

INSIDER TRADING AND THE INTEGRITY OF MANDATORY DISCLOSURE

JAMES J. PARK*

Insider trading regulation has been primarily shaped by two theories. The first argues that unequal access to material information corrupts the integrity of securities markets. The second contends that insider trading misappropriates corporate property. The dominance of the market integrity and property frameworks has obscured an important reason to regulate insider trading—it can undermine the integrity of the disclosure mandated by the securities laws. Such disclosure is meant to benefit all investors and should not be exploited by a few. Insider trading is particularly problematic in a periodic disclosure system where the release of significant information is deliberately delayed so it can be analyzed and verified. This Article argues that protecting the integrity of mandatory disclosure is a compelling reason for insider trading regulation. This disclosure approach suggests clearer limits to the reach of insider trading law and enforcement than the market integrity and property theories.

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INTRODUCTION

For decades, two theories have shaped insider trading regulation.¹ The first argues that insider trading should be prohibited because unequal access to information corrupts the integrity of markets. The second views trading on inside information as misappropriating property belonging to the corporation. Neither approach is entirely satisfying.² The market integrity theory does not address the reality that there will always be significant disparities in the ability and willingness of investors to access and analyze information. The property rights

1. The courts have read Section 10(b) of the Securities Exchange Act of 1934, which allows the SEC to pass rules prohibiting any “manipulative or deceptive device or contrivance,” 15 U.S.C. § 78j, and its implementing rule, 17 C.F.R. § 240.10b-5, to prohibit insider trading. *See, e.g., United States v. O’Hagan*, 521 U.S. 642, 653–54 (1997); *Chiarella v. United States*, 445 U.S. 222, 228–29 (1980). Insider trading is also addressed by section 16(b) of the Securities Exchange Act of 1934, which regulates trading by officers, directors, and controlling shareholders. *See* 15 U.S.C. § 78p (2012).

2. For decades, scholars have noted the lack of a consensus theory for regulating insider trading. *See, e.g.,* Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482, 1485 (2016) (observing that the “fundamental principles governing insider trading . . . are still in flux even today”); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 9–10 (1984) (“The history of the regulation of insider trading is largely the story of the legal system’s quest to find an internally consistent justification for banning such trading.”).

theory downplays the harm of insider trading by arguing that the corporation is the main victim of the offense. Despite their limitations, the Supreme Court cited both theories in one of its last major insider trading decisions, *United States v. O'Hagan*.³

The dominance of the market integrity and property rights theories obscures an important reason to regulate insider trading—it can undermine the integrity of the disclosure mandated of public companies by the securities laws. Federal insider trading regulation is on its firmest footing when it addresses insider trading on mandatory disclosure information. As federal regulation of mandatory disclosure has increased, the case for preventing insider trading on such disclosure has grown stronger.

This is not the first article to analyze the relationship between mandatory disclosure and insider trading regulation. Professor Roberta Karmel, a former SEC commissioner, wrote that insider trading regulation is necessary to “make the mandatory continuous disclosure system work.”⁴ Professor Joel Seligman argued that insider trading is generally inconsistent with the securities laws, which seek to equalize access to information through disclosure.⁵

These accounts, though, have been criticized as not adequately acknowledging the limited scope of disclosure mandates. Mandatory disclosure requirements are not complete and companies have substantial discretion to choose when they release information.⁶ Moreover, an equal access rule might actually reduce the amount of information communicated to markets if it prevents managers from voluntarily disclosing information to select analysts and investors.

This Article reexamines the argument that insider trading is inconsistent with a system of mandatory disclosure. It shows that even when mandatory disclosure is not continuous, there is a strong case for regulating trading on information that public corporations must compile to comply with disclosure mandates. A periodic system of disclosure is premised on the belief that investors benefit when the most important company results are compiled, verified, and released at some set

3. 521 U.S. 642 (1997).

4. Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 BROOK. L. REV. 149, 152 (1993); see also Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023, 2026 (2005).

5. See Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1103–15 (1995).

6. See, e.g., Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1236–37 (1995) (arguing that insider trading is only relevant to mandatory disclosure regulation to the extent that it affects discretionary disclosure decisions).

interval. Permitting favored traders to exploit the gaps in such a system would undermine its integrity. Unlike some prior efforts, this Article acknowledges that there are situations where a company can selectively disclose information without undermining the goals of mandatory disclosure.

The relationship between insider trading and disclosure mandates may have been underexamined because the formative debates about insider trading regulation happened at a time when public companies had fewer mandatory disclosure obligations than they do today. Prior to the 1970s, the SEC only required public companies to file an extensive disclosure once a year.⁷ The New York Stock Exchange mandated quarterly disclosure, but the quality of the disclosure was not uniform.⁸ Professor Henry Manne argued that insider trading was necessary to convey information to the market because of the ineffectiveness of SEC disclosure.⁹ The SEC and courts essentially supplemented this system through SEC Rule 10b-5 (Rule 10b-5),¹⁰ reading it to require disclosure of material information before it could be used for trading.

While the Supreme Court eventually limited Rule 10b-5 insider trading liability to individuals with duties to keep information confidential,¹¹ Congress and the SEC have steadily increased the disclosure obligations of public companies. The primary purpose of such mandatory disclosure is to provide equal access to the company's most important information. Public companies not only have to release their financial results, they must ensure that investors can rely on such reports. Two statutes passed after public company scandals, the Foreign Corrupt Practices Act (FCPA) and the Sarbanes-Oxley Act of 2002

7. Securities Exchange Act of 1934, 15 U.S.C. § 78m (1964).

8. See DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 357-58 (1969).

9. See Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565-66 (1970).

10. SEC Rule 10b-5 reads in full:

Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

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

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

17 C.F.R. § 240.10b-5 (2018).

11. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

(Sarbanes-Oxley), require public corporations to invest substantial resources in verifying the accuracy of their disclosures.¹²

Insider trading on the information contained in mandatory reports is fundamentally inconsistent with the policy goals of mandatory disclosure. Permitting advance knowledge and trading on a company's quarterly earnings reports would mean that insiders could personally profit from information that is produced for the benefit of all investors. Moreover, insider trading is particularly problematic in a system of periodic disclosure. The delay inherent in a periodic disclosure system creates opportunities for insider trading because the most valuable information is compiled and released at once. Insiders should not be able to exploit delay that is meant to allow verification of company information.

While there is a strong need to regulate insider trading in a system of mandatory periodic disclosure, there is also a need to incentivize public companies to disclose additional information to investors. In addition to wanting updates between quarterly reports, markets find it helpful to receive information through formats other than written disclosures or press releases. Companies have thus long voluntarily disclosed information selectively in conversations with investors and research analysts. The SEC has been suspicious of selective disclosure and attempted to regulate it with limited success through Regulation FD.¹³ On the other hand, a panel of the Second Circuit, in *United States v. Newman*,¹⁴ expressed concern that an insider trading prohibition that reached too broadly would undermine the way in which corporate information is disseminated to the market.¹⁵

In contrast to mandatory disclosure information, where there should be equal access, there is a case that information that is not subject to disclosure mandates should be governed by a property rights regime that allows for selective dissemination. The difficult question is whether there is a principled way to distinguish between information that must be disclosed to all investors and information that can be disclosed to a few. While it is clear that simply handing over a copy of a company's quarterly earnings would undermine the integrity of mandatory disclosure, selective disclosure is usually subtler. Rather than divulging the precise contents of an earnings filing, the tipper will more often give hints that allow a savvy trader to predict its contents.

12. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

13. 17 C.F.R. § 243.100.

14. 773 F.3d 438 (2d Cir. 2014).

15. *Id.* at 449. A later Second Circuit decision found the *Newman* court's approach inconsistent with the U.S. Supreme Court's decision in *Salman v. United States*, 137 S. Ct. 420 (2016). See *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017).

Even though it does not exploit exact knowledge of quarterly results, such trading is inconsistent with the policy of equal access to SEC disclosure.

Selective disclosure is less problematic when it conveys information relating to the company's long-term plans and prospects that is not effectively described by mandatory disclosure. The nuances of a company's strategy and character of its management are difficult to meaningfully describe within the limited confines of a dry disclosure document. Conversations with management about the business, tours of a new factory, a demonstration of a new product, are examples of information that is better released selectively to those investors willing to make an investment of time to learn about a company. When selective disclosure reveals information that is not easily disclosed and that does not allow easy prediction of a company's short-term results, it is less likely to conflict with the goals of mandatory disclosure.

The need to maintain the integrity of mandatory disclosure provides a better foundation for the prohibition of insider trading than either the market integrity or property rights theories. Rather than attempt to achieve an unrealistic parity between investors, a disclosure theory would focus insider trading regulation on information that must be disclosed pursuant to the securities laws. The property rights approach has some appeal with respect to certain types of voluntary disclosure, but it is not a good fit for disclosure that must be compiled, verified, and produced pursuant to a government mandate. Moreover, the disclosure theory provides answers to a number of puzzles such as why insider trading is prohibited in securities markets but not commodities markets.

The Article concludes by discussing how insider trading doctrine and enforcement is already shaped and could be influenced further by the concern of protecting the integrity of disclosure. Rather than policing trading on all information, insider trading cases usually target trading on information that easily enables investors to predict a company's short-term results. Insider trading law has been most controversial when it seeks to regulate trading on information that is not generated by the corporation to satisfy its securities disclosure obligations. Current doctrine faces pressure when it permits trading on what is clearly mandatory disclosure information.

It is worth emphasizing that disclosure is not the only lens through which to view insider trading regulation. There are substantial arguments that we should prohibit such trading on ethical grounds,¹⁶ or

16. See, e.g., Donald C. Langevoort, *Rereading Cady Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328 (1999) (noting that the insider trading prohibition may be based on "the expressive function of

because it fosters corruption.¹⁷ However, to the extent that the securities laws regulate insider trading, the best justification lies in protecting the integrity of mandatory disclosure.

This Article has five parts. Part I sets forth a brief history of the relationship between disclosure and insider trading regulation. Part II describes the essential elements of the modern disclosure system, which primarily mandates periodic disclosure that is supplemented with voluntary disclosure. Part III discusses how this disclosure system creates opportunities for insider trading that must be regulated for mandatory disclosure to have integrity but also creates the need to incentivize some types of voluntary disclosure. Part IV compares this Article's disclosure theory with the market integrity and property rights theories. Part V discusses insider trading doctrine and enforcement in light of a disclosure theory of insider trading regulation.

I. A BRIEF HISTORY OF DISCLOSURE AND INSIDER TRADING

When they first created insider trading regulation, the SEC and the courts developed a doctrine that used disclosure to address the problem of insider trading. At a time when companies were subject to minimal periodic disclosure requirements, insider trading law required disclosure of information before insiders could trade on it. As courts sought to make the scope of liability for insider trading more manageable, insider trading was re-conceptualized as a breach of fiduciary duty. As a result, insider trading law shifted from a disclosure rule to one that regulates the unjust enrichment of corporate officers.¹⁸

After the SEC began requiring quarterly disclosures, and the importance of those quarterly reports increased, new opportunities to benefit from unequal access to company information arose. The SEC attempted to address the problem of trading on advance knowledge of earnings information through a rule requiring public disclosure of material information a company passes on to certain parties such as research analysts.

law generally—the idea that both law and society are better off if the law systematically expresses certain virtues”).

17. See Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928 (2014).

18. See James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345 (2010). Two recent efforts to rethink insider trading doctrine both work within this fiduciary duty framework, though one argues that such duties should not extend to misappropriation, see Epstein, *supra* note 2, while the other argues that it only makes sense to think of insider trading law in terms of misappropriation, see Zachary J. Gubler, *A Unified Theory of Insider Trading Law*, 105 GEO. L.J. 1225 (2017).

A. Insider Trading in a World of Minimal Mandatory Disclosure

The early debates on insider trading regulation happened in a world where public company disclosure looked very different than it does today. Prior to 1970, public companies only had to file periodic disclosure on a semi-annual basis, with one of those two reports containing cursory information.¹⁹ The stock exchanges mandated quarterly reporting for listed companies, but they gave those companies significant discretion with respect to what they would disclose.²⁰ The SEC report that prompted reform of this system noted of these early periodic reports: “It was readily apparent (and acknowledged by representatives of the exchanges) that they varied from extremely useful to extremely poor and uninformative.”²¹

Mandatory regulation of disclosure was weak because until 1964, unlisted companies were not subject to federal disclosure obligations.²² The SEC feared that imposing stringent quarterly disclosure rules on listed companies would create an incentive to de-list.²³ After the Securities Acts Amendments of 1964 mandated disclosure regulation for unlisted companies, it became feasible for the SEC in 1970 to require all public companies to file quarterly reports on Form 10-Q.

Before then, while frequent disclosure by public companies was not mandated by particular SEC regulations, disclosure was used in a variety of contexts to address the problem of insider trading. In the SEC’s 1961 administrative decision in *Cady, Roberts*,²⁴ which first established that Rule 10b-5 prohibits insider trading, a director of a New York Stock Exchange (NYSE) company conveyed information of a decision to cut its dividend to a broker who sold the company’s stock on behalf of his clients.²⁵ *Cady, Roberts* is most famous for basing insider trading regulation on a broad equal access principle.²⁶ In doing so, it cited Rule 10b-5, the main anti-fraud provision of the securities laws, as establishing a duty for insiders to disclose material facts known

19. This report was filed on what was called a Form 9-K. *See* Semi-Annual Reports, Release No. 34-5189 (June 23, 1955). The disclosure contained in Form 9-K was limited to “a summary of profit and loss and earned surplus accounts.” Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1024 (1966).

20. *See* DISCLOSURE TO INVESTORS, *supra* note 8.

21. *Id.* at 39.

22. The disclosure requirements were extended to companies trading over-the-counter by the Securities Acts Amendments of 1964. Pub. L. No. 88-467, 78 Stat. 565.

23. *See* DISCLOSURE TO INVESTORS, *supra* note 8, at 62.

24. *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961).

25. *Id.* at 907–11.

26. *Id.* at 910–12.

to them before trading with outsiders.²⁷ If “disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances,” the SEC “believe[d] the alternative is to forego the transactions.”²⁸

In a less noticed statement, the SEC also described such trading as inconsistent with the New York Stock Exchange’s corporate disclosure regulation. It observed that the exchange had rules that required “immediate public release of dividend information by issuers.”²⁹ In a footnote to this statement, the SEC explained that “[t]he existence of the exchange requirement . . . represents an awareness of the potentialities for abuse by persons having access to inside information”³⁰ An article written years later by Arthur Fleischer, who worked on *Cady, Roberts* while at the SEC, highlighted these disclosure rules. Fleischer wrote that a reason for the stock exchange policy was that “[i]t prevents corporate insiders or others from, intentionally or inadvertently, obtaining the benefit of information before it is available to the public.”³¹

The use of disclosure to reduce opportunities for insider trading predated *Cady, Roberts*. As Professor Michael Perino has documented, in the early twentieth century, the chairman of U.S. Steel angered its directors by not giving them advance access to the company’s financial statements before they were disclosed.³² The chairman did so because of his belief that directors should not be able to profit from trading on such inside information prior to shareholders.³³

In 1968, the U.S. Court of Appeals for the Second Circuit adopted the *Cady, Roberts* equal access theory in its en banc decision in *SEC v. Texas Gulf Sulphur*.³⁴ It did so in a way that used insider trading regulation to encourage company disclosure. *Texas Gulf Sulphur* involved the question of whether insiders could deny the discovery of a substantial mineral find while trading on that information themselves.³⁵ The Second Circuit seconded the SEC in finding that Rule 10b-5 “is

27. *Id.*

28. *Id.* at 911.

29. *Id.* at 915.

30. *Id.* at 915 n.29.

31. Arthur Fleischer, Jr., *Corporate Disclosure/Insider Trading*, HARV. BUS. REV., Jan.–Feb. 1967, at 129, 132.

32. Michael A. Perino, *The Lost History of Insider Trading*, 2018 U. ILL. L. REV. (forthcoming 2018) (manuscript at 16), <http://ssrn.com/abstract=3099682>.

33. *Id.*

34. 401 F.2d 833 (2d Cir. 1968) (en banc). The Second Circuit broke new ground in doing so though it attempted to root its decision in prior authority. See Stephen M. Bainbridge, *Equal Access to Information: The Fraud at the Heart of Texas Gulf Sulphur*, 71 SMU L. REV. 643, 651 (2018) (arguing that *Texas Gulf Sulphur* was “built . . . on a foundation of sand”).

35. *Tex. Gulf Sulphur*, 401 F.2d at 856.

based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information”³⁶

The Second Circuit cited *Cady, Roberts* in crafting a doctrinal rule that used insider trading regulation to supplement the minimal disclosure requirements in place at the time.³⁷ It created a Rule 10b-5 “disclose or abstain rule” that instructed any trader with material information to either disclose it to the public or abstain from trading.³⁸ In doing so, it supplemented the substantial gaps in disclosure requirements at the time and in doing so, closely linked insider trading and disclosure regulation. Some early commentators thus viewed insider trading as violating a public company’s disclosure obligations rather than as a distinct offense.³⁹

Even with efforts to increase mandatory disclosure by public companies, the effectiveness of securities disclosure through the 1970s was questionable. In an age before the widespread use of computers and the internet, it was difficult for the public to access SEC filings. As a report by the Advisory Committee on Corporate Disclosure noted, “the 1934 Act periodic reports are not widely disseminated.”⁴⁰ Paper copies of Forms 10-K and 10-Q were filed at the SEC headquarters in Washington, DC and were not easily accessible to the retail investor.⁴¹

Given the limited usefulness of company disclosure, it was widely recognized that companies would disseminate information through other avenues such as personal communications with research analysts.⁴²

36. *Id.* at 848.

37. *Id.*

38. *See id.*; *see also SEC v. Adler*, 137 F.3d 1325, 1338 (11th Cir. 1998) (citing *Cady, Roberts* decision as having created a “‘disclose or abstain’ rule”).

39. *See, e.g.,* Morris Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 473 (1969) (book review) (arguing that “[i]f the insider capitalizes on information that could be made public, he violates the policy of disclosure that underlies federal securities regulation”). The primary concern of Rule 10b-5 today, the accuracy of disclosure, was not yet a primary part of SEC enforcement. *See, e.g.,* Herbert S. Wander, Book Review, 24 BUS. LAW. 1407, 1407–08 (1969).

40. REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 5 (1977) [hereinafter ADVISORY COMMITTEE ON CORPORATE DISCLOSURE].

41. *See, e.g.,* Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1171 (1970) (noting that it is “doubtful” that an “analyst routinely obtains copies of the Exchange Act filings”).

42. *See, e.g., Dolgow v. Anderson*, 53 F.R.D. 664, 687 (E.D.N.Y. 1971) (observing that “insiders are also encouraged to issue information and to open their doors to analysts”); *Investors Mgmt. Co., Inc.*, Exchange Act Release No. 3-1680, 44 SEC Docket 633, 646 (July 29, 1971) (“We also recognize that discussions between corporate management and groups of analysts which provide a forum for

Such selective disclosure was contrary to the equal access rule of *Cady, Roberts* and *Texas Gulf Sulphur* because it gave the clients of those analysts early access to important information. Even when insider trading regulation was at its broadest, given the gaps in mandatory disclosure, selective disclosure was necessary for stock market prices to be efficient.

Not only was disclosure less frequent, its content was less informative and reliable than it is today. Until the 1970s, the SEC discouraged companies from including projections in SEC filings.⁴³ This policy was motivated by the belief that investors would give too much credence to unreliable predictions if they were included in official documents.⁴⁴ Companies still issued projections, but they did so voluntarily on a limited basis to select investors.⁴⁵ Moreover, it was not until the late 1970s that the securities laws required accurate books and records and a basic level of internal controls to ensure the reliability of mandatory disclosure.⁴⁶ Without such controls, there was less assurance that disclosure was generated through procedures that would ensure its accuracy.

In this world of minimal mandatory disclosure, Henry Manne argued that insider trading was beneficial because it could efficiently

filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value.”).

43. See, e.g., Disclosure of Projections of Future Economic Performance, S.E.C. Release No. 5362, 1973 WL 149257 (Feb. 2, 1973) (“It has been the Commission’s longstanding policy generally not to permit projections to be included in prospectuses and reports filed with the Commission.”); F. Arnold Daum & Howard W. Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939, 954 (1962) (“[F]orecasts of sales or earnings, or appraisals, if published, would have a direct effect on the market, but not only is disclosure of such information not generally made, it is to a great degree frowned upon by the Commission.”).

The shift from prohibiting projections in mandatory disclosure to encouraging them started in the 1970s, see Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992 (Apr. 23, 1976), but it took several decades for the SEC’s shift in policy to take hold. Notably in 1995, the Private Securities Litigation Reform Act created statutory safe harbors for projections and other forward-looking statements. See 15 U.S.C. § 77z-2 (2012). Such protection was meant to encourage the use of projections by shielding issuers from liability under Rule 10b-5 when such projections are not fulfilled.

44. See Marc I. Steinberg & Robin M. Goldman, *Issuer Affirmative Disclosure Obligations—An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 MD. L. REV. 923, 937–38 (1987) (describing the rationale for SEC’s position).

45. See APPENDIX TO THE REP. OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION A272 (Comm. Print 1977).

46. The Foreign Corrupt Practices Act, which requires such controls, was not in place until 1977. See 15 U.S.C. §§ 78dd-1(a)–(c) (2012).

convey information to the stock market.⁴⁷ Put another way, Manne viewed insider trading as a substitute for disclosure. Manne specifically noted that the limited disclosure required by the SEC was insufficient to price securities because it did not include company projections. He wrote that “the company’s present worth is based not on current earnings but on information that has not been or indeed could not be legally divulged in any SEC-regulated financial statement.”⁴⁸ Though Manne’s argument was controversial even at the time he made it, it was stronger in a world where SEC disclosure was widely seen as ineffective.

Some of the early critics of Manne responded in terms of disclosure policy. They argued that if insider trading were permitted, then managers would have an incentive to delay releasing inside information so they would have time to trade on it before it was released.⁴⁹ Prohibiting insider trading “tends to encourage early disclosure, since disclosure is the best way a corporation has of preventing such trading by its officials and employees.”⁵⁰ This argument reflected the predominance of discretionary disclosure in the early years of securities disclosure. Later scholars have recycled this early disclosure argument for insider trading regulation without considering whether insider trading is inconsistent with a modern system that mandates more disclosure.⁵¹ Though Manne’s claim was

47. See HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* 77–101 (1966); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565 (1970) (“The efficient functioning of the stock market is actually one of the strongest arguments for unfettered insider trading, though at first blush it may appear to have little relationship to the issue at hand.”). *But see* Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and ‘Negative’ Property Rights in Information*, 87 VA. L. REV. 1229, 1234 (2001) (arguing that analysts are more efficient than insiders in distributing information to the market).

48. Manne, *Insider Trading and the Law Professors*, *supra* note 47, at 571.

49. See, e.g., Mendelson, *supra* note 39, at 476–77 (“But if the insider were allowed to trade on this kind of inside information, there would be a temptation to delay information when delay is unwarranted.”); Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448–49 (1967) (“If we abandon restraints on insider trading, we tempt insiders to delay disclosure so that they can buy more shares or arrange financing for more buying . . .”).

50. David Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 VAND. L. REV. 621, 623 (1970).

51. See, e.g., Laura N. Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 248 (2007) (noting argument that “insider trading is likely to distort managers’ incentives to disclose information in a timely manner”); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 333 (“The prospect of insiders’ gain may lead the firm to delay the release of information, and such delays lead to extra costs for the firm.”); Goshen & Parchomovsky, *supra* note 47, at 1260 (“If delaying disclosure

speculative,⁵² the counter-arguments in favor of prohibiting insider trading were also speculative. Just as Manne could not prove that insider trading made stock prices more efficient, the proponents of insider trading regulation could not prove that it distorted the disclosure decisions of corporate insiders.⁵³

B. The Rise of Fiduciary Duty Doctrine

Disclosure and insider trading regulation became separated through a series of Supreme Court decisions in the 1980s and 1990s. Insider trading law is now grounded on legal obligations between the trader and the source of information. This shift to focusing on whether the defendant had some specific duty not to trade was initially motivated by the desire to limit the scope of liability to identifiable individuals. Ironically, it then served as a basis for expanding the scope of insider trading regulation to information that is not subject to SEC disclosure regulation.

The problem with the Second Circuit's "disclose or abstain" rule was that it attempted to regulate the trading of every individual who possesses material information. While the insiders of the corporation can be expected to know of such an obligation, *Texas Gulf Sulphur* could be read to reach beyond insiders to traders without a relationship to the corporation, so-called outsiders. A disclose or abstain rule is ill-suited to regulate outsiders who do not have the ability to widely disclose information to the public. Such a rule could be read to prohibit trading on virtually any significant informational edge that is not publicly known.

In 1980, the Supreme Court in *Chiarella v. United States*⁵⁴ thus limited the "disclose or abstain" rule to individuals with a duty to disclose.⁵⁵ The Court noted that insiders have an affirmative duty to

provides the insider with better trading opportunities and increases her expected profits, she will postpone disclosure."); Seligman, *supra* note 5, at 1095 ("Insiders would have a personal incentive to delay the publication of news, whether good or bad.").

52. James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 648.

53. See, e.g., Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 19 & n.90 (1980) ("No evidence demonstrates, however, that insider trading usually results in a delay in the dissemination of information; it apparently has no effect."); see also Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 810 (1980) (asserting that delay in disclosure would likely be minimal).

54. 445 U.S. 222 (1980).

55. *Id.* at 233 (rejecting "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information").

disclose rooted in the fiduciary duties they owe to shareholders.⁵⁶ Such a requirement was seen as consistent with the anti-fraud origins of Rule 10b-5.⁵⁷ Though insider trading does not involve any affirmative misrepresentation, the failure to disclose information to shareholders by a fiduciary with a duty to disclose can be characterized as fraudulent.

Chiarella's classical doctrine of insider trading moved the law from its federal securities regulation roots. Fiduciary duty claims are typically thought of as state corporate law, as the Court had emphasized only a few years before *Chiarella* in *Santa Fe Industries v. Green*,⁵⁸ where it dismissed a Rule 10b-5 complaint that attempted to bring a state fiduciary duty claim.⁵⁹ With *Chiarella*, the Court shifted focus from the integrity of securities markets to the integrity of corporate directors and officers who violate duties to shareholders. The classical doctrine of insider trading seems to be premised on the belief that the wrong of insider trading is that fiduciaries siphon off corporate opportunities that belong to shareholders for themselves.⁶⁰ The case thus reconceptualized insider trading as a problem of unjust enrichment rather than the violation of a disclosure requirement.

In 1995, Professor Joel Seligman criticized this separation of insider trading regulation and disclosure. He described how the legislative history of the Securities Exchange Act of 1934 evidenced concern about the exploitation of retail investors by insiders with superior information.⁶¹ Mandatory disclosure requirements were meant to equalize this disparity by putting retail investors on equal footing with insiders.⁶² For Seligman, a “disclose or abstain” insider trading

56. *Id.* at 228–29 (“This relationship gives rise to a duty to disclose because of the ‘necessity of preventing a corporate insider from . . . tak[ing] advantage of the uninformed minority stockholders.’”). One theory is that such trading can come at the expense of shareholders because it harms the reputation of the corporation. *See Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969).

57. *Chiarella*, 445 U.S. at 234–35 (emphasizing Rule 10b-5’s focus on fraud); *Dirks v. SEC*, 463 U.S. 646, 666 n.27 (1983) (“[T]o constitute a violation of Rule 10b-5, there must be fraud.”).

58. 430 U.S. 462 (1977).

59. *Id.* at 476–78 (holding that breach of fiduciary duty by itself does not violate Rule 10b-5 and that the rule requires some “deception, misrepresentation, or nondisclosure”).

60. Indeed, in Delaware, insider trading bans are part of corporate law. It is a breach of the duty of loyalty if: “1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information.” *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904, 934 (Del. Ch. 2004).

61. Seligman, *supra* note 5, at 1109.

62. *See id.*

rule was continuous with the basic goals of securities disclosure.⁶³ Both insider trading rules and mandatory disclosure have the common purpose of promoting the “integrity of the market.”⁶⁴ Put another way, Seligman viewed mandatory disclosure as a reason for insider trading regulation to be based on a market integrity theory. Seligman thus proposed an “amendment of the federal securities laws to prohibit any person from trading while in possession of material nonpublic information”⁶⁵

The SEC also rejected the fiduciary duty framework in the particular context of tender offers. Soon after *Chiarella*, it passed Rule 14e-3, which prohibits trading on material information concerning a tender offer.⁶⁶ It did so partly on the ground that investors who transact with individuals with inside information relating to a tender offer “are effectively denied the benefits of disclosure and the substantive protections of the Williams Act.”⁶⁷ SEC regulation thus linked the problem of insider trading on information about a potential acquisition to the disclosure requirements of the securities laws.

Outside the context of tender offers, duty has defined insider trading rules over several decades. After the unjust enrichment of fiduciaries was prohibited, it was natural for the courts to conclude that similar enrichment by other market participants should also be regulated.⁶⁸ Thus, in *Dirks v. SEC*,⁶⁹ the U.S. Supreme Court found that tippees who receive and trade on inside information from a tipper can be liable under Rule 10b-5 if they knew or should have known that the information was disclosed in breach of a fiduciary duty.⁷⁰ In its 1998 *O’Hagan* decision, the Court extended insider trading liability beyond fiduciary duty relationships to cover those with a narrower duty

63. *Id.* at 1110; see also William H. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1385 (1965) (“[T]he disclosure of inside information to a favored few prior to its release to the general public smacks of the very type of abuse, so widely prevalent in the 1920’s, which formed the background for the Exchange Act.”).

64. Seligman, *supra* note 5, at 1115.

65. *Id.* at 1137. Seligman did acknowledge that there should be a few exceptions to such a blanket prohibition. *Id.* at 1138.

66. 17 C.F.R. § 240.14e-3 (2018).

67. Tender Offers, SEC Release No. 6239, 1980 WL 20869, at *5 (Sept. 4, 1980).

68. For a discussion of this point, see Park, *supra* note 18, at 360–74.

69. 463 U.S. 646 (1983).

70. *Id.* at 660. The tipper must have breached some fiduciary duty in conveying the information. Breaching a duty requires that some duty exist, and that the tipper received a personal benefit from conveying the information. The tippee, in turn, must have some degree of knowledge that the information was conveyed in breach of a fiduciary duty. See *id.*

to keep information confidential.⁷¹ Under this misappropriation doctrine, insider trading law stretches to cover relationships that have some, but not all of the characteristics of a fiduciary relationship.

By expanding the categories of duty that can trigger insider trading liability, the Court further separated insider trading regulation and public company disclosure. Duties of confidentiality can arise completely apart from the relationship between an individual and a public corporation. For example, a newspaper's policy that prohibits disclosure of upcoming stories is sufficient to trigger the misappropriation doctrine. Insider trading law now applies to trading on information that is not generated pursuant to disclosure mandates.⁷²

C. The Problem of Quarterly Projections

The narrow focus on duty created gaps in insider trading regulation that became apparent as quarterly disclosures became more important. A company's stock price now fluctuates dramatically based on whether it meets or misses projections of its performance. Selective disclosure that had long been an industry practice became more problematic as the opportunities to use such information to predict short-term price movements increased. Because of Rule 10b-5's limits, the SEC attempted to use a broad disclosure rule, Regulation FD, to reduce trading on earnings information.

Since a company's stock price is largely determined by the market's expectations as to its future earnings, valuation requires projections of a company's performance. Large companies have long created internal projections to manage their resources. Research analysts develop their own external projections for a company's performance but are at an obvious disadvantage relative to the company's managers. Though SEC policy did not permit filing such projections until the 1970s, it did not prohibit a company from voluntarily disclosing its projections.⁷³ As noted earlier, many

71. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

72. *See, e.g.*, Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 190 (1998) (noting that a "serious shortcoming of the misappropriation theory" is that "[i]nsider trading liability turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the source of the information, regardless of whether that source is a buyer or seller of securities or even a market participant at all"); *see also* Victor Brudney, *O'Hagan's Problems*, 1997 SUP. CT. REV. 249, 260.

73. Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1118 n.8 (1987).

companies disclosed information about the company's future performance selectively to market professionals.⁷⁴

As early as the 1960s, there were questions about whether selective disclosure of information relating to company projections was proper. The former SEC staffer who worked on the *Cady, Roberts* decision, Arthur Fleischer, reported that "[c]ompany officials . . . are often confronted with projections made by brokerage firms and investment banking houses and asked to confirm these figures."⁷⁵ He noted that while it would be better for the company to not comment on the projections, "it would be appropriate to call the analyst's attention to any egregious error in his assumptions or calculations."⁷⁶

The SEC's shift from prohibiting projections to encouraging them can be explained by discomfort with selective disclosure that conveys whether a company will meet its quarterly projections. If companies could include projections in SEC filings, it would reduce the advantage of those with favored access to such projections. As Joel Seligman noted, the SEC recognized that "[b]y prohibiting disclosure of earnings projections, [they] had perpetuated a form of differential disclosure."⁷⁷ The SEC's policy had mixed success in terms of increasing the number of companies issuing projections, but it highlighted a concern with selective disclosure that persists to the present day.

As the managerialism of the 1960s and 1970s gave way to the shareholder wealth maximization paradigm, the importance of projections increased. The new Form 10-Q ensured that companies would be required to report quarterly results that the market could use to assess the company's valuation. As one commentator noted of corporate executives in 1981, "their survival in office—depends on producing the steady quarter-to-quarter increase in profits that so please the financial community."⁷⁸

By the 1990s, meeting quarterly projections became especially important to investors.⁷⁹ Two finance professors report that "since the mid-1990s, but not before then, investors unambiguously rewarded . . . firms for reporting quarterly earnings meeting . . . analysts'

74. *Id.* at 1118–20.

75. Fleischer, Jr., *supra* note 31, at 134.

76. *Id.*

77. Joel Seligman, *The SEC's Unfinished Soft Information Revolution*, 63 *FORDHAM L. REV.* 1953, 1956 (1995).

78. Steve Lohr, *Overhauling America's Business Management*, *N.Y. TIMES*, Jan. 4, 1981, § 6, at 15.

79. Consensus analyst projections were first systematically collected and disseminated to the market in the early 1990s. See Joseph Nocera, *The Trouble with the Consensus Estimate*, 6 *MONEY* 59–60 (1998).

estimates.”⁸⁰ As forecasting improved and projections became more widely disseminated, they became an easy heuristic to determine whether a company was on track. In the present day, it is clear that “[t]here is often a stock market reward for meeting or beating expectations and a penalty for failing to do so.”⁸¹

The desire of investors to obtain earnings results was reciprocated by companies with incentives to provide such information. By communicating selectively with analysts, companies could shape market perceptions to avoid earnings surprises. As Chairman Levitt explained, “companies would increasingly leak to analysts what they thought their earnings would be. . . . to help shape, and thus avoid missing, the analysts’ consensus forecast.”⁸² Moreover, a company might develop relationships with investors and analysts by tipping them off to a surprise earnings miss. By providing influential market players with information, a company can encourage them to make substantial investments in its stock.

Selective disclosure of earnings looks like insider trading but is often not reachable under Rule 10b-5. If insiders do not personally benefit from the disclosure, there is no breach of fiduciary duty under *Chiarella*. If an employee disseminates the information with the consent of the company that owns the information, there is no breach of a duty of confidentiality that qualifies as misappropriation under *O’Hagan*. Under *Dirks*, so long as there is no breach of a duty, Rule 10b-5 does not prohibit recipients of the information from trading on it.

To address this gap in the law, the SEC passed Regulation FD, which requires issuers to disclose material information given to certain parties, such as research analysts simultaneously to the public.⁸³ In doing so, it indirectly regulated the practice of conveying such information privately to select individuals who can trade on it for profit. Rather than bringing insider trading cases to address the problem

80. Lawrence D. Brown & Marcus L. Caylor, *A Temporal Analysis of Quarterly Earnings Thresholds: Propensities and Valuation Consequences*, 80 ACCT. REV. 423, 425 (2005).

81. FINANCIAL EXECUTIVES RESEARCH FOUNDATION, A SURVEY OF INVESTOR RELATIONS AND EARNINGS GUIDANCE 3 (2015).

82. ARTHUR LEVITT, TAKE ON THE STREET WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW 89 (2002). This was an issue that the SEC had highlighted as early as the 1970s. See G. Bradford Cook, *The Role of the Investment Analyst in the Evolving Market System*, Speech before the New York Society of Security Analysts 9 (Mar. 27, 1973), <http://www.sec.gov/news/speech/1973/032773cook.pdf> [<https://perma.cc/NE5J-B4E9>].

83. 17 C.F.R. § 243.100 (2018). The regulation, however, does not “require issuers to disclose material information (just to make any disclosure on a non-selective basis).” Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,715, 51,731 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

of selective disclosure, the SEC mandated disclosure. As Arthur Levitt, the SEC Chairman at the time, explained:

We needed a different hook, and [SEC General Counsel and Columbia Law Professor] Goldschmid found one. Instead of focusing on insider trading, he turned to the part of the securities laws that allows the SEC to regulate communications between public companies to reveal material information in SEC filings or a prospectus prior to a stock offering, or to observe a “quiet period” for twenty-five days after an offering, then why not require them to disclose important information to all shareholders simultaneously?⁸⁴

Just as the Second Circuit in *Texas Gulf Sulphur* attempted to prohibit insider trading by requiring disclosure before trading, the SEC used a disclosure rule to prohibit selective dissemination of quarterly earnings information.

Regulation FD resurrected a form of disclose or abstain rule, but its influence has been limited. The SEC specified that a violation of Regulation FD would not constitute a securities fraud that violates Rule 10b-5.⁸⁵ The rule only provides for liability against the corporation that releases the information and does not punish those who may trade on it. The SEC has not vigorously enforced the rule. As a result, there is evidence that selective disclosure of earnings is still widespread.⁸⁶

84. LEVITT, *supra* note 82, at 92.

85. Selective Disclosure and Insider Trading, *supra* note 83, at 51,718.

86. There is substantial anecdotal evidence that selective disclosure continues. See Thomas Gryta, Serena Ng, & Theo Francis, *Analysts Steered to “Surprises”*, WALL ST. J., Aug. 5, 2016, at A1; Serena Ng & Thomas Gryta, *Analysts Say ‘Buy’ to Win Special Access*, WALL ST. J., Jan. 20, 2017, at A1; Serena Ng & Anton Troianovski, *How Some Investors Get Special Access to Companies*, WALL ST. J., Sept. 27, 2015. Academic studies also indicate that investors still receive inside information in private meetings with managers. See, e.g., Brian J. Bushee, Michael J. Jung & Gregory S. Miller, *Do Investors Benefit from Selective Access to Management?* (July 2016) (finding evidence of increase in trade size and trading gains after one-on-one meetings between managers and investors at conferences), <https://ssrn.com/abstract=1880149>; T. Clifton Green, Russell Jame, Stanimir Markov & Musa Subasi, *Access to Management and the Informativeness of Analyst Research*, 114 J. FIN. ECON. 239 (2014) (finding evidence that analysts benefit from meeting with management at investor conferences); David Solomon & Eugene Soltes, *What Are We Meeting for? The Consequences of Private Meetings with Investors*, 58 J.L. & ECON. 325 (2005) (finding that investors meeting privately with firm made more informed trading decisions).

On the other hand, there is evidence that Regulation FD has reduced asymmetry of information between the public and investors with access to management. See, e.g., Venkat R. Eleswarapu, Rex Thompson, & Kumar Venkataraman, *The Impact of Regulation Fair Disclosure: Trading Costs and Information Asymmetry*, 39 J. FIN. QUAN. ANAL. 209 (2004) (finding lower trading spreads after passage of Regulation FD); Frank Heflin, K. R. Subramanyam, & Yuan Zhang, *Regulation FD and the*

There is a close relationship between insider trading and disclosure policy. First, disclosure is a tool that can be used to prevent insider trading. Second, a disclosure system can create opportunities for insider trading that must be addressed for the system to have integrity.

II. THE MODERN DISCLOSURE SYSTEM

Understanding the issues raised by insider trading requires understanding modern disclosure regulation. The disclosure required by federal securities regulation has expanded substantially since the days of *Texas Gulf Sulphur* and Henry Manne's defense of insider trading. A public company not only must disclose more frequently than it did in the 1970s, expectations about the reliability of such disclosure have increased, especially after Congress passed Sarbanes-Oxley in 2002. For mandatory disclosure to be reliable, disclosure must be delayed so that companies can verify the accuracy of their filings. The most important public disclosure is thus compiled, extensively analyzed, and released to the public on a quarterly basis. Companies may also voluntarily release more disclosure than required by federal securities law. Such voluntary disclosure is valuable to the market but can raise problems of fairness when it is disclosed selectively.

This Part discusses the securities disclosure regime that governs public companies today to set the foundation for the analysis of insider trading regulation in Part III. Section A explains why the most important company information is disclosed periodically rather than continuously. Section B describes the scope of the disclosure mandated by the U.S. securities laws and discusses how delay is inherently part of the disclosure system. It also notes the role of voluntary disclosure in supplementing mandatory disclosure.

A. The Frequency of Disclosure

The typical public company is in frequent communication with the public. However, the company's most important financial information is released on a quarterly basis rather than continuously.⁸⁷ Courts have

Financial Information Environment: Early Evidence, 78 ACCT. REV. 1 (2003) (finding increase in voluntary disclosure after Regulation FD).

87. See, e.g., Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1300 (1965) ("Proposals to make mandatory the current reporting of all material events have been rejected in the past by the Commission, apparently on the ground that compliance with this standard would be very difficult because it is so vague; furthermore, it might expose corporations to significant risks of liability."); Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675 (1999) (describing lack of clarity

consistently held that companies do not have a general duty to immediately release material information.⁸⁸ Public company disclosure is structured in this manner in part to allow for better analysis and verification of data.⁸⁹ However, the disclosure gaps inherent in a periodic disclosure system create a need for supplemental disclosure.

1. PERIODIC DISCLOSURE

From time to time, there have been proposals to require companies to continuously disclose information to the public. One could imagine a live data stream from a company that would report sales as they occurred to the stock market. At first glance, such a system would better inform investors and make markets more efficient than a system of quarterly disclosure. Yet these proposals have all failed and public company disclosures are still periodic rather than continuous.⁹⁰ This raises the question of why U.S. securities law primarily mandates quarterly disclosure.

A disclosure system reflects a negotiation between investors and companies.⁹¹ Rather than bargain with each individual investor, it is

with respect to duty to disclose interim developments); Note, *Living in a Material World: Corporate Disclosure of Midquarter Results*, 110 HARV. L. REV. 923, 923 (1997) (“In general, if a company is not trading in its own stock, conducting an offering of its own securities, issuing a public statement about corporate developments, or taking responsibility for an analyst’s mistaken projections, it need not disclose even material midquarter developments.”).

There is an argument that Item 303 of Regulation S-K, which requires disclosure of “known trends or uncertainties” that “will cause a material change in the relationship between costs and revenues,” imposes a duty to disclose. However, some courts have not been willing to enforce a broad version of this duty. *See, e.g., In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1054 (9th Cir. 2014) (finding that breach of Item 303 duty is not actionable under Rule 10b-5).

88. *See, e.g., Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 44 (2011) (“§10(b) and Rule 10b-5(b) do not create an affirmative duty to disclose any and all material information.”); *Basic v. Levinson*, 485 U.S. 224, 239 n.17 (1988) (“Silence, absent a duty to disclose, is not misleading under Rule 10b-5.”).

89. *See, e.g., Fin. Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 519 (10th Cir. 1973) (explaining that duty to disclose is limited so that the disclosure can be “verified sufficiently to permit the officers and directors to have full confidence in their accuracy”).

90. *See, e.g., Dale Arthur Oesterle, The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: ‘Are We There Yet?’*, 20 CARDOZO L. REV. 135, 139–41 (1998) (describing periodic nature of disclosure); Robert B. Thompson & Ronald King, *Credibility and Information in Securities Markets After Regulation FD*, 79 WASH. U. L.Q. 615, 626 (2001) (“[T]he federal securities laws do not require disclosure of all material information.”).

91. *See, e.g., Frank Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682–83 (1984) (noting that investors can negotiate mutually agreeable disclosure with companies). While investors could individually negotiate with companies for disclosure, because a public

more efficient for companies to agree to standard disclosure rules that generally satisfy investors. Disclosure practices thus reflect a compromise between investors who generally want more information and companies that will generally want to disclose less. Understanding the periodic nature of disclosure requires examining the interests of both investors and companies.

One possibility is that periodic disclosure is the norm because companies resist continuous disclosure. Reporting results constantly would increase the cost of being a public company. Companies would have less discretion to withhold sensitive information from competitors. The rejection of continuous mandatory disclosure might reflect the power of public companies to minimize their disclosure obligations.

But it is likely that limited mandatory disclosure is not just explained by the narrow interests of public companies. It is also motivated by the reality that investors rely heavily on management to contextualize a company's financial performance. Without some organizing rubric, the raw data of the company's day-to-day transactions is unhelpful to most shareholders.⁹² Rather than clarifying the company's performance, a constant feed would likely confuse investors and increase the volatility of a company's stock price. Temporary spikes and valleys in performance would be given greater significance than warranted by the market.

A company's financial results are thus reported based on accounting standards that evaluate performance for particular periods. Before reporting raw results, managers must compile information and

corporation has many investors, this process would be inefficient. By providing a standard set of disclosure rules that meet the needs of all investors, securities regulation reduces transaction costs. *See, e.g.*, FRANK EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 288 (1996) (observing that "[a] decision by the firm effectively 'coordinates' the acts of many investors who could not bargain directly"). In bankruptcy law, scholars have noted a similar need for individual creditors to agree to a set of mandatory bankruptcy rules. If creditors individually bargained with the debtor, they might act in a way against their collective interest. Bankruptcy law thus reflects a creditors' bargain that reduces transaction costs. *See* Thomas H. Jackson, *Bankruptcy, Non-bankruptcy Entitlements, and the Creditors' Bargain*, 91 *YALE L.J.* 857, 860 (1982) (observing that bankruptcy might be viewed "as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate . . . an agreement from an *ex ante* position"); *see also* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 *J. LEGAL STUD.* 127, 128 (1986) ("If they had the opportunity, investors in a firm might bargain to accept a bankruptcy proceeding in advance in order to avoid a destructive race to a firm's assets that could arise when several investors exercise their right to withdraw their contribution to the firm.").

92. *See, e.g.*, Richard A. Rosen, *The Statutory Safe Harbor for Forward-Looking Statements After Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?*, 76 *WASH. U. L.Q.* 645, 668 (1998) (observing that continuous disclosure would be "transitory and fragmentary").

analyze it. Accounting rules facilitate the generation of standard results that allow for meaningful analysis. Periodic reports allow investors to compare a company's quarterly earnings to the prior year's quarter, or to the results of similar companies, to facilitate valuation.⁹³

Periodic disclosure allows companies to verify the accuracy of information. Delaying the release of financial reports gives companies time to weed out errors and bad information. Auditors can review financial results to ensure that there are no significant mistakes. Continuous disclosure would likely result in erroneous reports that would have to be revised later.⁹⁴

Investors seem mostly satisfied with a system where information is only released on a periodic rather than continuous basis. If they were not, they would lobby for reform or take their capital elsewhere. Rather than solely reflecting the interests of public companies, a periodic disclosure framework facilitates meaningful analysis of a company's financial performance.

2. INTERIM DISCLOSURE

The disadvantage of a periodic disclosure system is that it creates three-month intervals where a company is not required to provide substantial updates about its business. Investors will demand some interim disclosure and it will be in the interest of most companies to provide such information.

Interim disclosure is essential in a number of circumstances. Some events are so significant that they must be reported before the end of the quarter. For example, if the company's auditor or one of its directors suddenly resigns, such news can be a sign of potential turmoil in the company and there is a strong case for disclosing it immediately. Significant contracts or financing decisions can be so important to the firm that its stock price would be inaccurate without immediate disclosure.

Management might also use interim disclosure to shape market perceptions. If there is a false rumor that the company will miss its

93. See, e.g., Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators*, 14 ACCT. HORIZONS 235, 238 (2000) ("[P]erhaps by its very nature, but certainly as an empirical matter, accrual accounting tends to dampen the fluctuations in an entity's underlying cash flows to generate a number that is more useful to investors (for assessing economic performance and predicting future cash flows) than current-period operating cash flows.").

94. See, e.g., Wally Suphap, *Getting It Right Versus Getting It Quick: The Quality-Timeliness Tradeoff in Corporate Disclosure*, 2003 COLUM. BUS. L. REV. 661, 665 (2003) (observing that in a disclosure regime, "the objectives of quality and timeliness are in tension with each other").

earnings projections, the company could release information that its sales so far have been strong. Or, if a company looks like it will miss its earnings projections, the company could release bad news before the end of the quarter in order to avoid surprising the market.⁹⁵

In a system of periodic disclosure, mandatory interim disclosure is necessarily limited. If companies were required to disclose every event immediately, then they would essentially be subject to continuous disclosure. A periodic disclosure system thus leaves room for public companies to decide whether they will voluntarily disclose interim information.

B. The Scope of Disclosure Mandates

U.S. securities regulation mandates periodic disclosure and some interim disclosure. As federal law increasingly requires disclosure to be accurate, delay in disclosure cannot be avoided. Voluntary disclosure by companies of additional information has long been recognized as necessary to supplement the limited disclosure mandated by the securities laws. However, the selective release of such information has been controversial.⁹⁶

1. MANDATORY DISCLOSURE

Any company that wants its stock to be publicly traded must comply with the mandatory disclosure requirements of the securities laws.⁹⁷ Over the years, the demands of such mandates have increased substantially. Public company disclosure is more frequent and of higher quality than it was during the formative years of insider trading regulation.

95. Such early disclosure could reduce the risk of shareholder litigation. *See, e.g.,* Douglas J. Skinner, *Earnings Disclosures and Stockholder Lawsuits*, 23 J. ACCT. & ECON. 249, 249–50 (1997) (summarizing literature on voluntary disclosure and litigation). One criticism of interim disclosure is that firms have a greater incentive to disclose positive than negative information. *See, e.g.,* Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 658 (2001).

96. *See, e.g.,* Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 270–73 (1972) (discussing distinction between mandatory and voluntary disclosure).

97. The policy reasons for mandatory disclosure have been well-documented. *See, e.g.,* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984). *But see* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023 (2000); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

As noted earlier, it was not until the 1970s that the SEC mandated quarterly filings for public companies.⁹⁸ Now, public companies must file a yearly disclosure on Form 10-K as well as three quarterly updates on Form 10-Q.⁹⁹ There are also substantial interim disclosure requirements.¹⁰⁰ Companies must immediately report certain events on Form 8-K.¹⁰¹ The discovery of major accounting errors in previously filed financial statements,¹⁰² change of the company's auditor,¹⁰³ or resignation of a director,¹⁰⁴ are all events significant enough so that they must be disclosed before the end of a quarter.¹⁰⁵

Mandatory disclosure is distinguished by the fact that it must be filed with the SEC in written form and verified for accuracy. Thus, even if companies would choose to issue disclosure without a legal mandate, the securities laws shape such disclosure because they create expectations of reliability with respect to the information when it is

98. The requirement of periodic disclosure is set forth by Section 13 of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78m (2012); *see also* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1484 (1989) (providing overview of mandatory disclosure requirements).

99. *See* SEC. & EXCH. COMM'N, FORM 10-K (2018) [hereinafter FORM 10-K]; SEC. & EXCH. COMM'N, FORM 10-Q [hereinafter FORM 10-Q] (2018). The Form 10-Q is typically due 40 to 45 days after the end of the fiscal quarter. *See id.* at General Instruction A. The Form 10-K is typically due 60 to 90 days after the end of the fiscal year. *See* FORM 10-K, *supra* at General Instruction A(2).

100. Many of these requirements are linked to specific events or transactions. Companies must file a registration statement when selling securities under Section 5 of the Securities Act, 15 U.S.C. § 77f, and file proxy statements under Section 14 of the Securities Exchange Act in connection with shareholder votes, 15 U.S.C. § 78n. There are also disclosure requirements that cover securities transactions by insiders, 15 U.S.C. § 78p(a), takeover bidders, 15 U.S.C. § 78n(d), and institutional investors, 15 U.S.C. § 78m(f).

101. *See* SEC. & EXCH. COMM'N, FORM 8-K (2017).

102. *Id.* at Item 4.02.

103. *Id.* at Item 4.01.

104. *Id.* at Item 5.02.

105. There is some overlap between Form 8-K and the periodic disclosures required by Forms 10-Q and 10-K. A company has discretion to release information contained in its periodic reports before those reports are filed with the SEC. However, if it does, it must file the announcement with the SEC. If a company "makes any public announcement or release . . . disclosing material non-public information regarding the registrant's results of operations or financial condition for a completed quarterly or annual fiscal period," it must file a Form 8-K with the text of the release. *Id.* at Item 2.02(a). This provision was added by the SEC to implement section 409 of the Sarbanes-Oxley Act of 2002, which relates to "real time issuer disclosure." *See* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Mandatory Date, Release No. 33-8400 69 Fed. Reg. 15,594, 15,609 (March 16, 2004) (to be codified at 17 C.F.R. pts. 228, 229, et al.).

ultimately filed. Meeting such regulatory expectations often requires delayed rather than continuous disclosure.¹⁰⁶

The securities laws impose both specific mandates and general obligations that will delay a public company's disclosure. There is a longstanding requirement that public companies subject their annual financial statements to verification by an independent auditor.¹⁰⁷ This basic rule means that the company's annual results can only be released after the auditor has time to perform an audit of those results. Additionally, the threat of liability under Rule 10b-5 for fraudulent misstatements provides companies with an incentive to review disclosures for accuracy before they are filed.

Regulation directed at improving the accuracy of company disclosure has steadily increased over the years. Several years after *Texas Gulf Sulphur* was decided, in 1973, the SEC moved to mandate generally accepted accounting principles (GAAP) to replace a prior accounting framework that had been criticized as "piece-meal" because the "standards were not based on a consistent, underlying theme or framework."¹⁰⁸ It created the Financial Accounting Standards Board and made its standards concerning GAAP authoritative.¹⁰⁹ The Foreign Corrupt Practices Act of 1977 now requires that a public company's books and records "accurately and fairly reflect the transactions and dispositions of the assets of the issuer."¹¹⁰ This law also orders a company to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance" that the company's accounting complies with GAAP.¹¹¹ Almost twenty-five years later, Sarbanes-Oxley expanded a public company's obligations with respect to its internal controls. It requires management to file an annual report assessing "the effectiveness of [its] internal control structure and procedures"; and the company's auditor to "attest to, and report on, the

106. See, e.g., Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH. U. L.Q. 815, 819 (1997) ("Delay provides an opportunity for accountants, lawyers and managers to check and recheck the information."); Rosen, *supra* note 92, at 668 (noting that "[i]t takes time for a company to generate accurate and reliable information regarding current performance").

107. See FORM 10-K, *supra* note 99, at Item 8(a).

108. SEC. & EXCH. COMM'N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM 19 (2003), <https://www.sec.gov/news/studies/principlesbasedstand.htm> [https://perma.cc/JV77-4BBH].

109. ACCOUNTING SERIES RELEASE NO. 150, STATEMENT OF POLICY ON THE ESTABLISHMENT AND IMPROVEMENT OF ACCOUNTING PRINCIPLES AND STANDARDS (1973).

110. Securities Exchange Act § 13(b)(2)(A), 15 U.S.C. § 78m(b)(2)(A) (2012).

111. § 13(b)(2)(B).

assessment made by the management” of the company.¹¹² As expectations concerning the reliability of mandatory disclosure have increased, it has become difficult to imagine a public company continually releasing raw information to the public.

In addition to their periodic obligations, companies are sometimes required to issue interim disclosure. The scope of such duties is somewhat unclear. Rule 10b-5, which prohibits securities fraud, has been read to impose affirmative duties on public companies to update and correct their previously issued disclosures. Those duties, however, are only triggered in special circumstances such as when previously issued statements become materially misleading without a new disclosure.¹¹³ In addition, the New York Stock Exchange has a rule that “[a] listed company is expected to release quickly to the public any news of information that might reasonably be expected to materially affect the market for its securities.”¹¹⁴ Though on its face, this rule appears to require immediate disclosure of interim developments, it is not meaningfully enforced.¹¹⁵

Recently, the law has increased the obligation of companies to file disclosures between quarterly reports. For example, Sarbanes-Oxley required the SEC to expand Rule 8-K to increase the types of interim events that trigger immediate disclosure. In the final release for this rule, the SEC noted that “[u]nder the previous Form 8-K regime, companies were required to report very few significant corporate events.”¹¹⁶ It explained that “[t]he revisions that we adopt today will benefit markets by increasing the number of unquestionably or presumptively material events that must be disclosed currently.”¹¹⁷

The world in which Henry Manne wrote, where mandatory disclosure requirements were minimal, has changed as investors have demanded more and better information.

112. Sarbanes-Oxley Act of 2002 § 404, Pub. L. No. 107-204, 116 Stat. 745.

113. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) (“[A] duty to update opinions and projections may arise if the original opinions or projections have become misleading as the result of intervening events.”). Moreover, to trigger securities fraud liability, the violation of such a duty must be made with fraudulent intent. *Id.* at 268.

114. NYSE LISTED COMPANY MANUAL § 202.05.

115. See Oesterle, *supra* note 90, at 163.

116. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8400, 69 Fed. Reg. 15594 (Mar. 16, 2004) (to be codified at 17 C.F.R. pts. 228–30, 239, 240, 249).

117. *Id.* at 15594–95.

2. VOLUNTARY DISCLOSURE

Even as mandatory disclosure has become more extensive and reliable, there is still a need for companies to voluntarily disclose additional information to the public. Such voluntary disclosure, encompasses information that the issuer is not required to release under the securities laws.¹¹⁸ Voluntary disclosure is needed to supplement periodic disclosure but also creates opportunities for abuse.

Voluntary disclosure can benefit markets by conveying additional information to investors. Because SEC filings are necessarily summaries of performance, they do not disclose every fact about a company. Because of its written format, mandatory disclosure can be a clumsy way of communicating with the market.¹¹⁹ There is no opportunity for investors to convey what they are interested in learning and companies will only provide vague statements that do not delve into specifics. Personal communications can be a more effective way of disclosing information than the written format of an SEC filing or press release.¹²⁰ For example, it is common for companies to have conference calls where they discuss quarterly earnings. Investors who are willing to spend time listening can learn something about the competence of management by listening to how they field investor questions. Another example of voluntary disclosure is a product demonstration or a tour of a new factory.¹²¹ Seeing a product or factory in person can be much more informative than reading a written description.

118. The choice to accelerate the release of a periodic report, which is a common practice, would not be considered voluntary disclosure for purposes of this Article.

119. The SEC has attempted to make disclosures more readable over time and its filings must contain a narrative management discussion and analysis section. While such disclosure can be useful, it does not eliminate the need for information exchange outside of the disclosure context.

120. See, e.g., Rosen, *supra* note 92, at 662 (observing that companies are more comfortable conveying some information over the telephone); Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1029-30 (1990); Daniel R. Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127, 144 (1984) ("That firms voluntarily transmit information to analysts suggests that the use of analysts is an efficient method of communicating information.").

121. Consider a company with a secret new product that it thinks is promising and will increase the company's value. The written format of mandatory disclosure would be a clumsy way of conveying the potential of the product. Voluntary disclosure through a demonstration would be the best way to show investors that the product is likely to be a success. The product is not at a stage, though, where it can be shown to the entire world without danger of competitors stealing the details of the product. The best way to disclose this information would be through an in-person demonstration to a small group.

Companies and their managers cannot be expected to disclose information voluntarily for altruistic reasons.¹²² They will only do so to the extent that they benefit from such disclosure. As noted earlier, one motivation for disclosing information is to build credibility with the market by preempting surprises in periodic disclosure. Such a tactic is unproblematic so long as the information is disseminated to all investors and the company does not attempt to manipulate the market.

A more controversial form of voluntary disclosure involves disclosure of information selectively to influential analysts and investors. Such meetings are necessarily unavailable to the public as senior company management can only conduct a limited number of meetings in-person. As the Supreme Court has acknowledged, “[i]t is the nature of this type of information . . . that [it] cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.”¹²³

Such selective disclosure has long been recognized as necessary for disseminating information to markets. A 1977 report by the Advisory Committee on Corporate Disclosure observed that meetings with analysts are used to convey “information of a more specific or timely nature than that usually included in the annual report or Form 10-K.”¹²⁴ The Supreme Court in *Dirks* described the process where analysts “‘ferret out and analyze information’ . . . by meeting with and questioning corporate officers and others who are insiders” as “necessary.”¹²⁵ More recently, as noted earlier, the Second Circuit in *United States v. Newman* viewed communications between companies and analysts relating to earnings and earnings models as unproblematic.¹²⁶ Even the EU Market Abuse Regulation, which is said to take a stringent equal access approach to insider trading regulation, notes that it “is not intended to prohibit discussions of a general nature regarding the business and market developments between shareholders and management concerning an issuer. Such relationships are essential

122. See, e.g., Oesterle, *supra* note 90, at 159 (noting the importance of preserving incentive for companies to voluntarily disclose more than required by mandatory disclosure).

123. *Dirks v. SEC*, 463 U.S. 646, 659 (1983).

124. See, e.g., ADVISORY COMMITTEE ON CORPORATE DISCLOSURE, *supra* note 40, at 13; see also *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14 (2d Cir. 1977) (noting that managers communicate additional information to analysts).

125. *Dirks*, 463 U.S. at 658–59 (quoting 21 SEC Docket, at 1406) (describing the “role of market analysts” who are “necessary to the preservation of a healthy market”); see also *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (“[M]eetings and discussions with analysts serve an important function in collecting, evaluating and disseminating corporate information for public use.”). For a critique of the assumption that analysts always facilitate market efficiency, see Langevoort, *supra* note 120.

126. 773 F.3d 438, 454–55 (2014).

for the efficient functioning of markets and should not be prohibited by this Regulation.”¹²⁷

Selective disclosure can be a way for managers to develop trust with influential market participants. Even if no new information is explicitly discussed, occasional meetings with the CEO offer rich information that cannot be replicated through press releases or SEC filings. The market can benefit if the impressions of analysts who meet face-to-face with management are conveyed to the rest of the market.¹²⁸ On the other hand, such select access can create opportunities to give insider information to favored individuals.

Some commentators are untroubled by this possibility. They argue that a company should be able to subsidize market actors that invest time in following the company.¹²⁹ Because of the significant number of public companies, market participants have some choice about which companies they will examine. Selective disclosure might be especially important for a smaller company that finds it difficult to find analysts willing to cover it.¹³⁰

127. Council Regulation 596/2014, preamble (19), 2014 O.J. (L 173) 1, 4.

128. See, e.g., *United States v. Chestman*, 947 F.2d 551, 578 (2d Cir. 1991) (observing that “[a] rule commanding equal access would result in a securities market governed by relative degrees of ignorance because the profit motive for independently generating information about companies would be substantially diminished”); Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 15–18, 20–21 (1978) (discussing the incentive to invest in finding information).

129. See, e.g., Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 548 (2002) (“A firm may therefore increase overall shareholder welfare through a selective disclosure policy designed to subsidize analysts and large block shareholders.”); Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 625 (describing benefits of company relationships with research analysts); Lewis D. Solomon & Dan Wilke, *Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform*, 43 FORDHAM L. REV. 505, 518 (1975) (“[C]orporations, prodded along by the Securities and Exchange Commission or by their own self-interest, recognize the need for good rapport with security analysts.”).

Professors Haerberle and Henderson propose a market alternative to the current system where investors could pay issuers for access to information. See Kevin S. Haerberle & M. Todd Henderson, *Making a Market for Corporate Disclosure*, 35 YALE J. REG. 383 (2018).

130. See, e.g., Goshen & Parchomovsky, *supra* note 47, at 1269 (arguing that for “small companies whose shares are traded with low liquidity,” selective disclosure “is a necessary step on the way to competitive analyst coverage”); Paul B. Brontas Jr., *Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts*, 92 COLUM. L. REV. 1517, 1538 (1992) (“Analysts and corporations have strong interests in continuing voluntary corporate communications: many corporations, when they otherwise would be largely ignored, are assured of gaining the attention of a sizeable part of the market through the information-dissemination function of analysts . . .”).

Others, including the SEC and the Justice Department that brought the *Newman* case, believe that such selective disclosure should be prohibited.

III. MANDATORY DISCLOSURE AND INSIDER TRADING REGULATION

This Part sets forth the ways in which insider trading can undermine the integrity of the disclosure system just described. Insider trading regulation is necessary for a system of mandatory periodic disclosure to fulfill its goal of providing public investors with equal access to high quality information about the issuer. The disclosure delays inherent in such a system create opportunities for insiders to profit from short-term reactions to the release of quarterly results. Insiders should not be allowed to exploit delay that is necessary to verify the accuracy of disclosure for the benefit of public investors. Moreover, to the extent that a system of periodic disclosure gives companies discretion to not immediately disclose material information, insiders should not be permitted to take advantage of that discretion to profit. While companies should be encouraged to voluntarily disclose information, they should not be allowed to selectively disclose information that would allow the easy prediction of their short-term results.

A. The Integrity of Mandatory Disclosure

Consider a world in which companies were required and able to provide continuous disclosure to the market. All company information would be released immediately without any delay. Also assume that investors were able to instantaneously understand and analyze such information so that it is quickly incorporated into market prices. There would be little if any need for insider trading regulation in such a world.¹³¹ It would be very difficult for favored investors to utilize inside information to gain an edge over other investors.

131. See, e.g., Solomon & Wilke, *supra* note 129, at 544 (“Continuous corporate disclosure would assist the analyst and remove part of the temptation to seek inside information.”); see also Iman Anabtawi, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 396 (1989) (“If it is efficient for shares to be priced correctly, then this could be achieved instantaneously by adopting a disclosure rule requiring full disclosure by the company of material nonpublic information.”); Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303 (1998) (proposing mandatory pretrading disclosure by insiders).

The defendant in the famous *Dirks* case, Raymond L. Dirks, wrote a book on the scandal. He proposed continuous disclosure as a way of solving the problem of insider trading, explaining:

The European Union (EU) has attempted to eliminate disparities in access to information by mandating continuous disclosure. The EU Market Abuse Regulation provides that “an issuer shall inform the public as soon as possible of inside information which directly concerns that issuer.”¹³² Perhaps acknowledging the reality that companies may not always provide immediate access to all inside information, the EU prohibits trading by “any person who possesses inside information . . . where that person knows or ought to know that it is inside information.”¹³³ Moreover, “unlawful disclosure of insider information” is prohibited unless it “is made in the normal exercise of an employment, a profession or duties.”¹³⁴ The EU’s mandatory disclosure system reflects a policy decision to provide investors with equal access to all inside information. Any trading on such information is incompatible with this disclosure policy.¹³⁵

In contrast, as noted earlier, U.S. securities regulation does not mandate continuous disclosure. Delay in the release of information is not only permitted but effectively required by regulation. The securities laws have made a policy judgment that investors benefit from delay that allows assessment and verification of company information. Such a delay though means that the contents of periodic disclosure are more significant to the market, creating greater opportunities for insider trading than in a system of continuous mandatory disclosure. Moreover, in a system where continuous disclosure is not mandated, there is a need to incentivize companies to voluntarily release information that may not be present in the EU.

1. PERIODIC DISCLOSURE

The contents of an unreleased quarterly report are valuable to investors who want to make a quick profit through trading. Over the years, the stock market has become structured so that the revelation of a company’s financial results often has immediate implications for its

The solution is voluntary, full, and constant disclosure by the corporations. Every time anything of significance occurs in their operations, corporations should make it public. They should be subject to suit for not doing so if inside information is utilized by any investor in buying or selling stocks. Realistically, there can be no full disclosure until there are penalties for failure to fully disclose. There are no such penalties now.

RAYMOND L. DIRKS & LEONARD GROSS, *THE GREAT WALL STREET SCANDAL INSIDE EQUITY FUNDING* 286 (1974).

132. Council Regulation 596/2014, art. 17(1), 2014 O.J. (L 173) 34.

133. *Id.* art. 8(4).

134. *Id.* art. 10(1).

135. See Edward Greene & Olivia Schmid, *Duty-Free Insider Trading?*, 2013 COLUM. BUS. L. REV. 369, 410.

short-term stock price. Unlike in a system of continuous disclosure, the best information about a company's quarterly performance is delayed and released four times a year to the market. Investors make significant decisions based upon whether those results meet, exceed, or miss prior earnings projections. The U.S. system of mandatory periodic disclosure creates the problem that favored investors can profit from early knowledge of company news.

Securities disclosure is based on the premise that investors should have equal access to a public company's periodic results. Insider trading on those results is fundamentally inconsistent with that goal. The main reason disclosure of such results is delayed is so they can be verified for the benefit of all public investors. A system where equal access to the most reliable information is mandated on the one hand, but trading is freely permitted on such information before it is released to the public would be internally inconsistent and lack integrity.

It would be especially suspect for public companies and their agents to exploit such delay for their own purposes. Public companies are governed by periodic rather than continuous disclosure largely because it meets their interests in limiting their disclosure obligations. They cannot then permit their agents to take advantage of the limited number of disclosure events inherent in such a system to profit from their advance knowledge of quarterly results.

The public benefit of permitting some investors advance access to mandatory periodic disclosure is minimal. Early release of such disclosure would at best result in somewhat earlier incorporation of information into market prices. As Professors Easterbrook and Fischel have observed, marginally increasing the speed of information that will inevitably be released does not result in substantial social gains.¹³⁶

136. They write:

Some information, such as the quarterly earnings of a firm, offers opportunities for trading gains; the person who learns the news first can make great profits. In one important sense, though, the information is worthless. Trading on news that is bound to come out anyway does not change the future or lead to better investment in new securities. The price will ultimately change to reflect the true earnings. That it changes a day or so quicker is not of much moment for allocative efficiency.

EASTERBROOK & FISCHEL, *supra* note 91, at 288; *see also* Fried *supra* note 131, at 315 (noting that because of mandatory disclosure, "the period during which insider trading can make prices more accurate is likely to be rather short"); Merritt B. Fox, Lawrence R. Glossten & Gabriel V. Rauterberg, *Informed Trading and Its Regulation*, 43 J. CORP. L. 817, 853 (2018) (arguing that trading that only "improves price accuracy for only a brief period of time . . . will not have any important effects on enhancing the efficiency of the real economy"). Moreover, some commentators question whether insider trading actually enhances the efficiency of stock prices. *See* WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 2:2.2 (3d ed. 2010).

Moreover, while earnings numbers can move a stock price, they may not be a good indicator of the company's long-term valuation. Even if the market is quicker to learn of short-term results through insider trading, it would not mean that prices would more accurately reflect company prospects over the long run. An unhealthy focus on quarterly results could even distort corporate decisionmaking. To the extent that there is a concern that markets focus too much on short-term value, permitting individuals to profit from access to periodic results would create additional incentive to speculate rather than invest.

While there is an argument that companies could benefit by cultivating certain investors and analysts by giving them early access to periodic results, permitting such relationship building would risk corrupting the process of valuation. Rather than invest in a company because of its potential, some investors would be committing capital because they will be alerted to volatility in the stock price. Companies should only be permitted to develop ties with market participants if they can do so consistent with disclosure regulation that seeks to provide investors with equal access to certain types of information.

2. INTERIM DISCLOSURE

It would also be problematic to allow advance trading on specific events for which the securities laws mandate immediate disclosure through Form 8-K. In a system of periodic disclosure, only a limited number of occurrences must be disclosed on an interim basis. Presumably, such events are singled out because they are especially likely to be important enough to investors so that they would have an immediate impact on the company's valuation. A regulatory determination has been made to give the public equal access to news such as the resignation of a director. Permitting insider trading on such information would be inconsistent with the policy judgment that all investors should be immediately informed of certain developments.

A skeptic might note that an ardent opponent of insider trading could completely prohibit such trading by increasing the reach of mandatory disclosure. But such an expansion is unlikely because public companies would object to the costs of such a policy. U.S. insider trading regulation is thus limited in part because there is only so much disclosure that can effectively be mandated.¹³⁷

137. Even the EU disclosure system is not truly mandatory and continuous. The EU only requires semi-annual rather than quarterly reporting. *See* Council Directive 2013/50, 2013 O.J. (L 294) 13 (EC). Moreover, its regulations provide that an issuer may "delay disclosure to the public of inside information" if doing so would "prejudice" its interests, the failure to disclose "is not likely to mislead the public," and the company can "ensure the confidentiality of that information." Council Regulation 596/2014, art. 17(4), O.J. (L 173) 1, 34. Moreover, if the EU obligation is not

Disclosure policy and insider trading regulation are thus closely intertwined. There is a strong case that insider trading on information generated by mandatory disclosure requirements would undermine the integrity of a system that both mandates equal access to disclosure and delays the release of information so that it will be more reliable. Advance trading on such mandatory disclosure information has few benefits to justify corrupt enrichment by insiders.

B. Voluntary Disclosure

In a periodic disclosure system, companies have two types of discretion with respect to information that is not subject to mandatory periodic or interim disclosure. They have the discretion to delay disclosure of such information. They also have the discretion to disclose more information to investors than required by the securities laws. Such additional disclosure is controversial when it is conveyed to select individuals.

1. DISCRETIONARY DELAY

For a disclosure system to be truly periodic, it must give companies the discretion to delay disclosure. There is no duty to immediately disclose all material information.¹³⁸ If there was a rule requiring a public corporation to promptly disclose every piece of material information, it would be subject to continuous rather than periodic disclosure. The U.S. system has long afforded managers significant discretion with respect to the timing of disclosure. As the Second Circuit described in *Texas Gulf Sulphur*, disclosure is “a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.”¹³⁹

Such discretion must be exercised with integrity. The securities laws do not require continuous disclosure of all material information in

aggressively enforced, its continuous disclosure obligation is no greater than the unenforced NYSE obligation of continuous disclosure. *See, e.g.,* Oesterle, *supra* note 90, at 163 (describing the NYSE system).

138. *See* cases cited *supra* note 88; *see also* Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, 71 SMU L. REV. 835, 849–51 (2018) (explaining that courts never developed a general obligation to disclose after *Texas Gulf Sulphur*).

139. *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833, 850, n.12 (2d Cir. 1968); *see also* *Fin. Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 518 (10th Cir. 1973) (en banc) (noting that the timing of voluntary disclosure “is one concerned fundamentally and almost exclusively with matters of discretion and the exercise of business judgment”).

part because silence is often in the best interest of the corporation. If managers were to exploit their ability to delay disclosure by trading on important information before it is public, it would raise questions about whether such delay truly serves the interests of the corporation. As Professor Karmel has explained, prohibiting trading on such delayed disclosure is “necessary in order to ensure that confidentiality is not abused and utilized for the personal and secret profit of corporate managers and employees. . . .”¹⁴⁰ Even if it could not be proven that such trading actually resulted in delay, permitting such trading would raise questions about the integrity of the delay.

Evaluating the propriety of trading on delayed disclosure is particularly complicated when the materiality of the undisclosed information fluctuates over time.¹⁴¹ Consider the facts of *Texas Gulf Sulphur*. A company finds initial evidence of valuable minerals, but the extent of the find is very uncertain. Securities regulation would not require disclosure. If insiders trade on this speculative information, would this corrupt the integrity of the disclosure system? There is an argument that it would not. The insiders who purchase stock on this uncertain information are taking on the risk that the company does not find minerals of substantial value.

At some point, it became clear that the mineral find was a large one and would be material to the company’s results.¹⁴² Even at this point, there was no duty to immediately disclose the information (though it would eventually have to be included in a mandated periodic disclosure). Requiring immediate disclosure could endanger the project, harming the interests of the corporation.¹⁴³ In contrast to the case where the materiality of the information was uncertain, it would be troubling to permit trading on information that will clearly impact the company’s stock price. If an insider traded on this information, he would be exploiting the discretion to withhold the information to personally profit at little risk. Such personal enrichment would raise questions about whether the decision to delay disclosure was made with integrity.

2. DISCRETIONARY SELECTIVE DISCLOSURE

A periodic disclosure system not only gives companies the discretion to delay disclosure, it permits companies to disclose more

140. Karmel, *supra* note 4, at 170–71.

141. In contrast, information in mandatory disclosure reports, especially earnings reports, is more likely to be ripe information that is clearly material.

142. Materiality for such events is typically assessed by weighing both the probability and magnitude of the event. *See Basic v. Levinson*, 485 U.S. 224, 238 (1988).

143. *See, e.g.,* Scott, *supra* note 53, at 804–05 (discussing the interest of Texas Gulf Sulphur in keeping news of ore discovery confidential).

than regulation requires.¹⁴⁴ Such voluntary disclosure is not problematic when it is released to the general public. The difficult issue arises when companies disclose information selectively to a few investors or research analysts. Selective voluntary disclosure can undermine the integrity of mandatory disclosure when it allows easy prediction of the company's short-term results. On the other hand, selective disclosure relating to a company's long-term prospects is less likely to be problematic.

a. Selective Disclosure of Short-term Information

In an important early decision, the Second Circuit attempted to provide guidance with respect to whether selective disclosure triggers insider trading liability. In *Elkind v. Liggett & Myers, Inc.*,¹⁴⁵ a decision issued more than thirty years before *Newman*, the appellate court described a situation where a company employee confirmed an analyst's belief that "sales were slowing" because of stockpiling and competition, but would not confirm that this would significantly impact earnings.¹⁴⁶ Such information hinted at the content of future financial results, but the court found that it did not clearly go over the line in conveying the precise substance of the disclosure. In contrast, the *Elkind* court found improper an exchange where an analyst asked "whether there was a good possibility that earnings would be going down, and received an affirmative ('grudging') response."¹⁴⁷

The court appears to have distinguished between information that would allow definitive prediction of company earnings and ambiguous information relating to trends in a company's performance.¹⁴⁸ When an

144. Some prior efforts have not acknowledged the significance of voluntary disclosure in supplementing a mandatory disclosure system that is primarily periodic. See, e.g., Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 326 (1979) (describing disclosure regime as continuous); Karmel, *supra* note 4, at 152 (arguing that insider trading law is needed "to make the mandatory continuous disclosure system work"). But see Bainbridge, *supra* note 6, at 1236–37 (arguing that company discretion to disclose information rebuts argument that insider trading undermines the integrity of mandatory disclosure).

145. 635 F.2d 156 (2d Cir. 1980).

146. *Id.* at 160–61.

147. *Id.* at 161.

148. See, e.g., Proposed Rule: Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590, 72595 (Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, 249) ("[M]ore generalized background information is less likely to be material."); see also *SEC v. Siebel Sys., Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005) (finding that company statements were too general to be considered material information about the company's performance); *In re Schering-Plough Corp.*, Exchange Act Release No. 48461, 81 SEC Docket 54 ¶ III.C.3.a. (Sept. 9, 2003) (distinguishing between a "definitive, as opposed to a contingent, statement").

investor knows financial results before they are revealed, he will not have to take on substantial risk to profit from that information. When information is vague, the investor will have to work to analyze and confirm the implications of that information to take advantage of it.

To protect the integrity of disclosure, selective disclosure of information that allows easy prediction of the market's reaction to mandatory disclosure must be regulated. The precise contents of a periodic report need not be conveyed for traders to profit from short-term movements in a company stock price. So long as an investor knows the bottom-line result, he effectively has advance access to the report.

In modern times, it is difficult to see how feeding quarterly earnings results to select groups is necessary for market efficiency. There may have been a case that such practices were necessary in the days when SEC disclosure was not widely disseminated and a company press release would not make its way to the general public until it was published in a printed newspaper. The speed of communication through a company's established network of market contacts could be greater than written public communications. But in today's world of instantaneous communication, the need for such back channels is not as strong.

Insider trading regulation can counter the market's focus on profiting from short-term information. Permitting selective disclosure of earnings results would increase the incentive of traders to cultivate company sources that will allow them to guess whether a company will meet its latest earnings numbers instead of working to understand the long-term prospects of a business. By making it more costly to obtain information about a company's quarterly results, insider trading law can help divert traders from such short-term strategies. Even if it does not significantly deter such efforts, at the very least, there is expressive value in banning efforts to profit through early access to short-term information.

b. Selective Disclosure of Long-term Information

Selective disclosure of information that does not permit the easy prediction of short-term stock price movements would be less likely to be at odds with the policy goals of mandatory disclosure. Even if information does not immediately affect a company's stock price, it can be useful to investors seeking to understand the long-term prospects of the company. Selective disclosure of such long-term information is less likely to undermine the integrity of mandatory disclosure.

Mandatory disclosure is better at conveying a company's short-term results than detailing its long-term plans. While securities regulation requires some general discussion of a company's plans and

businesses in its periodic reports, it is difficult to meaningfully describe a company's long-term strategy in a written disclosure document. SEC filings usually speak in vague generalities and do not allow for back-and-forth discussion. A company may find it more effective to convey such information in conversations with smaller groups of investors. For example, a struggling retailer can explain how it will bolster its e-commerce capabilities to counter the threat of Amazon. Such meetings would provide a richer and more interactive description of that strategy than could be contained in a written legal document. Permitting selective disclosure of long-term information would allow companies to communicate information it could not through disclosure.

Selective disclosure of a company's long-term prospects is less likely to result in unfair informational disparities. Even though some investors will receive additional insight about the company, they will also have to invest time to meet face to face with management. Because of the inherent difficulty of predicting the long-term future of a company, such selective disclosure would not result in easy gains. Investors and analysts would have to take on substantial risk and effort to gain an edge from such information. The effort required to profit from long-term information would obviate the concern that certain investors are unfairly enriching themselves based solely on their favored position.

There are challenges in implementing a policy that permits selective disclosure of long-term but not short-term information. There will be difficult judgment calls about what will allow investors to predict a company's short-term results. A company that conveys a convincing long-term plan can signal to investors that it will consistently meet its short-term results. Moreover, frequent interactions with managers over time can give investors and analysts an edge in judging the mood of the company before an earnings release.

Even with its complications, a system where significant personal interaction between companies and market participants is preferable to one where disclosure is only conveyed in writing. So long as such conversations do not reveal information that allows easy prediction of short-term price movements, they would not be inconsistent with the policies of our disclosure regime.

A disclosure theory of insider trading regulation would thus make two distinctions. First, it would distinguish between mandatory and voluntary disclosure. There are especially strong policy reasons for regulating advance trading with respect to mandatory disclosure, especially to the extent that such disclosure is subject to regulatory delay. Second, it would distinguish between short-term and long-term information. Companies should only be permitted to selectively disclose information that does not convey the substance of market-moving information contained in mandatory reports.

IV. THE INTEGRITY OF MANDATORY DISCLOSURE AND THEORIES OF INSIDER TRADING REGULATION

This Article has argued that insider trading regulation is best understood as part of a system of disclosure regulation. This Part compares this disclosure theory to the two main theories of insider trading regulation—market integrity and property rights. The disclosure theory offers a more focused explanation for regulating insider trading than these prevailing approaches. It provides a more compelling account of why insider trading regulation should be considered a matter for securities regulation rather than some other body of law.¹⁴⁹ Connecting insider trading regulation to mandatory disclosure also answers a number of longstanding puzzles concerning the prohibition of insider trading.

A. Theories of Insider Trading Regulation

1. MARKET INTEGRITY

As discussed earlier, the SEC initially rooted insider trading regulation in the simple principle that investors should have equal access to any material information. The problem with this theory is that it reaches too broadly in potentially scrutinizing trading on information generated from all sources. A disclosure approach is narrower and more workable in that it would focus on the integrity of mandatory disclosure rather than the integrity of the entire marketplace.¹⁵⁰

In initiating the creation of modern insider trading doctrine, the SEC's *Cady, Roberts* administrative decision cited "the inherent unfairness involved where a party takes advantage of [inside] information knowing it is unavailable to those with whom he is dealing."¹⁵¹ The Second Circuit in *Texas Gulf Sulphur* adopted the SEC's view and linked it to market integrity in stating that the prohibition "is based in policy on the justifiable expectation of the

149. Securities regulation tends to protect the interests of trading investors. See James J. Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116 (2017). Under a disclosure theory, insider trading regulation furthers the policy goal of providing trading investors with equal access to certain types of information.

150. One might also question the ability of insider trading regulation to maintain public trust in markets in light of the proliferation of new forms of market manipulation. See, e.g., Tom C.W. Lin, *The New Market Manipulation*, 66 EMORY L.J. 1253 (2017).

151. In re *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961).

securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information”¹⁵²

Some prominent scholars have supported this market integrity theory.¹⁵³ Professor Victor Brudney argued that an equal access theory should prohibit an informational advantage if other investors cannot “overcome it lawfully, no matter how great may be their diligence or large their resources.”¹⁵⁴ Such information would include any “nonpublic information” that the possessor is “precluded by legal restrictions from disclosing to public investors.”¹⁵⁵ Writing a couple of decades later, Professor Joel Seligman rooted the equal access principle in mandatory disclosure requirements that were meant to equalize this disparity by putting retail investors on equal footing with insiders.¹⁵⁶ For Seligman, insider trading rules and mandatory disclosure have the common purpose of promoting the “integrity of the market.”¹⁵⁷

As discussed before, the Supreme Court retreated from the broadest form of market integrity in cases like *Chiarella* and *Dirks*. These decisions were partly motivated by concerns that a market integrity principle reaches too far. Securities markets are characterized by significant disparities in the ability and willingness of investors to obtain and analyze information.¹⁵⁸ There must be some way of distinguishing between proper and improper advantages, and the Court relied on a narrow conception of fraud to establish that the violation of a duty was necessary for trading to violate Rule 10b-5.¹⁵⁹

152. *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc).

153. William L. Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 415 (1962) (arguing that insider trading “infects the integrity of the market”); Homer Kripke, *Manne’s Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 954 (1985) (noting that insider trading “runs the risk of destroying an important public interest, namely, confidence in the national securities markets”); Painter, *supra* note 63, at 1385 (“[T]he disclosure of inside information to a favored few prior to its release to the general public smacks of the very type of abuse, so widely prevalent in the 1920’s, which formed the background for the Exchange Act.”).

154. Brudney, *supra* note 144, at 354; *see also* Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 122 (1982).

155. Brudney, *supra* note 144, at 355.

156. Seligman, *supra* note 5, at 1109.

157. *Id.* at 1115.

158. Some investors will always be able to obtain information at a lower cost than other investors. *See* Easterbrook, *supra* note 51, at 329–30; *see also* Macey, *supra* note 2, at 16–17.

159. Professor Brudney’s formulation was an attempt to find such limits, but in practice the test does not offer sufficient guidance with respect to what is an appropriate advantage. *See, e.g.*, Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 221–24 (1991) (discussing difficulty of distinguishing between fair and unfair advantages).

Despite these setbacks, the market integrity theory is still influential. Indeed, the Court referred to it in *O'Hagan*, writing that insider trading law serves to “insure honest securities markets and thereby promote investor confidence.”¹⁶⁰ The Court cited Professor Brudney’s scholarship and noted the concern that if ordinary investors do not trust the market, they will withdraw from it.¹⁶¹ Moreover, it is clear that the SEC still views market integrity as a policy reason for creating broad duties not to trade on inside information. A few years after *O'Hagan* was decided, the SEC passed a regulation clarifying that family members owe duties of confidentiality to each other that can trigger insider trading liability for misappropriation.¹⁶² In the release for the rule, the SEC cited Professor Brudney in noting that without the rule, there would be an informational disparity that “cannot be overcome by research or skill.”¹⁶³

A disclosure theory would meet the basic spirit of the market integrity principle, while suggesting limits to the reach of insider trading regulation. Even if it is impossible to achieve equality with respect to all market transactions, it is possible to create expectations about the proper use of mandatory disclosure information. Rather than aspiring to achieve equal access with respect to all material information, the prohibition of insider trading by the securities laws is better understood as focusing on providing equal access to information subject to disclosure mandates. A disclosure approach would thus avoid the most potent criticism of market integrity—that it overreaches in attempting to regulate trading on any important information obtained in a questionable manner.

The regulation of insider trading is on firmer ground when it polices trading on information generated by companies to comply with securities regulation rather than all material information that might affect a stock price. When information is not subject to mandatory disclosure, selective disclosure is more likely to meaningfully facilitate valuation and so there may at times be a policy reason for allowing a few individuals to enrich themselves. When information is subject to mandatory disclosure, the incremental benefit of somewhat earlier

160. *United States v. O'Hagan*, 521 U.S. 642, 658 (1997).

161. *Id.* at 659 (noting the “inhibiting impact on market participation of trading on misappropriated information”); see also WANG & STEINBERG, *supra* note 136, at §§ 2–3 (describing arguments that insider trading is harmful to investors, the market, and society).

162. See SEC Rule 10b-5-2(3), 17 C.F.R. § 240.10b-5-2(3) (2018). The Supreme Court in *Salman* appeared supportive of this approach. See *Salman v. United States*, 137 S. Ct. 420 (2016).

163. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881, 2000 WL 1201556 at *25 (Aug. 15, 2000).

disclosure would not justify undermining the integrity of the securities laws.

2. PROPERTY RIGHTS

The second theory, which has been primarily advanced by scholars with a law and economics perspective, views insider trading as a violation of the corporation's property rights.¹⁶⁴ The property rights theory has its appeal, but it also fits uneasily within an approach that views insider trading as a subject for securities regulation. A disclosure theory would reject the property rights approach with respect to mandatory disclosure information while retaining it for some types of voluntary disclosure.

The property rights theory can be understood as part of a larger project arguing against the mandatory nature of corporate law. If corporate law primarily facilitates private bargains or contracts, there is a case that law should not play a substantial role in shaping corporate governance. Similarly, if insider trading relates primarily to the violation of private property rights, the role of law in prohibiting such trading should be minimal. Instead, insider trading could be managed primarily through private ordering where parties contract to allow or disallow trading on inside information, perhaps to incentivize executives.¹⁶⁵ Unauthorized trading on insider information could be

164. See, e.g., Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1591 (1999) ("The insider trading prohibition ought to be viewed as a means of protecting property rights in information, rather than as a means of preventing securities fraud."); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 865–66 (1983) (relying on "[t]he notion that the dispute concerning insider trading is really a dispute about which party more highly values a property right"); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998) (arguing that misappropriation theory is based on property rights).

165. See, e.g., MANNE, *supra* note 47, 138–41 (arguing that insider trading is an efficient way of compensating managers); Carlton & Fischel, *supra* note 164, at 862–64 (arguing that investors might benefit by allocating insider trading rights to managers); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1451 (1987) (analyzing situations where allocating insider trading rights to managers might be optimal); see also Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313 (2002) (arguing that allocating right to trade to insiders is more efficient than allowing outsiders to trade).

Defenders of insider trading regulation have generally responded that the benefits of compensating executives by allowing them to trade on inside information would be minimal. See, e.g., Cox, *supra* note 52, at 649–53. An arrangement permitting managers to profit through insider trading would create incentives to manipulate markets and disclosure. See, e.g., Easterbrook, *supra* note 51, at 332–33.

treated as theft and prosecuted by local rather than federal prosecutors.¹⁶⁶

The *O'Hagan* Court accepted a form of the property rights theory in adopting the misappropriation doctrine. It stated that a corporation's "confidential information" is "property to which the company has a right of exclusive use."¹⁶⁷ It then implied that a corporation could authorize trading on such inside information, so long as there is "full disclosure" of the trading.¹⁶⁸

A problem with the property rights theory is that it goes too far in concluding that a company is the only party with an interest in its information. When a company chooses to be public, it gives up the right to completely control data on its performance and prospects. Mandatory disclosure requirements specify the information a company must collect, as well as the process by which it is verified. Public companies do not have total property rights in information that must be compiled subject to government requirements, filed with a government agency, and disseminated to the public.¹⁶⁹ As one commentator has noted, "[p]ublicly traded companies are comfortable with the idea that historical data about the company's financial performance 'belongs' to

166. Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1922 (2007) ("The rules against insider trading are meant to protect public companies and investors from theft of information that properly belongs to them."). An implication of this argument is that insider trading law should not be federal. *See, e.g.*, Bainbridge, *supra* note 6, at 1241 ("In the absence of a credible investor injury story, the protection of investors goal of the federal securities laws does not justify a uniform federal fiduciary standard."); Ribstein, *supra* note 164, at 154 (arguing that state law better regulates property interests). Regulation that prohibits insider trading might be better explained as a type of questionable interest group regulation that protects stock brokers who want to monopolize the market for information rather than a rule that is motivated by the public interest. *See, e.g.*, David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311 (1987). The states have differed in whether they seek to play a role in insider trading enforcement. *See* Donald C. Langevoort, *Federalism in Corporate/Securities Law: Reflections on Delaware, California, and State Regulation of Insider Trading*, 40 U.S.F. L. REV. 879, 880–81 (2006).

167. *United States v. O'Hagan*, 521 U.S. 642, 654 (1997).

168. *Id.* at 655 (noting that "full disclosure forecloses liability under the misappropriation theory"). Some courts have been wary of the idea that parties can avoid insider trading liability by trading openly on such information. *See, e.g.*, *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006) (rejecting argument that party obtained consent to trade on inside information).

169. *See, e.g.*, EASTERBROOK & FISCHER, *supra* note 91, at 286 (noting that "[a] mandatory disclosure system . . . controls the time, place, and manner of disclosure"); *see also* Karmel, *supra* note 4, at 151 (arguing that property rights theory does not adequately take into account the relationship between insider trading and mandatory disclosure regulation).

the investing public. . . .”¹⁷⁰ Because mandatory disclosure information is increasingly generated for public purposes, it is difficult to argue that insider trading on such disclosure is solely a matter of a corporation making decisions about what it should do with its own property.

On the other hand, public companies have stronger property rights in information that is not subject to disclosure mandates. To the extent that a corporation uses such voluntary disclosure information in a way that does not undermine the integrity of the mandatory disclosure system, it should be permitted to do so. As argued previously, a company should be allowed to selectively disclose long-term information to supplement its written disclosure and develop relationships with analysts and investors. Thus, just as some aspects of a disclosure theory are compatible with a market integrity approach, some aspects are compatible with a property rights theory.

Insider trading law would be more limited in some ways by a disclosure theory than a property rights theory. If insider trading is about property rights, a wide range of trading on information unrelated to corporate disclosures could give rise to insider trading liability. Under a disclosure theory, insider trading regulation would mainly be concerned with equal access to corporate information produced to comply with the securities laws.

B. Insider Trading Puzzles

The disclosure theory addresses a number of longstanding puzzles about the regulation of insider trading. First, why should we prohibit insider trading when it does not cause significant direct harm to particular investors? Second, why is insider trading regulated in securities markets but not in commodities markets? This Section briefly sketches some potential answers to these questions.

Over the years, numerous commentators have noted that in a public market, insider trading does not substantially damage particular investors.¹⁷¹ In contrast to a face-to-face transaction where the insider’s gain corresponds with a loss to the purchaser, it is more difficult to

170. Mahoney, *supra* note 106, at 844; *see also* Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 493–94 (2001) (arguing that corporations do not have exclusive property rights with respect to corporate information).

171. For a recent example of this argument, *see* John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 7–14. Other important accounts have identified different costs imposed by insider trading. *See, e.g.*, Kim, *supra* note 17, at 961–67 (detailing costs of corruption); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1234–35 (1981) (setting forth the Law of Conservation of Securities).

argue with respect to market transactions that a particular investor has been significantly harmed by the insider's purchase or sale. If the insider's gain does not cause much damage, it is more difficult to argue that insider trading is unethical.

Other theories of insider trading regulation do not have a compelling response to this argument. Under the market integrity theory, the harm might be that the market itself is harmed when some investors have substantial advantages over others. The problem with this argument is that even without insider trading some investors will be more sophisticated and earn returns at the expense of less sophisticated investors.¹⁷² It is difficult to explain why some disparities in information damage the integrity of markets while others do not. The property rights theory would argue that rather than harming markets, insider trading hurts corporations who lose control over their information. Under such an account, it is far from clear why the SEC, which primarily seeks to protect investors, should get involved. Corporations are sophisticated enough entities so that if insider trading affects their interests, they can be expected to respond with policies prohibiting such trading.

Under a disclosure theory, the focus of the insider trading prohibition is not on the harm to particular trading investors. Instead, the main rationale for the prohibition is that insider trading undermines the integrity of the regulatory regime governing public company disclosure, which seeks to equalize access to important company information. Selective disclosure or misappropriation of mandatory disclosure information undermines this goal and thus should be regulated. To the extent that trading on mandatory disclosure information involves a fraudulent intent to unjustly enrich particular individuals, there is a case for strong civil and perhaps criminal sanction.

The second puzzle is why insider trading is specifically regulated in stock markets but not with respect to some other markets. If market integrity is generally important, then why aren't all trading markets subject to insider trading law? Professor Andrew Verstein has extensively and thoughtfully described the similarities between commodities and stock markets in arguing for more insider trading regulation for commodities markets.¹⁷³ Under a disclosure theory, however, there is a distinctive reason for regulating insider trading in

172. To take a recent example, the rise of high-frequency trading results in a significant advantage for those who have invested in technology. *See, e.g.,* Yesha Yadav, *Insider Trading and Market Structure*, 63 UCLA L. REV. 968 (2016) (arguing that high frequency trading leads to questions about insider trading policy).

173. *See* Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 466–93 (2016).

securities. Mandatory disclosure is more essential to valuing securities tied to the performance of particular corporate issuers than it is for determining commodities prices, which mostly rise and fall based on market conditions. Commodities regulation does require some disclosure of transactions by traders and dealers,¹⁷⁴ but it does not generate as much sensitive, market-moving information as securities regulation.¹⁷⁵ Trading on non-public information about commodities may raise similar issues of market integrity and fairness as trading on non-public information about securities, but it does not threaten the integrity of an extensive system of mandatory periodic disclosure essential to valuing corporate issuers.¹⁷⁶ There may be compelling reasons to regulate insider trading in commodities markets, but the disclosure theory would not provide a basis for such regulation.

Rather than requiring equal access to all information, the goal of insider trading law should be to more modestly strive for equal access to the disclosures ordered by the securities laws. The property rights theory is not persuasive in the context of corporate disclosure that is shaped by regulatory requirements that must be met for securities to trade in a public market. By better articulating the relationship between insider trading and the broader goals of securities regulation, a disclosure theory provides a firmer foundation for regulating insider trading than prior efforts.

V. THE INTEGRITY OF MANDATORY DISCLOSURE AND INSIDER TRADING LAW

The law of insider trading has often been criticized for its failure to establish a clear boundary between permissible and impermissible trading. Despite their differences, the prevailing market integrity and property rights theories have both supported expanding the reach of Rule 10b-5 liability. The desire to punish unfair access to information has resulted in a tendency by courts to stretch the concept of fiduciary duty. The property rights theory has supported the extension of insider

174. *Id.* at 491–92.

175. *See* Commodity Exchange Act, Pub. L. No. 74-675, ch. 545, 49 Stat. 1491 (1936).

176. There have been some similar questions about whether insider trading laws apply to debt markets. *See, e.g.*, 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 3.12 (2018) (noting that misappropriation theory should reach most “abuses in the trading of debt securities”); R. Rene Pengra, *Insider Trading, Debt Securities, and Rule 10b-5: Evaluating the Fiduciary Relationship*, 67 N.Y.U. L. REV. 1354 (1992) (describing uncertainty in law governing insider trading with respect to debt). Because public debt is subject to mandatory disclosure requirements, there is a stronger case for insider trading regulation than there is for commodities markets.

trading rules to almost all sources of information. This Part discusses how the disclosure theory already shapes and could better limit insider trading doctrine and enforcement.

A. Insider Trading Doctrine

A theoretical framework can be difficult to match to the particular legal provisions that could implement it. For example, the primary regulation the SEC uses to bring insider trading cases, Rule 10b-5, requires a showing of fraudulent intent.¹⁷⁷ Rule 10b-5 is thus limited in its ability to police selective dissemination of mandatory disclosure.¹⁷⁸ Regulation FD is not limited to fraud but cannot be used to sanction trading by individuals.¹⁷⁹

Insider trading doctrine is established enough so that it would be too ambitious to propose completely starting from scratch. Moreover, insider trading law already prohibits much of the misconduct that would undermine the integrity of our disclosure system. For example, the classical doctrine of insider trading, which restricts trading by insiders, targets the corporate officers and directors who are most likely to have early access to information generated through the disclosure process.

Rather than proposing ambitious changes, this Article makes some initial inquiries into how a disclosure approach interacts with various areas of doctrine. It first discusses how courts and regulators have effectively limited the concept of materiality so that only information relating to the short-term prospects of the corporation is likely to trigger Rule 10b-5 liability. It then discusses the misappropriation

177. See, e.g., *Edward J. Goodman Life Income Tr. v. Jabil Circuit, Inc.*, 594 F.3d 783, 793 (11th Cir. 2010) (“Scienter is a component of section 10(b) and Rule 10b-5 insider trading claims.”).

178. For example, studies have found evidence that traders exploit access to SEC EDGAR filings before they are available to the public. See Ryan Tracy & Scott Patterson, *Fast Traders Are Getting Data From SEC Seconds Early*, WALL ST. J. (Oct. 29, 2014), <https://www.wsj.com/articles/fast-traders-are-getting-data-from-sec-seconds-early-1414539997> [<https://perma.cc/X46G-XXW3>]. Such trading undermines the integrity of mandatory disclosure, but it would not violate Rule 10b-5 because of the absence of a duty between the traders and the corporation.

179. In the view of some scholars, Regulation FD serves as a basis for finding that selective disclosure can violate Rule 10b-5. See, e.g., Michael D. Guttentag, *Selective Disclosure and Insider Trading*, 69 FLA. L. REV. 519, 525 (2017) (“[I]n light of changes wrought by Regulation FD and *O’Hagan* . . . evidence of a personal benefit should no longer be a required element to find that a selective disclosure is sufficiently deceptive to trigger insider trading liability.”); Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1, 36–41 (2016). On the other hand, Regulation FD is careful to note that it “is not an antifraud rule, and it is not designed to create new duties under the antifraud provisions of the federal securities laws or in private rights of action.” Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,715, 51,726 (Aug. 24, 2000) (codified at 17 C.F.R. §§ 240, 243, 249).

doctrine,¹⁸⁰ which commentators have criticized for regulating information that is generated outside the context of corporate disclosure. Finally, it looks at the problem of tipping liability where the current test has been criticized because it allows tippees in certain circumstances to freely trade on mandatory disclosure information.

1. MATERIALITY

An implication of this Article's analysis is that trading on information concerning the short-term prospects of the corporation is more likely to undermine the integrity of disclosure than trading on information about its long-term prospects. There is an argument that market participants and regulators already interpret the concept of materiality, which limits the reach of Rule 10b-5 and Regulation FD, as mainly covering trading on such short-term information. Public companies thus have some discretion to communicate selectively with investors and analysts about long-term developments.

The federal securities laws generally only apply to material information. In the particular context of insider trading, a trade can only result in liability under Rule 10b-5 if it is "on the basis of material, nonpublic information."¹⁸¹ Put another way, trading on unimportant information does not result in an unfair advantage that would trigger scrutiny under insider trading law. Similarly, Regulation FD's obligation to disclose information publicly only applies to "material nonpublic information regarding [the] issuer or its securities"¹⁸²

The courts and the SEC have generally defined the concept of materiality broadly.¹⁸³ For any Rule 10b-5 case, materiality encompasses any information that would be important to the decision of the "reasonable investor" to purchase or sell securities.¹⁸⁴ The courts have not provided much guidance on the characteristics of a reasonable investor.¹⁸⁵ As a result, it is difficult to definitively know ex ante whether a piece of information is material.

180. Courts often refer to misappropriation as a theory. *See, e.g., O'Hagan*, 521 U.S. at 649. This Article refers to it as a doctrine to distinguish it from the market integrity and property theories.

181. *O'Hagan*, 521 U.S. at 651–52.

182. 17 C.F.R. § 243.100(a) (2018).

183. For a more extensive discussion of this point, see James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 524–26 (2009).

184. *Basic v. Levinson*, 485 U.S. 224, 231–32 (1988).

185. One could imagine a number of ways to narrow this standard. If the goal of the securities laws is to facilitate accurate valuation, then perhaps a "reasonable" investor would only include informed investors rather than uninformed investors.

a. Materiality in Practice

There is evidence that insiders use their access to company information to gain an advantage in trading over outsiders. Numerous studies document that managers earn abnormal returns when trading in the stock of their employer.¹⁸⁶ Professor Jesse Fried has noted that much of this trading likely reflects the reality that insiders can trade on what he refers to as sub-material information.¹⁸⁷ Rather than trade on their knowledge of quarterly results that have an immediate impact on a stock, managers use their understanding of the long-term prospects of the corporation to make profitable investment decisions.

Such an advantage is troubling from a market integrity perspective, but there are no calls to aggressively root out trading on long-term information by executives. The SEC could perhaps bring such cases and argue for an aggressive interpretation of materiality that includes information that does not have an immediate effect on the company's price. If it did, it would likely spur a backlash against the reach of insider trading regulation. To prohibit managers from using their deep knowledge of the company's business to trade would essentially mean that they could not trade.

The SEC has signaled in some ways that it will limit its enforcement to trading on short-term information by managers. For example, it has set up a procedure where managers have an affirmative defense to insider trading charges if they pre-commit to securities transactions in advance.¹⁸⁸ Such a plan makes it difficult to trade on earnings information but still permits managers to leverage their knowledge of the company's trajectory. The SEC's position essentially acknowledges that its primary concern is trading that blatantly takes advantage of the contents of mandatory disclosure information that will immediately affect the company's stock price.

In the context of selective disclosure, the SEC has recognized that not every piece of inside information results in an unfair advantage. In a release interpreting Regulation FD, it noted that "[a]n issuer also would not be conveying [material nonpublic information] if it shared seemingly inconsequential data which, pieced together with public information by a skilled analyst with knowledge of the issuer and the industry, helps form a mosaic that reveals material nonpublic

186. See, e.g., Enrichetta Ravina & Paola Sapienza, *What Do Independent Directors Know? Evidence from Their Trading*, 23 REV. FIN. STUD. 962 (2010) (finding that executives and independent directors earn abnormal returns from trading in company stock). But see Dirk Jenter, *Market Timing and Managerial Portfolio Decisions*, 60 J. FIN. 1903, 1906 (2005) (finding that "excess returns to insider trades after controlling for size and book-to-market effects are indistinguishable from zero").

187. Fried, *supra* note 131, at 335–37.

188. See 17 C.F.R. § 240.10b5-1 (2018).

information.”¹⁸⁹ This mosaic theory has been recognized by some courts as a way of reducing the fear that trading on any nonpublic information could trigger insider trading liability.¹⁹⁰

One explanation for the lack of Regulation FD enforcement described earlier in this Article is that the SEC has accepted a narrow definition of materiality in that context. Rather than investigate the many private interactions between managers and analysts, the SEC presumes that CEOs and analysts are discussing mosaic information to understand the long-term prospects of the corporation.

b. A Narrower Materiality Test?

If the SEC, corporate managers, and research analysts are essentially limiting the concept of materiality to short-term information, there may be an argument for more formally limiting the test for materiality. Commentators have noted the lack of clarity with respect to materiality in the context of insider trading regulation.¹⁹¹ The “reasonable investor” can find a wide range of information potentially important to an investment decision.¹⁹²

Some formulations of materiality in insider trading cases have focused on information that will immediately affect a company’s stock price. One early decision observed that “a relevant decision in determining materiality in a case of alleged tipping to analysts is whether the tipped information, if divulged to the public, would have been likely to affect the decision of potential buyers and sellers.”¹⁹³ Another court limited the “disclose or abstain” rule to important information that is “extraordinary in nature” and “reasonably certain to

189. SEC Division of Corporate Finance, Compliance and Disclosure Interpretations 101.03 (Aug. 14, 2009), <http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm> [<https://perma.cc/6Z55-9VAT>].

190. *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14–15 (2d Cir. 1977) (noting that it is permissible to disclose “internal corporate information” that fills “interstices in analysis” or tests “the meaning of public information”). Support for the mosaic theory in the case law is not uniform. See WANG & STEINBERG, *supra* note 136, at § 4:2.3.

191. See, e.g., Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1160 (2003) (arguing for more precision in defining materiality). A recent article argues for a definition of materiality that would include any information that needs to be filed on Form 8-K and that would have a statistically significant impact on stock prices. See Cindy A. Schipani & H. Nejat Seyhun, *Defining “Material, Nonpublic:” What Should Constitute Illegal Insider Information?*, 21 FORDHAM J. CORP. & FIN. L. 327, 363–64 (2016).

192. Moreover, in federal mail and wire fraud cases, some courts apply a laxer standard of materiality than a “reasonable” investor test. See William K.S. Wang, *Application of the Federal Mail and Wire Fraud Statutes to Criminal Liability For Stock Market Insider Trading and Tipping*, 70 MIAMI L. REV. 220, 276–85 (2015).

193. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2d Cir. 1980).

have a substantial effect on the market price of the security.”¹⁹⁴ In the present day, the EU has implemented a narrow definition of materiality, requiring “information of a precise nature” that is “likely to have a significant effect on the prices” of securities.¹⁹⁵

This Article’s analysis suggests a hierarchy with respect to the types of information that are likely to be material. Advance copies of mandatory disclosure reports would be the most suspect. Information that essentially conveys the contents of such reports would be almost as problematic. In considering whether information that is not clearly subject to mandatory disclosure is material, courts might consider various factors such as whether it allows prediction of the short-term price movements of a company’s stock as well as whether it permits the trader to profit without taking on substantial risk.

Limiting the concept of materiality would help address the concern that insider trading law reaches too broadly and leaves regulators with too much discretion. It would provide issuers and investors with more guidance about what can be selectively disclosed and traded on.¹⁹⁶ Finally, it would better align insider trading law with a disclosure system that mandates equal access to some information while relying on companies to voluntarily supplement their required disclosure.

2. THE MISAPPROPRIATION DOCTRINE

As noted earlier, under the Supreme Court’s misappropriation doctrine, Rule 10b-5 applies not only to trading that violates a fiduciary duty to the corporation, but also covers trading that breaches any contractual duty of confidentiality. This broad view of insider trading regulation is consistent with the market integrity and property rights theories, but not with the disclosure theory. Discomfort with the reach of liability for misappropriation is consistent with the view that insider trading law should focus on the core goal of maintaining the integrity of mandatory disclosure.

The misappropriation doctrine has been controversial because it extends insider trading regulation beyond the context of information generated by the corporation. A number of scholars criticized *O’Hagan* soon after it was decided because it permits application of the securities laws to deceptions that are not directed at any market participant.¹⁹⁷ For example, as noted earlier, after *O’Hagan*, Rule 10b-5 can be triggered

194. *Bausch & Lomb*, 565 F.2d at 14–15.

195. European Parliament Regulation 596/2014, art. 7(1)(b), 2014 O.J. (L 173) 1, 24 (EU).

196. On the other hand, limiting materiality could provide unscrupulous investors with a roadmap to avoiding enforcement.

197. *See supra* note 72.

by the violation of a confidentiality agreement between a newspaper and its employees.¹⁹⁸ If a columnist trades on his stock recommendations before they are public, he would be liable under the misappropriation doctrine for deceptively violating his contract with the paper.

An expansive misappropriation doctrine is consistent with both the market integrity and property rights theories.¹⁹⁹ The supporter of market integrity would want to prohibit unequal access to information in a newspaper column that will certainly move markets. The supporter of property rights would see the exploitation of the contents of the column as the misappropriation of property.

Indeed, those two theories could support expanding insider trading liability beyond the misappropriation doctrine.²⁰⁰ If market integrity is the goal, then perhaps traders should have a general duty to the marketplace to refrain from trading while in possession of any important information.²⁰¹ If protecting property rights is the goal, then there is a case that the theft of sensitive information by a stranger with no duty of confidentiality would violate Rule 10b-5 if it is used to trade.²⁰²

198. In *Carpenter v. United States*, 484 U.S. 19 (1987), a *Wall Street Journal* column was the subject of a misappropriation analysis.

199. See, e.g., A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 48 (1998) ("The misappropriation theory protects more than just property rights in valuable information. It also protects the integrity of the stock markets and public confidence in those markets.").

200. This was an issue raised by trading on nonpublic information by members of Congress. While they may not owe fiduciary duties to investors, as Professor Sung Hui Kim has argued, government officials are governed by an anti-corruption norm that could provide a basis for finding their trading fraudulent under the misappropriation doctrine. See Sung Hui Kim, *The Last Temptation of Congress: Legislator Insider Trading and the Fiduciary Norm Against Corruption*, 98 CORNELL L. REV. 845 (2013).

201. See, e.g., Fisch, *supra* note 159, at 235 (arguing that "insiders owe a fiduciary duty to the market"); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1224-25 (1998).

202. In the *Dorzhko* case, the Second Circuit found that an outsider, a computer hacker, could misappropriate information when he stole a company's earnings report from a company computer. *SEC v. Dorzhko*, 574 F.3d 42, 44-46 (2009). The theft was characterized as fraudulent because the hacker misrepresented his identity. *Id.* at 51 ("[M]isrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."). Prominent scholars have questioned whether the case involved fraudulent conduct. See, e.g., Donald C. Langevoort, "Fine Distinctions" in *the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 458-60 (noting that "theft is typically neither a breach of fiduciary duty nor fraudulent"); see also John C. Coffee, Jr., *Introduction: Mapping the Future of Insider Trading Law: Of Boundaries, Gaps, and Strategies*, 2013 COLUM. BUS. L. REV. 281, 294 (noting that *Dorzhko* drew a "questionable line").

Under a disclosure theory, it is unclear why insider trading liability should be triggered by information that is not produced for regulatory purposes. A newspaper article could move markets, but it is not subject to securities disclosure requirements. If insider trading regulation is primarily concerned with maintaining the integrity of mandatory disclosure, corruption by reporters would be at best of second-order concern.

There is an argument that the misappropriation doctrine could be mainly limited to confidentiality agreements relating to information generated to comply with mandatory disclosure requirements.²⁰³ Thus, under an integrity of disclosure approach, an unpublished newspaper column or trading on information that Congress will pass market moving legislation, would not violate Rule 10b-5. Misappropriation unrelated to securities disclosure requirements could instead be

203. This is not a completely novel idea. In *Chiarella*, where the Supreme Court established a fiduciary duty theory of insider trading, attorneys for Chiarella attempted to distinguish between corporate information (such as earnings) and market information (such as the tender offers that Chiarella traded on). Chiarella argued that “unlike use of nonpublic ‘inside’ information, use of nonpublic ‘market’ information should not be regulated under Rule 10b-5.” Brief for the Petitioner, *Chiarella v. United States*, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 199452, at *36 (June 29, 1972). An amicus brief by the Securities Industry Association supported a distinction “between *inside* corporate information – the traditional subject of most Government and private actions under Rule 10b-5 – and *outside* market information.” Brief for Amicus Curiae of the Securities Industry Association, *Chiarella*, 445 U.S. 222 (No. 78-1202), 1979 WL 199456, at *11 (June 29, 1972). An author of this amicus brief, Arthur Fleischer, had written an article on such market information, which he defined as “information about events or circumstances which affect the market for a company’s securities but which do not affect the company’s assets or earnings power.” Arthur Fleischer, Jr., Robert H. Mundheim & John C. Murphy, Jr., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973). Chiarella thus argued that the equal access rule should only apply to certain types of information that would be subject to mandatory disclosure, but not other types of market information.

The Supreme Court’s opinion in *Chiarella* cited this distinction approvingly. It highlighted the fact that “the ‘market information’ upon which [Chiarella] relied did not concern the earning power or operations of the target company,” in concluding that Chiarella’s “use of that information was not a fraud under § 10(b)” *Chiarella*, 445 U.S. at 231. It also stated that “a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic *market information*.” *Id.* at 235 (emphasis added). The importance of this distinction was highlighted by the fact that Chief Justice Burger specifically addressed it in his dissenting opinion. He observed that the text of Section 10(b) and Rule 10b-5 does not distinguish between corporate and market information. *Id.* at 240 n.1 (Burger, C.J. dissenting); see also Brudney, *supra* note 144, at 331–32 (noting that the securities laws do not “distinguish between noncorporate and corporate information”). Though the lack of a fiduciary duty was determinative in overturning Chiarella’s conviction, the Court seemed to leave open the possibility that insider trading liability might hinge in part on the type of information that was traded on. *Chiarella*’s distinction between corporate and market information was later explicitly rejected by the Court, see *Dirks v. SEC*, 463 U.S. 646, 656 n.15, and insider trading law came to emphasize fiduciary duty.

regulated through other legal provisions. Federal mail fraud statutes, which broadly prohibit “any scheme or artifice to defraud,” might cover some misappropriation from sources other than the issuer.²⁰⁴ Broker-dealers, who often independently generate market moving information, are subject to rules relating to the misuse of “material, nonpublic information.”²⁰⁵

Such a reform might be too drastic given how misappropriation has become an accepted part of doctrine. It would also require difficult line-drawing that would leave the law unclear. Rather than abandon misappropriation, a more realistic solution might be for the SEC to de-emphasize it by limiting enforcement for trading on information that is not generated to comply with disclosure mandates.

3. THE REACH OF TIPPING LIABILITY

Rule 10b-5 only applies to fraudulent misconduct, and thus some selective disclosure and trading on mandatory disclosure is permitted by those without a legal duty to refrain from such trading.²⁰⁶ The limited scope of liability for an extensive tipping chain—where information is passed on from individual to individual so that the later recipients of the information have no duty that triggers Rule 10b-5—has been a source of frustration because it permits significant amounts of trading that would undermine the integrity of mandatory disclosure.

Under the *Dirks* test, a person who receives inside information from a tipper can only be liable under Rule 10b-5 for trading on that information if he knew or should have known that the information was conveyed in breach of a fiduciary duty.²⁰⁷ Such a breach typically requires that the tipper receive a “personal benefit” by passing on the information to the tippee.²⁰⁸ Thus, in *United States v. Newman*, the quarterly earnings numbers leaked by Dell’s head of investor relations to analysts and investors did not trigger liability under Rule 10b-5 because it was pursuant to corporate policy rather than for anyone’s personal benefit.²⁰⁹ Because of the prevalence of such selective disclosure, the Second Circuit held that “no rational jury would find that the tips were so overwhelmingly suspicious that [the defendants] either knew or consciously avoided knowing that the information came

204. 18 U.S.C. § 1341 (2012).

205. Securities Exchange Act of 1934, § 15(g), 15 U.S.C. § 78o(g) (2012).

206. 17 C.F.R. §240.10b-5 (2018).

207. *Dirks*, 463 U.S. at 660.

208. *Id.* at 662–63.

209. *United States v. Newman*, 773 F.3d 438, 454–55 (2014).

from corporate insiders or that those insiders received any personal benefit in exchange for the disclosure.”²¹⁰

Tipping liability becomes most complicated when the corporation is the tipper. The fiduciary duty framework of Rule 10b-5 is not a good fit for the context where a corporation decides it is in the best interest of the corporation to selectively disclose information. As noted earlier, there are many reasons why a corporation would want to cultivate relationships with investors and analysts. Such a relationship could be in the interest of shareholders. Of course, such a decision is now complicated by Regulation FD. Such selective disclosure could trigger sanctions (though the SEC does not often enforce the rule),²¹¹ and perhaps there is an argument that any violation of law by the corporation compromises the interests of shareholders.²¹²

Because the corporation’s decision to leak mandatory disclosure does not clearly trigger a breach of fiduciary duty, the *Dirks* test, which requires such a breach for there to be any tipping liability,²¹³ may not apply. That test proceeds on the assumption that a corporate officer disseminates corporate information without permission for his own selfish purposes.²¹⁴ It does not clearly address the more complicated context where the corporation is the disseminator of information.

Though it does not breach a fiduciary duty, it is clear that selective disclosure of periodic reports by a corporation undermines the integrity of mandatory disclosure.²¹⁵ If companies routinely leak earnings numbers, favored investors will be able to easily profit from their knowledge of the company’s short-term results. Prosecutors and some commentators have thus sought to extend the reach of tipping liability.

One potential solution to the inability of Rule 10b-5 to reach such corporate tipping would be to pass a statute prohibiting trading on non-public earnings information.²¹⁶ Such an approach seems to have been

210. *Id.* at 455.

211. *See, e.g.*, Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Assymetry*, in RESEARCH HANDBOOK ON INSIDER TRADING 112, 129 (Stephen Bainbridge ed., 2013) (describing SEC’s strategy under Regulation FD).

212. *See, e.g.*, Nagy, *supra* note 179.

213. *Dirks*, 463 U.S. at 647.

214. *Id.* at 660–61.

215. There is some evidence that after the Second Circuit narrowed the scope of tipping liability in *Newman*, insider trading on merger announcements increased. *See* Menesh S. Patel, Does Insider Trading Law Change Behavior? An Empirical Analysis (Sept. 29, 2017) (unpublished draft), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3044118.

216. *See, e.g.*, Peter J. Henning, *What’s So Bad About Insider Trading Law?*, 70 BUS. LAW. 751, 773–75 (2015); Stephanie Russell-Kraft, *Rakoff Calls for Clear Statute to Define Insider Trading*, LAW360 (Mar. 20, 2015, 4:57 PM), <http://www.law360.com/articles/633008/rakoff-calls-for-clear-statute-to-define-insider-trading> (last visited Oct. 20, 2018); *see also* Miriam H. Baer, *Insider Trading’s*

successful with respect to trading on material information concerning a tender offer, which is prohibited by SEC Rule 14e-3.²¹⁷ A disclosure statute would have the benefit of increasing the reach of insider trading regulation to all individuals who trade on selectively disclosed earnings information. The disadvantage is that such a statute might be too disruptive given the significant number of market participants that attempt to anticipate a company's earnings reports. It might thus be better to retain the current framework which tends to limit the most serious sanctions to individuals who trade in violation of a duty.

Another possibility would be to enforce Regulation FD more vigorously. If a corporation is likely to incur costs when selectively disclosing quarterly disclosure, it might be deterred from doing so. Such a policy though would not affect those individuals who obtain and trade on such information.

A final possibility would be to minimize or perhaps eliminate the *Dirks* personal benefit requirement. Scholars have extensively debated this issue.²¹⁸ An important Second Circuit decision took a very different view of tipping liability than *Newman* in light of the Supreme Court's decision in *Salman v. United States*.²¹⁹ In *United States v. Martoma*,²²⁰ the Second Circuit held that gifting information to even a stranger can trigger liability if the insider "discloses inside information to someone *he expects will trade on the information*," so long as the transaction "resemble[s] trading by the insider followed by a gift of the profits to the recipient."²²¹ The Second Circuit later clarified in an amended opinion that the personal benefit requirement could be satisfied if there was an "intent to benefit" the tippee.²²² It explained that "a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it."²²³

Legality Problem, YALE L.J. FORUM 129 (2017) (arguing that a statute could better differentiate between types of misconduct).

217. 17 C.F.R. § 240.14e-3 (2018).

218. Compare Epstein, *supra* note 2, and Guttentag *supra* note 179, and Schipani & Seyhun, *supra* note 191 (arguing that personal benefit should not be a requirement for tipper liability), with A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015) (arguing that personal benefit requirement is consistent with *Dirks*).

219. 137 S. Ct. 420 (2016).

220. 869 F.3d 58 (2d Cir. 2017), *opinion amended and superseded*, 894 F.3d 64 (2d Cir. 2017).

221. *Id.* at 71 (quoting *Salman*, 137 S. Ct. at 427).

222. 894 F.3d at 74.

223. *Id.* at 79.

Though it is too early to know how this standard will be applied by the courts, it appears to adopt a broader view of personal benefit. Some additional forms of selective disclosure of mandatory disclosure information by corporate insiders could be covered by this test. For example, an insider who selectively discloses information to develop ties with investors to further his career might be liable under *Martoma* but not under *Newman*, which required “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similar nature.”²²⁴ The Second Circuit’s change in course may have been motivated by the concern that narrow tipping liability would unduly hinder regulation of trading on mandatory disclosure information.

B. Enforcement Priorities

Even when doctrine is not entirely clear, enforcement policy can effectively limit the reach of insider trading law. If the primary purpose of insider trading regulation is to protect the integrity of the mandatory disclosure system, enforcement efforts should focus on cases where there is clear evidence of improper trading on mandatory disclosure information.

To some extent, federal prosecutors already view themselves as policing the integrity of trading on the most sensitive information. For example, the former U.S. Attorney for the Southern District of New York, Preet Bharara, argued that “there is some core of material nonpublic information that is so material and relevant and market-moving that people shouldn’t be able to take advantage of that over the average investor, and I think most people would agree with that and those are the kind of cases that we brought.”²²⁵

Enforcement policy might distinguish between trading on different types of disclosure.²²⁶ Sanctions for insider trading violations could differ based on whether mandatory or voluntary disclosure information is involved. Criminal prosecution for insider trading, which requires a showing of “willful” violation of the securities laws,²²⁷ should be largely limited to cases involving trading on mandatory disclosure

224. *Newman*, 773 F.3d at 452.

225. Jeffrey Toobin, *The Showman*, NEW YORKER, May 9, 2016, at 36, 40.

226. Alternatively, a legislature could better define the boundaries of that discretion by passing an insider trading statute. *See, e.g.*, Baer, *supra* note 216, at 147 (arguing for statutory gradations that prosecutors could apply to differentiate between types of insider trading).

227. Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (2012). A violation is willful if it is “done intentionally and deliberately” and is not “the result of innocent mistake, negligence or inadvertence.” *United States v. Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976).

information.²²⁸ Civil sanctions such as penalties or disgorgement would be more appropriate for trading on information that would not clearly allow the prediction of the contents of mandatory disclosure reports. Some cases where the nature of the information is especially unclear might even trigger a warning rather than a monetary payment.²²⁹

CONCLUSION

This Article has made the case that insider trading regulation is best understood in the context of public company disclosure regulation. As disclosure requirements have expanded and become more demanding, insider trading has become increasingly inconsistent with efforts to provide access to the most reliable information for all investors. Because U.S. securities regulation relies on periodic disclosure, there are opportunities for insiders and others to take advantage of regulatory delay. Insider trading undermines the basic purpose of such disclosure, to provide investors with equal access to the most important company developments. Selective disclosure of information that allows prediction of short-term results is most likely to undermine the integrity of mandatory disclosure. Rather than police all trading that affects market integrity and property rights, insider trading regulation should focus on ensuring equal access to the information an issuer files to satisfy disclosure mandates.

228. On the role of criminal prosecutors in enforcing the securities laws, see James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 154–57 (2012).

229. For example, the SEC has not imposed fines in some Regulation FD cases. See, e.g., *Raytheon Co. and Franklyn A. Caine*, Exchange Act Release No. 34-46897, 78 SEC Docket 2851 (Nov. 25, 2002).