Envy and Outsider Trading: The Case of Martha Stewart

Jeanne L. Schroeder  
*Benjamin N. Cardozo School of Law, schroedr@yu.edu*
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I. CORPORATE IRRESPONSIBILITY

On March 5, 2004, Martha Stewart was convicted of four counts of obstruction of justice, lying to federal investigators, and conspiracy in connection with statements she made about her December 2001 sale of approximately 4,000 shares of ImClone Systems, Inc. stock. The trial and its aftermath generated a media storm second only to that of O.J. Simpson. Although many if not most news accounts dutifully repeated the fact that Stewart was not even charged, let alone convicted, of insider trading, they frequently referred to the event as the “Martha Stewart insider trading case” in tones implying that she was morally, if not legally, guilty of that offense as well.1

In fact, it is far from clear whether Stewart’s trades were unlawful, let alone illegal, and it is hard to identify any harm her acts directly caused anyone.2 Indeed, the only clear harm to date has been to Stewart personally and the shareholders of Martha Stewart Living Omnimedia which stock price has been buffeted by what might be false accusations against its eponymous founder. In early March 2003, Martha Stewart

* Professor of Law, the Benjamin N. Cardozo School of Law, Yeshiva University, New York City. I would like to thank those who commented on earlier versions of this paper delivered at the 2003 Law & Culture Annual Meeting and faculty seminars at the Boston University Law School, Brooklyn Law School, University of Miami Law School, and the Benjamin N. Cardozo School of Law. I would also like to thank Mara Davis for her research and editing assistance.

1 The Securities and Exchange Commission (SEC) has brought a civil insider trading case against Stewart. Although she has not done so at the time this Article went to press, it is widely speculated that she will settle these charges rather than risk another trial. See Deborah Solomon, Criminal Convictions of Stewart, Baconovic Aid SEC’s Civil Case, WALL ST. J., Mar. 8, 2004, at C1; Charles Gasparino, Martha in Charge?, NEWSWEEK ONLINE, Feb. 25, 2005, available at http://www.msnbc.msn.com/id/7018932/site/newsweek.

2 One ground of Stewart’s appeal from conviction is that because the judge improperly barred her counsel “from arguing that the ImClone trade was perfectly legal,” the jurors may have been confused and “were left to make inferences about the propriety of the trade.” Matthew Rose & Kara Scannell, Lawyers for Stewart, Baconovic Vow to Appeal, Defense Team Considers a Variety of Arguments for Another Court Battle, WALL ST. J., Mar. 8, 2004, at C4; see also Constance L. Hays, Appeal of Stewart Verdict Says Trial Was Full of Errors, N.Y. TIMES, Oct. 22, 2004, at C3.
Living Omnimedia announced its first ever quarterly losses, which it attributed largely to adverse publicity. As a result, the price of her own stock dropped so much that before her trial she reportedly suffered paper losses of approximately $200 million, and other losses aggregating about $400 million, an amount that dwarfs any losses she allegedly tried to save by trading ImClone. The price of Martha Stewart Omnimedia's stock dropped an additional 23 percent immediately upon the announcement of Stewart's conviction.

To state what should be obvious, Stewart is not an insider of ImClone and is, therefore, incapable of engaging in classic insider trading. Nor could she have breached any duty of confidence and engaged in the "outsider" trading under the more controversial "misappropriation theory." Moreover, to date, no facts have been made public that would support a claim that Stewart was a tippee of a classic insider. A prosecution of Stewart on insider trading charges would require a court to adopt a new interpretation of the law of both misappropriation and tipping far beyond existing precedents. Consequently, the Department of Justice (DOJ) was reduced, in effect, to arguing that it was illegal for her to lie about something that was not

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4 See W. Michael Cox, Markets Are Quick To Judge When Firms Fail To Behave, INVESTOR'S BUS. DAILY, Nov. 21, 2002, at A17. Plaintiff lawyers filed breach of fiduciary duty law suits against Stewart on the theory that she should have known that her "illegal" activities would adversely affect the price of Martha Stewart Omnimedia stock and "insider trading" actions against other insiders of Martha Stewart Omnimedia on the grounds that, when they sold their stock, they must have known that insider trading allegations would eventually be raised against Stewart thereby depressing the price of the company's stock. See infra note 8.

5 See Jeffrey Toobin, Lunch at Martha's; Problems with the Perfect Life, NEW YORKER, Feb. 3, 2003, at 38.

6 See Gregory Zuckerman, Martha: The Dayenne of Dilemmas: Fear is Media Buyers, Consumers Will Shy Away From Company, WALL ST. J., Mar. 8, 2004, at C1. Stewart's fortunes have been recovering. In what looks like a brilliant public relations move, she chose to serve her five month prison term pending her appeal. She is now scheduled to star in two new television series. See Martha Stewart to Star in New Apprentice, J. NEWS, Feb. 3, 2005, at 9A. The stock price of Martha Stewart Omnimedia rebounded to a high of approximately $32 immediately prior to her release from prison in early March 2005 from a low of almost $8 following her sentencing. See Gregory Zuckerman & James Bandler, Martha Stewart Living: No Bars, WALL ST. J., Mar. 3, 2001, at C1.

7 The DOJ's indictment did lay out alleged facts presumably designed to support an allegation that Peter Bacakovic, Stewart's friend, broker, and co-defendant, misappropriated the fact that Sam Waksel was trying to sell his ImClone stock from Bacakovic's employer, Merrill Lynch, in violation of a duty of confidentiality imposed by his employment agreement and that Stewart was Bacakovic's tippee. The indictment did not, however, expressly set forth these legal conclusions. This theory forms the heart of the SEC's civil action against Stewart. Stewart's lawyers unsuccessfully moved to have this section stricken from the indictment on the grounds that it is inflammatory and irrelevant given the fact that she has not been charged with insider trading. See Colleen DeBaise, Stewart Seeks Dismissal of Charges, WALL ST. J., Oct. 7, 2003, at C12.
illegal and that her protestations of innocence constituted the fraud upon
which she should be considered guilty.\footnote{The charge that Stewart's statements concerning her ImClone stock constituted fraud upon the shareholders of Martha Stewart Omnimedia was eventually thrown out by the trial judge. Timothy E. Hoeffner & Risa B. Greene, Prosecutors too Bold, NAT'L L.J., Apr. 12, 2004, at 43. However, similar accusations form the basis of a shareholders' suit against Martha Stewart Omnimedia. See supra note 4.} That is, rather than being accused of engaging in criminal insider trading, she has been accused of obstruction of justice and lying to the government in connection with its investigation of her trades. The SEC is seeking restitution from Stewart of the approximately $40,000 in avoided losses on the grounds that she was a tippee of her broker who "stole" the fact that insiders were selling their stock—a novel theory that goes far beyond any other application of the misappropriation theory to date.

In other words, to securities lawyers, the public reaction to the Stewart affair appears wholly out of proportion, particularly when compared to the obvious corporate improprieties of 2001. What percentage of the American public can even identify such figures as Jeffrey Skilling, Andrew Fastow,\footnote{Skilling and Fastow are the former Chief Executive Officer and Chief Financial Officer, respectively, of Enron. Fastow pled guilty to multiple charges of securities fraud. Perhaps more well known by the public is the former Chairman of Enron, Kenneth Lay, because of the nickname "Kenny Boy" given him by President George W. Bush. Lay and Skilling are to be prosecuted for securities fraud in 2006. See 3 Former Enron Executives Will Share a Trial, N.Y. TIMES, Oct. 20, 2004, at C3.} Dennis Kozlowski,\footnote{Kozlowski may have entered into the general public's collective consciousness because videos of the notorious toga party he threw for his wife on the island of Sardinia were played at his first trial, and were repeatedly aired on television news. Kozlowski was the former CEO of Tyco who is currently being retried in New York State for looting the company by causing the company to make and then forgive hundreds of millions of dollars of unapproved loans. Once again, press reaction reflected more envy than jealousy. Story after story concentrated on Kozlowski's ostentatious life style, which included the purchase of a $6,000 shower screen and a $15,000 umbrella stand. From the perspective of both securities and corporate law, such extravagance \textit{per se} is irrelevant. What is relevant is that he allegedly used corporate funds for this purpose without obtaining board approval or disclosing this remuneration to the public. Kozlowski is the subject of a \textit{New Yorker} magazine article by James Stewart which states that Kozlowski, "more than any other executive who had prospered in the great bull market of the nineties, came to personify an epoch of corporate fraud, executive greed, and personal extravagance." James B. Stewart, \textit{Spend! Spend! Spend!}, \textit{NEW YORKER}, Feb. 17 & 24, 2003, at 132. New York's first attempt to convict Kozlowski ended in a mistrial. Based on their negative experience in the first trial, the prosecutors are now avoiding appeals to envy and directing the jury's attention to the elements of the alleged crimes. See Andrew Ross Sorkin, Prosecutors Rewrite Script in New Trial of 2 at Tyco, N.Y. TIMES, Jan. 27, 2005, at C1.} John Rigas,\footnote{Rigas is the founder and former CEO of Adelphia who was convicted, along with one of his sons, of treating this public company as their personal bank account by embezzling hundreds of millions of dollars. See Barry Meier, \textit{Corporate Conduct: The Overview; 2 Guilty in Fraud at a Cable Giant}, N.Y. TIMES, July 9, 2004, at A1. The trial of a second son ended in mistrial. See Barry Meier, \textit{Michael Rigas Is Free for Now After Mistrial Is Declared}, N.Y. TIMES, July 10, 2004, at C1.} or Scott Sullivan\footnote{Sullivan is the former WorldCom Chief Financial Officer who oversaw $11 billion in fraudulent accounting. The eventual discovery of this fraud led to the filing of the largest}—to name but a few potential inductees to the Corporate
Hall of Shame? I would bet that few would even recognize the name of Sam Waksal, Stewart’s friend and former chief of ImClone who is now doing jail time for his clear and admitted violation of the insider trading rules.

I suggest that the public reaction to the Stewart “scandal” may not be so much righteous outrage, but the ignominious sin of envy—the pain one feels in seeing another experience joy. Envy is the mirror image of *schadenfreude*—the joy one feels in seeing another experience pain. In this essay I will use the Stewart episode as a jumping-off point for analyzing the two competing legal theories of unlawful securities trading on the basis of material non-public information: the so-called “classic” theory, and the controversial “misappropriation” theory—more accurately termed “outsider trading”—adopted by the U.S. Supreme Court in the case of *United States v. O’Hagan*. Although the misappropriation theory is widely criticized, I believe that no one, to date, has convincingly explained precisely why it seems so intuitively “wrong.”

I posit that the distinction between the ethics of classic insider trading and misappropriation precisely reflects the distinction between the two often confused—but distinct—passions of jealousy and envy. Although the terms are often incorrectly used interchangeably, jealousy is the fear and anger one feels when contemplating the possibility that a rival either may take, or has taken, that which one believes rightfully belongs to one. Envy, in contrast, is the anger and pain one feels in observing the good fortune of another.

Similarly, classic insider trading reflects the fear of investors in a public company that rivals—specifically the company’s management and other fiduciaries—might take what rightfully belongs to investors—non-public information *concerning and obtained from that company*. To be more precise, I posit that a prohibition on classic insider trading law should be seen as a rough corollary to the mandatory disclosure regime of the federal securities laws that can be seen as a Congressional decision that certain information about public companies “belongs” to the investment public generally.

The misappropriation theory concerns the trading in securities based on information received from a source other than the issuer of the securities. It is based neither on the principles of federal securities law nor state corporate law, but derives from state trade secret law policy.

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bankruptcy in U.S. history. Sullivan pled guilty to charges related to the accounting fraud and, was a star witness in the successful federal prosecution of former CFO Bernard Ebbers.

13 “Schadenfreude (joy at another’s suffering), [is] the inverse of envy (pain at another’s success) . . .” Jerome Neu, *Jealous Thoughts, in EXPLAINING EMOTIONS* 425, 433 (Amélie Oksenberg Rorty ed., 1980) [hereinafter EXPLAINING EMOTIONS].

This policy is, unfortunately, totally antithetical to securities law policy in that it reflects a state decision that the public, generally, has no right to certain information so long as it is kept secret. That is, federal securities law is about eliminating or reducing informational advantages with respect to one class of information, while state trade secret law is about protecting informational advantages with respect to another class of information.

The misappropriation theory, consequently, involves the resentment by the investment public that other persons have the good fortune to enjoy something to which the public has no right—non-public information obtained from third party sources who are the legally recognized owners of the information.

The ethical status of jealousy and envy are completely diverse. In jealousy one wants to protect what one has or believes one should have. In envy, one wants to destroy the possession of another. Jealousy is the assertion of one's own claim of possession. Envy is the wish to destroy the enjoyment of another whether or not it is rightful. Jealousy may not be an attractive emotion, but even God admits that He is jealous. Envy, however, is one of the seven deadly sins. Indeed, it is second only to pride in its potentially corruptive effect on the soul. As etymology reveals, envy—*invidia*—is the most invidious sin.

We need to remember, however, that sometimes even paranoids have real enemies. Perhaps it is also true that what first appears to be envy might, upon closer look, seem more like jealousy. That is, it might be the case that certain informational advantages that the law currently allocates to specific individuals should, for one policy reason or another, be allocated to the public. As Jerome Neu accurately says in his analysis of envy:

> That envy may be one reason for demanding equality does not mean that demands for equality are unjustified. . . . There are other reasons, most importantly reasons of justice, for demanding (certain forms of) equality. But from another perspective the real issue is whether envy must form an inevitable obstacle to attempts to achieve justice and/or equality.\(^\text{15}\)

In this Article, I propose an internally consistent analysis of insider trading law based on any given allocation of property rights in non-public information. I am not, however, offering an apologia for the status quo. I believe the current case law is, and is doomed to remain, hopelessly inadequate because the Supreme Court's interpretation of the federal securities laws requires the government to force the square peg of insider trading into the round hole of actual fraud. This inevitably causes ambiguities that create the opportunity for prosecutorial abuse—

\(^\text{15}\) Jerome Neu, *Jealous Thoughts*, in *EXPLAINING EMOTIONS*, supra note 13, at 435.
as l’affaire Stewart illustrates. I believe that Congress should address the appropriate allocation of informational advantages based on the competing policies underlying the federal securities laws and trade secret law, among other ethical, legal, economic, and political considerations.

This Article proceeds as follows. First, I analyze the distinction between envy and jealousy from theological, psychoanalytical and philosophic perspectives. I will then explain the two rival theories of unlawful trading on the basis of material non-public information. Finally, I apply this analysis to insider trading law to explain that the misappropriation theory is incoherent and internally inconsistent because it attempts to piggy-back insider trading law on trade secret principles. The principles underlying these two different fields of law are logically antithetical.

The prohibition against insider trading implicitly reflects a Congressional determination that investors in a public company have a beneficial interest in material non-public information about, and in the possession of, that company. It reflects a rare egalitarian moment within our generally individualistic, libertarian property regime. The public is, therefore, rightfully jealous if a traditional insider of a public company having privileged access to this type of information were to exploit it for her own advantage without sharing it with the public. In contrast, trade secret law is premised on the determination that the right to control and commercially exploit certain other categories of information resides exclusively in specific individuals and that the public generally has no such rights—it is fundamentally individualistic and monopolistic. For the government to assert that the investment public is defrauded when this information is used to trade in securities reflects envy.

II. ENVY AND JEALOUSY

A. Martha, Martha, Martha!

After I admired the silver chopsticks that had been set out, Stewart said, “You know, in China they say, ‘The thinner the chopsticks, the higher the social status.’ Of course, I got the thinnest I could find.” After a pause, she added, “That’s why people hate me.”

The causes of the fracas about Martha Stewart are no doubt over-determined, involving among other things the misogyny of the public towards powerful women generally, Stewart’s carefully developed, but

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16 Toobin, supra note 5, at 39.
annoyingly smug perfectionist public image specifically, as well as widespread public misunderstanding that all trading based on non-public information or secret tips is generally unlawful. I argue that it also illustrates that envy is a strong component of “outsider” trading law. Stewart’s image inspires admiration, as well as ridicule and backbiting. As stated in an article on CNN.com concerning the effect of the insider trading allegations on Stewart’s public image:

The public has long had a love-hate relationship with Stewart. She is widely admired for her design and business acumen even as she’s disparaged for her perfectionist impulses and sheer omnipresence. Indeed, the infuriating thing about Stewart is that, although she presents each of her suggested projects as eminently doable, it would be inconceivable to accomplish all of the projects suggested in even any one-hour show. That is, she inspires guilt because she presents her world as being both possible and impossible for anyone except her. As stated in a Washington Post article, Stewart’s ostensible message is always “You can be just like me.” Her implicit message, however, is “Dream on!” I have to admit, that for all my feminist pretensions, she makes me green with envy.

Consequently, the press typically describe this successful entrepreneur, publisher, television personality, and former CEO of a New York Stock Exchange-listed corporation by such condescending terms as “homemaking,” “domestic” or “lifestyle” “queen,” “guru,” or “diva.” But, how could she complain when this is precisely the image she has promoted?

As argued in a Wall Street Journal piece appearing the first trading day after the conviction:

The culture demands scapegoats after periods of excess. So prosecutors—and a convinced jury—made an example of Martha Stewart. The trial, of course, had nothing to do with individual investors losing money. Instead, it was about how Ms. Stewart and her brokers dealt with prosecutors, who were legitimately demanding honesty. Nevertheless, [a juror’s] comments perfectly capture a general sense of outrage. Martha, by dint of her famous persona, seems to have been convicted, in part, of Trading While Rich.


Image Coming Under Attack, supra note 18.


Cox, supra note 4, at A17.
B. The Passions Defined

It is my thesis that the confused analysis that treats misappropriation or “outsider trading” as equivalent to classic “insider trading” reflects the common conflation of envy and jealousy. Although the two passions overlap, they are analytically distinct. Most importantly, the ethical dimensions of the two are completely diverse. Since at least the sixth century when St. Gregory the Great added it to his list, envy has been considered one of the seven deadly sins—-not merely a wrongful act, but a disposition that corrupts the soul and serves as the occasion of additional sins. Ethics suggests that we should, therefore, distinguish between the two. According to both theology and psychoanalytic theory, the difficulty in isolating envy from jealousy lies in the fact that envy, albeit radically evil, lies at the heart of human nature.

1. Envy as Deadly Sin

St. Augustine famously argued in his Confessions that the presence of envy in the heart of even the youngest children was evidence of the universality of Original Sin. He called envy “the diabolical sin.” This concept builds on St. Paul’s statement in the First Letter to the Corinthians that “Love envieth not.”

The Catholic Catechism identifies envy, along with avarice, as the concern of the tenth, and final Commandment—thou shalt not covet thy neighbor’s property. According to the United States Conference of Catholic Bishops: “The tenth commandment concerns the intentions of the heart;...it summarizes all the precepts of the Law.”

The term “envy” is often used to denote a feeling of ill will toward a person for his position, wealth, or dignity. However, envy is more than just a feeling; it is a disordered desire that can lead to tragic consequences. Envy is a powerful emotion that can drive people to commit acts of sabotage, theft, or even murder. The study of envy has been of great interest to philosophers, psychologists, and theologians for centuries.


25 Neu holds out the hope that there can be admiring envy as well as malicious envy. “In the case of admiring envy, one wishes to raise oneself (to become like the other).” Jerome Neu, Jealous Thoughts, in EXPLAINING EMOTIONS, supra note 13, at 434. I do not believe that this form of admiration accurately fits within the category of envy. As even Neu admits, what he calls admiring envy “may have different instinctual sources and developmental paths” than malicious envy. Id.

26 See infra text at notes 57-60.

27 St. Augustine, De catechizandis rudibus.


[The sadness at the sight of another’s goods and the immoderate desire to acquire them for oneself, even unjustly. When it wishes grave harm to a neighbor it is a mortal sin . . .

Envy represents a form of sadness and therefore a refusal of charity.30

Envy is both ethically and “historically” the second deadly sin, next only to pride.31 According to a standard interpretation of the Bible the first sin in the universe was Lucifer’s pride that led him to lead the revolt of the rebel angels against God. The second sin was Lucifer’s envy of Adam and Eve. Driven to destroy their happiness, Lucifer, in the form of the serpent, appealed to their pride—the first human sin—and seduced them into disobedience. That is, the serpent convinced Eve that if she ate of the Tree of the Knowledge of Good and Evil, she would become like God. This led, once again, to envy as the second human sin when Cain, infuriated by his envy at Abel’s good fortune, killed his brother. Consequently, the Bible states that “by the envy of the Devil, death entered into the world, and who are of his portion make trial thereof.”32

In the twentieth century, psychoanalysts Sigmund Freud and Jacques Lacan seized on this tradition to make envy central to psychoanalytic theory. Lacan’s followers have argued that envy is not merely an individual sin, but the source of racism, anti-semitism, terrorism, and the other horrors of contemporary life. Melanie Klein based a large part on her psychoanalytic theory on the concept of envy, which she describes as “the angry feeling that another person possesses and enjoys something desirable—the envious impulse being to take it away or to spoil it.”33 She contrasts it to its opposite, “gratitude.”34 She offers a psychoanalytic reason “why envy ranks among the seven ‘deadly sins’” and “suggest[s] that it is unconsciously felt to be the greatest sin of all, because it spoils and harms the good object which is the source of life.”35

Envy is a particularly cancerous sin in that its goal is nothing but the destruction of the good. In Chaucer’s words, “[i]t is the worst of sins as it sets itself against all other virtues and goodness . . .”36 As the Ulanovs explain:

30 Id. ¶ 2539-40.
31 See Ashwin, supra note 24.
34 Id. at 186-88.
35 Id. at 189.
At first glance, envy seems to differ from other sins because they each point to a goal in itself not evil, except when indulged to excess. Gluttony is hunger gone wild, for example. Lust is sexual desire run rampant. Anger is self-assertion enraged. In contrast, envy presents itself as feeling demeaned by another’s good fortune and wanting to belittle the other’s good to protect oneself. Envy wants to make something alive into something dead.37

2. Jealousy and Theft of Property

Jealousy is the fear and anger one feels that a rival will steal away that which is rightfully hers. Envy is the rancor and bitterness one feels when observing the good fortune of another. As Mary Ashwin describes it:

[E]nvvy comes from the Latin invidere: to look upon maliciously. . . . It is the feeling of mortification when we contemplate another’s advantages; it is the need to spitefully criticize and denigrate; it is the fear that others are getting more than their fair share.38

She continues:

Jealousy is the affect in a triangular situation when a person fears that something that they believe belongs to them has been or is about to be taken away. Essentially the difference between envy and jealousy is that envy is between two objects; jealousy between three.39

Klein describes the distinction as follows:

[E]nvvy implies the subject’s relation to one person only. . . . Jealousy is based on envy, but involves a relation to at least two people; it is mainly concerned with love that the subject feels is his due and has been taken away, or is in danger of being taken away, from him by his rival.40

In Neu’s words:

Jealousy is typically over what one possesses and fears to lose, while envy may be over something one has never possessed and may never hope to possess. Going with this, the focus of envy is typically the other person, rather than the particular thing or quality one is envious over (a thing that may not in itself even be desirable to the envier, whatever its perceived value to the present possessor).41

38 Ashwin, supra note 24.
39 Id.
40 KLEIN, supra note 33, at 181.
41 Jerome Neu, Jealous Thoughts, in EXPLAINING EMOTIONS, supra note 13, at 432-33.
In other words, the difference between jealousy and envy is that the former is triangular while the latter is bilateral. That is, the jealous party is concerned to protect or obtain the possession of an object of desire to the exclusion of a real or imagined rival. The jealous is concerned with insuring her own jouissance—a technical psychoanalytic term that for our limited purposes can be somewhat inaccurately translated as “enjoyment.” In contrast, the envious is concerned with preventing or destroying the jouissance of the other. The envious does not so much want to obtain, possess, or enjoy the object of desire for its own sake. Rather, the envious just wants to destroy the rival’s excess enjoyment in her object by taking it away or destroying it.

The difference between jealousy and envy is illustrated in Freud’s interpretation of the story of the judgment of Solomon. As is well known, it is recounted in the book of Kings that two prostitutes living together, perhaps in the same brothel, gave birth to boys within days of each other. One of the women came to Solomon alleging that the child of the other woman died “because she lay on it.” The mother of the dead boy took its corpse and laid it by the side of the plaintiff while stealing the living child and placing it in the defendant’s bed. “When I arose in the morning to nurse my child, behold, it was dead; but when I looked at it closely in the morning, behold, it was not the child I had borne.” Solomon, of course, ordered:

“Divide the child in two, and give half to the one, and half to the other.” Then the woman whose son was alive said to the king, because her heart yearned for her son, “Oh, my lord, give her the living child, and by no means slay it.” But the other said, “It shall be neither mine nor yours; divide it.” The king answered and said, “Give the living child to the first woman, and by no means slay it; she is its mother.” And all Israel heard of the judgment which the king had rendered; and they stood in awe of the king, because they perceived that the wisdom of God was in him, to render justice.

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42 Neu maintains that “[j]ealousy is typically over people, while envy extends to things and qualities.” Id. at 433. As a Hegelian, I find this analysis to be backwards, and argue that jealousy applies more appropriately to things. Indeed, when a person is the object of jealousy, this means precisely that the jealous treats the person who is the object of his desire as precisely that—an object. In other words, Neu believes that jealousy with respect to things is the treatment of objects as such, whereas I believe that jealousy with respect to people is the treatment of subjects as objects.

43 They “dwell[ed] in the same house.” 1 Kings 3:16.

44 Id. Today, we would probably assume that the unfortunate infant succumbed to Sudden Infant Death Syndrome. Traditionally however, it was assumed that the infant was smothered because his whoreson mother rolled over him while in a drunken stupor or while entertaining a client. This was how this story was told to me in Sunday school.

45 Id. at 3:21.

46 Id. at 3:25-28.
Solomon is extolled for his wisdom in identifying the true mother by her concern for the child. A supposedly more sophisticated version of this is that Solomon wisely identified, not necessarily the biological parent of the child, but the woman who would be a better parent.47

Freud correctly points out the fallaciousness of this interpretation.48 The fact that the plaintiff tried to protect the innocent child neither proved that she was his mother nor that she was even benevolent. All it showed was that she was not psychotic.

Rather, Solomon’s wisdom lay in his identification of which woman was more likely to harm the child in the future. Solomon was, in effect, testing the truth of the plaintiff’s accusation. The only possible explanation for the behavior charged by the plaintiff was that the defendant was envious to the point of madness. A woman who would steal the child of another could not be driven by jealousy. She could not fear losing her own son—this had already happened—and no one else’s child could be a substitute for the uniqueness of an individual who had been lost. Rather, bereft of the joys of motherhood, the defendant could not bear to see the plaintiff’s joy. The defendant stole the living child not so that she would have him, but so that the plaintiff would not. Solomon understood that ordering the death of the living child would reveal the true jouissance of the defendant. And indeed, the defendant’s enjoyment was in destruction—envy. In contrast, the jouissance of a “true” mother would be the love of her child. She might be expected to be jealous—frantic that that which by right belonged to her (her child) might be taken by a rival—but her love should overcome this jealousy if she thought that the alternative was losing her child through death.

Envy is always sinful. In contrast, jealousy can be either rightful or wrongful. For example, Yahweh correctly describes His passion as jealousy, not envy. By definition, God’s passions are righteous. The all powerful, all confident Yahweh could not conceivably be envious of Baal and the other false gods. And yet, He can fear that His chosen, but weak, people might be seduced away by the idols. The history recounted by the Bible suggests that this fear was frequently justified.49

47 In recent times, Ian Ayres and Eric Talley have suggested an egregiously incorrect interpretation of this story. See Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 YALE L.J. 1027 (1995).
49 For example, Solomon, because of the love of his “many foreign woman . . . seven hundred wives, princesses, and three hundred concubines . . . turned away his heart after other gods; and his heart was not wholly true to the Lord his God . . . .” 1 Kings 11:1-5.
Jealousy can be wrong if it is unjustified or misplaced. An example of the former is the jealous spouse irrationally fears that his faithful spouse will betray him. The classic illustration of the distinction between wrongful jealousy and envy is the contrast between Othello and Iago—the envious Iago is evil, the jealous Othello merely tragic. Many misogynist practices—such as purdah—are the institutionalization of unjustified jealousy.

When it is misplaced, the jealous party may have no rightful claim to the object to desire. The phenomenon of stalking is a frightening example of wrongful jealousy—the stalker fears the “loss” of the beloved who, in fact, never was his. Moreover, stalking is the point where wrongful jealousy threatens to pass over to envy—as when Othello strangles Desdemona.

C. Psychoanalysis

Envy plays a central role in the psychoanalytic tradition associated with Freud. Freud’s theory of the role of penis envy in the feminine psyche is notorious. His followers take a more radical position. For example, without denying Freud’s account of penis envy in the oedipal stage of development, Klein argues that envy is an essential constitutional basis of all personality, masculine and feminine, that arises much earlier in the infant’s development and derives from the child’s empirical experience of the maternal breast (or substitute). It is “operative from the beginning of life.” Lacan takes Freud’s analysis of envy to an even higher, philosophic level.

I find Freud and Klein’s accounts of the origins unsatisfactory because they claim to be empirical and, therefore, deterministic. Lacan’s account, in contrast, is theoretical and retrospective. That is, Freud seems to believe that children go through a stage in their lives when they literally wish to have sex with their mothers and kill their fathers. Girls literally are so impressed with the sight of a penis that they feel lacking the rest of their lives. Lacan, in contrast, states that “the Oedipus complex is Freud’s dream. Like all dreams it needs to be interpreted.” Indeed, according to Lacan, even Oedipus did not have an Oedipal complex.
Similarly, Klein’s object psychology is based on the proposition that from the time of birth children literally form relationships based on the mother’s breast. She quoted approvingly Freud’s analogy of psychoanalysis to archeology:

His [the psycho-analyst’s] work of construction, or, if it is preferred, of reconstruction, resembles to a great extent an archaeologist’s excavation of some dwelling-place that has been destroyed and buried or of some ancient edifice. The two processes are in fact identical, except that the analyst works under better conditions and has more material at his command to assist him, since what he is dealing with is not something destroyed but something that is still alive—and perhaps for another reason as well. But just as the archaeologist builds up the walls of the building from the foundations that have remained standing, determines the number and position of the columns from depressions in the floor and reconstructs the mural decorations and paintings from the remains found in the debris, so does the analyst proceed when he draws his inferences from . . . the behaviour of the subject of the analysis.54

The advantage to this approach is also its disadvantage—it arguably makes their theories falsifiable. If one studied infants and could show that they did not literally go through these stages, then the theories would be disproved.

Lacan, in contrast, works not only within the psychoanalytic tradition but also within the speculative philosophical tradition that is based on a study of human freedom.55 Consequently, he seeks to eliminate any remaining biological determinism from Freud’s theory. He seeks not to recover the child who once was, but to help the adult understand the person she is now. Lacan, following Hegel and Kant, posits that if the subject is essentially free, it is because subjectivity is nothing but a radical negativity. That is, the subject is subjected to no boundaries only because it has no positive characteristics. The Oedipal romance is, in a Lacanian reading, a sort of false-autobiography that we retroactively tell ourselves in order to explain, and give affirmative content to, our essential emptiness. Its very determinism is comforting not only because it seems to explain the modern subject’s feeling of alienation, but also because it places the blame for her condition elsewhere. As I shall explain in the next section, envy is one possible reaction that a subject can have when she is forced to confront her constituent negativity.

54 KLEIN, supra note 33, at 177-78 (quoting SIGMUND FREUD, CONSTRUCTIONS IN ANALYSIS (1937)).
55 I explain this at length in Jeanne L. Schroeder, The Stumbling Block: Freedom, Rationality and Legal Scholarship, 44 WM. & MARY L. REV. 263 (2002), and shall give only an abbreviated account of Lacan’s theory in the immediately following section.
The centrality of envy in Lacan’s psychoanalytic theory can be seen in his repeated references to a passage in the *Confessions* of St. Augustine. As noted, St. Augustine answered the critics of the doctrine of original sin who maintained a romantic belief in the innocence of children with the following anecdote. “I myself have seen and known even a baby envious; it could not speak, yet it turned pale and looked bitterly on its foster-brother.” Lacan explains how the passion identified by Augustine, which is sometimes translated as “jealousy,” is more correctly understood as “envy.” Lacan points out that the word envy, the Latin “*invidia*” comes, in turn, from *videre*—to see. It is the passion felt in seeing the enjoyment of the other.

In order to understand what *invidia* is in its function as gaze it must not be confused with jealousy. What the small child, or whoever, envies is not at all necessarily what he might want—*avoir envie*, as one improperly puts it. Who can say that the child who looks at his younger brother still needs to be at the breast? Everyone knows that envy is usually aroused by the possession of goods which would be of no use to the person who is envious of them, and about the true nature of which he does not have the least idea.

That is, Augustine’s point is not that the child jealously fears the loss of the maternal breast. The bitter child has already been weaned and is well-fed. Rather, it is the very sight of his brother’s enjoyment that fills him with envy. Consequently, he does not want to regain the breast, just to take it away from his hated little brother. This is sin.

Lacan agrees with Augustine that envy needs to be guarded against because it leads not only to personal and social evils, but also because it is constitutive of personality itself and, therefore, particularly invidious. A full account of Lacanian theory is far beyond the scope of this Article. For our purposes suffice it to say that Lacan goes beyond Freud’s theory of penis envy and Klein’s theory of breast envy, with their lingering aura of crude biological determinism. Lacan posits that


57 “Vidi ego et expertus sum zelantem parvulum, non dum loquebatur, et intuebatur pallidus amaro aspectu contactaneum suum.” THE CONFESSIONS OF ST. AUGUSTINE 11 (Edward B. Pusey trans. & Charles W. Eliot eds., 1909). In this passage, rather than using the more common “*invidere*,” Augustine uses the relatively unusual word “*zelantem*” which some other translators have rendered as “jealousy.” See, e.g., Barzilai, supra note 56. As Lacan’s analysis explains, the immediately following text explains that Augustine is referring to the passion that I am calling envy, not jealousy.


59 *Id.*
the very initiation of the subject into the symbolic realm of language, law and sexuality "splits" the subject leaving her with an insatiable feeling of lack. Or, more accurately, as I have said elsewhere, the "subject is split" is not so much a description but a definition—subjectivity is nothing but an internal, constituent emptiness or splitting.

To oversimplify, following Hegel, Lacan thought that subjectivity could only be created through intersubjective relationships with others—what he called the symbolic order of the big Other. The subject is nothing but this hollow shell that gains content from the outside. Consequently, one's most intimate self lies external to oneself. Lacan coined the neologism "extimacy" to describe the uncanny sense of one's own self-alienation. This constitutive lack appears even more negative when one realizes that the Other who gives the subject content also "does not exist." That is, the intersubjective order of the symbolic has no pre-existing, objective, and permanent essence but consists merely of a contingent, intersubjective, and temporary appearance of specific, fleeting social relations among a community of split subjects.

Lacan will eventually combine his insight that the subject is split, and that the Other does not exist, to formulate his single most controversial slogan "Woman does not exist." Although frequently dismissed as misogyny, Lacan's statement is more correctly interpreted as a statement of the human condition. To Lacan, true subjectivity is


64 Miller, supra note 63, at 81.

feminine in nature—the feminine is the part of personality that internalizes the fact of her own negativity. The masculine is the part that denies the truth. Or, to paraphrase Lacanian philosopher Slavoj Žižek, a man is a woman who thinks she exists.

The subject seeks an explanation of her sense of lack by formulating a retroactive account (an abduction or retroduction) of what must have happened. One way she does this is by identifying her lack of enjoyment (completion) with the excess enjoyment of someone else. She obsesses on the other’s enjoyment and concludes that not only does the other enjoy, he does so excessively while she, in contrast, is lacking. She speculates that the reason why she lacks enjoyment and the other enjoys too much must be that the other has stolen her enjoyment. In Žižek’s words:

What we conceal by imputing to the Other the theft of enjoyment is the traumatic fact that we never possessed what was allegedly stolen from us: the lack ("castration") is originary, enjoyment constitutes itself as "stolen," or, to quote Hegel’s precise formulation from his Science of Logic, it “only comes to be through being left behind.”

This is a false autobiography. Through this self-serving account, the subject tries to disguise her sinful envy as righteous jealousy—thereby shifting the blame from herself to the "thieving" other. This is both sinful and unjust.

Lacanians have extended and applied Lacan’s theory of excess enjoyment to the political field. We associate the other who has excess enjoyment with other groups with which we are proximate. We concentrate on the difference in the way the other, with his strange customs, enjoys. For example, Jacques-Alain Miller, Lacan’s son-in-law and editor, states:

Now, what we are attempting to see is what makes the Other other, that is, what makes it particular, different, and in this dimension of alterity of the Other, we find war. Racism, for example, is precisely a question of the relation to an Other as such, conceived in its difference. And it does not seem to me that any of the generous and universal discourses on the theme of “we are all fellow beings” have had any effectiveness concerning this question. Why? Because racism calls into play a hatred that is directed precisely toward what grounds the Other’s alterity, in other words, its jouissance. If no decision, no will, no amount of reasoning is sufficient to wipe out racism, this is indeed because it is founded on the point of extimacy of the Other.

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66 See SCHROEDER, THE VESTAL, supra note 60, at 328-29.
It is not simply a matter of an imaginary aggressivity that, itself, is directed at fellow beings. Racism is founded on what one imagines about the Other’s *jouissance*; it is hatred of the particular way, of the Other’s own way, of experiencing *jouissance*... However, what is really at stake is that he takes his *jouissance* in a way different from ours. Thus the Other’s proximity exacerbates racism: as soon as there is closeness, there is a confrontation of incompatible modes of *jouissance*. For it is simple to love one’s neighbor when he is distant, but it is a different matter in proximity.

Racist stories are always about the way in which the Other obtains a *plus-de-jouir*: either he does not work or he does not work enough, or he is useless or a little too useful, but whatever the case may be, he is always endowed with a part of *jouissance* that he does not deserve. Thus true intolerance is the intolerance of the Other’s *jouissance*.69

As Lacan says (in explanation of Augustine’s anecdote):

Such is true envy—the envy that makes the subject pale before the image of a completeness closed upon itself, before the idea that the *petit a*, the separated *a* from which he is hanging, may be for another the possession that gives satisfaction...70

Note that the theory of the relationship between the theory of excess enjoyment and racism lies precisely at the moment at which jealousy passes into envy—or, more accurately, when the guilty subject tries to disguise her sinful and deceitful envy as righteous jealousy. The subject pretends to be jealous—she tries to insist that the reason she is angry is because the Other has taken away that which is rightfully hers. But in her heart, she knows that her lack is constituent and is not caused by the absence of any specific thing. Consequently, what she really feels is envy. She is incensed at the supposed enjoyment of the Other in which she cannot participate.

All she can do, therefore, is try to destroy the other’s enjoyment. Unfortunately, because the subject identifies the other’s enjoyment with the other’s alterity (i.e., whatever it is that distinguishes the other from the subject) destruction of the other’s enjoyment requires the destruction of the other. Accordingly, in Lacan’s late seminar, *Encore*, Lacan invents the neo-logism “*jealouissance*” for the envy of the excess enjoyment (*jouissance*) of the other first identified by Augustine.71 Historically, as demonstrated in such examples of Lynch mobs, the Holocaust, the Serbian wars and, today, Islamacism and, perhaps, President Bush’s invocation to the “Axis of Evil,” this impulse becomes literal as political reality.

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69 Miller, supra note 63, at 79-80.
70 LACAN, supra note 58, at 116.
71 See LACAN, supra note 65, at 100.
E. Law

Freud identified envy as the source of our sense of social justice. "If one cannot be the favourite oneself, at all events nobody else shall be the favourite." But Freud thinks that humans are not naturally herd animals with benevolent social instincts. Liberal legal theory, as well as Lacanian psychoanalysis, suggests that the matter is more complicated. Social justice requires that we distinguish righteous jealousy from destructive envy—we must not merely claim property rights for ourselves, we must respect the property of others. As I have already quoted: "That envy may be one reason for demanding equality does not mean that demands for equality are unjustified."

Although I base my legal theory on the super-liberalism of Hegel, this is equally true of classic liberal theory associated with Locke. To Locke property is a natural right that pre-exists society. Under this interpretation liberalism requires that we respect property rights. This means that appropriate jealousy—the protection of valid property rights—is necessary even as envy—the desire to destroy the property rights of others—must be prohibited.

To Hegel, property and liberal society are self-constituting—property is created by liberal society, but liberal society logically requires property as its cornerstone. This can be seen as a fundamental principle of Hegel's philosophy of right. To Hegel, the abstract individual posited by classical liberalism is too frail a creature to act as a subject—a creature capable of bearing rights and interacting in the symbolic order of society. Related to this, he thinks that subjectivity could not exist in the state of nature posited by liberalism because one can only be a subject insofar as one is recognized as such by another subject. Consequently, the person seeking subjectivity must first seek to give other persons the status and dignity of

72 Freud, supra note 48, at 119-20.
73 See id.
74 See supra text at note 15.
76 Neu maintains that "the notion of 'possession' should not mislead us into thinking that what is at stake is property rights. What is at stake is the self, is an individual's identity." Jerome Neu, Jealous Thoughts, in EXPLAINING EMOTIONS, supra note 13, at 448. A Hegelian would agree with the second point, that jealousy concerns the establishment of identity (or what I call subjectivity) but disagree with the assertion that jealousy does not involve property. To a Hegelian, property is nothing but a moment in the creation of subjectivity.
77 See SCHROEDER, THE VESTAL, supra note 60, at 24; Schroeder, Pandora's Amphora, supra note 62, at 861-64.
78 See Schroeder, Pandora's Amphora, supra note 62, at 862.
79 As Michel Rosenfeld says, according to Hegel "self-consciousness can only achieve satisfaction in another self-consciousness." Michel Rosenfeld, Hegel and the Dialectics of Contract, 10 CARDOZO L. REV. 1199, 1221 (1989).
subjectivity—that is, subjectivity requires mutual recognition. For reasons that are beyond the scope of this Article, Hegel argues that the most basic and primitive regime of mutual recognition is the private law of property and contract. This means that subjectivity does not so much require that each individual claim and protect her own property rights. Rather, she must first grant and respect the property rights of others as a step in granting others the status of subjectivity.

As already introduced, Lacan, following Hegel, believes that even as the subject is alienated and envious, she is also essentially social—her subjectivity is created by, and only exists within, intersubjective relationships with other subjects in the symbolic order (the big Other). As Hegel argues, in the modern liberal Constitutional state, this intersubjective order is sustained by a regime of property—the possession, enjoyment, and exchange of actual and imaginary objects of enjoyment. Consequently, although the subject may on the one hand want to destroy the possession and enjoyment of the other, on the other hand she requires the existence of a property regime that allocates objects among subjects. In this sense, jealousy is as important to her constitution as envy. Jealousy is necessary in that it helps maintain the intersubjective regime of property. Envy, in contrast, is self-contradictory in that it threatens to destroy the regime of property that is necessary for the subject’s self-constitution.

This does not mean that society should necessarily respect any and all claims to property or that we should perpetuate the status quo of wealth and property distribution. The question is, how do we tell the difference between rightful and wrongful jealous claims to property, and between rightful jealous claims to property, and wrongful envious desires to destroy the property of others? Hegel argues that a property regime is a necessary and appropriate element of the modern liberal state, but he offers no advice as to what specific allocation of property is

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A person, in distinguishing himself from himself, relates himself to another person, and indeed it is only as owners of property that the two [persons] have existence ... for each other. Their identity in themselves acquires existence ... through the transference of the property of the one to the other by common will and with due respect of the rights of both—that is, by contract.

Id. Consequently, Hegel believes that only the “most uncultured,” “stubborn,” and “emotionally limited” people “insist most strongly on their rights.” Id. at 69. I explain this dialectic in Schroeder, Pandora’s Amphora, supra note 62, at 873-82; SCHROEDER, THE VESTAL, supra note 60, at 49-52.

81 See supra text at notes 62-64.

82 This is the subject of the first section of Philosophy of Right. I explain Hegel’s argument in SCHROEDER, THE VESTAL, supra note 60, at 15-52 and Schroeder, Pandora’s Amphora, supra note 62, at 864-70.
correct. He leaves this, as he does with all policy decisions, to pragmatic reasoning and positive law.

We can now return to the law of insider trading.

III. INSIDER TRADING

A. Fraud

Disputes arise over the proper scope of prohibitions against securities trading on the basis of material non-public information because of the simple, albeit surprising, fact that the federal securities laws neither define, nor expressly prohibit, "insider trading." Consequently, in the absence of Congressional action, if the SEC, the DOJ, plaintiffs, and the courts believe that trading on the basis of material non-public information should be unlawful, they must imply appropriate rules from the general language and policy of the statutes, combined with case law developed under the very different legal regimes of state corporate and trade secrets law. Indeed, this is the single most disturbing aspect of insider trading law—it is essentially a common law federal crime. This jurisprudential objection is beyond the scope of the specific argument of this Article, although it obviously informs it.

Both proponents and opponents of prohibitions on insider trading base their arguments on policies that they wished the law would follow, rather than on policies that the statute actually reflects. To


85 In Hegel's famous formulation from the introduction to Philosophy of Right, because his logic is retroactive in nature, philosophy always comes "too late" to give policy advice. HEGEL, supra note 80, at 23; see Schroeder, The Stumbling Block, supra note 55, at 323-25.

86 In 1984 and 1988, Congress amended the 1934 Act by adding provisions imposing civil liabilities on, and providing for a private right of action for persons trading contemporaneously with "any person who has violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security ... while in possession of material, non-public information in, or has violated any such provision by communicating such information." 15 U.S.C. §§ 78t-1, 78u-1 (2000). Although this language reflects Congress's agreement that some forms of insider trading should be restricted, this legislation begs the question of exactly what forms should be restricted.
oversimplify, proponents of rules against insider trading tend to base their objections on the intuition that it is immoral, unfair, or, as expressed in the title of Kim Sheppele’s classic article, It’s Just Not Right. Critics and opponents of prohibitions on insider trading tend to rely on an economic analysis of law that seeks to promote efficient securities markets. The problem with both approaches is that neither of the two primary securities acts—the Securities Act of 1933 (the “1933 Act”) and the Securities Exchange Act of 1934 (the “1934 Act”)—contain any language expressly imposing either fairness or efficiency criteria with respect to the issuers of securities and their affiliates. Consequently, while arguments made on fairness or efficiency grounds may be of great academic interest and would be relevant if Congress were considering a major overhaul of the

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90 Section 2 of the 1934 Act lists among the many reasons why regulation of the securities markets falls within the federal jurisdiction granted by the Commerce Clause of the U.S. Constitution the need “to insure the maintenance of fair and honest markets” and the fact that manipulation may “prevent the fair valuation of collateral for bank loans.” 15 U.S.C. § 78b (2000). None of the substantive provisions of that Act applicable to issuers or their control persons, however, contains any express fairness standard.

This is in striking contrast to state corporate laws which, by statute or common law, impose substantive fiduciary duties of loyalty and due care on corporate insiders and frequently apply standards of fundamental fairness to corporate and insider behavior.
regulatory regime, they are of less interest to the judge or lawyer who is trying to interpret the existing statutes. In contrast, in this Article, I try to analyze insider trading within the statutory policy of mandatory disclosure of certain types of information by certain classes of legal actors.

The Acts require issuers and certain other persons to make disclosures and file forms with the SEC on certain occasions. The Acts frequently impose liability on issuers and certain others for material misstatements and certain material omissions. The Acts also include general prohibitions against fraud and manipulation. Consequently, whether or not certain forms of trading on the basis of material non-public information should be prohibited because they are unfair, or permitted because they are efficient, the proponents of these positions must word their arguments within language that either mandates disclosure or prohibits fraud and manipulation. Indeed, most of the last thirty years of insider trading case law can arguably be characterized as an attempt by the Supreme Court to rein in the attempts by the SEC and the lower federal courts to ground insider trading jurisprudence in non-statutory fairness considerations. This history is well known among securities lawyers and I shall only give an abbreviated account in this Article.

1. Fairness

The catch-all anti-fraud provision of the federal securities laws is §10(b) of the 1934 Act which makes it unlawful for a person to use the jurisdictional means “to use or employ, in connection with the purchase or sale of any security... any manipulative or deceptive device or contrivance in contravention of such rules and the regulations

91 For example, § 11 of the 1933 Act allows purchasers of securities sold pursuant to materially misleading registration statements to recover the purchase price from the issuer, its directors, the officers who signed the registration statements, and underwriters and professionals who expeditiously a portion of the registration statement (i.e., usually the issuer’s auditor). The named defendants other than the issuer can raise the so-called “due-diligence” defense that they did not know and did not have reasonable grounds to believe (in some circumstances, after reasonable investigation) that the registration statement was misleading.
94 This is eloquently expressed in the title of an article by Jonathan R. Macey that traces the development of insider trading law: From Fairness to Contract: The New Direction of the Rules Against Insider Trading. See Macey, Fairness, supra note 89. Indeed, since he was writing in 1984 after the Chiarella and Dirks opinions (discussed infra in text at notes 102-07, 120-24, 133-39), Macey’s choice of title is perhaps better described as prescient of the next twenty years.
as the Commission may prescribe . . . .” Rule 10b-5 promulgated under this section provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.96

Since the great retrenchment cases of Ernst & Ernst v. Hochfelder97 and Santa Fe Industries, Inc. v. Green,98 the Supreme Court has made it clear that § 10(b)’s litany “manipulative or deceptive device or contrivance” indicates that Congress was codifying the traditional common law tort of deception, rather than proscribing negligent or unfair behavior or constructive fraud.99 Although the language of Rule 10b-5 is broader than that of § 10(b), under the basic principles of administrative rulemaking, the rule should not be read more expansively than the statute under which it is promulgated.100 Consequently, Rule 10b-5 must also be limited to actual fraud.101

The Supreme Court applied this underlying principle to insider trading in the seminal case of Chiarella v. United States.102 Because

99 The specific issue considered in Ernst & Ernst was whether or not mere negligent behavior could constitute a violation of § 10(b) and Rule 10b-5. The Supreme Court found that the language of the statute “connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” Ernst & Ernst, 425 U.S. at 199. Consequently, a plaintiff in a private right of action must establish that the defendant acted with scienter. Id. at 201.
910 Santa Fe Industries considered whether a plaintiff could maintain a § 10(b) and Rule 10b-5 cause of action against management of an issuer on the grounds that the terms of a merger were unfair, and in breach of management’s fiduciary duties without a showing that the defendants had made a misstatement or omission of a material fact. Santa Fe Indus., 430 U.S. at 464-65.
101 “The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law . . . .” As a consequence, the scope of Rule 10b-5 “cannot exceed the power granted by the Commission by Congress under § 10(b).” Id. at 472-73.
102 See id.
§10(b) only proscribes fraud the Court rejected the concept of “a
general duty between all participants in market transactions to forego
actions based on material, non-public information.” By doing so, the
Court also implicitly rejected the SEC’s holding in In re Cady, Roberts
& Co. and the Second Circuit’s opinion in SEC v. Texas Gulf Sulphur
Co. that implied that the rule against trading on non-public
information applied universally because it was grounded in preventing
unfairness. In the Court’s words, “not every instance of financial
unfairness constitutes fraudulent activity.” In other words, even if all
fraud is unfair, not all unfairness is fraudulent.

“Fraud” has many elements. In this Article, I concentrate only on
those that are most directly relevant to the issue at hand. First and
foremost, fraud requires deception—misrepresentation, or
nondisclosure, by the fraudster and reliance by the victim. To put this
in layperson’s terms, deception is the allegation that “you intentionally
lied to me and I relied on your lies to my detriment.”

Although the federal securities laws are designed to protect
investors and maintain the integrity of the securities markets, even after
the adoption of the much hyped Sarbanes-Oxley Act of 2002, federal
law applicable to issuers is generally not paternalistic in the same way
that state law is. The federal securities laws generally applicable to
issuers have sometimes been termed “rotten egg” rules. A


103 Chiarella, 445 U.S. at 233.
106 The Supreme Court has never expressly overruled Cady, Roberts and has on occasion
stated that it accepts its basic principles including the principle of unfairness. See, e.g., United
States v. Dirks, 463 U.S. 646, 653 (1983). Despite this, the Supreme Court has consistently held
that unfairness alone does not impose prohibitions on the trading of material non-public
information. Rather fraud can only be established through the breach of a fiduciary-type duty.
107 Chiarella, 445 U.S. at 232.
109 The Supreme Court has held that § 10(b) also covers manipulation but reads the word
“manipulation” as used in the statute as a “term of art” to refer to practices “that are intended to
mislead investors by artificially affecting market activity.” Santa Fe Indus., 430 U.S. at 476.
That is, the Court limits “manipulation,” as defined by the statute, like “fraud,” to a form of actual
deception. Fraud, apparently, is deception through words, whereas manipulation also includes
deception through deeds.
111 The 1934 Act does contain paternalistic and substantive rules applicable to market
professionals such as registered brokers and dealers. In addition, the rules applicable to parties
(including issuers) engaged in tender offers do contain some substantive provisions (see, e.g., 17
C.F.R. §§ 240.13e-4(f), 14d-7, 14d-11 (2004)) in addition to disclosure obligations. They also
contain a catch-all prophylactic provision that allows the SEC to adopt rules designed to prevent
fraud which is deemed broader than § 10(b) and Rule 10b-5 (which only proscribes actual fraud).
See infra text at note 155.
112 See Panel Discussion, New Approaches to Disclosure in Registered Securities Offerings, 28
BUS. LAW. 505 (1975) (quoting panelist A.A. Sommer, Jr.).
substantive rule would prohibit the sale of rotten eggs (or, to put this in a corporate context, to enter into a transaction unfair to shareholders). In contrast, under the securities laws, “if the investor purchases the ‘rotten eggs’ on an informed basis, [the federal securities law] provides no relief.” That is, issuers and insiders are allowed to treat investors unfairly, so long as they inform investors what they are in for. Consequently, under federal law, when a person speaks, she must not only speak truthfully, she must also speak completely—no lies, and no half-truths. This standard appears in the language of Rule 10b-5(b) quoted above that makes it unlawful “to make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.”

2. Silence

It is relatively simple to understand what this means as a practical matter when a person makes an affirmative public statement—it must be true and it must be complete. Virtually all alleged insider trading cases, however, involve compete silence, rather than incomplete statements—the trader trades without disclosing information in her possession. The analysis is much more difficult to apply, both practically and theoretically, in these cases. This is because Rule 10b-5 does not prohibit all omissions (silences) of material facts, but only omissions “necessary in order to make the statements made... not misleading.” Consequently, the rule against omissions applies only when either a person has spoken, but spoke incompletely, or if she has failed to speak when she has a duty to speak. To find that a person is guilty of unlawful insider trading under Rule 10b-5, therefore, we must first find that the trader had a duty to make a statement.

The securities acts impose statutory disclosure obligations on issuers and other actors in many circumstances. For example, under the 1934 Act issuers must file with the SEC quarterly reports on Form 10-Q, annual reports on Form 10-K, periodic reports on Form 8-K and proxy statements pursuant to Regulation 14A. There is considerable, but highly confusing, case law as to whether and when

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114 See supra text at note 111.
116 Id. § 249.310.
117 Id. § 249.308.
118 Id. § 240.14a-1 et seq.
issuers and other persons must update these mandatory reports.\(^{119}\) Insider trading cases almost always fall within the ambiguous gap periods between mandatory statutory reports.

As Chiarella makes clear, the federal securities laws do not impose "a general duty between all participants in market transactions to forgo actions based on material, non-public information."\(^{120}\) That is, silence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b)\(\ldots\) But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.\(^{121}\)

In other words, the mere possession of information giving a person an "unfair advantage over less informed buyers and sellers"\(^{122}\) does not itself impose a duty to disclose or refrain from trading.\(^{123}\) Examples of persons who may have a duty to speak given by the Supreme Court include traditional corporate insiders, agents, fiduciaries, and persons in whom sellers of securities have "placed their trust and confidence."\(^{124}\)

There is, according to the Court, no justification for imposing duties to speak on "a complete stranger who dealt with the sellers only through impersonal market transactions."\(^{125}\)

If fraud requires deception, then this implies there must be some person or class of persons who is deceived. The deceived person(s) must have relied on the misrepresentation or omission to his detriment. As I shall discuss below,\(^{126}\) one of the problems with the misappropriation theory as developed to date is that it threatens to disconnect these two interrelated aspects of the fraudster's deception—the person to whom the duty to speak runs is not necessarily the person who is deemed harmed by the omission. Ordinarily one would assume that if securities fraud occurred by definition there should be at least one person who could bring a private right of action under Rule 10b-5 for securities fraud. But, under the misappropriation theory, there can be no such plaintiff!


\(^{120}\) 445 U.S. 222, 233 (1980).

\(^{121}\) Id. at 230.

\(^{122}\) Id. at 232.

\(^{123}\) See id. at 227.

\(^{124}\) Id. at 232.

\(^{125}\) Id. at 232-33.

\(^{126}\) See infra text at notes 164-82.
3. Informational Advantages

One major theme that runs throughout this Article is that, even among those who intuit that insider trading is unfair, there is no clear consensus as to what is unfair about it, given certain basic premises of our capitalist economic system, generally, and American intellectual property law, specifically. Insider trading—the trading of securities on the basis of certain material non-public information—is the economic exploitation of an informational advantage by the possessor of the information, to the disadvantage of the rest of the public. Consequently, the regulation of insider trading can be seen as a limitation on informational advantages in the name of a more egalitarian distribution of information. But, neither American law generally, nor securities law specifically, has a policy of parity of access to information, as the Supreme Court expressly recognized in *Chiarella*.

As I discuss below, informational advantages are frequently protected by our law as “trade secrets.” As Henry Manne states rather sharply, but accurately: “Lawyers especially, it would seem, should be very circumspect about characterizing the utilization of superior information as immoral. That is, after all, their stock in trade.” And indeed, Justice Ruth Bader Ginsburg will paradoxically attempt to ground her misappropriation theory—which reflects an egalitarian approach towards non-public information—on trade secret law—which grants monopolistic rights in non-public information to specific legal actors. My analysis leads to the conclusion both that Congress has been derelict in failing to reconcile these two different regimes of ownership of...
material non-public information and that the resulting confusion has encouraged the federal courts' inappropriate extension of insider trading law beyond the scope of the disclosure and anti-fraud policies of the securities laws.

How, then, do we reconcile these two competing approaches to the law of informational advantages? I suggest that it is precisely the contradictory approaches of securities and trade secret law that suggests the answer to their reconciliation. Courts should apply insider trading law only to that subset of information that our society has expressly or implicitly allocated to the public. The public can justifiably be jealous if a party tries to appropriate and exploit for his own personal benefit such information that is rightfully public. In contrast, insider trading prohibitions should not apply to that information that our society has allocated to specific economic actors under trade secret law, or otherwise. Any objection by the public to the owner's use of her non-public information is mere envy. The reason why the misappropriation theory of insider trading law as articulated by Justice Ginsburg in *O'Hagan* is so troublesome is precisely because it tries to base insider trading—the law of eliminating informational advantages—on trade secret law—the law of protecting informational advantages.

Of course, by positing my analysis in this form I am arguably begging the essential policy question of what information should properly be allocated to the public, and what should be allocated to specific individuals. This is intentional. Such policy decisions are not within the bailiwick of the federal courts or the SEC applying the federal securities laws, but of Congress and the legislatures and common law courts of the several states.

**B. The Classic Theory**

1. Classic Insiders

The classic theory of insider trading holds that it is a fraud for a traditional corporate insider (such as an officer, director, senior employee, or control person of a corporation) to trade on equity securities issued by that corporation on the basis of material non-public information obtained from the corporation. This rule is rather misleadingly known as the "disclose or refrain rule"—if a traditional insider is in possession of material non-public information, she must either refrain from trading in equity securities of that corporation or she

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must make the information public before trading. This name is misleading because the trader usually has no right, *vis-a-vis* the source, to disclose the information. Consequently, as a practical matter, this may more accurately be a “refrain rule.”

Fitting this prohibition within the law of fraud is a stretch—or, more accurately, a contortion. The underlying problem is that rather than seeking implied duties to disclose from within the language and policy of the securities acts themselves, the courts and the SEC have looked towards state corporate law. This is problematic because, as mentioned, since at least *Santa Fe* and *Chiarella*, the Supreme Court has held that the securities laws generally, and insider trading law specifically, are designed only to require disclosure and to proscribe fraud. State corporate law, in contrast, imposes fiduciary duties and proscribes substantive unfairness. It is not surprising, therefore, that a duty of disclosure based on the latter will do an imperfect job in furthering the policies of the former.

In finding that insider trading constitutes fraud, courts have adopted a version of a common law rule of “special facts.” Although the cases are far from specific in explaining their reasoning, it seems to be roughly as follows: sometimes a fiduciary or other person in a confidential relationship has a duty to make disclosures to her beneficiary. Consequently, a beneficiary is sometimes entitled to rely on silence by the fiduciary as an implied negative representation. As Justice Powell stated in *United States v. Dirks*:

> In an inside-trading case this fraud derives from the “inherent unfairness involved where one takes advantage” of “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.” . . . Thus, an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material non-public information before trading on it and thus makes “secret profits.”

Although rather confusingly worded in the language of fairness, the *Dirks* opinion, in fact, reiterates the basic principal of *Chiarella* that federal securities laws do not impose duties on market participants generally merely because they are in possession of information. Consequently, the Supreme Court exonerated the defendant (an alleged tippee) in this case precisely because he was *not* subject to the duty to disclose or abstain himself, and his tipper, who did have such a duty,

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132 As I discuss below, things are a little more complex in the case of the most classic form of insiders—directors and executive officers of the issuer. This is because, while these persons may not have the right to disclose corporate information in their personal capacities, in their corporate capacities they may have considerable ability to cause the issuer to make the appropriate disclosure.


134 *Id.* at 654 (citations omitted).
did not violate his duty. By invoking “fairness” Powell seems to be invoking state law which imposes fiduciary duties of substantive fairness, but only on a limited class of people. Under state corporate law, traditional insiders of a corporation, such as officers and directors, have fiduciary duties to the corporation and to its equity security holders.\footnote{135}

A duty to speak is derived by analogy to the law applicable to trustees with respect to entrusted property. Under general principals of fiduciary duty law, a fiduciary may not deal on her own behalf in property of the beneficiary entrusted to her care. Non-public information generated by a corporation can be considered property of that corporation. Classic insiders can be analogized to trustees who hold this information as the corpus of a trust for the benefit of the corporation and its shareholders. Consequently, for the classic insider to use the information for her own individual purposes would be a breach of the insider’s duty of loyalty under corporate law analogous to a trustee’s embezzlement of a corpus.\footnote{136} In Powell’s language in Chiarella:

Application 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, non-public information.\footnote{137} Although I know of no case that specifically does so, this reasoning can also be analogized to the law of “corporate opportunity” which prohibits an officer or director of a corporation from exploiting a business opportunity that should belong to the corporation for his own personal advantage, at least not until he first offers the opportunity to the corporation.\footnote{138}

\footnote{135} “[[Insiders... have independent fiduciary duties to both the corporation and its shareholders.” Id at 655. Once again, this rule requires an additional tweak of the fiduciary duty traditionally imposed under state corporate law, as the Second Circuit noted in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992).

The insider’s fiduciary duties [as applied in federal insider trading cases], it should be noted, run to a buyer (a shareholder-to-be) and to a seller (a pre-existing shareholder) of securities, even though the buyer technically does not have a fiduciary relationship with the insider prior to the trade. Id. at 566 n.2. This is because, as the Supreme Court noted in Chiarella, although the insider does not technically have a fiduciary duty to the buyer immediately before the sale, the sale itself creates such a duty immediately upon its consummation. Consequently, “it would be a sorry distinction” to apply a lesser standard to the act that creates the fiduciary relationship. Id.

\footnote{136} As we shall see, Justice Ginsburg makes this analogy to embezzlement in her analysis of outsider trading. See infra text at notes 159-62. My criticism of Ginsburg is that she extends this analogy beyond what I believe is the legitimate context of corporate insiders to all confidentiality agreements and trade secret law.

\footnote{137} 445 U.S. at 230.

\footnote{138} See infra text at notes 195-97.
A literal-minded reading of the rule of fiduciary duty would suggest that it would prohibit only the purchase of equity securities by insiders on the basis of material non-public information but would not prohibit the sale. This is because state law duties run to the corporation’s shareholders, not to the public generally. This simplistic statement does not, however, account for the practical realities of a publicly traded corporation in which the shareholders are not a stable class of identifiable individuals, but a constantly changing pool of investors who buy shares, hold them for a while, and sell them. Consequently, for the purposes of insider trading law, one needs to stretch the class of beneficiaries of the rule from the class of persons who happen to be shareholders on any specific day, to the pool of actual and potential future shareholders—i.e., the investment public generally. To put this another way, the moment an insider sells an equity security, the buyer who had been a stranger instantaneously becomes a beneficiary of the insider’s fiduciary duty. Intuitively, it would seem strange to say that the insider has no fiduciary duties with respect to the transaction that creates the fiduciary relationship.

How does breach of fiduciary duty become fraud? Because a fiduciary has a duty not to use trust assets for her own benefit, whenever a person accepts the duties of a fiduciary, she is deemed to make an implied warranty of fidelity to her beneficiaries. Consequently, it is reasonable for the beneficiaries to rely on this implied warranty. This establishes the reliance factor of deception. Because of this justified reliance, the special facts rule imposes on the fiduciary a duty to disclose to the beneficiaries any attempt to breach the duty and invade the corpus. In other words, when a classic insider trades without first disclosing material non-public information in her possession she violates not only her duty of loyalty, but also her duty to speak. Violation of this duty, thereby, constitutes an “omission to state a material fact necessary ... in connection with the purchase or sale of any security” in violation of Rule 10b-5. This can be a fraud if the other elements of §10(b) and Rule 10b-5 are met.

139 See infra text at notes 160-62.

140 There are still problematic aspects of interpreting this as “fraud.” Specifically, there is the difficulty of identifying who specifically is defrauded for the purposes of private causes of action. The insiders’ duties to speak run not to any individual shareholder, but to past, present and future shareholders of the issuer as a class. They are all equally defrauded by the disloyal insider’s silence. The problem is that, under the rule of Blue Chip Stamps, only individuals who actually purchase and sell securities in reliance on fraud can sue for securities fraud. Consequently, the shareholders who did not sell (or potential shareholders who did not buy) their shares are not deemed victims of securities fraud.

Limiting plaintiffs to person who actually trade securities raises its own set of problems. First, it is not possible, and may not be advisable, to limit plaintiffs to those individuals who actually purchased shares from, or sold shares to, the insider in the public markets. Under modern trading practices it is both practically and theoretically impossible to match trades
Once again, this is a stretch. The real wrong underlying this analysis is that the insider *stole* property (information) from the corporation (and its investors), not that he *defrauded* them. As Saikrishna Prakash has persuasively argued, if the true gravamen of the offense were fraud, the insider would be permitted to trade if he first disclosed his intention to the corporation’s board of directors (or if the board or the shareholders grant him the right to trade). Indeed, this is the rule in the analogous law of “corporate opportunity”—an insider *may* lawfully exploit an opportunity for his own benefit if he *first* obtains the permission of the disinterested board members or the shareholders after making full disclosure. Moreover, as we shall see, this is the approach that the Supreme Court will take towards disclosure under the misappropriation theory.

Nevertheless, the courts have not had the courage to follow the logic of the “special facts” rule to this logical conclusion and have, instead, required the classic insider to either disclose the non-public information in his possession—something he is usually prohibited from doing for other legal reasons—or refrain from trading. This anomaly would be avoided if, instead, the courts had grounded the insiders’ duty executed over the public markets. Even if we could trace trades, it seems arbitrary to limit plaintiffs to those individuals who just happened to have traded with the insider, because the insider defrauded traders generally, not any individual specifically. Alternatively, we could allow everyone who traded contemporaneously with the insider to form a plaintiff class. This is consistent with the analysis that the insider defrauds the public generally. However, it has the problem that it would lead to unacceptably high damages. For example, assuming arguendo that Stewart did engage in unlawful insider trading, she avoided approximately $40,000 (or $10 per share) in losses by trading the day before the announcement of the FDA decision. Let’s assume that other persons purchased an aggregate of 100,000 shares of ImClone stock on the same day that Stewart traded at a price that was inflated by $10 per share because of lack of disclosure. Should they be able to sue Stewart for an aggregate of $1 million? And then there is the unfortunate fact that for every shareholder who was hurt by buying at the inflated price, there was another shareholder who was helped by selling at the inflated price. That is, under this hypothetical, because Stewart only sold approximately 4,000 shares on December 27th, other shareholders sold the other 96,000 shares at the higher price. If Stewart had disclosed her non-public information prior to trading, these shareholders would have lost $10 per share. How is this prevention of loss to be factored into the damage award? Congress has partially addressed this by adopting § 20A of the 1934 Act, which gives an express private right of action to any and all contemporaneous traders but limits the aggregate damages payable to all plaintiffs to the actual profits made (or losses avoided) by the insider minus any amount previously disgorged to the SEC. Section 20A does not by its terms preempt private rights of action under § 10(b) so these questions of liability remain unanswered.

141 Prakash, *infra* note 87, at 1495-96. Unfortunately, Prakash tries to argue not merely that this should be recognized as the logical implication of the special facts law, but that it is already the law. This is incorrect in that there is no case that follows Prakash’s analysis in the case of classic insider trading (i.e., where the source of the information is the issuer of the securities). As I discuss, Justice Ginsburg does adopt an analysis similar to Prakash’s in the context of the misappropriation theory.

142 See, e.g., AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 5.05 (1994).

143 See *infra* text at notes 168-69.
to disclose within the policy of federal disclosure and anti-fraud policies, rather than state fiduciary and substantive fairness policies.

2. Temporary Insiders and Tippees

A more important problem with the traditional interpretation of the classic theory is that a very literal-minded approach to it would seem narrowly to limit the class of persons subject to its jurisdiction—i.e., corporate officers, directors, controlling shareholders, and perhaps senior employees. The courts have addressed this by recognizing two classes of remote traders who can be held liable under the classic theory: “temporary”\textsuperscript{144} (or “constructive”)\textsuperscript{145} insiders and tippees. The former are persons who are not classic insiders who nevertheless take on a fiduciary or similar duty of confidence to the issuer either by professional status (such as that owed by outside counsel to an issuer or psychiatrist of a classic insider),\textsuperscript{146} by express contract (such as when an independent contractor signs a confidentiality agreement)\textsuperscript{147} or perhaps by implied contract established by course of conduct (as when a classic insider regularly confides and discusses material non-public information with a family member for the purpose of obtaining business advice).\textsuperscript{148} The latter are persons who, as the terminology suggests, are “tipped off” by an insider either because the insider-tipper hopes to receive a benefit from the tippee in return, or because the tipper wants to benefit the tippee.\textsuperscript{149}

\begin{itemize}
\item COFFEE & SELIGMAN, supra note 131, at 1106.
\item For example, in United States v. Chestman, the Second Circuit, looking to state law for guidance, found that duties of confidence can be imposed by virtue of status. Examples cited by the court include “attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder.” 947 F.2d 552, 568 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992).
\item In order to become a temporary insider having duties of confidentiality, a person must have a pre-existing relationship with the shareholders of the issuers in which he traded, such as becoming “their agent . . . a fiduciary . . . [or] a person in whom [they] had placed their trust and confidence.” Chiarella v. United States, 445 U.S. 222, 232-33 (1980). The Supreme Court has established in Dirks that mere access to information does not make a person into a temporary insider:
        The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.
463 U.S. at 655 n.14. Basic principles of authority suggest that such duties can be established by contract.
\item For example, in United States v. Reed, 601 F. Supp. 685, 690 (S.D.N.Y. 1985), rev’d on other grounds, 773 F.2d 477 (2d Cir. 1985), it was shown that a father became a temporary insider because his son, a classic insider of an issuer, “frequently discussed business affairs” with him.
\item According to the Supreme Court in Dirks, “the test is whether the insider personally will
\end{itemize}
I have found that students have a hard time telling the difference between tippees on the one hand and remote temporary insiders (and from misappropriators who I discuss in the next section) on the other. Actually, they are easily distinguished if one keeps in mind that the former is a reversed mirror-image of the latter. A remote temporary insider (like a misappropriator) is given information in a relationship of confidence for the source's own purposes under circumstances that prohibits the temporary insider from exploiting the information for her own purposes or from further disclosing the information to others. In contrast, a tippee is given non-public information with the expectation that the tippee shall trade on, or otherwise use, the information for her own purposes. In other words, when a remote temporary insider (or misappropriator) trades on the information, she is thwarting the will and violating the property rights of the source of the information. But when the tippee trades, she is fulfilling the intent of her tipper (albeit in violation of the tipper's duty to the source).

3. Under-, and Over-, Inclusiveness

The classic theory is troublesome to proponents of restrictions against trading on the basis of material non-public information in that it fails to cover behavior that seems equal in culpability. First, it is not at all clear that trading even by classic insiders in debt securities of an issuer is unlawful. This is because, under state law, the duties that an issuer (and, therefore, its insiders) owes to debt holders are contractual, rather than fiduciary, in nature. Standard form debt contracts do not impose a general duty of disclosure and candor on the issuers of debt. Tippee liability is prophylactic. It is designed to prevent the tipper from doing indirectly through the tippee what he is prohibited from doing directly (i.e., trading on securities on the basis of non-public material information received in a relationship of confidence). Drawing on the basic principal that mere possession of information does not create duties, the Court rejected the SEC's proposition that a tippee "inherits" the insider's duties merely by receiving the information, even if the tippee knows that the tipper is an insider. Rather, a tippee can only become subject to the duties of the disclose or refrain rule if she assumes these duties. This means that the tippee must know "the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information." Id. at 661.


clear whether the managers of limited liability companies would be subject to insider trading prohibitions because it is not clear whether their duty to their members is contractual or fiduciary in nature. Second, the Supreme Court assumed that the classic theory does not cover the facts of the O'Hagan case when an insider or temporary insider of a bidder in a tender offer used confidential information obtained by the bidder to trade on securities of the target. The bidder, and therefore its insiders, have no fiduciary duties to the target—indeed, their interests may be hostile.152

The critic of classic insider trading law may come to the opposite normative conclusion from the supporter. If these various cases are morally equivalent to insider trading, then whatever is intuitively “wrong” with insider trading cannot be fraud. Consequently, it is inappropriate for courts to find that even classic insider trading violates § 10(b). If Congress believes that certain trading on the basis of certain categories of material non-public information is “wrong” then it should enact a statute prohibiting it. This is why the SEC has adopted Rule 14e-3 prohibiting trading on the basis of information received from bidders not as securities fraud, but as a prophylactic rule to prevent indirect violations of the substantive requirements applicable to tender offers.153

In contrast with both the traditional proponents of insider trading, and its traditional opponents, I argue that it is indeed coherent and appropriate to prohibit classic insider trading but not misappropriation on the grounds that only the former is consistent with the policy of the federal securities laws that allocates rights to certain information to the investment public.

C. The Misappropriation Theory

1. Defined

In O'Hagan v. United States154 the Supreme Court adopted the alternate so-called misappropriation theory of outsider trading. The difference between the classic theory and the misappropriation theory is the identity of the original source of the information. Under the classic theory, the source must be the issuer of the security being traded. Under the misappropriation theory, it is sufficient that the trader misappropriates material non-public information in violation of a duty

152 I will challenge these assumption later in this Article and suggest that the securities laws might imply disclosure obligations in both of these cases. See infra text note 183.
of confidence to any source of the information. That is, the source of the information need not be the issuer of the securities traded and the trader need have no duty running directly or indirectly back to the issuer, let alone indirectly to the investment public.\footnote{O'Hagan was a partner in a law firm that had represented Grand Met in connection with a planned hostile tender offer of Pillsbury. Knowing that the price of a target’s shares usually rises upon the announcement of a tender offer, he bought call options in Pillsbury before the announcement and reaped a profit of approximately $4.3 million when he exercised his options and sold Pillsbury shares after the announcement. O'Hagan’s actions clearly and unambiguously violated the prophylactic rules of Rule 14e-3 prohibiting certain trading while in possession of material non-public information obtained from certain identified persons in connection with a tender offer. He also violated his ethical duties as an attorney to his ex-client, Grand Met. However, he did not engage in classic insider trading under Rule 10b-5 for the obvious reason that the source of his information was not Pillsbury, the issuer of the traded securities. Moreover, because he had no previous relationship to Pillsbury, he owed no duties whatsoever to Pillsbury or its shareholders.

Although the misappropriation theory maintains the classic requirements that i) silence cannot constitute fraud unless the silent party has a duty to speak imposed by a fiduciary or other confidential relationship, and that ii) the recipient of the information must trade securities, it jettisons the requirement that the person who is defrauded and the person (or class of persons) with whom she trades must be one and the same. That is, under the misappropriation theory, it is not necessary that the duty of confidence (and related duty to speak) run to the issuer of the securities (and, thereby, to the shareholders of the issuer).\footnote{Although the misappropriation theory maintains the classic requirements that i) silence cannot constitute fraud unless the silent party has a duty to speak imposed by a fiduciary or other confidential relationship, and that ii) the recipient of the information must trade securities, it jettisons the requirement that the person who is defrauded and the person (or class of persons) with whom she trades must be one and the same. That is, under the misappropriation theory, it is not necessary that the duty of confidence (and related duty to speak) run to the issuer of the securities (and, thereby, to the shareholders of the issuer). Consequently, the Court had to adopt an alternate interpretation as to how the fraud “is in connection with” the purchase and sale of securities.}

\footnote{Id. at 652:  
The “misappropriation theory” holds that a person commits fraud “in connection with” a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary’s undisclosed self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.}

\footnote{“In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.” Id.}
In *O'Hagan*, both the majority and the otherwise vociferous dissent assumed that the defendant had no duty of confidence to the investment public generally (an assumption I will question later). Indeed, Justice Ginsburg expressly stated that the misappropriation theory applies only if there is no such duty. Moreover, they both accepted the proposition that a person who receives material non-public information in a relationship of confidentiality defrauds his source if he uses the information for his own use.

The reasoning is as follows: whenever one entrusts non-public information to a person in a confidential relationship for a specific purpose, the recipient of that information makes an express or implied representation and warranty to the source that he will not use that information for any other purpose. The Supreme Court had already held in *United States v. Carpenter* that confidential information constitutes property for the purposes of the federal mail and wire fraud statute and that the use of the confidential information by the confidant for any other purpose can constitute a misappropriation of the property of the source. The source has the right to rely on the confidant's contractual representations and warranties of loyalty. Consequently, if the recipient is in fact disloyal and intends to use the information for his own behalf, he has a duty to speak and warn the source that he should not rely on his loyalty. Accordingly, the use of the information in violation of the duty of confidence without prior disclosure constitutes fraud—specifically, it is analogous to embezzlement.

How does it constitute fraud “in connection with the purchase and sale of securities?” Justice Ginsburg asserts that *O'Hagan* “consummated” his fraud when he used the misappropriated information to trade in securities. This aspect of Justice Ginsburg’s opinion generated probably the most vociferous part of Justice Clarence Thomas’s dissent. I will turn to the concept of “consummation” later.

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157 See id. at 679-701.
158 See supra note 156.
159 “A company’s confidential information, we recognized in *Carpenter*, qualifies as property to which the company has a right of exclusive use . . . .” *O'Hagan*, 521 U.S. at 654.
160 See id. at 656:

[The] element is satisfied because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide.
2. Trade Secrets

The Supreme Court’s holdings in Carpenter and O’Hagan that confidential information constituted property are highly controversial among intellectual property lawyers who have long debated whether trade secrets should be analyzed as property, contract, tort or as a sui generis body of law.\(^{163}\) By doing so, the Supreme Court transformed trade secret law into property law and virtually all contractual confidentiality breaches into fraudulent misappropriation of property.

These interesting issues are beyond the scope of this Article. What concerns us is that the majority of the Supreme Court found that O’Hagan’s misappropriation of confidential information constituted fraud in connection with the purchase and sale of securities within the meaning of § 10(b) and Rule 10b-5. This was Justice Thomas’s primary complaint, albeit on somewhat different reasoning from mine. The problem is that if, as Justice Ginsburg asserts, Grand Met, and not the public, was the owner of the information as a trade secret, then the investment public, by definition, has no property or other right in the information. Moreover, under trade secret law the source of confidential information, and its confidants, has a right vis-a-vis the public, to commercially exploit the information to the detriment of the public. Consequently, for the public to complain that Grand Met (the source) or O’Hagan (its unfaithful confidant) was using this information is not jealousy, but envy—the pain at seeing others enjoying their good luck—and O’Hagan is wrongfully decided.

3. Anomalies

There are some obviously troubling anomalies about Ginsburg’s formulation of the misappropriation theory. First, despite the fact that

Justice Ginsburg states that such a misappropriation constitutes securities fraud, strangely enough there are no identifiable victims of a securities fraud who could sue for damages. The source of the information may be the victim of fraud, but not of securities fraud. This is because the rule of Blue Chip Stamps\(^{164}\) established that to be the victim of securities fraud, the plaintiff must show that it purchased or sold securities in reliance on the fraud. O’Hagan’s source (Grand Met) did not do so, however. This does not mean that absent the misappropriation theory, O’Hagan would be able to profit from his despicable behavior to his client. There are already many state and federal rules that vindicate the rights of the source—state trade secret and, perhaps, fraud law, state professional responsibility law, federal wire fraud law, and Rule 14e-3 promulgated under the 1934 Act specifically governing trading during tender offers. Consequently, the question at bar was not whether O’Hagan violated the law, or whether his source had legal redress, but whether the investment public was also harmed.

Under basic principles of Rule 10b-5 jurisprudence, however, even contemporaneous traders in the class of securities as the misappropriator are not deemed to be victims of securities fraud.\(^{165}\) This is because the Court expressly stated that the misappropriator owed no duty to speak to these traders. Consequently, they cannot claim to have been defrauded by his silence.\(^{166}\)

This anomaly is not of merely theoretical interest because it has practical implications for the application of the disclose-or-refrain rule. Indeed, in O’Hagan the Supreme Court took seriously the question of the substance of disclosure which courts had glossed over in their application of the classic theory.\(^{167}\) That is, if the fraud consists in the confidant making an implied misrepresentation of his loyalty to the source, then the fraud can be avoided if the confidant discloses his intent to trade. But note, because the misappropriator’s duty does not run to the investment public, no disclosure need be made to the investment public. In Justice Ginsburg’s words:

Similarly, full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the


\(^{165}\) If the trading constitutes unlawful trading, then § 20A of the 1934 Act (15 U.S.C. § 78t-1) gives contemporaneous traders a statutory cause of action to recover the trader’s trading profits. This is not a fraud action as the plaintiff is not entitled to damages for her loss and has no right of recovery if the SEC has previously sought to recoup these ill-gotten gains. Moreover, as discussed supra note 140, the language of this section does not define what types of trade violate the Act.

\(^{166}\) Ginsburg realizes this in that she defines the misappropriation theory as applying only to persons “who owe no fiduciary or other duty to that corporation’s shareholders.” United States v. O’Hagan, 521 U.S. 642, 653 (1997). I will challenge this assumption later in this article.

\(^{167}\) See supra text at notes 142-44.
misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the non-public information, there is no “deceptive device” and thus no §10(b) violation . . . .168

In other words, although Justice Ginsburg claims that:

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.”"169

In fact, the misappropriation theory does no such thing. Under the theory, misappropriators are perfectly free to trade on material non-public information to the detriment of the investment public so long as they do not “deceive” their sources (i.e., so long as they reveal their intent to trade to their sources).

This follows from the Supreme Court’s grounding of the misappropriation theory in trade secret law. By definition, only the owner of the trade secret has the right to determine who may know or use the trade secret.170

Furthermore, the logic of O’Hagan implies that there are at least two other circumstances under which persons can trade on the same material non-public information without running afoul of §10(b). Justice Ginsburg does not discuss the first circumstance. The source would not violate §10(b) if it were to trade on behalf of the non-public information because the information belongs to the source and the source has no fiduciary duty to the issuer’s shareholders. To state this more strongly, to say that the source owns this information is not merely to say that the source would not violate the law if it traded on the information, it is to say that it has the affirmative right to do so. In the specific facts of O’Hagan, such trading by Grand Met in Pilsbury stock may have been subject to the substantive and disclosure restrictions applicable to bidders in tender offers.171 In other cases, the source would be under no limitations.

An example of permissible trading by a source is suggested by the facts of Carpenter v. United States.172 The defendant, R. Foster Winans was an employee of The Wall Street Journal who was one of the writers of the periodic Heard on the Street column that reports on market trends and rumors. Knowing that the market tended to react to information

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169 Id. at 653.
170 See infra text at notes 182-85.
171 Once again, the tender offer rules impose both disclosure duties and substantive standards on the bidders in tender offers. Certain trading in target securities by a potential bidder may or not violate these rules.
published in this column, Winans and his co-conspirators would, immediately before publication, trade on securities of issuers to be mentioned in the columns. The Supreme Court found that the content and timing of The Wall Street Journal’s articles were confidential business information belonging to The Wall Street Journal, and, therefore, property. Because Winans had a duty of confidence to the newspaper pursuant to his employment agreement, by breaching this confidence, he had stolen property by fraud in violation of the federal mail fraud statute. Although the Supreme Court split on whether this also constituted unlawful trading under §10(b), the reasoning anticipates its eventual adoption of the misappropriation theory in O’Hagan. Note, however, that in this case, although it might be a violation of journalistic ethics, The Wall Street Journal could have traded on the basis of the information in question without violating any federal law.

Justice Ginsburg does recognize the second anomalous circumstance of lawful trading: the source could give the confidant permission to trade.

The textual requirement of deception precludes §10(b) liability when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal—even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory.

Why a source might do so can be illustrated by looking at the facts of O’Hagan. O'Hagan was a partner in a law firm that represented Grand Met in a planned hostile tender offer for the stock of Pillsbury. O'Hagan used this information in violation of his attorney’s duty of confidence to purchase call options on Pillsbury’s stock making a profit of $4.3 million. Lawyers are expensive and frequently negotiate premium fees over and above their hourly rate for complex transactions. Grand Met could, theoretically, have offered that, rather than paying a premium fee in cash, it would grant the firm the right to use the confidential information to trade in target securities. In this instant case, as Justice Ginsburg notes, such an arrangement might violate the

173 See id. at 23-26.
174 See id. at 27.
175 In Carpenter, “[t]he conspirators agreed that the scheme would not affect the journalistic purity of the ‘Heard’ column, and the district Court did not find that the contents of any of the articles were altered to further the profit potential of petitioners’ stock-trading scheme.” Id. at 23. Accordingly, there were no facts to support an allegation that Winans was engaged in unlawful manipulation under § 9(e) of the 1934 Act (15 U.S.C. § 78i(e)). It seems likely to me, however, that the real concern of the DOJ in bringing the case was not so much insider trading, but the potential for manipulation.
176 See 521 U.S. at 659 n.9 (emphasis added).
177 See id. at 648.
178 See id. at 657 n.8.
substantive and prophylactic provisions governing tender offers. But, according to Justice Ginsburg it would not constitute securities fraud under §10(b) and Rule 10b-5.

When Justice Thomas confronted Justice Ginsburg with this second anomaly (that confidants may freely trade with their source’s permission), Justice Ginsburg suggested half-heartedly—and tucked away in a footnote—that this is merely an unfortunate example of an under-inclusive law. “[T]he fact that §10(b) is only a partial antidote to the problems it was designed to alleviate does not call into question its prohibition of conduct that falls within its textual proscription.”

This supposed defense, in fact, contradicts the entire basis of the misappropriation theory as articulated by Justice Ginsburg and implicitly reveals its intellectual bankruptcy. According to Justice Ginsburg, the confidant’s use of non-public information constitutes a misappropriation and, therefore, a fraud, because the source is the owner of the non-public information. Justice Ginsburg has also expressly recognized that O’Hagan owed no duty to the issuer or its shareholders, implying that they have no property interest in the information. If, however, the source has a valid property interest in the information, then it should be entitled to use it however it sees fit. Indeed, trade secrets are nothing but a monopolistic power of the source to economically exploit its information for its own purposes, and to keep the information out of the hands of the public.

Consequently, the source should be entitled to buy securities of other issuers on the basis of the information. Moreover, the source should be able to transfer “its” property to whomever it wants and grant others the right to trade on this information.

If, however, as Justice Ginsburg suggests, in an ideal world the source would not be permitted to give others the permission to trade on the basis of the information, then she is suggesting that the source does not have a valid property interest in the information as a trade secret. But, if the source does not have a valid property interest in the

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179 See id. at 689-90.
180 Id. at 659 n.9.
181 See supra text at notes 157-58.
182 I must once again emphasize that the Supreme Court’s choice of O’Hagan to announce the misappropriation theory confuses the analysis because O’Hagan involves a tender offer. The substantive rules governing tender offers under Rule 14e-3 clearly limit the right of Grand Met and its disloyal confidant, O’Hagan, to freely trade on confidential information concerning the proposed tender offer. In my analysis, O’Hagan should not be considered a misappropriation case because it is consistent with the policy underlying the classic theory. That is, Congress and the SEC have allocated rights in information concerning tender offers to the investment public. Consequently, public resentment against O’Hagan’s use of this information reflects jealousy, not envy. Unfortunately, as I discuss throughout this Article, the fact that, under current statutory analysis, insider trading must be shoe-horned into the category of traditional fraud prevents a court from reaching this result. A consistent insider trading law would, therefore, probably require an amendment to the federal securities laws.
information, then the confidant should be able to use the information without violating the source’s rights or committing fraud. That is, the proposition that the confidant is committing securities fraud is parasitic on the proposition that it is not fraudulent for the source to trade on the information. Consequently, in order to find that trading on the basis of this type of non-public information constitutes securities fraud, it should first be necessary to find that the public, rather than the source, has rights in this information.

IV. Securities Law and Trade Secret Policy

As discussed, the classic theory of insider trading holds that it is unlawful for traditional insiders of an issuer (i.e., officers, directors, employers, and other persons having a confidential relationship with the issuer) to trade in the equity securities of that issuer on the basis of material non-public information obtained from that issuer. The misappropriation theory of outsider trading holds that in some cases it is unlawful to trade in securities on the basis of material non-public information obtained in a relationship of confidence to the source of the information who need not be the issuer of the securities traded. Although many proponents of the classic theory intuitively find the classic theory to be underinclusive in regulating objectionable behavior, others intuit that the misappropriation theory risks being objectionably overinclusive.

In this section, I argue that by combining an analysis of material non-public information in terms of property (or quasi-property) with a consideration of the disclosure regime established by Congress in the federal securities laws, one can bring some order into the seemingly chaotic law of insider trading. I argue that application of the distinction between envy and jealousy shows that the classic theory is, in fact, the correct analysis of insider trading as a violation of securities law policy and the misappropriation theory is an inappropriate extension of the doctrine of fraud. Classic theory addresses the righteous jealous fear of shareholders that rivals—classic insiders—will take away something that belongs to the shareholders—information that belongs to the issuer. The misappropriation theory, however, reflects the envy of the investment public of the good fortune of other traders who have informational advantages. Moreover, this judgment is implicit in Justice Ginsburg’s internally contradictory language. Congress might decide to change the status quo and reallocate property rights in a broader category of non-public information to investors. There might also be other good reasons for Congress to adopt broad, prophylactic rules governing non-fraudulent trading on the basis of material non-
public information. The misappropriation theory as articulated to date, however, represents judicial over-extension of the law of securities fraud.

A. Classic Theory: Information About the Issuer Belongs to the Public

As discussed, the classic theory of insider trading treats non-public information obtained from an issuer as property belonging indirectly to the shareholders of the issuer. Many academics who question the wisdom of an across-the-board prohibition of classic insider trading agree that non-public information should be analyzed as property, but challenge the assumption that this information belongs to the issuer's shareholders. This argument is based on the technical proposition that, under state law, shareholders are not recognized as the legal title holders of corporate property, but ignores the fact that the law often recognized beneficial and other equitable interests in property. Under basic principles of corporate law, the corporation and its shareholders are separate legal persons. Property owned by the corporation belongs to the corporation, and not its shareholders, even though the corporate officers and directors have a fiduciary duty to manage the corporation, and therefore, its property, for the benefit of the shareholder. This means that under corporate law, non-public information does not belong to the shareholders. Critics argue from this that an issuer should be able to allocate its "property" in non-public information through private contracting in whatever way it deems fit so long as it follows its duties to its shareholders.

This argument is most closely identified with Henry Manne, one of the earliest and probably the most vociferous and consistent critic of rules against insider trading. He specifically argues that, just as issuers may use other corporate assets to remunerate management, issuers should be able to grant corporate insiders the right to trade on

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inside information as part of their compensation package. From this perspective, concerns about abusive insider trading are, in fact, no different than concerns about any other form of excessive executive compensation and conflicts of interest between management and shareholders. He believes that many of the traditional concerns expressed by the proponents of restrictions on insider trading can be addressed through full disclosure and, perhaps, prior approval by disinterested directors or the shareholders. Indeed, this is the usual approach of the securities laws. Concerns about fairness should be left to state corporate law. For example, in order to keep such compensation plans within the protections of the business judgment rule, management should have them approved by a majority of disinterested directors (if any) or the public shareholders, after full disclosure.

It is often said that insider trading law is necessary because investors would flee the market if they thought the scales were tipped. However, as Manne argues, no one has ever tested this empirical assumption. One way to do so would be to allow corporate insiders to trade on non-public information so long as they disclosed their intent publicly and obtained consent from the issuer’s board and/or shareholders. If investors find such behavior objectionable, this should be reflected in the issuer’s stock prices. If stock prices were

185 See Manne, supra note 89, at 565, 578-79, 582-83. In Frank Easterbrook’s words: [I]nsider trading should be permitted to the extent the firm that created the information desires (or tolerates) such trading. The firm extracts value through exploiting the knowledge itself or reducing the salary of those who exploit it. The firm’s decision to allow insiders to profit through a given device is the same in principle as any ordinary compensation decision, or as any decision to license know-how in exchange for a payment. If the managers err in setting their compensation, redress lies in the market, which will reduce their future earnings.

186 Manne, supra note 89, at 581.

187 For example, Ginsburg partially defends her decision in O'Hagan on these policy grounds: The theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. . . . Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor’s information disadvantage vis-a-vis a misappropriator with material, non-public information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.

521 U.S. at 658-59 (citations omitted). This concept of preventing informational advantages that cannot be overcome is most closely associated with Victor Brudney’s argument in his seminal article Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws. See Brudney, supra note 88.

188 See Manne, supra note 89, at 555-57.

189 This would parallel the rule announced in O’Hagan that one can avoid liability as a misappropriator if one discloses one’s intentions to trade to the source of the information. See supra text at notes 169-72. As discussed, Prakash has argued that this rule of permitted candid trading is already implicit under the classic theory. See supra note 141.
negatively affected, one would expect corporations to react by imposing restrictions on trading. Alternately, if prices are not negatively affected, this would be strong evidence that investors do not care about such behavior.

B. The Classic Theory as a Corollary of Mandatory Disclosure

Needless to say, critics attack both the substantive and moral assumptions underlying Manne’s arguments. I will not engage in this specific debate here because I believe it is beyond the limited point of this Article. This debate relates to the question of what an ideal federal securities policy might be if we were starting from scratch from a state of nature before property rights in information have been allocated. I am interested, however, in analyzing the issue in the context of the given federal securities law regime and current securities practice.

I agree with Manne that the insider trading law is profitably analyzed as an issue of the allocation of beneficial interests in information conceived as a valuable asset, regardless of the location of legal title. However, I argue that the policy as to how beneficial interests should be allocated has already been decided by Congress. It is, therefore, not currently subject to reallocation either by regulation by the SEC, adjudication by the federal courts, or contract between issuers and their insiders.

Manne scoffs at the claims of supporters of insider trading regulation that certain information is the property of shareholders. He is technically correct that under corporate law, legal title to corporate information resides in the corporate entity, and only indirectly to the shareholders who are separate legal persons. But the very example he uses to demonstrate that insider trading law is an aberration within American law, in fact, illustrates the ambiguity of the concept of ownership in corporate law.

In SEC v. Texas Gulf Sulphur Co., the Second Circuit found that classic insider trading by officers and directors violated Rule 10b-5, albeit on the now discredited fairness justification. In that case, the issuer, a mining company, learned that initial tests indicated that certain land contained a potentially rich mineral strike. Classic insiders purchased securities of the issuer before this information was made public. Manne proclaims:

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190 See Manne, supra note 89, at 549-50.
191 Boyle has called this an enigmatic “island of egalitarianism” in an otherwise individualistic ocean. See infra text at note 204.
So notice the irony: TGS officials buying stock with knowledge of a new ore vein have somehow done something immoral, but the company itself buying surrounding land, utilizing precisely the same information, has merely performed in a business-like fashion. In other words, far from mandating parity of information, the usual rule of American law is the protection of informational advantages.

This argument is supposed to support his contention that the argument that insider information belongs to shareholders is empty, “not worthy of serious attention” and fallacious. To a corporate lawyer, however, this analogy is so inapt that it comes close to being facetious. Manne’s argument invokes the relative ownership rights in information of a corporation and a stranger. It does not address the issue involved in insider trading—the relative property rights in information among an issuer of registered securities, its insiders, and the issuer’s investors, to whom the issuer and its insiders owe fiduciary duties. Manne is suggesting that state real property and general fraud law would permit the issuer to buy neighboring land from a stranger without first disclosing its non-public information to the stranger. Even if this is true, Manne is ignoring the fact that it would almost certainly have been a violation of fiduciary duty under corporate law for an insider of the issuer to purchase this land for her own benefit. The land would be deemed a “corporate opportunity” that belonged directly to the corporation for the indirect benefit of its shareholders. Consequently, such a purchase by an insider would be a breach of the insider’s duty of loyalty. This is the more appropriate analogy to insider trading.

Manne’s stronger argument is to analogize from the law of corporate opportunity to suggest a more appropriate rule for insider trading. An insider is permitted to take a corporate opportunity if he first offers it to the corporation and, after full disclosure, the corporation declines to take it. That is, the modern rule of corporate opportunity is not a complete ban, but is a matter of private contract between the board of directors and the opportunist coupled with a duty of full disclosure that does not apply to contracts among strangers. One might be able to argue that, by analogy, insiders should be able to exploit non-public information belonging to the issuer if they obtain prior approval of the

193 Manne, supra note 89, at 550-51.
194 Id. at 550.
195 The definition of “corporate opportunity” differs from state to state and case to case. However, the Texas Gulf Sulfur facts would seem to fall within all of the traditional interest or expectancy, line of business, and fairness tests. JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY, MATERIALS AND PROBLEMS 788-91 (5th ed. 2003).
196 As discussed, Prakash goes so far as to suggest not merely that this should be the rule, but that it is currently the rule. See supra note 141. This is empirically incorrect. No court has so held.
disinterested members of the board or the shareholders after full disclosure of their intent to do so. Even if one accepts this analogy, it is not clear what the appropriate parallel law of insider trading would be. A board may not grant blanket approval to insiders to take future corporate opportunities but must consider each opportunity on a case-by-case basis. Does this imply that an insider should seek board approval each and every time she wishes to trade on insider information?

Manne also argues that property rights, generally, and ownership of information, specifically, are a matter of positive law and can be allocated however society deems fit. In the absence of statutory allocation, this is left to the private ordering of contract. This may be true as a general rule of American law, but in arguing that it is true of classic insider information, Manne is, however, suppressing an important point he makes later in his argument.

As he admits, his critique "calls into doubt not simply the rule about insider trading, but the entire "philosophy of full disclosure." This is precisely correct: the classic theory of insider trading is inextricably linked to the existing mandatory disclosure regime. The one is the corollary of the other. Consequently, Manne may be correct that absent a statutory allocation of property rights in information, such allocation would be left to the private ordering of contract. However, Manne is wrong to suggest that Congress has not in fact already allocated a limited beneficial interest to the public in one class of information.

It is my thesis that the mandatory disclosure regime of the federal securities laws should be analyzed as an implicit Congressional allocation of an indirect or beneficial interest in information generated by and obtained from the issuers of registered securities to persons who trade in these securities. That is, a public corporation must either disclose the information to the public (i.e., give actual possession of the information to the investment public generally) or use it for corporate purposes (i.e., recognize its shareholders' right to enjoy the information indirectly through their investment in the corporation). Consequently, it is consistent with this policy that those who have special access to this information should not have incentives to keep the information non-public by allowing them to use it for themselves. That is, some form of

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197 See id.
198 Manne, supra note 89, at 569.
199 Manne is somewhat to be defended in that, writing in 1970, he does not make the distinction between insider trading under the classic theory and outsider trading under the misappropriation theory. (Consider, for example, that he includes in his definition of insider trading "any trading by any individual based on information which had not yet been publicly disclosed or completely exploited by other traders." Id. at 562).
classic insider trading prohibition is the corollary of a mandatory disclosure regime.\textsuperscript{200}

As Manne understands, if one really believed, on efficiency or other grounds, that issuers should be able to adopt policies allowing classic insiders to trade on the basis of material non-public information, then, to be consistent, one should have the courage of one’s convictions and also argue for a major revision, if not a complete abandonment, of the mandatory disclosure regime of the 1934 Act. Of course, many legal economists do challenge the wisdom or efficiency of the mandatory disclosure regime.\textsuperscript{201} It is highly unlikely that Congress is about to radically amend the federal securities laws to eliminate or severely undermine this regime at this time.\textsuperscript{202}

James Boyle has suggested that insider trading is a “puzzle”\textsuperscript{203} because it is “a statutory island of egalitarianism at the very heart of capitalism.”\textsuperscript{204} In fact, the better metaphor would be that classic insider trading should be seen as only a prominent peninsula of a much larger egalitarian continent called mandatory disclosure.

C. Return to the Misappropriation Theory

As discussed above,\textsuperscript{205} the majority of the Supreme Court in the \textit{O'Hagan} opinion grounded its opinion on an analysis of trade secrets as a form of intellectual property belonging to the source of the information. The problem is that trade secret law’s treatment of non-public information is diametrically opposed to the federal securities laws’ treatment of such information. In the previous section I argued that the federal securities acts in effect allocate beneficial rights in material non-public information generated by an issuer to the investment public generally (i.e., its existing and potential future shareholders). In contrast, trade secret law gives the generator of other types of non-public information the exclusive right to exploit this information for its own advantage so long as it keeps the information secret. Federal securities law generally, and insider trading law

\textsuperscript{200} Manne claims that proponents of insider trading rules naively “assume that a rule against insider trading is the equivalent of a full and timely disclosure rule perfectly enforced.” \textit{Id.} at 552. I am not making the assumption that forbidding insider trading would encourage disclosure. Rather, I am suggesting that it is a corollary to mandatory disclosure rules because it removes one incentive to violate these rules.


\textsuperscript{202} Indeed, the Sarbanes-Oxley Act, passed in the wake of the scandals of 2001, reflects a strengthening, not a dilution, of this regime.

\textsuperscript{203} Boyle, \textit{supra} note 87.

\textsuperscript{204} \textit{Id.} at 1491.

\textsuperscript{205} See \textit{supra} text at notes 154-62.
specifically, is designed to minimize the informational advantages of a
certain class of persons *vis-a-vis* the public by granting rights in
information to the public. It is egalitarian in spirit. In contrast, trade
secret law is designed to maximize informational advantages of a
certain class of persons *vis-a-vis* the public. It is individualistic, indeed
monopolistic, in spirit. Consequently, any attempt to base an extension
of insider liability based on trade secret law is doomed to contradiction.
To do so conflates jealousy—the appropriate protection of one’s
rights—with envy—the inappropriate desire to deprive another of her
rights.

The Uniform Trade Secrets Act defines a trade secret as follows:

“Trade Secret” means information, including a formula, pattern,
compilation, program, device, method, technique, or process that: (i)
derives independent economic value, actual or potential, from not
being generally known to, and not being readily ascertainable by
proper means by, other persons who can obtain economic value from
its disclosure or use, and (ii) is the subject of efforts that are
reasonable under the circumstances to maintain its secrecy.

The Restatement of Torts states that a “trade secret is any information
that can be used in the operation of a business or other enterprise and
that is sufficiently valuable and secret to afford an actual or potential
economic advantage over others.” The differences between these two
definitions are beyond the scope of this Article. What both
definitions have in common is that trade secrets are non-public
information that gives the source economically valuable information
advantages over the public generally. Many commentators disagree
with the Supreme Court’s blanket assertion that trade secrets are a form
of property rather than “a collection of other legal norms—contract,
fraud and the like—united only by the fact that they are used to protect
secret information.” Nevertheless, in any case a trade secret is a right
of the claimant to exploit secret information and to prevent certain
misappropriation of the secret by others.

Since at least Friedman, Landes, and Posner’s classic article *Some
Economics of Trade Secret Law*, the predominant justification of
trade secret law is that our society gives a limited monopolistic right to
the source to exploit trade secrets as an incentive to create this

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208 For a discussion of the differences, see generally Chiappetta, *supra* note 163, at 76-81.
209 The basis of trade secret law is so unclear that one analyst states bluntly that “there is no
such thing as a normatively autonomous body of trade secret law.” Bone, *supra* note 163, at 245.
Bone wishes to limit trade secret protection to rights “created by express contract or justified as
contract default rules.” *Id.* at 246.
210 See *supra* note 163.
information. In order to make it financially attractive for the source to invest resources to create this information we give the source a monopoly vis-a-vis the public to exploit this information commercially. The other competing, or complementary, rationale for trade secret law is business ethics—that is, to prevent certain “bad acts” in the sense of independent wrongs (i.e., such as theft, fraud and breach of duty). What both of these justifications have in common is the recognition that the source has the exclusive rights to commercially exploit secret information. The economic benefits of such exclusive rights can serve as the incentive desired under the first theory. Moreover, by definition the appropriation of control over the information could not constitute a “bad act” under the second justification unless one first presupposes that the source has valid and exclusive rights in the information that could be misappropriated.

Elsewhere I argue that from both a Hegelian jurisprudential perspective and as a practical matter, it is both coherent and analytically helpful to analyze exclusive trade secret rights as a limited form of property. For the limited purposes of this Article, we do not need to reach the question of proper categorization. Whether we consider a trade secret right as property, contract, tort, or a sui generis combination of rights, it is a right of the source to keep the information secret from the public, and the right to exploit that secrecy. It is a form of monopolistic informational advantage. The public by definition has no right to the information—in fact, a trade secret is nothing but the right to keep the information away from the public to the public’s economic disadvantage.

This is why Justice Ginsburg’s analysis of outsider trading in O’Hagan is so unsatisfactory. Her entire misappropriation theory is

211 “Our analysis of trade secret law is congruent with the basic economic explanation for patent protection—that it provides a means of internalizing the benefits of innovation.” Friedman, Landes & Posner, supra note 163, at 64. Bone divides the efficiency rationale into two forms. “The first argues that trade secret law enhances incentives to create. The second argues that it reduces the level of private investment in discovering and protecting secrets as well as the transaction costs associated with value-enhancing transfers.” Bone, supra note 163, at 262. I discuss the efficiency rationale elsewhere, see Schroeder, Unnatural Rights, supra note 84, and shall not raise it further at this juncture.

212 Consequently, there are “two separate categories of trade secret misappropriation: breach of duty and bad acts.” Chiappetta, supra note 163, at 73. For example, the Uniform Trade Secret Act, which has been adopted in over forty states, defines misappropriation of trade secrets either as “(1) disclosure or use without consent when under a duty to maintain secrecy or limit use, or (2) an acquisition by improper means. ‘Improper means’ include ‘theft, bribery, misrepresentation, breach [of duty] or inducement of a breach of duty to maintain secrecy or espionage through electronic or other means.’” Id. at 78 (quoting UNIF. TRADE SECRETS ACT §§ 1(1), 1(2)(ii)(A)). In other words, the Uniform Trade Secret Act makes a clear distinction between mere breach of confidentiality and fraud—precisely the distinction the Supreme Court failed to perceive in Carpenter and O’Hagan when it found that mere misappropriation of confidential information constitutes fraud.

213 Schroeder, Unnatural Rights, supra note 84.
based on an analysis that the misappropriated information is a trade secret *that belongs to the source*. By definition, a trade secret does not belong to the public—under the basic logic of trade secret law, if information belonged to, or became known by, the public, it *would not be a trade secret*. Justice Ginsburg recognizes this when she stated that the misappropriation theory only applies when the trader has *no* duty to the investment public. To say that the disloyal confidant’s use of his source’s information was wrongful *vis-a-vis* the source is to say that the source had a valid trade secret in the information. Putting these together, the public, by definition, has no entitlement to the information and the use of the information does not, therefore, interfere with any rights of the investment public. Use of this information cannot, therefore, be securities fraud.

Justice Ginsburg implicitly realizes this contradiction when she opines that the fact that, under her theory, the confidant would not be engaging in securities fraud if he first obtained the consent of the source to trade as an unfortunate underinclusiveness of the statutory scheme. This is also equivalent to saying that, in an ideal world, Congress would have allocated the property rights in the source’s material non-public information to the public. This means that the information should be allocated to the public, not the source. This is inconsistent with her grounding of the misappropriation theory in the infringement of the source’s property rights in its information. That is, the first leg of the misappropriation theory (fraud on the source) depends on the judgment that the source’s property rights in the information are legitimate, but the second leg (securities fraud) depends on the judgment that the source’s property rights are illegitimate and that the property rights in the information should be allocated to the public.

Consequently, one can not consistently argue, as Justice Ginsburg does, that a misappropriator has stolen trade secrets from the source *and* that ideally the source would not have the right to grant the right to others to use the property.

A coherent insider/outside trading policy would distinguish between information that “belongs” to the public and information belonging to the source. If the information belongs to the public, then no one but the public—not even the source—should be able to trade on the information without first making disclosure. If the information belongs to someone else, then the owner of the information should be able to exploit the information in whatever way it deems appropriate, including by securities trading. If a misappropriator trades on information, it should be deemed securities fraud only if the information belongs to the investment public. If, however, the information belongs to some other party, the law of trade secrets should apply.
D. A Brief Aside on Martha Stewart

The SEC’s civil insider trading action against Stewart is based on a novel application of the misappropriation theory that would extend it even beyond Justice Ginsburg’s stated justification. Presumably the government first began investigating Stewart’s trading in ImClone stock because she was a friend of Sam Waksal, ImClone’s former chairman, who had admittedly engaged in illegal trading of ImClone stock in advance of the public announcement of bad news. Obviously, this raised the suspicion that Waksal had spoken to Stewart. If he had, Waksal would have been a classic tipper and Stewart might have been a tippee of a classic insider. Investigation, however, showed that this was not the case.

The only communication Stewart had with respect to ImClone stock on the date of her trade was indirectly with her broker Peter Bacanovic through his assistant Daniel Faneuil. At the trial, Faneuil testified that he told Stewart that Waksal was trying to sell his stock. Assuming the SEC’s argument will follow allegations made in the DOJ’s indictment, it will allege that Bacanovic was a misappropriator because he violated Merrill Lynch’s policy that forbids its brokers from piggy-backing on the investment strategy of its clients. That is, a Merrill Lynch broker is not supposed to tell his customers what his other customers are doing. If Stewart understood that Bacanovic was violating his duty then she might be a tippee of a misappropriator. I would argue that, in fact, Bacanovic would not be a misappropriator under the rule of O’Hagan. In order to misappropriate information it is not enough that the defendant violate a fiduciary type duty of confidentiality, as Bacanovic might have done. The information disclosed must be the property of the person to whom the duty of confidentiality runs, otherwise the disclosure is not a misappropriation, merely a breach of contract. The SEC would have to, therefore, maintain that Merrill Lynch was the proprietor of the fact that Waksal was trying to dump his stock.

Unlike the misappropriated information in Carpenter and O’Hagan Merrill Lynch did not generate this information itself, nor was it the source. More importantly, as we have seen to be a trade secret by definition the claimant must derive actual or potential economic value from the fact that the information is not generally known. As I have discussed, this means that the claimant has the right to exploit the secret for its own economic benefit. To argue that the fact of Waksal’s trading was the property of Merrill Lynch, therefore, the SEC would have to, in effect, argue that Merrill Lynch was entitled to exploit this

214 See supra text at notes 207-12.
information—presumably by trading on this information on its own account!

E. Trade Secret v. Securities Law Policies

Justice Ginsburg’s intuition in O’Hagan that there is something anomalous in letting the source trade in information, does, however, raise a very different and valid concern—should our society grant trade secret protection to sources for the type of information involved in the misappropriation cases, or should society adopt a positive law granting the public generally a property right in this information (as it enjoys in information generated by issuers)? This question requires a balancing of the competing policies of federal securities law and state trade secret law.

Indeed, one criticism of Carpenter and O’Hagan from trade secret specialists is that the Supreme Court is overly solicitous towards the claimed property interests of the sources of information. The Court has assumed that the states have unequivocally granted property rights in certain information when the state law precedents are far more ambiguous. Arguably, Carpenter should better have been analyzed as a garden-variety breach of contract suit that did not invoke property, let alone fraud, at all. As others have asked before me, do we really want to reinterpret federal fraud law so broadly that we are criminalizing simple breaches of contract?215

The trade secret misappropriated by Winans in the Carpenter case was The Wall Street Journal’s publication schedule.216 As discussed, the standard justification of trade secret law is that it incentivizes the creation of information through the grant of informational monopolies. It is intended to prevent potential competitors from using the information. Presumably, a newspaper needs a publication schedule as a practical matter and does not need further incentives to create one. Moreover, Winans and his conspirators were not attempting to compete with The Wall Street Journal—they did not intend to publish a rival newspaper and did not seek to sell the information to The New York Times, Forbes, or any other competitor. Consequently, when The Wall Street Journal exposed Winans’ misdeeds on its front page and fired him, it was not because it was worried about competition. Presumably, it was concerned with its journalistic reputation—who would trust a newspaper that held itself out as a neutral reporter of business news if it was known that its writers were trading on their articles? This may be

215 See supra note 163 and accompanying text.
216 See supra text at note 173.
an important ethical value, but it has nothing to do with the federal securities laws.

Similarly, there may be very good reasons why stock brokers should not reveal one customer’s trading strategy to another customer or otherwise piggy-back on that knowledge. This is presumably why Merrill Lynch prohibited its employees from doing so and Merrill Lynch was justified for firing Bacanovic and Fanuil for violating the terms of their employment. These reasons might relate to the SEC’s substantive regulation of registered broker-dealers under the 1934 Act. It is not clear, however, that these reasons invoke the anti-fraud concerns of Rule 10b-5.

F. Gaps and Anomalies Under the Current Statute

Under my analysis, a coherent insider trading law would be grounded on the statutory disclosure duties of the securities law conceptualized as an allocation of certain non-public information from the person having a disclosure duty to the investment public generally. It is a short-cut that allows us to avoid the circuitous route followed by the traditional special circumstances rule. That is, rather than relying on a multi-step process by which federal law would incorporate state law that imposes duties on an insider to a corporation, and on the corporation to its shareholders, and then expanding this to a duty of the corporation and its insiders to all potential shareholders (i.e., the investment public), my approach would recognize a federal duty imposed directly on the insiders of reporting companies and running directly to the investment public. That is, the insiders’ duty not to trade would be reconceptualized as a duty related to the issuer’s disclosure obligations. This analysis would probably leave the theories of temporary insiders and tippees largely intact.

Standing alone, however, this analysis may be correct as a matter of policy, but is probably insufficient as a matter of judicial jurisdiction and statutory interpretation. The catchall provision of Rule 10b-5 is limited to fraud, and the concept of fraudulent silence is dependent on a duty to speak. I have argued that as a matter of policy, an implied duty to speak for insiders is consistent with mandatory disclosure by issuers and others. Unfortunately, the statute does not contain an express duty to speak. Moreover the absence of an express duty to speak, by negative pregnant, should probably be read to imply that there is no such implied duty.

The federal securities laws do not currently mandate continuous disclosure. Rather, the statute expressly requires disclosures at specific times, such as at the end of the fiscal year and each fiscal quarter, and
when parties take certain actions, such as making a public offering of securities, soliciting proxies, and making tender offers. The jurisprudence as to when parties have an implied duty to speak in the gap periods between these statutory disclosures is complex and confusing. A federal judge might justifiably be reluctant to adopt my theory and continue to rely on state law as the source of duties.

Consequently, a coherent insider trading law would probably require that Congress amend the 1934 Act. Ideally, Congress would specify when trading on the basis of material non-public information is unlawful. Alternately, Congress could change the language of § 10(b) to make it more like the language of § 14e-3 authorizing the SEC not merely to define fraud (as it does now), but also promulgate prophylactic rules governing trading on the basis of non-public information.

CONCLUSION

Insider trading law should recognize the righteous jealousy of the investment public when insiders try to enjoy the public’s information for their own benefit, but should not encourage the public’s envy when others enjoy information that the law recognizes is rightfully theirs. Consequently, a coherent and ethical law of insider trading should begin with a consideration of the allocation of property rights in information. The misappropriation theory is both unethical and incoherent precisely because it tries to graft insider trading law upon trade secret law. The federal securities laws reflect a fundamental egalitarian moment in that they allocate certain types of material insider information to the public. Trade secret law, in contrast, is radically individualistic and libertarian in nature in that it grants exclusive monopolistic rights in non-public information. If Congress believes that trading on this type of information is somehow wrong, it needs to amend the law to supersede state trade secret law and re-allocate property rights in the information from the source to the public. This would not merely result in a law of insider trading that is consistent with the federal securities law policy, it would also remedy the current embarrassment that insider and outsider trading are de facto common law crimes.