A SYNTHESIS OF INSIDER TRADING: THE PERSONAL ACCESS TO, ACQUISITION OF, AND USE OF INSIDE INFORMATION

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Dr. Ioseph Maria ORTIZ IBARZ

Dr. Modestus SANTOS

Coram tribunali, die 27 mensis iunii anni 1996, hanc dissertationem ad Lauream Candidatus palam defendit

Secretarius Facultatis
Dr. Iacobus PUJOL

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«Executives do it. Bankers do it, accountants, secretaries, and messengers do it. And the employees of printers do it, taxi drivers, waiters and barbers... The illegal use of inside information is out of control»1.

This is the conclusion reached by Jeffrey M. Laderman after his well-known investigation which involved 229 public securities offers which took place between 1983 and 1984 in New York, Washington, and Chicago2. In short, he deduced that just about anyone could abuse inside information.

But how does someone determine who illegally or immorally abuses inside information? With such a variety of people and professions mentioned above, what distinguishes an individual to be an insider? Are all market players insiders?

Traditionally those who hold fiduciary positions like directors, officers, and majority shareholders have been considered insiders. Could all employees be seen as fiduciaries to their own employer? Is it possible to extend a fiduciary status to family members of employees who merely possess confidential information? Would an individual be guilty of using inside information, regardless of the fact that he may not have had the intention of making use of such an advantage? Instead of focusing on the subject of insider trading, maybe that which determines the illegality of using inside information is the very nature of the object of insider trading: privileged information. If this is so, then what particular characteristics would describe inside information? Could secret information be classified as intellectual property whether it be private or public?

It would seem that the abuses of inside information are not due to the ready availability of relevant financial corporate information, which at times may be communicated instantly and globally in today’s technologically advanced society, but rather, the problem appears to stem from a disordered understanding of justice, a lack of individual responsibility, and a
deficient personal administration of human action. Individuals entrusted with material, pertinent financial data, unknown to the public, execute trades in the stock market or communicate such facts to third parties for their own personal benefit, not considering the reality that they form part of and effect the company in question, the market society and the community.

If such illicit practices have occurred, what has the legal system contrived to stop insider trading? Many people have been held liable for insider trading, but has the government been successful in protecting the financial markets in its task of efficiently allocating resources and sufficiently generating the wealth of the nation?

The present work «What is Insider Trading?», intends to explain the absence of the existence of a legal definition for insider trading in the United States and offers at the same time a brief academic description of insider trading to help the reader navigate the doctrinal and historical highlights of the life, law, and theory of insider trading. The historical summary of the legislative, administrative, and juridical struggles regarding the regulation of insider trading are principally limited to the United States during the present twentieth century.

The author would like to end this prologue in the first place by giving thanks to the Ecclesiastical Faculty of Philosophy of the University of Navarre for the opportunity to realize this investigation under its tutelage. The author is also very grateful to the Rode Foundation for its economic support provided for this further personal and educational development. Additionally, the director of this doctoral dissertation, Dr. José María Ortiz-Ibarz, should be acknowledged for his continual assistance and key guidance in this undertaking, from the initial inspirations of the topic to the final clarifications of the conclusion. Finally, several other individuals need to be thanked for their aid and consultation in the process and development of this work, namely, Dr. Leonardo Polo, Dr. Carlos Moreda, Dr. Hernán Fitte, Mr. José M.ª Rodríguez Landeras, Mr. G.F. Mannion Jr., Mr. Bill Keen, Mr. James Bostick, Mr. David Carridini and Mr. Carlos Jódar.
NOTES OF THE PROLOGUE


2. **PRAT RODRIGO, M., El uso ilegal de la información privilegiada en las ofertas publicas de adquisición de acciones (EE.UU. 1933-1988), Deusto, Madrid 1990, p. 51.**
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<td>Cir.</td>
<td>Circuit.</td>
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<td>ed.</td>
<td>edition, edición.</td>
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<td>F Supp</td>
<td>Federal Supplement.</td>
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<td>Inc.</td>
<td>Incorporated.</td>
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<td>loc. sit.</td>
<td>as already cited.</td>
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<td>NASD</td>
<td>National Association of Securities Dealers.</td>
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<td>S.D.N.Y.</td>
<td>Southern District of New York.</td>
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<td>SA of 1933</td>
<td>Securities Act of 1933.</td>
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<td>SEC</td>
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<td>US</td>
<td>United States Supreme Court Reports.</td>
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<td>USC</td>
<td>United States Code.</td>
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A. DEFINING INSIDER TRADING

1. There is no Legal Definition

What is insider trading? That is a good question; unfortunately, there is no easy answer. Sure, there exist plenty of academic definitions and an extensive quantity of administrative, legislative, and juridical developments. Nevertheless, the clamors for a legal definition that is concrete and complete have remained unanswered. Several battles in Congress during the 1980's have been attempted to forge a legal definition, but without success.

Any attempt to define the idea of insider trading by Congress has been blocked because it limits the application of the law against insiders who can easily claim that a legal definition does not apply to them. Congress has supported its position stating that juridical decisions have constructed a sufficient parameter of principles to combat insider trading, and with these principles it has been argued that the Courts should define insider trading on a case by case basis.

2. An Academic Description of Insider Trading

Although no legal definitions have been elaborated, it is appropriate at this point to provide the reader with at least one, well-thought out, academic description of insider trading. While assessing the description provided as well as the historical summary, it is important to keep in mind two questions: Who is an Insider? and What is Insider Information? Professor Langevoort begins his treatise on insider trading as follows:

Insider Trading is an issue of cultural significance. Until recently, regulating those who seek to exploit inside information had been seen simply as an «investor protection» issue, a way of promoting rules of fair
play in the securities markets so as to retain the confidence of the average investor. «Insider trading» is a term of art that refers to unlawful trading in securities by persons who possess material non-public information about the company whose shares are traded over the market².

With this sample description of insider trading, it will be easier to navigate the historical, legislative, and juridical waters of insider trading, above all in the United States³, which is the chosen context of the following article. For the most part, this work will present some legal highlights of the past century in order to gain a broader perspective of the development of the task of answering the question «What is Insider Trading?».

B. LIFE, LAW, AND THEORY OF INSIDER TRADING

1. Life, then Law, then Theory

a) Life

A long legal tradition has affirmed that «Life comes first and then the law». Reflection on the interactions between life and law generates theory. And theory, in time, returns to influence life and law. Given these assumptions, the underlying format of this section will be to trace a sketch of the life, law, and theory of insider trading. Life will be depicted by the historical occurrences and particular cases of insider trading.

b) Law

The legal context will be delineated by legislative, administrative or juridical proceedings. Legislative activity is comprised primarily of Congressional debates, statutes, and laws. Administrative undertakings concern the rules and regulations of the vigilant Securities and Exchange Committee (SEC) and juridical proceedings accumulated in the form of numerous court rulings and decisions like the more important organs of legal judgment handed down by the Second Circuit courts, the Appellate Courts and especially the Supreme Court of the United States. Keep in mind that Common Law is understood as «the law based on usage and custom and confirmed by juridical decision, that is, the unwritten law as distinguished from statute law»⁴.

c) Theory

Finally, theory has been expressed by three main legal theories of responsibility, namely the fiduciary duty theory, the equal access theory,
and the *misappropriation theory*, all of which will be described briefly here in their historical context.

The *fiduciary duty theory* focuses upon the particular fiduciary duty or responsibility with which an insider is entrusted by a company. Upon trading or communicating inside information confided to the fiduciary within the context of that responsibility, that insider is said to have breached that fiduciary duty. The legal solution adopted to help insiders who hold a fiduciary duty and who still desire to make transactions in the shares of their company is to disclose important non-public information or abstain from trading. On account of this «disclose or abstain» rule, this fiduciary duty theory is also called by some authors the *disclose or abstain theory*.

The *equal access theory* assumes that «all traders owe a duty to the market to disclose or refrain (abstain) from trading on non-public corporate information so that all investors have equal access to the same information»⁵. Some describe this objective as a «transparent market», where all market participants see clearly and equally the same facts while deciding on investment possibilities.

The last of the three main theories, the *misappropriation theory*, establishes that any person, with or without a fiduciary responsibility, who has been entrusted with inside information, is liable for insider trading if that person uses that relevant information for personal gain⁶.

2. Historical Summary

Before starting the historical summary, it is advisable to make one final qualifying statement. Many authors admit the absence of a unified and centralized legal theory in the financial securities industry regarding the abuse of inside information. Part of this financial legal theory involves insider trading⁷. Oftentimes, conflicting viewpoints and changing emphases will be noted in the historical overview which demonstrates to some degree the interactions between life, law and theory. Kraakman sums up the situation well when he says,

The law governing insider trading in the United States has developed with little legislative guidance or real consensus among lawmakers on what the basic elements of legal theory should be. The Supreme Court has split evenly over the doctrinal bases for regulating it under federal securities law. Further, the academic literature is divided on the fundamental issue of whether insider trading by corporate managers ought to be prohibited at all. Nevertheless, the campaign against insider trading flourishes today as never before, under the watchful eyes of Congress and the SEC⁸.
a) Early History

The concept and terminology of insider trading and manipulation in the business enterprise is nothing new. In the year 1696, a statement was made in the British Parliament condemning «conduct which amounted to insider manipulation and trading... which would pervert and end the design of companies». This was one point of view, but more recently since the late 1800's, the popular and primordial defense in favor of insider trading is that it has been viewed as «a perk on the job», that is, an added form of managerial compensation.

Experience has shown that although such trading often gives rise to a conflict between self-interest and fiduciary obligations, and thus to potential liability in civil law, there are few examples of such legal actions ever having been undertaken. Despite the absence of legal precedents, James Burk in his book entitled «Values in the Marketplace: the American Stock Market under Federal Securities Law», shows how early securities regulation initiated by the U.S. Congress created the Industrial Commission in 1898 which recommended once in 1900 and again in 1902 that promoters and organizers of corporations be required to disclose the information necessary for investors to make a safe and intelligent decision about their offerings and that the larger corporations be required to publish annual statements of their financial condition.

Citing Professor Loss, he adds that the members of the Industrial Commission considered «failure to comply with these requirements» as «fraud».

Clearly, the attitude of those times shows a sensitivity toward the importance of disclosing information. This is further evidenced by «the chronology of the increased number of disclosure requirements imposed by the New York Stock Exchange (NYSE)» starting back in 1869 up until the first federal Securities Act of 1933. «The list is so comprehensive it is difficult to find any significant disclosure requirement in the securities regulations of the 1930's that had not been previously required by the NYSE».

b) Three Early Court Cases at Common Law

Three early court case types are cited by Professor Louis Loss, the author of «Fundamental Securities Regulation» and one of the most authoritative figures in securities law. He presents the three cases to show the
development of the degree of fiduciary duty expected of the corporate manager or director with respect to and the extent to which the disclosure of inside information is owed to the corporation or to the shareholders. In other words, each case represents a distinct posture of the Common Law fiduciary duty demanded of the corporate manager in disclosing privileged information. The discussion of this issue will closely follow the presentation of Professor Loss due to the complicated nature and the importance of this idea of a fiduciary duty which is the key concept at issue in many of the legal decisions involving inside information.

The questions to be answered and which can serve also as an aid for reflection are: Does the corporate manager owe a fiduciary duty of the disclosure of inside information to the company alone? Does the corporate manager have a fiduciary duty to communicate relevant non-public information only to shareholders? At this point, someone could pose this last question: Who are the owners of the company, the managers, or the shareholders?

The first case mentioned refers to the year 1868 in the New York Supreme Court, Carpenter v. Danforth (52BArb.581), and is in support of the first posture, also called the «majority» or «strict» rule. The decision states that «directors and officers have a fiduciary duty obligation only to the corporation and to the stockholders in their dealings with or on behalf of the corporation... «Hence as individuals they may trade in the securities of the corporation without any affirmative obligation of disclosure as long as there is no misrepresentation... in deed or in truth». Instead of calling this a strict rule, Professor Loss describes it as a «loose» rule as it gives more leeway to act for the executives of the company.\(^15\)

Other court decisions typifying the contrary extreme, known as the «minority» or «fiduciary» rule, come mostly from the rural, agrarian courts and not the city courts. The fiduciary duty rule designates that corporate insiders are held to fiduciary standards with stockholders and hence must make full disclosure of facts.\(^16\)

Two extremes have been presented, one which favors a loose expectation of the corporate insider's fiduciary duty of disclosure to the shareholders and one which favors a full disclosure of the facts to shareholders.

The third case type introduces a moderate doctrine, an intermediary position between the other two extremes presented above, which has been called the «special circumstances doctrine». As one might have guessed, this doctrine encompasses all of the exceptions to the rules, but clearly does not confirm any rule. Professor Loss employs the Strong v. Repide case from the year 1909 as an example of this type of precedent.\(^17\) In this
case, a general manager, who was also a major stockholder, purchased all of the shares from the minor stockholder without informing the minor stockholder of his actions. The court decided that «it became the duty of the defendant (the general manager and major stockholder in this case) to state the facts (to the minor stockholder) before making the purchase». Professor Loss, relating the decision with the two extremes and to the special circumstances doctrine says that taking the loose doctrine into account, the general manager and major stockholder never would have owed an «affirmative obligation of disclosure», but on account of his special circumstances of being a major shareholder, he owed the «duty of informing» the minor shareholder 18.

Analyzing the facts of these cases, Professor Loss arrives at the conclusion that the result of these actions and reactions shows the «generally growing attitude of increased responsibility of corporate insiders» to shareholders because of the «status of trusteeship» which a corporate insider should maintain in his dealings with the shareholders 19. Later, in his treatise on securities regulation, Professor Loss states that «most judges in the second half of the twentieth century seem to view the majority rule at common law» 20 which favors the corporate insider only having to disclose information to the corporation and to the shareholders on behalf of the corporation.

Early Common Law set the stage for subsequent legislation which could be used to repress insider trading, but initially the only recourses available were the state laws known as the «blue sky laws» as well as the federal Mail Fraud Statute.

c) Mail Fraud Statute 1919

The Mail Fraud Statute (and later the Mail and Wire Fraud Statute), originally legislated against fraud committed using the postal system (which was later extended to the telephone, the radio or the television) 21, was also wielded to prosecute insider trading activity. It states:

> Whoever having devised or intended to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises...for the purposes of executing some scheme or artifice...shall be fined...or imprisoned for not more than five years or both 22.

Even though principally designed to convict fraudulent activity in the mail and communication services, the application of the law in fraudulent securities transactions is supported based upon the argument that any negotiation must necessarily be carried out using the mail system or vias of
communication. The link is a weak one, but the articulation of «false representation» fits one description of the abuse of a fiduciary duty.

In short, early juridical and legislative history centered its attention on clarifying the responsibilities of a fiduciary duty and protecting the business enterprise from illegal market practices, one of which was insider trading.

Along with these efforts, «in the 1920’s the American vision was one of opportunity and wealth for all through participation in the financial markets»\(^23\). The vision of the equal opportunity of each investor in the market was essential because «the system rested upon mutual confidence and mutual exchange»\(^24\). Even though the market boomed, there were many abuses which led to the fall of the «golden age» or the «prosperity decade» marked chiefly by the stock market crash of 1929. There followed also a drop in investor confidence and a corresponding lack of stability in the market\(^25\). As a result of this deficient investor confidence in equal opportunity, the government was called upon to intervene under the presidential leadership of Franklin Delanor Roosevelt. Within his New Deal Program of 1933, he urged Congress to react.

d) Securities Act of 1933

The previously depicted market instability, and the abuses that boomed along with the market activity during the 1920’s, forced a crisis situation and the Great Depression. To respond to these problems, Congress legislated the Securities Act of 1933 on May 27, 1933 (SA of 1933)\(^26\).

Though the direct purpose of the SA of 1933 was not specifically opposed to insider trading, it provided a precedent for succeeding legislative affronts. It can be added that an impulse was needed to reassess the practices of a fiduciary in the financial industry.

In his message to Congress on April 29, 1933, shortly before the SA of 1933, President Roosevelt called for financial reform within the context of what Burk names the «revitalization movement». Roosevelt told Congress that it must.

...give importance to honest dealing...to a clear understanding of the ancient truth of those who manage banks, corporations and other entities where the money of others is employed, that they are fiduciaries who act on account of others\(^27\).

The historical situation which saw many abuses committed against investors by corporate irresponsibilities in the securities market gave rise
to a major shift in defense of the investor. The objective of the act is well expressed by the motto of that time referring to the new legislation: «Truth-in-Securities»\(^28\). More responsibility was placed in the hands of those who issued securities. Before this legislation «Caveat Emptor»\(^29\) (buyer beware) was the slogan; in 1933 it became «Caveat Venditor» (seller beware). Truly, this was watershed securities legislation and reform.

In order to bring about «truth-in-securities», public disclosure of information as the basis for all American law was required. The goal was the transparency of market information\(^30\). Specifically, Section 17 of the SA of 1933, punished as fraud the operations undertaken with deceit or false affirmations\(^31\). It is important to make an ongoing comparison of the key texts of the statutes and regulations so as to take note of the continual adaptations. Concretely, Section 17(a) reads:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly

1. to employ any device, scheme, or artifice to defraud, or
2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser\(^32\).

Before this Securities Act, as already noted above, the only way for the federal government to criminally process someone for securities fraud was in violation of the Mail Fraud Statute. The reader may have noticed a resemblance to the wording of the Mail Fraud Statute. Neither «fiduciary duty» nor «insider trading» are directly articulated in Section 17(a), however, in 1942 this legislative step would become the basis for the most effective anti-insider trading legislation yet formulated: SEC Rule 10b-5.

In 1933 the general banking chaos needed additional controls and thus more explicit legislation was called for in 1934.

e) 1934: The First Legislative Platform

*Created Against Insider Trading*

The Securities and Exchange Act of 1934 (The SEA of 1934) was passed by Congress in order to further regulate the conduct of speculative
trading\textsuperscript{33}. The SEA of 1934 barred certain illicit practices such as short selling by corporate insiders (which, in essence, is insider trading with inside information), reemphasized the disclosure and registration stipulation of the Securities Act of 1933, and constituted the Securities and Exchange Commission (SEC).\textsuperscript{34} The SEC was formed «to regulate the issuance of stock and to supervise the operations of the stock exchange» so as «to prevent over-speculation and the reoccurrence of the stock market crash of 1929»\textsuperscript{35}.

Despite the fact that the act fails to expressly mention insider trading, it was an important theme of the SEA of 1934 which has served as the first set of anti-insider trading statutes. Evidence that insider trading was considered to be unethical and a betrayal of a fiduciary duty can be gleaned from the following definition of the then Senate Banking and Currency Committee, concerning Stock Exchange Practices:

> Among the most vicious practices unearthed at the hearings before the Subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and confidential information which come to them in such positions to aid them in their market activity\textsuperscript{36}.

This quote is a very concise description of insider trading performed by corporate insiders. The description of using confidential information acquired on account of a fiduciary duty and later used for personal market activity is not ambiguous. There is no question what the attitude of the Committee was towards insider trading: the terms «flagrant betrayal» and «a vicious practice» leave little room for speculation.

So the topic of insider trading and breaching a «fiduciary duty» were in the discussions which led up to the SEA of 1934; it may not have been explicitly mentioned because it was considered plain and simple fraud. Additionally, it is quite possible that the specific term «insider trading» was not in common usage at the time, but the practice is certainly under attack.

\textit{f) Key Insider Trading Sections of The SEA of 1934: §10 and §16}

The most important part of the anti-insider trading legislation of the SEA of 1934 were Sections 10 and 16. Initially Section 10 was not utilized against insider trading until the adoption of SEC Rule 10b-5 in 1942, which will be discussed shortly, but Section 16 was enacted primarily to regulate the activity of the corporate insider. There are three parts to Section 16, each part with its own purpose\textsuperscript{37}:
Section 16a: Pre-Registration and Disclosure:

Section 16a requires directors, officers, and beneficial owners to file an initial report of all the issuer’s equity securities and an additional report within 10 days after the close of each calendar month in which there has been any change in holdings.

Section 16b: Recovery of Gains (Disgorgement):

Section 16b states that for the purpose of preventing unfair use of the information which may have been obtained by a 10% beneficial owner, director, or officer,...any profit realized in a securities transaction within six months is recoverable by the issuer irrespective of the intention of the beneficial owner, director or officer.

Section 16c: Prohibition of Short Sales:

Section 16c prohibits short sales made by whatever person who possesses privileged information.

These statutes are intended to regulate the abuse of insider trading, although the specific term «insider trading» is not utilized. It enforces pre-registration and post-disclosure of any transaction made by a corporate insider, enables the company shareholders the recovery of illegal gains made, and prohibits short sales by insiders. Loss, in a passing remark, comments, «It is interesting that the only explicit answer of Congress to insider trading was Section 16» yet, whatever may have been lost due to the clumsiness of Section 16 with respect to insider trading, was recuperated by the subsequent agility of Section 10b developed and nurtured by the SEC’s Rule 10b-5 of 1942.

Section 10b of the SEA of 1934 states:

It shall be unlawful...

b) to use or employ, in connection with the purchase or sale of any security registered on a national security exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission (SEC) may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Basically, this statute grants a wide-ranging power to the newly constituted SEC (Commission), a blank check if you will, to «prescribe as necessary or appropriate in the public interest or for the protection of investors» whatever rules and regulations it deemed necessary. With these words the SEC was authorized «to prescribe» rules and regulations without any immediate limits in order to safeguard the investing interests of
the public. Once again the statute does not explicitly mention insider trading in the phrasing; «the enabling section was not in fact designed to deal with the problem of insider trading at all».

Many criticisms have been asserted against this stipulation claiming that it gives excessive liberty to the SEC to create a «a federal common law» as one judge described it. But what was seen as «one of the most vicious practices unearthed» in the financial industry needed to be corrected with the authoritative leeway granted to the SEC to curb deception in the best interests of the investing public and to safeguard the financing of society’s development.

If there could be any doubt on this point, one might refer back to the Senate Banking Currency Committee’s description of the abuses of fiduciary duty which took place involving the use of confidential information for personal, self-interested market activity.

Under Section 10, part b, the SEC erected numerous rules and regulations, the most famous of which was SEC Rule 10b-5 enacted in 1942.

g) SEC Rule 10b-5: Heart of Insider Trading Legislation

During the revision process of the SEC in 1941, aimed at filling in some non-liability loopholes in the securities rules and regulations, another solution was discovered. In a first person narrative account, Milton V. Freeman, the head of the SEC in Philadelphia, relates the circumstances of how SEC Rule 10b-5 was formulated.

Mr. Freeman retells that there was a blatant case of insider fraud involving the president of a Boston-area company who was buying the stock of the shareholders of his company, after having informed those shareholders in a deceitful way that the company was performing poorly, when in reality the company was on the verge of quadrupling its earnings. In response to this deception, Mr. Freeman narrates, «I looked at Section 10b and I looked at Section 17a (of SA of 1933) and I put them together, and the only discussion we had there was where to place “in the connection with the purchase and sale” (phrase from Section 17a) and we decided it should be at the end of Rule 10b-5».

Looking at the administrative and enforcement powers invested in the SEC by Section 10b of the Securities and Exchange Act of 1934, the Commission (SEC) promulgated Rule 10b-5 which reads:

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,
to employ any device, scheme, or artifice to defraud

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

(3) to engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person, in connection with the purchase or sale of any security

h) SEC Rule 10b-5: A Catch-All

Once again SEC «Rule 10b-5 does not expressly bar insider trading, but its sweeping language (which prohibits “any act, practice or course of business which operates... as fraud or deceit upon any person, in connection with the purchase or sale of any security”) proved sufficiently flexible to reach most of what is ordinarily considered to be insider trading».

The Supreme Court would later call the SEC Rule 10b-5 a «catch-all» legislation due to the general, wide-ranging capacity of the SEC to manage insider trading, which was never intended to be more than a residual anti-fraud mechanism. Loss clarifies that the powers of the SEC were all-encompassing as long as the authority was applied contrary to insider trading in the name of fraud. To express more graphically the extensive applicability of SEC Rule 10b-5, several authors have composed some vivid metaphors. Professor Loss likens Rule 10b-5 to «a horse of very dubious pedigree, but very fleet of foot»: and Chief Justice Renquist compares Rule 10b-5 to «a judicial oak which has grown from very little more than a legislative acorn».

The insignificant administrative scene in the office of Mr. Freeman could be likened to a major motion picture which would dominate the future juridical drama against insider trading for decades. Up until this time, the administrative origins of the SEC Rule 10b-5 have been portrayed. The SEC left the remaining questions in the hands of the Courts. The following two court cases show the initial responses of juridical action to the SEC Rule 10b-5, and the later arrival of the well-known «disclose or abstain» rule.

i) Precedents of Disclose or Abstain

In 1947, two court cases provided precedent-making use of SEC Rule 10b-5: Kardon v. National Gypsum Company and Speed v. Transamerica Corporation. These two cases also furnished part of the develop-
ment of the disclose or abstain rule which briefly affirms that an insider should disclose any non-public, material information before trading. If he does not disclose the information, he is obliged to abstain from trading.

Recalling the three early court cases at Common Law, the Courts vied to determine which level of fiduciary duty was demanded of by corporate managers in their service to their company and shareholders. The protection of the investor was enhanced by increased fiduciary standards, especially the outcome of the stock market abuses of the late 1920's and the catch-all SEC Rule 10b-5.

Judge Kirkpatrick in *Kardon v. National Gypsum Company* applied Section 16b and SEC Rule 10b-5 against the National Gypsum Company for having failed to notify or disclose pertinent financial information. The judge stated that SEC Rule 10b-5 was applicable «to directors and officers who, in purchasing the stock of the corporation from others, failed to disclose a fact coming to their knowledge by reason of their position, which would materially effect the judgment of the other party to the transaction»51. The result of the ruling is that SEC Rule 10b-5 demands disclosure by corporate insiders to shareholders of knowledge which would «materially effect» the judgment of the other party to the transaction. Fiduciary duty in this case refers to omission, a «failure to disclose a fact» to the other party which in most cases will be shareholders.

Later in the same year, Judge Leahy in *Speed v. Transamerica*, also employed SEC Rule 10b-5. «The rule (SEC Rule 10b-5) is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of a minority stockholder without disclosing the material facts...»52. Not only corporate officers and directors have to comply with the rule, but also major stockholders must «disclose material facts» to minority stockholders before a transaction.

Having demanded the disclosure of material facts, there remained the need to specify the implicit requirement that it take place «before transacting» and that if there were no disclosure before trading, «one must abstain from transacting».

j) *Disclose or Abstain: The SEC regarding Cady Roberts*

In the administrative proceedings of the SEC in 1961 regarding Cady Roberts & Company, the «disclose or abstain» rule was first formalized. The case involved a transmission of non-public information which consisted of the fact that Cady Roberts & Company had planned on releasing a dividend. On the part of the SEC discussions, they were «to determine whether leakage of the news of an impending dividend cut by a board
member to a stockholder, and the subsequent sale by a securities broker, violated the Rule(10b-5)». Several expressions from the case exhibit the idea of the disclose or abstain rule.

«Intimacy (of those who are in a special relationship) demands restraint of trading in securities, lest the uninformed be exploited»54. Consequently any sales by the insider must await disclosure of the information, or, said more explicitly, the insider must disclose material information if that insider chooses to negotiate in the shares of the company to which the information belongs. If that insider does not disclose the information, abstaining from negotiation is the only alternative. In some cases disclosure is required even if that insider chooses not to make transactions in the shares of that company. As noted above, failure or omission to disclose important facts leaves the insider open to liability. In conclusion, out of respect for the privileged information, it would seem safest to disclose and to abstain from trading.

The Commission stipulated two pre-requisites or conditions in order to use Rule 10b-5.

Analytically the obligation (to disclose material information) rests upon two principal elements:

(1) first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone, and

(2) second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing55.

Professor Loss himself debates the two possibilities: to disclose or to abstain. «Since the conflict is inevitable between the director’s 10b-5 duty to the other party to the transaction to disclose material facts, and the common law duty that he will often have to the company not to make premature disclosure, the director has no viable alternative but to abstain»56. «Even though an insider chooses to abstain from trading or to temporarily withhold (not to disclose) the information, that corporate insider could be charged equally by the SEC Rule 10b-5, if there is an omission of facts that should have been disclosed»57.

Furthermore, disclosure properly carried out is not so simple. Disclosure is not limited to just notifying the SEC of soon to be realized transactions, but requests other procedures like allowing adequate time for investors to digest the information before making any decisions58. In theory the rule says «disclose or abstain», but in practice the only real option available to the insider is to abstain59.
Many authors find the origins of the equal access theory in the SEC proceedings regarding Cady Roberts. One author calls it «the beginning of a new era» in insider trading law because it was then that «they (the SEC) established for the first time the basis for responsibility of the insiders to disclose material facts in impersonal transactions as opposed to the previously held face-to-face transactions». The defense used was that the corporate insiders did not owe a duty of disclosure because there was no face-to-face transaction. The SEC wanted to contend that the duty of disclosure is not limited to face-to-face transactions, but that same duty is owed to the market as a whole or in general, giving equal access to the material information which would affect investment decisions of «purchasers on the exchange». Described using the SEC’s words:

We cannot accept the respondent’s contentions that an insider’s responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. This approach is too narrow. It ignores the plight of the buying public-wholly unprotected from the misuse of special information.

The obligation to disclose information to the other party of the transaction is required so as to avoid unfair or unjust situations, that is, to provide equal access and equal opportunity to everyone in the market. But it cannot be forgotten that these obligations of fairness fall within the same context of a fiduciary duty that is owed primarily to stockholders and secondarily to possible future investors. Within the same context of a fiduciary duty, some authors refer to the disclose or abstain rule as a theory of responsibility whereas others consider it a rule of behavior for fiduciaries or corporate insiders.

Further analysis would be developed years later as to the theories of responsibility which have evolved due to the reflections undergone on the life and law of insider trading. For the moment though, it is necessary to turn to the 1968 juridical and legislative reactions to the SEC’s Rule 10b-5.

k) SEC v. Texas Gulf Sulphur

Several employees of Texas Gulf Sulphur were sent to investigate a possible mining site in Canada, and while on this assignment, the employees discovered a large mineral deposit. Knowing that this new discovery would cause a rise in the market price of the company, these few employees purchased the stock of Texas Gulf Sulphur and also tipped the notable information to other family and friends who in turn bought shares of the company. Surprisingly enough, although these employees communicated the information to family and friends promptly, they failed to inform the
corporate directors and officers. When the news reached the directors and officers, it was then publicly announced, immediately increasing the price of the shares in the marketplace. After the elevation of prices, the employees, their friends, and relatives, who had previously bought shares, had earned a profit on the shares purchased before the public disclosure of the mineral deposit discovery.

The SEC became aware of this activity and charged the employees for having violated SEC Rule 10b-5 for having made illegal market transactions in the company stock as insiders of that company (regardless of the fact that they were not directors, officers, nor shareholders) prior to the announcement of the mineral deposit discovery. Thus «other restrictions were placed on situations of an ordinary nature and which would cause a substantial effect on the market».

Moreover, the case affirmed that any individual in possession of important information has the obligation to disclose or abstain. These employees were middle management and technical professionals, not directors, officers nor beneficial owners. Lastly, besides the disgorgement of profits, the two essential elements determined by the SEC necessary to apply SEC Rule 10b-5, were reiterated, namely, that inside information should be used only for the good of the company and not in one’s own personal benefit, and that there had existed an inherently unfair advantage.

Meanwhile Congress, motivated by the SEC and under the impulse of Senator Williams of New Jersey, was in the process of amending once again the SEA of 1934 to respond to insider trading abuses in the most important realm of tender offers.

1) Legislative Reaction to Insider Trading Abuses: The Williams Act of 1968

In the 1960’s, the SEC witnessed many abuses in the tender offers market. Previous to the this decade, tender offers took place at shareholder meetings by way of a proxy vote of the shareholders. This procedure is known as a «proxy fight» because voting blocks which vote in favor or against the tender offer are formed by accumulating the «proxies of shareholders» (the rights to vote of the shareholders). Later in the 1960’s, the procedure to purchase a company was by way of a cash tender offer proposed directly to the directors and officers of the company and made without consulting or informing the shareholders.

Corporate directors and officers were placed in a conflict of interest in their fiduciary status between the actual, present owners (stockholders) and the possible future owners of the company targeted for takeover. In
most cases, many authors have commented that these corporate managers only sought to maintain their positions.

As a consequence, the shareholders were left uninformed of any offer by the intending purchaser. When the shareholders were notified of a purchase, frequently they were made privy to the offer late in the negotiation stages, and therefore were forced into a situation where they had to make their decision hastily and with limited information.

To confront these abuses, specific amendments to the SEA of 1934 were passed: Section 13 parts d and e as well as Section 14 parts d, e, and f. Section 14, which in general made it possible to impose insider trading liability in relation to tender offers, is more pertinent to the present discussion.

Section 14 part e, more specifically, demands the disclosure or emission of material non-public information regarding tender offers. Most significant was Section 14e which was designed not to facilitate a better informed market, but to protect directors in their decision-making capacity. It required also that corporate managers of the target company, provide shareholders with a statement of the position of the company on the tender offer. This measure assured that investors could make intelligent financial investment decisions based upon available, timely information of the pending tender offer.

This sort of insider trading had, to a large extent, been localized in the realm of corporate takeovers and characterized by astounding abuses. Principal legislative defense against insider trading within this setting would later base itself upon Section 14e.

m) What happened in the 1970’s?

The 1970’s, familiarly coined the «Sour Seventies», were difficult reform years in the financial industry. Due to the economic chaos and reorganization efforts in the stock markets, little new legislative action was carried out directly against insider trading; it seems as though it was a period of refining previous rules and regulations.

One author mentions that the Supreme Court during the 1970’s intended to limit the liability of insider trading under SEC Rule 10b-5 by erecting a number of filter doctrines like the «scienter» requirement or the reduction of private investor legal action available under SEC Rule 10b-5 to those who purchased and sold securities. An opposing opinion could be taken based upon the decision of the Supreme Court v. Merrill Lynch in 1974, which based the prohibition of insider trading to «any» person who finds himself in the «mere» possession of privileged information.
One particular piece of legislation passed by Congress to fight unlawful racketeering activity was the Organized Crime Control Act of 1970. It is often referred to as «RICO» which stands for the initials of title 96 of the Criminal Code: «Racketeer Influenced Corrupt Organizations». As Professor Loss points out, part of the statute states «Racketeering activity is defined to include fraud in the sale of securities». On account of this phrase, RICO became part of the criminal law wielded against insider trading together with the Mail Fraud Statute. Both of which have been used to punish insider traders, although in a manner deemed questionable and liberal to many critics. One author comments that RICO was designed to repress «the criminal infiltration of legitimate business and labor unions by organized crime».

Once again in 1975, Congress improved the SEA of 1934 adding sections 11a and 17a. Congress authorized the SEC to establish more rules to regulate and to prevent off-floor trading by members of the exchanges if it were determined to be «detrimental to the maintenance of a fair and ordered market». For the purposes of establishing standard pricing across the nation, Congress «directed the SEC to establish a national market system for settlement and clearing of transactions».

Late decade activity showed that between 1978 and 1981 the SEC dealt with 39 insider trading cases of which 27 had to do with initial public offers. The most famous case of this sort was the SEC v. Chiarella, which was initiated in 1975 and was finalized in 1980.

n) SEC v. Chiarella: A Pivotal Case

In 1975, Mr. Chiarella worked as a printing professional in Pandick Press, an editorial dedicated to printing financial information. All of the documents which the company printed were related to public offers, but customarily the documents involving the transactions were sent without names or with false company names. Even though the names of the companies were absent from the documents, Mr. Chiarella could often decipher the identity of the enterprises involved in the transaction documents. After having guessed the names of the companies, based upon the privileged information contained in the documents of the companies which were about to transact a public offer of acquisition, Mr Chiarella then bought shares of the target company in the market. Using this method of insider trading, he earned $30,000 in a 14 month period.

Why is this case pivotal? Because, aside from being the first Supreme Court judgment on the SEC Rule10b-5, upon this decision depended the future applicability of the three central theories of responsibility by
which an individual could be held liable for insider trading: the *fiduciary duty* theory, the *equal access* theory, and the *misappropriation* theory.

First of all, the Supreme Court gave a strict interpretation of Section 10b holding that, «in order to be subject to insider trading and the disclose or abstain rule, there must be a fiduciary duty»[^83]. Mr. Chiarella had been determined by the Supreme Court not to have had such a fiduciary duty to the financial firms in which he was trading and to which the inside information pertained. Nevertheless, Justice Lewis F. Powell did leave open the possibility that Mr. Chiarella may have been accused of having breached a fiduciary duty towards his employer, Pandick Press[^84].

Additionally, the Supreme Court wanted to clarify the nature of the liability under a fiduciary duty stating, «the allegation of fraud based upon silence only exists if there is an obligation to speak, and that no obligation arises from the mere possession of privileged information»[^85]. Possession of privileged information does not create a relation of confidence to the firms undergoing a public offer, but reconsidering the opinion of Justice Powell, Mr. Chiarella could have been accused of breaching his fiduciary duty to Pandick Press which in turn owed a certain degree of silence of office to their printing clients.

The *equal access* theory, known for its tendency toward «market egalitarianism», claims that all those in possession of privileged information are possibly liable or responsible for insider trading, even persons not holding a fiduciary position[^86]. In the Chiarella decision, the Supreme Court, overturning the ruling of the lower Appellate Court, declared that the previous Appellate Court «supported its decision exclusively on the belief that federal securities laws had reached a system which granted equal access to information necessary to make investment decisions». The ruling continued «that neither Congress nor the SEC have ever concluded such a rule of the equality of information»[^87].

Finally the *misappropriation theory* was anticipated in Justice Barger's dissenting opinion in the Chiarella case, which differs, stating that a person is liable for insider trading if, for personal gain, that person takes advantage of inside information entrusted to him in some fiduciary capacity, even though that same person may not be a corporate insider nor a tippee[^88].

The Supreme Court received its first opportunity to opine on the SEC Rule 10b-5 which called for the prior existence of a fiduciary duty in order to be liable for insider trading. The opinion handed down was that those persons without some relationship of trust and confidence would not be accountable for insider trading. However, the SEC, Congress, and the lower courts counterreacted beginning with the SEC's Rule 14e-3[^89].
The SEC’s Counterreaction to the Supreme Court’s Chiarella Decision: SEC Rule 14e-3

The Supreme Court decided the Chiarella case in March of 1980, and by September of the same year, the SEC had adopted Rule 14e-3 which specified:

If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the «offering person»), it shall constitute a fraudulent, deceptive or manipulative act or practice...within the meaning of section 14e of the Act (SEA of 1934) for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is non-public and which he knows or has reason to know has been acquired directly or indirectly from (an insider)... to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or in exchange for any such securities or any option or right to obtain or to dispose of any foregoing securities, unless within a reasonable time prior to any purchase or sale of such information and its source are publicly disclosed by press release or otherwise.

Briefly summarized, «Rule 14e-3 explicitly prohibits trading by any person (inside or outside the firm) with access to material non-public information about incipient tender offers».

The SEC quickly reacted, striving to cover the gap left open by the Supreme Court Chiarella ruling, but three years later, the Supreme had its second ruling opportunity in the Dirks case.

Dirks v. SEC: The Concept of Tippee

The following abbreviated Supreme Court proceedings provide the background to the Dirks case:

In 1973, Mr. Dirks was an officer of a New York broker-dealer firm which specialized in providing investment analysis of insurance company securities to institutional investors...Mr. Secrist, a former officer of Equity Trading of America, alleged that the assets of Equity Trading were vastly overstated as a result of fraudulent corporate practices...Dirks decided to investigate the allegations...visiting Equity Funding’s headquarters in Los Angeles and interviewing senior management who denied any wrongdoing. Later Mr. Dirks tipped the information received from Mr. Secrist to clients and investors. During a two week period, the price of Equity Funding fell from $26 to less than $15 per share...eventually forcing Equity Funding into bankruptcy.
The Supreme Court faced its second SEC Rule 10b-5 case, where the individual indicted did not hold a fiduciary duty. Obviously, it can be assumed that the Supreme Court had taken note of the reaction of the SEC to the *Chiarella* decision. The Supreme Court had concluded that a fiduciary duty was necessary in order to be liable for insider trading, and that the SEC responded with the Rule 14e-3 affirming that «any» person could be liable for insider trading.

Examining Mr. Dirk’s actions, he had no fiduciary duty to Equity Funding, but Mr. Secrist who had tipped Mr. Dirks on to the inside information, had held a corporate fiduciary duty. Mr. Secrist had been an insider who no longer worked for Equity at the time when he tipped the relevant information to Dirks, and therefore, he was not considered an insider. Yet it could be argued that the information possessed by Mr. Secrist had been obtained as a result of his prior fiduciary duty at Equity Funding, and as a consequence, he could have been held to respect the silence of office with regard to that information. The relationship in this case between Secrist and Dirks became one of tipper to tippee, respectively. Then Dirks, having received the information which he knew was material and confidential, became a tipper upon communicating the information to his clients and other investors, even though not a fiduciary to Equity.

Anterior court cases such as *SEC v. Texas Gulf Sulphur* and *Shapiro v. Merrill Lynch* had discussed the idea of tipping, so there were precedents to work with for the Supreme Court. The Supreme Court also had the previous experience of the Chiarella case which reaffirmed the *fiduciary duty theory*, dissolved the *equal access theory*, and originated in a more direct way than in *Chiarella*, the *misappropriation theory*.

The question became that if the Supreme Court had already stressed the necessity of holding a fiduciary duty in order to be held liable for insider trading, now was it going to apply the fiduciary obligation to Dirks who held no such duty?

In this case, the Supreme Court extended the fiduciary duty to tippees, those who commit insider trading based upon important information received from a tipper or insider. It seems that the Supreme Court obliged itself to continue basing the responsibility for insider trading upon the *fiduciary duty theory* so as to remain coherent with the *Chiarella decision*.

From this assumption another question arises: How did the Supreme Court link the fiduciary duty of an insider (tipper) to another person who had no fiduciary duty (tippee), but who had received relevant information from the insider?

The situation was classified by the term «co-venture» between the tipper and the tippee. The tippee is made answerable to both a fiduciary duty and the disclose or abstain rule, if two conditions are satisfied:
(1) that the precedent conduct of the insider be illicit and in breach of a fiduciary duty, and

(2) that the tippee may know or should have known the privileged nature of the information, that is non-public, or reserved, and that the tippee may know or should have known that the tippee violated a fiduciary duty\(^96\).

Applying the conditions to the case at hand, Mr. Dirks was declared innocent because, despite the fact that he knew the privileged nature of the information as well as the breach of the fiduciary duty on the part of Mr. Secrist, he was determined to have obtained the information «licitly» from Mr. Secrist\(^97\).

In any case, when both conditions are met, the tippee is said to have been considered to have participated in the breach of the fiduciary duty committed by the tipper. For this reason it is termed an «after the fact» violation. The tippee participates subsequently in the breach of the fiduciary duty committed by the tipper who had previously transmitted the inside information to the tippee\(^98\).

Now in the wake of the Dirks case, not just fiduciaries can be liable for insider trading, but «anyone» who enters into a «co-venture» with an insider (tipper).

The SEC from 1982 to 1985 was investigating 77 illegal insider trading cases\(^99\) compared with the aforementioned 39 cases from 1978 to 1981\(^100\). The number of cases doubled in the second three year period, probably due to the more intensified and restrictive legislation which increased the possibilities for potential insider trading vigilance.

One could guess whether the increase in the volume of cases was due to abuses which were already existing but which were not exposed. Perhaps the increase was due to the consequences of the two previous Supreme Court cases which made it seem difficult to successfully prosecute insider trading. Before it could have been that only the tip of the iceberg was showing, but later, due to the increased legislation and administrative efforts, the rest of the iceberg from below the water began to show at the surface.

Additionally, the heightened awareness promoted by the SEC could have caused an increased knowledge on the part of investors as to how to commit insider trading. Did insider trading increase precisely because it was forbidden by law? Could a comparison be made between the intent of the government to stop alcoholic drinking during the prohibition and its efforts to stop insider trading? Many questions and answers could follow. The duplicated volume of insider trading in the second three-year period remains a fact which clamored for an additional congressional reaction.
q) Another Amendment of SEA of 1934: The Age of Sanctions in 1984

«Dissatisfaction with the enforcement procedures in deterring insider trading and in order to put an end to this threat to the securities markets»\textsuperscript{101}, the SEC lobbied Congress to pass the Insider Trading Sanctions Act of 1984 (ITSA), an additional amendment to the SEA of 1934\textsuperscript{102}. (The reader might take note of the 50th anniversary of the SEA of 1934; what better way to celebrate it than to amend it!) A before and after look at SEC powers will help to better understand the effectiveness of the enforcement authority granted to the SEC by the ITSA of 1984.

Before ITSA, the SEC could «enjoin any person engaged or about to engage in insider trading by means of a court injunction» which would prohibit a trader from trading based on the orders and authority of the courts\textsuperscript{103}. It could also force disgorgement of profits made or losses avoided, or also recommend the criminal prosecution of an insider to the Justice Department. But the SEC could not impose any civil penalties until a criminal action was imposed\textsuperscript{104}.

After ITSA of 1984, there was a major shift in favor of the SEC as it was empowered to impose sanctions in the form of civil penalties without the prerequisite of a criminal prosecution. Thus began the age of sanctions.

These sanctions included treble damages on top of the disgorgement of profits made or losses avoided. These treble damages were allowed up to three times (3X) the gains earned or losses avoided for anyone who traded with or transmitted (tipped) material non-public information\textsuperscript{105}. In addition to this, Congress closed two large loopholes stating in Section 21a that, «the mere possession of privileged information was sufficient to make someone liable to civil penalties», and Section 20d added that it was illegal «to communicate or to negotiate with options or whatever other type of derivative instruments with the possession of inside information»\textsuperscript{106}

The posture of Congress in 1984 respecting insider trading is gleaned from the Report of the Committee on Energy and Commerce given to Congress in the procedural development stages of the anti-insider trading legislation. It reads that «the formation of capital and the wealth of the economy of our nation and stability, depends on the confidence of the investors in the justice and integrity of our capital markets. Insider trading threatens those markets suffocating the expectations of the public»\textsuperscript{107}.

Furthermore, in 1984, an attempt was made during the ITSA proceedings to propose a definition of inside trading. «The Senate Subcommit-
tee proposed the introduction of a definition of insider trading, which gave rise to a deep debate, but finally it was thrown out\textsuperscript{108}. Why was the definition thrown out? During the insider trading legislation of 1988, reasons were provided by Congress and will be discussed later.

r) \textit{Life During the 1980's: RICO}

Among the multitudinous examples of insider trading, some brief accounts serve to show the lively insider trading activity and enforcement during the decade of the 1980's.

Rudolph Giuliani, the United States District Attorney in New York in 1987 «dispatched fifty federal marshals equipped with weapons and bulletproof vests to raid the Princeton/Newport offices in order to pursue illegal securities activity. Five partners were indicted based upon the RICO statutes referred to earlier, aimed to control racketeering activity\textsuperscript{109}. Mr. Giuliani was the famous U.S. Attorney who broke the nationwide mafia cocaine drugring called the «Pizza Connection». Using the same RICO statutes, Mr. Giuliani prosecuted the eight leaders of the commission of the Pizza Connection, who were the eight family heads of the mafia. They were convicted and sent to prison with heavy, lifetime sentences. Later, Mr. Giuliani became the Mayor of New York City, after being elected in 1993.

Another incident dealt with Michael Milken, the inventor and mastermind of the famous Junk Bonds, who worked in Drexel, Burnham, and Lambert, one of the top investment banks on Wall Street. Both Mr. Milken as well as his firm, Drexel, Burnham, and Lambert, were treated severely by the Justice Department for their insider trading activity. Drexel was fined $650,000,000 under the pretexts of RICO, and Mr. Milken was indicted by a federal grand jury on 98 counts of fraud and was forced to serve several years in prison, along with a severe fine of $1,200,000,000\textsuperscript{110}. This is a large sum of money, even considering the fact that Michael Milken once received a year-end bonus of $500,000,000. Shortly following these incidents, the firm self-proclaimed bankruptcy after having dispersed some extremely generous bonuses to all the top level executives.

s) \textit{US v. Carpenter: Insider Trading by a Journalist}

R. Foster Winans, the co-author of the \textit{Wall Street Journal}’s «Heard on the Street» financial column, obtained pertinent inside information regarding financial forecasts. In his capacity as a reporter for the \textit{Wall Street Journal}, he became privy to that non-disclosed material information, which he transmitted to a broker named Peter Brandt. Mr. Brandt, with
possession of the information, traded in the stocks of those companies. He earned $650,000 on his market transactions of which he remunerated Mr. Winans a tip of $31,000 for having provided the investment advantage.\textsuperscript{111}

Neither of the persons involved in this case held fiduciary duties with the companies involved in the market transactions, although it could be argued that Mr. Winans, as a reporter, had been entrusted with advance information by the companies so as to report in a timely manner, the non-public information. «The attitude adopted by the Supreme Court in 1987 in the Carpenter case is significant. By a vote of 4-4, it eluded pronouncing the misappropriation theory as a foundation of responsibility for insider trading.\textsuperscript{112} Despite the tie of 4-4, it was sufficient to convict the journalist, because in the event of a tie, the lower court’s decision is upheld.\textsuperscript{113} Furthermore:

To the surprise of many observers, the court unanimously upheld the journalist’s conviction under the federal Mail and Wire Fraud Statute, but barely affirmed his conviction under SEC Rule 10b-5 and the misappropriation theory by a 4-4 vote.\textsuperscript{114}

«This rule required the court to hold that the journalist had fraudulently misappropriated his employer’s “property,” confidential business information used for writing the column.\textsuperscript{115} The author here emphasizes the word «property» because the information was seen as a tangible good of the Wall Street Journal which was used wrongly, misappropriated, by the journalist for his own profit.\textsuperscript{116} Newly created legislation was enacted to respond once again to the financial antics of the 1980’s.

1) Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)

Seeking the support of Congress, the SEC sought to sharpen its teeth in order to crush insider trading abuses. This time the focus of the legislation was aimed directly at «public companies» and those individuals who control the persons who commit insider trading. Typically this relationship describes the company as a «controlling person», because to some extent the company is responsible for the actions of its employees or agents. The public companies were required to adopt explicit policies to police insider trading within their confines and forced to assume more responsibility for the actions of their employees. Also the controlling person could be fined up to a $1,000,000 penalty, or up to three times the profits earned or losses avoided, if that controlling person «failed recklessly» to take proper precautions to prevent the illegal activity.\textsuperscript{117}
For the first time in financial legislative history, a bounty system was organized to pay cash rewards called «bounties», up to 10% of the insider trading profits made or losses avoided to anyone who would aid or abet in the capturing of financial criminals «wanted» by the law. This sounds like a movie of the old west, where a gun-slinger seeks killers, «dead or alive», along with a sheriff in order to earn a living. Along with the «new» bounty system, the maximum prison sentence was increased to 10 years\(^{118}\).

Just as it had attempted in 1984, Congress once again tried to forge a definition of insider trading in 1988, but was unsuccessful. To justify the negation of a definition of insider trading, the Senate Securities Subcommittee offered several reasons.

First, because the Committee believed that the parameters of insider trading designed by the judges in the courts had covered the majority of the traditional insider trading cases, and that a legal definition could potentially reduce the effectiveness of the legal framework and facilitate in an undesired manner artifices to evade the definition, and second, the Committee did not believe that the lack of consent over the adequate delineation of a definition of insider trading should impede progress upon the necessary reform of the application and sanction\(^{119}\).

To define was inappropriate because there was no common consent as to a proper definition of insider trading. A definition was viewed skeptically on the basis that the typical attitude of many with respect to the law is to seek loopholes in legal definitions by which to escape liability. Meanwhile, court cases continued to pile up.

\[\textbf{u) 1990 United States v. Chestman}\]

A Second Circuit court «questioned the validity of the SEC Rule 14e-3 of 1980 in the Chestman case, precisely because it did not call for a fiduciary duty in order to be held responsible for insider trading which had already been sustained by the Supreme Court in the Chiarella case of 1980». The outcome or effect of the decision was «the upholding of the SEC Rule 14e-3, but the Rule 10b-5 was further limited». The Court ruled that trading based upon the material non-public information does not necessarily violate SEC Rule 10b-5 unless the trader has explicitly agreed to keep the information confidential, has misappropriated the information, or has a fiduciary duty to disclose or abstain\(^{120}\). Summarizing these citations, the necessity of a previous, explicit consent by the trader is required, together with a misappropriation or breach of fiduciary duty.
v) **Securities Enforcement Remedies and Penny Stock Reform Act of 1990**

The SEC continued its legislative push in the 1990's to combat insider trading, seeking more authority under this act which garnishes the Commission the power «to issue cease-and-desist orders to prevent further insider trading, and to suspend and revoke the licenses of security industry professionals»\(^{121}\). The bounty system as established in 1988 offered 10% bounty reward payments based on the profits earned or losses avoided. In the 1990 Act, that 10% is now based upon the civil penalty imposed which usually amounts to a greater sum of money to be rewarded.

w) **Recent Case History**

The newspaper headlines and their stories provide a recent update as to the insider trading developments.

«SEC watches Main Street as well as Wall Street: Agency is going after those who get stock tips across the dining table and through family ties»\(^{122}\). Can «anyone» be an insider, even those at the dinner table as long as they possess non-public material information. The SEC has «successfully concluded five civil lawsuits against people accused of using family ties».

Another example of family ties was exposed in an article, entitled: «Former AT&T Exec Charged in Scheme»\(^{123}\). «In one of the biggest insider trading scams outside Wall Street, federal authorities charged a former AT&T executive and 16 others in a far-flung scheme to exploit the secret takeover plans of the huge telephone company». The case involved a mid-level executive, a labor relations manager, and «a web of 16 friends and family spanning five states». One can realize that the topic of insider trading is a rather serious matter when a mid-level executive of one of the largest companies in the world has the wherewithal, the money, and the means, to takeover a company with thousands of employees.

Another case of interest is entitled: «Manager Censured, Another Charged». The article states, «Another top-performing mutual fund manager has been censured for stock trades in his personal account... fined $20,000 in a settlement with the SEC, forced to relinquish $5,300 in trading profits, and forced to forgo his 1994 bonus and stock options worth $200,000»\(^{124}\). The article begins referring to «another» which gives the impression that this incident is becoming common. The SEC is clearly making use here of its powers granted by previous legislation, but the question many people are asking themselves is: Are people stopping their insider trading activity or increasing it?
More recently an article was published in the Chicago Tribune signaling: «Insider-trading prosecution theory not fully in place»\(^{125}\). The article describes how a California psychotherapist, Mr. Cooper, received inside information from a company executive during marriage counseling sessions about merger negotiations between Lockheed and Martin Marietta Corporation, and with that privileged information obtained, he communicated it to a friend, and together they bought common stock in the Lockheed Corporation earning a nice profit on the transaction. «Under a legal doctrine known as the *misappropriation theory*, Mr. Cooper violated securities laws because he stole information from a person who had assumed his trust and discretion, and then used the information to trade on the stock market».

The article continues explaining that the *misappropriation theory* is not accepted equally as a legal doctrine by all States and that neither has the Supreme Court fully condoned such a theory. Unfortunately for Mr. Cooper, the article states, that California unlike other states has endorsed the *misappropriation theory*, and therefore, he was obliged to plead guilty.

Another case is mentioned in the same article about a West Virginia state official who was declared innocent of insider trading because the U.S. Court of Appeals for the 4th Circuit in Richmond, Va., contrary to four other Courts of Appeal, rejected the *misappropriation theory*. The West Virginia state official bought stock in a company just before awarding it a state contract, but since he had no obligation to the company in which he bought the stock, he was not liable for insider trading. Despite the fact that the Supreme Court has never ruled conclusively on the *misappropriation theory*, Colleen Mahoney, the SEC's deputy director of enforcement, said that the federal agency has no intentions of withdrawing its support from the *misappropriation theory*.

Finally, the most recent case summarized here depicts the current situation and attitudes with regards to insider trading. The title of the article is «The Return of Insider Trading: It's the 1980s all over again —only worse— and the top cop on the beat can't stop it»\(^{126}\). The top cop referred to in the title is SEC Chairman Arthur Levitt who is quoted as having told a gathering of NASD officials and stockbrokers in Washington, «We have every right to be proud of the industry that has been so good to us, and is so good for America. But we must also be realistic about its problems. Fundamental to our markets is investor confidence that they are fair, that they are open, and that they are level. And lately, that reputation stands threatened».

A number of recent insider trading cases are depicted in the article showing that insider trading activity is vibrant, but one of the most interesting facts presented is that, despite all of the budget reforms and cost
reductions taking place, the SEC will be proportioned an additional $250,000,000 for enforcement-related costs through the year 2001. Perhaps here there could be found one answer to the question: Who gets hurt by insider trading? The article ends citing a Wall Street professional's opinion of the present situation and the SEC's role: «The SEC tries to do its best. But I really believe they don't understand what's happening. Crime on Wall Street has gotten out of control. The inmates are now running the prison. There is nowhere else in the world that you can steal so much money so fast and never get caught».

C. CONCLUDING THE LIFE, LAW AND THEORY ANALYSES

Having made this brief synopsis of the life, law, and theory of insider trading in the United States, the theoretical and practical struggles between the administrative, legislative, and judicial sources of law have been observed. With this in mind, as well as the continuing absence of a concrete legal definition of insider trading, it should render the lack of a unified legal theory of responsibility for insider trading at least somewhat more understandable. The task of this article was to take stock of the primary historical events of the market related to insider trading as well as to situate the three primary theories of responsibility for insider trading which have been developed by academics in an historical context.
NOTES


3. Ashe, M.-Counsel, L., *Insider Trading*, Tolley Publishing, Surrey 1993, p. 7. The basis for focusing primarily on the United States in this study is due to the fact that «the legal approach (of insider trading), as it has evolved in most jurisdictions, is due entirely to the influences from the United States of America».


32. 15 U.S.C. § 17A.


50. Section 16b facilitates disgorgement. Disgorgement is a term which has been developed specifically to describe the situation when the Courts force the return of illegal insider trading profits.


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74. Racketeering is the occupation by which money is made illegally, usually by making use of a business enterprise.

75. 84 Statute 922.


78. Off-floor trading refers to the buy and sell orders that are made in the offices of exchange members outside of the exchanges themselves.


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