sake, and not as a means of obtaining other goods”¹²¹—hence they are not instrumental but fundamental to each human being. Based upon exhaustive anthropological studies, Finnis describes these fundamental values as being self-evident in nature.

“All human societies show a concern for the value of human life; in all, self-preservation is generally accepted as a proper motive for action, and in none is the killing of other human beings permitted without some fairly definite justification. All human societies regard the procreation of a new human life as in itself a good thing unless there are special circumstances. No human society fails to restrict sexual activity; in all societies there is some prohibition of incest, some opposition to boundless promiscuity and to rape, some favor for stability and permanence in sexual relations. All human societies display a concern for truth, through education of the young in matters not only practical but also speculative or theoretical. Human beings, who can survive infancy only by nurture, live in or on the margins of some society which invariably extends beyond the nuclear family, and all societies display a favor for the values of co-operations, of common over individual good, of obligation between individuals, and of justice within groups. All know friendship. All have some conception of title or property, and of reciprocity. All value play, serious and formalized, or relaxed and recreational. All treat the bodies of dead members of the group in some traditional and ritual fashion different from their procedures for rubbish disposal. All display a concern for powers or principles which are to be respected as suprahuman; in one form or another, religion is universal.”¹²²

Finnis continues to remind us that these universal goods are non-moral goods that are intrinsic to each individual. Morality is the product of practical reasonableness which will come into play in the next section. The basic goods are those that are necessary for a human being to fully flourish. We now examine which goods are at stake in Rule 10b-5, and in particular, the misappropriation theory which is used to determine insider trading liability.

I. Finnis’ Basic Goods as Associated to Rule 10b-5

Life

“The term life signifies every aspect of the vitality of life which puts a human being in good shape for self-determination. Thus it includes bodily (including cerebral) health, and

¹²⁰ *Id.* at 86-90.

¹²¹ See Finnis, *supra* note 119, at 83.

¹²² *Id.*

freedom from the pain that betokens organic malfunctioning or injury.”¹²³ It is well known that the stock market, although purely an economic activity, has a major effect on mental and physical health. In a study conducted at Princeton University, researchers studied the mental and physical health of those individuals who were moderately to highly invested in the market during the crash of 2008. The researchers found that due to the crash, the subjects were more likely to encounter emotional and psychological problems which eventually would lead to physical pain.¹²⁴ In times of economic expansion these problems tend to be lower than during times of economic contraction. For example during the Great Depression, emotional problems leading to suicide amongst individuals spiked 22.8%. On the other hand, the suicide rate decreased significantly during the 1980s through 2000.¹²⁵

As discussed above, insider trading is not only unfair, but creates deficiencies in capital allocation due to the imbalance of information amongst investors. This imbalance eventually leads to a decrease in the quality of projects funded by organizations. Like a house of cards, eventually the decrease in the quality of projects causes the “whole house to collapse.” When this happens, the innocent investor becomes a victim due to the imbalance of information. When the market crashes, emotional and physical problems amongst the victims arise leading some heavily leveraged individuals to take their own lives. Rule 10b-5 recognizes people’s lives are at stake when insider trading is allowed to run rampant—hence Finnis’ basic good of life is of interest in the statute regulating it.

¹²³ *Id.* at 86.

¹²⁴ Recession Depression: Physical and Mental Health Effects of the Stock Market Crash, Princeton.edu, <http://paa2012.princeton.edu/download.aspx?submissionId=121786> (last visited April 6, 2012).

¹²⁵ Study Ties Suicide Rate in Work Force to Economy, nytimes.com, <http://www.nytimes.com/2011/04/15/health/research/15suicide.html> (last visited April 6, 2012).

Knowledge

Knowledge is an intrinsic good that is considered to be desirable for its own sake and not merely as something sought after, as an instrument, to obtain other goods. “Knowledge is something good to have and being well informed and clear-headed is a good way to be.”¹²⁶

“The value of truth is obvious and self-evident. It need not be and cannot be demonstrated. It is not innate but becomes obvious only to one who has experienced the urge to question, who has grasped the connection between question and answer, who understands that knowledge is constituted by correct answers to particular questions, and who is aware of the possibility of further questions and other questioners who like himself could enjoy the advantage of attaining correct answers.”¹²⁷

One of the values at stake in the creation of Rule 10b-5 is knowledge. Finnis says that knowledge should be pursued for its own sake and should not be used instrumentally for personal gain. Insider trading is in its essence a direct violation of this principle. Through insider trading, investors are able to obtain sensitive information and directly profit from trading upon it. The information attained is used directly for pecuniary gain. Hence because a direct violation of the good of knowledge is at stake, 10b-5 serves as a remedial tool.

The stock market is the gauge of how the economy is doing as a whole. It is premised on accurate valuations of the companies listed. The stock price generally tells the investor all that is needed to be known about the company in terms of its financial condition. Although investors buy into the market for financial gain, the stock market affects behavior unrelated to an actual investment made by an individual—this behavior includes an individual’s general curiosity as to how the overall economy is doing. When insider trading infiltrates the market, the gauge becomes skewed. Hence when an individual becomes curious as to how the economy is doing generally, the knowledge they seek is either inflated or deflated depending upon the extent of the trading. Thus attaining knowledge for the sake of knowledge becomes futile, prohibiting the flourishing of the individual. By leveling the playing field in terms of knowledge available

¹²⁶ See Finnis, *supra* note 119, at 63.

¹²⁷ See Finnis, *supra* note 119, at 65.

amongst investors, Rule 10b-5 seeks to uphold the integrity of the market as an accurate gauge of the health of the economy.

Play

Play as a standalone has “its own value.” Play involves “engaging in performances which have no point beyond the performance itself, enjoyed for its own sake. The performance may be solitary or social, intellectual or physical, strenuous or relaxed, highly structured or relatively informal, conventional or ad hoc in its pattern”¹²⁸ “Play can enter into any human activity” including in this instance, participating in the market.

“Playing the market” is a prevalent phrase in our society today. It can relate to an investor, avid or sporadic, or a trader working for an institution involved in managing its clients’ money. In all of these instances, the notion of play cannot be divorced from the activity being performed. For the investor, at a certain point, making a pecuniary gain becomes a byproduct to the drive the individual gets from participating in a highly time-sensitive and unpredictable market. This drive is obstructed when certain individuals play the market with sensitive nonpublic information at the expense of others resulting in economic inefficiencies.

The obstruction is also seen when traders, who are hired by institutions solely on their ability of picking the right investments, are unable to effectively do their job due to the lopsidedness of information that insider trading promotes. Those that love what they do, regardless of the paycheck they receive at the end of the week, are unable to utilize their skills because of unfair advantages gained by others.

Insider trading directly attacks the notions of play and in turn fosters a sense of futility amongst those participants listed above. Rule 10b-5 recognizes and attempts to remedy the

¹²⁸ See Finnis, *supra* note 119, at 87.

deleterious effects the practice has on participants who engage in market participation for its own sake.

Aesthetic Experience

Finnis explains that aesthetic experience, unlike play, “need not involve an action of one’s own; what is sought after and valued for its own sake may simply be the beautiful form outside one, and the inner experience of appreciation of its beauty.”¹²⁹ This experience can be found in “the creation/and or active appreciation of some work of significant and satisfying form.”¹³⁰ In this instance aesthetic experience, although not facially implicated, is at stake in the context of insider trading.

All economists are in agreement that market efficiency is the lynchpin of a successful economy. Market efficiencies affect the economy which in turn affects all individuals—whether they are market participants or non participants. According to Finnis then, market efficiency as a whole is a work “of significant and satisfying form” as it serves as the foundation to a full functional economy. Those that participate in it only do so because of their appreciation for its form. Nonparticipants also appreciate this form since economic repercussions implicate their lives in one way or another. Insider trading, as discussed above, creates inefficient markets due to its taxing effect on capital resource allocations. This inefficiency directly attacks the satisfying form that investors and non investors appreciate. Thus, Rule 10b-5 recognizes aesthetic experience as another value that is at stake and serves to remedy it by placing strict limitations.

Sociability (Friendship)

Friendship, as Finnis explains, of “is the most intense form of community.”

¹²⁹ See Finnis, *supra* note 119, at 88.

¹³⁰ See *Id.*

“In the fullest sense of friendship, A is the friend of B when A acts or is willing to act for B’s well-being, for the sake of B, while (ii) B acts for A’s well-being, for the sake of A, (iii) each of them knows of the others activity and willingness and of the other’s knowledge, and (iv) each of them coordinates his activity with the activity of the other so that there is a sharing, community, mutuality, and reciprocity not only of knowledge but also of activity.”¹³¹

Many friendship that are premised on business or “private need or advantage, or for play and individual pleasure, ripen into relationships of intense friendship. In the insider trading context, using Finnis’ logic, a business relationship would never ripen into an intense friendship.

Friendship first requires an individual to act for the sake of another while also requiring each to coordinate activity with the activity of the other “so that there is a sharing, community, mutuality and reciprocity of not only knowledge but also of activity.”¹³² Insider trading is premised on making the most money as possible from nonpublic information. Therefore, the sharing of information is clearly out of the question since divulging information would do nothing but decrease the insider trader’s return—more people trading on the stock would mean a decrease in overall profits. Therefore, those with business relationships with insider traders can never develop true friendships since insider traders are more likely focused upon themselves and the amount of money they can make by hoarding sensitive information. Although not blatantly, Rule 10b-5 subtly recognizes that friendship is a good that is at stake.

Religion

Religion ultimately represents one’s journey in discovering how orders engaged in earthly life relate to the “order of the cosmos.” Finnis asks, “does not one’s own sense of responsibility, in choosing what one is to be and do, amount to a concern that is not reducible to the concern to live, play, procreate, relate to others, and be intelligent?”¹³³ In regards to the atheist, Finnis says the individual nonetheless appreciates that he is “responsible... in choosing

¹³¹ See Finnis, *supra* note 119, at 142.

¹³² See Finnis, *supra* note 119, at 88.

¹³³ See Finnis, *supra* note 119, at 89.

what he is to be; and prior to any choice of his, recognizes that man is and is-to-be free.”¹³⁴ This recognition represents a concern for the “order of things beyond each and every one of us.”¹³⁵ This concern, which “is a good consisting in an irreducibly distinct form of order,”¹³⁶ is religious. The responsibility that we all have as individuals is at stake when insider trading is allowed to run rampant. One of the main teachings of any religion is to be a good person and perform honest work. Insider trading is a form of work that is not honest. Rule 10b-5 therefore acknowledges this dishonesty and its nonconforming nature with that of the order of the cosmos. Rule 10b-5 therefore recognizes religion as a value which is at stake.

Practical Reasonableness

The next good Finnis lists as a universal good is that of practical reasonableness. Finnis explains that “there is the basic good of being able to bring one’s own intelligence to bear effectively on the problems of choosing one’s actions and lifestyle.”¹³⁷ In its essence, practical reasonableness is “participated in precisely by shaping one’s participation in the other goods, by guiding one’s commitments, one’s selection of projects, and what one does in carrying them out.”¹³⁸ Practical reasonableness aids us in determining which value to promote and which to subordinate when two or more basic goods clash. Finnis has listed nine principles of reasonableness to determine whether a given path taken is reasonable. The moral analysis of Rule 10b-5, in relation to the misappropriation theory, will establish whether the action taken is a reasonable solution to the problem of insider trading. Therefore this value will be discussed in conjunction with the nine principles in the following section.

¹³⁴ See *Id.*

¹³⁵ See *Id.*

¹³⁶ See *Id.* at 90.

¹³⁷ See Finnis, *supra* note 119, at 88.

¹³⁸ See *Id.* at 100.

II. Finnis' Requirements of Practical Reasonableness in Relation To Rule 10b-5

All of the goods just described are basic in themselves. "First each is equally self-evidently a form of good. Secondly, none can be analytically reduced to being merely an aspect of any of the others, or to being merely instrumental in the pursuit of any of the others. Thirdly each one can reasonably be regarded as the most important."¹³⁹ In this section how one can determine the reasonableness of choosing a specific path is discussed. The nine principles of practical reasonableness discussed below express the natural law method of working out the (moral) natural law from the first (pre-moral) principles of natural law¹⁴⁰—the good is to be promoted and evil is to be avoided. The nine principles of practical reasonableness, whose product entails a moral judgment are: a coherent life plan, no arbitrary preferences amongst values, no arbitrary preferences amongst persons, detachment, commitment, the relevance of consequences, respect for every basic value in every act, the requirements of the common good, and following one's conscience.¹⁴¹

A Coherent Plan of Life

A coherent plan of life is one that "contains a harmonious set of purposes and orientations, not as blueprints but as effective commitments."¹⁴² Because deep commitments don't have a specific schema, a coherent plan of life cannot be solely tailored to a specific project. Although the plan "requires both direction and control of impulses and the undertaking of specific projects, they also require the redirection of inclinations, the reformation of habits, the

¹³⁹ See *Id.* at 92.

¹⁴⁰ See Finnis, *supra* note 119, at 100.

¹⁴¹ See *Id.*

¹⁴² See *Id.* at 104.

abandonment of old and adoption of new projects, and overall the harmonization of all one's deep commitments.”¹⁴³

Rule 10b-5 was written in a very expansive manner containing an overall harmonization of Congress' plan to prohibit the use of nonpublic information when buying or selling securities. No blueprint is laid out, but a spirit of commitment in terms of promoting an anti-fraudulent environment upon which investors could trade upon is highlighted. The misappropriation theory currently is the doctrine used in establishing Rule 10b-5 liability for insider trading. But this doctrine did not always govern the reach of 10b-5. As seen in the previous discussion, the statute evolved in terms of its scope of liability. The statute allowed for the “redirection of inclinations and the reformation of habits” by having the ability to be construed broadly as time went on and investors were able to circumvent the system. Because of the way the rule was written along with its ability to evolve, Congress' plan of prohibiting insider trading through Rule 10b-5 represents a coherent plan.

No Arbitrary Preferences Amongst Values

In making a rational decision, there must be “no leaving out of account, or arbitrary discounting or exaggeration, of any of the basic human values.”¹⁴⁴ This decision will inevitably focus on “one or some of the basic forms of good, at the expense, temporarily or permanently, of other forms of goods.”¹⁴⁵ Nevertheless the highlighting and subordinating of these values cannot be “willy-nilly.” In the insider trading context, the “misappropriation theory holds that a person commits fraud in connection with a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in

¹⁴³ See *Id.*

¹⁴⁴ See Finnis, *supra* note 119, at 105.

¹⁴⁵ See *Id.*

breach of a duty owed to the source of the information.”¹⁴⁶ Although all of the basic goods are implicated, in one way or another, in determining liability based on the misappropriation theory, some are highlighted while others are not. The statute focuses mainly upon the basic goods of life, knowledge, play, and reason.

As discussed above, life is taken into account by the statute since insider trading creates deficiencies in capital allocation due to the imbalance of information amongst investors. This inevitably affects the projects sought by an institution which ultimately affects the economy and innocent investors. Because the economy is intertwined with emotional and physical problems amongst the victims, leading some to take their own lives, Rule 10b-5 recognizes that people’s lives are at stake without stringent regulation.

Knowledge is also taken into account by the statute in two ways. First, because knowledge is to be pursued for its own sake and should not be used instrumentally for personal gain, insider trading, in its essence, serves as a direct violation. The information that insiders trade upon is solely motivated by pecuniary gains—knowledge therefore becomes an instrument in attaining that gain. Secondly, the inefficiency created by insider trading adversely skews the stock market which serves as a gauge on overall economic health. As a result, when an individual becomes curious as to how the economy is doing generally, the knowledge they seek is also skewed. Therefore, attaining knowledge for the sake of knowledge becomes futile. Rule 10b-5 seeks to level the playing field in terms of knowledge available amongst investors, so that the integrity of the market as an accurate gauge of the health of the economy can be upheld.

Finally, Play is taken into account by the statute to remedy the deleterious effects insider trading has on participants who engage in the activity of buying and selling securities for its own sake. Although the buying and selling in a market seems primarily pecuniary, for a lot of

¹⁴⁶ O’Hagan, 521 U.S. at 652.

investors it becomes a byproduct to the drive of actual participation in a highly time-sensitive and unpredictable market. For employees of large institutions who trade as their occupation, regardless of the amount of money they make, they are primarily motivated to use their skills in participating in the volatile market. The lopsidedness of information that results from inside trading creates an unfair advantage directly attacking the notions of play and in turn fostering a sense of futility amongst those participants engaging in the activity. By imposing strict limitations, the statute recognizes this basic form of good.

Although the statute is premised mainly upon the basic goods of life, knowledge, play, and reason, it does not arbitrarily prefer these over those that aren't premised upon it such as aesthetic beauty, friendship or religion although they do play a minor role. Commitment will be rational only if it is on the basis of one's assessment of one's capacities, circumstances, and even one's tastes. The four goods that are preferred here reflect most the circumstances that are implicated by insider trading. Therefore, the plan discussed does not arbitrarily make preferences amongst values.

No Arbitrary Preferences Amongst Persons

The third requirement of practical reasonableness is the "fundamental impartiality amongst the human subjects who are partakers of those basic goods."¹⁴⁷ Finnis explains that there is room in this requirement for self-preference but it cannot be made through "selfishness, special pleading, double standard, hypocrisy, indifference to the goods of others whom one could easily help, and all the other manifold forms of egoistic and group biases."¹⁴⁸

The interpretation of Rule 10b-5 through the misappropriation theory does not single out a specific group when determining liability. It is meant to implicate any individual who

¹⁴⁷ See Finnis, *supra* note 119, at 107.

¹⁴⁸ See *Id.*

misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Because self-preference is one of the main motivations for insider trading, the statute seeks to subdue it. Based upon a reading of the statute and the theory that is used to interpret it, no arbitrary preference amongst people is being shown. As Finnis proclaims, “provided we make the distinctions between basic practical principles and mere matters of taste, inclination, ability, we are able to favor the basic forms of good and to avoid and discourage their contraries. In doing so we are showing no improper favor to individuals...”¹⁴⁹

Detachment and Commitment

Both detachment and commitment are needed to carry out a coherent life plan. Detachment prevents both fanaticism and hopelessness amongst a particular project. “There is no good reason to take up an attitude to any of one’s particular objectives, such that if one’s project failed and one’s objective eluded one, one would consider one’s life drained of meaning.”¹⁵⁰ “There are also evil consequences of succumbing to the temptation to give one particular project the overriding and unconditional significance which only a basic value and a general commitment can claim—these consequences relate to those that result due to fanaticism.”¹⁵¹ The balance between “fanaticism and apathy” thus is the “requirement that having made one’s general commitments one must not abandon them lightly...while also looking for new and better ways of carrying out one’s commitments rather than restricting one’s horizon to the methods which one is familiar.”¹⁵²

¹⁴⁹ See *Id.* at 109.

¹⁵⁰ See Finnis, *supra* note 119, at 110.

¹⁵¹ See *Id.*

¹⁵² See *Id.*

It has been established above that Rule 10b-5 represented what Finnis called a coherent life plan. Based upon its history the Rule has been subject to numerous interpretations in terms of the scope of liability. Nowhere in its history has the Rule been abandoned. Similarly, nowhere in history has a single theory been stubbornly abided to without any room for further interpretations. On the contrary the law has evolved in new and improved ways in associating liability to those engaged in the practice of insider trading. From the days of classical insider theory to the current misappropriation understanding of Rule 10b-5 it can be seen that the statute served the balance between fanaticism and sheer hopelessness.

The (Limited) Relevance of Consequences: Efficiency, Within Reason

The following requirement “brings about good in the world by actions that are efficient for their purposes. One’s actions should be judged by their effectiveness, by their fitness for their purpose, by their utility, their consequences.”¹⁵³ Finnis reminds us that this is just one requirement though and that efficiency must also be balanced amongst the other principles of practical reason including the second principle which states that each basic good is equally important and no arbitrary preference can be shown for one good over another. Therefore, seeking efficiency cannot be the sole factor in the decision making process.

Unlike a utilitarian point of view (which Finnis believes is irrational), Finnis believes that “cost-benefit analysis be contained within a framework that excludes any project involving certain intentional killings, frauds, etc.”¹⁵⁴ But this “sphere of proper application has limits, and every attempt to make it the exclusive or supreme or even the central principle of practical thinking is irrational and hence immoral.”¹⁵⁵ Because Rule 10b-5 is a project seeking to exclude

¹⁵³ See Finnis, *supra* note 119, at 111.

¹⁵⁴ See *Id.* at 112.

¹⁵⁵ *Id.*

fraud, a cost-benefit analysis can be used in determining the efficiency of the statute—but this analysis cannot be the sole factor in the implementation of the regulation to justify it as rational.

Insider trading results in an eventual inaccuracy in stock prices. As stated above, “when companies raise capital at inaccurate prices, existing shareholders derive gains to the extent that new investors overpay for their shares, and suffer losses to the extent that new investors underpay.”¹⁵⁶ The overpayment by new investors therefore is a central focus of insider trading regulation. Because inside traders represent a significant minority within the market, the majority of individuals are materially affected by their actions. Seeing this, aside from the inherent unfairness of an unlevelled playing field, Rule 10b-5 was implemented to prohibit that overpayment. Throughout its history though, insiders were able to circumvent the system because of the statute’s reach. With the misappropriation theory though, it has become very difficult for these insiders to effectively circumvent the market. The result, i.e. benefits, of the regulation has made the market more representative as to its value where investors pay the true worth of an investment. Although more regulation means more cost, the benefits of a market which upholds its accurate value outweighs those costs and in turn makes Rule 10b-5 efficient within reason.

Respect For Every Basic Value in Every Act

This principle represents the idea that no decision can directly attack or destroy a basic good, even though it may be subordinated.

“Reason requires that every basic value be at least respected in each and every action. If one could ever rightly choose a single act which itself damages and itself does not promote some basic good, then one could rightly choose whole programs and institutions and enterprises that themselves damage and do not promote basic aspects of human well-being for the sake of their net beneficial consequences.”¹⁵⁷

¹⁵⁶ Marcel Kahan, Securities Laws and the Social Costs of “Inaccurate” Stock Prices, 41 Duke L.J. 977, 1006 (1992).

¹⁵⁷ See Finnis, *supra* note 119, at 120.

Finnis explains that net beneficial consequences in themselves are “literally absurd general objectives.”¹⁵⁸ In the matter before us, Rule 10b-5 does not directly attack any basic good. Instead as previously discussed, each value is directly or indirectly promoted through its implementation. Although some are focused more on while others aren’t, each value is respected and none are damaged.

The Requirements of the Common Good

This is the requirement of “favoring and fostering the common good of one’s communities.”¹⁵⁹ Finnis declares that the common good does not mean the “the greatest good for the greatest number” as preached in utilitarian doctrine. “There is a common good for human beings, inasmuch life, knowledge, play, aesthetic experience, friendship, religion, and freedom in practical reasonableness are good for any and every person.”¹⁶⁰ “An ensemble of conditions of collaboration which enhance the well-being of all members of a community is the common good.”¹⁶¹

The necessary and sufficient conditions for the common good represent justice. “The objective of justice is not equality but the common good, the flourishing of all members of the community, and there is no reason to suppose that this flourishing of all is enhanced by treating everyone identically when distributing roles, opportunities, and resources.”¹⁶² This objective is governed by the principles of distributive justice which is made up of five criteria listed in order of importance—need, function, capacity, merit, and who created the risk of harm.¹⁶³

¹⁵⁸ *Id.*

¹⁵⁹¹⁵⁹ See Finnis, *supra* note 119, at 125.

¹⁶⁰ See Finnis, *supra* note 119, at 155.

¹⁶¹ See *Id.* at 165.

¹⁶² See *Id.* at 174.

¹⁶³ See *Id.* at 174-175.

Determining need means determining whether given individuals in a society are taking more than their fair share at the expense of others. Need is the “fundamental component of the common good.”¹⁶⁴ In the insider trading context, a few individuals reap profits based upon information obtained wrongfully. These individuals, more likely than not, are those who are higher up in society. Thus they are those which least likely need the benefits which they seek to reap. Finnis carves out an exception by stating that “a few or even many may rightly be deprived of much in order that those who can defend the whole community against its dangers may be enabled and encouraged to do so.”¹⁶⁵ In our scenario, this is deemed inapplicable as insider traders serve no role in the protecting the community from any sort of danger imposed. On the contrary, their circumventing the market actually poses a danger upon society in terms of the risk of an eventual collapse.

The next element of distributive justice, function, represents “need relative not directly to basic human good but to roles and responsibilities in the community.”¹⁶⁶ In other words, distribution based upon position. In this case, insider traders trade upon nonpublic information for their own personal gain. The distribution here is one earned through unfair means. Hence position is irrelevant within this matter—the activity engaged in is not related to any type of role or responsibility the individual has within the community, but is only related to how well connected the individual is and how timely the trades are made prior to information becoming public knowledge.

The next criterion within distributive justice is capacity, which is “relative not only to roles in communal enterprises but also to opportunities for individual advancement.”¹⁶⁷ In other

¹⁶⁴ See *Id.* at 174.

¹⁶⁵ See *Id.*

¹⁶⁶ See Finnis, *supra* note 119, at 175.

¹⁶⁷ See *Id.*

words capacity means benefits distributed upon the ability to be able to do something. In our context, insider trading creates capital allocation inefficiencies which affect the overall market. The adverse effect of insider trading in turn affects the ability of investors to individually achieve their goals in market participation. Because insider trading is premised on new market participants overpaying for a particular security, the practice affects innocent investors' capacity to trade. Although inside traders may justify the benefits attained based upon their "skill" of trading on nonpublic information, as compared to other investors, they are not shouldering their share of the risk when investing to justify receiving a greater share of the benefits.

The next criterion within distributive justice is that of distributions based upon merit.¹⁶⁸ Those that are deserving, through their arduous efforts, in the end can justify receiving a greater share of the benefits. In our continuing context, insider trading is representative of attaining information that no one else knows of through suspect means and profiting from it. Nowhere is merit involved within this context. On the contrary, insider trading deceives all other market participants who are arduously studying market trends and economic conditions to determine when the right time to buy or sell a particular investment is. Insider traders do not represent those that are to be rewarded for their merit.

The last criterion within distributive justice is a determination of who created the risk of harm.

"In the distribution of the costs and losses of communal enterprise fairness will often turn on whether some parties have created or at least foreseen and accepted avoidable risks while others have neither created them nor had opportunity of foreseeing or of avoiding or insuring against them"¹⁶⁹

Insider traders, as discussed above, create market inefficiencies by deriving gains to the extent that new market participants overpay for their shares. Furthermore, the inside trading creates

¹⁶⁸ See *Id.*

¹⁶⁹ See Finnis, *supra* note 119, at 175.

capital allocation problems which result in a decrease in the quality of projects funded by institutions. This eventually leads to the overall decline in the economy. In this chain of events, it is evident that the risk of harm is solely created by the insider trader. On the other hand, the majority of investors have no protection against this practice, and instead are severely disadvantaged. In the end, it would not be deemed just for the innocent investor to have to bear the burden of a risk of loss created by the actions of the insider traders.

Based upon the five criterion listed above, it is clear that the unequal distribution that insider traders get is not just. Because it is not just, the act does not promote the common good. Rule 10b-5 attempts to impose regulations upon this act so that a level playing field is provided for all investors—in other words to make trading fair based upon public information. As such, the statute promotes the common good.

Following One's Conscience

This final principle of practical reasonableness asks whether the action conforms in accordance with one's conscience. In regards to mistaken conscience, Finnis relies on Thomas Aquinas' formulation that

“if one chooses to do what one judges to be in the last analysis unreasonable, or if one chooses not to do what one judges to be in the last analysis required by reason, then one's choice is unreasonable no matter how erroneous one's judgment of conscience may happen to be.”¹⁷⁰

In the insider trading context, aside from the market inefficiencies and capital allocation issues that arise, there seems to be a bigger wrong at stake. There is something fundamentally wrong with someone gaining nonpublic information and trading upon it for a profit. Although justifications can be made by the perpetrators, everyone knows that this is a dishonest practice. Regulations preventing this unfairness conform to not only an individual's conscience, but that of society. Ever since we were children, we have been taught to be honest in all aspects of our

¹⁷⁰ See Finnis, *supra* note 119, at 126.

lives. Insider trading directly violates this seemingly elementary principle. Hence regulating it promotes the fundamental principles that are inherent within all of our consciences.

The Product of These Requirements: Morality

Each of the nine principles “plays a part in reasonable deciding” with regards to any act or decision.

“Not every one of the nine requirements has a direct role in every moral judgment, but some moral judgments do sum up the bearing of each and all of the nine on the questions in hand, and every moral judgment sums up the bearing of one or more of the requirements.”¹⁷¹

Based upon the nine principles examined in relation to Rule 10b-5 and the related misappropriation theory used to determine the scope of liability for insider trading, it can be seen that the regulations are appropriate means to achieve the good sought. The solution for insider trading has a harmony of purposes, recognizes all of the basic goods, does not show arbitrariness amongst individuals, is detached from particular realizations of good, has fidelity towards commitments, is efficient in terms of its cost/benefit, respects every basic value, promotes the common good, and conforms to one’s conscience.¹⁷² Based upon a deep structure of practical thinking which Finnis proposes, Rule 10b-5 and the corresponding misappropriation theory is consistent with a practical reasonable approach in preventing insider trading.

¹⁷¹ See *Id.*

¹⁷² See Finnis, *supra* note 119, at 126.