Salman v. U.S.: Another Insider Trading Case, Another Round of Confusion

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Last term, the Supreme Court took up its first insider-trading case in 20 years, *Salman v. United States*.[1] Insider trading is an area of law crying out for clarification and simplification, so the Court's decision to hear the case was encouraging. Unfortunately, the opinion the Court issued in *Salman* answered only a very narrow question and answered it in the way most likely to lead to confusion and muddled opinions in the lower courts. Given that a conviction for insider trading can carry a penalty of a decade in prison, this decision is disappointing.

Salman involves three members of the same family: brothers Maher and Michael Kara, and their brother-in-law Bassam Salman. Maher worked for Citigroup's healthcare division. He passed nonpublic information he obtained through his employment to his brother, Michael, who traded on it and shared it with Salman, who also traded on it. It is not clear when Maher became aware that Michael was trading on the information. According to the record, he first shared information with Michael because Michael has a degree in chemistry and he was hoping that Michael could provide some insight into the companies he was handling. He later shared information with Michael as the brothers were considering treatment options for their dying father in the hope that some of the treatments he had encountered in his work might help their father's condition. Finally, and in the eyes of the law most damnably, Maher passed information along to Michael with the intention that Michael would trade

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[1] 137 S. Ct. 420 (2016).

on it. He testified that he wanted to "help" his brother and "fulfill whatever needs he had."[2]

As I describe below, there are three theories of insider-trading law: classical, tipper/tippee, and misappropriation. *Salman* implicated the tipper/tippee theory, but the root of the problem is that none of these theories is clear on the harm that insider-trading law is trying to prevent. Without a unifying theory of harm, it is difficult to state a unifying theory of liability.

I. Theories of Insider-Trading Law

No federal statute prohibits insider trading. Instead, over the years courts have developed various theories of how what is known as "insider trading" operates as a kind of fraud. Fraud in connection with securities transactions *is* proscribed by statute. Under the Securities Exchange Act of 1934, it is unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[3] Pursuant to this provision, the Securities and Exchange Commission (SEC) issued a rule that prohibits the use of "any device, scheme, or artifice to defraud . . . [or] 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."[4]

The fact that any theory of insider trading must ultimately be tied back to some notion of "fraud" is one of the factors that has so tied the courts in knots over the years.[5] Underpinning any insider-

[2] *Id*. at 424.

[3] Securities Exchange Act, 15 U.S.C. § 10(b).

[4] 17 C.F.R. § 240.10b-5.

[5] The proscription on the use of deceit has been interpreted to extend beyond the scope of common law fraud, which requires that the plaintiff or government show that the defendant made a misleading statement, knew it was misleading, and intended for the victim to rely on the statement; then the victim did rely on it and as a result suffered a harm. While Rule 10b-5 certainly captures actions that would fall within this definition of fraud, the SEC has stated that it is a "broad remedial provision[] aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." In the Matter of Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

trading case must be some argument that the conduct in question operated as a fraud on some identified person or persons. Naming the victim and working backward to construct the theory that demonstrates how the victim was defrauded has been a difficult process.

One of the chief problems is that an action for fraud typically seeks to redress harm to a participant in a particular transaction. To the extent that a securities transaction involves direct fraud, the victim and the harm are easy to identify. If a seller intentionally provides untrue and material information about a security to a potential buyer with the intent that the buyer rely on that information and therefore overpay, the transaction clearly involves fraud. In the case of insider trading, however, the insider typically has not communicated any information to the other party. Fraud is much trickier when the problem is a lack of communication. The question is therefore: who has an obligation to disclose such that a failure would constitute fraud? While each of the theories of insider trading offers an answer, none provides one that is fully satisfactory.

A. Classical Theory of Insider Trading

Under the classical theory of insider trading, an insider—someone who owes a duty to the company as an employee or director—obtains nonpublic information through her relationship to the company. Without disclosing the information to the public, she trades on this information and earns a profit.

One of the earliest cases to establish the crime of insider trading was *In the Matter of Cady, Roberts & Co.*, decided by the SEC.[6] In this case, a broker received information from his business partner, who sat on the board of a company about to announce its quarterly dividends. The broker traded on the dividend information before it was publicly announced. The SEC found the trade to be illegal because "[an] affirmative duty to disclose material information . . . has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders."[7] The SEC went on to note that it and "the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position

[6] 40 S.E.C. 907 (1961).

[7] *Id.* at 911.

but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."[8]

The path from *Cady* could have been a broad one, and a simple one to administer. The rule could have been simply that it is illegal to trade on nonpublic information received from an insider. "Disclose" or "abstain" could have been the rule for everyone.

The notion that those involved in securities transactions must provide accurate information when it is "material" appears in other areas of securities law. In *TSC Industries v. Northway, Inc.*, and later in *Basic v. Levinson*, the Supreme Court held that a fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[9] Using this principle as a basis for asserting a unifying theme underlying securities law, the courts could have determined that withholding nonpublic material information is not permitted when engaging in a securities transaction or related activity, whether the activity is trading in the secondary market, issuing securities, or sending out proxy materials.

In *Chiarella v. United States*, the Court squarely considered this question: does a trade based on material nonpublic information qualify as insider trading if the information was not directly obtained by or through an insider?[10] In this case, the Court answered "no." Vincent Chiarella worked for a financial printer. In the course of his work, he came across documents related to a merger that had not yet been announced. Although the documents did not have the names of the companies on them, he was able to divine them through other information in the documents. He traded on this information and was charged with insider trading. In holding that Chiarella's actions did *not* constitute insider trading, the Court found that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak" and held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market

[8] *Id.*

[9] TSC Industries v. Northway Inc., 426 U.S. 438, 449 (1976) (determining whether omitted information was "material" in the context of proxy disclosures); Basic v. Levinson, 485 U.S. 224, 231–32 (1988) (determining whether information was "material" such that its omission would trigger liability under Section 10(b)).

[10] Chiarella v. United States, 445 U.S. 222 (1980).

information."[11] Because Chiarella had no explicit duty to either of the companies involved in the merger, the Court found, his use of the information, without disclosure to the market, did not constitute insider trading. "[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[12]

Whether a broader prohibition may have been more prudent either because it would be the better policy or because it would be easier to administer—and therefore more fair to market participants who must know when they are running afoul of the law—the Court clearly felt constrained by the language of Section 10(b). "Section 10(b) is aptly described as a catchall provision," the Court noted, "but what it catches must be fraud."[13]

In light of *Chiarella*, the rule guiding the classical theory of insider trading is that there is no universal duty to disclose nonpublic information when engaging in a securities transaction. Instead, liability exists only when the individual also breached some identified duty in failing to make a disclosure. The nature and scope of this duty was not definitively settled by the Court. Indeed, the Court noted that the government had put forward a theory under which Chiarella would be liable due to his duty as an employee of the financial printer. This theory had not been presented at trial, however, and because the Court could not "affirm a criminal conviction on the basis of a theory not presented to the jury," the Court could not "speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)."[14]

B. Tipper/Tippee Theory of Insider Trading

If there is to be a prohibition on insider trading, the prohibition must extend beyond the insider herself to be truly effective. Otherwise, the rule could be easily evaded. The insider could simply pass the information to a friend and say "trade on this and give me the profits." Or the insider could sell the information to willing traders. This theory of liability, under which the insider passes information

[11] *Id.* at 235.

[12] *Id.* at 228.

[13] *Id.* at 234–35.

[14] *Id.* at 236–37.

to a third party who then trades on it, is "tipper/tippee" liability. The insider is known in insider trading law as the "tipper" and the person to whom he passes the information is the "tippee."

Salman is a tipper/tippee case: Salman traded on tips received through a chain beginning with his brother-in-law Maher Kara, the insider at Citigroup. This theory adds a new wrinkle to the basic question underpinning all insider-trading cases. Instead of simply determining, as *Chiarella* requires, whether the person who originally obtained the information had an existing duty, a court must also determine whether and how the person who ultimately traded on the information became subject to such a duty. There are clear cases, of course. My first example is one. If the tipper asks the tippee to trade and give him (the tipper) the profits, the tipper is clearly attempting to obtain the same result as if he himself had made the trade. The rule rejected by *Chiarella*—that *any* trader must disclose or abstain—would have at least been easier to administer even if it still suffered from other flaws.

In 1983, the Court attempted to clarify this area of law in *Dirks v. SEC*.[15] This case did not involve a typical insider-trading transaction, however, because the insider disclosed the information to right a wrong, not to make money for himself or his friends. In *Dirks*, a corporate insider disclosed information to Raymond Dirks, a broker, about widespread fraud within the insider's company. His stated purpose in making the disclosure was for Dirks to investigate and ultimately uncover the ongoing fraud. Dirks did just that. He even went to the *Wall Street Journal* with the information and urged one of the editors to run a story. The editor declined, fearing a libel suit. Dirks also disclosed the information to many of his clients, who traded on the information. The fraud was eventually uncovered, charges were brought against the company's employees, and the *Wall Street Journal* ran a front-page story on it.[16] Dirks was censured by the SEC for insider trading because he had disclosed the information to his clients who then traded on it.

The Supreme Court ruled in Dirks's favor on appeal, substantially narrowing the holding of *Chiarella*. Not every breach of fiduciary

[15] 463 U.S. 646 (1983).

[16] See William Blundell, A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus at Equity Funding Life, Wall St. J., Apr. 2, 1973, at 1.

duty is sufficient to support a charge of insider trading. "There must also be manipulation or deception . . . . Thus, an insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes secret profits."[17] It clearly troubled the Court that someone who was trying to uncover wrongdoing could, in the process, be deemed guilty of wrongdoing himself. The Court therefore rejected the government's proposed rule, that anyone who "knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading."[18] The correct reading of *Chiarella*, according to the Court, is that "only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information."[19]

The result, however, was to introduce a fair amount of muddiness into the legal waters. Instead of the potential bright-line rule that *Cady* could have presented—disclose or abstain—or even a broader rule set forth in *Chiarella*—if the information was obtained pursuant to a fiduciary duty, disclose or abstain—the post-*Dirks* rule is substantially more complex. Under *Dirks*, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[20] In what is arguably nonbinding *dictum*, the Court went on to say that, although it may be difficult to divine when the insider has indeed benefited from the disclosure:

> [t]here are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[21]

[17] Dirks, 463 U.S. at 654 (internal quotations and citations omitted).

[18] *Id.* at 656.

[19] *Id.* at 657.

[20] *Id*. at 662.

[21] *Id*. at 664.

This introduced the question at the heart of *Salman*. It is clear that any theory of tipper/tippee liability must extend beyond the exchange of cash. There is no material difference between the insider saying "trade on this and give me the profits" and saying "trade on this and give me a Porsche." But what of intangible benefits? For example, what if the insider says "trade on this and in exchange admit my kid to your exclusive school"? Or what if the insider receives nothing in return? What if, as the *Dirks dictum* states, the insider "makes a gift of confidential information"? Must tipper/tippee liability always involve some sort of quid pro quo?

An earlier case out of the U.S. Court of Appeals for the Second Circuit implied that the answer was "yes." *United States v. Newman* was part of a massive insider-trading investigation focused on a number of hedge funds.[22] The case itself centered on a chain of tippers and tippees; the inside information that formed the basis of the trades had passed through three to four people before it reached Todd Newman and his acquaintance at another firm, Anthony Chiasson. There was no evidence that Newman or Chiasson had provided any benefit to the tippers in a quid pro quo exchange for the information. It was also not clear, or at least not sufficiently proven, that Newman and Chiasson knew that the information they received had been obtained from someone who had breached a fiduciary duty. Newman and Chiasson were found guilty at trial, however, pursuant to a jury instruction that required a guilty verdict if the jury found the defendants "knew that the material, nonpublic information [on which they had traded] had been disclosed by the insider in breach of a duty of trust and confidence." On appeal, the Second Circuit surprised much of the legal and financial world by finding the lower court had erred. "In light of *Dirks*," the court noted, "we find no support for the Government's contention that knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability."[23] The rule as established by *Newman*, at least for the Second Circuit, seemed to be

[22] 773 F.3d 438 (2d Cir. 2014).

[23] *Id.* at 448.

that a conviction for insider trading requires the government to establish that the tipper received something of value from the tippee.[24]

Although the government asked the Supreme Court to review the *Newman* ruling, its petition was denied. Salman then attempted to use *Newman* to support his defense in the U.S. Court of Appeals for the Ninth Circuit. That court, however, both asserted its prerogative to establish its own precedent—independent from its sister circuit—and distinguished *Newman*. While *Newman* addressed the question of whether the government must prove some benefit to the tipper, it did not address the question of whether *Dirks* prohibited insiders from making gifts of information to "a trading relative or friend." Nothing of substantial value was given by any tippee for the information in *Newman*, and the chain of tippers and tippees included no close friends, only acquaintances. There was therefore no evidence to support an inference that the tippers had given information as true gifts to the tippees.

The facts in *Newman* were therefore materially different from those in *Salman*, where the insider asserted that he had given the information to a close relative to "benefit him." The question of whether insider-trading liability attaches when the information is given as a gift remained open. The question of whether the relationship between the tipper and tippee was relevant also remained open. The *Newman* court expressly considered the relationships among the individuals in the tipping chain. The relationships are relevant because they can, in the language of *Dirks*, serve as "objective facts and circumstances that often justify . . . an inference" that the tipper received something of value because there is a "relationship between the insider and the recipient that suggests . . . an intention to benefit the particular recipient."[25] In *Newman*, however, the Second Circuit found that the individuals in the tipping chain were acquaintances or, at best, family friends who occasionally socialized with one another, and not the kind of close friends contemplated by the *Dirks dictum*.

[24] It should be noted that while the Second Circuit can bind only itself and the courts within its circuit, it tends to be a leader in the area of securities law given its deep experience and well-developed law arising out of its jurisdiction over New York City.

[25] 463 U.S. at 664.

C. Misappropriation Theory

The last theory of insider trading is "misappropriation." This theory, unlike the other two, expressly attempts to identify the harm insider trading causes. Under this theory, the harm is that the insider misappropriates the company's information, and it is this theft that insider trading law seeks to redress. During oral argument in *Salman*, the government asserted a misappropriation theory of insider trading, claiming that Maher Kara had used secret information for his own benefit. Because Kara was not an insider at the companies on which his brother and brother-in-law traded, but at Citigroup, the government needed this theory to support its claim that the information nonetheless was tainted.

The last insider-trading case that the Court decided before *Salman, U.S. v. O'Hagan*, affirmed the misappropriation theory and with it the concept of the "temporary insider."[26] James O'Hagan was a partner at the law firm Dorsey & Whitney. His firm represented a company contemplating a takeover of another company, although O'Hagan himself was not involved in the matter. O'Hagan's position as a partner in the firm afforded him access to confidential information about the proposed tender offer, which he used to trade. He had embezzled funds from a client account and hoped to use the proceeds of his trade to cover the missing money.

One particularly tricky aspect of this case is the distance between the deception and the securities transaction. A person who merely misappropriated confidential information would not be guilty of a securities violation. Section 10(b) prohibits (1) the use of "any manipulative or deceptive device" (2) "in connection with the purchase or sale of any security." First, O'Hagan misappropriated confidential information. This is where the deceptive practice occurred. Then he used that information to trade. The trade itself involved no "deceptive device" beyond the use of material nonpublic information. Under *Chiarella,* the mere possession of material nonpublic information does not render a trade based on that information "deceptive." The theory allowing criminal liability to attach must therefore show something more.

The misappropriation theory as articulated in *O'Hagan* holds that "a fiduciary's undisclosed, self-serving use of a principal's information

[26] U.S. v. O'Hagan, 521 U.S. 642 (1997).

to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[27] While the Court noted that "[a] fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal,"[28] it later went on to assert that the harm Section 10(b) intends to prevent is not to the principal but to the market. According to the Court, "[t]he misappropriation theory is thus designed to protect the integrity of the securities markets against abuses."[29] Further, "[a]lthough informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law"—especially as the advantage in such a case "stems from contrivance, not luck" and as such "it is a disadvantage that cannot be overcome with research or skill."[30]

Although the holding in *Chiarella* does not encompass a misappropriation theory, the *O'Hagan* Court was clear that it read *Chiarella* as expressly reserving the question of whether a noninsider could be liable for insider trading if he received the nonpublic information through a position of trust. Chiarella, recall, received the relevant information through his employment with a financial printer. Given the sensitive nature of the materials such a business handles, there would usually be an understanding between the printer and its clients that it would protect the information it receives. The Court in *Chiarella* did indeed note the possibility of asserting insider-trading liability on this basis. But, because the government had not presented the argument at trial, the Court was not able to consider it.

O'Hagan expanded the universe of potential tippers. Because some, but not all, people may freely trade on material nonpublic information, the question in any insider-trading case is to which group does the defendant belong? Those for whom trading is permitted, or those for whom trading is a felony? After *O'Hagan*, the latter group expanded

[27] *Id.* at 652. To further complicate matters, O'Hagan did not trade in the stock of the company his firm represented. Instead, he traded in the target company's stock. The Court nonetheless found that this trade constituted insider trading.

[28] *Id.* at 653–54 (internal quotations omitted).

[29] *Id.* at 653 (internal quotations omitted).

[30] *Id.* at 658–59 (internal quotations omitted).

beyond company insiders, as traditionally understood, to anyone with a particular relationship with the company.

II. And So We Come to *Salman*

Viewed in one light, *Salman* was simply closing the loop opened in *Dirks*. In *Dirks,* the Court considered, but was not presented with, the possibility that a tipper who makes a gift of information could be guilty of insider trading. *Newman* was viewed at the time as a potential departure from *Dirks* in the Second Circuit. The court devoted considerable attention to the question of whether there was a quid pro quo arrangement between tipper and tippee, noting as well that the tipper must receive a considerable personal benefit from the exchange. Any gift language in either *Dirks* or *Newman*, however, was arguably *dictum*. In *Dirks,* there was no allegation that the insider had given Dirks information because he wished to make him a present. The discussion of gifts is therefore not relevant to the holding. In *Newman*, the court found that the information provided neither to Newman nor to Chiasson was intended as a gift, and therefore in that case, too, any discussion of gifts was not relevant to the holding. As the Court noted in *Salman*, the gift of information from one brother to another, provided to "benefit" him and "provide for his needs" is "in the heartland of *Dirks*'s rule concerning gifts."[31] This is not to say that *Salman* rejects the premise that the insider must personally benefit from the disclosure. Instead it asserts that giving a gift can itself be a benefit to the tipper. The fact that "determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts"[32] did not trouble the Court. "[T]here is no need for us to address those difficult cases today," the Court stated, "because this case involves precisely the gift of confidential information to a trading relative that *Dirks* envisioned."[33]

The actual holding of the case is quite narrow in light of existing precedent. It simply affirmed the *Dirks dictum*. And yet the resulting rule is incredibly complex. As the Court stated in the opening of the opinion, the rule is now:

[31] Salman v. United States, 137 S. Ct. 420, 429 (2016).

[32] *Id.* (quoting Dirks, 463 U.S. at 664).

[33] *Id.* (internal quotation marks omitted).

> Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b-5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage . . . . These persons also may not tip inside information to others for trading. The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty . . . . [L]iability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty . . . when the tipper discloses the inside information for a personal benefit . . . . [A] jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or makes a gift of confidential information to a trading relative or friend.[34]

To fully understand the crime, it may be useful to break it down into its elements. And there are many elements. Even the comparatively simple classical insider trading has six elements:

1. A person who is an insider, typically an officer or director,
2. obtains information that is
3. material and
4. nonpublic,
5. and executes a securities transaction
6. based on that information.

Under the misappropriation theory, the "insider" status is less clear and thus must include the following elements:

1. The individual held a position in which she owed a duty of trust and confidence to another and
2. obtained information by virtue of that position.

Finally, the tipper/tippee theory adds these elements:

1. The tipper/insider discloses the information
2. to obtain a benefit
3. that is personal.

[34] *Id*. at 423.

4. It can be something of value, or
5. the tip may constitute a gift.
6. The tippee knows the information was disclosed by
7. an insider
8. who obtained a benefit
9. that is personal
10. or provided the information as a gift, and
11. the tippee trades on the information.

On the one hand, the presence of so many elements works against the government since, to obtain a conviction, the government must prove each element beyond a reasonable doubt. But on the other, the existence of such complexity makes it more difficult for individuals and companies who are trying to avoid illegal acts in the first place.

This comes back to the central problem: insider-trading law has not clearly defined the harm it seeks to avoid. Consider, for example, a crime such as murder. The harm is abundantly clear. A person is dead. Whether the person's death is due to murder or to accident, manslaughter, or some other action, there is no serious disagreement over the fact that a person's untimely death is a tragedy to be avoided. Insider trading is entirely different.

III. Arguments for Restricting Insider Trading and Why They're Flawed

The core problem with devising good insider-trading law is that the central function of insider trading—introducing material information to the market—is good. It improves the market's ability to properly direct resources. Securities markets provide both a common meeting place for buyers and sellers and, crucially, a means of ensuring that resources are allocated to their best use. Basic economics teaches that the price that a buyer is willing to pay reflects that buyer's understanding of the thing's value (whether that "thing" is a security, a loaf of bread, or a taxi ride). The buyer will use the information available to assess what price she is willing to pay. The seller conducts a similar evaluation, using information about the thing to determine at what price he is willing to sell. Every time a price changes, other buyers and sellers incorporate the change into their own assessment of price. For example, consider a homeowner who believes his house to be worth $300,000. If a similar house in his neighborhood sells for

$600,000, he will assume that $300,000 is no longer the value of his house and will no longer sell at that price—even if he knows nothing more about the house that sold, the seller, or the buyer. He will assume that there is something about his house—the neighborhood, popular taste in housing styles, *something*—that doubled the value of his neighbor's house and therefore must increase the value of his own similar house. When a security is heavily traded, such price signals flow through the market constantly. Any trade made on the basis of material information provides such a signal.

As securities change in price, the market learns information about the underlying company. A company that is doing well will attract more money. Why should this be? Because, presumably, the company is doing something valuable. In the first two decades of life as a public company, Apple stock bumped along around $1 or $2 per share. By the end of 2007, it jumped to around $27. What did Apple do in 2007? It invented the iPhone. iPhones provide value to consumers who like having access to so much information and data in one place. Apple received more money from the market because it was using the money well. It hit a spike again in 2015, the year the iPad came out. As of April 28, 2017, it was trading at around $144. The pharmaceutical company Pfizer saw a massive increase in its stock price between 1996 and 1998—from around $12 to $44. What did it do in that time? It released the blockbuster heart medication Lipitor, which has contributed to a huge decrease in deaths due to heart disease. A properly functioning market will ensure that good ideas get funded and bad ideas are starved of precious resources.

Although introducing information into the market is important, something about insider trading seems to induce a strong negative reaction in many policymakers and commentators. Many see something "unfair" about the process. Beyond general fairness concerns, the argument typically assumes that if insider trading were permitted, investors would lose confidence in the market and would therefore abandon it. At oral argument in *Salman*, the deputy solicitor general opened by saying that permitting an insider to "parcel out" valuable information to family and friends "would be deleterious to the integrity of the securities markets" and "would injure investor confidence."[35]

[35] Transcript of Oral Arg. at 23–24, Salman v. United States, 137 S. Ct. 420 (2016).

Despite the advantages of introducing accurate information into the market, there may be a role for restrictions on insider trading. Unfortunately, the case law as it currently exists—constrained as it is by the need to tie any theory back to Section 10(b)—has not adequately explained either what constitutes insider trading or why what has been tagged "insider trading" should be punished as a felony. More unfortunately still, the Court missed an opportunity in *Salman* to provide either to the public.

A. Using Inside Information Is Cheating

One of the chief arguments against insider trading is that it constitutes a form of cheating. Business ethics professor Bruce W. Klaw has argued that insider trading constitutes cheating because the person trading on nonpublic information is gaining an advantage through the use of information that could not also be accessed by others "through their independent and otherwise lawful diligence."[36] Such arguments might be persuasive if there were a complete ban on the use of material nonpublic information in the securities markets—or at least on any information that could not be discerned through the careful use of data available to those who would collect and properly analyze it. But, under *Chiarella*, a taxi driver who overhears an indiscrete conversation between passengers may freely trade on the information even though the information came to him by luck. If the driver trades on the information, he is arguably deceiving the counterparty to his transaction because that person would likely demand a different price if she were aware of the information the driver has. *Chiarella*, however, explicitly rejected a "parity-of-information" rule.[37] Why is this trade less deceptive, though, than the same trade based on the same information, but with a company insider in the place of the taxi driver?

To be fair, Professor Klaw argues that *Chiarella* was improperly decided. It was "Chiarella's *access* to the dealbooks that was the

[36] Bruce W. Klaw, Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory, 7 Wm. & Mary Bus. L. Rev. 275, 310 (2016) ("This Article would submit that the 'rule' violated by insider trading is the implied rule that 'thou shalt not trade in securities on the basis of information concerning that issuer unless such information could also be available to others through their independent and otherwise lawful diligence.'").

[37] See Chiarella, 445 U.S. at 233.

proximate and structural cause of his informational advantage, rather any true financial acumen or diligence on his part[,]" he notes. So a rule that would bar someone like Chiarella "from exploiting his position of access against his counterparties, whom he knew could not possibly lawfully access the same information, could have formed the basis for a limited rule about why, under the circumstance, he should have been under a unique obligation to abstain from trading."[38]

Perhaps this luck-based method of obtaining inside information does not concern the law because it is likely to happen so rarely. Someone may overhear a conversation in a taxi or an elevator, or may find a revealing memo accidentally dropped from a briefcase, but those opportunities are likely to happen once in a lifetime, if at all. The likelihood of someone trading on such information at any given time is so low that it is unlikely to deter others from entering the market. But even if it is likely to be rare, if the problem is that it is deceptive for one party to use secret information to gain an advantage over another, it should not matter how frequently such deception occurs.

Professor Klaw argues that insider trading constitutes cheating in part because the inside information cannot be gained through acumen or skill. But it may go too far to say that obtaining insider information requires no skill. In her book *Black Edge*: *Inside Information, Dirty Money, and the Quest to Bring Down the Most Wanted Man on Wall Street*, journalist Sheelah Kolhatkar recounts in great detail the lengths that hedge fund employees have gone to in order to cultivate just such information.[39] While there may be an easy and entirely fortuitous way to access such information—by belonging to the kind of family that has deep connections with industry titans or by going to the schools that foster such ties—such connections are likely to be limited by chance. Family ties to one industry do not guarantee similar ties in another unrelated field. Developing a professional network, however, is a skill at the heart of many occupations. Journalists, for example, require a broad web of sources to produce timely scoops. Anyone who must bring in

[38] Klaw, *supra* note 36, at 303–04.

[39] Sheelah Kolhatkar, Black Edge: Inside Information, Dirty Money, and the Quest to Bring Down the Most Wanted Man on Wall Street (2017).

clients must cultivate relationships with the right people. Those looking for work are frequently advised to work their networks. It is not entirely clear how developing sources as a journalist, for example, is fundamentally different from developing sources for market information. The difference is certainly not that only the former requires any "skill."

Existing law creates a strange paradox. Information that one party has but that is not available to the market broadly is permitted if it was attained by pure luck (as with our taxi driver) or if it was attained through *some* kinds of skill, but not through the skill of developing human sources of information. If a trader wants to watch the road outside a factory to glean information about a company's output, or study satellite pictures of parking lots to gauge retail activity, these sources of information, while not widely available, are nonetheless permissible for use in trading.

B. Investors Will Lose Confidence in the Market If They Believe that Insiders Are Using Nonpublic Information

Those who argue against insider trading on the basis of fairness often buttress their positions by noting the likely effect of insider trading on the markets. During oral argument in *Salman,* counsel for the United States stated that allowing corporate insiders to "parcel . . . out [material nonpublic information] to favored friends, family members, and acquaintances . . . would be deleterious to the integrity of the securities markets."[40] The idea is that if some market participants have information unavailable to others, investors will be wary and shy away from the markets, uncertain of whether they are being exploited.

But under the formulation expressed in *Salman*, what matters is that information is provided by an insider *in breach of a duty*. If the concern is the duty that has been breached, this may make sense. But to the extent that the concern is—as the deputy solicitor general argued—the integrity of markets and the willingness of investors to participate, then whether a duty was breached seems hardly relevant. If the breach of duty were truly the concern, a company could grant certain officers and directors leave to trade on inside information as a form of cheap compensation. But this

[40] Transcript of Oral Arg. at 23–24, Salman v. United States, 137 S. Ct. 420 (2016).

is not permitted because, in the end, the integrity of the market is ostensibly the concern. Yet such a stance disregards the value to the market of a high-ranking officer or director trading in the company's stock. Imagine if a CEO were to short her own company, or buy up additional shares in a spending spree. Either move would send a very strong signal to the market and help improve the existing information. If the concern is that some traders may have information unavailable to others, then whether that information was obtained through a breach of duty should be irrelevant.

C. Companies Have the Right to Exclusive Use of Their Information

A final argument for restricting insider information is perhaps the least persuasive, which is that companies have the right to exclusive use of their information. Under this formulation, which is the foundation of the misappropriation theory, insider trading is essentially theft. It is true that companies clearly have an interest in controlling the dissemination of their sensitive information. Whether the law should affirmatively protect that interest with the use of criminal sanctions is less clear.

Companies routinely keep news of a merger quiet until the transaction is complete. The concern is that the merger is premised on a particular stock price. Assuming the merger is a good one, the price of the merged company's stock should rise once the merger becomes public knowledge. Between the time that the merger is under consideration and the time it becomes public, therefore, the stock is underpriced. If the price would rise if the market knew about the merger, that means that the existing price is incorrect and does not reflect the true value of the company. Anyone who sells the stock without knowing about the merger is selling too cheaply. In some ways, the company's keeping the information private is a form of insider trading. Anyone who knows that a stock's value is likely to rise because of secret information, and therefore holds the stock with the expectation of profits once the information is disclosed, is making a trading decision based on material nonpublic information.

In *Salman*, the trades at issue involved just such a contemplated merger. At trial, Maher Kara testified about a contemplated merger that would proceed only if the information remained private and therefore only if the stock prices of the relevant companies remained stable. The company, a client of Citigroup's, insisted on the strictest

confidentiality. Because Michael had become aware of the merger through information disclosed by Maher, he rightly commented that the company seemed "cheap."

Ultimately, however, the misappropriation theory proves too much because it is limited to misappropriation *for the purpose of trading* only. It is not difficult, however, to imagine other uses to which information might be put that would deprive the company of its exclusive use without involving a securities transaction. It is not even necessary to speculate or devise hypothetical situations; *Salman* itself includes such a use. Maher Kara testified that he had shared information with Michael for the purpose of exploring treatment options for their dying father. While this use is clearly sympathetic—it would seem cruel to punish two sons for using information at their disposal to try to save their father—it is just as clearly one with only a personal benefit to Kara. Neither Citigroup nor any of its clients benefited from the elder Mr. Kara receiving improved medical treatment.

So why must the harm be tied to a personal use that also involves a securities transaction? One answer may be that such a use risks affecting the company's position in the market. Activity unexplained by public information would hint to traders that there was some material nonpublic information to be had. The market might react and harm the company both through a price movement itself (if the price were to go down) and from the presence of a hint that might lead others to guess the secret information—for example, that a long-rumored merger was finally going ahead.

While the harm to the company would be clear, the fact that these trades might move the market suggests that the presence of the currently illicit trades would actually improve the market. Perfect information should lead to prices reflecting the actual value of a security. If a security is trading at an artificially high or low price, the market suffers. Introducing secret information sooner rather than later benefits the market as a whole (and the rest of society, which benefits from resources being directed to their best use), even if it disadvantages the company whose securities are being traded.

What if the trades do not move the market? In a very active security, one person trading may go entirely unnoticed, especially if that person is a step or two removed from the company itself. (A CEO's trades will never go unnoticed, of course.) These trades introduce

no new information into the market because no one takes notice of them. In that case, however, it seems even harder to show that there is a harm to the company. A few trades that have no impact on price, and that might have happened anyway—just with a different buyer or seller—arguably incur no harm on the company itself.

There is a disconnect in this logic. If it is harmful to a company for its information to be used for a purpose it does not approve, if it loses the exclusive use of its information, the harm must exist even if the use is not trading in the company's securities. But if the harm exists only when it is tied to a securities transaction, why does a trade that has no impact on price harm the company? And in the case that the trade does move the price, why should the company's desire to have exclusive use of the information be protected by law? If the rapid dissemination of accurate information is a benefit to the market and society more broadly, why criminalize activity that forwards that interest? It would seem that a better approach would be to permit the company to take measures to protect its own information, but refrain from interfering when someone breaches that protection.

IV. A Better Solution

There is arguably no need for a law that proscribes insider trading. First, the introduction of accurate information into the marketplace is an inherent good. Restricting this flow of information through criminal law only serves to make markets less efficient and prices less accurate. Second, companies already have a strong incentive to protect their own information and the means to punish their own insiders who improperly disclose the information, including by using it to trade. Confidentiality provisions are common in employment agreements. These agreements can be enforced by the companies themselves—through threat of termination or by clawing back certain compensation from employees who violate the contract, or through litigation, which provides employers with remedies to help recoup the losses sustained through the employee's illicit disclosures. Employers are free to punish almost any unauthorized disclosure, including a disclosure to a friend or relative with the intent that the individual use the information to trade.

Despite these arguments against insider-trading law, it is unlikely that insider-trading law will be abandoned any time soon. There remains a strong sense among many that insider trading is

"cheating."[41] A more rational, easily understood, and easily administered rule is needed.

Chief Justice Warren Burger's dissent in *Chiarella* presented one such rule. Burger noted that "neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation . . . [but] the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."[42] Chiarella's conviction should stand, he reasoned, because the act of obtaining data from confidential client sources is itself unlawful.

Assuming that the various laws proscribing certain means of obtaining information are just—which may be a large assumption but is at least the subject of a separate inquiry—then dissuading individuals from employing those proscribed means to obtain information itself promotes a good. Unlawfully breaking into a company's headquarters or, more likely in 2017, servers and stealing information is clearly harmful because it violates the company's property rights. A law that enforces a company's agreements with its employees—including provisions against using confidential company data for personal reasons—similarly promotes the value of strong contract rights.

Such a substantial change in the law would be best attempted by Congress. The prohibition on insider trading could therefore be completely untethered from the language of Section 10(b) and its insistence on fraud, and written to address a specific harm.

To the extent that the harm investors fear is truly that they may be trading with someone who has access to information entirely unavailable to themselves, the proper rule is simply to bar any trading on material nonpublic information, no matter how it was obtained. This would of course cause some reduced flow of information into the market, but it would at least provide clear guidance for those wishing to avoid criminal liability. It would also require a firm commitment to the stated principle of protecting market integrity.

[41] The reason for such sentiment is the subject for another paper. It should be noted, however, that fully lawful means of trading often face similar emotional reactions. Consider, for example, sentiments surrounding high frequency trading: those who use such methods are often depicted as "cheaters" as well.

[42] Chiarella, 445 U.S. at 239–240 (Burger, C.J., dissenting).

The way things stand now, it is not entirely clear why investors would fear insiders' trading but would not fear other traders using equally secret information.

* * *

The Court in *Salman* clarified a small question of insider trading law—whether an insider could make a gift of information—but failed to provide any additional clarity on why such trading is illegal at all. While the process of developing rules through the common law system of legal precedents can be beneficial, in this case the mix of an underlying statute with a crime that has been built haphazardly on top of it has only resulted in confusion. Existing law, in part because it relies on a catch-all that must catch fraud, has followed a tortuous path. Justice requires that individuals be able to clearly understand what actions will result in criminal penalties. This clarity depends in part on a clear understanding of what harm is being prevented. This is what is meant by adhering to the "spirit of the law." It is not clear that insider trading must be criminalized at all. But if it must be, then the law should be written in a way that all market participants can clearly understand. This requires a clear statement of the harm to be avoided and a body of law devoted to avoiding that particular harm. That is far from what our current law provides.