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From Equality to Duty: On Altering the Reach, Impact, and Meaning of the Texas Gulf Legacy

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FROM EQUALITY TO DUTY: ON ALTERING THE REACH, IMPACT, AND MEANING OF THE TEXAS GULF LEGACY

Lisa M. Fairfax*

ABSTRACT

As the first federal court decision to hold that insider trading represented a violation of the federal securities laws, the historical importance of SEC v. Texas Gulf Sulphur Co. is clear. However, its current relevance may not be so clear. This is because while there are some aspects of Texas Gulf that have endured and remain a fixture of federal insider trading jurisprudence, the Supreme Court has firmly repudiated the normative rationale for insider trading articulated by Texas Gulf. This essay contends that this repudiation has important descriptive and normative implications. Perhaps most importantly, this essay contends that Texas Gulf continues to be important because of this repudiation. The rejection of the normative rationale underlining Texas Gulf serves as an important reminder that legal doctrine is not the product of inevitability, but of deliberate choices. It is also a reminder that theory matters. Theory shapes the choices we make and the evolution of doctrine that stems from those choices. Without appreciating the significance of the rejected normative theory that is Texas Gulf, current students and consumers of insider trading law may view securities law, and the regime it support, as value-neutral. Instead, Texas Gulf represents a critical reminder that our securities regime is in fact a dynamic reflection of values accepted and values rejected.

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THE historical importance of *SEC v. Texas Gulf Sulphur Co.*¹ (Texas Gulf) is clear and undeniable. It is the first federal court decision to hold that insider trading represents a violation of the federal securities laws.² It is the first federal court to articulate the elements necessary to demonstrate an insider trading violation. It is the first federal court to pinpoint a normative rationale for holding those who violate the insider trading laws liable for engaging in securities fraud.

However, its current relevance may not be so clear. Indeed, many law professors do not even teach *Texas Gulf*. Indicative of this trend, the most recent edition of the Corporations casebook from which I teach does not even include *Texas Gulf*.

To be sure, there are some aspects of *Texas Gulf* that have endured and remain a fixture of our insider trading jurisprudence. The Supreme Court continues to embrace the definition of non-public information articulated in *Texas Gulf* as one of the necessary elements for insider trading. The Supreme Court not only adopted the *Texas Gulf* framework for materiality for all insider trading cases, but also adopted the *Texas Gulf* materiality framework for all forms of federal securities fraud.³

By sharp contrast, the Supreme Court has firmly repudiated the normative rationale for insider trading articulated by *Texas Gulf*. In establishing the insider trading standards, *Texas Gulf* clearly relied upon the normative presumption that the primary, if not exclusive, objective of the federal anti-fraud provision was to ensure equitable access to material information.⁴ The *Texas Gulf* court then reasoned that the primary, if not exclusive, objective of the insider trading laws should be to ensure equitable access to material information. When the Supreme Court had the opportunity to theorize insider trading, it shifted gears, embracing a theory that repudiated the reasoning in *Texas Gulf*. As a result, many aspects of our current insider trading jurisprudence bear very little resemblance to insider trading as defined by *Texas Gulf*.

1. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

2. In 1909, the Supreme Court did hold that a director of a corporation must abstain from trading or disclose before trading on privileged information. *See Strong v. Repide*, 213 U.S. 419, 430–33 (1909). However, that case predated enactment of the federal securities laws in 1933 and 1934.

3. *See generally* Basic v. Levinson, 485 U.S. 224 (1988).

4. *See Texas Gulf*, 401 F.2d at 849, 851–52.

This essay contends that this shift has important descriptive and normative implications. Perhaps most importantly, this essay contends that *Texas Gulf* continues to be important *because* of this shift. The shift serves as a reminder that legal doctrine is not the product of inevitability, but of deliberate choices. It is also a reminder that theory matters. Theory shapes the choices we make and the evolution of doctrine that stems from those choices. Without appreciating the significance of the rejected normative theory that is *Texas Gulf*, current students and consumers of insider trading law may view securities law and the regime it supports as value-neutral. *Texas Gulf* reminds us that our securities regime is in fact a dynamic reflection of values accepted and values rejected.

I. FROM EQUALITY TO DUTY

A. ESTABLISHING THE EQUAL ACCESS PRINCIPLE

For those in the securities law community, the facts of *Texas Gulf* are exceedingly familiar. Those facts stem from the discovery by the Texas Gulf Sulphur Company (TGS) of one of the largest copper and zinc ore deposits in history. In March 1959, four TGS employees conducted aerial geophysical surveys spanning more than 15,000 miles of land in Canada. The surveys revealed extraordinary variations in the rock formations, prompting a ground geophysical survey in October 1963 and the drilling of an initial hole in November, 1963. The visual and eventual chemical testing of the hole was so remarkable that TGS decided to acquire the land surrounding the hole, directing its employees to keep information about the hole confidential. TGS completed the land acquisition program in March, 1964 and then drilled several additional holes. By early April, 1964, that drilling confirmed a major ore find. When rumors began circulating about the find, TGS initially issued a press release that essentially denied the rumors, but three days later, on April 16, 1964, TGS confirmed the find of millions of tons of ore at a major press conference. Beginning in November, 1963 through the day of the April 16 press conference, various TGS directors, officers, and employees not only purchased TGS stocks and calls, but also recommended such purchases to other people who purchased TGS stocks and calls. During that same time period, TGS stock began to steadily climb, moving from \$17 ³/₈ a share to a high of \$37 a share on April 16. By May, TGS stock was trading at \$58 ¹/₄ a share.

Thereafter followed the genesis of the federal court's theoretical and descriptive articulation of the insider trading doctrine. The Securities and Exchange Commission (the SEC) brought suit against various TGS directors, officers, and employees in the Second Circuit under § 10b and Rule 10b-5 of the Securities Exchange Act of 1934. § 10b makes it unlawful to use any "manipulative or deceptive device" in connection with the purchase or sale of a security.⁵ Similarly, Rule 10b-5, promulgated under

5. See 15 U.S.C. § 78(j) (2012).

§ 10b, makes it unlawful to employ any “device, scheme or artifice to defraud” in connection with the purchase or sale of a security.⁶ In bringing suit against the TGS defendants, the SEC contended that Rule 10b-5 should be interpreted to prohibit trading on the basis of material, non-public information—i.e., insider trading. The Second Circuit agreed. In so doing, the Second Circuit became the first federal court to not only hold that insider trading represented a violation of the federal securities laws, but also to articulate the core elements and normative rationale for such a violation.⁷

The Second Circuit devoted considerable attention to the factors needed to prove that information being traded upon implicated the insider trading prohibition. In order to be held liable for insider trading, it must be proven that such information is both material and non-public. With respect to materiality, the Second Circuit adopted a two-step analysis still in existence today. First, the court stated that the basic test for materiality was whether a reasonable investor would attach importance to the information.⁸ Second, the court stated that when such information is contingent, materiality would be measured by balancing the probability of the event occurring with its anticipated magnitude.⁹ With respect to the non-public nature of the information, the court concluded that information should be deemed non-public so long as the information was not made widely available to the investing public.¹⁰

In addition to pinpointing these standards, the Second Circuit articulated a rationale for determining *who* should be liable for trading on the basis of material, non-public information. Importantly, in 1909—and therefore prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934—the Supreme Court concluded that a corporate insider could not use privileged, undisclosed information for his own profit.¹¹ However, the Court did not clearly address the issue of who should be considered an insider.¹² Thus, the Second Circuit was the first federal court to devote attention to this issue, particularly in the context of the federal securities acts.¹³

In the Second Circuit’s view, congressional and regulatory intent revealed that the primary, if not sole, objective of Rule 10b-5 was to ad-

6. See 17 C.F.R. § 240.10b-5 (2017).

7. *Texas Gulf* also included rulings on insider trading in the context of the issuance of stock options as well as federal securities fraud related to the disclosure of misleading information in the TGS press release. This article focuses on insider trading and thus does not reach analysis of these aspects of the *Texas Gulf* opinion.

8. *Texas Gulf*, 401 F.2d at 849.

9. *Id.*

10. *Id.* at 854.

11. See *Strong v. Repide*, 213 U.S. 419, 419 (1909).

12. See *id.*; see also *Major Decisions in Insider Trading Law*, N.Y. TIMES (Nov. 17, 1987), <https://www.nytimes.com/1987/11/17/business/major-decisions-in-insider-trading-law.html>.

13. The SEC did consider this issue in an administrative decision. See *infra* note 20 and accompanying text.

dress concerns related to equal access to material information.¹⁴ The court based its view primarily on analysis of the legislative history of the federal securities acts. After reviewing that history, the court concluded: “The core of Rule 10b-5 is the implementation of the congressional purpose that all investors should have equal access to the rewards of participation in securities transactions.”¹⁵ In the Second Circuit’s view, equal access was critical not only because it ensured that individuals traded with similar risks,¹⁶ but also that individuals did not gain an unfair advantage in the marketplace because they had access to information intended to be available for a corporate purpose but then used for a personal benefit.¹⁷ Either result would have a negative impact on the markets by reducing investors’ willingness to participate and by increasing unfairness in securities transactions.

The Second Circuit also interpreted the SEC’s administrative opinion as supporting an equal access theory. In *In re Cady, Roberts & Co.*,¹⁸ the SEC issued an administrative decision where it decided for the first time that insider trading represented a violation of the federal securities laws. *Texas Gulf* not only confirmed that decision, but also interpreted that decision as an endorsement of the equal access rationale.¹⁹ In the Second Circuit’s view, *In re Cady, Roberts & Co.* confirmed that “[t]he *only* regulatory objective [of Rule 10b-5] is that access to material information be enjoyed equally.”²⁰

The Second Circuit reasoned that the equal access theory had particular relevance to insider trading. Those trading on material, non-public information were trading with significantly fewer risks, particularly the risks that one’s capacity to evaluate a securities transaction would be relatively lower than others with access to material, non-public information.²¹ Also, those trading on material, non-public information enjoyed an unfair advantage because their trading activity was based on access rather than education, research, or ingenuity. With these concerns in mind, the Second Circuit premised its insider trading theory entirely on this concept of equal access.

The Second Circuit’s equal access rationale guided its decision regarding who could be held liable for insider trading. Because of their unequal access, the Second Circuit found that all of the corporate insiders (TGS directors, officers, and employees) should be found liable to the extent that they had traded while in possession of material information undisclosed to the public. The Second Circuit also concluded that those insiders who recommended the securities to others on the basis of material

14. See *Texas Gulf*, 401 F.2d at 849.

15. *Id.* at 851–52.

16. See *id.* at 852.

17. See *id.* at 848.

18. 40 S.E.C. 907 (1961).

19. See *Texas Gulf*, 401 F.2d at 848.

20. See *id.* at 849 (emphasis added).

21. See *id.* at 852.

information undisclosed to the public should be liable, because such recommendation afforded others with unequal access. In the court's view a tipper (someone who recommends/passes material, non-public information) could be liable because such tipper passed information that resulted from unequal access. Importantly, the court made clear that its holding extended beyond corporate insiders such as directors, officers, and employees. Thus, the Second Circuit stated that "anyone" in possession of material, non-public information must either disclose such information to the investing public, or abstain from trading while such information remained undisclosed.²² This "disclose or abstain" rule also applied to recipients of material, non-public information. Hence, the court appeared willing to hold tippees (people who trade based on passed information) liable based on this equal access theory. In the court's view, so long as the tippees traded with actual or constructive knowledge that the material information on which they traded was undisclosed, the tippees could be held liable for insider trading.²³ The court suggested that by trading on material, non-public information that resulted from inappropriate access, the tippees could be deemed to have engaged in conduct "equally as reprehensible" as the corporate insiders.²⁴

The court's equal access theory explicitly did not depend on how the access was obtained or the relationship from which such access was obtained. "Whether predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine, . . . the Rule is 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."²⁵ As this language suggests, the court's theory did appear to give significant weight to the relationship between corporate insiders and shareholders. The court also did not address a relationship, or lack thereof, in the context of tippers and tippees. Instead, the courts pronouncement that liability could be extended to "anyone" eliminated any need to focus on specific relationships.

The notion that the insider trading rules were premised on equal access appeared to be held universally by all of the *Texas Gulf* judges. Three judges dissented in *Texas Gulf*. The dissent by Judge Hays began with an explicit statement of agreement with the majority's views as to the "proper interpretation of § 10(b) and Rule 10b-5 and as to the standards which are to be employed in the application of the statute and the rule."²⁶ The other dissent (by Judge Moore with whom Chief Judge Lombard concurred) did not dispute or otherwise even discuss the equal access theory. The Moore dissent focused primarily on the issue of materiality, and thus disagreed with the majority's holding with respect to TGS individuals for whom the dissent believed the materiality concept had been inap-

22. *See id.* at 848.

23. *Id.* at 853.

24. *Id.*

25. *Id.* at 848.

26. *Id.* at 869 (Hays, J., dissenting).

propriately applied. Importantly, the dissent concurred with the majority's holding with respect to three TGS directors and employees.²⁷ Because that holding rested on the equal access theory, the dissent's concurrence suggests that the dissent had no quarrel with the equal access theory or its application.

B. THE SUPREME COURT STRIKES BACK

When the Supreme Court finally weighed in on insider trading and its contours under Rule 10b-5, it would firmly repudiate the equal access theory in favor of one that centered on the necessity of a fiduciary duty or fiduciary-like relationship. In three critical decisions, the Supreme Court outlined the elements necessary to establish insider trading violations, as well as the theory that animated those elements.

1. *Strike One: Chiarella and the Traditional Insider*

*Chiarella v. United States*²⁸ was the Supreme Court's first opportunity to address insider trading under Rule 10b-5. In that case, Vincent Chiarella was the employee of a financial printer. The financial printer had been hired to print corporate takeover documents by a company contemplating a takeover of several companies. Although the names of the target companies were concealed, Chiarella was able to deduce the names. Without disclosing his knowledge, Chiarella purchased stock in each of the target companies. Once the takeover attempts were made public, Chiarella sold his stock and made some \$30,000. Among other violations, Chiarella was indicted and convicted for insider trading under Rule 10b-5. Chiarella appealed his conviction.

Justice Powell, writing for the *Chiarella* majority, insisted that any insider trading liability had to be premised on the breach of a fiduciary duty or a similar relationship of trust and confidence.²⁹ Thus, Powell reasoned that in order to be held liable for insider trading, a relationship must exist between the trader and the corporation in which she trades.³⁰ Guided by this reasoning, the *Chiarella* majority overturned Chiarella's conviction because it was based on a theory that did not require, and hence did not identify, a relationship between Chiarella and the shareholders of the target companies.³¹ Pointing out that Chiarella was a "complete stranger" to such shareholders, the Court concluded that it could not affirm his conviction for insider trading.³²

The *Chiarella* majority barely acknowledged *Texas Gulf*. In fact, the decision only explicitly referred to *Texas Gulf* once. The reference was done in relation to the relatively non-controversial proposition that prior

27. *Id.* at 888 (Moore, J., dissenting).

28. 445 U.S. 222 (1980).

29. *Id.* at 230.

30. *Id.* at 227.

31. *Id.* at 232.

32. *Id.* at 232-33.

cases had found insider trading liability where corporate insiders had used undisclosed information for their personal benefit.³³

Nonetheless, the Supreme Court's decision was a clear repudiation of *Texas Gulf* and its equal access concept. From a process standpoint, the *Chiarella* decision arose in the Second Circuit. The Second Circuit opinion, which the Supreme Court overturned, was written by a judge who had concurred in the core reasoning and majority opinion in *Texas Gulf*.³⁴ As a substantive matter, the Second Circuit opinion relied upon *Texas Gulf* for its normative reasoning and ultimate holding. That opinion re-confirmed *Texas Gulf's* theoretical framework of equal access and made clear that such framework was not dependent on any relationship or duty. Emphasizing this point, the Second Circuit opinion opens with the following pronouncement: "The draftsmen of our nation's securities laws, rejecting the philosophy of [c]aveat emptor, [c]reated a system providing equal access to the information necessary for reasoned and intelligent investment decisions."³⁵ The Second Circuit opinion reasoned that insider trading did not depend on the existence of a fiduciary relationship and thus *Chiarella* could and should be held liable based on the fact that he had access to material, non-public information and he used that information improperly.³⁶ The *Chiarella* majority rejected this reasoning. Finally, the dissent in *Chiarella* explicitly relied on *Texas Gulf* in seeking to refute the majority's reasoning.³⁷ Hence, the *Chiarella* majority was well aware of *Texas Gulf* and its reasoning; its refusal to give *Texas Gulf* any weight was a clear repudiation.

The repudiation was perhaps made worse by the majority's failure to acknowledge the prominence of *Texas Gulf*. In the minds of many, *Texas Gulf* had been the "pre-eminent insider trading rule" for at least a decade.³⁸ Yet the *Chiarella* majority claimed there was no judicial authority for the equal access principle.³⁹ In so doing, the majority opinion cited other federal circuits to support its view that insider trading required a relationship.⁴⁰ Hence, the Supreme Court was willing to rely on other federal circuits (and even state courts)⁴¹ for judicial precedent—just not the one circuit that had set the stage and tone for insider trading.

33. *See id.* at 229.

34. The Second Circuit opinion in *Chiarella* was written by Chief Judge Kaufman. *United States v. Chiarella*, 588 F.2d 1358, 1362 (2d Cir. 1978). Kaufman, as a Circuit Judge, had concurred in the *Texas Gulf* opinion, except for its findings related to injunctive relief. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 869 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

35. *Chiarella*, 588 F.2d at 1362.

36. *Id.* at 1369.

37. *Chiarella v. United States*, 445 U.S. 222, 250 (1980) (Blackmun, J., dissenting).

38. *See* Kurt A. Hohenstein, *Fair to All People: The SEC and the Regulation of Insider Trading*, SEC HISTORICAL SOCIETY (Nov. 1, 2006), <http://www.sechistorical.org/museum/galleries/it/> [<https://perma.cc/9HQN-F38H>].

39. *See Chiarella*, 445 U.S. at 233.

40. *See id.* at 229, 230–31 (and accompanying footnotes).

41. *See id.* at 228–29 (citing Delaware court decisions).

2. Strike Two: O'Hagan and the Misappropriation Theory

In *United States v. O'Hagan*,⁴² the Supreme Court articulated a new theory related to insider trading liability. James O'Hagan was a law firm partner. His law firm had been hired by Grand Metropolitan PLC (Grand Met) to represent them in a potential tender offer for the Pillsbury Company (Pillsbury). Although O'Hagan did no work for Grand Met, O'Hagan learned of the potential tender offer and purchased stocks and calls in Pillsbury. When the tender offer was eventually announced, O'Hagan sold his interest in Pillsbury and made more than \$4.3 million in profit.⁴³ The SEC brought suit against O'Hagan for violations of numerous securities laws, including Rule 10b-5. O'Hagan was convicted and sentenced to prison, but the Eighth Circuit overturned the conviction. In the Eighth Circuit's view, O'Hagan was similar to Chiarella because O'Hagan had no relationship with the company in whose stock he traded, and thus seemed to have no duty on which his liability could be premised.

The Supreme Court embraced a new theory—the misappropriation theory—to find O'Hagan liable for insider trading. While agreeing that O'Hagan had no relationship, and thus no duty, to the company in whose stock he traded, the Court disagreed that the lack of that specific relationship prohibited a finding of liability.⁴⁴ Instead, the Court found that because O'Hagan had a relationship of trust and confidence with the source of his information (his law firm and its client Grand Met), he could be held liable for breaching that relationship and thus for engaging in insider trading.⁴⁵

While the Supreme Court announced a new theory of liability, that theory was firmly rooted in an embrace of the relationship principle and a corresponding rejection of the equal access principle. The Supreme Court began its discussion of liability by reconfirming its holding that a violation of Rule 10b-5 requires a violation of a fiduciary relationship or a similar relationship of trust and confidence. It then noted that the relationship in *Chiarella* involved a fiduciary relationship between shareholders and other insiders in the corporation or those such as attorneys, accountants and consultants who temporarily become fiduciaries of the corporation.⁴⁶ However, the Court concluded that relationships forming the basis of insider trading liability could be established in other ways.⁴⁷ It further noted that *Chiarella* had explicitly left open this possibility.⁴⁸ Thus, the Court expanded its theory of liability to include other forms of relationships of trust and confidence, while continuing its requirement that liabil-

42. 521 U.S. 642 (1997).

43. *Id.* at 648.

44. *Id.* at 661.

45. *Id.* at 652.

46. *Id.*

47. *Id.* at 661.

48. *Id.* at 661–62. According to the Court, *Chiarella* did not hold that “the *only* relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders.” *Id.* at 661 (emphasis added).

ity must be premised on some relationship.⁴⁹ This requirement explicitly rejected any notion that liability could arise without such relationship, and thus implicitly rejected the equal access theory, which contemplated such liability.

3. *Strike Three: Dirks and Tipper/Tippee Liability*

Dirks v. SEC,⁵⁰ decided before *O'Hagan*, was the Supreme Court's first opportunity to opine on the parameters of the insider trading rules as applied to those who pass information (tipplers) as well as those who trade on the basis of such passed information (tippees). In that case, Ronald Secrist, a former officer of Equity Funding of America (Equity), told Raymond Dirks, an analyst at a New York broker-dealer, that Equity was engaging in massive amounts of securities fraud. Secrist urged Dirks to verify the fraud and make it public. Dirks began investigating by interviewing various officers and employees of Equity, many of whom denied the fraud. Dirks also contacted members of the media, but they were reluctant to publish a story without significant confirmation of the fraud. As rumors began circulating, the SEC launched its own investigation of the fraud and eventually filed a complaint against Equity. During the period of Dirks' activities, and before information about the fraud was publicly disclosed, Dirks informed several of his clients about the fraud and those clients sold their holdings in Equity, saving some \$16 million. The SEC brought suit against Dirks under Rule 10b-5 for passing material, non-public information to his clients, and he was ultimately found liable. When the D.C. Circuit affirmed the finding, Dirks appealed.

Dirks anchored insider trading liability for tipplers and tippees to relationships. In the very first paragraph of *Dirks*, the Supreme Court explained the facts by noting that Dirks "had no connection" to the company in whose stock was being traded, appearing to lay the groundwork for the core issue—can liability be imposed without such a connection?⁵¹ The Court answered in the negative, eventually stating that *Dirks* represented the Supreme Court's reaffirmation that insider trading liability arises from a relationship between parties.⁵² The *Dirks* court then announced a two-prong framework for analyzing tipper/tippee liability. First, a tipper must pass material, non-public information in violation of a fiduciary duty or similar relationship, which the Court defined as passing for a personal benefit.⁵³ Second, when the tippee trades on such information, it must be proven that the tippee knew or should have known that the information was passed in violation of such relationship.⁵⁴ Importantly, the Court emphasized that a tippee cannot be held liable unless the tipper is held liable based on the tipper's pass in violation of a rela-

49. *See id.*

50. 463 U.S. 646, 649–62 (1983).

51. *See id.* at 648.

52. *Id.* at 657–58.

53. *Id.* at 662.

54. *Id.* at 660.

tionship.⁵⁵ In this way, in contrast to *Texas Gulf* in which the Second Circuit seemed prepared to hold tippees liable so long as they knew that the information on which they traded was material and non-public, the *Dirks* Court made clear that liability, even in the tipper/tippee context, depended upon the violation of some relationship.

The *Dirks* court, like the *Chiarella* court, firmly rejected the equal access theory. The *Dirks* court cited with approval courts who had since noted that *Chiarella* had “repudiat[ed] any notion” that traders should enjoy some form of equality of access to information.⁵⁶ The Court also rejected the SEC’s theory of liability for *Dirks* because it was rooted in concepts of equal access.⁵⁷

II. JUSTIFYING THE SHIFT

Importantly, as *Chiarella* reveals, the Supreme Court never expressly acknowledged a shift in insider trading jurisprudence because it never officially acknowledged the relevance or prevalence of *Texas Gulf*. However, it did justify its rejection of the equal access theory in favor of fiduciary duty in several ways. This section examines that justification.

A. INCLUSION

The Supreme Court indicated that the equal access theory was over-inclusive because it would impose insider trading liability on those who traded or passed on material information for legitimate purposes. In both *Chiarella* and *Dirks*, the Court pointed out the SEC had recognized that some market participants must engage with material, non-public information, and that such engagement is necessary to the healthy functioning of the market.⁵⁸ The Court not only insisted that the market relied on analysts and other market participants to “ferret out” and analyze material, non-public information, but also that the ability to rely on such actions would be compromised if such information always had to be simultaneously shared with shareholders and the public.⁵⁹ In this regard, the equal access theory, which would presumably prevent these actions, would prove problematically overbroad. In *Dirks*, the Court also reasoned that some “may mistakenly think the information already has been disclosed or that it is not material enough to affect the market.”⁶⁰ Additionally, as the Court believed was the case with *Dirks*, some may pass information with the desire to expose fraud, and thus for a purpose that should not be viewed as improper. Because the equal access theory would capture such individuals, its reach is overbroad and hence inappropriate.

55. *See id.*

56. *See id.* at 657.

57. *Id.*

58. *Id.* at 657–59; *Chiarella v. United States*, 445 U.S. 222, 233–34 (1980).

59. *Dirks*, 463 U.S. at 658–59; *Chiarella*, 445 U.S. at 233–34.

60. *Dirks*, 463 U.S. at 662.

On the one hand, over-inclusion is clearly a problem. Indeed, over-inclusion is always a concern, particularly if it impedes the appropriate functioning of our markets. The dissent indicates that the equal access rule, at least on the surface, appears to apply to individuals regardless of intent, even if the intent is legitimate and appropriate. Hence, even the dissent acknowledges that the equal access theory focuses on “actions and their consequences” rather than on motives.⁶¹ As a result, the dissent appears to acknowledge that the theory would apply to Dirks even if he had passed information only to executives and other officials with the sole aim of rooting out fraud. This fact validates the concern regarding over-inclusion.

On the other hand, the dissent argues that applying the equal access theory to Dirks would not have reflected an example of over-inclusion. In the dissent’s view, Dirks could have achieved his goal of exposing fraud and simultaneously refrained from passing non-public information in a manner intended to result in the trading of such information.⁶² Instead, Dirks chose to share material information with his clients prior to its public disclosure so that those clients could take advantage of that information.⁶³ In this regard, Dirks’s selective disclosure gave some shareholders an unfair advantage, allowing them to profit based on their inequitable access.⁶⁴ The dissent argued that the insider trading laws not only should prohibit such shareholders from profiting based on that inequitable access, but also should prohibit tippers like Dirk from passing, particularly when such passing was done with the aim of facilitating such profits.⁶⁵

Then too, it seems relatively clear that the fiduciary duty rule is under-inclusive. Indeed, the Supreme Court explicitly acknowledged the under-inclusiveness of the fiduciary duty rule. In *O’Hagan*, for example, the Court noted that too often problems of proof could prevent a showing of violation of fiduciary duty even in cases where such violation most likely occurred.⁶⁶ This acknowledgement demonstrates that the application of such a principle could result in the failure to hold liable those individuals who do in fact trade or pass material information in breach of a duty. This acknowledgement, however, also suggests that the Supreme Court was willing to accept the risks posed by under-inclusion as opposed to the risks posed by over-inclusion.

61. *See id.* at 674 (Blackmun, J., dissenting).

62. *See id.* at 676–77 (Blackmun, J., dissenting).

63. *Id.*

64. *See id.* at 670.

65. *Id.* at 677–78.

66. *United States v. O’Hagan*, 521 U.S. 642, 676 (1997). As the court acknowledges, “it is a fair assumption that trading on the basis of material, non-public information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives.” *Id.*

B. COHERENT LINE-DRAWING

The Court expressed serious concern that insider trading liability premised on the equal access theory would make line drawing difficult and incoherent. *Texas Gulf* indicates that the equal access theory applies to “anyone” that passes or trades material, non-public information. As noted above, this formulation appears overbroad and thus is likely to capture people and actions not intended to be included. Even advocates of the equal access theory—including members of the Second Circuit and those who concurred in the *Texas Gulf* decision—seem to agree that a theory applying insider trading laws to “anyone” would be too broad, and thus that standards must be developed to distinguish between those whose actions run afoul of the equal access theory and those whose do not. Hence, advocates of the equal access theory made efforts to formulate such standards.⁶⁷ The Supreme Court was unimpressed with those efforts.⁶⁸ Thus, the Court repeatedly raised concerns regarding the extent to which a theory premised on parity of information could (and as a normative matter *should*) distinguish between those who properly had material, non-public information, and those who did not.⁶⁹

To be sure, it is relatively clear that premising insider trading liability on concepts of fiduciary duty or relationships does not eliminate the line drawing problem. In fact, the Supreme Court specifically acknowledged the difficulties with line drawing posed by its relationship requirement. Thus, the Court noted that the “requirement of a specific relationship between the shareholders and the individual trading on inside information has created analytical difficulties for the SEC and courts”⁷⁰ Our current efforts at line drawing in the realm of remote tippees underscores the validity of this concern, while revealing that the concern reflects a long-standing feature of our insider trading jurisprudence. The continued problems with line-drawing suggest that to the extent the imposition of the fiduciary duty standard was designed to ensure better line-drawing, that assurance has proved to be elusive. In this regard, to the extent the Court’s rejection of the equal access theory was based on concerns about line drawing, that rejection appears questionable especially given that the rejection occurred in the face of the Court’s clear acknowledgement that line drawing would persist regardless of the insider trading theory adopted.

C. CONGRESSIONAL INTENT

The Supreme Court also insisted that the equal access theory was not consistent with congressional intent. To this end, the Court repeatedly

67. See *United States v. Chiarella*, 588 F.2d 1358, 1365–66 (2d Cir. 1978) (suggesting a test that would only apply to those with regular access to market information).

68. See *Chiarella v. United States*, 445 U.S. 222, 231–32 (1980) (and accompanying footnotes).

69. See *O’Hagan*, 521 U.S. at 656.

70. *Dirks v. SEC*, 463 U.S. 646, 655 (1983).

pinpointed the lack of any specific legislative history or statutory language in Rule 10b-5 requiring adoption of an equal access theory.⁷¹ The Court believed that the breadth of the equal access theory required specific congressional intent mandating adoption of the theory and hence found the lack of such intent to be a significant barrier.

The Court appeared to be especially persuaded by at least two factors. First, in other areas of federal securities laws, Congress has drafted explicit language, particularly with respect to eliminating a fiduciary duty requirement in other contexts.⁷² Second, to the extent that the failure to adopt an equal access theory could be viewed as under-inclusive, the Court noted that Congress had crafted other provisions that provided the SEC and the courts with alternative tools to combat securities fraud.⁷³ In this regard, the Court emphasized that there was no evidence to suggest that Congress intended that Rule 10b-5 would be used to eradicate all instances of financial unfairness and inequality.⁷⁴

Advocates of the equal access theory clearly viewed congressional intent quite differently. After analyzing the history of the Rule and its impetus, the Second Circuit insisted that the legislative history revealed that the “core” purpose of the Rule was to ensure that “all investors should have equal access to the rewards of participation in securities transactions.”⁷⁵ The Second Circuit reiterated this belief in *Chiarella*, stating that the “draftsmen of our nation’s securities laws” sought to create “a system providing equal access” to information.⁷⁶ Advocates of the theory also insisted that the statutory language does provide support for their insider trading formulation. Hence, judges argued not only that the broad language of the statute reaches “any person engaged in any fraudulent scheme,”⁷⁷ but also that the repeated use of the word “any” supports a broad reading of the statute.⁷⁸

Ultimately it may be difficult to determine how best to interpret the legislative history and statutory language. Indeed, seeking to use legislative history as a guide is fraught with difficulty. At least one reason for this difficulty is that the many legislators who participate in the drafting of, comment on, and vote in favor of particular legislation may have many different purposes for their actions. It is also a problematic assumption that legislators are aware of the intricacies of existing laws, to such an extent that the failure to address particular intricacies of those laws should be construed in any particular fashion. The dissent in *Chiarella* was certainly correct in its pronouncement that the requirement of a rela-

71. See *Chiarella*, 445 U.S. at 226.

72. See *O’Hagan*, 521 U.S. at 669.

73. See *Chiarella*, 445 U.S. at 233–34.

74. See *id.* at 232.

75. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851–52 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

76. United States v. *Chiarella*, 588 F.2d 1358, 1362 (2d Cir. 1978).

77. *Chiarella*, 445 U.S. at 240.

78. *Id.* at 241 (emphasis added).

tionship “finds no mandate in the language of the statute or is legislative history.”⁷⁹ Moreover, the justices in both the majority and the dissent in *Chiarella* acknowledged that neither the legislative history nor the statutory language of Rule 10b-5 provide specific guidance on the specific factors needed to demonstrate insider trading.⁸⁰ The disagreement revolves around how this lack of guidance should be interpreted.

D. ALLEGIANCE TO THE COMMON LAW

It is an axiomatic doctrine of common law fraud that silence on its own is not actionable. Instead, it must be proven that the silent actor had a duty to speak in order to find liability for fraud.⁸¹ The Supreme Court appears to rely on these basic tenets of common law fraud when embracing its fiduciary doctrine and in rejecting any articulation of insider trading laws that did not rest on some duty.

Of course, at the very least, it is not clear that federal securities fraud had to map on to common law concepts of fraud. As early as 1938, the Supreme Court had held that there was “no federal general common law.”⁸² Relying on that doctrine, the *Chiarella* dissent also argued that securities law protections often arise when common law protections have proven inadequate.⁸³ Hence, it is not clear that there was any mandate to conform federal securities law fraud doctrine with common law fraud doctrine. Importantly, in 2008, the Supreme Court delivered an opinion inapposite to such a mandate in which it noted that “§ 10(b) does not incorporate common-law fraud into federal law.”⁸⁴ Such an opinion strongly suggests that to the extent our insider trading laws stemmed from adherence to common law fraud, such adherence was misguided at best.

E. RELATIONSHIP AS *SINE QUA NON*

The Supreme Court also interpreted the common law fraud doctrine as requiring that the duty to speak when silent must arise in the context of a fiduciary or similar relationship. Common law fraud doctrine makes silence actionable only if the silent actor has a duty to speak. The Supreme Court interpreted this doctrine as also requiring that such duty must arise in the context of a relationship for several reasons. First, traditional fraud doctrine required such a particular relationship. Second, the Court interpreted the “special facts” doctrine as requiring a relationship. Prior cases had held that a duty to speak could arise from the existence of “special

79. *Id.* at 246 (Blackmun, J., dissenting).

80. *See id.* at 226 (noting that the Rule does not state whether silence may constitute a manipulative or deceptive device, and that after the Rule was promulgated, the SEC did not discuss the possibility).

81. *Id.* at 228.

82. *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938).

83. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting).

84. *See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 149 (2008).

facts.”⁸⁵ The Second Circuit in both *Texas Gulf* and *Chiarella* interpreted that doctrine to mean that a duty could arise based on the fact that someone had access to essential facts undisclosed to another party.⁸⁶ However, Justices for the *Chiarella* majority disagreed, and instead concluded that the special facts doctrine was premised upon a duty between corporate insiders and shareholders.⁸⁷ Third, the Court reasoned that the very fact that all other insider trading cases had arisen in the context of a relationship meant that such relationship was required. Ironically, the one and only time the *Chiarella* majority explicitly cited *Texas Gulf* was for the proposition that silence may operate as a fraud, but only when it is premised on a duty to speak arising from a relationship.⁸⁸ The citation appeared to stem solely from the fact that the TGS defendants had a relationship with TGS.

However, the notion that the common law fraud doctrine dictated a duty premised on a special relationship is debatable. At the outset, there is certainly reason to debate whether the mere fact that prior insider trading cases all involved relationships meant that such relationships constituted a necessary factor in an insider trading case. Also, the Supreme Court majority could have embraced a different interpretation of the special facts doctrine. As noted above, the Second Circuit in both *Texas Gulf* and *Chiarella* interpreted the special facts doctrine in a manner that did not require a relationship. Instead, the Second Circuit insisted that the special facts doctrine was designed to emphasize an individual's access to essential facts, rather than the relationship giving rise to that access.⁸⁹ Then too, the Court could have recognized the emerging trend in the common law in which courts had begun to formulate a duty to speak that was not dependent upon a particular relationship. Indeed, in applying the common law, courts had begun to depart from a disclosure duty strictly based on relationships to a duty recognizing that a party's superior knowledge of essential facts could warrant a duty to disclose and render a transaction fraudulent without such disclosure.⁹⁰

As the *Chiarella* dissent suggested, premising the insider trading laws on a historical understanding of fraud had the potential to place the securities laws in the “rearguard.”⁹¹ Modern formulation of the duty to disclose, in which the duty arises in a broad array of circumstances outside of fiduciary-like relationships, appears to have converted this potential

85. See *Strong v. Repide*, 213 U.S. 419, 431–32 (1909).

86. See *Chiarella*, 445 U.S. at 249–50; see also *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978).

87. See *Chiarella*, 445 U.S. at 228 n.10 (noting that the special facts doctrine is “pre-mised” upon a duty between corporate insiders and shareholders).

88. See *id.* at 229–30.

89. *Id.* at 249–50 (Blackmun, J., dissenting).

90. See *id.* at 248.

91. See *id.*

into reality.⁹²

Finally, the Court's own jurisprudence suggested that our normative framework of federal securities laws should not unduly rely on the existence of fiduciary relationships. In 1977, the Supreme Court held that breaches of fiduciary duty do not violate federal law.⁹³ As the *Chiarella* dissent notes, this holding suggest that the securities laws "were not intended to replicate the law of fiduciary relations."⁹⁴ It also suggests that such relations should not serve as the primary premise for violations of federal securities law.

As this discussion reveals, on the surface the justifications for rejecting the equal access concept appear sound. However, peeling back the layers reveals that those justifications were contestable, at the very least.

III. EQUALITY V. DUTY: DESCRIPTIVE AND NORMATIVE IMPLICATIONS

The *Chiarella* dissent argued that rejection of the equal access theory in favor of one based on fiduciary duty would significantly limit the reach of the insider trading laws. The dissent called the majority's formulation an effort "designed to transform § 10(b) from an intentionally elastic 'catch-all' provision to one that catches relatively little of the misbehavior" that makes investments in the securities market risky.⁹⁵ Of course that formulation meant that the insider trading laws did not reach *Chiarella*, *Dirks*, and those who traded on information passed by *Dirks*. While the misappropriation theory expanded the reach of the insider trading doctrine, it is nevertheless undeniable that the majority's formulation fails to capture many who would have been captured under an equal access theory. To be sure, throughout history Rule 10b-5 has been employed to catch a significant amount of misbehavior in the securities market. Moreover, it is entirely possible that *Texas Gulf* would have caught legitimate behavior as well as misbehavior. From this perspective, while the fiduciary duty principle is no doubt under-inclusive, the potential for over-inclusion under an equal access theory may make it difficult to determine whether this descriptive limitation should be viewed as especially problematic. This difficulty is enhanced by the fact that we cannot know whether efforts at limiting the overreach of the equal access theory would have proved successful.

The rejection of the equal access theory, however, does have significant normative implications in at least two respects. First, it had implications for the kind of interest and values being protected by the insider trading laws. The equal access theory was aimed at protecting the market and

92. See *Hill v. Jones*, 725 P.2d 1115, 1117–18 (1986); RESTATEMENT (SECOND) OF CONTRACTS § 161 (AM. LAW INST. 1981); W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS § 106 (5th ed. 1984).

93. *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977).

94. See *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting).

95. *Id.* at 246.

ensuring equal access to essential information. This access was deemed critical because of our disclosure-based securities system, premised on the notion that investors would be able to use essential information to evaluate the sufficiency of securities, make appropriate investment decisions, and thereby protect themselves and their investments. *Texas Gulf* stood for the proposition that inequitable access to information posed risks not only to individual investors by undermining their ability to engage in these actions, but also to our securities market in light of its heavy dependence on disclosure as its ultimate form of investor protection. Under the equal access theory, the wrong committed was against the investing public because the investing public had a right to expect a level informational playing field in the securities market. In addition, the equal access standard was aimed at elevating the concerns of the investing public above those of the corporation. Thus, in rejecting the notion that insider trading should serve as a form of corporate incentive, the Second Circuit insisted that because such incentive would come “at the expense of the uninformed investing public,” it must be deemed as illegitimate.⁹⁶ By framing the gravamen of the offense in the form of equity, the Second Circuit elevated concerns of the investing public over the concerns of the corporation and any particular individualized expectations. The rejection of the equal access theory appears to reflect a rejection of these equity-based concerns.

To be sure, the Supreme Court insisted that its insider trading theory was aimed at protecting the securities markets.⁹⁷ While the Court noted that insider trading liability is not aimed at catching all conceivable forms of fraud, the *O’Hagan* court did insist that insider trading liability is aimed at catching those who have an informational advantage that allows them to gain no-risk profits in the securities market.⁹⁸ The Court further insisted that while informational disparities are inevitable in the securities market, insider trading liability is aimed at prohibiting the kind of informational disadvantage that stems from “contrivance, not luck” because “it is a disadvantage that cannot be overcome with research or skill.”⁹⁹ The Court concluded that this form of informational disadvantage would inhibit market participation because investors would “hesitate to venture their capital in a market” where such disadvantages went “unchecked by law.”¹⁰⁰

However, it is clear that the fiduciary duty theory is under-inclusive for these purposes because it focuses less on overall market concerns and more on protecting expectations that arise from particular relationships. Indeed, this is obvious from the fact that liability under the misappropriation theory cannot attach to someone who trades on material, non-public

96. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

97. *United States v. O’Hagan*, 521 U.S. 642, 652, 663 (1997).

98. *Id.* at 656.

99. *Id.* at 658–59.

100. *Id.* at 658.

information so long as the person or entity with whom the trader has a relationship has no expectation that the information would be kept confidential.¹⁰¹ Thus, because the misappropriation theory turns on individual expectations of confidentiality, its protection seems aimed at those expectations. Perhaps more importantly, even when an individual has such an expectation, insider trading liability does not attach so long as the trader discloses her intention to trade to whomever she owes a duty.¹⁰² Of course, the informational advantages, along with the risks posed by them and identified by the Supreme Court, persist. In this regard, the fiduciary duty theory appears under-inclusive and aimed primarily at remedying harm to individual expectations and relationships rather than harm to the securities market as a whole.

The second normative impact of rejecting the equal access theory relates to the normative expectations for shareholders. *Texas Gulf* sought to establish a normative expectation of fairness and equal access. The Second Circuit was well aware that some corporate insiders, market participants, and investors expected and even condoned trading on material, non-public information and the inequities that resulted from it.¹⁰³ However, *Texas Gulf* aimed to reject this expectation as a normative preference. *Texas Gulf* stood for the principle that the expectation of equal access to material information was not simply “justifiable,”¹⁰⁴ but normatively preferable. From this perspective, the Second Circuit sought to make clear that the securities law *should* prefer a standard of equal access, and should embrace a normative preference in favor of shareholder expectations of such access. As the Second Circuit noted, “inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.”¹⁰⁵ Rejection of the equal access theory could be viewed as a rejection of the normative expectation in favor of equal access, and a corresponding rejection of the notion that our laws should be used to promote the expectation of equality—regardless of how elusive the goal.

IV. CONCLUSION

Texas Gulf marked an important beginning to a long line of federal cases seeking to shape the contours of the insider trading laws under Rule 10b-5. The insider trading laws have evolved significantly since the doctrine and theory articulated by *Texas Gulf*. Looking back on *Texas Gulf* on its fiftieth anniversary, and the first set of Supreme Court cases that marked our departure from the theoretical roots of *Texas Gulf*, provides

101. *See id.* at 663.

102. *See id.* at 655.

103. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

104. *See id.* at 848.

105. *Id.* at 852.

an opportunity to reflect on how legal doctrine takes shape. That look back also provides an opportunity to ponder whether and to what extent the securities laws and our securities markets would have been significantly different if the Supreme Court had fully embraced *Texas Gulf*. And finally, the look back serves as a reminder of the important role theory plays in the evolution of the law.