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## ARTICLES

# PROPOSALS FOR INSIDER TRADING REGULATION AFTER THE FALL OF THE HOUSE OF ENRON

*James P. Jalil\**

*"We have always known that heedless self-interest was bad  
morals; we know now that it is bad economics."*

— Franklin Delano Roosevelt<sup>1</sup>

### I. INTRODUCTION

In the landmark decision of *SEC v. Texas Gulf Sulphur Co.*,<sup>2</sup> the United States Court of Appeals for the Second Circuit found that an elemental fraud had been committed when corporate insiders<sup>3</sup> profited from securities transactions at the expense of an unwary and uninformed public.<sup>4</sup> The court noted that trading by corporate insiders on the basis of material non-public information frustrated "the justifiable expectation of the securities marketplace

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1. Franklin Delano Roosevelt, Second Inaugural Address (Jan. 20, 1937), available at <http://www.americanpresidents.org/inaugural/31b.asp> (last visited Feb. 26, 2003).

2. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

3. The court in *Texas Gulf Sulphur* was considering a situation involving senior management. *Id.* at 833. For the purposes of this Article, the definition of "corporate insiders" includes both senior management and those who would be considered "affiliates." 15 U.S.C. § 78c (2002) (referencing the definition of "affiliate" in section 1841 of Title 12 of the United States Code). An "affiliate" is defined as "any company that controls, is controlled by, or is under common control with another company." 12 U.S.C. § 1841(k) (2002).

4. *Texas Gulf Sulphur*, 401 F.2d at 833.

that all investors trading on impersonal exchanges have relatively equal access to material information.”<sup>5</sup> But is this expectation realistic?

Certainly not all traders in the impersonal marketplace have the same ability, background, knowledge or sophistication in business and financial matters, nor do they have the same access to material corporate information.<sup>6</sup> The ordinary day trader cannot call the chief financial officer of a major public company and chat with her about the affairs of the business, as can the securities analyst for a major brokerage house.<sup>7</sup> Some traders have large, well-paid, sophisticated and talented staffs to study and investigate the intricacies of various businesses and industries.<sup>8</sup> Some traders are more insightful, more skillful, and frankly better investors than others.<sup>9</sup> Inequality among investors is a basic reality of the marketplace.

To attract and keep investors over the long term, however, securities markets must be perceived as taking place on a level playing field, with rules (securities laws) and referees (the Securities and Exchange Commission (“SEC”)) to keep the game

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5. *Id.* at 848.

6. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 569 (1984) (discussing the differences between traders).

7. The Securities and Exchange Commission tried to address this issue to some extent by adopting Regulation FD. SEC Regulation FD, 17 C.F.R. § 243.100 (2001). Regulation FD provides that whenever a public company, or a person acting on behalf of a public company, discloses material, non-public information to a broker, dealer, investment adviser, investment company or stockholder (under circumstances in which it is reasonably foreseeable that the stockholder will act on such disclosed information by buying or selling securities), then the public company must make *public* disclosure of the same information. *Id.* § 243.100(a). The intent behind Regulation FD was to level the playing field so that analysts and others with access to senior management do not have an unfair advantage over the uninformed public. See Practising Law Institute, *Regulation FD: Dealing With Analysts*, 1352 PLI/Corp 1153, 1176 (2003).

8. See Gilson & Kraakman, *supra* note 6, at 570; see also Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 932 (1994) (evaluating the resources uniquely available to only certain groups of traders).

9. See Gilson & Kraakman, *supra* note 6, at 571.

fair.<sup>10</sup> To support this objective, securities laws have evolved to address the uneasy tension between marketplace confidence and the legitimate needs of corporate insiders to purchase and sell their company's securities.<sup>11</sup> The reality is that corporate insiders will almost always have better insight into the affairs of their employers than will the average investor.<sup>12</sup> Thus, the mere possession of material non-public information is not, in and of itself, a bar to trading.<sup>13</sup> All learning on the bedrock law of insider trading flows from this principle.

## II. HISTORICAL PERSPECTIVE

Insider trading has not always been limited by law. Prior to the New Deal reform legislation of the 1930s, specifically the Securities Act of 1933<sup>14</sup> ("Securities Act") and the Securities Exchange Act of 1934<sup>15</sup> ("Exchange Act"), legal prohibitions against trading by corporate insiders were either non-existent, covered by state securities laws, or founded on common law theories of fraud.<sup>16</sup> Trading on United States securities markets,

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10. See sources cited *infra* note 24 (supporting the argument that securities laws have evolved to create a level playing field).

11. See Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 353-54 (1988) (discussing the tension between "traditional principles of fraud and fiduciary duty on the one hand and a more general desire to provide equal access to material information and economic opportunity on the other," as the impetus to create such laws).

12. See *id.* at 360.

13. Cf. *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that the mere possession of material, non-public information does not trigger a duty to disclose under section 10(b), absent some fiduciary "duty to speak"); *Dirks v. SEC*, 463 U.S. 659 (1983) (citing *Chiarella*, and noting that a finding of fraud under 10(b)(5) requires more than the mere possession of such information).

14. Securities Act of 1933, 15 U.S.C. § 77a (2000).

15. Securities Exchange Act of 1934, 15 U.S.C. § 78a.

16. See Cox & Fogarty, *supra* note 11, at 353; see also *Freeman v. Decio*, 584 F.2d 186, 191 (7th Cir. 1978) (holding that, absent fraud, officers and directors may trade their own company's securities without disclosing that they are doing so); *Taylor v. Wright*, 69 Cal. App. 2d 371 (1945) (discussing "majority" rule permitting insider trading); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 883 (1983) (discussing the

which dates from the earliest days of the republic, was an open, unregulated affair.<sup>17</sup> As trading was predominantly limited to select groups of merchant and investment bankers, regulation was largely self imposed.<sup>18</sup>

The development of the impersonal securities market began gradually, but it is clear that it dates at least from the period after the Civil War.<sup>19</sup> The growth of railroads and the large industrial enterprises of the industrial revolution necessitated obtaining capital from greater segments of the general population than just the big city investment and merchant bankers.<sup>20</sup> Thus, by the turn of the twentieth century, securities markets had grown, largely unregulated by any statutory or administrative oversight.<sup>21</sup> Just as a downhill skier gains speed, the pace of trading grew faster as greater numbers of investors, fueled by an increasing prosperity, flocked to the securities markets.<sup>22</sup> By the 1920s "playing the market" had become a national obsession.<sup>23</sup>

As the obsession turned into the nightmare of the stock market crash of 1929, and the country slid from prosperity through recession to economic depression, some perspectives began to emerge from the debacle. One such perspective that endures to

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general common law rule that, with some exceptions, insider trading is permissible).

17. See 1 JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES* 93-119 (2001).

18. See *id.*

19. See Securities and Exchange Commission, Report on the Practice of Preferencing (Apr. 15, 1997) (discussing the role of securities specialists in the years following the Civil War), available at <http://www.sec.gov/news/studies/prefrep.htm> (last visited Feb. 23, 2003).

20. See Arthur Levitt, Remarks at the Commission Commonwealth Club San Francisco, CA (May 17, 1996) (discussing how the capital markets helped finance the construction of the railroads that tied the East to the West), available at <http://www.sec.gov/news/speech/speecharchive/1996/spch101.txt> (last visited Feb. 26, 2003).

21. See *id.*

22. See Ted A. Smith, *Congress Must First Learn to Surf the Internet, If It Ever Hopes to Catch the Next Wave of Securities Fraud*, 17 J. MARSHALL J. COMPUTER & INFO. L. 589, 591 (1999) (noting that this increase in the popularity of securities trading was a contributing factor behind the great crash of 1929).

23. *Id.* at 594.

this day is that if confidence and trust are to be restored to the securities markets, the investing public must correctly perceive that the securities markets are indeed a level playing field, and that investors privy to information not available to the investing public will not use that information to gain an advantage.<sup>24</sup> Many investors today have the perception that this is the case. Unfortunately for them, it is not the law.

### III. FEDERAL SECURITIES LAWS

The Securities Act was one of the first pieces of New Deal legislation, enacted in a time of economic crisis.<sup>25</sup> Although it has been amended many times since 1933, the structure that the Securities Act crafted remains the foundation of securities regulation.<sup>26</sup>

At its core, the Securities Act is a consumer protection

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24. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851–52 (2d Cir. 1968) (stating that the goal of insider trading rules is to establish identical market risks for all investors thereby increasing investor confidence); *United States v. O'Hagan*, 521 U.S. 642, 644–45 (1997) (holding that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating § 10(b) and Rule 10b-5); Wendy Ehrenkranz, Comment, *Whistle Blowing As a Rule 10b-5 Violation: Dirks v. SEC*, 36 U. MIAMI L. REV. 987, 992 (1982) (stating that the broadening of the duty to disclose is attributable principally to the SEC's goal of equalizing the availability of market information onto the objectives of the federal securities laws: promoting investor confidence and the efficient functioning of capital markets); Mark Dallas, *United States v. O'Hagan: A Failed Attempt to Protect Public Policies Underlying the Securities Laws*, 32 U.C. DAVIS L. REV. 1107 (1999) (noting that Congress's purpose in enacting securities laws was to erect an efficient market and to protect investors from insider trading which harms investor confidence).

25. In fact, the Securities Act was one of the key pieces of legislation proposed by the Roosevelt administration in the "first 100 days" of the New Deal. See EDWARD T. MCCORMICK, *UNDERSTANDING THE SECURITIES ACT AND THE SEC* 20–24 (1948) (describing the Act's genesis as part of the New Deal).

26. See James D. Cox, *The Future Content of the US Securities Laws: Premises for Reforming the Regulation of Securities Offerings: An Essay*, 63 LAW & CONTEMP. PROB. 11 (2000).

statute.<sup>27</sup> It is founded on the theory that when investors buy securities in the public market from the issuer of those securities, such investors are entitled to know something about that company.<sup>28</sup> The investor is entitled to know the good, the bad and the ugly. In other words, a company should disclose every material fact a reasonable investor would need to know prior to making an investment.<sup>29</sup> The process by which a company discloses this information is known as registration.<sup>30</sup> Simply put, a company wishing to sell securities in the public market must file what is known as a registration statement with the SEC, wherein it registers the offering of its securities.<sup>31</sup> The bulk of this registration statement consists of a prospectus detailing all the material information about the company, including pertinent risk factors, financial information and a readable narrative.<sup>32</sup> After review by the SEC staff, the registration statement is declared effective and

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27. See *supra* note 24 and accompanying text.

28. Section 5 of the Securities Act contains the principles of registration and disclosure. See Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000). It is not too far off the mark to say that the essence of the Securities Act is contained in section 5 and that the balance of the Securities Act is all but commentary. See Peter D. Santori, *Selling Investment Company Shares Via an Off-The-Page Prospectus: "Leveling the Playing Field" or "Diminishing Investor Protection,"* 20 IOWA J. CORP. L. 245, 248 (1995) (stating that the most important provision of the 1933 Act is section 5 which provides the "statutory engine that makes the 1933 Act run").

29. The standard of materiality is often expressed by quoting from *TSC Indus. Inc. v. Northway Inc.*, 426 U.S. 438 (1976), which states that information is material if a reasonable investor would consider it important in making an investment decision. *Id.* at 449.

30. See Nicholas J. Guttilla, *Securities Regulation—Disclosure of Intra-Quarter Performance Information Constituting Extreme Departure from Public Information Required in Shelf Registration Prospectus—Shaw v. Digital Equipment Corp.*, 82 F.3d 1194 (1st Cir. 1996), 31 SUFFOLK U. L. REV. 1023 (1998) (stating that the Securities Act of 1933 requires directors to furnish information in a registration statement through disclosure documents).

31. Securities Act of 1933 § 5.

32. See Forms for Registration Statements, 17 C.F.R. § 239.11 (2001), available at <http://www.sec.gov/info/edgar/forms.htm> (last visited Apr. 2, 2003). For a sample form S-1 and attending schedules, visit <http://www.sec.gov/divisions/corpfin/forms/s-1.htm> (last visited May 2, 2002).

the company may sell its securities in the public marketplace, provided that each offer is accompanied by the prospectus from the registration statement.<sup>33</sup>

The theory of the Securities Act is that if proper and fair disclosure is made by way of the prospectus, investors are better able to make informed decisions about whether or not to invest.<sup>34</sup> Naturally, if the disclosures contained in a prospectus are proven faulty, incomplete or misleading in any material respect, aggrieved investors who suffered a loss can recover the loss from the issuer of the securities as well as its directors and the underwriters of the offering.<sup>35</sup> The company has no responsibility under the Securities Act for continuing disclosure or for after market trading.<sup>36</sup> However, companies with publicly traded securities, or those that have recently completed a registration under the Securities Act, are required under the Exchange Act to file periodic reports containing detailed disclosures and financial information.<sup>37</sup> These reports are publicly available and are intended to give the trading public continually accurate information about companies whose securities are publicly traded.<sup>38</sup>

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33. See Securities Act of 1933 § 5.

34. Cf. Guttilla, *supra* note 30, at 1025 (stating that the Securities Act was enacted to reduce the risk of fraudulent investment schemes).

35. See Securities Act of 1933 § 11, 15 U.S.C. § 77k (2000). Indeed, the issuer of the securities has no defense if a material misstatement or material omission is proven. Directors and underwriters have what is known as a "due diligence defense." *Id.* § 77k(a).

36. See *id.*

37. 15 U.S.C. §§ 78m, 77l.

38. Form 10-Q is the quarterly report firms are required to file. See Sample Form 10-Q, available at [www.sec.gov/divisions/corpfin/forms/10q.htm](http://www.sec.gov/divisions/corpfin/forms/10q.htm) (last visited Apr. 3, 2003). Form 10-K is the annual report for the same purpose. See Sample Form 10-K, available at [www.sec.gov/divisions/corpfin/forms/10k.htm](http://www.sec.gov/divisions/corpfin/forms/10k.htm) (last visited Apr. 3, 2003). Form 8-K is for reporting material events and changes in the corporate structure not previously reported on Form 10Q. See Sample form 8-K, available at [www.sec.gov/divisions/corpfin/forms/8-k.htm](http://www.sec.gov/divisions/corpfin/forms/8-k.htm) (last visited Apr. 3, 2003).



## IV. SALES BY CORPORATE INSIDERS

What does this have to do with sales of securities by corporate insiders? The Securities Act did not stop at requiring disclosure on the part of a company issuing securities. As a general matter, absent an exemption, when corporate insiders sell securities in the public markets, the offer of those securities must be registered with the SEC in exactly the same way as if the company itself were issuing the securities.<sup>39</sup> This involves filing a registration statement with the SEC, in effect registering the offer by the insider.<sup>40</sup> A prospectus must disclose the affairs of the company, including all facts material to investors.<sup>41</sup> If a material misstatement or omission is found in such registration statement, both the selling corporate insider and the company itself would be liable for damages.<sup>42</sup>

The Securities Act does not deal with open market purchases by corporate insiders.<sup>43</sup> However, Rule 10b-18<sup>44</sup> issued by the SEC

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39. This is because of a definition clause in the definition of "underwriter." Section 5 of the Securities Act requires the registration of offers of securities by the issuer of those securities as well as by any underwriter of the offering. See Securities Act of 1933 § 5, 15 U.S.C. § 77e. Section 2(a)(11) of the Securities Act defines an underwriter as one who purchases securities from the issuer with an intent to distribute those securities into the hands of the public. Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77(b)(11). The last clause of section 2(a)(11) adds the notion that one who purchases from a corporation insider (essentially) for the purpose of public distribution is deemed to have purchased from the issuer itself. *Id.* Hence that person is an "underwriter" and therefore that offering must be registered under section 5. It may not be elegant drafting, but it has stood the test of time. See *Laventhall v. Gen. Dynamics Corp.*, 704 F.2d 407, 410 (8th Cir. 1983) (noting that corporate insiders are prohibited from trading without disclosing material, inside information); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (stating the goal of insider trading rules is to establish identical market risks for all investors, thereby increasing investor confidence).

40. See cases cited *supra* note 39.

41. See cases cited *supra* note 39.

42. Securities Act of 1933 § 11.

43. See Betty Ann Maxey, *Securities Regulation—Private Actions Under Rule 10b-5—Damage Causation for Nondisclosure in the Open Market*, 51 TUL. L. REV. 1293, 1294 (1977) (citing *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), in which the Sixth Circuit Court of Appeals held open market purchases by insiders were not causally connected to losses suffered by plaintiffs, who had sold their

under the Exchange Act does contain provisions regulating the manner in which corporate insiders may purchase securities on the open market.<sup>45</sup>

Notwithstanding the registration provisions of the Securities Act, the vast majority of sales by corporate insiders do not go through this registration procedure. If all did, then both corporate insiders and their companies would be personally liable whenever disclosures made in the prospectus contained material misstatements or omissions.<sup>46</sup> Thus, if the formulation adopted by the Securities Act in 1933 were universally followed, the playing field would be level, or at least less skewed toward corporate insiders and against the investing public. Armed with the prospectus relating to the sale by the corporate insider, the anonymous investor would be in possession of all material and timely facts about the company prior to making an investment decision.<sup>47</sup> In addition, as with sales by the company itself, if the disclosures found in the prospectus proved to be faulty in any material respect, remedies for damages would be available from the company as well as the corporate insider.<sup>48</sup>

So why are all sales by corporate insiders to the public not subject to the requirements that the Securities Act originally intended? The reason has to do with simple expediency.<sup>49</sup> The

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securities prior to the information being available to the public. Therefore, plaintiffs failed to prove a claim for damages based upon the insiders' violation of the security laws).

44. 17 C.F.R. § 240.10b-18 (2001).

45. Rule 10b-18 allows an issuer to repurchase its own shares under certain conditions. *See id.* An issuer may want to repurchase some of its own shares for several reasons, which include a change in capital structure, providing a more tax-efficient distribution of income to shareholders, creating a positive signal to the market, or defending against a prospective takeover. Issuer repurchase is permitted under Rule 10b-18 provided certain specific time, pricing and volume restrictions are satisfied. *See id.*

46. Securities Act of 1933 § 11.

47. *See supra* notes 29–32 and accompanying text.

48. Securities Act of 1933 § 11.

49. *See* Notice of Adoption of Rule 144, Exchange Act Release No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487, at 81,056 (Jan. 11, 1972). *But see* Martha Jane Snyder, *Securities Regulation: Rule 144—From*

registration process is cumbersome, time consuming and expensive.<sup>50</sup> As a result, the SEC adopted Rule 144, instituting a system whereby corporate insiders may sell securities: i) without having to go through the registration process, ii) without having to deliver a prospectus to the investing public; and iii) without having to make any disclosure about the company at all.<sup>51</sup>

#### A. Rule 144

A corporate insider may sell securities of his employer in the public markets without complying with registration, disclosure and prospectus requirements if he complies with the three basic requirements of Rule 144.<sup>52</sup> First, his company must be a public company and be current in all its filings with the SEC as required by the Exchange Act.<sup>53</sup> Second, all sales must be in "regular way" brokerage transactions.<sup>54</sup> Third, within any three-month period the

*Lawyers to Mathematicians*, 40 TENN. L. REV. 399 (noting that the impetus for the adoption of Rule 144 as the prospective purchaser's need for information).

50. A registration statement may take several weeks from preparation to filing with the SEC to effectiveness, may cost tens of thousands of dollars in legal and accounting fees, and may distract senior management during the process. *See* Securities and Exchange Commission, Report of the Advisory Committee on the Capital Formation and Regulation Processes, pt. II, at 2 (July 24, 1996) (identifying the high transaction costs, including legal, accounting, printing, and filing fees, involved when filing a registration statement), at <http://www.sec.gov/news/studies/capform.htm> (last visited Feb. 9, 2003); *Id.* at app. A, tbl 2 (finding one study that found that the average length of time for a filed registration statement to become effective for an IPO is 38.9 days).

51. 17 C.F.R. § 230.144.

52. *Id.*

53. *Id.* § 230.144(c). The theory is that the public thus has all relevant material information necessary to make an investment decision. The problem of course is twofold. First, in a fast moving economy when facts become material after the filing of the last periodic report, but before the due date of the next, information is often dated by the time the public sees it. Second, there is no liability to the corporate insider for a material misstatement in the company's Exchange Act report, as there would be in the case of a registered offering under the Securities Act. *Id.*

54. *Id.* § 230.144(g). "Regular way" transactions are ordinary sales into the impersonal market, delivery and settlement of which is made on the third full

corporate insider may sell no more than the greater of i) one percent of the class of securities outstanding; or ii) the average weekly trading volume of the security being sold during the four weeks preceding any sale.<sup>55</sup> This last restriction is known as the “volume limitation.”

If a corporate insider follows Rule 144, no registration is required for her sale, meaning that no prospectus offering detailed disclosure about the company need be delivered to the investing public.<sup>56</sup> Rule 144 in effect frustrates the original intention of the Securities Act, which requires the registration of offers of securities by corporate insiders.<sup>57</sup> There may be valid reasons why it makes sense to allow sales under Rule 144 without registration.<sup>58</sup> Nevertheless, the fact remains; it was not what Congress had in mind in 1933.<sup>59</sup>

Consider, for example, the corporate insider with material information concerning his company that is unknown to the general public, and has not yet been disclosed in the company's current filings with the SEC under the Exchange Act. If the insider were to comply with the registration requirements of the Securities Act, as originally intended by Congress, this new information

business day following the transaction (for government securities transactions, the settlement is the first full business day following the transaction). See BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 472 (5th ed. 1998). Negotiated or private sales are outside the scope of Rule 144. See 17 C.F.R. § 230.144.

55. 17 C.F.R. § 230.144(e).

56. If the securities being sold are “restricted securities,” that is, securities that were purchased from the issuer in a private transaction, then the corporate insider must hold such securities for at least a year before they can be sold, and a simple Form 144 disclosing the sale must be filed with the SEC. *Id.* If the securities were purchased on the open market or from the company pursuant to an effective registration statement, as is the case with most stock options, there is no holding period requirement and no Form 144 need be filed. *Id.*

57. See *supra* notes 39–42 and accompanying text.

58. See Revisions to Rule 144, Exchange Act Release No. 6488, [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,429, at 86,249 (Sept. 23, 1983) (“The purpose of [Rule 144] is to relax restrictions on resales of securities that are more burdensome than necessary.”).

59. See S. REP. NO. 73-1455, at 47–50 (1934); Comm. on Banking and Currency, 77 CONG. S. RES. 84, 2982–83 (1934) (statement of Sen. Fletcher).

would be disclosed in the requisite registration statement.<sup>60</sup> For sales by corporate insiders made pursuant to Rule 144, as the vast majority are, no disclosures need be made.<sup>61</sup> The insider is seemingly free to trade with impunity.

*B. A Legal Remedy Is Fashioned By The Courts*

Congress, aware of this problem, attempted to address it to some degree in the Exchange Act.<sup>62</sup> Where Congress has left off, the courts have advanced the cause of the unwary public.<sup>63</sup>

*1. The Short Swing Profit Rule*

The Exchange Act contains two provisions directly addressing insider trading.<sup>64</sup> Taking these provisions out of order, section 16(b) is the well-known "short-swing profit" rule.<sup>65</sup> The rule prohibits insiders from actively trading their company's securities.<sup>66</sup>

60. See *supra* notes 39–41 and accompanying text.

61. See *supra* notes 52–55 and accompanying text.

62. Courts have created an implied private cause of action under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (2000), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2001). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

63. See *Ernst & Ernst*, 425 U.S. at 196 (stating that, while Congress did not expressly contemplate a civil remedy for those harmed by Rule 10b-5 violations, the existence of a private cause of action for such violations is well established).

64. These are: Section 10(b), 15 U.S.C. § 78j(b); and Rule 10(b)(5), 17 C.F.R. § 240.10b-5 (2001). There are, however, other provisions in the Exchange Act which deal with the standard of pleadings for insider trading cases and which address the issue of liability, both to the SEC and private litigants. The Private Securities Litigation Reform Act (PSLRA) specifically addresses pleading requirements, creating a heightened standard for securities litigation. 15 U.S.C. § 78u-4(b)(2).

65. 15 U.S.C. § 78p.

66. See *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243 (1976) (noting that Congress enacted § 16(b) for the purpose of curbing insider trading); see also *Hearing on Stock Exchange Practices Before Senate Comm. on Banking and Currency*, 73d Cong. 6557 (1934) (explaining that the purpose of section 16(b) is "to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information.").

It does this by requiring that an insider who sells his company's securities within six months of purchase to turn over to the company any profit gained in that trade.<sup>67</sup> Interestingly, though, section 16(b) does not require any element of knowledge or use of non-public information by the insider in order for liability to attach.<sup>68</sup>

## 2. Section 16(a) Reporting Requirement

The second provision of the Exchange Act dealing with insider trading is section 16(a),<sup>69</sup> which until recently required corporate insiders to report their transactions in their companies' securities the month after the transactions were made.<sup>70</sup> If a transaction had been with the company itself—for example, if the corporate insider sold securities directly to his employer—the public filing disclosing the transaction did not have to be made until 45 days after the end of the fiscal year in which the transaction took place.<sup>71</sup> To make matters worse, these reports—both monthly and annual—are among the few the SEC still requires be made via mailed hard

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67. The converse is also true. If there is a sale and subsequent purchase within six months, there is equal liability, in this case for the loss avoided. 15 U.S.C. § 78p.

68. It is said that the purpose of section 16(b) is “prophylactic” and as such no showing of use of material non-public information is required. *See* Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57 (S.D.N.Y. 1971) (explaining the most efficient application of the “prophylactic purpose” of section 16(b)); *In re* Haven Indus. Inc., 462 F. Supp. 172, (S.D.N.Y. 1972) (quoting *Nathanson* for the same proposition).

68. 15 U.S.C. § 78p(a).

69. *Id.*

70. *Id.*; *see also* SEC Rule 16(a)(3), which proscribes the reporting requirements for transactions and holdings, and provides, in relevant part:

Initial statements of beneficial ownership of equity securities required by section 16(a) of the Act shall be filed on Form 3. Statements of changes in beneficial ownership required by that section shall be filed on Form 4. Annual statements shall be filed on Form 5. At the election of the reporting person, any transaction required to be reported on Form 5 may be reported on an earlier filed Form 4.

17 C.F.R. § 240.16a-3(a).

71. 17 C.F.R. § 240.16a-3(f)(1).

copy, furthering the delay.<sup>72</sup> On July 30, 2002 President Bush signed into law the Sarbanes-Oxley Act of 2002.<sup>73</sup> Included in this legislation was a provision requiring the report of an insider trade to be made two days after effected.<sup>74</sup> However, electronic real time filings will not be required to be made until July 30, 2003.<sup>75</sup> Until then, these reports will continue to be mailed to the SEC in hard copy form.<sup>76</sup>

Presumably, the purpose of these filings is to make the public aware of what corporate insiders have been doing with the securities of their company—to provide insight into how those insiders view the securities. The filing requirements do not provide for real time disclosure of trading by corporate insiders with non-public, material information, but only require after-the-fact disclosure of such transactions.<sup>77</sup> Furthermore, the required filings do not provide insight into why the corporate insider made the purchases or sales. That is left to be divined by the investing public.

### 3. What Recourse to the Public?

So where does that leave the unwary and uninformed public? Has the public no redress if corporate insiders trade on the basis of material non-public information? One would think that over the years, Congress would have established some direct statutory prohibition, or at least have offered some guidance in the area of trading on the basis of non-public information by corporate insiders. Unfortunately, it has not. The courts have, however, fashioned a framework of jurisprudence that has evolved over many years and many judicial decisions.<sup>78</sup> Despite this framework,

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72. This will remain the case until July 2003. *See infra* note 76 and accompanying text.

73. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

74. *Id.* § 16(a)(2)(C).

75. *Id.* § 16(a)(4).

76. *Id.*

77. *See supra* notes 73–76 and accompanying text.

78. *See generally* Lisa J. Finnell, *United States v. Carpenter: Second Circuit*

the structure of the case law may not be as clear as expected. The ambiguity stems from the way the courts have used Rule 10b-5 in the area of corporate insider trading.<sup>79</sup>

Section 10(b) of the Exchange Act permits the SEC to adopt rules regulating deceptive and manipulative conduct.<sup>80</sup> Under this authority the SEC adopted Rule 10b-5,<sup>81</sup> the workhorse of securities enforcement.<sup>82</sup> The problem with using Rule 10b-5 as an enforcement tool against the practice of trading on non-public information is that nowhere in the Rule is insider trading mentioned.<sup>83</sup> To further complicate matters, the theoretical basis of Rule 10b-5 is the prohibition of deceptive and manipulative conduct in the context of securities transactions.<sup>84</sup> Trading by

*Overextends the Misappropriation Theory of Criminal Liability*, 12 DEL. J. CORP. L. 605 (1987) (stating that the absence of a statutory definition of insider trading has led to expansive interpretation of Rule 10b-5 by the courts).

79. See *id.* at 609.

80. 15 U.S.C. § 78j(b) (2003).

81. 17 C.F.R. § 240.10b-5 (2001). The actual text of this much quoted rule is as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.* Much like the Big Bang, from these few words, there has developed an entire universe of law.

82. See Paul S. Maco, *Building a Strong Subnational Debt Market: A Regulator's Perspective*, 2 RICH. J. GLOBAL. & BUS. 1, 18 (2001) (noting that § 10b of the Exchange Act is the well-known workhorse of U.S. securities litigation); see also Kevin C. Bartels, *Click Here to Buy the Next Microsoft: The Penny Stock Rules, Online Microcap Fraud, and the Unwary Investor*, 75 IND. L.J. 353, 354 (2000) (noting that since being added to the Exchange Act, § 10b has become the workhorse of the securities fraud regulation under the Act).

83. See Finnell, *supra* note 78, at 607-08 (discussing the confusion caused by Congress and the SEC neglecting to define insider trading in section 10b and Rule 10b-5, respectively).

84. Rule 10b-5 is, in fact, entitled *Employment of Manipulative and Deceptive Devices*. 17 C.F.R. § 240.10b-5.



corporate insiders while in possession of information not known to the investing public may constitute a sharp practice or unfair advantage, but there is some question as to whether it is manipulative or deceptive.<sup>85</sup> Nevertheless, courts have not been shy about taking the round peg of Rule 10b-5 and using it to plug the square hole of insider trading.<sup>86</sup>

The courts have fashioned a common law structure that strains the very language of Rule 10b-5.<sup>87</sup> If trading on the basis of non-public information is itself a "deceptive and manipulative device," following the language of Rule 10b-5, then if an investor has material non-public information about a particular public company, he would presumably be barred from trading the securities of that company. Consequently, the playing field would be level. Indeed, many believe that this is the law.<sup>88</sup> Unfortunately,

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85. See Kim Lane Schepple, *"It's Just Not Right": The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 125 (1993) (stating that "a fiduciary relationship creates an obligation not to use any information acquired within the relationship only because such relationships provide privileged access to information."). Courts have considered the purchase or sale of securities while in possession of material, non-public information a "deceptive device" under Rule 10b-5 without equalizing disclosure. See Julia K. Cronin et al., *Securities Fraud*, 38 AM. CRIM. L. REV. 1277, 1293-97 (2001). Though the courts employed this broad interpretation of the "deceptive device" required to bring the purchase or sale within the ambit of 10b-5, prosecutors had difficulty prosecuting cases under that theory, and urged the court to utilize the "misappropriation theory" set forth in *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). *Id.* Under the "misappropriation theory" a user of material, non-public information is liable for the trader's misappropriation of that information. *Id.* The "deceptive device" prong is satisfied when the user of the information "feigns loyalty" to the provider, while trading on such information for profit. *Id.* The rule requiring that a fiduciary relationship exist in a finding of insider trading is preserved. *Id.*

86. See, e.g., *O'Hagan*, 521 U.S. at 652-53; *SEC v. Warde*, 151 F.3d 42, 48-49 (2d Cir. 1998) (holding that the personal benefit requirement of *Dirks v. SEC*, 463 U.S. 659 (1983), can be satisfied by a showing of friendship); *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981) (holding that misappropriation theory was an appropriate rationale to demonstrate insider trading under Rule 10b-5).

87. See Finnell, *supra* note 78, at 607-08.

88. See *id.* at 611 ("[The] strong deterrent effect of an action by the SEC under existing law is significantly diluted by a general misconception of what is actually proscribed.").

it is not.<sup>89</sup> The mere possession of material inside information, in and of itself, is not a bar to trading.<sup>90</sup>

What the courts have done is to start the engine of the law of insider trading at Rule 10b-5, then steer a course somewhere in the direction of the law of fiduciary responsibility.<sup>91</sup> Therefore, the question of whether trading on material, non-public information is indeed "deceptive and manipulative," for the purposes of Rule 10b-5, turns on whether a fiduciary relationship factors into the equation.<sup>92</sup> The fiduciary relationship may be to the company itself, its stockholders, or the trader's employer.<sup>93</sup> It is not necessary that the trader or the employer have any connection with the company whose stock is being traded, but there has to be a fiduciary relationship somewhere.<sup>94</sup>

Therefore, whether trading on non-public information constitutes a violation of Rule 10b-5 depends on the trader.<sup>95</sup> The playing field is never truly level. Some get the benefit of unfair advantage over the uninformed public while others do not.<sup>96</sup> For example, consider the non-public material fact that a company's sales are down sharply in the last quarter of the year. It would be a violation for that company's accountant, who is reviewing the numbers, to trade on that information.<sup>97</sup> But if the accountant

89. Cf. *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that the mere possession of material, non-public information does not trigger a duty to disclose under section 10(b), absent some fiduciary "duty to speak").

90. See *id.*

91. See Finnell, *supra* note 78.

92. See *id.*; *Chiarella*, 445 U.S. at 227.

93. See Finnell, *supra* note 78, at 614-16.

94. See, e.g., *Chiarella*, 445 U.S. 222; *United States v. O'Hagan*, 521 U.S. 642 (1997); *Dirks v. SEC*, 463 U.S. 659 (1983); *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

95. See Finnell, *supra* note 78, at 622 (noting that neither the language nor the legislative history of section 10 (b) indicated congressional intent to create a general duty among market participants to abstain from trading based on nonpublic information absent a specific relationship between two parties creating such a duty).

96. See *id.*

97. See *id.* at 633; *Carpenter*, 791 F.2d at 1026 ("[S]ection 10 (b) of the Securities Exchange Act of 1934 and Rule 10b-5 proscribe an employee's unlawful misappropriation from his employer... of material nonpublic

accidentally left her work papers on the seat of a commuter train, a stranger to the company who picked them up could trade on that information without violating Rule 10b-5.<sup>98</sup> Trading by the accountant, in this example, is “deceptive and manipulative” based on the accountant’s fiduciary obligation to the company, while trading by the fellow commuter, who owes no such fiduciary obligation, is not.<sup>99</sup>

Yet nowhere in Rule 10b-5 is the concept of fiduciary relationship expressed.<sup>100</sup> That idea has been hand crafted by the courts.<sup>101</sup> Consider this in relationship to the ideal expressed by the Second Circuit in *Texas Gulf Sulphur*.<sup>102</sup> The law turns not on the fact that an unwary investor has been fleeced, but on who did the fleecing.<sup>103</sup>

Where does that leave our corporate insider? Surely a corporate insider holds a fiduciary relationship to his employer, if not the employer’s stockholders. Not surprising, courts have had no difficulty in finding the requisite fiduciary relationship to find trading by corporate insiders on the basis of material non-public information to be a violation of Rule 10b-5.<sup>104</sup>

However, this leads to another theoretical maze. May it not be said that at least the senior management of any publicly traded company are almost always in possession of information that is not public and may very well be material? As they have an obvious fiduciary relationship to the company and its stockholders, would

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information . . . in connection with a scheme to purchase and sell securities.”).

98. See *Dirks*, 463 U.S. at 659 (holding that a duty to disclose or abstain does not arise from the mere possession of nonpublic market information).

99. The commuter owes no fiduciary obligation, so there is no Rule 10b-5 liability. This would not be the case if the information concerned a tender offer. Rule 14e-3 provides that *no one* may trade while in possession of non-public information concerning a tender offer. 17 C.F.R. § 240.14e (2001).

100. 17 C.F.R. § 240.10b-5.

101. See generally Finnell, *supra* note 78.

102. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). For a discussion of this ideal, see *supra* note 5 and accompanying text.

103. See *Texas Gulf Sulphur*, 401 F.2d at 833.

104. *Cf. id.* (mentioning an individual’s obligation to either divulge non-public information or abstain from trading on the basis of non-public information).

that not constitute an almost permanent bar to trading? For many years this particularly nasty little problem has lived under the rug, near the edge, having been swept there by a law that did not care to deal with this troublesome reality.<sup>105</sup>

In the last several years, however, the issue has surfaced, forcing both the courts and the SEC to address the problem.<sup>106</sup> The first of these rulings was made by the Second Circuit in *United States v. Teicher*.<sup>107</sup> The court adopted a rather strict stance, holding that a corporate insider violates Rule 10b-5 if he trades while knowingly possessing non-public material information.<sup>108</sup> This ought to have struck fear into the hearts of corporate insiders. But the stance has since been softened.

#### 4. Use versus Possession

In 1998, the Eleventh Circuit adopted a more pragmatic approach in *SEC v. Adler*.<sup>109</sup> Or at least it thought it did. The court crafted the “use versus possession” test. Under this test, the mere possession of material non-public information on the part of a corporate insider is not a bar to trading.<sup>110</sup> To implicate Rule 10b-5 (and the requisite breach of fiduciary duty), the material non-public information must have been the basis of the insider’s trade.

<sup>111</sup> If it can be shown that the corporate insider would have traded

105. Public companies often have policies prohibiting trades within a certain number of days of a public announcement of earnings so as to avoid any appearance of trading on non-public information. See Dan Bailey, *New Insider Trading Rules* (June 2001), available at <http://www.artterhadden.com/publications/other/inside.asp> (last visited Feb. 26, 2003). However, these types of safeguards do little to address the problem of corporate insiders generally having a better understanding of the affairs of the public company due to access to non-public information that is often of a material nature. *Id.*

106. *See id.*

107. *United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993), *cert. denied*, 510 U.S. 976 (1993).

108. *Id.* at 121.

109. *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

110. *Id.* at 1337.

111. *Id.* at 1325.

anyway, regardless of the information, then there is no violation of Rule 10b-5.<sup>112</sup> For the insider to be liable, there must be a showing that, but for the information, and the advantage gained over the uninformed impersonal marketplace, the insider would not have made the trade.<sup>113</sup> Following *SEC v. Adler*, the Ninth Circuit also adopted this use versus possession test.<sup>114</sup>

In light of this changing approach to the standard for 10b-5 violations by corporate insiders, the SEC adopted Rule 10b5-1<sup>115</sup> in 2000.<sup>116</sup> Rule 10b5-1 acknowledges that the mere possession of material non-public information by a corporate insider who trades the company's securities is not, in and of itself, a violation of Rule 10b-5.<sup>117</sup> There must be use of that information.<sup>118</sup>

The SEC added the subtle twist that when a corporate insider trades while in possession of material non-public information there is a presumption that he used that information as the basis of the trade.<sup>119</sup> This presumption may be rebutted by certain defenses available to the corporate insider.<sup>120</sup> However, these defenses are limited to situations establishing that the insider's desire or intent to trade existed before he obtained the information at issue.<sup>121</sup>

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112. *Id.* at 1334 (quoting *United States v. O'Hagan*, 521 U.S. 642 (1997)).

113. *Id.* at 1337.

114. *See United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998).

115. 17 C.F.R. § 240.10b-5(1) (2001).

116. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51736-37 (Aug. 24, 2000) (codified at 17 C.F.R. pt. 240) (discussing the various approaches courts took to 10b-5 and the SEC's attempt to balance these views).

117. 17 C.F.R. § 240.10b-5(1).

118. *Id.*

119. *Id.* § 240.10b-5(1)(b).

120. The affirmative defenses listed in Rule 10b-5(1) are: before becoming aware of the information, the person had:

- (1) Entered into a binding contract to purchase or sell the security,
- (2) Instructed another person to purchase or sell the security for the instructing person's account, or
- (3) Adopted a written plan for trading securities.

17 C.F.R. § 240.10b-5(1)(c)(1)(i)(A).

121. *Id.*

## V. CONCEPTUAL DIFFERENCES OF OPINION ABOUT TRADING BY INSIDERS

Notwithstanding the elusive quest for a level playing field as elucidated by the Second Circuit in *Texas Gulf Sulphur*,<sup>122</sup> the opinion has sometimes been advanced that trading by corporate insiders is actually beneficial and conducive to a healthy, rational market.<sup>123</sup> Like scavengers who tidy up nature, trading by corporate insiders on the basis of material, non-public information is seen as serving the common good by tidying up the marketplace.<sup>124</sup> Such market activity adjusts the trading price of a security to its "true" value.<sup>125</sup> Under this analysis, injured public buyers and sellers are sacrificed to a greater goal—market efficiency.<sup>126</sup> In addition, insider trading prohibitions are sometimes blamed for forcing public companies to inopportunately disclose information better kept confidential.<sup>127</sup>

Experts have been debating the efficiency and efficacy of corporate insider trading for years.<sup>128</sup> However, three issues relating to such trading merit particular emphasis. The first is the importance of public perception.<sup>129</sup> The number of people who

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

123. See, e.g., Carlton & Fischel, *supra* note 16.

124. See David D. Haddock & Jonathon R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1452 (1986) (discussing the effects of insider trading on share prices).

125. See *id.* at 1461–62.

126. See *id.* at 1449.

127. See generally Nicholas K. Georgakapoulous, *Insider Trading As a Transaction Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993).

128. Compare H. L. Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder*, 8 MICH. L. REV. 267 (1910) (discussing the negative aspects concomitant with the practice by insiders of trading securities based upon non-public information), with HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (arguing for less restrictive regulation of insider trading because market efficiency would be increased).

129. The perception stated in *Texas Gulf Sulphur* has not seriously been refuted. For a discussion of this perception, see *supra* notes 2–5 and accompanying text.

own securities in the United States has reached record levels.<sup>130</sup> The growth of 401(k) plans, IRAs and self-directed retirement accounts, along with a prolonged period of national prosperity, notwithstanding a recent bear market, have all contributed to this phenomenon.<sup>131</sup> That widely distributed securities ownership is a good thing is not seriously open to question.<sup>132</sup> It generates liquidity, a vast reservoir of capital to fuel a growing economy, and allows more Americans to share in the vast richness of the American bounty.<sup>133</sup> Underpinning the exodus from traditional havens, such as bank savings accounts and debt obligations, must surely be confidence in equity markets.<sup>134</sup> This is confidence in the future, confidence in the strength of the American economy, and confidence in America itself. This trend also shows confidence in the structure and elemental fairness of the securities markets.<sup>135</sup>

Nothing—not wars, not recessions, not political uncertainties—does greater damage to confidence in securities

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130. See David Cay Johnston, *As Ye Profit, So Shall Ye Pay*, N.Y. TIMES, Feb. 14, 1999, § 3, at 11.

131. See Laura M. Holson, *The Deal Still Rules*, N.Y. TIMES, Feb. 14, 1999, § 3, at 1; see also John McClaughry, *Who Owns America? A New Declaration of Independence*, AMERICAN ENTERPRISE, Oct. 2000, at 59 (book review) (noting how 401(k), IRA, and pension account ownership has led to increased asset ownership by Americans).

132. See generally Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1218 (1999) (discussing Alford Berle's and Gardiner Means' view that the stock market functions to provide liquidity to stockholders).

133. See *id.* See generally Jay Norman, *Not Going Public? Consider Employee Stock Ownership*, HARTFORD COURANT, Jan. 24, 2000, at E3 (noting how employee stock ownership in privately held companies can help resolve certain liquidity problems); *Letter From the Editors*, BLACK ENTERPRISE, Aug. 2002, at 14 (noting that increased stock ownership is a way for blacks to achieve the American dream).

134. See generally Jerry Duggan, Note, *Regulation FD: SEC Tells Corporate Insiders to "Chill Out"*, 7 WASH. U. J.L. & POL'Y 159, 170 (2001) ("[P]erceived inherent unfairness leads not only to investor suspicion, but also to nonparticipation in the market by possible investors.").

135. See generally Adam Smith, *Jump-Start the Economy*, SAN DIEGO UNION-TRIB., Dec. 15, 2002, at G1 (noting that people will not invest if they believe the system is unfair).

markets than the perception that trading is not elementally fair to all.<sup>136</sup> There can be no doubt that the average investor understands that insider trading takes place.<sup>137</sup> But the knowledge that it is not permitted, and that the SEC is ever vigilant in detecting and preventing such activity, is enough to establish the requisite investor confidence.<sup>138</sup> To remove all restriction on corporate insider trading in the name of efficiency, as has been suggested by some commentators,<sup>139</sup> would do far more harm than good.<sup>140</sup> The view that market efficiency is more desirable than investor confidence comes from the wrong end of the telescope.<sup>141</sup>

Second, there is some doubt that insider trading would efficiently affect the price of traded securities at all—or at least sufficiently to achieve the effect desired by those opposing regulation.<sup>142</sup> Clearly the massive sales by insiders of the Enron Corporation did not efficiently adjust market prices of the common

136. Consider public reaction to the revelation of sales by corporate insiders in the declining days of Enron Corporation. Lost in the tumult and outcry has been any congratulations to the insiders for contributing to the more efficient pricing of Enron stock. Indeed, given the vast public float of Enron stock, there may be some question whether even massive selling by corporate insiders had any real effect on the price of Enron, given all extraneous facts.

137. See Jerry Knight, *Even if It Walks & Talks Like Insider Trading, It May Not Be*, WASH. POST, May 22, 1990, at D3 (noting that insider trading shakes the average investor's confidence in the market).

138. The SEC, like the IRS, seems at times to use the “in terrorum” effect of high profile, well publicized, prosecutions to achieve and maintain a perception of vigilance. See *Gekko Redux; Adelphia Arrests Show the Party's Over*, DALLAS MORNING NEWS, July 26, 2002, at A26.

139. See Carlton & Fischel, *supra* note 16. See generally Robert Prentice, *An Ethics Lesson for Business Schools*, N.Y. TIMES, Aug. 20, 2002, at A19 (noting that finance professors at many business schools believe that insider trading rules hurt the market's efficiency and that “many business professors impart to their students an impression that the law exists simply to be manipulated or evaded.”).

140. See A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 46 (1998) (discussing various ills that can result when insider trading is allowed).

141. See *id.*

142. See John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1092–93 (1996) (claiming that empirical evidence shows that trading on non-public insider information does not significantly affect market prices).



stock in that case.<sup>143</sup> To be sure, there may be situations when trading by corporate insiders would efficiently adjust the price; but other times that would not be so, as in the case of public companies with massive public floats and large trading volumes.<sup>144</sup> The question, then, is whether the goal of efficiency in some cases warrants the destruction of investor confidence in the fairness of securities markets.

Which leads to the third and perhaps most persuasive argument against the removal of restrictions on corporate insider trading: The theory of the corporation is the theory of capitalism itself. That is, that wealth (in the economic sense, not the personal sense) is created by the partnership of labor and capital.<sup>145</sup> Capital, in a corporation, is the contribution made by the holders of the corporation's securities; the stockholders.<sup>146</sup> Communism would eliminate capital,<sup>147</sup> and socialism would place capital in the hands of the state.<sup>148</sup> In the capitalistic system, labor is contributed by every employee, from the day laborer to the Chief Executive Officer.<sup>149</sup> Over time, it has become accepted managerial theory to incentive-ize labor, particularly for those in positions of senior

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143. Enron heads Ken Lay and Jeffrey Skilling profited to the tune of \$247 million and \$89 million dollars respectively from salaries and the sale of Enron stock prior to its demise. See Ian Cheng, *Survivors Who Laughed All the Way to the Bank: Barons of Bankruptcy Part I*, FIN. TIMES (London), July 31, 2002, at 10.

144. See Beeson, *supra* note 142, at 1093.

145. See Duncan Kennedy, *The Role of Law in Economic Thought: Essays on the Fetishism of Commodities*, 34 AM. U. L. REV. 939, 950 n.25 (1985).

146. 18a AM. JUR. 2D *Corporations* § 431 (1985).

147. See AMERICAN HERITAGE DICTIONARY 374 (2000) (defining Communism as "a system of government in which the state plans and controls the economy.").

148. See *id.* at 1649–50 (defining socialism as "[a]ny of various theories or systems of social organization in which the means of producing and distributing goods is owned collectively or by a centralized government that often plans and controls the economy.").

149. See Houman Shadab, *Capitalism: Frequently Asked Questions* (1999) (stating that "in a more fundamental sense, a capitalist is anyone . . . from a janitor to a millionaire . . . who lives solely by his own effort and who respects the rights of others."), available at <http://www.ocf.berkeley.edu/~shadab/capit-2.html#1> (last visited Feb. 28, 2003).

management, with equity ownership.<sup>150</sup> This better marries the interests of the capital providers (the stockholders) with labor (senior management). Therefore, as the stockholders succeed in increased value of their capital, so too does labor benefit. This is the rationale for finding it beneficial that labor, particularly senior management, join the true owners of the corporation in reaping the rewards of success.<sup>151</sup>

Stock ownership by labor is not, and never has been, seen as a device to render these employees of the stockholders obscenely wealthy, and certainly not in enormous disproportion to the stockholders and the total distributive profit of the business enterprise itself.<sup>152</sup> In addition, when corporate insiders trade on material non-public information, they do so, by definition, at the expense of their employers, the stockholders.<sup>153</sup> This disunites the community of interest that is the goal of having labor participate in stock ownership in the first place.<sup>154</sup> It is this diversity of interest analysis that has been the basis of courts' fiduciary obligation standard for corporate insider trading cases brought under Rule 10b-5.<sup>155</sup>

## VI. MODEST PROPOSALS FOR REGULATION OF SALES BY INSIDERS

The owners of the corporation employ managers to efficiently

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150. See Joseph Blasi et al., *Employee Stock Ownership and Corporate Performance Among Public Companies*, 50 INDUS. & LAB. REL. REV. 60, 60-61 (1996).

151. See *id.*

152. See generally *id.*

153. See, e.g., Timothy M. Wong, *United States v. O'Hagan: SEC Prevails on Misappropriation Theory, Yet May Now Face Heightened Standard of Proof for Securities Insider Trading*, 32 U.S.F. L. REV. 841, 843 (1998).

154. See generally Susan J. Stabile, *Pension Plan Investments in Employer Securities: More Is Not Always Better*, 15 YALE J. ON REG. 61, 75 (1998) (mentioning benefits of employee involvement in stock ownership).

155. See *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (noting that "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.").

and profitably run the corporation for the benefit of its owners, the stockholders.<sup>156</sup> The corporation does not exist to feather the bed of its employees. It exists to create value for its owners.<sup>157</sup> To the extent that some employees also become holders of their employer's securities, it seems self evident that their fiduciary obligation to their employers must take precedence.<sup>158</sup> It is wise and efficacious to link the prosperity of the employees with their employers, and so security ownership by corporate insiders is a good thing.<sup>159</sup> But it is a good thing only so long as the interests of labor and capital are linked, and the incentive remains to maximize value for the owners at large through proper and competent management of the corporation.<sup>160</sup>

When corporate insiders trade in the corporation's securities in any manner, self-interest must obviously overtake proper interest in management for stockholder benefit. Clearly, however, any suggestion that corporate insiders never be permitted to trade in the securities of their employer is neither fair nor realistic. It would, however, be interesting to see if senior managers better managed for the long term interests of the stockholders if they could not sell their securities until the earlier of their retirement or five years after they were no longer employed. It may be argued that American corporations would be managed far differently, and perhaps far more prudently. But such a proposal is not realistic.

On a more realistic note, this article proposes the following conditions to level the playing field.

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156. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 2.01 (Mike Greenwald ed. 1984).

157. See *id.* That is not to say the corporation owes no obligation to its employees, vendors, creditors or society in general. See *id.*

158. Michael J. Kennedy, *The Business Judgment Syllogism—Premises Governing Board Activity*, 1316 PLI/Corp 285, 294 (June 2001) ("The duty of loyalty requires that a director be disinterested and independent, and that his or her decisions and actions be motivated only by the best interests of the corporation and its stockholders.").

159. See generally Blasi et al., *supra* note 150 (containing empirical data pointing towards this conclusion).

160. See *id.*

### A. Registration

Registration of public offers and sales of securities by insiders is required under the Securities Act.<sup>161</sup> This is what was intended at the beginning of federal securities legislation, and pre-dates the SEC itself.<sup>162</sup> A corporate insider could always avail herself of the registration procedure prescribed by the Securities Act, in the case of a sale, in which case all the following proposals would no longer be applicable.

### B. Prior Notice

With respect to any transaction not involving a registration under the Securities Act, whether pursuant to Rule 144 or otherwise and whether a purchase or sale, prior notice would have to be filed with the SEC (rather than subsequent notice as now required under section 16(a) of the Exchange Act<sup>163</sup>). The notice would have to be filed electronically, be made immediately public and state the nature of the proposed transaction, the amount to be purchased or sold and the reasons for the transaction.<sup>164</sup> No trade could be made until 10 days after such filing. This would certainly make the price more efficient, and would thus address the concerns of those that would eliminate insider trading prohibitions. The only difference would be that the stockholders, rather than the employees of the stockholders, would be the beneficiaries of the

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161. See *supra* notes 30–31 and accompanying text.

162. See Securities and Exchange Commission, *The Laws That Govern the Securities Industry* (stating that the “Securities Act of 1933 requires that investors receive financial and other significant information concerning securities being offered for public sale,” that “a primary means of accomplishing [this goal] is the disclosure of important financial information through the registration of securities” and that the SEC itself was not created by Congress until the passage of the Securities Exchange Act of 1934), available at <http://www.sec.gov/about/laws.shtml#secact1933> (last modified Aug. 8, 2000).

163. 15 U.S.C. § 78p (2000).

164. See Press Release, Securities Exchange Commission, SEC to Propose New Corporate Disclosure Rules (Feb. 13, 2002) (outlining the current proposals to update and modify the public disclosure rules), available at <http://www.sec.gov/news/press/2002-22.txt> (last visited Apr. 9, 2002).

efficiency.

This proposal merely reverses the timing of the existing requirement<sup>165</sup> to make public the details of purchases and sales by corporate insiders. Prior notification allows the market to react prior to the transaction rather than subsequent to it. This reverses the advantage and restores the concept that the corporation, including all information about it, belongs properly to its owners, the stockholders, and not their employees.<sup>166</sup> The proposal goes further to underscore this proper relationship by requiring the corporate insider to state the reason for the sale. Balancing the equities, it seems that the employers, the stockholders, should know why a member of senior management is purchasing or selling securities of their company.

### C. Adjustment of Volume Limitation

Rule 144 volume limitations should not relate to the amount of securities outstanding or traded, but rather to the percentage of the ownership of the corporate insider. Outstanding securities of many public companies are so large in number and trading so voluminous that many corporate insiders can sell their entire holdings, totaling massive amounts of securities, and still be within Rule 144 volume limitations.<sup>167</sup> Under the suggested proposal, a corporate insider may not sell more than 10% of his holdings in any three-month period without the filing of a registration statement. Similar limitations on purchases may also be imposed, such as percentages of compensation.

Volume limitations were originally incorporated into Rule 144 to protect the market from large blocks being traded without the

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165. 15 U.S.C. § 78p.

166. See Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 308, 352-53 (1998) (discussing pre-trading disclosure).

167. See Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. LAW. 773, 800 (1992) (discussing the ability of an insider to sell securities without violating the volume limitations of Rule 144 if they fall within certain broad limitations).

benefit and protection of registration.<sup>168</sup> Certainly this has merit. But volume limitations can also be used to put the brakes on large unregistered sales by corporate insiders.<sup>169</sup> Rule 144 was meant as a convenience, to allow corporate insiders to easily sell small amounts of securities without having to go through the time and expense of a full registration. There is nothing wrong with this theory.<sup>170</sup> But Rule 144 should not be available as an alternative to full registration when the corporate insider is selling substantially all of her holdings. In that case, the stockholders, and the investing public, have a right to require full registration and all the protection that it affords. The offered proposal works to avoid massive sell offs that are below the current Rule 144 volume limitations by limiting the amount of securities that a corporate insider can sell at one time. In the case of purchases, similar volume limitation would serve to discourage massive buying in advance of advantageous news. This is important because each purchase by the employee is a sale by one of her employers, a stockholder. Central to this proposal is the conceptual basis that corporate information, good, bad or indifferent belongs to all the stockholders, not any one employee or group of employees.

#### D. Repeal Section 16b

Section 16(b) would have outlived its usefulness after adoption of the proposals outlined above, and should be repealed as no longer necessary and serving no legitimate purpose.<sup>171</sup> Short term buying and selling would no longer be a concern if there were

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168. See J. William Hicks, *The Concept of Transaction As a Restraint on Resale Limitations*, 49 OHIO ST. L.J. 417, 438 (1988).

169. See Fried, *supra* note 166, at 352-53 (claiming that although not explicitly aimed at insider trading, Rule 144 can reduce insider trading profits).

170. See Rutheford B. Campbell, Jr., *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 KY. L.J. 127, 156 (1985) (stating that Rule 144 was promulgated in order to correct the problems associated with common law public re-sales).

171. For an excellent analysis on section 16(b) and its repeal, see Michael H. Dessent, *Weapons to Fight Insider Trading in the 21st Century: A Call for the Repeal of Section 16(b)*, 33 AKRON L. REV. 481 (2000).

advance notice of purchases and sales and reasons were stated for all to consider. Likewise, it seems senseless to impose a section 16(b) restriction to sales that are the subject of a full registration process against purchases limited by volume and announced prior to execution.

## VII. CONCLUSION

Public trust must be earned, and once lost is difficult to recapture. In the dark days of 1933, it took fundamental changes in governmental involvement in the securities industry and sweeping legislation to restore investor confidence.<sup>172</sup> Perhaps the time has come to reconsider the relationship between a public corporation and its senior management when it comes to securities purchases and sales. The owners of a public corporation, its stockholders, have the responsibility to compensate its senior management fairly, and to grant incentives that unite the stockholders' interests in the company's profitability, growth and appreciation of value with the interests of senior management. This is in the stockholders own best interest. However, stockholders have the right to expect that senior management, once incentive-ized through stock ownership, will not disunite that commonality of interest by trading in these securities to the detriment of the stockholders. This happens, of course, when senior management trades before informing stockholders.

There can be no doubt that senior management has every right to realize gains on stock ownership. That is, after all, the point. But management should not profit at the expense of the other stockholders. The modest proposals outlined above address this tension and seek to once again level the playing field. The first proposal merely re-states the original statutory framework.<sup>173</sup> That is, that when corporate insiders wish to sell securities, they must register the sale with the SEC pursuant to section 5 of the

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172. For a good historical analysis of these changes, see JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 73-100 (Northeastern University Press 1995).

173. See *supra* Part VI.A.

Securities Act.<sup>174</sup> This brings with it all the protection that registration was designed to afford in the first place.<sup>175</sup> Surely there can be no disagreement that this ought to be the standard method of corporate insider sales to the public market. It was what was intended in the beginning. Rather than the exception, such registration should be the rule, literally, as well as figuratively.

The remaining proposals soften what has become an abuse of the simplified Rule 144 mechanism. Rule 144 was intended to allow small sales without cumbersome registration.<sup>176</sup> These proposals re-establish that principle.

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174. See *supra* note 28 and accompanying text.

175. See discussion *supra* Part II.

176. See *supra* note 170 and accompanying text.



## *Notes & Observations*