The campaign against the supposed evils of insider trading suffered a major setback last December when the Second Circuit Court of Appeals overturned the conviction of two hedge fund managers who had traded on tips about technology companies Dell and NVIDIA. In essence, the court ruled in *United States v. Newman* that the prosecutor did not prove the traders knew the information was improperly disclosed by the source “tipper.” So the traders had no legal duty not to trade on the tip.

The *Newman* decision has prompted the usual shock-shock from legal scholars and other critics because the defendants had assembled so-called expert networks in such a way that they would never need to know the details of why a source spilled the beans. The argument seems to be that if we know the defendants traded on material nonpublic information of the sort that must have come from an improper source, we should convict them—somehow. In other words, there oughta be a law.

Columnist James B. Stewart argued in the *New York Times* that Congress needs to enact a statute to replace the common-law case-by-case approach to insider trading. As he points out, in the European Union it is simply illegal to trade on material nonpublic information irrespective of how one obtains it. And to date four bills have been introduced in Congress that would adopt essentially that approach.

Bad idea. Such a law would severely reduce incentives for market research and render the market less efficient. Why dig for gold if you cannot keep it when you find it? Trading on nonpublic information drives market prices to the correct level more quickly, giving investors added assurance that they get the best possible price when they trade. But before we get too deep into the policy weeds, we should be clear about the law as it stands.

**TIPPING AND FIDUCIARY DUTY**

There is no law against trading on nonpublic information just because it is nonpublic (with one minor exception for information about a planned tender offer). Ironically, Congress has enacted statutory penalties for insider trading but it has never been able to agree on what constitutes insider trading. Rather, the definition of insider trading depends on judge-made (common) law and is based on the general legal duty that information entrusted to one for business purposes may not be used for personal gain.

To be specific, the U.S. Supreme Court held in *Dirks v. SEC* (1983) that to be found guilty of insider trading, the receiver of the tip—the “tippee”—must know (or at least should know) that the source tipper violated a fiduciary duty or similar obligation—for example, to an employer—in disclosing material nonpublic information. This usually requires some evidence that the tipper was effectively bribed (although it may suffice to show that the tipper wanted to make a gift of valuable inside information to the tippee).

In *Newman*, prosecutors prevailed on the trial court not to require any such evidence as to the motivation of the tipper. Again, the problem with this argument is that it is not per se illegal to trade on inside information in the United States. Rather, the information must have been disclosed improperly and the tippee must (or should) know so. But there was zero evidence in *Newman*...
man that the defendants knew that the tipped information had been improperly disclosed.

Still, it is not completely clear under the law that a prosecutor must prove a personal benefit (or gift) to get a conviction—although Newman now says so. Rather, it is (or should be) enough that a tipper violated a duty to the source of the information—disclosed it improperly—irrespective of motivation.

It is important to consider the language used by the Supreme Court. What the Court said when it laid down the law in Dirks was:

A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

Realistically, the Court allowed that it may not be easy to determine whether a tippee has breached a fiduciary duty to the source. There are many situations in which confidential information may properly be disclosed even though the information is likely to affect the market. Thus, the Court went on to say:

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.

Notice that the second and third sentences do not really follow from the first. It is black-letter law that fiduciary duty comprises both a duty of loyalty and a duty of care. It is clearly contrary to the duty of loyalty to use corporate information for personal gain. But it is also a breach to disclose it negligently. Loose lips sink ships. So the idea that fiduciary duty is only about personal benefit misses half of the point.

To be sure, it may be difficult to show such a breach of fiduciary duty in the absence of a personal benefit. And it will certainly be difficult to show that a tippee knew of such a breach. But these are matters of proof, not the standard to be applied.

Specifically, the requirement is that the tippee must know—or at least suspect—that the tipper acted improperly. In other words, the tippee must have “scienter” in the argot of the law. But the tipper’s breach need not be intentional.
Moreover, as the Newman court noted, the prosecution must show willfulness on the part of the tippee in order to prove criminal culpability. Although one might think that willfulness requires something more than mere scienter—for which recklessness may suffice—the caselaw is far from clear in part because scienter is a judge-made requirement borrowed from the common law of intentional torts. It does not appear anywhere in the statutes that comprise federal securities law.

In fairness, the Supreme Court’s opinion in Dirks must have been colored by the unusual facts in that case, where the tip relating to a massive insurance fraud by Equity Funding came from a whistleblower who sought to expose the fraud with the help of a prominent investment adviser who specialized in insurance stocks. Thus, there was little doubt that the tipper in Dirks acted for a proper purpose, even though the company presumably wanted to keep its fraud a secret. So it turns out that easy cases make bad law too. Ironically, the 2010 Dodd–Frank Act now provides for rewards to whistleblowers in just such situations, though it would still be illegal for the tipper to trade on the information for personal gain. Go figure.

But wait, there’s more. Subsequent to Dirks, the Supreme Court held in United States v. O’Hagan (1997) that insider trading may be based on the misappropriation and personal use of material nonpublic information “in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information” (emphasis added). In the same case, the Court upheld Securities and Exchange Commission Rule 14e-3, which provides that nonpublic information about a planned tender offer may be presumed to be obtained in violation of a fiduciary duty (by someone) without the need to prove whom or how. Note that there is no mention in O’Hagan of the need to show that the trader knows that the information has been disclosed in violation of some obligation to the contrary, though it may be implicit in the idea of the misappropriation theory.

HACKERS AND SHARKS

It is odd that the courts have not paid more attention to the question of the duty behind insider trading, since the issue seems to arise with regularity. For example, in SEC v. Dorozkho (2008) the court declined to order seizure of the proceeds from insider trading based on information stolen by Oleksandr Dorozkho, a hacker in Ukraine. Remarkably, the court’s rationale was that he had not breached any fiduciary duty in misappropriating the information. But is it not enough that everyone has a duty not to steal?

In SEC v. Cuban (2010), the defendant, Mark Cuban of Dallas Mavericks and Shark Tank fame, was a major (but not controlling) investor in a struggling Internet search business. The firm was in need of more capital and (in effect) decided to sell additional stock at a bargain price. Reckoning that Cuban might not be happy with that plan—because of the dilution he would suffer as a result—the firm’s chief executive informed him about the plan and offered him the opportunity to share in the offering. Predictably, Cuban went ballistic. At the end of the call, he told the CEO: “Well, now I’m screwed. I can’t sell.” Indeed, the CEO may have intended to tie Cuban’s hands with the tip. But reflecting on his situation—and maybe after getting a little legal advice—Cuban apparently realized that he could not be made a fiduciary against his own will. To be clear, a stockholder owes no fiduciary duty to fellow stockholders (except in some situations involving the exercise of control). And it was clearly a proper purpose for the CEO to discuss company plans with a major stockholder. So Cuban called back the CEO and declared that he intended to sell his shares before the deal was announced. Then he called the SEC to tell them what he had done!

The SEC was not amused and commenced an enforcement proceeding against Cuban on the theory that information about the planned transaction had been disclosed to him in confidence and subject (at least implicitly) to an agreement not to trade on it. The trial court dismissed the complaint because it was based on an agreement to keep the information confidential and not an agreement not to trade. After all, one can agree to keep a secret without agreeing not to act on it. But the Fifth Circuit (per Judge Patrick Higginbotham) reversed, ruling that the confidentiality agreement could imply an agreement also not to trade depending on the totality of the circumstances. The case was remanded for further proceedings, but Cuban ultimately prevailed.

Notably, the Fifth Circuit Cuban opinion does not once use the word “fiduciary” other than in quotes from Dirks and O’Hagan. In the view of the Fifth Circuit, the case turns wholly on whether Cuban agreed not to trade—and necessarily so because there is no real argument to be made from fiduciary duty. So the court tentatively broke new legal ground, albeit consistent with the suggestive language in O’Hagan. (It also raises nice questions about whether and how fiduciary duty differs from contract, but that is another can of worms.)

On the other hand, fiduciary duty is often said to be a relationship of trust and confidence. So, in Cuban the SEC sought to rely on its own Rule 10b5-2, which states that a person has “a duty of trust and confidence” for purposes of misappropriation liability.

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when that person “agrees to maintain information in confidence.”

Nice try. But aside from the facts that Cuban was not a misappropriation case, that Cuban did not clearly agree to refrain from trading, and that the rule conveniently omits the need for a fiduciary to agree to be bound (not to mention the circular reasoning), it is not clear that the SEC has the authority to rewrite the common law. Indeed, the Second Circuit has held the rule is of no moment in a criminal prosecution for insider trading.

FINANCIAL INFORMATION NETWORKS

Entertaining as these cases may be (at least for those of us so easily amused), would it not be better for Congress to adopt a clearer rule like the EU standard that simply prohibits trading on material nonpublic information, however it is obtained?

Hardly. The obvious problem with the EU approach is that it eliminates the incentive to look for such information. To be sure, U.S. law effectively invites the formation of so-called expert networks like those at work in Newman. By their nature, such networks may skate close to the edge of the law. But there is no reason to presume that they are designed primarily to provide cover for insider trading even if network members cross the line on occasion. Valuable inside information may often be disclosed gratuitously by a source who just wants to talk—or several such sources whose stories may be fitted together like a mosaic. (Ask any detective or reporter about this.) If a bribe happens, we can deal with it when we find it.

Indeed, if the ultimate problem is a breach of fiduciary duty, why not let the firms deal with their faithless agents? To be sure, no one has ever been prosecuted solely as a tipper under federal securities law. And one could argue that tipping itself is not a crime—at least, in the absence of payment. But employers and other principals have every incentive to protect their own information when it matters, and they are much better placed to know when it matters than are federal regulators. Indeed, there is every reason to think that they act swiftly and surely—as Warren Buffett did when David Sokol bought Lubrizol ahead of merger talks with Berkshire Hathaway and as the University of Michigan did when neurology professor Sid Gilman tipped SAC Capital about the results of a drug study. Some might argue that criminal prosecution would be a more effective deterrent—jail can be somewhat embarrassing (though less than it once was thanks to Michael Milken, Martha Stewart, and other celebrity convicts). On the other hand, losing the No. 2 position at Berkshire Hathaway and a department chair at a major medical school are strong cautionary tales.

Moreover, someone must be the first to hear—and react—to the latest market-moving news despite SEC Regulation FD, which seeks to assure that firms speak to the whole market when they choose to speak rather than practicing selective disclosure to a chosen few. (See “Questioning the SEC’s Crusades,” Winter 2001.) But a rule like the EU rule might arguably require traders to check to see if others have also heard the news before trading. In contrast, the U.S. rule permits the market to get to the right price faster. And if fewer trades happen at the wrong price, investors are better off. Indeed, it is arguable that some insider trading is good for the market. Here (as elsewhere) the Europeans cleave to the precautionary principle: better to throw the baby out with the bathwater if that is what it takes to eliminate insider trading. In the United States, we tend to think it better to ask forgiveness than permission.

There is a real danger that the crusade against insider trading may render the market less efficient. In the United States, about 80 percent of all stock is held by institutional investors in portfolios that turn over about 50 percent per year on average (and about a third of that is indexed with a turnover rate of less than 15 percent per year). Given that total turnover is about 150 percent marketwide, it appears that no more than 20 percent of investors account for most of the trading motivated by stock picking.

In contrast, more than 60 percent of trading was so motivated in the 1960s when much of the law relating to insider trading (and other forms of securities fraud) began to coalesce like galaxies after the Big Bang. Moreover, finance scholars have suggested that because of the trend toward indexing, stock-picking may decline to little more than 10 percent of aggregate trading over the next decade. And with the rise of flash trading, that number may go even lower. Indeed, as of late 2014 index funds had attracted almost $90 billion in new investor funds for the year and exchange-traded funds had experienced a similar inflow, while managed (stock-picking) mutual funds saw only about $2.5 billion in new money (all according to Bloomberg).

WHY THE CRUSADE AGAINST INSIDER TRADING?

If so few investors seek to beat the market anyway, it is not clear why the government is so focused on insider trading enforcement. An investor who trades as little as possible and only for purposes of portfolio balancing is equally likely to sell a mispriced stock as to buy one. For such an investor, the financial effects of insider trading by others come out in the wash. As I’ve argued in these pages, other things equal, such an investor should prefer less enforcement—perhaps none at all—in exchange for a more efficient market. (See “The End of Securities Fraud Class Action?” Summer 2006.) On the other hand, studies indicate that there is less stock picking where there is better corporate governance. So it may be that laws against insider trading are necessary for investors to get comfortable with passive strategies.

Still, if most investors would prefer more efficient markets to perfectly fair markets, why does the U.S. Justice Department devote so much capital to prosecuting insider trading and discouraging tippees from trading on what they discover? And why does the SEC continue to harp on the importance of protecting retail investors—the vast majority of whom are perfectly protected by diversification as fund investors—from the supposed scourge of a two-tier market?

So who exactly benefits from insider trading enforcement? The answer must be that insider trading enforcement is intended to protect investors who seek to beat the market. But do stock-
picking investors need protection? Will they give up if they think other investors may have an edge? And do we care? Most scholars of law and finance would likely agree that, as a policy matter, we should discourage most investors from stock-picking, since the odds of beating the market are no better than even and the cost of active trading is thus a deadweight loss that reduces return. The best strategy for most investors is to maximize diversification and minimize expenses by investing in an index fund.

The one class of investors that may have a real interest in seeing the market remain less efficient is activist investors—hedge funds and corporate raiders—who stand to benefit from slower reaction times as they buy up as many shares as possible before anyone notices. Indeed, hedge funds have been vocal supporters of insider trading enforcement. To be sure, we want to encourage activists to seek out worthy targets: mismanaged companies whose takeover can increase stockholder value. But activists can and should protect their own information from leaks. Moreover, public stockholders who sell out to activists in the process have the image of the economist who declined to pick up a $50 bill that was lying on the sidewalk on the theory that if it were really there someone would already have grabbed it.

Still, if everyone believed in the efficient market and stopped doing research, the market would no longer be efficient. Then, even Jack Bogel, founder of Vanguard and champion of indexing, would become a day-trader. But this efficiency paradox is really no paradox at all. Traders will trade until the next dollar they spend on research—or inside information—brings in just another dollar of additional return. So there is no reason to think the market will slide back into inefficiency. Yet the campaign against insider trading encourages the small fry to swim with the sharks.

It is little wonder that at least two justices of the Supreme Court have suggested that they are eager for another bite at the insider trading apple. Although the prosecutor in *Newman* has so far declined to seek review, it cannot be long before the issue is argued before the Court again.

In addressing the supposed problem of insider trading, we should be clear about the cost to market efficiency and who stands to benefit. Perfect fairness is not free. We should let the market find its own equilibrium between these competing goals without placing a thumb on the scale. *Newman* is one step in that direction.