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"WE’LL KNOW IT WHEN WE CAN’T HEAR IT": A CALL FOR A NON-PORNOGRAPHY TEST APPROACH TO RECOGNIZING NON-PUBLIC INFORMATION

J. Scott Colesanti*

I. INTRODUCTION: AN OVERVIEW

Supreme Court Justice Potter Stewart once authored a concurring opinion in which he explained that, while he would not attempt to delineate pornographic materials, he knew pornography when he saw it. That test, which is said to have invited sarcasm among the clerks of the highest bench, nonetheless announced a threshold analysis for obscenity cases that many find appealing to this day.

Likewise, in the field of insider trading, the courts and others have embraced such pragmatism, namely, effectively transforming the test for finding insider trading (trading while aware of “material” and “non-public” information) to a weighing of such considerations as whether the defendant had access to insiders, betrayed a confidence, and/or captured a profit. Such a pornography test approach—while satisfying on some level of expedience—fails to provide businesses with certainty, the law with clarity, the market with confidence, and the layman with guidance. Meanwhile, the definitional term non-public is reduced to a shibboleth,

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2. Bob Woodward & Scott Armstrong, The Brethren: Inside the Supreme Court 198 (1979) (describing Supreme Court clerks jovially blurting out “[t]hat’s it, that’s it, I know it when I see it” during the Justices’ private screenings of controversial movies as part of adjudicating obscenity cases).

3. See, e.g., R. George Wright, The Role of Intuition in Judicial Decisionmaking, 42 Hous. L. Rev. 1381 (2006) (observing that Justice Stewart’s dissent was marked by a quality of intuition and highlighting the usefulness of judicial intuitionism in decisionmaking).
the mere utterance of which triggers insider trading investigations, cases, penalties, and press.

With instances of the crime both growing in number,\(^4\) and manifestations in novel forms,\(^5\) insider trading and its dire consequences have once again called into question the legitimate scope of the largely undefined prohibition. To wit, scandals centering on the theft of internally-broadcast research\(^6\) and the granting of backdated options to corporate executives\(^7\) presently highlight the unpredictable applications of the most feared securities law prohibition. The Securities and Exchange Commission ("SEC" or "Commission") has, to date, survived attacks on these unpredictable applications (while garnering a fair share of headlines) by bringing enforcement actions showcasing exorbitant profits, salient boardroom details, indefensible criminal acts and

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6. See, e.g., United States v. Mahaffy, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *7-8, *49 (E.D.N.Y. Aug. 2, 2006) (finding as sufficient an indictment alleging criminal securities fraud wherein brokerage house employees alleged to have permitted non-employees to "secretly listen" to their firms' internal "squawk box" system in order to obtain "material, non-public information concerning large orders to purchase and sell securities" for their institutional clients).

approach to recognizing non-public aristocratic defendants. Nonetheless, the dirty little secret of the "material, non-public information" definition of insider trading is that the non-public half lacks clarity and consistent application—indeed, it may not truly exist at all. Consequently, the Commission's winsome approach is destined to win some and lose some, as the courts, as they did often in 2006, begin to rule for defendants in cases relying on definitional vagaries or unprecedented application of the prohibition.

This Article thus urges the Commission to abandon its totality of the circumstances approach (as well as its lip service to the term non-public as a separate definitional element) in favor of a well-defined two-tier standard in insider trading cases. Part II of the Article provides a brief history of the application of Rule 10b-5 to insider trading. Part III details the specific enigmas occasioned by applications of the prohibition to varied examples of trading on non-public information, and highlights some recent decisions refusing to accept the SEC's approach. Part IV concludes by positing that the primary market regulators (i.e., the stock exchanges), with a little help from existing SEC guidance, are poised to clear up the vagueness and help the SEC or U.S. Attorneys asserting SEC findings and theories surmount courtroom obstacles.

II. A HISTORY OF THE INSIDER TRADING PROHIBITION (THE DIRECTOR'S CUT)

It is axiomatic that, despite the crime's ubiquitous presence and ever-growing popularity, insider trading is undefined by statute. A relatively young juridical construct disappointing to lawyers and laymen


9. See Securities and Exchange Act of 1934 §10(b), 15 U.S.C. § 78j(b) (2000). The Supreme Court has also commented on the noticeably absent definition:

Notwithstanding the ambiguities surrounding Section 10(b)'s impact on insider trading—including its very definition—Congress has increased the penalties for violations of that prohibition. The SEC in turn has failed to promulgate rules outside the area of tender offers but its decisions have continued to march, in the eyes of one commentator, to the beat of its own drummer.

alike, this distinctly American contribution to business regulation is alternatively found to be intimidating and worthy of ridicule.\(^\text{10}\)

The outlawing of insider trading by the SEC (the “Program”) dates back to an administrative proceeding brought approximately forty-five years ago. The operative definition of insider trading—trading while aware of “material, non-public information”—has proven a useful refrain to jurists,\(^\text{12}\) journalists,\(^\text{13}\) and authors,\(^\text{14}\) but remains a cacophony to litigants. The result is that those responsible for applying the prohibition inevitably rely on its pleading requirements or the crime’s results, a task not unlike identifying a speed limit by the cars that passed by it or the hedges that were overrun. The undesirability of charging this highly publicized yet amorphous crime in this manner results foremost from congressional reluctance to commit the crime to paper.

A. More Outtakes than Intakes

The 1934 Congress did not outlaw insider trading. One explanation is that such an action would have indirectly targeted members of Congress themselves.\(^\text{15}\) A less jaded view recalls that the adopting

\(^{10}\) See, e.g., Commerce Clearing House, Inc., Insider Reporting and Short-Swing Trading, Federal Securities Law Report 1527, Part 2, at 3 (Nov. 5, 1992) (“Failure to comply with the regulatory framework can result in costly litigation and damaged reputations. Familiarity with legislative, judicial and regulatory pronouncements is a necessity for the corporate insider.”).

\(^{11}\) See, e.g., Henry G. Manne, The Case for Insider Trading, WALL ST. J., Mar. 17, 2003, at A14 (“[T]he SEC never realized that insider trading was already the form of ‘disclosing’ that maintained the efficiency of stock pricing. Instead, they outlawed it. Happily for us all, enforcement has not been too successful.”).

\(^{12}\) See, e.g., In re Investors Mgmt. Co., 44 S.E.C. 633, 641 (1971) (“All the requisite elements for the imposition of responsibility were present . . . . We consider those elements to be that the information in question be material and non-public . . . .”).

\(^{13}\) See Andrew Countryman, Stewart Faces Criminal Charges; Insider Trading Case No Cakewalk for Prosecutors, CHI. TRIB., June 4, 2003, at Cl (“The government would need to prove that Stewart had important, non-public information when she sold her ImClone shares . . . .”).

\(^{14}\) See generally Douglas Frantz, Levine & Co.: Wall Street’s Insider Trading Scandal (1987) (describing the rise and fall of one of the most notorious insider traders of the 1980s). See id. at 54 (defining the crime as trading on “private, nonpublic corporate information” that affects the stock price); John Downes & Jordan Elliot Goodman, Barron’s Dictionary of Finance 281 (7th ed. 2006) (“[I]t is illegal for insiders to trade based on their knowledge of material corporate developments that have not been announced publicly . . . .”).

\(^{15}\) See Manne, supra note 11, at A14. The former dean of George Mason University School of Law reported: “In 1934 Congress refused an early draft of the Securities and Exchange Act that contained a provision outlawing insider trading, perhaps because it would have covered members of Congress.” Id. For a thorough history of the legislation’s deliberate silence on the topic of insider trading, see Charles R. Geist, Wall Street: A History 234 (1997) (“The new regulations did not restrain traders as Wall Street had feared when [the Securities Exchange Act of 1934] was being drafted . . . . The restrictions placed on short selling and margin trading were thought to be ample to
approach to recognizing non-public information

committees for the Securities Exchange Act simply embraced the more "passive" concept of disclosure, stating:

Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity.... The Committee is aware that these requirements are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage. It is hoped, however, that the publicity features of the bill will tend to bring these practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges.16

What Congress did effectuate was section 16 of the Securities Exchange Act, which established reporting requirements (and an attendant statutory remedy) compelling officers, directors, and "ten percent shareholders" to: 1) timely disclose their purchases and sales in the stock of the company they inhabited, and 2) disgorge profits from purchases and sales of their company's stock less than six months apart.17 Among the criticisms of section 16(b)’s approach were that it was limited by its concern only with public corporations, its mild penalty of a shareholder cause of action to seek the relinquishing of profits, and its denial of a cause of action to the SEC for disgorgement of profits.18 Significantly, the text of section 16(b) commenced with a mission statement: "For the purpose of preventing the unfair use of

prevent abuses of the past from flaring up again."). Other authors perhaps gild the lily of congressional inaction by portraying the legislative silence as part of a grander plan. See JONATHAN MORELAND, PROFIT FROM LEGAL INSIDER TRADING: INVEST TODAY ON TOMORROW’S NEWS 1 (2000) ("When the U.S. Congress of 1934 legislated the Securities and Exchange Commission (SEC) into existence to protect individual investors, it realized that corporate executives had an unfair advantage when trading their own company's shares.... In lieu of banning insider transactions, Congress dictated disclosure.").

18. Section 16 only applies to companies registered on a national securities exchange, and only requires that enumerated parties profiting from purchases and sales of company shares within a rolling six-month window return those profits to the company, leading some commentators to opine that the provision is toothless. See Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857, 893 (1983) ("The effect of section 16 on shareholders' welfare, therefore, is ambiguous.").
information... until the 1980s, this preamble remained the only reference to inside information in the Securities Exchange Act.

The SEC’s adoption of its famed Rule 10b-5 in 1942 was in direct response to the securities laws’ inability to reach pernicious purchases, namely the buyback by the president of a private company (an “insider”) of floundering shares from his co-investors under the guise of continued weak economic results. Violations of the generic anti-fraud prohibition have since been held to a list of pleading requirements that were announced, restated or implicitly approved by the Supreme Court over the years to include materiality, scienter, causation, fraud or deception, and satisfaction of the regulation’s “in connection with the purchase or sale of any security” language. The materiality element, often most expediently defined as the effect of the subject inside information on market price, has often dominated considerations.

20. Although universally feared by traders, Rule 10b-5 does not expressly refer to insider trading. The full text of the rule is as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
   in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5 (2006). Section 10(b) of the Securities Exchange Act of 1934, and corresponding Rule 10b-5 are often charged together in both civil and criminal proceedings. It is rarely specified which of Rule 10b-5’s three prohibitions applies to the insider trading in issue. See In re Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961) (noting that the tippee’s practices “at least violated clause (3) as a practice which operated as a fraud or deceit upon the purchasers”); see also United States v. Finnerty, No. 05 Cr. 393, slip op. at 18 (S.D.N.Y. Feb. 21, 2007) (discussing the case against a NYSE Specialist alleged to have “interpositioned” his interest by trading ahead of customer orders said to violate, if any, clauses (a) and (c) of the Rule).
27. Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963) (stating that materiality was said to rely on those facts “which in reasonable and objective contemplation might affect the value of the corporation’s stock or securities”).
28. See United States v. Carpenter, 791 F.2d 1024, 1032 n.8 (2d Cir. 1986) (“In any event, a fraudulent scheme need not be foolproof to constitute a violation of Rule 10b-5. It is enough that
Further, various elements have been deemed satisfied by the conspicuous nature of the defendant’s ultimate trading. 29

In 1961, acting foremost on considerations of fairness, the SEC commenced the Program by bringing a modest action within its own four walls that applied Rule 10b-5 to the trading caused by J. Cheever Cowdin, a board member of Curtiss-Wright Company. Cowdin was also a broker at Cady, Roberts & Co., a stock brokerage. 30 When he heard of an imminent dividend reduction at the Curtiss-Wright board meeting, he notified Robert Gintel, a fellow broker at the brokerage. In anticipation of a price decrease, Gintel immediately started selling Curtiss-Wright stock in his personal and discretionary accounts. A transmission error delayed the news of the dividend reduction to the New York Stock Exchange (“NYSE”) and Gintel’s quick trades effectively jumped ahead of the market. 31

In finding the trading violative, Cady, Roberts noted that “a special obligation has been traditionally required of corporate insiders,” 32 and held that Rule 10b-5 is violated (even in faceless transactions on a stock exchange) when a buyer or seller trades without disclosing the inside information he possesses. Drawing upon authorities ranging from Judge Learned Hand 33 to the NYSE guidance for its listed companies, 34 the SEC decision did not define “inside information,” instead referring generally to the “affirmative duty to disclose material information.” 35 Elsewhere, the decision characterized the dividend reduction information as information that “Gintel knew was not public.” 36

Cady, Roberts broke new ground in several areas by creating the “abstain or disclose” rule for “corporate insiders,” 37 and serving notice appellants reasonably expected to and generally did reap profits by trading on the basis of material, nonpublic information misappropriated from [one defendant’s employer].”

29. See, e.g., In re Apple Computer Sec. Litig., 886 F.2d 1109, 1117 (9th Cir. 1989) (“Insider trading [i.e., trading by corporate insiders] in suspicious amounts or at suspicious times is probative of bad faith and scienter.”).
31. Id.
32. Id. at 912-15.
33. See id. at 914 n.23.
34. See id. at 915.
35. Id. at 911.
36. Id. at 916.
37. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud
upon corporate boards that their previous opportunism was now illegal. But it was only an administrative proceeding. Seven years later, the SEC obtained federal court imprimatur on the Program in the Second Circuit’s famed case, SEC v. Texas Gulf Sulphur Co. ("TGS"), affirming the liability of certain defendants (and expanding liability to others) in a case involving employees of a mining company who had traded in advance of news of successful drilling results in Canada that jumped company stock nearly ninety percent.

TGS coined the phrase “material inside information” and represented federal court approval of the seminal steps of the Program. In finding that the trading by the respondents violated Rule 10b-5, the Second Circuit “expand[ed] the limited protection afforded outside investors by the trial court’s narrow definition of materiality.” The non-public nature of the subject information was only addressed indirectly, through the appellate court’s oblique references to terms such as “information intended to be available only for a corporate purpose,” “the uninformed investing public,” and the public’s “unequal access to knowledge.” TGS was not exactly written on a blank slate, as pre-existing SEC Rule 405 (for purposes of the Securities Act of 1933) had defined material as “those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.” However, the court relied instead on congressional intent in federalizing the new crime:

provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.


38. 401 F.2d 833 (2d Cir. 1968).

39. Id. at 842-43. The Supreme Court later ratified the court’s definition of material in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (holding that information is material if there is “a substantial likelihood that, under all circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder”). The TSC Industries holding has been generally referred to as the “total mix” test. See JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOOR, SECURITIES REGULATION: CASES AND MATERIALS 884 (5th ed. 2006).

40. TGS, 401 F.2d at 839.

41. Id. at 851.

42. Id. at 848 (quoting Cadry, Roberts, 40 S.E.C. at 912).

43. Id. at 852.

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks. The insiders here were not trading on an equal footing with the outside investors. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

Less than a year after TGS, the "material inside information" definition was cited in a shareholder complaint against corporate officers in a state derivative action premised upon considerations under "Federal law." By the late 1960s, the Program still focused on the actions of insiders (i.e., those who could be said to possess a fiduciary duty to the company's shareholders).

B. Losing Focus

In the 1970s, the Program enjoyed a string of legal victories, successfully applying Rule 10b-5 as an insider trading prohibition to the activities of, among others, a CEO and his secretary-treasurer, a printer, government agents, and a student marketing corporation (along with its officers, accountants, and attorneys). Class action plaintiffs lacking privity with the defendants joined the litigious banquet after the Supreme Court quietly ratified a lower court's creation of an implied cause of action based upon the SEC rule. Over time, a
curious side effect was the expansion of subject knowledge from \textit{issuer} information to \textit{market} information. Thus, news of a market player (i.e., an "outsider") planning to acquire a block of stock grew to rival information about the issuer of the stock itself, the common denominator being whether the price moved appreciably after the public learned the news.\textsuperscript{53} The more curious side effect was the ensnaring of those outside the boardroom, based upon the informational asymmetry—mere possession of information not similarly possessed by the market.\textsuperscript{54}

As the Program expanded exponentially, the signs of court unrest similarly grew, and the dangers of entrusting the totality of the circumstances to the outrage of the triers of fact became evident. In \textit{SEC v. Bausch & Lomb, Inc.},\textsuperscript{55} a case involving the CEO of the company that patented the famed "Soflens" vision aid, two courts found against the Commission on allegations that a select group of analysts had been tipped with negative news. Prior to the trial, some of the analysts had already consented to Rule 10b-5 violations. Nonetheless, the district court judge exonerated the CEO and the company, ruling that the CEO (who had not engaged in any trading) was "a defendant who cannot fairly be described as a man ‘full of cunning and guile.’"\textsuperscript{56} On appeal, the Second Circuit agreed, declaring that the Commission’s coloring of

\textsuperscript{53} One critic of Wall Street’s practices in the 1990s phrased the gamut of prized data as such:

\begin{quote}
Most precious of all is inside information, which comes in many forms. The most famous kind is news about some dramatic business development, like an unexpected drop in profits, or a takeover attempt, or an imminent indictment. Obviously, whoever knows this before the public can make big money when the news hits the Street. But that’s not the only kind of inside info that can be turned into ready money. News that a brokers’ research department is about to recommend Intel, or that a client is about to place an order for a million shares of IBM, can be valuable to the firm’s trading desk, which can take a position ahead of the event and profit from the ensuing price thrust as the news spreads.
\end{quote}

\textsuperscript{54} See \textit{Chiarella v. United States}, 445 U.S. 222, 230 (1980) (rejecting the parity of information theory and reiterating that silence alone is not an adequate basis to impute liability to an outsider without there first existing a fiduciary relationship).

\textsuperscript{55} 565 F.2d 8 (2d Cir. 1977), aff’d 420 F. Supp. 1226 (S.D.N.Y. 1976).

\textsuperscript{56} \textit{Bausch & Lomb}, 420 F. Supp. at 1228.
an eleven-point stock drop after the alleged tip was a "facile inference" when viewed against the stock's forty-point decline in the immediately preceding weeks. Most enlightening was that the Southern District decried the lack of any applicable definition, as evidenced by the following passage:

This Court is not the first to suggest that the SEC provide concrete guidance. In 1969, then [SEC] Commissioner Smith observed:

In the *Texas Gulf* case itself the Court of Appeals for the Second Circuit suggested that the Commission promulgate further rules to clarify how soon after a public announcement insiders may trade upon the basis of important information contained in the announcement. Since then, thoughtful persons have lined up on both sides of the question of whether rules or guidelines are really feasible or desirable. Recently, the press gave coverage to my own comment sympathizing with those urging that an effort be made at devising guidelines in the area of inside information.

Too often, it seems to me, we debate abstractly among ourselves whether or not something is feasible or desirable but never get down to trying it. Instead of continuing the debate, or whatever you want to call it, over guidelines, perhaps we should set forth a systematic discussion of this particular segment of the insider information area. We should not delude ourselves that the attempt will necessarily be successful or that it is a simple matter. The trouble with any rulemaking process, as anyone who has lived through it must know, is that when you start drafting specific rules, it leaves room for and gives access to doing the very thing you are trying to prevent. That doesn't bely [sic] the need to make the effort, but we can't assume that it is a simple chore or one that will necessarily provide any greater degree of certitude than we now have. A well researched, ranging treatment of the subject by the Commission might not end up more informative or much different than many of the guidelines that have already been suggested by private individuals and groups. They would, however, bear an authoritative basis that could give some guidance and assurance to the many persons of integrity who are eager to comply with the law. The Commission, in my opinion, should make every effort to provide guidance where that is possible.

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That guidance never came and, in the early 1980s, two noteworthy setbacks at the nation’s highest bench called into question the SEC’s drive to expand its net to catch all individuals, be they insiders or outsiders. Cady, Roberts had applied Rule 10b-5 only to board members, a group that, although expanded by TGS to include all company employees, still owed a duty to shareholders and, more importantly, still constituted but a fraction of the market. In a criminal case, Chiarella v. United States, an employee of a financial printing firm (who was completely unattached to the companies he traded) was able to decipher five encoded announcements of takeover bids and purchase stock in the target companies ahead of the publication of the news. Chiarella, who earned over $30,000 in a little more than a year by these practices, was ultimately fired by his employer and forced by SEC consent decree to return his profits; his criminal indictment and conviction followed.

In overturning Chiarella’s conviction, the Supreme Court, noting that the proceeding was the first criminal case premised on a buyer’s non-disclosure, highlighted his status as a “complete stranger” to other market participants. The Court expressed its desire to cabin the Program, acknowledging that section 10(b) of the Securities Exchange Act is a catchall provision, but adding that “what it catches must be fraud.” Most important to the SEC, the Court rejected the “parity of information theory,” under which the jury had been informed that Chiarella “owed a duty to everyone; to all sellers, indeed, to the market as a whole.” Moreover, several years later, the SEC brought an action under section 10(b) and Rule 10b-5 against the head coach of the University of Oklahoma football team after he bought shares. An Oklahoma judge exonerated him, finding that, although the coach spoke to a board member several times at a track meet, the coach actually learned of the inside information while resting supine on a bleacher near the source’s conversation with a third party, and thus was excepted from Rule 10b-5’s reach as an “eavesdropper.”

60. Id. at 224-25.
61. Id. at 235 n.20. Chiarella received a sentence of one year in prison, which was suspended except for one month. Id.
62. Id. at 232-33.
63. Id. at 234, 235.
64. Id. at 231.
66. Id. at 762, 766.
Likewise, in *Dirks v. SEC*, a securities analyst prevailed in avoiding an SEC censure after using confidential information imparted by a whistleblower to help his clients unwind positions in a public company. The Commission charged the analyst—who did not trade for himself—with aiding and abetting violations of Rule 10b-5 (and its Securities Act equivalent, section 17). The Court overturned the minimal penalty of a censure and took the occasion to remind the Commission:

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information “was not [the corporation’s] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.” Not to require such a fiduciary relationship, we recognized, would “depart[ ] radically from the established doctrine that duty arises from a specific relationship between two parties” and would amount to “recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.”

In response to the loss in *Chiarella*, the Commission adopted Rule 14e-3, which outlawed trading by anyone “in possession of material information” relating to another’s tender offer when such information is known (or should be known) to be non-public and acquired from the broadly defined “offering person.” The Rule—which has endured many constitutional attacks—in design and effect—was to serve as a prophylactic approach to the possession of merger information; nonetheless, the Rule hinted at the Commission’s concern with the ambiguous nature of non-public information by expressly providing the accused with a defense where “within a reasonable time prior to any

68. Id. at 650-52.
69. Id. at 654-55 (alterations in original) (citations omitted). In denying the SEC victory, the *Dirks* court nonetheless advanced the Commission’s program by delineating the dual two-part tests that continue to establish tipper/tippee liability. Also, the *Dirks* opinion inspired a third theory to cover “certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation,” id. at 655 n.14, termed the “constructive insider” theory (now more commonly referred to as the “temporary insider” theory), *SEC v. Lund*, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983).
purchase or sale such information and its source are publicly disclosed by press release or otherwise." 72

C. Stepping "Outside"

Despite the setbacks in Chiarella and Dirks, the Commission continued to believe that the Program must apply equally to insiders and outsiders, for two reasons: 1) that the latter group could be utilized to effectuate the plans of the former, and 2) that the outsiders (like insiders) would benefit unfairly. 73 The "misappropriation theory," inspired in spirit and name by Chief Justice Burger's dissent in Chiarella, 74 thus provided the academic conduit to utilizing unethical behavior to ensure that the government could reach the activities of any individual trading the shares of the company whose stock price skyrocketed or plunged. Simply stated, the theory holds that Rule 10b-5 is violated when a person, in connection with the purchase or sale of a security, violates a fiduciary duty owed to the source of the information—more accurately, any source of information to whom a duty can be found. 75 In a celebrated case involving a Wall Street Journal reporter, the government put forth the theory that the journalist had effectively stolen the timing and tenor of his own forthcoming column. 76 In various other cases, the victimized source of information was an employer. 77 In a noted criminal case brought in the Second Circuit, a son was found to have

74. Chief Justice Burger quoted: "'Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.' Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, J., dissenting) (quoting W. Page Keaton, Fraud—Concealment and Non-disclosure, 15 TEX. L. REV. 1, 25-26 (1936)). He continued: "I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." Id.
76. Carpenter v. United States, 484 U.S. 19, 23-24 (1987). By splitting 4-4 on the securities fraud charges, the Justices effectively upheld the Second Circuit's affirmance of the convictions of journalist R. Foster Winans and his tippees on all grounds. See id. at 24.
77. See infra notes 87, 90 and accompanying text.
misappropriated merger information from his father, a member of the subject company’s board.\textsuperscript{78}

Concurrently in the 1980s, partially in response to much-publicized insider trading scandals,\textsuperscript{79} Congress twice accepted the challenge of amending the securities laws to strengthen the Program and the position of civil plaintiffs alike. Despite increasing penalties, identifying victims of “fraud on the market,” and imposing supervisory and procedural obligations on financial service providers, the legislative body refused to define the crime.\textsuperscript{80} Specifically, in the Insider Trading Sanctions Act of 1984, Congress wrote the dual element refrain into law for purposes of setting SEC penalties, but did not define \textit{material} or \textit{non-public}.\textsuperscript{81} Four years later, in the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress extended the liability of insider traders to all “contemporaneous traders” and imposed duties on financial firms to implement procedures designed to detect and prevent insider trading, but again did not define insider trading or its key components.\textsuperscript{82} Thus, key terms remained judge-made, and the judge-made prohibition retained its flaws.

The 1980s saw the Program surge forward, fueled by noteworthy indictments of targets ranging from another opportunistic financial

\textsuperscript{78} United States v. Reed, 601 F. Supp. 685, 717-18 (S.D.N.Y. 1985) (holding that the functional equivalent of a fiduciary relationship could exist where a father and son, as the indictment alleged, were in a “confidential relationship,” demonstrated \textit{inter alia} by the fact that they “frequently discussed” business affairs).


\textsuperscript{81} 98 Stat. at 1264 (authorizing SEC penalties against any party violating the Securities Exchange Act “by purchasing or selling a security while in possession of material nonpublic information,” as well as the relief of treble damages therefore).

\textsuperscript{82} See 15 U.S.C. § 78t-1(a) (2000), which created an express cause of action for private parties as “contemporaneous traders” with insider traders, and 15 U.S.C. §§ 78o(f), 78t(a) (2000), which together establish control person liability for their employers.
 printer\textsuperscript{83} to President Reagan's Deputy Secretary of Defense.\textsuperscript{84} Certain procedural requirements were so attenuated as to disappear, such as the requirement under \textit{Dirks} that a tipper be found to have obtained a "benefit" from his tip.\textsuperscript{85} At decade's end, the Second Circuit reiterated its support for the misappropriation theory by finding a psychiatrist guilty of insider trading based upon a tip gleaned from a patient's therapy session.\textsuperscript{86}

After the Supreme Court deadlocked on the soundness of the theory in 1987,\textsuperscript{87} the government steadfastly continued on a path towards eventual reconsideration by the high court, along the way racking up victories in select circuits. But the path was not without pitfall. Several circuits opposed the new reach of the Program, some with appreciable venom. In 1994, the Fourth Circuit refused to find the machinations of a state lottery director within Rule 10b-5's grasp, holding that the misappropriation theory, by treading so randomly on the varied terrain of "fiduciary" duties, made investors "the targets of \textit{ad hoc} decision-making or pawns in an overall litigation strategy known only to the SEC."\textsuperscript{88} Likewise, the Eighth Circuit dismissed all criminal charges (including money laundering) against a felon because application of the misappropriation theory was seen to be against "venerable" precedent and imposing liability "even though no market participant was deceived or defrauded."\textsuperscript{89} Even the Commission-friendly Second Circuit—which had embraced the misappropriation theory first\textsuperscript{90}—found cause to have

\textsuperscript{83} SEC v. Matera, 745 F.2d 197, 199 (2d Cir. 1984).
\textsuperscript{85} See Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,979 (S.D.N.Y. Apr. 15, 1985) (explaining that a corporate officer who provided information to the writer of an industry newsletter was found to do so in order to gain "a reputational benefit").
\textsuperscript{86} United States v. Willis, 737 F. Supp. 269, 271-72, 277 (S.D.N.Y. 1990) (stating that "when Dr. Willis purchased . . . securities on the basis of his patient's confidential information, he defrauded his patient").
\textsuperscript{87} See Carpenter v. United States, 484 U.S. 19, 22-24 (1987) (holding that the co-author of a weekly \textit{Wall Street Journal} column was guilty of mail and wire fraud for having stolen the "timing contents" of his own column through an insider trading scheme; the Rule 10b-5 conviction was upheld by the Second Circuit when justices deadlocked at 4-4 on the applicability of the securities laws to the crime).
\textsuperscript{88} United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995). The Fourth Circuit further found the theory "irreconcilable with applicable Supreme Court precedent." \textit{Id.} at 944.
\textsuperscript{89} United States v. O'Hagan, 92 F.3d 612, 619 (8th Cir. 1996). Interestingly, the Eighth Circuit opinion termed the information at issue "privileged" and "confidential," but not \textit{non-public}. \textit{Id.} at 628.
\textsuperscript{90} United States v. Newman, 664 F.2d 12, 15-17 (2d Cir. 1981) (finding that investment bankers violated fiduciary duties to both their employer and their clients by using confidential information for trading purposes).
pause when the law's reach seemed a stretch; namely, the appellate court (sitting en banc) exonerated a stockbroker tipped by a client who, in the eyes of the government, had allegedly misappropriated the information from his wife.91

Yet the Program persisted in its goal of reaching both halves of the market, and, in 1997, finally obtained Supreme Court approval of the misappropriation theory in a case showcasing perhaps the least sympathetic 10b-5 defendant of all time. James O'Hagan was a partner in a prominent law firm who learned from his employer that a client, Grand Met, was going to takeover Pillsbury. During the next few weeks, O'Hagan made a bid to corner the market for options on Pillsbury stock and ultimately profited over $4.3 million from the eventual public news of the takeover.92

O'Hagan was charged with insider trading (based upon violations of both Rules 10b-5 and 14e-3) on the theory that he had stolen the information from either his employer or Grand, or from them both. It is noteworthy that, even before the Supreme Court heard his appeal, O'Hagan had been convicted of embezzlement by a state court.93 Faced squarely with the choice to convict or not convict a convicted felon, the Supreme Court found his actions to come within the securities laws. Among other noteworthy findings, Justice Ginsburg's majority opinion (which was joined by five other Justices) found the nagging 10b-5 pleading requirement of fraud or deception to be satisfied by O'Hagan's "feigning fidelity" to his employer by showing up at work each day and remaining silent about his trading.94 Regardless of any academic gymnastics, the case forms both the present underpinning and reach of the Program, which presently outlaws trading based upon material, non-public information by insiders (who owe a duty to shareholders)95 and

91. United States v. Chestman, 947 F.2d 551, 570-71 (2d Cir. 1991) (en banc). But see United States v. Willis, 737 F. Supp. 269, 272 (S.D.N.Y. 1990) (finding a psychiatrist to have violated the duty of confidentiality to his patient when he used information from a therapy session to trade). Commentators have noted that Willis actually stands for the ability of a misappropriation analysis to redefine the underlying fiduciary duty, as the psychiatrist's trading was not a breach of the duty of confidentiality. See Steven A. Ramirez & Christopher M. Gilbert, The Misappropriation Theory of Insider Trading Under United States v. O'Hagan: Why Its Bark Is Worse Than Its Bite, 26 SEC. REG. L.J. 162, 183-84 (1998).
93. Id. at 648 n.2.
94. Id. at 655.
95. Id. at 651-52.
everyone else who is found to owe a duty of confidentiality to the source of their information. 96

Several other developments round out the Program’s history. The Supreme Court in recent years has substantially lowered the bar for 10b-5 actions by weakening three of the elements required to plead the violation: 1) an actual purchase or sale, 2) fraud or deception, and 3) activity “in connection with” the purchase or sale. 97 Finally, in October 2000, the Commission adopted three measures aimed at lightening its load at insider trading trials by: 1) outlawing selective disclosure of corporate information by management, 98 2) clarifying that insider trading defendants need only be aware of the subject information (as opposed to showing they relied upon or used it), 99 and 3) expressly recognizing familial and confidential relationships as predicates for the misappropriation theory 100 (in response to the question of whether a husband could steal inside information from his wife). 101 It is, thus, on this difficult combination of SEC rule and judge-made law that the Program proceeds.

But O’Hagan did not enjoy the peaceful slumber of Supreme Court precedents. Critics were quick to point out that, by focusing on any fiduciary duty, the decision hopelessly ties a federal prohibition to a state law concept. Further, the sanctioned approach effectively creates a novel, triangular analysis that punishes parties for a breach of a duty to the source of the information that somehow harmed a third party (i.e.,

96. Id. at 652-53.
97. In the O’Hagan case, Justice Ginsburg found Rule 10b-5’s fraud or deception element satisfied by the defendant showing up to work each day (“feigning fidelity”). Id. at 655. In 2002, the Court refused to continue to hold 10b-5 actions to the Rule’s “‘in connection with the purchase or sale’” limitation, stating that in enacting the Securities Exchange Act of 1934, “Congress sought ‘to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry’” (and so found the Rule a proper remedy for a thief whose theft involved no trading). SEC v. Zandford, 535 U.S. 813, 819-20 (2002) (overturning the Fourth Circuit’s holding that outright theft merely incidental to the maintenance of a securities brokerage account was not “in connection with the purchase or sale of securities”) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (quotation omitted)). In March 2006, the Court effectively reversed the purchase or sale requirement (commonly referred to as “the Birnbaum Rule” from Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952)) by deciding in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1514 (2006), that state class actions alleging securities fraud brought by plaintiffs who had not purchased or sold were nonetheless pre-empted by the federal Securities Litigation Uniform Standards Act of 1998 § 101(b), 15 U.S.C. § 78bb(f) (2000).
"the market"). The two dissenting opinions in O'Hagan found many flaws in the majority's reasoning, a chief one being:

Even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of the source of the information. Moreover, as we have repeatedly held, use of nonpublic information to trade is not itself a violation of § 10b.

**D. The Vanishing Duty**

It seemed only time, therefore, before jurists chose to weaken the O'Hagan precedent. Stated more bluntly: What would a federal court do when the defendant did not evidence O'Hagan's criminality and the government did not have Rule 14e-3 to fall back on? One noteworthy example comes from a California district court in February 2006. J. Thomas Talbot, the director of Fidelity National Financial, Inc., a publicly traded title insurance corporation, obtained summary judgment against the SEC after being charged with violating Rule 10b-5 by earning approximately $67,000 in profits trading on the boardroom news that LendingTree, Inc., (an online realty mortgage corporation) would be seeking a merger with a third party. Fidelity owned between eight and ten percent of LendingTree at the time, and earlier in the year had even been approached as a possible acquirer of LendingTree. Among other things, the California court held that, while the information of the likely merger was non-public despite flowing through a number of officers at both Fidelity and LendingTree, there was no explicit acceptance by Fidelity or its agents to maintain LendingTree acquisition confidentiality and also no implied duty of confidentiality under law. Absent an express or implied fiduciary duty of Fidelity to LendingTree, there could be no breach of a duty by Talbot—an outsider—and no resulting liability under the misappropriation theory.

In Talbot, the totality of the circumstances approach clearly worked to the SEC's disadvantage. The respondent, a seventy-year-old man with an economics degree from Stanford (in addition to his law degree) who possessed thirty years experience on corporate boards, had traded on two

102. See O'Hagan, 521 U.S. at 656.
103. Id. at 690-91 (Thomas, J., concurring in part, dissenting in part) (footnote omitted).
105. Id. at 1031-33 & 1033 n.9.
106. Id. at 1046.
dates subsequent to learning of news of a possible acquisition.\textsuperscript{107} Shortly after his trading commenced, LendingTree forwarded a "tender offer letter," a confidentiality provision which restricted Fidelity's use of information received in connection with the still non-public merger. Five days later, Talbot bought more LendingTree stock. Despite the defendant's persistent trading, the judge—in the spirit of Potter Stewart—not only refused to find any obscenity in Talbot's profits, but also awarded him costs.\textsuperscript{108}

Putting aside considerations of materiality and the satisfaction of the "in connection with" 10b-5 element, the Talbot decision relied more heavily on the lack of any express duty to the Fidelity board or LendingTree at the time of the board meeting to keep the boardroom discussion confidential.\textsuperscript{109} The irony here should not be glossed over: The SEC, which had commenced its insider trading enforcement program by focusing on those in attendance of a closed board meeting, after working so long and hard to expand the scope of that program to include those outside the boardroom,\textsuperscript{110} lost an insider trading case against someone in the boardroom. At the very least, the Program's hard fought victory in O'Hagan has become suspect, as the California bench refused to equate Fidelity's duty to LendingTree (or Talbot's duty to Fidelity) with O'Hagan's duty to his law firm.\textsuperscript{111}

\textbf{E. Economic and Moral Rationale for the Program}

Despite the SEC's success in legal forums and attendant internal rulemaking, the insider trading prohibition commenced and continues on a questionable economic premise: A share's price reflects all public information on an individual stock. Such a cornerstone, while viscerally appealing, does not comport with traditional, European economic thought, which often posited that a share price reflected all information, public or otherwise.\textsuperscript{112} The incongruity has prompted this stark disclosure by one former SEC Commissioner:

\begin{quote}
\textsuperscript{107} Id. at 1032, 1035.
\textsuperscript{109} See Talbot, 430 F. Supp. 2d at 1046-64.
\textsuperscript{111} Talbot, 430 F. Supp. 2d at 1064.
\textsuperscript{112} French economist Louis Bachelier (1870-1946) is credited with popularizing the "efficient market hypothesis," a precept which posits that "stock market prices are the best available estimates of the real value of shares since the market has taken account of all available information on an individual stock." JENNIFER BOTHAMLEY, DICTIONARY OF THEORIES 168 (1993). Modern American prosecutors thus espouse—either knowingly or unknowingly—the "semi-strong" theorem.
\end{quote}
Many securities industry professionals have questioned this [efficient market] theory, or at least its applicability to stocks that are not traded on a major securities exchange or actively followed by analysts.

If the efficient market theory were true, it would be possible to conclude that a government mandated disclosure system is unnecessary and that a large portion of the SEC’s enforcement program is irrelevant. Particularly suspect would be the Commission’s devotion to the elimination of trading on inside information on the premise that such trading is unfair.\textsuperscript{113}

Regardless of any questionable economic premise, it seems clear that the insider trading prohibition comes from the desire of well-meaning government officials to create a stock market that echoed egalitarian principles permeating our democratic society. In the roughly forty-five years since \textit{Cady, Roberts}, that desire has been both fortified and expanded. The ideal occupies a place of prominence on the SEC agenda that was perhaps best summarized by the agency’s Chairman in 1998:

Our markets are strong because investors are confident of their basic fairness. Trading on inside information—and giving early tips to other potential traders—damages the entire structure of our markets, because it deeply shakes this vital investor confidence. It can especially demoralize individual investors.

Our law has no tolerance for favoritism. It holds no place for privilege. Everyone deserves a fair shot at success in our nation’s securities markets.

Well-connected people don’t deserve any greater chance for success than the average citizen. Nor do the friends and relatives of those well-placed people, who may reap unfair profits because they happen to know the news before it breaks.

\textsuperscript{113} ROBERTA S. KARMEL, \textsc{Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America} 258 (1982).

of the efficient market hypothesis; such theorem alters the hypothesis to assume that the market can only factor in \textit{public} information on any individual stock. \textit{See Burton G. Malkiel}, \textit{A Random Walk Down Wall Street} 189-91 (1996). The traditional analysis continued to appeal to market professionals at least until recent decades. \textit{See Homer Kripke}, \textit{The SEC and Corporate Disclosure: Regulation in Search of a Purpose} 84 (1979) ("The strong form of the efficient market hypothesis asserts that prices also reflect what may not be publicly known.").
It's simply a question of integrity.\textsuperscript{114}

That well-meaning prohibition has twice in recent decades escaped definition by Congress,\textsuperscript{115} leaving intact the traditional "material and non-public" approach of \textit{TGS}. Such a largely undefined, common law standard continues to set the tone in case law,\textsuperscript{116} regulatory disciplinary decisions,\textsuperscript{117} and SEC actions.\textsuperscript{118}

But two interrelated questions are begged: 1) What is non-public information?, and 2) How does one know when one has obtained it? These questions grow in significance when one considers the battles lost by the Program and the lack of clarity in its predicate terms. It bears noting that jurists forced to continually weigh the totality of the circumstances put before them are apt to seize upon any weaknesses or incongruities in the insider trading definition, bringing all discussion back to the vagueness of that premise.

\textbf{III. "NON-PUBLIC INFORMATION": NO ONE KNOWS IT WHEN THEY SEE IT}

Just what qualifies as "non-public?" In the broad context of non-public offerings exempt from securities registration, both the SEC and foe were surprised by the Supreme Court's holding in 1953 that a securities offering, to be public, "need not be open to the whole world."\textsuperscript{119} In reaching its conclusion that the determinant is whether a company's employees were able to "fend for themselves" through access

\begin{itemize}
  \item \textsuperscript{115} See \textit{supra} notes 79-82 and accompanying text. ITSFEA has perhaps had its biggest impact on the written procedures of brokerage firms, which face SEC action for inadequate procedures even in the absence of a resultant violation. See Press Release, SEC, SEC Charges Morgan Stanley with Failure to Maintain and Enforce Policies to Prevent Misuse of Inside Information (June 27, 2006), \textit{http://www.sec.gov/news/press/2006/2006-103.htm} ("Despite the legal requirements to do so, Morgan Stanley for years failed to maintain and enforce adequate written policies and procedures to prevent the misuse of material nonpublic information, commonly referred to as inside information.").
  \item \textsuperscript{116} See \textit{infra} notes 171-74 and accompanying text.
  \item \textsuperscript{117} See, e.g., NYSE, Inc., Exchange Hearing Panel Decision 89-52, at 1 (June 5, 1989), \textit{available at} \url{http://www.nysc.com/pdfs/89-050.pdf} (explaining that a firm was fined by the NYSE for failing to provide for appropriate supervisory control "to assure that material non-public information was not improperly disseminated within the firm").
  \item \textsuperscript{118} See, e.g., Second Amended Complaint \S 12, SEC v. Waksal, No. 02 Civ. 4407 (S.D.N.Y. Oct. 10, 2003) ("The information Sam Waksal received on December 26 and 27, 2001 . . . was material and non-public.").
  \item \textsuperscript{119} SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953).
\end{itemize}
to financial data normally found in a registration statement, the Court expressly rejected the Commission’s contention that a bright line number (e.g., twenty-five purchasers) could distinguish public from non-public offerings.\textsuperscript{120}

On the question of what news public investors are owed during merger negotiations, the Supreme Court has eschewed a bright line test in favor of an analysis that mirrors considerations of whether the news was material.\textsuperscript{121} Separately, the section of the Securities Exchange Act governing proxy preparation defines “non-public, confidential information” as that information not required to be publicly disclosed by publicly held corporations pursuant to SEC disclosure laws.\textsuperscript{122} Further, the Supreme Court has held that securities analysts are seen as efficient when piecing together public information into a non-public conclusion,\textsuperscript{123} a curious (albeit quixotic) dictate that is cited to this day.

In the context of improper securities trading, \textit{TGS}, long ago, arguably succeeded in only opening a debate that now often confuses \textit{material} (as in the definition of insider trading) with \textit{materiality} (as in the attendant pleading requirement). It hardly bears noting that any approach depending upon information to be non-public in order to be material could equally be said to require that conclusions as to confidentiality hinge upon findings of market import. Concurrently, while volumes have since been written on the difficult question of what is material information,\textsuperscript{124} relatively scant is the scrutiny of the reluctance of the regulators to define the adjoining term, \textit{non-public}. Such a career path for the latter half of the definition seems peculiar, especially when even the promise of non-public information has paved the way for private lawsuits.\textsuperscript{125}

\begin{flushright}
\textsuperscript{120} \textit{Id.} at 125.
\textsuperscript{123} \textit{See Elkind v. Liggett & Myers, Inc.}, 635 F.2d 156, 165 (2d Cir. 1980).
\textsuperscript{124} \textit{See, e.g., Arthur Levitt with Paula Dwyer, \textbf{Take on the Street: How to Fight for Your Financial Future} 95-97} (2003) (describing the difficulties posed by the inclusion of the term material from the perspective of an insider trading prohibition of selective disclosure by issuers to analysts); \textit{SEC v. Bausch & Lomb, Inc.}, 565 F.2d 8, 10 (2d Cir. 1977) (“[M]ateriality has become one of the most unpredictable and elusive concepts of the federal securities laws.”).
\textsuperscript{125} \textit{See, e.g., Bateman Eichler, Hill Richards, Inc. v. Berner}, 472 U.S. 299, 303 (1985) (involving a private action under Rule 10b-5 premised upon the misrepresentation of agents of the defendant and an issuer that inside information was being imparted).
\end{flushright}
A. Angles of the SEC and Others

Attempts at clarification of the term *non-public* have come in installments, and unfulfilling ones at that.\(^ {126}\) SEC Rule 14e-3, the more focused parallel to Rule 10b-5 that covers only the situation of tender offers, is conspicuously silent and its related interpretive materials provide only a short list of examples (i.e., the intention to make a tender offer, the withdrawal of a tender offer, and the decision to increase the amount of the tender offer).\(^ {127}\) In cases charging both rules against parties trading on news of a merger, the SEC has relied heavily on written policies protecting corporate confidences at either of the companies involved.\(^ {128}\)

Other laws and regulations have not fared much better at crystallizing the phrase *non-public*. Before it was amended, a regulation adopted pursuant to the Commodity Exchange Act\(^ {129}\) added the wrinkle that non-public information is that which has not been made available "through recognized channels of distribution."\(^ {130}\) Abroad, the nearly two-decade-old European Community Directive on insider dealing mainly emphasized the material nature of the information.\(^ {131}\) In 2000, the SEC's adoption of Regulation FD avoided altogether defining *non-public*.\(^ {132}\) The rule manual for the National Association of Securities Dealers ("NASD"), while defining "material news," does not attempt


\(^ {128}\) See, e.g., Lohman, *Initial Decision Release No. 214*, 78 SEC Docket 1327, 1328-32 (Sept. 19, 2002) (describing one issuer's policy advising employees that "[i]nformation should not be considered to have been publicly disclosed until a reasonable time after it has been made public (for example, by a press release)").


\(^ {130}\) 17 C.F.R. § 1.59(a)(4) (1988). The regulation has been amended to an equally amorphous definition: "information which has not been disseminated in a manner which makes it generally available to the trading public." 17 C.F.R. § 1.59(a)(6) (2006).

\(^ {131}\) The 1989 measure included the following definition of inside information:

> Information which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question.


written guidance for either public or non-public;\textsuperscript{133} the NYSE rulebook is similarly silent on both.

The SEC has never prohibited the disclosure of all internal corporate information, acknowledging that management may reveal non-public information that merely fills "interstices in analysis . . . [or tests] the meaning of public information."\textsuperscript{134} In 1973, the SEC formally announced its refined "public access" definition of non-public information in \textit{In re Faberge, Inc.}, in which the Commission stated that in order "to achieve a broad dissemination to the investing public generally and without favoring any special person or group," information must be disclosed "in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."\textsuperscript{135} The stock exchanges have elaborated on the methodology for the benefit of companies that list their stock issues with them; these guidelines tend to simultaneously over-require dissemination and over-emphasize a concrete list of information vendors who are sure to fall in and out of fashion.\textsuperscript{136} A wholly different approach has been expounded by certain courts, which instead emphasize the market's impoundment of the material information as evidenced by a new price.\textsuperscript{137} Such an approach, if lacking in considerations of general access, at least boasts a lack of tangible investor harm.

\textsuperscript{133} "Material news" is defined in the NASD Glossary as news "that might reasonably be expected to affect the value of a company's securities or influence investors' decisions." NASD, Glossary of Terms—M, http://www.nasd.com/Resources/Glossary/NASDW_011116 (last visited Mar. 10, 2007).

\textsuperscript{134} \textit{In re Investors Mgmt. Co.}, 44 S.E.C. 633, 646 (1971).

\textsuperscript{135} \textit{In re Faberge, Inc.}, 45 S.E.C. 249, 255, 256 (1973). The Commission had previously espoused a similar position two years earlier in its review of an internal examiner's findings concerning the actions of an investment adviser. \textit{See Investors Mgmt.}, 44 S.E.C. at 644.


\textsuperscript{137} \textit{See}, \textit{e.g.}, United States v. Libera, 989 F.2d 596, 601 (2d Cir. 1993).
B. To Know What Mayhew Knew

A series of takeover cases decided by the Second Circuit in the mid-1990s embraced and then let go of definitions of non-public information for purposes of finding insider trading. In United States v. Libera, that Circuit affirmed the “market impoundment” approach by holding that information becomes public once, even if known only by a small group of persons, trading “has caused the information to be fully impounded into the price of the particular stock.” 138 In that popular case, the court upheld the criminal convictions of an outsider who had earned approximately $95,000 from tips gleaned through copies of Business Week obtained for $30 each approximately eight hours before the famed magazine hit the newsstand. 139

Later, in United States v. Mylett, the Second Circuit elaborated, holding that information could be non-public even though it failed to reveal all the details of a tender offer. 140 In a case centering on a single trading day, the court noted that The Wall Street Journal had speculated about an AT&T acquisition, a possibility that was privately confirmed to a stockbroker upon a telephone call in which a company vice president stated: “AT&T was going to attempt to acquire NCR.” 141 In upholding convictions brought under 10b-5, the court added to the mix by holding: “To constitute non-public information under the [Securities Exchange Act], information must be specific and more private than general rumor.” 142

Finally, in SEC v. Mayhew, the court was called upon to weigh the informational advantage of Jonathan Mayhew, a private trader specializing in takeover candidates. 143 Mayhew had obtained information from a neighbor that went beyond news in the press concerning the year-long efforts of Rorer Group, Inc. to finalize a merger. After learning on November 15, 1989 that Rorer was actively pursuing a merger partner, Mayhew reinvested in Rorer stock, ultimately yielding a profit exceeding $250,000 when news of a contemplated tender offer broke in January 1990. 144

138. Id. at 601 (“Once the information is fully impounded in price, such information can no longer be misused by trading because no further profit can be made.”).
139. Id. at 598-99.
140. 97 F.3d 663, 666-67 (2d Cir. 1996).
141. Id. at 666.
142. Id.
143. 121 F.3d 44 (2d Cir. 1997).
144. Id. at 49.
The Mayhew bench discounted Mayhew’s prior unprofitable trades in Rorer during the relevant time period as well as the fact that the company had been publicized as a takeover candidate. More importantly, in finding Mayhew liable for violations of Rule 14e-3, the Second Circuit adopted the expanded notion that non-public information could include information transforming the “total mix” of investor knowledge from the “likely” to the “probable” when it stated:

In sum, the aggregate of public information prior to November 15, 1989, was to the effect that Rorer was willing to merge if it found the right partner and that Rorer was discussing this possibility with up to three companies. Privately, Rorer executives took care to keep information about actual merger discussions secret by limiting the persons who knew about specific merger negotiations to top executives and by using codes in related documents.

We agree with the district court that the information Piccolino conveyed to Mayhew went beyond that which had been publicly disseminated. Mayhew learned from Piccolino that [the president of Rorer’s pharmaceuticals business] had confirmed that Rorer was “actually in discussions” toward merger with a candidate or candidates. He also learned that these merger talks were at a “serious” stage—far enough along to warrant [Mayhew’s company’s] involvement in negotiating a new employment agreement for Rorer’s CEO. To a reasonable investor, this combination of new information, acquired privately, transformed the likelihood of a Rorer merger from one that was certainly possible at some future time to one that was highly probable quite soon.

One might have expected such a ruling if a bright line had been crossed, but Mayhew never actually learned that a merger had been finalized, just that the two companies were in some pronounced state of negotiation termed “in discussions” by industry experts. He was thus penalized for knowledge beyond that proscribed by the SEC in its adoption of Rule 14e-3 and that was quite possibly only of value to those already closely following the market for Rorer stock. A requirement to abstain from the market in such circumstances seems draconian, particularly since the Second Circuit had years earlier found no affirmative duty on market participants “to verify whether or not their

145. The district court found no violations of Rule 10b-5 by Mayhew, so the appellate court did not consider that Rule. See id.
146. Id. at 50-51.
[trading] information could be deemed public information.\textsuperscript{147} Once again, observers must wonder how much the defendant’s sizeable profit weighed in the court’s analysis.

More importantly, Mayhew and Faberge/Investors Management indicate two distinct approaches, either: 1) news is public once broadly disseminated, or 2) news is public once impounded in the price of the subject stock. Absent clear enunciation of the import of “market chatter,” some courts have quite understandably proven gun-shy about supporting the Program: In a Ninth Circuit case from the year after Mayhew was decided, the court granted summary judgment for the defendants against the Commission’s charges of insider trading, which, based primarily on “massive and well-timed trading” and generic, incriminating statements, were characterized as “pure speculation.”\textsuperscript{148} Several years later a federal judge sitting in the Southern District of New York granted summary judgment for the defendants from what the SEC alleged was an “insider trading ring operating out of Mexico City.”\textsuperscript{149} In a case involving the tender offer for CompUSA, the judge clearly signaled his disdain for the SEC’s speculation, stating:

In this case, the SEC concedes that it has not uncovered direct evidence of the existence of “inside information,” relying instead on the circumstances, the timing, and the nature of the relationships. Prior to the tender offer announced on January 24, 2000, the market had started to move, with trading increasing 110% on January 19 over the previous day’s volume and more than doubling over the next two days. Whether this movement resulted from inside information, market perception, or shrewd judgment was the issue presented to the SEC. Certainly the circumstantial evidence warranted the investigation. Only after full discovery could A.Duclaud’s knowledge, or lack of it, be determined. However, here there is direct evidence that the “inside information,” the making of the tender offer, could not have been known at the time of the attacked purchases as it did not, as a matter of uncontroverted fact, exist at that time. Under such circumstances, summary judgment is appropriate.\textsuperscript{150}

\textsuperscript{147} SEC v. Monarch Fund, 608 F.2d 938, 943 (2d Cir. 1979) (reversing guilty findings under Rule 10b-5).
\textsuperscript{149} SEC v. Gonzalez de Castilla, 184 F. Supp. 2d 365, 368 (S.D.N.Y. 2002).
\textsuperscript{150} Id. at 376-77.
Thus, even after criminal convictions, judicial scrutiny, and corresponding publicity, the questions persist: How does one know when she has received inside information? And when will it become public? The answers consistently fall back onto the "material, non-public" language of the early insider trading cases, which fails as a yardstick and suffers from four notable setbacks: The standard is too intertwined, too conclusory, too undefined, and too costly.

1. Too Intertwined

The same TGS case that federalized the crime of insider trading and contributed so much in clarifying the material part of its definition may have hopelessly confused the debate over the term non-public. Indeed, the case at best triggered an analysis weighing events both before and after disclosure and at worst confused the two concepts entirely with statements such as this:

Our survey of the facts found below conclusively establishes that knowledge of the results of the discovery hole... would have been important to a reasonable investor and might have affected the price of the stock.¹⁵¹

Indeed, the Program's own emphasis on circumstantial evidence to prove insider trading has led to a bounty of misappropriation cases in which market moves favorable to the defendant after the trade are utilized as primary evidence of the illegality of the transaction. This goes as far back as 1984, when the Second Circuit held, in a case involving two bond traders given tips by a law firm manager, that prior successful stock tips supported the inference that a defendant "either knew or should have known that he was trading on improperly obtained non-public information."¹⁵² Likewise, as recently as 2002, in a case involving a tipping investment banker, the Southern District held that a "substantial increase in the stock price upon the public announcement of the merger" supported a finding that the transaction was material.¹⁵³ Not surprisingly, at least one court has followed the TGS lead to its logical

¹⁵¹ SEC v. TGS, 401 F.2d 833, 850 (2d Cir. 1968); see also Rubin, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,769, at 97,713 (S.D.N.Y. Sept. 3, 1993) (stating that information is material where it turns the "rumor into a sure thing").


conclusion by dismissing a claim of materiality where no market decline ensued.\footnote{154.}{In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1425 (3d Cir. 1997).}

2. Too Conclusory

Apart from definitional inter-reliance, and the result of avoiding any bright line test, the court’s findings of the presence of non-public information are at times derived from determinations of whether separate indicia of a crime are present. Roughly stated, holdings more often than not brand news non-public if, in hindsight, someone thought it was worth stealing.

This circuitous reasoning inevitably prompts courts into a case-by-case factoring of all events attending suspect trading or noteworthy profits. The phenomenon is perhaps best exemplified by the Eleventh Circuit’s holding in \textit{SEC v. Ginsburg},\footnote{155.}{362 F.3d 1292 (11th Cir. 2004).} in which a CEO of a company that owned radio stations was accused of tipping his family members to impending mergers. In overturning the district court’s verdict for the defendant based upon a finding that “[e]vidence that . . . [he] could have communicated inside information to [his brother] is not evidence that he \textit{did} communicate inside information,”\footnote{156.}{SEC v. Ginsburg, 242 F. Supp. 2d 1310, 1319 (S.D. Fla. 2002).} the appellate court concluded:

The temporal proximity of a phone conversation between the trader and one with insider knowledge provides a reasonable basis for inferring that the basis of the trader’s belief [that the price would increase] was the inside information. The larger and more profitable the trades, and the closer in time the trader’s exposure to the insider, the stronger the inference that the trader was acting on the basis of inside information.\footnote{157.}{Ginsburg, 362 F.3d at 1299.}

As further example of this hindsight approach, a much publicized 2002 SEC case against an investment banker and his “tippees” went so far as to cite two defendants’ transferring money out of the country and “abrupt departure from the United States to avoid prosecution” as two facts helping to establish 10b-5 liability in an SEC civil action.\footnote{158.}{Sekhri, [2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,576-77. That decision also premised the finding of the defendants’ “knowledge or reckless disregard of the fact that they were trading on confidential information” on their prior knowledge that their source “worked in the corporate finance department at Salomon [Brothers] and was in a position likely to have access to confidential information.” \textit{Id.} at 90,580.}
3. Too Undefined (The Lost Martha Stewart Opportunity)

While the much-publicized case against Martha Stewart proved to be a media delight, it should perhaps be remembered for what it did not provide lawyers, judges, compliance officers, and academics: The answer to the question of whether news of the trading efforts of another customer is inside information under the law. To wit, in June 2003, the SEC brought civil charges against Stewart and her stockbroker, alleging that the passing of a tip that the head of ImClone was selling his company shares was "material, nonpublic information." Specifically, the Commission charged that Martha Stewart's broker had instructed her that ImClone's CEO and his daughter "were selling or attempting to sell all of their ImClone shares at Merrill Lynch and that [the broker] believed that Stewart might wish to act on that information." Additionally, the Commission's complaint relied heavily on Merrill Lynch's internal procedures, which banned the disclosure of one customer's order to another.

Notably, when the U.S. Attorney for the Southern District of New York brought its criminal case, the office apparently found the theory shaky, for the parallel criminal indictment, while boasting a robust total of nine charges (including obstructions of justice and securities fraud), did not include insider trading. The press was quick to pick up on the irony of a prosecution premised on purported lies centering on trading activity that may not have been criminal at all. Indeed, many articles aptly noted the questions not resolved by the Stewart matter, as well as the Rule 10b-5 elements left unaddressed. Counsel for a leading white collar law firm in Washington, D.C. went so far as to state that the news of sales by a company insider in question might not even be illegal if the

160. The SEC charges relied upon Merrill Lynch's confidentiality policy to prove the illegality of the disclosure of Sam Waksal's trading by Stewart's broker, Peter Bacanovic. See Complaint at 1, 7-9, SEC v. Stewart, No. 03 CV 4070 (S.D.N.Y. June 4, 2003). For a compelling account of the breadth of questions that might have been answered by a Martha Stewart trial, see Donald C. Langevoort, Reflections on Scienter (And the Securities Fraud Case Against Martha Stewart that Never Happened), 10 LEWIS & CLARK L. REV. 1 (2006).
162. Id. at 10.
163. Id. at 7-9.
164. See Naomi Aoki & Tatsha Robertson, Stewart Is Indicted, Steps Down, BOSTON GLOBE, June 5, 2003, at A1 ("Charges of insider trading were notably absent from the criminal case.").
165. See, e.g., Langevoort, supra note 160, at 11 ("Much of the discussion [about a hypothetical trial of Martha Stewart for insider trading] has been with respect to the particular use of the misappropriation theory of liability that would be necessary to create liability.").
underlying news had already been the subject of Internet chatter.\textsuperscript{166} Moreover, the public debate on what did and did not need to be proven at a hypothetical insider trading trial approached the sublime.\textsuperscript{167}

The SEC’s case against Stewart was stayed pending her criminal trial and later settled.\textsuperscript{168} Among the many peculiarities occasioned by that non-trial, investors and other market watchers were denied edification as to whether the news of another customer’s order is per se non-public. It seems safe to conclude that, given the shakiness of the misappropriation theory and the recent, unpredictable outcomes of cases relying thereon, the Program could have used any guidance the court would have had to offer.

4. Too Costly (The Next Great Setback?)

The government’s universal application of its Supreme Court-approved misappropriation theory to outsiders generating considerable profits from advance knowledge has resulted in mixed results.\textsuperscript{169} Indeed, a rash of cases from 2006 further highlights the flaws of any conclusory approach to the difficult questions surrounding insider trading charges.

In the late summer of 2006, two separate juries acquitted defendants accused of using their position as specialists on the floor of

\begin{quotation}
\textbf{Money & Markets: Twist & Turns of Waksal Woes} (CNN television broadcast Aug. 12, 2002).
\end{quotation}

\begin{quotation}
\textbf{Host:} [I]f it’s just a rumor \ldots and you don’t know it’s true, you didn’t get it directly from the source, how does that affect whether or not this is illegal?

\textbf{Former USA:} Well, whether it’s material or not would—

\textbf{Host:} If it’s definitely material—

\textbf{Former USA:} Well, it wouldn’t necessarily be material if it were an unverified rumor. Then, the question becomes whether or not it is really a nonpublic material fact that the company knows or the company insiders know and that others don’t[,] particularly the investing public.
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\textbf{Money & Markets: Twist & Turns of Waksal Woes} (CNN television broadcast Aug. 12, 2002).
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\begin{quotation}
\textbf{See Press Release, SEC, Martha Stewart and Peter Bacanovic Settle SEC’s Insider Trading Charges (Aug. 7, 2006), http://www.sec.gov/news/press/2006/2006-134.htm.} Stewart consented to a penalty of three times the loss she allegedly avoided ($195,000) and a five-year bar from serving as a director of a public company.\textsuperscript{Id.}
\end{quotation}

\begin{quotation}
\textbf{See, e.g., SEC v. Yun, 327 F.3d 1263, 1272-74 (11th Cir. 2003)} (finding that husband and wife possessed the requisite fiduciary relationship for 10b-5(1) liability for purposes of applying the misappropriation theory); United States v. Kim, 184 F. Supp. 2d 1006, 1008 (N.D. Cal. 2002) (finding the actions of a CEO and member of a young president’s club to possibly “warrant expulsion from the club,” but not to “fall within the criminal laws of the United States”).
\end{quotation}


\textsuperscript{167} For example, a CNN interview transcript of an August 2002 segment describing the Martha Stewart case memorializes the following tautological exchange on “inside information” between television hosts Bruce Francis and Kathleen Hays, and a former U.S. Attorney, Zachary Carter:

\textbf{Host:[I]f it’s just a rumor \ldots and you don’t know it’s true, you didn’t get it directly from the source, how does that affect whether or not this is illegal?}

\textbf{Former USA:} Well, whether it’s material or not would—

\textbf{Host:} If it’s definitely material—

\textbf{Former USA:} Well, it wouldn’t necessarily be material if it were an unverified rumor.

\textbf{Then, the question becomes whether or not it is really a nonpublic material fact that the company knows or the company insiders know and that others don’t[,] particularly the investing public.}

\textbf{Money & Markets: Twist & Turns of Waksal Woes} (CNN television broadcast Aug. 12, 2002).

\textsuperscript{168} See Press Release, SEC, Martha Stewart and Peter Bacanovic Settle SEC’s Insider Trading Charges (Aug. 7, 2006), http://www.sec.gov/news/press/2006/2006-134.htm. Stewart consented to a penalty of three times the loss she allegedly avoided ($195,000) and a five-year bar from serving as a director of a public company.\textsuperscript{Id.}

\textsuperscript{169} See, e.g., SEC v. Yun, 327 F.3d 1263, 1272-74 (11th Cir. 2003) (finding that husband and wife possessed the requisite fiduciary relationship for 10b-5(1) liability for purposes of applying the misappropriation theory); United States v. Kim, 184 F. Supp. 2d 1006, 1008 (N.D. Cal. 2002) (finding the actions of a CEO and member of a young president’s club to possibly “warrant expulsion from the club,” but not to “fall within the criminal laws of the United States”).
the NYSE\textsuperscript{170} to “front run” customer orders that were but minutes old—a form of insider trading based upon market information—as well as intervening in trades, as opposed to matching buyer and seller (a practice coined “interpositioning” by the regulators).\textsuperscript{171} Shortly thereafter, a federal judge dismissed Commission allegations that the president of a Milwaukee investment company had sold shares and “tipped” clients after learning from board meetings of liquidity and pricing problems, stating that “the SEC has not proffered any evidence to demonstrate a genuine issue” that would entitle it to a trial.\textsuperscript{172} Moreover, in October 2006, in a case where the jury agreed that the trader interpositioned in violation of Rule 10b-5, the judge nonetheless publicly commented that, although he was not willing to overturn the jury verdict, there was “some fuzziness in the law” advanced by the prosecutors.\textsuperscript{173} Approximately four months later, the judge followed his instincts and formally overruled the jury, deciding that the government had failed to establish a Rule 10b-5 violation—even in the presence of interpositioning in violation of NYSE rules—by neglecting to prove that the defendant had misled or deceived customers. Noteworthy is that the judge undercut the government’s emphasis upon sizeable profits by reminding that “historically specialists have made a profit in the overwhelming majority of their proprietary trades” and concluding that a showing that the defendant “was good at what he did and was well compensated for his

\begin{itemize}
\item \textsuperscript{170} A specialist is a “member of a stock exchange who maintains a fair and orderly market in one or more securities,” performing “two main functions: executing limit orders on behalf of other exchange members for a portion of the floor broker’s commission, and buying or selling—sometimes selling short—for the specialist’s own account to counteract temporary imbalances in supply and demand and thus prevent wide swings in stock prices.” \textit{Downes & Goodman, supra} note 14, at 661.
\item \textsuperscript{171} Chad Bray, \textit{Volpe Is Acquitted in NYSE Case}, \textit{Wall St. J.}, Sept. 19, 2006, at C3 (noting also that a month earlier a separate jury acquitted another specialist from the same firm of securities fraud charges for the same behavior). Both Volpe and his former co-Specialist had been charged with violations of SEC Rules 10b-5 and 11b-1 based upon their “using knowledge of a trade to deal in front of it” and “interpositioning.” Jenny Anderson et al., \textit{15 Specialists from Big Board Are Indicted}, \textit{N.Y. Times}, Apr. 13, 2005, at C1; see also Chad Bray, \textit{Ex-Van der Mooler Specialist Acquitted}, \textit{Boston.com}, Aug. 1, 2006, \url{http://www.boston.com/business/articles/2006/08/01/ex_van_der_mooler_specialist_acquitted/}.
\item \textsuperscript{172} \textit{SEC v. Heartland Advisors, Inc.}, No. 03-C-1427, 2006 U.S. Dist. LEXIS 62450, at *18 (E.D. Wis. Aug. 31, 2006).
\end{itemize}
efforts was hardly compelling evidence he engaged in securities fraud."

Perhaps the realm of class action litigation will be the area where the underpinnings of the Program suffers their next Dirks or Chiarella. Conspicuously tied to 10b-5 precedent, but unfettered by criminal case standards, private actions choosing to reinterpret or attenuate the insider trading definition or attendant elements appear eager to kick questionable cases out of the courts. In August 2006, a district court in Arizona dismissed insider trading claims against two company directors who allegedly sold their shares in advance of disclosure of a substantial net loss for the quarter ending December 2004. The suit brought by shareholders was held to fatally not “indicate how or in what form the ‘non-public information regarding the improper accounting’ was disclosed” to the defendants. The district court judge reiterated: “Plaintiffs have failed to plead particular facts that show that [the defendants] face a ‘substantial likelihood’ of liability for insider trading.” Three weeks later, the Southern District of New York dismissed a shareholder complaint in its entirety because the plaintiffs had failed to allege any facts supporting the inference that outside directors who sold their shares had possessed (either constructively or otherwise) any “adverse nonpublic information” concerning the company’s products.

Of greater moment is the highly publicized criminal case pending against Joseph Nacchio, CEO of Qwest Communications International, Inc. Nacchio was indicted in 2005 and charged with forty-two counts of insider trading based upon his sales of approximately $101 million in company stock in 2001. Legal experts have characterized the government’s case as overreaching for nondisclosure of information


176. Id. at *24 (quoting the allegation made in the shareholders’ complaint).

177. Id. at *25.


180. See id. at *1-5.
regarding a public company's eventual accounting failures. In a lengthy battle that may ultimately turn on the defendant's belief in his company's prospects for an economic turnaround, the judge has been quoted as stating during a March 2006 evidentiary hearing that the government had not brought a "model indictment." Further, in his August 2006 procedural ruling, the judge granted the defendant's motion to compel the government to provide additional details on alleged material, non-public information prompting Nacchio's sales.

Obviously, cases are dismissed everyday, and courtroom losses are bound to occur. But what is troubling is the willingness of juries to exonerate "insiders," such as specialists, and the concurrent eagerness of jurists to speak out on the inappropriateness of the charges. To be sure, just hoping that judges and juries will, at best, fill in the details and, at worst, know insider trading when they see it, is not an effective SEC strategy for the new millennium. Moreover, any recent stumbles aside, lawyer and layman alike have long remained unconvinced of the efficacy of the agency's efforts. This raises the question: Why wait any longer to heed the calls for clarity that have been sounding for over thirty years?


183. United States v. Nacchio, No. 05-cr-00545, 2006 U.S. Dist LEXIS 60623, at *24 (D. Colo. Aug. 25, 2006). On April 20, 2007, Nacchio was found guilty of nineteen counts of insider trading, and found not guilty of twenty-three other counts. See Dionne Searcey et al., Qwest's Nacchio Is Found Guilty in Trading Case, WALL ST. J., Apr. 20, 2007, at A1. The split verdict came after jurors had asked the judge during the six day deliberations for a "precise definition" of "material information." Andy Vuong, Joe Nacchio on Trial, Jurors Ask for Clarification, DENV. POST, Apr. 18, 2007, at C-01. After the verdict against the infamous telecommunications CEO, the U.S. Attorney for Colorado was quoted as saying, "For anyone who has ever made a call in Qwest territory, the term 'convicted felon Joe Nacchio' has a nice ring to it." Searcey et al., supra.

184. See Gretchen Morgenson, Whispers of Mergers Set off Bouts of Suspicious Trading, N.Y. TIMES, Aug. 27, 2006, at A1. Morgenson cited the latest results of an analytical research firm that studied the trading in subject stocks prior to a merger in the preceding twelve months. The study concluded that of ninety sizeable mergers during the study period, thirty-seven "target companies exhibited abnormal trading in the days and weeks before the deals were disclosed" and that "in a handful of the mergers, significant progress toward a deal was being made on the days unusual trading occurred." Id. The SEC was reported to have had no comment on the study. Id.

185. See id.
C. Listening to the Same Soundtrack?

Overall, the varied SEC and court approaches to non-public information have created a dissonance; that dissonance swells to a cacophony when one considers the veritable panoply of industry regulators and forums that must enforce insider trading prohibitions. To wit, as the result of conflicting interpretations of both Rule 10b-5 and Rule 14e-3, different sectors and regulators of the market have announced different rules for pursuit of trading information.  

A brokerage firm research report is thought to become public twenty-four hours after its release, while an independent magazine article is presumed absorbed when it hits the newsstand. News on the NYSE Floor is thought to be absorbed by the world in ninety seconds, and customer trades are thought to become public either once effected or reported. But a significant customer order may demand brokerage firm inaction, even fourteen hours after it hits the queue. In the area of

186. For example, the regulatory arms of the various stock exchanges play a key role in both enforcing and shaping the nation’s securities laws. See, e.g., David P. Doherty et al., The Enforcement Role of the New York Stock Exchange, 85 NW. U. L. REV. 637 (1991) (delineating the NYSE’s enforcement, investigation, and disciplinary functions and how these functions substantively shape its polices).

187. See, e.g., NYSE, Inc., Exchange Hearing Panel Decision 99-67, at 3 (June 17, 1999), available at http://www.nyse.com/pdfs/99-067.pdf (“The Firm had in place a written policy which prohibited employee and employee-related accounts from trading in securities which were the subject of Firm research (‘Restricted Securities’) for a 24-hour period (the ‘Restricted Period’) following the release of a recommendation or change in recommendation.”).

188. See NYSE, Inc., Exchange Hearing Panel Decision 94-9, at ¶ 19 (Jan. 26, 1994), available at http://www.nyse.com/pdfs/94-009.pdf (involving a broker charged with trading on material information that he knew or was reckless in not knowing was non-public where he effected “purchases on Thursdays before the 5:00 p.m. official release time of the issue of the [magazine in question]”).

189. See N.Y. Stock Exch., Inc., Exchange Act Release No. 51,524, 85 SEC Docket 517, 520 (Apr. 12, 2005) (noting that up until 1999, in monitoring trading by specialists for their own accounts, NYSE surveillance systems only noted trades ahead of customer orders that had been posted to the primary order processing system for ninety seconds).

190. See NYSE, Inc., Exchange Hearing Panel Decision 04-172, at 2, 5-6 (Nov. 12, 2004), available at http://www.nyse.com/pdfs/04-172.pdf (finding a Rule 10b-5 violation where a “Floor Clerk” caused a trade to be executed at 10:06 a.m. while aware of a customer order that was not executed until 10:15 a.m.); see also SEC v. TGS, 401 F.2d 833, 854, 856 (2d Cir. 1968) (finding that certain defendants must have known that their trades effected at the market opening would not be immediately appreciated by the market).

191. See Gretchen Morgenson, A Big Nasdaq Penalty in an Old Bugaboo: Delayed Trade Reports, N.Y. TIMES, July 22, 1998, at D8 (“N.A.S.D. rules require that every transaction, and the price at which it changes hands, be made public within 90 seconds of execution so that all investors have equal access to information.”).

communications with analysts, some issuers have simply stopped talking altogether. Further, in the absence of any clear law, brokerage firms are still faulted for failing only to enforce their own internal standards. The practical effect is arguably a lack of deterrence, as industry participants at many levels of the market game attempt to divine the proper standard for abstinence.

In sum, while Justice Stewart's practical pornography test approach was born from his experiences confronting exotic literature, not many judges and jurists will have had prior, relevant experience when it comes to defining insider trading. And despite the continued prioritizing of insider trading offenses by the SEC and concerted efforts by varied marketplace strata to discern its rules, again, the two main questions persist: 1) When does someone know if they have received non-public information?, and 2) How long until it is public?

IV. AN OBJECTIVELY VISIBLE SOLUTION

Congressional action, judicial interpretation, untold pleadings, and SEC rulemaking have not cleared up the evasiveness of the insider trading prohibition, or the obtuseness of its arguably most identifying component—the term non-public. Even those trying in good faith to comport with the Commission's expectations are going to be left wondering when information has been adequately disseminated. While the crime remains a priority, surely some action regarding the applicable

193. Within a week of the SEC's adoption of Regulation FD—which outlawed "selective disclosure" by an issuer of material information—the California law firm that was serving as counsel to Cisco Systems, Inc. and E*Trade Group, Inc. stated that it planned to advise clients "that if it isn't too detrimental to relations with analysts and others, forgoing such conversations 'is the safest thing to do.'" Jeff D. Opdyke & Aaron Lucchetti, Mum's the Word in Wake of Disclosure Rule, WALL ST. J., Aug. 16, 2000, at C1.

194. See, e.g., NYSE, Inc., Exchange Hearing Panel Decision 04-30, at 1, 8 (Mar. 8, 2004) (explaining that a firm consented to the disciplinary penalty of a censure and a $625,000 fine because it "failed to have or implement specific procedures to prevent a violation of the policies prohibiting disclosure").

195. But see MALKIEL, supra note 112, at 210 ("[T]ightened rules on disclosure make time lags in the dissemination of new information much shorter than they may have been in previous years.").

196. Authors Bob Woodward and Scott Armstrong provide the foundation for Stewart's obscenity test:

He had seen it during World War II, when he served as a Navy lieutenant. In Casablanca, as watch officer for his ship, he had seen his men bring back locally produced pornography. He knew the difference between the hardest of hard core and much of what came to the [Supreme] Court. He called it his "Casablanca Test."

WOODWARD & ARMSTRONG, supra note 2, at 194.
law should be taken. In the spirit of insider trading’s two-part definition, a two-part solution is hereby offered.

A. For the "Insider"

The regulatory cause would perhaps best be served by drawing guidance from the latest trend of the industry’s primary regulators, the stock exchanges. Functioning as self-regulatory organizations (“SROs”) under the Securities Exchange Act of 1934, exchanges such as the NASD and NYSE are the day-to-day regulators of the marketplace. These SROs have the expertise, personnel, and experience, as well as a track record of bringing thousands of disciplinary actions against industry professionals to date. And these SROs have been shying away from any inclusion of the term material in the notion of inside information, the result being that all confidential corporate information is thought to be suspect, and all premature trading based thereon thought to be illegal.

For example, witness the blanket prohibition of the NYSE’s “Code of Business Conduct and Ethics” for its directors. Adopted after the NYSE’s much publicized internal conflicts and its agents’ ethical lapses in recent years (e.g., floor trading sanctions, the resignation of its highly compensated CEO, and the indictment of NYSE board member Martha Stewart), the code addresses the nagging questions concerning the contours of insider trading as follows:


http://scholarlycommons.law.hofstra.edu/hlr/vol35/iss2/5
All non-public information about the NYSE or its member firms or listed companies should be considered confidential information. To use non-public information for personal financial benefit or to "tip" others who might make an investment decision on the basis of this information is not only unethical but also illegal.\(^{200}\)

Accordingly, traditional corporate insiders (as defined by section 16(b)—officers, directors and ten-percent shareholders) should be advised through internal company policies that all confidential information is *material*. Such a construct eliminates the "before and after" analysis that gauges price drops and surges. Board members, analysts, specialists and other exchange floor personnel are, by nature of their position, given priority in the aquarium of market life; the cost for that privileged position will be a presumption that the prettiest flora will be subject to an "abstain or disclose" rule.

Outsiders in attendance at board meetings, or other information-sensitive events and locales, could simply be made to sign confidentiality agreements that bring them within the purview of law covering insiders, recourse that, in actuality, is likely already to exist given such cases as *O'Hagan* and *Talbot*. This isolation should stem the tide of confidential information while impressing upon its conduits the seriousness of the wave. Further, by extricating the term *material* and, consequently, the efficacy of the trading scheme, from the analysis, the proposed reform even reaches *attempted* insider trading, in line with the bold expansion of enforcement policy quietly undertaken by the Commission in recent years.\(^{201}\)


\(^{201}\) See, e.g., Amended Complaint at 10, SEC v. Waksal, 02 Civ. 4407 (S.D.N.Y. Mar. 11, 2003) ("As part of and in furtherance of this violative conduct, Waksal, in breach of a fiduciary duty to ImClone’s shareholders and while in possession of material non-public information, attempted to sell 79,797 shares of his ImClone stock on December 27 and 28, 2001."). Waksal, Martha Stewart’s alleged "tipper," ultimately pled guilty to actual and attempted insider trading and was sentenced to seven years and three months in prison. Constance L. Hays, *Former Chief of ImClone Is Given 7-Year Term*, N.Y. TIMES, June 11, 2003, at C1 (reporting that the judge "ordered Dr. Waksal to spend 87 months in prison").
B. For the Non-insider

As for outsiders, a simple twenty-four-hour clock would uniformly advise laymen when it is safe to trade, the key consideration in any insider trading hypothetical. Existing SEC rules already provide specific guidance on this topic. Although itself limited in design and effect, Regulation FD, which targets the specific ill of selective disclosure of inside information by public companies, actually includes arguably the best insider trading timepiece formulated to date. Specifically, its tiered approach to remedies distinguishes between conscious and inadvertent slips of the tongue, and affords corresponding remedial periods ranging from immediately to twenty-four hours.

Rule 100 of the SEC regulation reads as follows:

General rule regarding selective disclosure.
(a) Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any person described in paragraph (b)(1) of this section, the issuer shall make public disclosure of that information as provided in § 243.101(e):

(1) Simultaneously, in the case of an intentional disclosure; and
(2) Promptly, in the case of a non-intentional disclosure. 204

“Promptly” is defined: “as soon as reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day’s trading on the New York Stock Exchange)” after an issuer’s senior official “learns that there has been a non-intentional disclosure.” 205

Elsewhere, the Regulation clarifies the natural divide between material and non-public by expressly stating requirements in the conjunctive:

202. Scholars were quick to note that “Regulation FD does not apply when the company is communicating with the press, ratings agencies, and ordinary-course business communications with customers and suppliers.” THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 557 (rev. 5th ed. 2006).

203. To be sure, Regulation FD, as an insider trading prohibition, has had an inauspicious start. In one of the first cases brought against an issuer by the SEC’s Division of Enforcement, a federal judge dealt the regulation a harsh blow by exonerating company management on grounds that the information allegedly disclosed selectively by management was neither material nor non-public. SEC v. Siebel Sys., Inc., 384 F. Supp. 2d 694, 710 (S.D.N.Y. 2005).


205. Id. § 243.101(d).
A selective disclosure of material nonpublic information is "intentional" when the person making the disclosure either knows, or is reckless in not knowing, that the information he or she is communicating is both material and nonpublic.\textsuperscript{206}

Regulation FD thus exhibits a no tolerance policy for the insiders and market professionals (who are more likely to comprehend "abstain or disclose") while incorporating a twenty-four-hour grace period for all others. By reiterating the above passages through an SEC release, the solution suggested herein would likewise aptly inform all market participants of relevant government expectations. As a yardstick, the measure would succeed on many levels. It would remind issuers and their management that there is no "gray area" when it comes to tipping inside information to potential friends of the company; it would also provide the entire industry with guidance as to the heightened level of culpability attending the actions taken by those who should know better. But perhaps first and foremost, concerning all other market participants, it contributes a time period that is knowable and acceptable: "\textit{When in doubt, wait twenty-four hours before trading.}"

Such a call for a finite deadline also seems in lockstep with the instantaneous nature of market news in the age of the Internet, an investment tool that the Commission now agrees is used by seventy-five percent of all Americans.\textsuperscript{207} Simply put, in a world where any outsider can get real-time news on trades and quotes, clear guidance on windows of opportunity seem fair. Any investor wondering whether information that has come into his hands should sleep on it before trading. Such a "doctor's orders" approach may seem simplistic, but it surpasses the current state of confusion, where even those trying in good faith to comport with the SEC guidelines are caught between jumping ahead of the market and watching it pass by, while those executing the Program, so often faulted for their zeal, find their efforts doubted for letting too much "deviant trading" proceed unchecked.\textsuperscript{208}

\textsuperscript{206.} \textit{Id.} \S 243.101(a).

\textsuperscript{207.} The Commission has observed:

\begin{quote}
Internet usage in the United States has grown considerable since 2000 when we published our most recent interpretive guidance on the use of the electronic media in securities offerings, including with regard to prospectus delivery by electronic means. For example, recent data indicates that 75\% of Americans have access to the Internet in their homes, and that those numbers are increasing steadily among all age groups. Securities Offering Reform, Securities Act Release No. 8501, Exchange Act Release No. 50,624, Investment Company Act Release No. 26,649, 84 SEC Docket 4, 74 n.353 (Feb. 11, 2005).
\end{quote}

\textsuperscript{208.} \textit{See supra} note 4 and accompanying text.
V. CONCLUSION

The SEC’s war on insider trading has been a noble one. With scant congressional support, a diligent agency has expanded a vague but consistent notion of fairness into a body of case law encapsulated in some bold victories with far-reaching results. The notion embodies a persistent mission that has outpaced the goals of most other agencies and outlasted over four decades of political administrations. But along the way, judges and juries have questioned the bounds of that notion, and even cases in accordance with SEC theory concede that not every unfairness rises to the level of violation.209

Contrary to any excessive criticism, the Commission’s insider trading enforcement program is far from dead, as evidenced by a continuing parade of settlements and even, on some occasions, the supportive testimony of learned academics.210 Noteworthy is that in a recent six-month period alone the Commission obtained significant settlement and attendant penalties in Rule 10b-5 insider trading cases brought against a widely varied list of respondents, including a major securities broker-dealer,211 a bank broker selling mutual funds,212 a New Jersey letter carrier,213 a group of ten “day traders,”214 and an accountant

209. The aforementioned Dirks case, the rationale of which remains the basis for tipper-tippee liability, stated that “in a statutory area of the law such as securities regulation, where legal principles of general application must be applied, there may be significant distinctions between actual legal obligations and ethical ideals.” Dirks v. SEC, 463 U.S. 646, 661 n.21 (1983) (quotation omitted).


The SEC in its enforcement program does an excellent job of balancing the important public policy goal of detecting and punishing insider trading with the important public policy goal of conducting insider trading investigations in a careful and professional manner so as to not needlessly ruin the professional reputations of innocent people.

Id.


at the company that hired a popular radio personality for satellite radio. During that same period the Commission also brought or settled insider trading charges against an executive at a dermatology cream company, a financial analyst, a company controller, a Philadelphia lawyer, a doctor who participated in company drug trials, and a salesman of implantable human tissue. Concurrently, successful criminal insider cases have been brought in hotly contested trials, including the Enron litigation. Clearly, in cases involving both civil or criminal charges, insider and outsider alike, the heart of the Program is still beating.

However, the legal underpinnings of the Program have remained vague for too long, and loud judicial questions hint at its reformation. With the augur of untold new insider trading inquiries, novel securities fraud cases, and the burgeoning era of unfathomable penalties for white collar crimes, now might be the most opportune

time to address the shortcomings. Times have changed, and so should the pivotal portions of the SEC enforcement program. Thus, with a sense of urgency the Commission should defer to burgeoning SRO and market standards, and hold the professionals to a higher standard. The Second Circuit said decades ago: “Because of their positions, insiders know when they have the kind of knowledge that is likely to affect the value of stock.” Likewise, the stock exchanges have long recognized the role of securities professionals of fiduciaries to the market and the concomitant duty to be “ever vigilant.” As for the layman, the guidance would also be more clear.

This two-prong solution to the problematic two-prong definition should draw supporters from across the spectrum. It gets at the board member feigning loyalty, the broker stealing a squawk box transmission, and the self-feeding exchange specialists, but exonerates the unknowing “tippees,” those buried in the trading curve of merger speculation, and the celebrity objects of scorn. The SEC’s bright new net would still ensnare those who would trade early on advance copies of Business Week (for not waiting twenty-four hours) but flow over those who would follow their broker’s advice to sell a stock (who have no idea when the recommendation was spawned). It heeds the call for written guidance sounded so elegantly in Bausch & Lomb while continuing to shield the eavesdropper, sympathetic or not. The reformed program would thus preserve the worthwhile elements of the Program, while even expanding it to criminalize attempts at violating Rule 10b-5 (a goal often more worthy than some of the completed schemes that have drawn scrutiny to

to those for “first-degree murder, high-level drug dealing and espionage” and noting the abolition of parole and lengthening of prison terms for white-collar crimes in recent years).  

227. It may already be too late for the Commission to fix its roof before the rain: In October 2006, it was reported that the SEC Division of Enforcement had come under formal scrutiny from Congress because of allegations of preferential treatment and declining numbers of cases. See Judith Burns & Kara Scannel, SEC Brings Fewer Enforcement Cases, WALL ST. J., Oct. 27, 2006, at C3 (noting that the number of cases fell ten percent, the third year of decline, and that the Government Accountability Office had informed Senator Charles Grassley “that it would grant his request and review the SEC’s enforcement and examinations divisions”). Further, in February 2007, an interim Senate report concluded that in 2005 the Commission “mishandled its inquiry into suspect trades by a prominent hedge fund [Pequot Capital Management], then may have tried to cover up those mistakes after its chief investigator on the case complained,” prompting former committee chairman Arlen Specter and Charles Grassley to ask the SEC or the Justice Department to investigate the hedge fund. Walt Bogdanich, Senate Report Says S.E.C. Botched Hedge Fund Inquiry, N.Y. TIMES, Feb. 2, 2007, at C2.

228. SEC v. Monarch Fund, 608 F.2d 938, 941 (2d Cir. 1979).

Surely, fairness—that standard that first enlivened the Program over forty years ago—dictates that all market participants be forewarned. And by clarifying the prohibitions and the remedies, best of all, judge, business man, regulator and layman alike will all know the warning when they see it.

As for the "message cases," precedent already amply supports charging those in the vortex of market information, as well as noted captains of industry, for theft of information under the mail fraud and wire fraud statutes—two prohibitions better suited to capturing those who deal in contraband. For the prosecutor and the enforcement attorney who would cling to the Program and Rule 10b-5 as a weapon shunning the insider trading headlines for good old fashioned claims of theft may be less tantalizing, but then again, non-pornographic approaches often are.

230. A triage concept that has been floating around the SEC’s halls for decades, the notion of charging attempted insider trading took flight in the publicized action against Samuel Waksal, Martha Stewart’s alleged tipper. See Amended Complaint, supra note 201, at 1.

231. See Andrew Pollack & David Cay Johnston, Former Chief of ImClone Systems Is Charged with Insider Trading, N.Y. TIMES, June 13, 2002, at C1 (noting the morning arrest of Dr. Samuel Waksal at his home, as well as the subsequent setting of bail at $10 million). In June 2003, Waksal was sentenced to over seven years in prison. See supra note 201.

232. See, e.g., Carpenter v. United States, 484 U.S. 19, 28 (1987); United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) (explaining that a stock broker’s conviction under the mail and wire fraud statutes were upheld because his trading ahead of his customers’ block orders was found to be fraudulent); Jenny Anderson, Arrest Highlights Risks to Secrecy in Stock Trading, N.Y. TIMES, Mar. 10, 2005, at C1 (discussing a former NYSE floor clerk indicted on federal counts of securities fraud and commercial bribery for tipping a day trader on “confidential information” concerning pending large customer trades).

233. At the time of Martha Stewart’s indictment, the Director for the Northeast Regional Office of the SEC acknowledged the import of the case as a message to other chief executives, pointing out that, if not addressed, insider trading “suggests to investors that the game is rigged.” Jyoti Thottam, Why They’re Picking on Martha, TIME, June 16, 2003, at 46 (quoting Wayne Carlin).