

# COMMENTARY

## INFORMATION, PRIVILEGE, OPPORTUNITY AND INSIDER TRADING

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### I. BACKGROUND OF INSIDER TRADING LEGISLATION

Insider trading legislation requires insiders to publicly report their trades through securities commissions and prohibits them from using confidential, undisclosed information that is material to the value of securities in connection with the trades.<sup>1</sup> In Canada, insider trading is both a civil and quasi-criminal offense.<sup>2</sup> In the United States, Rule 10b-5 of the Securities Exchange Act is often cited as authority for prosecuting insider trading cases.<sup>3</sup>

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1. F.H. BUCKLEY AND M.Q. CONNELLY, CORPORATIONS: PRINCIPLES AND POLICIES 657 (1988) [hereinafter *PRINCIPLES AND POLICIES*]. Chapter 8 of this book gives one of the best presentations of insider trading, from both an economic and legal perspective. Both Canadian and United States laws are discussed.

2. *Id.* For civil sanctions, see OSA 131(1)-(2), (4) and CBCA § 125(5)(a)-(b). For criminal treatment of insider trading, see OSA § 75.

3. 17 C.F.R. § 240.10b-5 (1989). Rule 10b-5 addresses the employment of manipulative and deceptive devices. It states:

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, . . . 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.

One of the earliest and most important cases involving insider trading was *SEC v. Texas Gulf Sulphur Co.*<sup>4</sup> In this case, the company's geologist discovered valuable mineral deposits in Ontario, Canada in 1959. In late 1963, company drilling discovered evidence that there might be rich deposits of copper and zinc at the spot in question. After the geologist notified management of the find, the company's officers, directors and employees began buying shares of the company's stock on the open market, before the find was known to the general public. Other individuals who were not connected with the company also bought shares before the information became public. Those individuals who were connected with the company were named in a Securities and Exchange Commission (SEC) complaint. The others involved were not prosecuted by the SEC, but some of them later became parties to private civil actions.

By early 1964, word began to spread and the stock's price began to climb. On April 12 of that year, the company announced that it was working in the area in question, but more drilling would be required before a proper evaluation could be made. Four days after that announcement, Texas Gulf announced a major strike. In its suit, the SEC alleged that between the time of the "misleading" press release of April 12 and the accurate announcement four days later, many shareholders sold their stock for prices that were lower than what they would have sold them for if they had known the information that was announced on April 16. Insiders acquired shares during this period, but the number of shares they acquired during the twenty-two week period in question represented less than 10% of the total shares traded during that timespan. The share price doubled within three weeks after the announcement of April 16. The appellate court held that:

not only are directors or management officers of corporation 'insiders' within meaning of rule of Securities and Exchange Commission, so as to be precluded from dealing in stock of corporation, but [the] rule is also applicable to one possessing information, though he may not be strictly termed an 'insider' within meaning of Securities Exchange Act, and thus anyone in possession of material inside information is an 'insider' and must either disclose it to investing public, or, if he is disabled from disclosing it in order to protect corporate confidence, or he chooses not to do so, must abstain from trading in or

4. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

recommending securities concerned while such inside information remains undisclosed.<sup>5</sup>

#### A. THE CONCEPT OF JUSTICE

Before proceeding further, a definition of justice would be appropriate. Once justice is defined, the definition can be applied to the practice of insider trading to determine whether the practice is just. A just act can be between individuals or between the state and one or more individuals although, in the final analysis, an act involving the state is carried out by an individual. According to one popular theory, justice is the absence of coercion; acts between consenting adults are just. Individuals or governments who prevent such acts are acting unjustly, and individuals who commit acts that aggress against others, except in self-defense, are acting unjustly.<sup>6</sup> A corollary to this view is that the proper scope of government is to protect life, liberty, and property, and any act by government that goes beyond this scope results in injustice because it must necessarily use coercion to take from some to give to others.<sup>7</sup> Space does not permit a detailed defense of this position, but others have already discussed the point thoroughly.<sup>8</sup>

If injustice results when one individual takes the property of another without that person's consent, and the proper scope of government includes prevention of such acts, then government should attempt to prevent coercive (or fraudulent) takings and should refrain from interfering in nonfraudulent transactions that are between consenting adults. In the case of insider trading, the SEC might be the proper agency of government to prevent such transactions, if insider

5. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 833 (2d Cir. 1968).

6. Robert Nozick's and Murray N. Rothbard's definitions are along the same lines, but John Rawls' is not. For an elaboration of various theories of justice, see R. NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974); M. ROTHBARD, *THE ETHICS OF LIBERTY* (1982); J. RAWLS, *A THEORY OF JUSTICE*; B. BARRY, *THE LIBERAL THEORY OF JUSTICE* (1973); O. BIRD, *THE IDEA OF JUSTICE* (1967). Perhaps the most detailed bibliography on the theory of justice, at least for books first published before 1900, is in I *THE GREAT IDEAS: A SYNTOPICON* 850-79 (R. Hutchins ed. 1952).

7. A similar view is taken by John Locke in his *THE SECOND TREATISE ON CIVIL GOVERNMENT* (1986) and at least some of America's founding fathers. The view is also developed in R. NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974); R. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* (1985); F. BASTIAT, *THE LAW* (1950); and D. RUSSELL, *GOVERNMENT AND LEGAL PLUNDER: BASTIAT BROUGHT UP TO DATE* (1985).

8. See NOZICK, EPSTEIN, BASTIAT and RUSSELL, *supra* note 7.

trading is deemed to be an unjust act. However, at least one former SEC Commissioner has pointed out the potential abuses that can occur when the SEC is given such regulatory authority,<sup>9</sup> as have others.<sup>10</sup> Some commentators have even questioned the constitutionality of SEC enforcement actions.<sup>11</sup> Perhaps regular common law

9. See R. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES & EXCHANGE COMMISSION VERSUS CORPORATE AMERICA (1982).

10. For more on SEC regulatory abuses, see *Lowe v. SEC*, 472 U.S. 181 (1985); G. LITTLER, ABOLISH THE SEC, in L.H. ROCKWELL, JR., THE FREE MARKET READER 273 (1988); Bubb, *SEC Regulations Endanger Free Press*, 4 FREE PRESS NETWORK 1 (Spring 1985); Freedman, *A Civil Libertarian Looks at Securities Regulation*, 35 OHIO ST. L.J. 280 (1974); McMenamin & Gorenc, Jr., *Subverting the First Amendment*, REASON 23 (Jan. 1983); *The First Amendment and Federal Securities Regulations: A Symposium*, 20 CONN. L. REV. 261-477 (1988); Comment, *The Right to a Free Press and the Regulation of Securities Newsletters: The Controversy Continues*, 56 U. CIN. L. REV. 1445 (1988). A whole body of literature is developing around the *Lowe* decision. For some recent articles on this case, see Aman, *SEC v. Lowe: Professional Regulation and the First Amendment*, 1985 SUP. CT. REV. 93 (1985); Coffhan, *Lowe v. Securities and Exchange Commission: The Deterioration of Financial Newsletter Regulation*, 10 NOVA L.J. 1267 (1986); Desch, *Lowe v. SEC: Guaranteeing the Right to Publish Investment Newsletters Through Statutory Construction*, 64 WASH. U.L.Q. 577 (1986); Draughon, *SEC v. Lowe: Redefining the Bona Fide Newspaper Exclusion*, 14 SEC. REG. L.J. 291 (1987); Garver, *Lowe v. SEC: The First Amendment Status of Investment Advice Newsletters*, 35 AM. U.L. REV. 1253 (1986); Gora, *Supreme Court Report: Five Wins and Nine Losses for Free Speech Fans*, 71 A.B.A. J. 116 (1985); Law, *Regulation of Investment Newsletter Publishers: The SEC's Power Reaches a New "Lowe,"* 11 VT. L. REV. 175 (1986); Lee, *The Effects of Lowe on the Application of the Investments Advisers Act of 1940 to Impersonal Investment Advisory Publications*, 42 BUS. LAW. 507 (1987); Levant, *Financial Columnists as Investment Advisers: After Lowe and Carpenter*, 74 CALIF. L. REV. 2061 (1986); Mohr, *Lowe v. SEC: Avoidance of the Commercial Speech Definition—The Right Result for the Wrong Reasons*, 17 U. TOL. L. REV. 1007 (1986); Nites, *The SEC's Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory*, 52 BROOKLYN L. REV. 43 (1986); Norquist, *SEC v. Lowe: The Constitutionality of Prohibiting Publication of Investment Newsletters Under the Investment Advisers Act*, 69 MINN. L. REV. 937 (1985); Thompson, *Lowe v. SEC: Investment Advisers Act of 1940 Clashes with First Amendment Guarantees of Free Speech and Press*, 21 U. RICH. L. REV. 205 (1986).

11. See *Morrison v. Olson*, 108 S. Ct. 2597 (1988); *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984); *Blinder, Robinson & Co., Inc. v. SEC*, 837 F.2d 1099 (D.C. Cir.), cert. denied, 109 S. Ct. 177 (1988); *SEC v. Blinder, Robinson & Co., Inc.*, 511 F. Supp. 799 (1981); Balboni, *Section 3(a)(10) of the Securities Act of 1933—SEC v. Blinder Robinson & Co.—Proposed Standards for Fairness Hearings*, 17 NEW ENG. L. REV. 1397 (1981); Falon, *On Legislative Courts, Administrative Agencies, and Article III*, 101 HARV. L. REV. 916 (1988); McLucas & Romanowich, *SEC Enforcement Proceedings Under Section 15(c)(4) of the Securities Exchange Act of 1934*, 41 BUS. LAW. 145 (1985); Steinberg, *SEC Subpoena Enforcement Practice*,

contract and tort would be sufficient to protect individuals from harm. Property law may also be used, given that insider information has been identified as a property right.<sup>12</sup>

*Lowe v. SEC*<sup>13</sup> illustrates the potential abuse of free speech that might result when the SEC is given the authority to regulate securities trading. In *Lowe*, the SEC attempted to prevent an "unsavory" individual from publishing a newsletter that gave investment advice and commentary, alleging that he violated the Investment Advisers Act of 1940. The district court held that his right to publish was protected by the first amendment and that he should be permitted to publish as long as he complied with the provisions of the Act.<sup>14</sup> The Supreme Court held that *Lowe* did not have to be a registered investment adviser to publish his newsletter because the information was given impersonally to anyone who subscribed rather than on a person-to-person basis.<sup>15</sup>

Whether insider trading is fraudulent is questionable. St. Thomas Aquinas said that fraud can be perpetrated in three ways, either by selling one thing for another or by giving the wrong quality or quantity.<sup>16</sup> A more modern definition is "intentional deception to cause a person to give up property or some lawful right."<sup>17</sup> A more general definition is that fraud is perpetrated when a person knowingly or intentionally makes a false representation of fact to another with the intent that the other party rely on the representation, and that the other party actually did rely upon the false statement to his loss, detriment or damage.<sup>18</sup> Some courts have extended liability to include

11 J. CORP. L. 1 (1985); Note, *SEC Investigations—SEC Need Not Notify Target of Third-party Subpoenas—SEC v. Jerry T. O'Brien, Inc.*, 104 S. Ct. 2720, 75 J. CRIM. L. & CRIMINOLOGY 940 (1984); *SEC vs. the Constitution*, Wall Street Journal, Dec. 6, 1988, at A-24, col. 1.

12. See Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933 (1985), reprinted in ECONOMIC LIBERTIES AND THE JUDICIARY 317-27 (Dorn and Manne eds. 1987); Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. (1987).

13. 472 U.S. 181 (1985).

14. 556 F. Supp. 1359 (E.D.N.Y. 1983).

15. *Lowe v. SEC*, 472 U.S. 181, 211 (1985).

16. G. DALCOURT, THE PHILOSOPHY AND WRITINGS OF ST. THOMAS AQUINAS 105 (1965); ST. THOMAS AQUINAS, SUMMA THEOLOGICA, Pf. II-II, Q.77 Art. 3, obj. 4 (Fathers of the English Dominican Province trans. 1947).

17. WEBSTER'S NEW WORLD DICTIONARY OF THE AMERICAN LANGUAGE (college ed. 1964).

18. *Kaufman Inv. Corp. v. Johnson*, 623 F.2d 598 (9th Cir. 1980), cert. denied, 450 U.S. 914 (1981); *Meader v. Francis Ford, Inc.*, 286 Or. 451, 595 P.2d 480 (1979);

























