

## MISAPPROPRIATORS, TIPPEES AND THE INTENT-TO-BENEFIT RULE: WHAT WE CAN STILL LEARN FROM *CADY, ROBERTS*

Craig W. Davis\*

### INTRODUCTION

In early 1997, while in the process of dissolving their marriage, David and Donna Yun were discussing their post-nuptial settlement agreement.<sup>1</sup> David, president of Scholastic Book Fairs, Inc., explained to his wife that the value of Scholastic stock included in his statement of assets reflected an anticipated \$10-per-share decline in value due to an unfavorable earnings report, which was to be announced within the week.<sup>2</sup> At her husband's request, Mrs. Yun agreed not to disclose this confidence to anyone except her lawyer.<sup>3</sup>

Shortly thereafter, two days before the earnings announcement, Donna Yun telephoned her attorney, Sam Weiss, from her real-estate office to discuss the assets statement. Jerry Burch, a co-worker and fellow sales agent, was present and standing within feet of Mrs. Yun as she explained the Scholastic stock price discrepancy to Weiss. That evening, Mrs. Yun and Burch attended a trade banquet together,<sup>4</sup> where they discussed the Scholastic earnings situation.<sup>5</sup>

---

\* J.D. Candidate, 2005, Seton Hall University School of Law; M.A., Boston College; B.A., University of Maine.

<sup>1</sup> SEC v. Yun, 327 F.3d 1263, 1267 (11th Cir. 2003). See generally M. Anne Kaufold, Casenote, *Defining Misappropriation: The Spousal Duty of Loyalty and the Expectation of Benefit*, 55 MERCER L. REV. 1489 (2004) (setting forth facts and holdings of Yun).

<sup>2</sup> *Id.* On the weekend of February 15–16, 1997, Scholastic was trading at \$65 per share. The poor earnings announcement was to be made on February 20, and David Yun anticipated a drop in price to about \$55 per share. *Id.*

<sup>3</sup> *Id.* at 1267 & n.4.

<sup>4</sup> *Id.* at 1268.

<sup>5</sup> SEC v. Yun, 130 F. Supp. 2d 1348, 1356–57 (M.D. Fla. 2001), vacated by 327 F.3d 1263 (11th Cir. 2003); see also Yun, 327 F.3d at 1268. Over the course of the SEC's subsequent investigation Burch and Yun changed their story regarding when and where the tip occurred. It is not entirely clear whether the alleged tip occurred as a result of Mrs. Yun's telephone call to her lawyer or at the party later that evening, and the matter was submitted for the jury's consideration. Yun, 130 F. Supp. 2d at

The next morning, the day before Scholastic's earnings announcement, Jerry Burch placed an order through his broker to purchase approximately \$20,000 worth of two-day puts.<sup>6</sup> The following day the price of Scholastic stock dropped forty percent in response to the earnings report, closing at \$36 per share. Burch then sold his options, reaping a profit of more than one quarter of a million dollars.<sup>7</sup>

The Securities and Exchange Commission ("SEC" or "Commission") began an investigation into Burch's trading activities within hours of his covering trades.<sup>8</sup> As a result of its investigation, the Commission brought a civil action against both Donna Yun and Burch, alleging that the pair had violated section 10(b) of the Securities Exchange Act of 1934<sup>9</sup> and Rule 10b-5<sup>10</sup> promulgated thereunder. Since there was no contention of any wrongdoing by David Yun in disclosing the earnings information to his wife, and since Donna Yun was not an insider of Scholastic, the SEC brought its action under the misappropriation theory of insider trading liability.<sup>11</sup> Following a jury determination against them, the defendants moved for judgment as a matter of law, or a new trial,<sup>12</sup> contending that they lacked the requisite state of mind insofar as Donna Yun, the alleged tipper, did not intend to benefit from tipping Burch.<sup>13</sup> The United States District Court for the Middle District of Florida denied the motions, holding that, under the misappropriation theory, a Rule 10b-5 violation did not require a showing that the tipper intended to

---

1356–57. The Court of Appeals did not focus on this issue, treating both possibilities as equally subject to its analysis. *See Yun*, 327 F.3d 1263.

<sup>6</sup> *Yun*, 327 F.3d at 1268; *Yun*, 130 F. Supp. 2d at 1357. A put is an option contract which gives the purchaser the right to sell a particular security at a predetermined price at any time before a specified expiration date. LAWRENCE G. McMILLAN, *OPTIONS AS A STRATEGIC INVESTMENT* 866 (3d ed. 1992). Since the put option confers the right to sell at a certain price (the strike price), its value increases algorithmically to the extent that the price of the underlying stock decreases below the strike price. *See id.* at 838–39. A forty-eight hour option is a substantially risky investment, being in essence a wager on the immediate short-term movement of a stock's price. If the underlying security is trading above the strike price at expiration, the options are worthless. Burch's two-day puts expired the day after Scholastic's scheduled earnings announcement.

<sup>7</sup> *Yun*, 327 F.3d at 1268.

<sup>8</sup> *Id.*

<sup>9</sup> 15 U.S.C. § 78j(b) (2000).

<sup>10</sup> 17 C.F.R. § 240.10b-5 (2004).

<sup>11</sup> *See Yun*, 327 F.3d at 1267; *see also* *United States v. O'Hagan*, 521 U.S. 642 (1997) (adopting misappropriation theory); *infra* Part I.B.

<sup>12</sup> *Yun*, 130 F. Supp. 2d at 1348.

<sup>13</sup> *Id.* at 1350.

benefit from the tip.<sup>14</sup>

The United States Court of Appeals for the Eleventh Circuit disagreed, holding that the state-of-mind requirement for tippers was the same—an intent to benefit from the tip<sup>15</sup>—whether the tipper was an outsider-misappropriator or a classic corporate insider.<sup>16</sup>

The Commission's effort, as exemplified in *Yun*, to curtail the reach of the intent-to-benefit requirement is consistent with its historically persistent advocacy of a far-reaching insider trading ban under a theory of equal access to market information.<sup>17</sup> The upshot of the SEC's approach is the imposition of insider trading liability whenever a person trades with the benefit of an informational imbalance, however gained. In opposition to the SEC's push for relatively unrestrained liability, the United States Supreme Court has consistently limited the scope of Rule 10b-5 by interpreting the Rule as an antifraud provision.<sup>18</sup> As a result of the Court's fraud-based approach, insider trading liability has hinged on two prerequisites: (1) a requirement of a breach of a fiduciary or fiduciary-like duty as supplying the requisite fraudulent act<sup>19</sup> and (2) a state-of-mind requirement that is consistent with a theory of fraud;<sup>20</sup> for example,

---

<sup>14</sup> *Id.* at 1353.

<sup>15</sup> See *Dirks v. SEC*, 463 U.S. 646, 662 (1983) (holding that test for breach of duty owed to corporation by corporate insider is whether tipping of inside information would benefit tipper); *infra* notes 72–96 and accompanying text.

<sup>16</sup> *Yun*, 327 F.3d at 1280. The court noted the differing opinions on this matter among the federal courts. *Id.* at 1274–75 & nn.25, 26. Compare *id.* at 1276 (requiring an intent to benefit under misappropriation theory), and *SEC v. Trikalis*, No. CV 92-1336-RSWL(EEX), 1992 WL 301398, at \*3 (C.D. Cal. July 28, 1992) (applying improper motive test under misappropriation theory), with *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993) (requiring breach of duty by tipper and knowledge of breach by tippee, “without more”), and *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (rejecting improper motive test under misappropriation theory). See also *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (noting disagreement on issue but declining to resolve it).

<sup>17</sup> See *infra* Parts I.A, II.

<sup>18</sup> See *infra* notes 31–45 and accompanying text.

<sup>19</sup> See *infra* Part II.A.

<sup>20</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). The *Yun* decision also highlights some of the ambiguities which have developed in civil actions for insider trading regarding the state-of-mind requirement in general. The United States Supreme Court's early pronouncement that scienter was an essential element of Rule 10b-5 claims, *Ernst & Ernst*, 425 U.S. at 197, 214, was followed by indications that a lesser standard might suffice in certain situations. See *Dirks*, 463 U.S. at 660 (implying a negligence standard by stating that tippee may be liable if he knew or should have known his receipt of nonpublic information was result of impropriety). Moreover, the Court's deferral of the issue of whether recklessness is a sufficient standard for liability, *Ernst & Ernst*, 425 U.S. at 193 n.12, has predictably led to disagreement among the federal courts. See, e.g., *Yun*, 327 F.3d at 1274–75 (rejecting recklessness standard); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (adopting

the intent-to-benefit rule.

The facts of *Yun* provide a felicitous opportunity to explore this tension between two opposing theories of insider trading liability as it relates to the intent-to-benefit requirement, as well as more universal concerns of the legitimacy and justifiable scope of the prohibition of insider trading. *Yun* sets out two possible factual contexts in which an illegal tip might have occurred. Either Jerry Burch was a chance, inadvertent recipient of inside information when he overheard Mrs. Yun's telephone conversation,<sup>21</sup> or he received the information by means of a deliberate breach of confidence by Mrs. Yun when she willfully divulged the information to him at a social gathering.<sup>22</sup> Under the SEC's theory, there need be no intent to benefit from providing a tip in order for there to be insider trading liability.<sup>23</sup> Thus, Jerry Burch would be liable for insider trading in either case, simply because he took advantage of an informational imbalance, without regard to how that advantage came about. The Commission sought to accomplish this result by eliminating the intent-to-benefit requirement when an action is brought under the misappropriation theory of insider trading liability.<sup>24</sup>

An exploration of the doctrinal underpinnings of insider trading law will show, however, that this approach is inconsistent with the law as the courts have interpreted it under Rule 10b-5. Analysis of the seminal SEC decision in *In re Cady, Roberts & Co.*<sup>25</sup> will reveal that the

---

recklessness standard). In *Yun*, although the appellate court disagreed with the trial court on the state-of-mind issue, the higher court affirmed the denial of defendants' motions for judgment as a matter of law since there was sufficient factual basis for finding the intent standard had been met. *Yun*, 327 F.3d at 1280. The court did, however, grant the defendants a new trial based on the jury instructions given in the lower court, which articulated a recklessness standard and did not include instruction as to the intent requirement. *Id.* at 1282.

It should perhaps be noted that the state of mind required for criminal prosecutions of inside traders is more clearly defined, both judicially and statutorily. See generally Brian J. Carr, Note, *Culpable Intent Required for All Criminal Insider Trading Convictions After United States v. O'Hagan*, 40 B.C. L. REV. 1187 (1999). The present analysis will be confined to the state-of-mind requirement for civil actions, where a willful intent to violate the securities laws is not purported to be an issue. See *id.* at 1194-1210. It is also worth noting that civil actions under Rule 10b-5 are brought by and large by the SEC. Although there is a judicially created implied private right of action under Rule 10b-5, *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), such actions are rarely brought, owing largely to statutory restrictions on class actions for securities fraud and limits on damage awards. See STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 123-24 (1999).

<sup>21</sup> *Yun*, 327 F.3d at 1268.

<sup>22</sup> *Id.*; *Yun*, 130 F. Supp. 2d at 1356-57.

<sup>23</sup> See *Yun*, 130 F. Supp. 2d at 1353.

<sup>24</sup> See *id.*; *infra* text accompanying notes 243-48.

<sup>25</sup> 40 S.E.C. 907 (1961).

SEC's current position is, and has been for some time, based on a misconception of the idea of fairness as set forth in *Cady, Roberts* as one of the doctrinal pillars of the insider trading ban.<sup>26</sup> This analysis will also show that the Supreme Court, in contrast to the SEC, has for the most part correctly applied *Cady, Roberts* by emphasizing that the *Cady, Roberts* rationale bases liability on the abuse of a relationship of trust.<sup>27</sup> This abuse, and not mere informational inequality, gives rise to the unfairness inherent in insider trading. The exegesis of *Cady, Roberts* will also confirm the notion, strongly implied in Supreme Court decisions,<sup>28</sup> that the misappropriation theory is not fundamentally distinct from the classical theory.<sup>29</sup>

Part I of this Comment will survey the development of Rule 10b-5 as a regulatory mechanism for the prosecution of insider trading. Part I.A will trace the development of the classical theory of insider trading, based on fiduciary duties owed to the shareholders with whom an insider trades. The misappropriation theory of liability, premised on duties owed to the source of the misappropriated information, will be detailed in Part I.B. In Part II, the theoretical and policy rationales underlying insider trading prohibitions will be explored and analyzed afresh with an eye towards establishing a doctrinal setting in which to analyze the intent-to-benefit requirement. This discussion will take its cue from the seminal opinion of former SEC Chairman William Cary in *Cady, Roberts*.<sup>30</sup> The dual prongs of the *Cady, Roberts* rationale, breach of trust and fairness, will be analyzed in Parts II.A and II.B, respectively, to determine their appropriateness vis-à-vis the insider trading prohibition and the parameters that they should set for liability.

Finally, in Part III, the conclusions and insights gained in Part II will be brought to bear on the current controversy (the state-of-mind problem as exemplified in *Yun*), to resolve that particular issue and to give more definite shape to the scope of the insider trading prohibition in general.

## I. BACKGROUND—THE LAW OF INSIDER TRADING

Section 10(b) of the Securities Exchange Act of 1934<sup>31</sup> is an enabling provision, the purpose of which was the prevention of

---

<sup>26</sup> *Id.* at 912; *infra* Part II.B.

<sup>27</sup> *Cady, Roberts*, 40 S.E.C. at 912; *infra* Part II.

<sup>28</sup> See *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

<sup>29</sup> See *infra* Part III.

<sup>30</sup> *Cady, Roberts*, 40 S.E.C. 907.

<sup>31</sup> 15 U.S.C. § 78j(b) (2000).

surreptitious manipulation of securities markets.<sup>32</sup> The statute prohibits “any manipulative or deceptive device or contrivance” employed “in connection with the purchase or sale of any security” that contravenes any rules and regulations that the SEC may promulgate “as necessary or appropriate in the public interest or for the protection of investors.”<sup>33</sup> While the legislative purpose behind section 10(b) seems to have been the regulation of abusive acts of speculation and market manipulation that misrepresent the value and liquidity of securities,<sup>34</sup> the United States Supreme Court has consistently construed the statute as a broader measure against securities fraud.<sup>35</sup>

Rule 10b-5,<sup>36</sup> promulgated by the SEC in 1942 under authority of section 10(b), was originally drafted in response to a particular instance of market manipulation; namely, a corporate director falsely talking down the corporation’s financial condition and then buying the shares of credulous stockholders at a profitable discount.<sup>37</sup> From this rather humble and exigent beginning, the rule has become the federal government’s indispensable weapon in combating insider trading,<sup>38</sup> a problem to which it was not originally addressed.<sup>39</sup>

Rule 10b-5 prohibits “any person, directly or indirectly” from “(a) . . . employ[ing] any device, scheme, or artifice to defraud . . . or (c) . . . engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in

---

<sup>32</sup> See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990).

<sup>33</sup> 15 U.S.C. § 78j(b).

<sup>34</sup> Thel, *supra* note 32, at 385–86.

<sup>35</sup> See, e.g., *United States v. O’Hagen*, 521 U.S. 642, 670 (1997) (stating that section 14(e) of the Exchange Act is modeled on the antifraud provisions of section 10(b)) (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 10 (1985)); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 198 (1994) (Stevens, J., dissenting) (noting that “acknowledged purpose” of section 10(b) is “to strengthen the antifraud remedies of the common law”); *Dirks v. SEC*, 463 U.S. 646, 646 (1983) (stating that section 10(b) is one of the antifraud provisions of the Exchange Act).

<sup>36</sup> 17 C.F.R. § 240.10b-5 (2004).

<sup>37</sup> See *Conference on the Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (remarks of co-drafter Milton Freeman), *cited in* *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 n.32 (1976).

<sup>38</sup> Then-Justice Rehnquist’s enduring remark on the phenomenon of Rule 10b-5 bears repeating: The rule had become “a judicial oak which has grown from little more than a legislative acorn.” *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

<sup>39</sup> *Cf. United States v. Chestman*, 947 F.2d 551, 578 (1991) (Winter, J., concurring in part and dissenting in part) (“[T]he law [of insider trading] is far enough down th[e Rule 10b-5] road . . . that a court . . . has no option but to continue the route.”).

connection with the purchase or sale of any security.”<sup>40</sup> A line of Supreme Court cases has articulated the necessary elements of any Rule 10b-5 claim as those inhering in an action for common-law fraud. In *Blue Chip Stamps v. Manor Drug Stores*,<sup>41</sup> the Court limited standing in civil actions brought under Rule 10b-5 to those who traded in a security in connection with fraudulent activity proscribed by the Rule.<sup>42</sup> In holding that Rule 10b-5 did not proscribe mere negligence, *Ernst & Ernst v. Hochfelder*<sup>43</sup> affirmed the scienter requirement for Rule 10b-5 securities fraud. The materiality requirement of common-law fraud was subsumed under the federal securities laws in *TSC Industries, Inc. v. Northway, Inc.*<sup>44</sup> Under the *Northway* standard, an omitted fact is considered material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to” act.<sup>45</sup>

#### A. *The Classical Theory of Insider Trading*

Rule 10b-5 was first used to combat insider trading in the SEC’s groundbreaking decision, *In re Cady, Roberts*.<sup>46</sup> *Cady, Roberts* premised

---

<sup>40</sup> 17 C.F.R. § 240.10b-5.

<sup>41</sup> 421 U.S. 723 (1975).

<sup>42</sup> *Id.* at 754–55.

<sup>43</sup> 425 U.S. 185 (1976).

<sup>44</sup> 426 U.S. 438 (1976).

<sup>45</sup> *Id.* at 449. *Northway* involved the proxy rules of section 14(a). The standard was adopted in the Rule 10b-5 context in *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988). In insider trading cases, the standard is virtually self-satisfying. The very act of trading speaks to the materiality of the inside information.

Causation is of particular interest in the securities fraud context. Assuming that a hypothesis of efficient securities markets accurately reflects economic reality, which in the high-volume, high-liquidity, impersonal securities exchanges is a fair assumption, then securities prices reflect a discounting of all publicly available information. This is the so-called “weak” efficient markets hypothesis. The strong hypothesis, rather less adhered to, is that securities prices in efficient markets discount *all* information, whether or not it is public and available. Interestingly, the strong form of the hypothesis takes into account information reaching the markets through clandestine channels, like insider trading. *See generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). Similarly, any omissions or misinformation will also be discounted. It is therefore reasonable to presume reliance, or transaction causation, whenever trades are conducted on a national exchange in a security as to which there has been a material misstatement or omission. *See Basic*, 485 U.S. at 247. This fraud-on-the-market theory, *id.*, makes causation in securities fraud cases a somewhat pat proposition. The Supreme Court has accepted the presumption of reliance under the fraud-on-the-market theory. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). *But cf. Litton Indus. v. Lehman Bros. Kuhn & Loeb, Inc.*, 967 F.2d 742 (2d Cir. 1992) (holding that causation of actual pecuniary damages, or loss causation, could not be presumed).

<sup>46</sup> *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

liability for insider trading on a willful violation of the federal securities laws, specifically Rule 10b-5.<sup>47</sup> The opinion of SEC chairman Cary pronounced what has become the accepted rule governing insider trading and articulated the underlying doctrinal rationale for its prohibition. The disclose or abstain rule prescribes that insiders must either disclose nonpublic, material information to which they are privy by virtue of their position as insiders or, if disclosure would be improper or is not feasible, abstain from trading.<sup>48</sup> While officers, directors and controlling shareholders came within the rule's constraints,

[t]hese three groups . . . do not exhaust the classes of persons upon whom there is such an obligation [to disclose or abstain from trading]. Analytically, the obligation rests on two principal elements; first, the existence of a *relationship* giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent *unfairness* involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.<sup>49</sup>

The dual concerns of *Cady, Roberts*—respecting fiduciary relationships and avoiding unfairness—have driven the federal courts' insider trading jurisprudence since SEC Chairman Cary committed their expression to paper.<sup>50</sup> These two prongs of the *Cady, Roberts* rationale anchor contrary tendencies, which have since guided and defined the debate over insider trading. On the one hand is the Supreme Court's dogged persistence in basing insider trading liability on a breach of duty, and, on the other, the SEC's ceaseless, though largely futile attempts to broaden the scope of Rule 10b-5, in the name of fairness, under a theory of equal access to information for all market participants.<sup>51</sup> The post-*Cady, Roberts* development of insider trading law manifests the tension inherent in these opposing viewpoints.

In *SEC v. Texas Gulf Sulphur Co.*,<sup>52</sup> a paradigm insider trading case, the United States Court of Appeals for the Second Circuit expressly adopted *Cady, Roberts*' disclose or abstain rule under a theory of equal access to information.<sup>53</sup> *Texas Gulf Sulphur* involved

---

<sup>47</sup> *Id.* at 908–10.

<sup>48</sup> *Id.* at 911.

<sup>49</sup> *Id.* at 912 (footnote omitted) (emphasis added).

<sup>50</sup> See discussion *infra* Part II.

<sup>51</sup> See discussion *infra* Part II.

<sup>52</sup> 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

<sup>53</sup> *Id.* at 848.

insider trading by corporate officers after the firm's explorations uncovered a potentially massive ore deposit in Ontario, Canada.<sup>54</sup> While the insiders were buying up TGS stock, the corporation was buying all of the land and mineral rights in the area that it could.

Appraising the policy underlying Rule 10b-5, the court deemed the congressional purpose behind the rule to be "that all members of the investing public should be subject to identical market risks . . . ."<sup>55</sup> In holding that the disclose or abstain rule applied to anyone who traded while in possession of material, nonpublic information,<sup>56</sup> the Second Circuit erected a daunting ban on trading with an informational advantage, however gained.<sup>57</sup> But the triumph of the equal access theory in *Texas Gulf Sulphur* was not to abide.

In *Chiarella v. United States*,<sup>58</sup> the Supreme Court took the opportunity to trim back the broad prohibition of *Texas Gulf Sulphur* by rejecting the equal access theory.<sup>59</sup> In an opinion by Justice Powell, the Court emphasized the first prong of the *Cady, Roberts* rationale, respecting fiduciary relationships. This reemphasis acted to delimit the fairness consideration, which had been the dominant, if not the exclusive doctrinal consideration in the *Texas Gulf Sulphur* decision, by restricting its purview to those who have a duty to disclose.<sup>60</sup>

Vincent Chiarella worked for a printing company that printed merger and acquisition documents.<sup>61</sup> He managed to decrypt the documents of his firm's clients, discerned the identities of the companies involved, and traded their stock.<sup>62</sup> The Court read the first *Cady, Roberts* prong narrowly, for although Chiarella had indeed gained access to the information by virtue of insider status, he was not an insider of the companies whose stock he had traded, and thus owed neither them nor their shareholders any fiduciary duties.<sup>63</sup> Absent a duty to disclose, Chiarella's silence could not render him

---

<sup>54</sup> *Id.* at 843.

<sup>55</sup> *Id.* at 852.

<sup>56</sup> *Id.* at 848.

<sup>57</sup> Under the Second Circuit's all-encompassing rule, a local who observed the hurried activities of TGS's agents, took an educated guess as to what might be going on, and bought shares of TGS stock, would presumably be liable for insider trading. BAINBRIDGE, *supra* note 20, at 47-48; *see also* SEC v. Sargent, 229 F.3d 68, 74 (1st Cir. 2000) (providing example of similar set of circumstances).

<sup>58</sup> 445 U.S. 222 (1980).

<sup>59</sup> *Id.* at 231.

<sup>60</sup> *Id.*; *see also* discussion *infra* Part II.

<sup>61</sup> *Chiarella*, 445 U.S. at 224.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 231.

liable for defrauding anyone under Rule 10b-5.<sup>64</sup> The Court expressly rejected the lower court's contention that Chiarella, by virtue of his position as a regular recipient of material, nonpublic, corporate information, owed a duty to all market participants.<sup>65</sup> In other words, the Court rejected the equal access theory's insistence on informational parity and identical market risks.

*Chiarella* is a pivotal insider trading case for several reasons. First, the Supreme Court adopted Chairman Cary's rationale in *Cady, Roberts* for the ban on insider trading.<sup>66</sup> At the same time, however, it rejected the equal access theory then advanced by the SEC as overbroad, and made clear the Supreme Court's determination to limit insider trading liability to instances where fiduciary duties were disregarded—a person would not be liable for insider trading simply because of an informational advantage. This, the Court implied, was an erroneous reading of *Cady, Roberts*.<sup>67</sup> And finally, the Court declined to adopt the misappropriation theory. Chief Justice Burger, in dissent, argued that a duty to disclose should arise whenever nonpublic information was gained improperly.<sup>68</sup> The majority declined to address the matter only because it had not been raised below.<sup>69</sup> *Chiarella* is thus the model case for the classical theory of insider trading, which requires that a fiduciary breach a duty to disclose owed to the persons with whom he trades.<sup>70</sup> The misappropriation theory would have to find sustenance among the federal circuit courts until the Supreme Court's 1997 decision in *United States v. O'Hagan*.<sup>71</sup>

Tippee liability was analyzed within the classical liability framework in *Dirks v. SEC*.<sup>72</sup> Raymond Dirks was a stockbroker and analyst who received inside information concerning Equity Funding of America from Ronald Secrist, an insider at Equity Funding.<sup>73</sup> Secrist informed Dirks that Equity Funding had been deliberately

---

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 233.

<sup>66</sup> *See id.* at 226–28.

<sup>67</sup> *See Chiarella*, 445 U.S. at 227–28, 232 n.14.

<sup>68</sup> *Id.* at 240 (Burger, C.J., dissenting). The Chief Justice's argument plainly had some force. *See* discussion *infra* Part I.B.

<sup>69</sup> *Chiarella*, 445 U.S. at 236.

<sup>70</sup> The SEC was also dissatisfied with the result in *Chiarella*. In response, it promulgated Rule 14e-3, which prohibits anyone from trading on material, nonpublic information regarding a tender offer, regardless of whether or to whom fiduciary duties are owed. 17 C.F.R. § 240.14e-3 (2004).

<sup>71</sup> 521 U.S. 642 (1997). *See* discussion *infra* Part I.B.

<sup>72</sup> 463 U.S. 646 (1983).

<sup>73</sup> *Id.* at 648–49.

overstating its assets on a grand scale. Secrist, who had unavailingly informed regulators of the fraud, asked Dirks to investigate the matter and to disclose his findings. Dirks confirmed Secrist's allegations and, during the course of his investigation, discussed the matter with clients and other investors. While Dirks himself did not trade Equity Funding stock, his advisees liquidated substantial holdings based on the allegations of accounting fraud.<sup>74</sup> During this time, the price of Equity Funding stock declined \$11 per share, a more than forty-percent drop. Trading on the New York Stock Exchange was halted two weeks after Dirks began his investigation, and the SEC subsequently uncovered the fraud after impounding the corporation's records.<sup>75</sup> Dirks himself, with consummate bureaucratic irony, was implicated as a tippee. The SEC censured Dirks under a theory that was an unabashed repudiation of *Chiarella*.<sup>76</sup> The Commission asserted that the disclose or abstain rule applied to everyone who received material, nonpublic information from a corporate insider, "regardless of their motivation or occupation."<sup>77</sup> But, relying on the fiduciary duty rationale of *Cady, Roberts*, as conceived in *Chiarella*, the Court both rejected the SEC's assertion that a tippee inherits an insider's fiduciary duty simply by virtue of the tip and repudiated the equal access theory upon which it was based.<sup>78</sup> The duty to disclose "arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."<sup>79</sup> In other words, not everybody who possesses inside information is barred by the federal securities laws from trading.<sup>80</sup>

While the Court agreed that a tippee's duty to disclose was derivative of that of the insider who provided the tip,<sup>81</sup> it explained that the duty is inherited not simply by virtue of the tip, but because the tip constitutes a breach of the insider's fiduciary duty to shareholders.<sup>82</sup> "[T]he initial inquiry is whether there has been a

---

<sup>74</sup> *Id.* at 649.

<sup>75</sup> *Id.* at 650.

<sup>76</sup> *Id.* at 652 (citing *In re Dirks*, Exchange Act Release No. 17,480, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,939, at ¶ 83,951 (Jan. 22, 1981), *rev'd*, 463 U.S. 646).

<sup>77</sup> *Id.* at 651 (internal quotation marks omitted).

<sup>78</sup> *Dirks*, 463 U.S. at 656–57 & n.15.

<sup>79</sup> *Id.* at 658 (quoting *Chiarella*, 445 U.S. at 232 n.14) (internal quotation marks omitted).

<sup>80</sup> *Id.* at 657.

<sup>81</sup> *Id.* at 659.

<sup>82</sup> *Id.* at 660. The Court distinguished a corporate officer's common-law duty to the corporate entity from his duty to the shareholders not to trade on inside

breach of duty by the insider.”<sup>83</sup> It follows that not all disclosures of material, nonpublic information are breaches of the “*Cady, Roberts* duty.”<sup>84</sup> In a tipping case, therefore, the threshold inquiry is whether the tipper breached a fiduciary duty in providing the tip.<sup>85</sup> The Court established the intent-to-benefit, or improper-motive test as a limiting mechanism for determining whether the requisite breach had occurred.<sup>86</sup> The test provides that if the insider/tipper’s disclosure of confidential corporate information results in a benefit to him, then the insider has breached his *Cady, Roberts* duty.<sup>87</sup> Only then can a fiduciary duty be imputed to the tippee.<sup>88</sup> For the insider’s duty to pass to the tippee, it must further be shown that the tippee “kn[ew] or should [have] know[n]” of the breach.<sup>89</sup> Thus, a tippee is potentially liable for insider trading only if the tipper’s disclosure results in a personal benefit to him, and if the tippee knows, or should know, that he received the tip “in breach of a duty by a person having a special relationship to the [corporation] not to disclose the information.”<sup>90</sup>

The personal benefit (or improper motive) test is not as favorable to tippees as may appear at first blush, for the Court defined “personal benefit” broadly. The benefit may be direct or indirect.<sup>91</sup> It could include a benefit to a tipper’s family member, for example by making a gift of the tip.<sup>92</sup> The Court further determined that personal benefit was not limited to financial gain but might also consist in a “reputational benefit.”<sup>93</sup> For example, it might enhance the tipper’s standing in a way that will later bring him a higher salary, or more clients.<sup>94</sup> In sum, if the tipper’s motive for disclosing the information is an improper one, then the tippee will inherit a *Cady, Roberts* duty if he knew (or should have known) of the impropriety of

---

information. *See id.* at 653 n.10. The latter is the “*Cady, Roberts* duty” to disclose or abstain. *Id.* at 662. *See* discussion *infra* Part II.B. *See also* BAINBRIDGE, *supra* note 20, at 59 (speculating that *Cady, Roberts* duty might be a matter of federal law and distinct from state-law duties of corporate officers).

<sup>83</sup> *Dirks*, 463 U.S. at 663.

<sup>84</sup> *Id.* at 661–62.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 662.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Dirks*, 463 U.S. at 660; *see also id.* at 661 (stating that tippee who knows of breach by insider inherits duty, but not mentioning those who should know).

<sup>90</sup> *Id.* at 661 (internal quotation marks omitted).

<sup>91</sup> *Id.* at 662.

<sup>92</sup> *Id.* at 664.

<sup>93</sup> *Id.* at 663.

<sup>94</sup> *See id.*

the tip.<sup>95</sup> In *Dirks*, Ronald Secrist's motive for tipping Dirks was to uncover massive fraud at Equity Funding, not, the Court concluded, to benefit personally.<sup>96</sup>

### B. *The Misappropriation Theory*

In absolving Raymond Dirks, the *Dirks* majority noted that he did not "misappropriate or illegally obtain the information about Equity Funding."<sup>97</sup> This might have been a signal that the Court, given the proper factual setting, would be willing to reconsider Chief Justice Burger's dissenting support in *Chiarella* of the misappropriation theory.<sup>98</sup> That factual setting was amply provided by James O'Hagan, a partner in the Minneapolis law firm of Dorsey & Whitney.<sup>99</sup> Dorsey & Whitney had been retained by Grand Metropolitan ("Grand Met") in its planned takeover bid of Pillsbury.<sup>100</sup> O'Hagan became aware of

<sup>95</sup> See *Dirks*, 463 U.S. at 660.

<sup>96</sup> *Id.* at 667. The Court's language is mildly ambiguous on this point, alternating between simply requiring that the tip result in a benefit to the tipper, *id.* at 662 ("[T]he test is whether the insider personally will benefit . . . from his disclosure."), 663 (test is "whether the insider receives a . . . benefit from the disclosure"), 667 ("The tippers received no . . . benefit."), and speaking of the tipper's motive or purpose in making the tip. *Id.* at 662 ("Whether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure."), 667 ("[T]he tippers were motivated by a desire to expose the fraud."). In turn, the lower courts have similarly equivocated on the precise requirement. Compare SEC v. Yun, 327 F.3d 1263, 1274 (11th Cir. 2003) (intent to benefit), with SEC v. Sargent, 229 F.3d 68, 77 (1st Cir. 2000) (simply a resulting benefit). Nevertheless, the tipper's purpose is clearly the point of the test. See *Dirks*, 463 U.S. at 662 ("Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.").

The determination of whether the tipper breached a duty to shareholders and whether the tippee inherited that duty is distinct from the determination of scienter, or intent to defraud. *Id.* at 663 n.23. The benefit test, based on the tipper's intent, speaks to whether or not a tippee owes a duty to shareholders, see *id.* at 662, not whether he himself acted with scienter when he traded, which is a separate inquiry. See *id.* at 663. Thus, the scienter requirement of Rule 10b-5 applies separately to tippees. See *id.* at 663 n.23. This follows from the Court's earlier decision in *Aaron v. SEC*, 446 U.S. 680 (1980). *Aaron* was in turn a clarification of the Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which left undecided whether the scienter requirement of Rule 10b-5 applied in actions for injunctive relief. *Id.* at 193 n.12. In *Aaron*, the Court was unequivocal. The *Ernst* decision "ineluctably leads to the conclusion that scienter is an element of a violation of §10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought." *Aaron*, 446 U.S. at 691.

<sup>97</sup> *Dirks*, 463 U.S. at 665.

<sup>98</sup> *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting). As noted *supra* text accompanying note 69, the majority in *Chiarella* did not reject the misappropriation theory on doctrinal grounds, but rather because the government did not invoke the theory at trial. *Id.* at 236.

<sup>99</sup> *United States v. O'Hagan*, 521 U.S. 642, 647 (1997).

<sup>100</sup> *Id.*

the proposed tender offer and began purchasing Pillsbury call options<sup>101</sup> and common stock.<sup>102</sup> When the merger was announced, the price of Pillsbury shares nearly doubled and O'Hagan liquidated his holdings for a profit of \$4.3 million.<sup>103</sup> O'Hagan was subsequently indicted on fifty-seven counts, including mail fraud and violations of Rules 14e-3 and 10b-5.<sup>104</sup>

The unique nature of O'Hagan's position vis-à-vis the corporations affected by his scheme required that the misappropriation theory be advanced as the basis of his conviction for securities fraud. That is because O'Hagan's fiduciary duties ran to his law firm, and in turn to its client, Grand Met. O'Hagan, however, traded the stock of Pillsbury, an entity to whom he owed no duties at all.<sup>105</sup> Since, under the classical theory of insider trading, the requisite fraud inheres in the breach of a fiduciary duty to the shareholders with whom one trades,<sup>106</sup> O'Hagan could not be convicted under that theory.<sup>107</sup> The misappropriation theory was thus the only available theory upon which O'Hagan could be convicted.

The misappropriation theory had been circulating among the federal circuits since before the Supreme Court first addressed it, inconclusively, in *Carpenter v. United States*.<sup>108</sup> *Carpenter* involved a journalist's misappropriation of pre-publication information from the *Wall Street Journal's* "Heard on the Street" column.<sup>109</sup> The Court split 4-4 on the issue of whether the reporter's conviction under the federal securities laws could stand.<sup>110</sup> The judgment of the Second Circuit Court of Appeals, affirming the defendant's convictions based on the misappropriation theory,<sup>111</sup> was affirmed simply by reason of the evenly divided Court.<sup>112</sup> The appeals court had held that a breach

---

<sup>101</sup> A call is an option contract that gives the purchaser the right to buy the underlying security at a predetermined price at any time before a specified expiration date. See McMILLAN, *supra* note 6, at 855.

<sup>102</sup> *O'Hagan*, 521 U.S. at 647-48.

<sup>103</sup> *Id.* at 648.

<sup>104</sup> *Id.* at 648-49.

<sup>105</sup> *See id.* at 653 n.5.

<sup>106</sup> *See supra* notes 56-69 and accompanying text.

<sup>107</sup> *See O'Hagan*, 521 U.S. at 652-53.

<sup>108</sup> 484 U.S. 19 (1987). *See generally* Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 868-78 (2003) (discussing pre-*O'Hagan* development of misappropriation theory).

<sup>109</sup> *Carpenter*, 484 U.S. at 22.

<sup>110</sup> *Id.* at 24.

<sup>111</sup> *United States v. Carpenter*, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) (4-4 decision).

<sup>112</sup> *Carpenter*, 484 U.S. at 24.

of a duty to one's employer met the requirement of Rule 10b-5 that there be fraud in connection with a securities transaction, even though the misappropriator did not trade in his employer's stock, but in the stock of an unrelated entity.<sup>113</sup>

The misappropriation theory was tailor-made for O'Hagan. One court has succinctly stated the theory as:

provid[ing] that Rule 10b-5 is violated when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.<sup>114</sup>

In *O'Hagan*, the confidential information regarded a corporate merger and O'Hagan's firm, and thus O'Hagan, owed a duty of confidence to Grand Met, but not to the shareholders of Pillsbury, whose stock he furtively traded.<sup>115</sup> Moreover, O'Hagan's exploits were on their face particularly egregious.<sup>116</sup> The Supreme Court upheld the misappropriation theory as a valid basis for convicting O'Hagan under Rule 10b-5.<sup>117</sup> O'Hagan's misappropriation of confidential information, in breach of a duty owed to the source of that

---

<sup>113</sup> See *Carpenter*, 791 F.2d at 1026. The Second Circuit Court of Appeals had previously adopted the misappropriation theory in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). In a subsequent series of cases, the courts in that circuit applied the theory to various types of relationships. See, e.g., *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993) (print-shop employee's duty to employer); *Carpenter*, 791 F.2d 1024 (journalist's duty to his newspaper); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984) (printer's duty to employer); *Newman*, 664 F.2d 12 (investment banker's duty to bank); *SEC v. Willis*, 777 F. Supp. 1165 (S.D.N.Y. 1991) (psychiatrist's duty to patient); *SEC v. Musella*, 748 F. Supp. 1028 (S.D.N.Y. 1989) (office manager's duty to employer); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.) (father-son relationship), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985). *But cf.* *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (holding that requisite fiduciary relationship between husband and wife not established for purposes of misappropriation theory). The theory was also gaining favor in other circuits. See, e.g., *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985). *But see* *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) (rejecting misappropriation theory), *rev'd*, 521 U.S. 642 (1997); *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) (same).

<sup>114</sup> *SEC v. Trikalis*, No. CV 92-1336-RSWL (EEX), 1992 WL 301398, at \*3 (C.D. Cal. July 28, 1992) (quoting *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990)) (internal quotation marks omitted).

<sup>115</sup> *O'Hagan*, 521 U.S. at 653.

<sup>116</sup> See *id.* at 657 n.8, 659 (speaking of O'Hagan's readiness to betray confidences and the illogic of letting him off the hook simply because he defrauded one group as opposed to some other group). *Cf.* Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993).

<sup>117</sup> *O'Hagan*, 521 U.S. at 659.

information, sufficed as the statutorily required “decepti[on] . . . in connection with securities transactions.”<sup>118</sup>

Justice Ginsburg, writing for the majority, described the classical theory of insider trading and the misappropriation theory as “complementary.”<sup>119</sup> Both theories were designed “to protect the integrity of the securities markets.”<sup>120</sup> The classical theory is a net for insiders (and their tippees) who threaten that integrity by abusing their positions of trust within the corporation.<sup>121</sup> The misappropriation theory is designed to snare outsiders (and their tippees) who have access to corporate information through a relationship that does not entail a duty to the corporation’s shareholders, and who misappropriate that information for their personal gain.<sup>122</sup>

In spite of this expressed complementarity, there is disagreement among the lower courts with regard to the misappropriation theory’s scope and application,<sup>123</sup> as well as a fair amount of scholarly rancor over the issue.<sup>124</sup> The force driving the debate is whether or not the two theories really are different aspects of the same general theory, or whether they are in fact based on unrelated doctrinal foundations.<sup>125</sup> This is the root of the disagreement over the respective state-of-mind requirements for tippee liability.<sup>126</sup> Its resolution turns on a careful analysis of the two-

---

<sup>118</sup> *Id.* (internal quotation marks omitted).

<sup>119</sup> *Id.* at 652.

<sup>120</sup> *Id.* at 653 (internal quotation marks omitted).

<sup>121</sup> *See id.* at 652–53.

<sup>122</sup> *See id.* at 653.

<sup>123</sup> Compare *SEC v. Yun*, 327 F.3d 1263, 1276 (11th Cir. 2003) (requiring intent to benefit under misappropriation theory), and *SEC v. Trikalis*, No. CV 92-1336-RSWL(EEX), 1992 WL 301398, at \*3 (C.D. Cal. July 28, 1992) (applying improper motive test under misappropriation theory), with *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993) (requiring, “without more,” breach of duty by tipper and knowledge of breach by tippee), and *SEC v. Willis*, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991) (rejecting improper motive test under misappropriation theory). *See also SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (noting disagreement on issue but declining to resolve it).

<sup>124</sup> *See, e.g.,* Steven M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1591 (1999) (complaining that the Supreme Court “ducked, misunderstood, or mishandled virtually every issue presented by [the *O’Hagan*] case”). *Cf.* Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O’Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865 (2003) (defending misappropriation theory).

<sup>125</sup> *See, e.g.,* Bainbridge, *supra* note 124; David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41 (1998).

<sup>126</sup> *See supra* notes 8–24 and accompanying text.

pronged rationale for the ban on insider trading as originally conceived in *Cady, Roberts*—respecting relationships of trust and fostering fairness in securities markets.

## II. THE “CADY, ROBERTS DUTY” AND THE CONCEPT OF FAIRNESS

Outside of academia,<sup>127</sup> the idea that insider trading should be regulated is by and large an accepted norm of the American legal and ethical landscape.<sup>128</sup> This is due in no small part to former SEC Chairman William Cary’s decision in *In re Cady, Roberts & Co.*,<sup>129</sup> which continues to be the driving intellectual force behind the regulation of insider trading.<sup>130</sup> Although the doctrinal basis for insider trading regulation has shifted in emphasis and nuance over time,<sup>131</sup> the *Cady*,

---

<sup>127</sup> See BAINBRIDGE, *supra* note 20, at 125–46 (surveying arguments in support of deregulation of insider trading). But the prohibition of insider trading stems from a legitimate social motive to curb certain manifestations of avarice. Cf. ARISTOTLE, *ETHICA NICHOMACHEA* [NICHOMACHEAN ETHICS] bk. V, chs. 1–5. Aristotle characterizes the unjust or unfair man as the “grasping” or “overreaching” man. *Id.* at 1129b10–11. The unjust man takes excessive pleasure in profit and as a result grasps for more than his due of goods (or accepts less than his due of harms). *See id.* at 1130a28–b5. *Pace* Gordon Gecko, *see* WALL STREET (Twentieth Century Fox 1987), if the impulse towards greed is left unchecked, certain segments of society will tend to “create subcultures that glorify and rationalize selfishness.” Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328 (1999). “[T]he deep belief that insider trading is a wrong and needs a legal remedy . . . derives from the more fundamental attitude that economic power and status demand a strong dose of self-restraint and accountability.” *Id.* The mere existence of laws against insider trading is a powerful social placebo; a symbol of society’s deep-seated disapproval of the already-advantaged abusing positions of trust to grasp for even more. *See id.* Professor Langevoort speaks of the “mythic” nature of the insider trading ban, meaning its usefulness as a symbol of certain cultural values and experiences, as opposed to a measure reflecting an empirically precise assessment of legal cause and effect. *Id.* But see also *infra* note 204 for a discussion of the role that envy might play in the insider trading debate.

<sup>128</sup> This has not always been the case. The rule against insiders taking advantage of their positions within the corporation to profit from nonpublic information about the corporation’s stock price was slow in coming over the first half of the twentieth century. *See* BAINBRIDGE, *supra* note 20, at 8–14. The jurisdictions that did regulate insider trading usually limited sanctions to face-to-face transactions where there was clear evidence of fraud. *Id.*

On the other hand, Americans’ disapproval of insiders benefiting from their advantage vis-à-vis securities markets is as old as the markets themselves. Alexander Hamilton, as the nation’s first treasury secretary, forbade his treasury employees from speculating in the then newly created government securities, which were the objects of frenzied speculation at the time. RON CHERNOW, *ALEXANDER HAMILTON* 293 (2004).

<sup>129</sup> 40 S.E.C. 907 (1961).

<sup>130</sup> *See* Langevoort, *supra* note 127, at 1319.

<sup>131</sup> *See* discussion *supra* Part I.A.

*Roberts* concerns—respecting fiduciary relationships and ensuring fairness with regard to informational advantages gotten from those relationships—have remained the metajudicial fonts of all federal insider trading law. From this central notion arises the *Cady, Roberts* duty: A trader of securities might in certain circumstances have a duty to disclose inside information in his possession or to abstain from trading, when not to do so would be inherently unfair.<sup>132</sup> Chairman Cary stated the foundational principles underlying this duty with perduring incisiveness:

[This] obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.<sup>133</sup>

Thus, it is seen that fairness is an element of the *Cady, Roberts* rationale. However, the *Cady, Roberts* notion of fairness is not tantamount to a broad imposition of equality on all market participants. Rather, the “inherent unfairness” with which *Cady, Roberts* is concerned arises only within certain relational contexts; namely, those involving a fiduciary or fiduciary-like duty.

#### A. *The Cady, Roberts Duty to Disclose or Abstain*

What has been referred to as the “*Cady, Roberts* duty”<sup>134</sup> has its source in the first prong of the preceding passage: The duty “rests [in part on] the existence of a relationship giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone . . . .”<sup>135</sup> Significantly, the disclose or abstain rule requires a relationship; specifically, one providing access to privileged corporate information.<sup>136</sup> The existence of a relationship is thus paramount with regard to the prohibition on insider trading, for without it, there arises no *Cady, Roberts* duty.<sup>137</sup> Absent such a duty to abstain from trading,<sup>138</sup>

<sup>132</sup> *Cady, Roberts*, 40 S.E.C. at 911.

<sup>133</sup> *Id.* at 912.

<sup>134</sup> See *supra* notes 81–96 and accompanying text.

<sup>135</sup> *Cady, Roberts*, 40 S.E.C. at 912.

<sup>136</sup> See *id.*

<sup>137</sup> See *id.*

<sup>138</sup> This is in essence what the duty to disclose or abstain amounts to, since more often than not disclosure is impracticable and probably a breach of an officer’s state-law duties. See BAINBRIDGE, *supra* note 20, at 45–46.

corporate insiders would be free to profit by trading on nonpublic information.

The meaning of the word “relationship” requires clarification. It is commonly (though imprecisely)<sup>139</sup> used to refer to merely situational arrangements, as when one describes the location of one object in relation to another object (i.e., their “spatial relationship”). But “relationship” generally implies some kind of intersubjectivity; that is, some kind of association between persons<sup>140</sup> (whether legal or natural). This is how the courts have tended to view the matter and, in insider trading cases, the relationship at issue is by and large viewed as fiduciary in nature.<sup>141</sup> The insistence on some special relationship of trust and confidence<sup>142</sup> is a conscious attempt by the Supreme Court to bridle the tendency to treat all informational imbalances as coming within the ambit of Rule 10b-5.<sup>143</sup> The Court has been unwilling to expand liability beyond the scope of an implicitly fraud-based<sup>144</sup> rule in such a manner absent congressional direction.<sup>145</sup>

By contrast, the SEC has unflaggingly insisted that even merely situational relationships should suffice to bring a person under the strictures of the insider trading ban.<sup>146</sup> This position is nothing more than a permutation of the discredited equal access theory,<sup>147</sup> and is further flawed by the fact that it completely disregards the fraud basis of Rule 10b-5. While “[s]ection 10(b) is aptly described as a catchall provision . . . what it catches must be fraud.”<sup>148</sup>

<sup>139</sup> See MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 1050 (11th ed. 2003).

<sup>140</sup> See *id.*

<sup>141</sup> See, e.g., *Chiarella*, 445 U.S. at 228, 232 (noting that duty to disclose or abstain arises only from a fiduciary or other similar relation of trust and confidence and emphasizing that duty to disclose rests on “a specific relationship between two parties”); *Dirks*, 463 U.S. at 654 (quoting *Chiarella* approvingly); *United States v. Chestman*, 947 F.2d 551, 565 (2d Cir. 1991) (same).

<sup>142</sup> See *Chiarella*, 445 U.S. at 228, 232.

<sup>143</sup> See *id.* at 232 n.14 (“A duty arises from the relationship between parties . . . and not merely from one’s ability to acquire information because of his position in the market.”).

<sup>144</sup> See *supra* notes 31–45 and accompanying text.

<sup>145</sup> *Chiarella*, 445 U.S. at 233–35.

<sup>146</sup> See, e.g., *United States v. Chiarella*, 588 F.2d 1358, 1374 (2d Cir. 1978) (agreeing with “SEC’s own view that anyone is subject to Rule 10b-5 disclosure obligations if he or she has inside information obtained by reason of access to the issuer”), *rev’d*, 445 U.S. 222 (1980) (internal quotation marks omitted); *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984) (involving SEC action brought against college football coach who allegedly traded on information overheard at sports event).

<sup>147</sup> See *Dirks*, 463 U.S. at 657; *Chiarella*, 445 U.S. at 231.

<sup>148</sup> *Chiarella*, 445 U.S. at 234–35.

Furthermore, since Rule 10b-5 has been construed as an antifraud measure, the federal courts, and particularly the Supreme Court, have been compelled to find an act of deception upon which to premise liability.<sup>149</sup> It follows that for a breach of a state-law fiduciary duty to suffice for liability under Rule 10b-5, there must be “some element of deception.”<sup>150</sup> Insider trading arguably provides the requisite act of deception insofar as a breach of a duty to disclose involves a deceit upon those to whom the duty is owed.<sup>151</sup> Since the *Cady, Roberts* duty is a duty to disclose, its breach qualifies as a deceit within the meaning of Rule 10b-5.

The actual source of the duty to disclose has been a somewhat murky issue.<sup>152</sup> Common-law fiduciary duties of corporate managers are owed to the corporation and derivatively to the corporation’s shareholders.<sup>153</sup> In *Santa Fe v. Green*, the Supreme Court rejected the idea that breach of these state-law duties in themselves constituted a violation of Rule 10b-5.<sup>154</sup> The *Santa Fe* Court, however, left a narrow opening in its holding for some “federal fiduciary principle under Rule 10b-5. . . .”<sup>155</sup> But, it warned, any “federal fiduciary standards” should not be so expansive as to “cover the corporate universe.”<sup>156</sup> The Supreme Court subsequently addressed this confusion,<sup>157</sup> somewhat parenthetically, by noting that the *Cady, Roberts* duty is distinct from state common-law fiduciary duties owed by corporate managers.<sup>158</sup>

The origins of the *Cady, Roberts* duty are found, not surprisingly, in the *Cady, Roberts* opinion itself. As originally conceived in *Cady, Roberts*, an insider’s access to privileged corporate information created a duty to the investing public, which included, but was not

<sup>149</sup> See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473–74 (1977) (finding no violation of Rule 10b-5 absent deceit or manipulation); 17 C.F.R. § 240.10b-5(c) (2004) (making it unlawful to practice or engage in any “fraud or deceit” in connection with securities transactions).

<sup>150</sup> *Santa Fe*, 430 U.S. at 475.

<sup>151</sup> *Chiarella*, 445 U.S. at 228–29.

<sup>152</sup> See Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 192–93 (1991).

<sup>153</sup> See AM. LAW INST., PRINCIPLES OF CORP. GOVERNANCE pt. V, introductory note (1992).

<sup>154</sup> See *Santa Fe*, 430 U.S. at 479–80 (holding, on federalism grounds, that Rule 10b-5 does not apply broadly to all instances of “internal corporate mismanagement”).

<sup>155</sup> *Id.* at 479 (internal quotation marks omitted).

<sup>156</sup> *Id.* at 480 (quoting William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 700 (1974)) (internal quotation marks omitted).

<sup>157</sup> See BAINBRIDGE, *supra* note 20, at 59–63.

<sup>158</sup> *Dirks*, 463 U.S. at 653 n.10.

exclusively comprised of, corporate shareholders.<sup>159</sup> Justice Powell seems to have acknowledged this in his opinion in *Dirks*, where he uses the phrase “*Cady, Roberts* duty” no less than six times.<sup>160</sup> The *Dirks* opinion may thus be read to some degree, at least implicitly, as adopting Chairman Cary’s intended program for a federal common law of insider trading that was separate and distinct from state corporation law.<sup>161</sup> The fine distinctions of state law concerning the nature of the fiduciary duties of corporate agents should not, the Chairman argued, be invoked in order to take the bite out of federal securities laws designed to protect investors and financial markets.<sup>162</sup> The Chairman presciently cautioned that in applying those laws, judges should avoid erecting “artificial walls of responsibility.”<sup>163</sup>

But that is often what the federal courts have tended to do. Courts have at times added unnecessary confusion to insider trading law by failing to distinguish the *Cady, Roberts* duty owed to investors from state-law fiduciary duties owed to shareholders. In doing so, they have missed sight of the doctrine’s underlying policy of protecting investors from unscrupulous insiders and maintaining the integrity of the nation’s financial markets<sup>164</sup> by policing the unfair abuse of privileged relationships. Adopting and adhering to this germinal rationale for regulating insider trading would produce in a more direct fashion results which the courts have been arriving at in a contorted manner since the conception of the restrictions on insider trading.<sup>165</sup>

Moreover, an originalist approach that preserves the *Cady, Roberts* roots of insider trading law would lend itself to a reasonable mean between the terminal positions of complete deregulation of

---

<sup>159</sup> See *Cady, Roberts*, 40 S.E.C. at 910 & n.10, 915 n.29.

<sup>160</sup> *Dirks*, 463 U.S. at 655, 660, 662, 663, 665, 666.

<sup>161</sup> *Cady, Roberts*, 40 S.E.C. at 910 n.10 (stating that Securities Exchange Act, in effecting its purpose of protecting investors, “constitute[d in part a] far reaching federal substantive corporation law”); Cary, *supra* note 156, at 700 (arguing for federal fiduciary principles), cited in *Santa Fe*, 430 U.S. at 480 n.17; Langevoort, *supra* note 127 (discussing Chairman Cary’s project).

<sup>162</sup> *Cady, Roberts*, 40 S.E.C. at 909. It is an unavoidable legislative fact that the prohibition of insider trading is meant to protect investors. “It shall be unlawful . . . [t]o . . . contraven[e] . . . such rules and regulations as the Commission may prescribe as necessary or appropriate . . . for the protection of investors.” 15 U.S.C. § 78j(b) (2000).

<sup>163</sup> *Cady, Roberts*, 40 S.E.C. at 913.

<sup>164</sup> For an early acknowledgement of the effect of the law on maintaining the public’s faith in economic institutions, see *Veazie v. Williams*, 49 U.S. 134, 154 (1850) (expressing concern for adverse effects of fraudulent “puffing” by land auctioneers on national real-estate market).

<sup>165</sup> See Fisch, *supra* note 152.

insider trading, and an overreaching imposition of equality on all market participants. The former position is defended on predominantly, if not exclusively, economic grounds<sup>166</sup> and is for all practical purposes a purely academic matter.<sup>167</sup> The latter position is the result of a general misunderstanding of the concept of fairness and a misreading of that concept as it is used in *Cady, Roberts*.<sup>168</sup>

*B. The Concept of Fairness*

The fairness issue can be thought of as the battleground on which insider trading law has been waged. But in order to be a workable legal concept, fairness must be conceived within limitations that serve to distinguish it from bare equality. These limits are to be found in the *Cady, Roberts* rationale itself, and are reinforced by a conceptual analysis of what it means for something to be fair.

The competing concepts engaged in the debate are diametrically opposed viewpoints on the meaning and role of fairness in the regulation of insider trading. On the one side is the historical position of the SEC that fairness is essentially equality; if not an absolute equality of information, then equality of access to information.<sup>169</sup> At the other extreme, proponents of the Law and Economics school argue that fairness is a vague and unhelpful legal concept, of little value in terms of assessing the scope and legitimacy of a prohibition against insider trading.<sup>170</sup>

Both positions are open to criticism. On the one hand, fairness need not, and in fact can not, especially in the case of securities markets,<sup>171</sup> be identified with equality. Both in general conceptual terms, and as expressed in the *Cady, Roberts* decision, the concept of fairness must be interpreted with certain constraints that tend to delimit its scope and render it something other than simple equality. A philosophical explication of this semantic truism is found in John Rawls' theory of justice as fairness.<sup>172</sup> Under that theory, "fairness" is

---

<sup>166</sup> See BAINBRIDGE, *supra* note 20, at 125–45.

<sup>167</sup> See *supra* note 127 and accompanying text.

<sup>168</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>169</sup> See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968).

<sup>170</sup> See, e.g., Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323–30.

<sup>171</sup> See Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 16 (1984) (observing that broad reading of concept of fairness "would ban virtually all trading activity" since trading by nature depends on informational inequalities).

<sup>172</sup> JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

defined as describing those social and legal institutions that people would choose while in a hypothetical state of ignorance about their own personal status, needs, and predilections.<sup>173</sup> The resulting hypothetical social contract might therefore adopt certain inequalities if they were objectively deemed to inure to the benefit of all.<sup>174</sup> These inequalities are fair by definition. Rawls' contractarian theory provides a compelling argument against equating fairness with simple equality.

On the other hand, the concept of fairness is only vague (and hence useless) when it is conceptualized in overbroad and fuzzy terms. When properly articulated, a concept of fairness is seen to be a fundamental social virtue, which is a proper and legitimate concern of a culture's legal institutions, insofar as the human sentiment for fairness is the underlying source of a basic sense of justice.<sup>175</sup> As such, fairness is indeed an essential legal concept. Seen in this light, when the concept of fairness, as expressed in the *Cady, Roberts* rationale, is correctly interpreted and applied, it bestows legitimacy on the prohibition of insider trading and is seen as a sensible and intuitive foundation for that prohibition.

One broad and fuzzy interpretation of the idea of fairness is the equal access theory; though it is not without some degree of merit, if a venerable pedigree is any indication of merit. The theory made an early appearance in *Laidlaw v. Organ*,<sup>176</sup> a somewhat obscure opinion by Chief Justice John Marshall involving international politics and the tobacco market. The Treaty of Ghent had just put an end to the War of 1812 and opened up previously closed commodities markets. One effect of the treaty was an increase in demand for, and hence in the price of, tobacco. The buyer in *Laidlaw* knew about the treaty. He had received the news directly from the fleet which had brought it from Europe, and in fact had awoken early to conduct his business before the news was disseminated.<sup>177</sup> The seller knew nothing.<sup>178</sup> When he asked the purchaser about any news that might impact the

---

<sup>173</sup> *Id.* at 136–42.

<sup>174</sup> *See id.* at 95–96.

<sup>175</sup> *See id.* at 111–12.

<sup>176</sup> 15 U.S. 178 (1817).

<sup>177</sup> *Id.* at 183.

<sup>178</sup> *Id.* at 182–83. An ancient permutation on the equal access theory was advanced by Cicero, in a scenario involving corn rather than tobacco. After assembling ancient opinion on the matter, Cicero concluded that good faith and social harmony require a vendor to disclose to a vendee any market information in his possession. MARCUS TULLIUS CICERO, DE OFFICIIS [ON DUTIES] bk. III, §§ 50–72. According to Cicero, it would be unethical “to plunder another’s ignorance.” *Id.* § 72 (author’s trans.).

price of the commodity, the buyer was silent.<sup>179</sup>

Marshall decided in favor of the purchaser because the information concerning “extrinsic” market circumstances was publicly available.<sup>180</sup> The fact that the purchaser was in an advantageous position with respect to the news was not determinative; nor was the fact that the buyer was silent in the face of a request for any news. The Court essentially concluded that the buyer owed no duty of disclosure to the seller simply because he possessed an informational advantage.<sup>181</sup>

The district judge had concluded that the vendee’s nondisclosure of the information constituted fraud,<sup>182</sup> in essence finding a duty among all market participants to disclose material information.<sup>183</sup> The lower court espoused a view that fairness demands equality of information in the context of contractual market transactions.<sup>184</sup> This is a strong admonition, demanding not just equal access to information, but equal results of that access; to wit, parity of knowledge. Chief Justice Marshall’s resolution of the issue was to retreat to the less stringent (and at least conceivably practicable) equal access theory. When market information<sup>185</sup> is “equally accessible to both parties,” enforcing a duty of disclosure, Marshall argued, would be “difficult to circumscribe within proper limits.”<sup>186</sup>

The blurring of fairness and equality evinced or implied in the opinions of both the district judge and the Chief Justice is common,<sup>187</sup> and persists among current-day advocates of the equal access theory.

---

<sup>179</sup> *Laidlaw*, 15 U.S. at 188–89.

<sup>180</sup> *Id.* at 194.

<sup>181</sup> *See id.*

<sup>182</sup> *Id.* at 184–85.

<sup>183</sup> Cicero came to the same conclusion for the sake of good faith and social concord. CICERO, *supra* note 178, §§ 69–70.

<sup>184</sup> *Laidlaw*, 15 U.S. at 184–85. Basing his argument on what appears to be a misunderstanding of Roman civil law, the district judge seems to have overlooked the distinction made in his sources between legal duties and moral obligations as well as between market information and information about the item of commerce itself. *See id.* at 191 note c.

<sup>185</sup> Marshall’s phrase is “intelligence of extrinsic circumstances,” as opposed to intrinsic information about defects in the item itself. *Id.* at 194.

<sup>186</sup> *Id.*

<sup>187</sup> *Cf.* RICHARD T. LAPIERE, A THEORY OF SOCIAL CONTROL 199–200 n.8 (1954) (warning against confusing equality, which is “almost never found in the social relationships of human beings” and equity, viz. fairness, which is “everywhere and always insisted upon”), *quoted in* HELMUT SCHOECK, ENVY: A THEORY OF SOCIAL BEHAVIOUR 282–83 (Liberty Press 1987) (1966); SCHOECK, *supra*, at 282 (discussing “[t]he confusion of justice and equality, so common today”).

But Marshall's reasoning in *Laidlaw* has at least one virtue. Mere situational advantages, such as that of the buyer in *Laidlaw*, are not the type of advantages that should give rise to a duty to disclose.<sup>188</sup> By implication, there is nothing "inherent[ly] unfair[]"<sup>189</sup> about such situations. Jerry Burch exemplified this set of circumstances when he overheard Mrs. Yun's telephone conversation.<sup>190</sup> Merely standing within earshot of an insider while he discusses material, nonpublic information does not constitute the kind of relationship that gives rise to a *Cady, Roberts* duty. Likewise, standing at the wharf when the fleet arrives with news that might affect market prices does not involve a special relationship which gives one privileged access to information not meant for personal use.<sup>191</sup> In general, simply being fortuitously present somewhere does not give rise to any type of relationship that is not merely situational. Correspondingly, informational imbalances are not unfair *per se*, but only when they are the result of some sort of privileged, non-situational relationship.<sup>192</sup>

This limited notion of fairness is the essence of the *Cady, Roberts* rationale. In *Cady, Roberts*, "inherent unfairness" is defined as a function of the relationship giving rise to the duty to disclose or abstain.<sup>193</sup> An insider's trading is considered unfair when he appropriates privileged information obtained as a result of his relationship to the corporation giving him access to that information.<sup>194</sup> As one federal district court had explained a decade prior to *Cady, Roberts*:

The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed . . . . It is an attempt to provide some degree of equalization of bargaining position . . . . One of the primary purposes of the Securities Exchange Act . . . was to outlaw the use of inside information by corporate officers . . . for

---

<sup>188</sup> See *Laidlaw*, 15 U.S. at 193–94.

<sup>189</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>190</sup> See SEC v. Yun, 327 F.3d 1263, 1268 (11th Cir. 2003); see also SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (holding that there was no duty to disclose or abstain in case of famed college football coach who overheard conversation between CEO and his wife while sunning on bleachers behind them and then traded on inadvertently communicated information).

<sup>191</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>192</sup> Cf. *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951) (stating that informational imbalances are unfair when resulting from a person's insider status).

<sup>193</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>194</sup> *Id.*

their own financial advantage.<sup>195</sup>

When a correct understanding of the *Cady, Roberts* rationale informs Rule 10b-5's prohibition of insider trading, fairness, instead of being simply a matter of informational equality,<sup>196</sup> is meant to provide "some degree of equalization"<sup>197</sup> to compensate for the imbalance created by an insider's privileged position.

Fairness, then, like justice, aims at restoring an artificial social equality that is meant to correct imbalances created by certain morally neutral advantages, like insider status, or superior physical strength, so that such advantages cannot be used to the detriment of those less advantaged.<sup>198</sup> Fairness can thus be thought of as reflecting the socio-legal process of restoring balance.<sup>199</sup> In the insider trading context, equilibrium and its disruption depend on a logically prior imperative not to take advantage of a position of trust for one's own personal benefit;<sup>200</sup> in other words, not to breach one's *Cady, Roberts* duty. Seen in this light, the duty to disclose or abstain acts to limit the potential breadth of the fairness requirement.<sup>201</sup>

The Supreme Court's decisions have by and large incorporated this conceptualization of the rule against insider trading by requiring a breach of a duty of trust or confidentiality.<sup>202</sup> The SEC, on the other hand, has generally eschewed restraints on the concept of fairness,<sup>203</sup> and instead would rather see fairness stretched to the extent that it becomes virtually coterminous with equality. The equal access theory is the foremost manifestation of this approach to insider trading law. The attempt to eliminate the intent-to-benefit requirement under the misappropriation theory is a nuance on the same theme—it is an attempt to snare those whose market advantage is merely situational and not a result of a special relationship as

---

<sup>195</sup> *Speed*, 99 F. Supp. at 829.

<sup>196</sup> See Macey, *supra* note 171 (asserting dependency of market activities on informational imbalances). Cf. Langevoort, *supra* note 127, at 1326 ("[One] strongly suspect[s] that disturbingly large numbers of people are actually led to trade by the belief . . . that they themselves have some sort of inside advantage.").

<sup>197</sup> *Speed*, 99 F. Supp. at 829.

<sup>198</sup> See H.L.A. HART, *THE CONCEPT OF LAW* 164–65 (2d ed. 1994). In the case of the strong man, justice intervenes to restore social equilibrium, ordinarily by means of compensation, when the strong man has used his strength to injure another. *Id.* at 165.

<sup>199</sup> See *id.* at 159.

<sup>200</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>201</sup> See *id.*

<sup>202</sup> See *supra* notes 134–68 and accompanying text.

<sup>203</sup> See *supra* notes 169–201 and accompanying text.

defined in *Cady, Roberts*.<sup>204</sup>

Viewed as a whole, the two-pronged *Cady, Roberts* rationale for prohibiting insider trading reduces in broad terms to a duty not to act unfairly.<sup>205</sup> This duty is imposed only on those who have “a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”<sup>206</sup> The duty is breached by “[t]he abuse of informational advantages that other investors cannot hope to overcome through their own efforts.”<sup>207</sup> The “inherent unfairness”<sup>208</sup> that the law is meant to address is a function of the *Cady, Roberts* rationale as a coherent whole, and not just the existence of informational inequality. Keeping an eye on this holistic view of the

<sup>204</sup> Looked at another way, there is nothing inherently unfair about a mere situational advantage, also known as luck. Luck is by nature random. Cf. ARISTOTLE, PHYSICS bk. II, ch. 5 (describing luck as a fickle and indeterminate cause). This means that, over time, it will be equally distributed. Thus, in the long term, good fortune is not at all unfair, even though in the short term it might befall us unevenly. But the fact that a particular instance of good (or bad) fortune is a random event means that any cries of “unfair!” in the face of pure chance can be little more than envy, or jealousy, as the case may be. See generally SCHOECK, *supra* note 187. If fairness is conceived as a matter of the just distribution of goods, see Bernard Williams, *The Idea of Equality*, in PHILOSOPHY, POLITICS AND SOCIETY, 2D SERIES 120 (Peter Laslett & W.G. Runciman eds., 1962), then if good fortune is equally likely to befall anyone, there is simply no issue of unfairness. A sentiment that would begrudge another his good fortune, with no gain to oneself, is little more than envy-fueled resentment. See JOSEPH EPSTEIN, ENVY: THE SEVEN DEADLY SINS 21 (2003) (characterizing “pure” envy as particularly “ugly” when the envier “doesn’t even require any advantage for oneself but is perfectly content to make sure that the next person derives no advantage”); SCHOECK, *supra* note 187, at 19 (defining envy as the spiteful wish that another’s possessions or achievements be taken from him with no corresponding benefit to the envier). It has been argued that envy is a universal and essential human characteristic that is too often overlooked by social scientists. SCHOECK, *supra* note 187, at 34. Envy conceivably provides at least a partial explanation of social phenomena as disparate as black magic and progressive income taxes. See generally *id.* In fact, Freud, with characteristic audacity, derives the very institution of human justice from primordial feelings of envy. SIGMUND FREUD, GROUP PSYCHOLOGY AND THE ANALYSIS OF THE EGO 67 (James Strachey, trans., W.W. Norton & Co. 1989) (1922). See also EPSTEIN, *supra*, at 21 (noting the blurry line between a sense of injustice and feelings of envy). But even apart from such a bold theory, there is little doubt that envy plays some role in the opprobrium with which society views insider trading. See Langevoort, *supra* note 127, at 1329 (suggesting that envy plays role in society’s disapproval of insider trading). When this envy is directed at actual wrongdoing, it can be deemed constructive, or legitimate envy. See SCHOECK, *supra* note 187, at 296. Misdirected, however, envy has no redeeming social value.

<sup>205</sup> Cf. John Rawls, *Legal Obligation and the Duty of Fair Play*, in LAW AND PHILOSOPHY: A SYMPOSIUM 3 (Sidney Hook ed., 1964) (positing a “prima facie duty of fair play” for social interaction in general).

<sup>206</sup> *Cady, Roberts*, 40 S.E.C. at 912.

<sup>207</sup> H.R. REP. NO. 98-355, at 5 (1983), reprinted in 1984 U.S.C.C.A.N. 2274, 2278.

<sup>208</sup> *Cady, Roberts*, 40 S.E.C. at 912.

prohibition against insider trading, as grounded in the *Cady, Roberts* opinion, an informed and coherent understanding of the scope and meaning of the intent-to-benefit rule should come into view.

### III. THE INTENT-TO-BENEFIT REQUIREMENT FOR TIPPEE LIABILITY

The *Yun* case involved the tipping of inside information.<sup>209</sup> The alleged inside trader (Jerry Burch) was not an actual insider, but received inside information from a putative insider (Mrs. Yun). Under the *Cady, Roberts* rationale, properly understood,<sup>210</sup> trading in securities is proscribed only when it would be inherently unfair. Inherent unfairness, in turn, results from a breach of a duty of trust, and not simply when an informational imbalance inheres in a given trade. Thus, unless a fiduciary-like duty could be imputed to Jerry Burch with respect to his relationship with Mrs. Yun, there should be no liability for insider trading. The intent-to-benefit rule is one means of imputing such a duty between a tipper and his tippee.

The prohibition of insider trading would be a dead letter unless there were rules covering tippees—persons who obtain inside information from those having the requisite relationship of access, and hence a *Cady, Roberts* duty to disclose or abstain, but who themselves have no such relationship, and therefore no corresponding *Cady, Roberts* duty.<sup>211</sup> In the context of the classical theory, the Supreme Court deftly<sup>212</sup> addressed this matter by holding that an insider's *Cady, Roberts* duty is transposed to a tippee when the tip was made with an improper motive to personally benefit the tipper in some way, and the tippee knew of the impropriety.<sup>213</sup> This standard for tippees is at the same time a sensible expansion and limitation of liability. As noted, a doctrine expanding liability to tippees is necessary if the prohibition is to have any teeth. And since *Cady, Roberts* bases insider trading liability on misconduct vis-à-vis a relationship of trust, a tippee, like anybody, may only be implicated for insider trading if he can also be implicated in a breach of that trust. The intent-to-benefit rule of *Dirks* provides a test to determine

---

<sup>209</sup> See *supra* Introduction.

<sup>210</sup> See *supra* Part II.

<sup>211</sup> Cf. *Cady, Roberts*, 40 S.E.C. at 912 (concerning relationships giving access to inside information either “directly or indirectly”); 17 C.F.R. § 240.10b-5 (2004) (prohibiting use of manipulative or deceptive devices either “directly or indirectly”).

<sup>212</sup> But cf. Langevoort, *supra* note 127, at 1339 (arguing that personal benefit test never amounted to the refining concept that the Court had hoped it would).

<sup>213</sup> *Dirks v. SEC*, 463 U.S. 646, 660–61 (1983); see also *supra* text accompanying notes 72–96.

whether or not such an imputation is justified.<sup>214</sup>

The improper motive test, or personal benefit test, relates directly to the issue of fairness, which arguably is the doctrinal pillar upon which insider trading law is poised.<sup>215</sup> The test ties in directly with the *Cady, Roberts* prohibition against an insider taking advantage of “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”<sup>216</sup> As formulated in *Dirks*,<sup>217</sup> the rule against insider trading is designed to exonerate tippees who did not gain possession of the information as a result of wrongdoing.<sup>218</sup> Ronald Secrist, for example, was not abusing his insider status for improper personal gain,<sup>219</sup> and hence the *Cady, Roberts* concern with fairness, that is, with restraining abuses of relationships of confidence, was not implicated.

*Dirks* was brought under the classical theory of insider trading.<sup>220</sup> In *Yun*,<sup>221</sup> the SEC argued that the intent-to-benefit requirement for tippee liability set forth in *Dirks* did not apply in misappropriation cases because the basis of the misappropriation theory was distinct from that of the classical theory under which the *Dirks* rule had been articulated.<sup>222</sup> The SEC suggested that the intent-to-benefit requirement was “inextricably linked to” duties owed to corporate shareholders and that, since the justification of the misappropriation theory is that the trader owes no such duties, the benefit rule was inapposite.<sup>223</sup>

There is no justification, however, for this different treatment of

---

<sup>214</sup> See *Dirks*, 463 U.S. at 660–61. The additional requirement of knowledge on the part of tippees is somewhat ambiguous but adds little to the analysis. When the analytically prior breach of duty by the insider is present, knowledge by the tippee is unlikely to be an issue. It seems to amount to no more than knowing that the insider is deliberately conveying inside information to the tippee. All of the cases to date analyzed by this author that exonerate tippees are based not on the lack of an appropriate state of mind on the part of the tippee, but on the fact that there was no breach by the insider in the first place. See, e.g., *Dirks*, 463 U.S. 646 (finding no breach by insider, therefore no tippee liability); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (finding no *per se* duty owed to family members, therefore no breach); *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984) (finding no breach when insider talking to his wife is unwittingly overheard by a third party).

<sup>215</sup> See discussion *supra* Part II.B.

<sup>216</sup> *Cady, Roberts*, 40 S.E.C. at 912.

<sup>217</sup> *Dirks*, 463 U.S. at 663–64.

<sup>218</sup> See *id.* at 667; see also *supra* text accompanying notes 72–96.

<sup>219</sup> *Dirks*, 463 U.S. at 667.

<sup>220</sup> Ronald Secrist, the alleged tipper, was an insider of Equity Funding, and the ultimate tippees traded in the stock of Equity. *Id.* at 648–49.

<sup>221</sup> *Yun*, 327 F.3d 1263.

<sup>222</sup> See *id.* at 1275.

<sup>223</sup> *Id.*

the misappropriation theory, which has been described as “the abstain or disclose theory’s fiduciary cousin.”<sup>224</sup> In repeatedly requiring a breach of a fiduciary duty as a prerequisite to a Rule 10b-5 violation, the Supreme Court is faithfully following the rule as originally interpreted in *Cady, Roberts*. There is no *Cady, Roberts* duty unless there is a relationship giving access to privileged information.<sup>225</sup> Relationships of this sort are very often fiduciary in nature. But even when they are not, strictly speaking, state-law fiduciary duties owed to shareholders, they are sufficiently fiduciary-like that the presence of a fiduciary duty is a reliable indicator of a coexisting *Cady, Roberts* duty.<sup>226</sup> By confusing the indicator (fiduciary duty) with the thing indicated (*Cady, Roberts* duty) courts sometimes took it for granted, without comment, that the duties in question were owed to shareholders *qua* shareholders.<sup>227</sup> But the Supreme Court has noted that the two duties are not identical.<sup>228</sup>

---

<sup>224</sup> Langevoort, *supra* note 127, at 1334.

<sup>225</sup> See *Cady, Roberts*, 40 S.E.C. at 912.

<sup>226</sup> Cf. *O’Hagan*, 521 U.S. at 653 (“The misappropriation theory is thus designed to ‘protect the integrity of the securities markets against abuses by ‘outsiders’ . . . who owe no fiduciary or other duty to that corporation’s shareholders.’”) (emphasis added).

<sup>227</sup> This also treats federal insider trading law as an aspect of state corporate law, an approach which the Supreme Court has rejected. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). Keeping the *Cady, Roberts* duty to all market participants distinct from corporate officers’ state-law fiduciary duties to shareholders helps assuage the criticism that the Supreme Court has completely ignored the federalism concerns it raised in *Santa Fe*. See BAINBRIDGE, *supra* note 20, at 111–12.

<sup>228</sup> *Dirks v. SEC*, 463 U.S. 646, 653 n.10 (1983) (noting that *Cady, Roberts* duty is distinct from state-law fiduciary duties owed by corporate managers); see also *supra* text accompanying notes 152–65.

Characterizing duties under the classical theory as owed to one type of entity (the corporation whose stock is being traded) and under the misappropriation theory as owed to another (the corporate source of the information) also makes it tempting to view liability under the two theories as, respectively, agency-based and property-based. Though nothing conceptually prevents a separate action for misappropriation of trade secrets or conversion of corporate property, when such theories are feasible (which will not always be the case), section 10(b) and Rule 10b-5 are not concerned with theft, at least not directly, but with duties of fairness owed to investors by those in privileged positions. See discussion *supra* Part II. “[I]nsider trading is prohibited to protect against unfairness.” Langevoort, *supra* note 127, at 1334. The policy goal of Rule 10b-5, as originally interpreted in *Cady, Roberts*, is to enforce duties of fairness owed to the investing public (whose status as shareholders of one entity or another is simply incidental) by those who would abuse positions of privileged access to information. See *Cady, Roberts*, 40 S.E.C. at 912. While intellectual property law can be a more or less relevant aspect of insider trading law (under both theories) it cannot be said that insider trading law is property-based. Ostensibly, it is fraud-based. See *supra* note 35 and accompanying text; see also Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 5–9 (1982) (arguing that fraud basis of insider trading law is really

Moreover, in *O'Hagan*, Justice Ginsburg took care to emphasize the symmetrical relationship between the misappropriation theory and the classical theory:

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders.<sup>229</sup>

The Court's language makes it clear that the misappropriation theory is motivated by the same concerns, and meant to address the same ills, as the classical theory.<sup>230</sup> Indeed, one can say that they are not really separate theories at all, but the same theory applied to different circumstances. The classical theory is designed to net the actual corporate insider.<sup>231</sup> The misappropriation theory, on the other hand, is meant to snare the outsider who, for all practical purposes, should be treated as an insider, because his conduct contravenes the *Cady, Roberts* proscription and its foundational concern with the unfairness that results from the abuse of certain privileged relationships.<sup>232</sup> There is no reason why the *Cady, Roberts* prohibition should not extend to abuses of special relationships that give access to information that would otherwise escape sanction simply because of the fact that violated duties run to certain persons rather than to others. As Chief Justice Burger saw it, "Congress

---

a version of constructive fraud). *But cf.* Raymond L. Baribeault, Jr., Note, *Insider Trading: The Current Move Toward Increasing Civil and Criminal Liability for an Ill-Defined Crime and the Need for a Definition*, 14 VT. L. REV. 79, 79 (1989) ("[C]ourts have failed to develop any rational principles in applying the anti-fraud provisions of the 1934 Securities and Exchange Act . . . to insider trading.").

<sup>229</sup> *O'Hagan*, 521 U.S. at 652-53 (alterations and internal quotation marks omitted).

<sup>230</sup> The misappropriation theory is entirely consistent with Chairman Cary's project for a broad federal common law of insider trading. *See Langevoort, supra* note 127, at 1323.

<sup>231</sup> *O'Hagan*, 521 U.S. at 652.

<sup>232</sup> Under both theories the misused information has been misappropriated. This detracts somewhat from the significance of the label "misappropriation theory" as characterizing only one of the two theories.

cannot have intended one standard of fair dealing for ‘white collar’ insiders and another for the ‘blue collar’ level.”<sup>233</sup>

What Justice Ginsburg refers to as complementarity in *O’Hagan* is explicable in terms of the “open texture”<sup>234</sup> of Rule 10b-5. All laws are beset by some degree of vagueness, due in part to the nature of language.<sup>235</sup> But it is this very vagueness that imbues law with the flexibility that is necessary to meet the infinite variety of human experiences.<sup>236</sup> The open texture of law is what keeps lawyers and judges out of hock, for it is the basis for the innumerable questions of interpretation that arise with respect to legal rules.<sup>237</sup> The courts’ interpretation of Rule 10b-5 provides a paradigmatic application of this phenomenon.<sup>238</sup> The underlying legal precept that anchors the process and remains constant is the *Cady, Roberts* rationale proscribing unfair abuses of certain fiduciary-like relationships.<sup>239</sup> As the courts have encountered widely divergent real-life situations which intuitively fall under the *Cady, Roberts* rubric, they have exploited the open texture of Rule 10b-5 in attempting to arrive at a just outcome. The misappropriation theory is a manifestation of this dynamic flexibility. It is not distinct from the classical theory insofar as both theories are rooted in the same underlying precept, which necessarily remains a constant throughout the interpretive process.

In the end, Judge Tjoflat of the Eleventh Circuit Court of Appeals offered what is probably the most forceful argument against the SEC’s position that the two theories involve different elements of liability. The judge warned that courts should avoid “construct[ing] an arbitrary fence” between the two theories and “unduly dichotomizing . . . insider trading liability,” which “essentially would allow the SEC and the courts to ignore precedent involving the classical theory of liability whenever the SEC brings its actions under a misappropriation theory, and vice versa.”<sup>240</sup>

The attempt to treat the misappropriation theory differently from the classical theory when it comes to tippee liability is little more than an effort to supplant the Supreme Court’s careful and deliberate refinement of the *Cady, Roberts* rationale and to resurrect

---

<sup>233</sup> *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting).

<sup>234</sup> HART, *supra* note 198, at 128.

<sup>235</sup> *Id.*

<sup>236</sup> *See id.* at 128–29.

<sup>237</sup> *See Langevoort, supra* note 127, at 1340.

<sup>238</sup> *See* Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 *FORDHAM L. REV.* S7 (1993).

<sup>239</sup> *See Cady, Roberts*, 40 S.E.C. at 912; *see also* discussion *supra* Part II.

<sup>240</sup> *SEC v. Yun*, 327 F.3d 1263, 1275–76 (11th Cir. 2003).

the ill-defined and unsophisticated equal access theory, which the Court resolutely rejected in *Chiarella*.<sup>241</sup> Like the equal access theory, a theory that would implicate a trader whose informational advantage was gotten simply by virtue of his “position in the market”<sup>242</sup> is an ill-fated and misguided attempt to equalize market risks. As long as *Cady, Roberts* is to be taken seriously as providing the doctrinal justification for a ban on insider trading, any such attempts at market equalization should be rejected as incompatible with the objectives and motives of insider trading law.

The case of Donna Yun and Jerry Burch<sup>243</sup> provides an apt practical illustration of why the two theories should not be doctrinally bifurcated, and demonstrates that the intent-to-benefit test must be applicable under both theories if logical absurdities are to be avoided. If Mrs. Yun herself had traded on the information conveyed to her by her husband, she would have to be held liable under the misappropriation theory, since the prerequisite breach of duty by her husband was lacking.<sup>244</sup> But Mrs. Yun did not trade. Instead, she tipped Jerry Burch in either (or both) of two ways: either inadvertently while talking on the telephone,<sup>245</sup> or purposefully during a cocktail party.<sup>246</sup> Under the SEC’s theory, these two situations should be treated no differently from each other, at least as far as Burch is concerned. Since there would be no intent-to-benefit requirement, it would make no difference whether Mrs. Yun deliberately tipped Burch for some personal reason or inadvertently leaked the information while conversing on the telephone. But assume, *arguendo*, that Burch himself directly overheard the conversation between the Yuns and then traded on what he had gleaned. Since Burch owed no duties to the source of the information (Mr. Yun and Scholastic Books) he would be off the hook. And yet there is no substantial difference between the circumstances of Burch overhearing Mrs. Yun’s conversation with her lawyer and overhearing her conversation with her husband. In both situations he benefited from a mere situational advantage.<sup>247</sup> But, depending on which conversation he overhears, he is liable in one

---

<sup>241</sup> See *Dirks v. SEC*, 463 U.S. 646, 657 (1983); *Chiarella*, 445 U.S. at 231.

<sup>242</sup> *Chiarella*, 445 U.S. at 232 n.14.

<sup>243</sup> See *Yun*, 327 F.3d 1263.

<sup>244</sup> See *United States v. O’Hagan*, 521 U.S. 642, 659 (1997).

<sup>245</sup> *Yun*, 327 F.3d at 1268.

<sup>246</sup> *SEC v. Yun*, 130 F. Supp. 2d 1348, 1356–57 (M.D. Fla. 2001), *vacated by Yun*, 327 F.3d 1263.

<sup>247</sup> Cf. *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

case but not in the other.<sup>248</sup> This *reductio ad absurdum* is a further (and final) verification of the weakness of the SEC's position in *Yun*.

#### CONCLUSION

The *Cady, Roberts* decision not only set the stage for federal insider trading law; it has also directed the interpretation of Rule 10b-5 for roughly the past half century. The decision articulated the rationale for prohibiting insider trading which still drives courts' thinking on the matter: enforcing duties of fairness in securities transactions against those whose positions of trust within a corporation give them access to information which it would be impossible for others to obtain legally. To effectuate this goal, the federal courts have developed and applied two versions of a theory of liability based on the principles of *Cady, Roberts*. Both involve the misappropriation of privileged information. The classical theory applies to insiders who trade in their own company's stock. The misappropriation theory expands the insider trading rule to cover those who are not insiders in the classical sense, but who benefit from some relationship giving them access to nonpublic corporate information. Other than having different objects, the theories are indistinguishable in their goals and motivation. Treating the two theories as having different requirements, and in particular different state-of-mind standards for tippee liability, threatens to fragment and complicate an area of law that already suffers from an acute identity crisis.<sup>249</sup> Until Congress or the Securities and Exchange Commission promulgates a new, hopefully more focused and precise legislative or regulatory statement on insider trading, the present body of doctrine must be applied as coherently and consistently as possible in order to further the policy goals first set forth by Chairman Cary and seemingly agreed upon, at least by tacit implication, by the majority of jurists and lawmakers.<sup>250</sup> Distinctions as to the elements of a cause of action under the different theories of liability should be avoided absent a substantive doctrinal justification. In the case of the

---

<sup>248</sup> This odd result is exacerbated by the fact that, in the hypothetical scenario, Burch got his information from an actual agent of the corporation, and is exonerated, while in the actual case he would be liable for trading on third-party hearsay, which would generally be somewhat less reliable and might amount to no more than rumor or speculation. See Stuart Sinai, *Rumors, Possession v. Use, Fiduciary Duty and Other Current Insider Trading Considerations*, 55 BUS. LAW. 743, 743 (2000) ("When is it appropriate for prosecutorial discretion to turn trading in securities about which rumors and speculation abound, into a crime?").

<sup>249</sup> Cf. *supra* note 228.

<sup>250</sup> See generally William N. Eskridge, Jr., *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67, 71 (1988) (discussing interpretive value of congressional inaction).

personal benefit test for tippee liability, no such justification has been put forth; nor is one likely to be. In sum, any attempts to misappropriate the misappropriation theory from its *Cady, Roberts* foundations must remain unsuccessful. Although the majority of judicial opinion is in accord with this view of the matter, there is some disagreement. The resolution of this disagreement becomes clear when it is seen that the misappropriation and the classical theories of insider trading liability are two sides of the same *Cady, Roberts* coin—which, at least for now, is the coin of the realm.