SELECTIVE DISCLOSURE AND INSIDER TRADING:
TIPPER WRONGDOING IN THE 21ST CENTURY

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Insider trading tends to be a small group affair. Too often inside information is covertly passed from one person to another before it is used for securities trading. As a result, insider trading often involves not one, but two wrongs. The first is the improper selective disclosure of material nonpublic information, and the second is the act of trading based upon that information. Unfortunately, the way federal courts evaluate the legality of the first of these wrongs, the improper selective disclosure of material nonpublic information, is now hopelessly obsolete.

To show how to remedy this situation I begin with an analysis of Dirks v. SEC. I identify four reasons the Court in Dirks introduced a personal benefit test to determine when a selective disclosure violates federal securities law. But much has changed since Dirks was decided in 1983, most notably the adoption of Regulation Fair Disclosure by the SEC in 2000 and the Court’s decision in United States v. O’Hagan in 1997. Today the justifications offered in Dirks for requiring evidence of a personal benefit are no longer valid.

The best approach going forward to determining when a selective disclosure is wrongful is to go back to the underlying statutory prohibition against deceptive conduct. There are several ways a selective disclosure might be sufficiently deceptive to trigger insider trading liability, including not only receipt of a direct pecuniary benefit, but also a violation of company policy, a violation of Regulation FD, and some forms of computer hacking. Evidence of receipt of a personal benefit in exchange for a selective disclosure should be a sufficient, but not necessary condition, for providing evidence of deception.

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I. INTRODUCTION

White collar crime tends to be a small group affair for reasons both psychological and operational. In terms of psychology, evidence suggests that small groups often act in ways that go beyond limits individuals set for themselves. In terms of operations, it is almost always easier to carry out a fraud when working in cahoots with others.

The factors that encourage small group deviance in white collar crime generally appear to be at work in the context of insider trading. Many, if not most, incidents of insider trading are carried out by small groups, rather than by an individual acting alone. Therefore, insider trading often involves not one, but two wrongs. The first is the improper selective disclosure of material nonpublic information and the second is the act of trading based upon that information. Unfortunately, the doctrine used to evaluate the legality of the first of these wrongs, the selective disclosure of material nonpublic information, is now hopelessly obsolete.

Determining when a selective disclosure triggers insider trading liability has important policy ramifications. Too lax a rule on when selective disclosure is wrongful makes it a simple matter to circumvent the prohibition against insider trading by passing information along among a small group of confederates. Too strict a rule on when selective disclosure is wrongful might criminalize legitimate efforts to share corporate information with those outside the firm.

Why is the current doctrine on when a selective disclosure should trigger insider trading liability increasingly obsolete? One reason is that the prohibition against insider trading in the United States is largely a creation of federal common law, derived from the statutory prohibition against using a "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities. It therefore falls to the federal judiciary to maintain and update rules for determining when the selective disclosure of material nonpublic information is sufficiently deceptive to constitute a violation of federal securities law.

Judges, in turn, have looked to common law precedent to determine what constitutes a manipulative or deceptive practice. For example, to answer the question of when trading in impersonal securities markets based on material nonpublic information can be deceptive the Supreme Court relied on the common law doctrine that silence is deceptive only when one party in a transaction owes a fiduciary duty to the other. However, there is no obvious common law precedent for determining when the selective disclosure of material non-public information constitutes a deceptive practice.

Dirks v. SEC, the one Supreme Court case to consider at length the relationship between selective disclosure and insider trading, might appear to
have resolved much of the uncertainty about how to determine when a selective disclosure is sufficiently wrongful to trigger insider trading liability. *Dirks* held that a selective disclosure by an insider will only trigger insider trading liability if “the insider personally will benefit, directly or indirectly, from his disclosure.” Most courts and scholars interpret the *Dirks* opinion as resolving the question, at least at a general level, of how to determine when a selective disclosure is wrongful. The Supreme Court, for example, implicitly endorsed the view that some form of a personal benefit test is still good law by only addressing a question related to how best to apply the personal benefit test in the grant of certiorari in *United States v. Salman*.

But the personal benefit test even in 1983 was, at best, an imperfect effort to balance four different and in many ways competing rationales for determining when a selective disclosure should trigger insider trading liability. Two developments since *Dirks* was decided have made the problems with the personal benefit test insurmountable. First, the SEC in 2000 enacted Regulation Fair Disclosure (Regulation FD). When *Dirks* was decided, the selective disclosure practices of public companies were primarily governed by federal common law, and plausibly an area where the Court still needed to make difficult securities markets policy decisions. After the enactment of Regulation FD, federal courts no longer had the same degree of responsibility for making these determinations. Second, in the 1997 with the decision in *United States v. O'Hagan*, the Court held that breach of a fiduciary duty owed to a source of information could lead to insider trading liability. This holding expanded the kinds of deceptive conduct that could lead to insider trading liability, including, for example, making affirmative misrepresentations to the source of the information, so long as the deceptive conduct was sufficiently “in connection with the purchase or sale of securities.”

A reconsideration of the four justifications that originally led to the adoption of the personal benefit test in *Dirks*, in light of changes wrought by Regulation FD and *United States v. O'Hagan*, shows why exclusive reliance on a personal benefit test is no longer appropriate. Fortunately, there is a better way to determine when a selective disclosure is sufficiently wrongful to trigger insider trading liability. Federal courts can return to the underlying prohibition against deceptive practices in Section 10(b) of the Exchange Act and identify not one, but several different ways, or multiple triggers, if you will, to show that a selective disclosure constitutes a sufficiently deceptive practice to trigger insider trading liability. The types of conduct that could be found sufficiently deceptive to trigger insider trading liability would include not only receipt of a direct pecuniary benefit, but also violations of company policy, violations of
Regulation FD, and some forms of computer hacking.

Returning the question of when selective disclosure is wrongful to the statutory prohibition against deceptive conduct obviates the need to contort a personal benefit test to address the significantly changed landscape since *Dirks* was decided in 1983.