THE EQUALITY PRINCIPLE: HOW TITLE VII CAN SAVE INSIDER TRADING LAW

Kenneth R. Davis†

TABLE OF CONTENTS

INTRODUCTION 200

I. A COMPARISON OF THE LAW AND POLICIES OF INSIDER TRADING AND EQUAL EMPLOYMENT OPPORTUNITY 203
   - A. *The Purposes and Sources of Insider Trading Law* 203
   - B. *The Purposes and Source of Equal Employment Opportunity Law* 205
   - C. *The Policy Connection* 207

II. THE DISTORTIONS OF THE CURRENT FRAMEWORK OF INSIDER TRADING LAW 211
   - A. Chiarella v. United States*: The Classical or Traditional Theory* 212
   - B. United States v. O'Hagan*: The Misappropriation Theory*..................... 213
     - 1. Hacking 214
     - 2. Tips Without a Promise of Confidentiality 216
   - C. Dirks v. SEC*: Tipper/Tippee Liability*.. 216
     - 1. Breach of Fiduciary Duty to the Source..217
     - 2. The Benefit Requirement...218
     - 3. Scienter 219
     - 4. Eavesdropping..220
     - 5. Market Professionals 221
   - D. Salman v. United States*: An Affirmation of* Dirks 222

III. THE LESSONS OF TITLE VII 225
   - A. *Disparate-Treatment Theory: Intentional Discrimination* 226
     - 1. *Price Waterhouse v. Hopkins*: The Motivating Factor Test.........226
     - 2. The Civil Rights Act of 1991: Codification and Modification 228

† Professor of Law and Ethics, Fordham University Graduate School of Business. J.D., University of Toledo, School of Law, 1977; M.A., University of California, Long Beach, 1971; B.A., State University of New York at Binghamton, 1969. Thanks to my wife, Jean, the Wonder Woman of law librarians.

B. *Disparate-Impact Theory: Strict Liability*..........229
1. The Analogy of Disparate Impact to Insider Trading Law..........231
2. Knowledge That Information Is Nonpublic..........232
3. The "Business Necessity" Defense..........233
a. The Burden of Persuasion..........234
b. The Analogy of the Business Necessity Defense to Insider Trading..........237
4. *Ricci v. DeStefano*: The Death of Disparate Impact?..........239
CONCLUSION..........240

INTRODUCTION

The law of insider trading needs to be scrapped and replaced. Because Congress has not passed a statute directly addressing insider trading, the Supreme Court has, by default, based insider trading law on section 10(b) of the Securities Exchange Act of 1934 (Exchange Act)[1] and its regulatory complement, Rule 10b-5.[2] An antifraud provision, section 10(b) is not equipped to deal with issues arising from the misuse of informational advantages.[3] The prevailing legal framework has failed because trading wrongfully on inside information does not necessarily involve fraud. If, for example, an eavesdropper trades on inside information,[4] or someone trades on a gratuitous tip or on the spoils of

1 Section 10(b) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pub. L. No 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)).

2 Rule 10b-5 provides in pertinent part:

> 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 (2016).

3 This Article refers to section 10(b) and Rule 10b-5 interchangeably.

4 *See* SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (finding that an eavesdropper did not breach a fiduciary duty to the source of the information, and therefore that he did not violate section 10(b)).

corporate espionage,[5] it is doubtful that fraud came into play. A consensus of market participants and the general public might well condemn some, if not all, of these practices.[6] Yet, the current approach permits them. The conflation of informational abuses with deceptive practices harms investors economically, shakes their confidence in the financial system, and erodes the efficiency of capital markets.[7]

The job of insider trading law is to root out and penalize, either civilly or criminally, those who trade unfairly on material, nonpublic information. It is regrettable that insider trading law is littered with extraneous elements that divert it from its purpose. Irrelevant preconditions to liability, such as a breach of fiduciary duty to the source of the information and a benefit to the tipper of inside information, sap the current law of its potency.[8]

Tinkering with existing law will not solve these problems. They run too deep to allow for repair. Congress should reject the current antifraud approach and enact a new legal framework that targets all informational abuse, whether or not based on fraud. The question is: where might lawmakers look for guidance on how to craft a new insider trading law?

The answer may come from an unexpected source. Title VII of the 1964 Civil Rights Act provides the statutory basis for equal employment opportunity law.[9] Although this body of law has had a choppy history,

---

5 *See* SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009) (holding that computer hacking is a deceptive device within the meaning of section 10(b) if the hacker gained access to the computer's data by misrepresenting his identity).

6 Some scholars have used the term "outsider trading" to refer to instances when non-insiders trade on material, nonpublic information. *See, e.g.*, Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information,* 61 HASTINGS L.J. 881, 884 (2010) (noting the frequent use of the term "outsider trading"). For the sake of simplicity, this Article uses the term "insider trading" to refer to anyone trading on material, nonpublic information, regardless of whether the trader is an insider or not.

7 *See, e.g.*, Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 2 (1982) (commenting that investors feel cheated when their counterparties trade on inside information); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223, 235 (1992) (warning that unconstrained insider trading drives investors out of capital markets, and leads to market failure); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 399 (1999) (condemning on deontological grounds trading on "morally tainted" information, and highlighting the disagreement among scholars as to the economic consequences of insider trading on investors, their confidence in the securities markets, and market efficiency).

8 *See* United States v. O'Hagan, 521 U.S. 642, 653 (1997) (adopting the misappropriation theory, which requires, as a precondition to an insider trading violation, that the trader breached a duty of confidentiality to the source); Dirks v. SEC, 463 U.S. 646, 662 (1983) (holding that, to establish a breach of fiduciary, the plaintiff must prove that a tipper received a benefit in exchange for providing the information); Chiarella v. United States, 445 U.S. 222, 228 (1980) (requiring that, to sustain a claim of unlawful insider trading, the government must prove an insider breached a fiduciary duty to the source of inside information).

9 Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (codified as amended at 42 U.S.C. § 2000e (2012)).

several effective statutory and judicially-created rules have emerged to combat invidious workplace discrimination. One might ask, however, why the rules of Title VII provide insight to lawmakers who wish to restructure a seemingly unrelated area of law. The response is that these areas share a similar fundamental policy.[10] Title VII strives to achieve equality of workplace opportunity for those in protected classes, but it does not guarantee equality of result.[11] In other words, members of protected classes should have an equal chance to seek and secure jobs, promotions, and other employment benefits, but ultimately such benefits go to the best workers, regardless of race, color, religion, or national origin. This is an equality principle. The fundamental policy underlying insider trading law is analogous: to achieve equality of access to material, nonpublic information, but not equality of outcome. In other words, although everyone should have equal access to inside information, some may be more successful than others at ferreting it out. This, too, is an equality principle. Lawmakers should therefore consider applying some of the principles of equal employment opportunity law when fashioning a new law of insider trading. At the same time, one must remember that the rules of Title VII should be taken as guidance, not gospel. Before adapting an approach of Title VII to insider trading law, one must determine whether such an adaptation would advance the equality principle of insider trading.

Part I of this Article compares the law and policies of insider trading to the law and policies of equal employment opportunity. This Part begins with a discussion of the differences between these two areas. It then examines the policy similarity, which invites the transposition of some of the rules of Title VII into the domain of insider trading law.

Because current insider trading law has proven inadequate, Congress should discard the current regime. To expose these inadequacies, Part II examines the dubious brand of insider trading law that the Supreme Court has extracted from section 10(b). This Part analyzes the traditional theory,[12] the misappropriation theory,[13] and the theory of tipper/tippee liability.[14] Based on section 10(b), liability under these theories requires that the person trading on inside information breached a fiduciary duty to the source of the information.[15] This

---

10 See Section I.B for a discussion of the overlapping policies of insider trading and equal employment opportunity.

11 *See* Griggs v. Duke Power Co., 401 U.S. 424, 429 (1971) (recognizing that Title VII guarantees equality of opportunity, not equality of result).

12 *See Chiarella*, 445 U.S. 222.

13 *See O'Hagan*, 521 U.S. 642.

14 *See* Dirks v. SEC*,* 463 U.S. 646 (1983).

15 *See, e.g.*, J. Kelly Strader, *(Re)conceptualizing Insider Trading:* United States v. Newman *and the Intent to Defraud,* 80 BROOK. L. REV. 1419, 1427–33 (2015) (discussing the traditional and misappropriation theories).

superfluous requirement misdirects the law, permitting practices that most people would denounce. Furthermore, to establish tipper/tippee liability, a plaintiff must show that the tipper benefited from providing the information to the tippee.[16] This requirement frustrates insider trading policy because the harm that insider trading causes has nothing to do with whether the tipper received a satchel of cash, an Armani suit, or a free round of golf at Mar-a-Lago.

Part III delves into the two main theories of equal employment opportunity law: disparate treatment or intentional discrimination, and disparate impact or discrimination absent discriminatory intent. Arguing that both these theories provide useful analogies for formulating a new law of insider trading, Part III emphasizes the strict-liability aspect of disparate-impact theory as a model for insider trading law. Part III recommends that, in addition to abandoning the breach-of-fiduciary-duty framework, a new insider-trading law should prohibit trading on inside information even when the violator does not know that the information is nonpublic.

This Article concludes with a request to Congress. Partly because of congressional inaction and partly because of Supreme Court muscle-flexing, federal insider trading law suffers from conceptual mayhem. It is time for Congress to pass a law dedicated to stamping out the abusive exploitation of inside information. Title VII, particularly the law of disparate impact, shows the way.

I. A COMPARISON OF THE LAW AND POLICIES OF INSIDER TRADING AND EQUAL EMPLOYMENT OPPORTUNITY

If insider trading law bears any resemblance to equal employment opportunity law, the connection at first glance would seem tenuous. Insider trading law is a component of federal securities regulation. In stark contrast, Title VII of the 1964 Civil Rights Act is the source of equal employment opportunity law. Despite the differences of these two areas, a fundamental commonality links them.

A. The Purposes and Sources of Insider Trading Law

The purposes for regulating trading on inside information stem from the policies supporting federal securities law, which protect the investing public from unscrupulous issuers, their confederates, and market insiders.[17] James Landis, one of the architects of the Securities

[16] *Dirks*, 463 U.S. at 662.

[17] *See, e.g.*, Exchange Act, Pub. L. No. 73-291, § 2, 48 Stat. 881, 881–82 (codified as

Act of 1933 (1933 Act),[18] criticized the preexisting system, which had failed to impose sufficient constraints on "persons whose function it was to handle other people's money."[19] Responding to the crisis following the stock market crash of October 1929, President Franklin Roosevelt demanded a law—ultimately the 1933 Act—that would require issuers of securities to make full disclosure of material information to the public.[20] Animated by the same considerations as the 1933 Act, the Exchange Act sought to deprive "[m]anipulators who have in the past had a comparatively free hand to befuddle and fool the public . . . of the opportunity to grow fat on the savings of the average man and woman in America."[21] By protecting the financial interests of ordinary investors, these laws promote investor trust in securities markets.[22] As a consequence of advancing these policies, federal securities law fosters an atmosphere where capital markets thrive.[23]

In recent years, more and more foreign markets have emerged.[24] The competition of countries vying for capital investment is intense, and the stakes are high.[25] By promoting a level playing field that earns

---

amended at 15 U.S.C. § 78b (2012)) (providing that one of the purposes of the Exchange Act is "to insure the maintenance of fair and honest markets" and to avoid "manipulation and control" of prices); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334 (1979) (noting that "the antifraud provisions are said to serve principally a protective function").

18 Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–aa (2012)).

19 James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) (reviewing the legislative process that culminated with the passage of the Securities Act of 1933).

20 *See* H.R. REP. NO. 73-85, at 2 (1933).

21 78 CONG. REC. 2271 (1934) (statement of Sen. Fletcher).

22 Brudney, *supra* note 17, at 334–35 (pointing out that the disclosure requirements of the federal securities laws were "essential to restoring trust in the securities markets . . . after the market disasters of 1929 and 1930, and the revelations of later investigations."); *see, e.g.*, Sung Hui Kim, *Insider Trading as Private Corruption*, 61 UCLA L. REV. 928, 967 (2014) (warning that "[i]f investors come to see the securities markets as a rigged game—one that seems by design to systematically disadvantage ordinary investors—they could respond by discounting the amount they are willing to pay for all securities, thereby raising the cost of capital [and] rampant insider trading might also discourage investors from trading as much or as often, or may even catalyze exit en masse").

23 *See, e.g.*, Luis A. Aguilar, Comm'r, U.S. Sec. & Exch Comm'n, Public Statement at the Securities and Exchange Commission, U.S. Market Equity Structure: Making Our Markets Work Better for Investors III. (May 11, 2015), https://www.sec.gov/news/statement/us-equity-market-structure.html (noting that the most important priorities for the Securities and Exchange Commission (SEC) are the interests of both investors and issuers and "[d]eep, efficient, and liquid capital markets").

24 *See, e.g.*, Bloomberg News, *How the NYSE and Nasdaq Snatch Foreign IPOs from Overseas Competitors*, CRAINS (Oct. 27, 2015, 11:40 AM), http://www.crainsnewyork.com/article/20151027/FINANCE/151029858/the-prestigious-new-york-exchanges-are-fighting-a-turf-war-with-london-and-hong-kong-to-take-the-worlds-biggest-companies-public (examining the rivalry between the major U.S. capital markets, the NYSE and Nasdaq, and foreign capital markets such as those in Hong Kong, London, and Frankfurt).

25 *See, e.g.*, Flora Xiao Huang, *New York vs. Hong Kong—A Burst of Regulatory Competition: The Listing of Alibaba* 2 (Univ. of Leicester Sch. of Law, Research Paper No. 15-

investor confidence, insider trading law seeks to strengthen securities exchanges, such as the New York Stock Exchange and the NASDAQ. Robust markets encourage high levels of capital investment and an abundance of new offerings.[26]

To protect the interests of ordinary investors and to promote confidence in and the vitality of the securities markets, section 10(b) of the Exchange Act authorized the Securities and Exchange Commission (SEC) to promulgate a rule prohibiting securities fraud.[27] Rule 10b-5 does so by making it unlawful to use "any [deceptive or manipulative device] in connection with the purchase or sale of any security."[28] The Supreme Court has interpreted this rule to proscribe certain fraudulent practices when trading on material, nonpublic information.[29] Although scholars have debated whether trading on inside information is actually unfair to ordinary investors, foments their distrust in the capital markets, or ultimately harms those markets, the fact remains that these policies have provided the rationales for restricting such trading.[30]

B. *The Purposes and Source of Equal Employment Opportunity Law*

Title VII concerns issues far removed from those addressed by securities laws. The touchstone of Title VII is section 703(a)(1).[31] This section makes it

22, 2015), http://ssrn.com/abstract=2630060 (discussing the competition between the NYSE and the Hong Kong Stock Exchange for the Alibaba initial public offering).

26 *Id.* at 3 (pointing out that some issuers list on highly regulated markets to achieve better corporate governance and increased market capitalization).

27 Exchange Act, Pub. L. No 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)).

28 17 C.F.R. § 240.10b-5 (2016).

29 *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 659 (1983) (stating, "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.").

30 *See, e.g.*, Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 55–61 (1986) (discussing arguments that trading on inside information is unfair to ordinary investors, and arguments that trading on inside information reduces investor confidence and consequently results in market flight); James D. Cox, *Insider Trading and Contracting: A Critical Response to the 'Chicago School,'* (1986) DUKE L.J. 628, 630–31 (1986) (noting that the initial formulation of the disclose-or-abstain rule forbade anyone from trading on inside information on the ground that such trading eroded the integrity and efficiency of securities markets, and adding that the Supreme Court abandoned this approach, "rendering the rationale underlying insider-trading regulation a dark mystery."); Adam R. Nelson, *Extending Outsider Trading Liability to Thieves*, 80 FORDHAM L. REV. 2157, 2187 (2012) (stating that the purposes of the insider trading prohibition is "to protect investors and the integrity of the market").

31 Civil Rights Act of 1964, Pub. L. No. 88-352, § 703(a)(1), 78 Stat. 241, 255 (codified as amended at 42 U.S.C. § 2000e-2(a)(1) (2012)).

> an unlawful employment practice for an employer . . . to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, condition, or privileges of employment, because of such individual's race, color, religion, sex, or national origin . . . .[32]

Title VII strives to eliminate the discriminatory treatment of African Americans and others who have historically suffered and continue to suffer from oppression in and exclusion from segments of the workplace.[33] Senator Hubert Humphrey summed up the primary purpose of Title VII when he remarked that it seeks to address "the plight of the Negro in our economy."[34] In these few words, Senator Humphrey evoked concerns of both fundamental fairness and economic opportunity. When Congress passed the 1964 Civil Rights Act, unemployment was far more prevalent among African Americans than whites.[35] As Senator Clark observed, "[t]he rate of Negro unemployment has gone up consistently as compared with white unemployment for the past 15 years. This is a social malaise and a social situation which we should not tolerate."[36] The equality policy of Title VII strives to afford African Americans and others in historically disadvantaged groups the opportunity to land a good job and to earn a fair wage based on capability and performance.

Title VII tackles these concerns by forbidding employment practices, whether explicit or implicit, based on stereotypes or naked bigotry.[37] It consequently promotes fundamental fairness in the workplace by condemning discrimination based on race, sex, religion, or national origin.[38] Title VII therefore serves the goal of economic equality.[39] It also enhances productivity by promoting merit-based employment practices.[40] Finally, it creates an environment of social cohesion where all individuals may feel a sense of full participation in the American experience.[41]

---

32 *Id.*

33 *See infra* notes 34–41 and accompanying text (discussing the purposes of Title VII).

34 110 CONG. REC. 6548 (1964) (statement of Sen. Humphrey).

35 *Id.*

36 *Id.* at 7220 (statement of Sen. Clark).

37 *See, e.g.*, Price Waterhouse v. Hopkins, 490 U.S. 228, 250–51 (1989) (holding that Title VII prohibits the denial of partnership to an accountant where sex stereotyping played a role in the employment decision).

38 Civil Rights Act of 1964, Pub. L. No. 88-352, § 703(a)(1), 78 Stat. 241, 255 (codified as amended at 42 U.S.C. § 2000e-2(a)(1) (2012)).

39 *See supra* text accompanying notes 34–36.

40 *See, e.g.*, Robert Cooter, *Market Affirmative Action*, 31 SAN DIEGO L. REV. 133, 137–38 (1994) (arguing that workplace discrimination excludes highly qualified workers from job opportunities and thus lowers productivity).

41 *See, e.g.*, Elizabeth S. Anderson, *Integration, Affirmative Action, and Strict Scrutiny*, 77 N.Y.U. L. REV. 1195, 1202–06 (2002) (arguing that racial segregation denies equal economic opportunities and "undermines democratic values").

C. *The Policy Connection*

An insider's exploitation of material, nonpublic information seems patently unfair to ordinary investors who risk their savings when they purchase securities and deserve an equal chance at financial success. Permitting those with special access to inside information to reap big profits spawns investor distrust, which might threaten the prosperity of the securities markets.[42] To prevent such outcomes, strong restrictions must apply to those who trade on inside information. The concerns that support Title VII are roughly analogous: social and economic fairness in the workplace, and a more just and prosperous society as a result of more diverse workplace participation.[43] As shown below, this commonality implies analogous guiding principles.

In *Griggs v. Duke Power Co.*,[44] the Supreme Court announced that the goal of Title VII is "to achieve equality of employment opportunities. . . ."[45] Expanding on this pronouncement, the *Griggs* Court observed that "Congress did not intend by Title VII, however, to guarantee a job to every person regardless of qualifications. In short, the Act does not command that any person be hired simply because he was formerly the subject of discrimination, or because he is a member of a minority group."[46] The *Griggs* Court left no room for misunderstanding the equality principle of Title VII. That principle promotes equality of opportunity, not equality of result.

A similar principle emerges from a common sense view of what sparks insider trading law. Insider trading law should not condone trading on inside information when a party has greater access to the information than the counterparty to the transaction. *In the Matter of*

---

42 *See, e.g.*, Aguilar, *supra* note 23 (stressing the importance of healthy capital markets); Langevoort, *supra* note 7, at 2 (reflecting on "the strongly held intuition that insider trading is unfair," and noting that "[p]ersons in a position to have special access to confidential information bearing on the value of a security are perceived as being unjustly enriched when they trade with others who are unable to discover that information.").

43 *See infra* notes 44–46 and accompanying text (discussing the goals of Title VII).

44 401 U.S. 424 (1971).

45 *Id.* at 429. Elaborating further, the Court went on to note that Title VII seeks to:

> remove barriers that have operated in the past to favor an identifiable group of white employees over other employees. Under the Act, practices, procedures, or tests neutral on their face, and even neutral in terms of intent, cannot be maintained if they operate to "freeze" the status quo of prior discriminatory employment practices.

Id. at 429–30; *see also* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 800 (1973) (reiterating in language nearly identical to the language used by the *Griggs* Court that the purpose of Title VII is "to assure equality of employment opportunities").

46 *Griggs*, 401 U.S. at 430. The Court continued: "[d]iscriminatory preference for any group, minority or majority, is precisely and only what Congress has proscribed. What is required by Congress is the removal of artificial, arbitrary, and unnecessary barriers to employment when the barriers operate invidiously to discriminate on the basis of racial or other impermissible classification." *Id.* at 430–31.

Cady, Roberts & Co.[47] crystallized this principle when it announced the disclose-or-abstain rule. This rule requires that a party in possession of inside information must either publicly disclose the information or abstain from trading on it.[48] When adopting this rule, the SEC stressed that the rule applied not only to officers, director, and majority shareholders, but also to anyone possessing inside information, because the rule addressed "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[49] As Professor Brudney has suggested, "the logic of the disclose-or-refrain rule precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset."[50] Professor Brudney challenged the efficacy of section 10(b) to protect the public, noting that section 10(b) prohibits insider trading only when fraud is involved. He observed that while the antifraud provisions have addressed informational advantages of corporate insiders and market professionals, "the principle [the disclose-or-abstain rule] embodies extends to protecting public investors against transactions by *all* who possess such informational advantages."[51] All market participants should have an equal opportunity to profit from material information.[52] It is incumbent on each market participant, however, to expend the effort to acquire publicly disclosed information. Moreover, if information is nonpublic, the law should encourage legitimate research efforts.[53]

The policies of Title VII and section 10(b) are therefore strikingly alike. Regardless of whether the issue is employment rights or informational rights: all market participants (either in the labor or securities markets) are entitled to equal opportunity or access, but not equal outcomes, whether in the acquisition of jobs or information. In short, like equal employment opportunity law, the fundamental policy

---

47 Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961). In this administrative proceeding, a stockbroker acquired inside information that Curtiss-Wright planned to cut its dividend. Acting on this nonpublic information, the broker sold his clients' holdings in Curtiss-Wright. *Id.* at *2. Based on these facts, the SEC found that the broker had committed unlawful insider trading. *Id.* at *4.

48 *Id.* at *3.

49 *Id.* at *4.

50 Brudney, *supra* note 17, at 360.

51 *Id.* (emphasis added).

52 *See, e.g.*, Laura Palk, *Ignorance Is Bliss: Should Lack of Personal Benefit Knowledge Immunize Insider Trading?*, 13 BERKELEY BUS. L.J. 101, 146–47 (2016) (criticizing the requirement that tippees know that tippers received a personal benefit, and advocating a "parity of information" standard to replace the fiduciary standard currently in place); Shannon Seiferth, *No More Quid Pro Quo: Abandoning the Personal Benefit Requirement in Insider Trading Law*, 50 U. MICH. J.L. REFORM 175, 208–09 (2016) (proposing a change to insider trading law that would discard the fiduciary standard and the personal benefit requirement).

53 United States v. O'Hagan, 521 U.S. 642, 658–59 (1997) (pointing out that the research efforts of market professionals are essential to vital securities markets).

underlying insider trading law is an equality principle. This Article uses the term the "equality principle" when referring to either insider trading law or equal employment opportunity law.

Guided by the equality principle, the SEC promulgated Rule 14e-3.[54] This rule makes it unlawful for a person to trade on nonpublic information of a pending tender offer if he knows or has reason to know that (1) the information was both material and nonpublic, and (2) the information came directly or indirectly from an insider of the offeror.[55] Liability under this rule is predicated solely on the trader's unequal access to the information.[56] The European Union has adopted an anti-insider trading directive that is even broader than Rule 14e-3.[57] The Directive instructs member states to prohibit trading "where a person . . . uses [inside] information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly,

---

[54] 17 C.F.R. § 240.14e-3 (2016). The rule provides:

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice with the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

Id. Section 16(b) of the Exchange Act is a provision of the Exchange Act which creates strict liability for insider short-swing sales. This prohibition applies even in instances where the insider does not possess inside information. Section 16(b) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security . . . purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security [involved] or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Exchange Act, Pub. L. No 73-291, § 16(b), 48 Stat. 881, 896 (codified as amended at 15 U.S.C. § 78p(b) (2012).

[55] 17 C.F.R. § 240.14e-3 (2016).

[56] *Id.*

[57] Commission Regulation 596/2014, art. 8, ¶ 1, 2014 O.J. (L 173) 25 (EU), http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0596&from=EN.

financial instruments to which that information relates."[58] This Directive would ban trading on inside information, even if the trader did not know or had no reason to know that the information was material or nonpublic. Those who trade on inside information would be strictly liable.[59]

The Second Circuit in *SEC v. Texas Gulf Sulphur Co.*[60] endorsed the equality principle's broad application to insider trading law. The court emphasized: "the [disclose-or-abstain] 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."[61] In *Unites States v. O'Hagan*,[62] the Supreme Court recognized that the law of insider trading must "insure honest securities markets and thereby promote investor confidence."[63] The Court therefore held it unlawful to trade on misappropriated material, nonpublic information.[64] To justify its holding, the Court observed that "an investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill."[65] In other words, informational disadvantages are acceptable if they result from research, skill, or even luck. The Court intimated therefore that informational advantages gained by other means are unacceptable. This view comports with the equality principle.

It is perplexing that immediately after seeming to support the equality principle, the *O'Hagan* Court rejected it.[66] The Court

---

58 *Id.*

59 French law takes an extreme position, making a tipper civilly liable and subject to criminal prosecution for conveying inside information to another party even if the recipient does not trade on the information. *See* CODE MONÉTAIRE ET FINANCIER [C. MON. FIN.] [MONETARY AND FINANCIAL CODE] art. L. 465-1 (Fr.), https://www.legifrance.gouv.fr/content/download/1996/13927/version/2/file/CoMOFI+%C3%A0+jour+L+version+EN+novembre+2010.pdf; Carol Umhoefer & Alain Pietrancosta, *Le Delit D'Initie: Insider Trading Law in France*, 30 COLUM. J. TRANSNAT'L L. 89, 99 (1992).

60 401 F.2d 833 (1968).

61 *Id.* at 848. The Second Circuit went on to state:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing that it is unavailable to those with whom he is dealing" . . . . Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" . . . .

Id. (quoting Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961)).

62 521 U.S. 642 (1997).

63 *Id.* at 658.

64 *Id.* at 658–59.

65 *Id.*

66 *Id.* at 652.

conditioned liability on a breach of confidentiality to the source of the information, a barrier that blocked the equality principle's implementation.[67] The irony is remarkable.

The Court's misstep is partly attributable to the language of section 10(b) and Rule 10b-5, which require a deception as a precondition to liability.[68] The precondition of a deception, however, leads to unsound outcomes because there are numerous situations where a trader may acquire inside information absent a deception, such as through corporate espionage, eavesdropping, or a tip without a promise of confidentiality.[69]

Unlike insider trading law, the basic legal framework of Title VII effectively promotes its foundational equality principle.[70] The policy linkage between equal employment opportunity law and insider trading law might therefore inform the approach lawmakers take to redefining the unlawful use of inside information. Before this Article explores how lawmakers might profitably adapt the statutory provisions and judicial interpretations of Title VII to insider trading law, Part II of this Article examines in more detail the shortcomings in the current state of insider trading law.

II. THE DISTORTIONS OF THE CURRENT FRAMEWORK OF INSIDER TRADING LAW

The inadequacies of insider trading law do not arise solely from section 10(b) and Rule 10b-5. Through a series of dubious decisions, the Supreme Court has compounded the problem by creating an opaque and counterintuitive body of law.

---

[67] *Id.*

[68] Exchange Act, Pub. L. No 73-291, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)); 17 C.F.R. § 240.10b-5 (2016).

[69] *See infra* Part II (discussing worrisome implications of current insider law).

[70] This Article does not argue that either disparate-treatment or disparate-impact jurisprudence, as currently applied by the courts, is the ideal approach to addressing and reducing workplace discrimination. *See, e.g.*, Deborah C. Malamud, *The Last Minuet: Disparate Treatment After* Hicks, 93 MICH. L. REV. 2229, 2301 (1995) (advocating the abandonment of the *McDonnell Douglas* framework because *Hicks* strips courts of the flexibility to address novel issues); Sandra F. Sperino, *Rethinking Discrimination Law*, 110 MICH. L. REV. 69, 94–97 (2011) (criticizing overly formalistic judicial applications of both the disparate-treatment and disparate-impact frameworks); Charles A. Sullivan, *Disparate Impact: Looking Past the Desert Palace Mirage*, 47 WM. & MARY L. REV. 911, 984–85, 995 (2005) (arguing that disparate impact theory provides the most optimistic avenue for improving the serious shortcomings of Title VII, and calling for the dilution of the business necessity defense to achieve an improved equal employment opportunity law that would be more responsive to valid claims of workplace discrimination). Rather, this Article argues that the basic principles of disparate treatment law and particularly disparate-impact law hold great potential, not only for reducing workplace discrimination, but also for providing useful guidelines for lawmakers who wish to reformulate insider trading law.

A. Chiarella v. United States*: The Classical or Traditional Theory*

The Supreme Court took its first misstep in *Chiarella v. United States*.[71] Chiarella was a "markup man" working for Pandick Press, a printer of financial documents.[72] As part of his job, Chiarella handled several announcements of corporate takeover bids.[73] Although the documents he saw did not disclose the names of the acquiring or target companies, Chiarella was able to determine what companies were involved.[74] Trading on this inside information, he made more than $30,000 over a fourteen-month period.[75] The SEC launched an investigation into this unusual trading activity, and Chiarella ultimately signed a consent decree agreeing to return his profits to the counterparties of the trades.[76] The Department of Justice (DOJ) prosecuted Chiarella for unlawful insider trading under section 10(b) and Rule 10b-5.[77] After trial, he was convicted on all seventeen counts alleged in the indictment.[78]

The Supreme Court, applying the fraud requirement of Rule 10b-5, noted that corporate insiders may "not benefit personally through fraudulent use of material, nonpublic information."[79] The Court stated that "such liability is premised upon . . . a relationship of trust and confidence between parties to a transaction."[80] Chiarella's trading activities did not violate Rule 10b-5 because they failed to meet the fraud requirement for two reasons.[81] First, Chiarella was not a corporate insider with fiduciary duties of trust and confidence.[82] Second, even if he were a corporate insider, his duty of confidentiality would have been only to the acquiring companies because they had engaged Pandick Press to perform printing services.[83] No one at Pandick Press owed a duty of confidentiality to the target companies because any relationship between Pandick Press and the target companies arose from "impersonal market transactions."[84] The Court therefore overturned

71 445 U.S. 222 (1980).

72 *Id.* at 224.

73 *Id.*

74 *Id.* These names were omitted from the documents that Chiarella handled. The identities of the acquiring and target companies were inserted into the documents before the final printing. *Id.*

75 *Id.*

76 *Id.* On the very day that Chiarella signed the consent decree, Pandick Press terminated his employment. *Id.*

77 *Id.* at 225.

78 *Id.*

79 *Id.* at 230.

80 *Id.*

81 *Id.*

82 *Id.* at 232.

83 *Id.*

84 *Id.* at 232–33.

Chiarella's conviction.[85]

The *Chiarella* Court's holding contradicted the equality principle: insider trading law should strive to achieve equal access to material, nonpublic information. Equal access does not mean that all interested parties obtain the information—the law should not guarantee equality of result. Equal access simply means that all parties have an equal chance to obtain the information. Chiarella had the unfair advantage of access to the information of corporate takeovers because he worked for Pandick Press.

The unacceptability of the *Chiarella* holding prompted the Supreme Court to enunciate a second theory of liability, which broadened the reach of section 10(b) and Rule 10b-5.[86] Labeled the misappropriation theory, it would have snagged Chiarella for unlawful insider trading.

B. United States v. O'Hagan*: The Misappropriation Theory*

In *United States v. O'Hagan*,[87] Grand Met, which was planning to launch a tender offer for Pillsbury, retained the law firm of Dorsey & Whitney as local counsel.[88] Both Grand Met and Dorsey & Whitney strove to keep the planned tender offer confidential.[89] A partner of Dorsey & Whitney, O'Hagan did not work on the Grand Met matter.[90] Having learned of the takeover plan, however, he purchased Pillsbury shares and call options, and profited over $4.3 million.[91]

Like Chiarella, O'Hagan was not liable for unlawful insider trading under the classical theory.[92] Although he traded Pillsbury securities, he owed no fiduciary duty to that company.[93] To avoid another decision as unacceptable as *Chiarella*, the Supreme Court recognized the misappropriation theory.[94] "The 'misappropriation theory,'" Justice

---

85 *Id.* at 237.

86 *See infra* Section II.B (discussing the misappropriation theory).

87 521 U.S. 642 (1997).

88 *Id.* at 647.

89 *Id.*

90 *Id.*

91 *Id.* at 647–48. After investigation, the SEC issued a fifty-seven-count indictment against O'Hagan. *Id.* at 648–49. O'Hagan was convicted of theft in Minnesota state court, where he was convicted to thirty months of imprisonment and fined. The Minnesota Supreme Court disbarred him from the practice of law. *Id.* at 648 n.2.

92 *Id.* at 653 n.5.

93 *Id.*

94 *Id.* at 652–53. Justice Scalia disagreed with the majority, noting that under the principle of lenity the ambiguous language of section 10(b) could not support O'Hagan's criminal conviction. *Id.* at 679 (Scalia, J., concurring in part and dissenting in part). Justice Thomas faulted the majority for adopting an incoherent and inconsistent theory to meet the requirements of section 10(b). *Id.* at 680 (Thomas, J., concurring in the judgment in part, and

Ginsburg explained, "holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[95] Simply put, promising to keep information confidential and then trading on that information is a fraud that violates section 10(b) and Rule 10b-5.[96]

Chiarella and *O'Hagan* established two pathways for establishing securities fraud in insider trading cases. Requiring fraud to establish a claim of unlawful insider trading, however, defeated the purpose of equal access because a party might use non-fraudulent means to acquire material, nonpublic information.

1. Hacking

Computer hacking is one improper method of acquiring inside information that may stand beyond the reach of both the classical and misappropriation theories. In *SEC v. Dorozhko*,[97] the Second Circuit faced such a case. Oleksandr Dorozhko opened a trading account with Interactive Brokers.[98] Shortly thereafter, he allegedly hacked into the server of Thompson Financial to access the unreleased third-quarter earnings report of IMS Health Services.[99] Scheduled for release that very day, the report showed a steep decline in earnings.[100] Based on this nonpublic information, Dorozhko allegedly purchased over $41,000 of IMS short-term put options.[101] Later that day, when IMS released the earnings report, the value of IMS shares plummeted twenty-eight percent.[102] At the opening of trading the next morning, Dorozhko sold

---

dissenting in part).

95 *Id.* at 652; *see, e.g.*, Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 830–31 (1988) (observing that the misappropriation theory "has [nothing] to do with securities fraud," because the injury, if any, occasioned by misappropriation occurs absent any trading based on the inside information).

96 *O'Hagan*, 521 U.S. at 656. In *Carpenter v. United States*, 484 U.S. 19, 25–26 (1987), the Supreme Court applied the misappropriation theory in the context of mail fraud and wire fraud. In *Carpenter*, Winans, a co-author of the *Heard on the Street* column of the *Wall Street Journal*, shared confidential information with Felis prior to publication. *Id.* at 22–23. Felis traded on the information in this influential column, and split the profits with Winans. *Id.* at 23. The Supreme Court upheld their convictions for mail fraud and wire fraud because Winans misappropriated the information from the *Wall Street Journal*, which had an exclusive property right to the information. *Id.* 26–27.

97 574 F.3d 42 (2d Cir. 2009).

98 *Id.* at 44.

99 *Id.*

100 *Id.*

101 *Id.*

102 *Id.*

his put options and profited over a quarter of a million dollars.[103] Interactive Brokers reported Dorozhko's irregular trading activity to the SEC, which, based on persuasive circumstantial evidence that Dorozhko was the hacker, commenced an enforcement action against him.[104]

Judge Buchwald denied the SEC's motion for a preliminary injunction, observing correctly that Dorozhko's alleged conduct, though unlawful, did not violate section 10(b) because he did not breach a fiduciary duty to IMS or Thompson Financial.[105] The Second Circuit reversed the decision of the district court, noting that although the Supreme Court may have held that a breach of fiduciary duty is sufficient to establish an actionable insider trading case, the Court never ruled that such a breach is a necessary element.[106] One party might deceive another without breaching a fiduciary duty.[107] The Second Circuit held that, if Dorozhko misrepresented his identity to gain access to the server of Thompson Financial, the computer hacking would be a "deceptive device."[108] But the mere theft of the information without such a deception would not be actionable.[109] The Second Circuit's acknowledgement that section 10(b) permits a thief of material, nonpublic information to profit from his wrongdoing reveals the inadequacy of current law. This inadequacy extends to all forms of corporate espionage and theft of corporate records. The equality principle provides a superior alternative to section 10(b). It prohibits such practices because they provide wrongdoers with unequal access to material, nonpublic information.

---

[103] *Id.*

[104] *Id.* The circumstantial case against Dorozhko was persuasive. The purchase of the put options occurred on October 17. Tellingly, Dorozhko had not executed a single trade in his Interactive Brokers account before that date. Moreover, these options, which the SEC characterized as "extremely risky," were to expire on October 25 and October 30. Finally, Dorozhko's purchases of these options accounted for ninety percent of all purchases of IMS put options for the six weeks preceding the announcement of the earnings report. *Id.*

[105] *Id.* at 45.

[106] *Id.* at 49.

[107] *Id.*

[108] *Id.* at 51; *see also* Mark F. DiGiovanni, *Weeding out a New Theory of Insider Trading Liability and Cultivating an Heirloom Variety: A Proposed Response to* SEC v. Dorozhko, 19 GEO. MASON L. REV. 593, 596–97 (2012) (arguing that a thief who steals inside information violates a constructive trust, and that such a theft constitutes a deceptive practice prohibited by Rule 10b-5); Nelson, *supra* note 30, at 2196–97 (arguing that non-deceptive thieves of inside information, though not breaching fiduciary duties, nevertheless violate Rule 10b-5 because thievery raises concerns about the flow of material information in the securities markets).

[109] *See Dorozhko*, 574 F.3d at 51. The Second Circuit remanded the case, authorizing the district court either to reach a determination of Dorozhko's intent to deceive based on the existing record, or to reopen the proceedings for the submission of additional evidence. *Id.*

2. Tips Without a Promise of Confidentiality

There is another scenario where the misappropriation theory results in an indefensible outcome. If someone conveys inside information to a third party, absent a request that the third party not trade on the information, the third party may do so with impunity. Consider a securities broker who has learned that a prominent retail clothing chain, unable to compete with surging online Amazon sales, will close half its stores. The broker shares this nonpublic information with people she meets at a cocktail party. Before the information is disclosed to the public, the recipients of the information sell stock of the retail company short and buy its put options. Under the misappropriation theory, the SEC, the DOJ, and the counterparties to these trades have no recourse.

The equality principle would lead to the opposite result. The recipients of the information enjoyed access to inside information denied to others. Because of unequal access, the equality principle would deny the recipients of the information the right to trade on it.

The requirement of a breach of fiduciary duty stymies insider trading law from reaching its objective of fairness for all market participants. Laden with arbitrary impediments, the law of tipper/tippee liability is even more befuddling.

C. Dirks v. SEC*: Tipper/Tippee Liability*

The seminal case of tipper/tippee liability is *Dirks v. SEC.*[110] Ronald Secrist, a disgruntled former officer of Equity Funding informed Dirks, an investment analyst, that Equity Funding had fraudulently overstated its assets.[111] Dirks investigated these allegations, and, although Equity Funding's senior management denied any wrongdoing, several of its employees corroborated Secrist's charges.[112] While conducting his investigation, Dirks disclosed this information to a number of his clients who liquidated their holdings of Equity Funding.[113] Dirks also disclosed the information to William Blundell, the *Wall Street Journal*'s Los Angeles bureau chief, and urged him to publish a piece on the alleged fraud, but fearing a libel suit, Blundell refused.[114] In the meantime, word of the alleged fraud leaked to the public and the price of Equity Funding

[110] 463 U.S. 646 (1983).
[111] *Id.* at 648–49.
[112] *Id.* at 649.
[113] *Id.*
[114] *Id.* at 649–50.

plunged from twenty-six dollars per share to fifteen dollars per share.[115] In response, the New York Stock Exchange halted trading on Equity Funding stock, and shortly thereafter California authorities uncovered the fraud.[116]

The SEC launched an investigation into Dirks' involvement in the Equity Funding scandal, and charged him with violating section 10(b).[117] After a hearing, the SEC found that Dirks had aided and abetted unlawful insider trading by disclosing Equity Funding's fraud to clients who traded on the information.[118] The SEC concluded that a tippee in possession of inside information "inherits" the duty of the tipper to the source of the information.[119] The tippee therefore may not trade on that information if he knows that the information has not been publicly disclosed.[120] A divided panel of the D.C. Circuit affirmed the decision of the SEC.[121]

Citing *Chiarella*, the Supreme Court rejected the SEC's equal-access-to-information theory.[122] In doing so, it repudiated the applicability of the equality principle to trading on inside information, holding that the disclose-or-abstain rule "attaches only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws."[123] Not only must the tipper have breached a fiduciary duty to the source of the information, but also the tippee must know of the breach.[124]

1. Breach of Fiduciary Duty to the Source

To shoehorn insider trading liability into the strictures of section 10(b), the Supreme Court had to establish a fraud element, though fraud ordinarily has nothing to do with wrongful insider trading. All three

---

115 *Id.*

116 *Id.*

117 *Id.* at 650–51.

118 *Id.*

119 *Id.* at 655.

120 *Id.* at 651.

121 *Id.* at 652.

122 *Id.* at 657. The Court stated: "[i]n effect, the SEC's theory of tippee liability in both cases appears rooted in the idea that the antifraud provisions require equal information among all traders." *Id.* It is regrettable that the Court, relying on *Chiarella*, not only rejected the equality principle, but also eviscerated the potential impact of Rule 10b-5 in regulating trading on inside information.

123 *Id.* (quoting Dirks v. SEC, 681 F.2d 824, 837 (D.C. Cir. 1982)).

124 Dirks v. SEC, 463 U.S. 646, 660 (1983); *see also* SEC v. Obus, 693 F.3d 276, 287 (2d Cir. 2012) (interpreting the scienter requirement to mean that a tippee must know or have reason to know that the tipper breached a fiduciary duty to the source of the information); United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015) (holding that an element of a section 10(b) violation is a tippee's knowledge that the original tipper breached a fiduciary duty, i.e., a tippee in a chain must know that the original tipper received a benefit for the tip).

theories of insider trading have worsened this analytical error by premising liability on a breach of fiduciary duty to the source of the information. Such a breach of fiduciary duty, however, is distinct from the injury that insider trading causes.[125] Insider trading is unfair to and may inflict harm on the counterparty to the trade.[126] It also may upset the public's confidence in the securities markets.[127] It does not, however, harm the source of the inside information. Put another way, whatever harm a breach of fiduciary duty causes to the source, that harm is unaffected by whether or not anyone trades on the information. By conflating the wrong to the source with the wrong of trading on inside information, current law is trapped in a conceptual no-man's-land. Worse, the law has drifted farther away from the equality principle.

2. The Benefit Requirement

The Court imposed yet another roadblock to liability for insider trading. It stated that a tipper has breached a fiduciary duty only if the tipper derived a personal benefit by disclosing the information to the tippee.[128] Whether direct or indirect, such a benefit may be monetary or reputational if likely to translate into future, financial gain.[129] Making a gift of inside information to a relative or friend, said the Court, is tantamount to a pecuniary or reputational benefit.[130]

Applying these principles, the Court exonerated Dirks.[131] First, he was a securities analyst with no fiduciary duty to Equity Funding shareholders.[132] Second, he did not misappropriate the information about Equity Funding by promising to keep it confidential.[133] Third, neither Secrist nor other Equity Funding employees who disclosed information to Dirks violated section 10(b) because none received a

---

125 *See, e.g.*, Kenneth R. Davis, *Insider Trading Flaw: Toward a Fraud-on-the-Market Theory and Beyond*, 66 AM. U. L. REV. 51, 68 (2016) (observing that "[i]t is analytically suspect to make the wrong that gives rise to an insider trading violation something other than the trade itself.").

126 Bryan S. Schultz, *Feigning Fidelity to Section 10(b): Insider Trading Liability After* United States v. O'Hagan*, 117 S. Ct. 2199 (1997)*, 66 U. CIN. L. REV. 1411, 1435 (1998) (criticizing the misappropriation theory because it "ignores the plight of the deceived investor and focuses on the injury to the source of stolen information").

127 Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 192 (1991) (faulting the traditional theory because it focuses on the fiduciary duty to the corporation rather than on the market at large).

128 *Dirks*, 463 U.S. at 663. Joined by Justices Brennan and Marshall, Justice Blackmun argued that the personal benefit requirement adopted by the majority gratuitously engrafted a limitation on liability. *Id.* at 676 (Blackmun, J., dissenting).

129 *Id.* at 663 (majority opinion).

130 *Id.* at 664.

131 *Id.* at 665.

132 *Id.*

133 *Id.*

benefit for providing him with the information.[134] Their motive was to expose Equity Funding's fraud, not to profit personally.[135]

The Court's imposition of the personal benefit requirement as a barrier to liability is perplexing for two reasons.[136] First, the language of section 10(b) does not require that liability depends on proving personal gain. A person may deceive another, even without benefiting personally. Second, the results of imposing this requirement are undesirable. For example, suppose a Fortune 500 beverage company is planning to launch a revolutionary sports drink. After attending a board of directors meeting of that company, a director takes a taxi, and tells the cabbie about the company's plan. He says that the information has not been publicly disclosed, and that the company will soon announce its strategy in a press release. The cabbie trades on this information. Because the director derived no benefit by disclosing the information to the cabbie, and because he did not provide the information confidentially, neither he nor the cabbie violated section 10(b).[137] Such trading practices are not only unfair, but, if exposed publicly in the press or otherwise, they also might threaten investor confidence. The equality principle, however, would hold the director and cabbie liable for unlawful insider trading. The cabbie traded on inside information denied to the public at large, and the director facilitated this violation.

3. Scienter

To establish a section 10(b) violation, a plaintiff must prove fraud in connection with the purchase or sale of any security.[138] One of the elements of fraud is scienter, defined as the intent to deceive, or at the very least recklessness, which means conscious disregard far exceeding negligence.[139] The scienter requirements of tipper/tippee liability are

---

134 *Id.* at 666–67.

135 *Id.* at 667.

136 *See id.* at 673–74 (Blackmun, J., dissenting) (arguing that the antifraud provisions do not require the personal benefit element of tipper/tippee liability). *But see* Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 453 (2013) (remarking that *Dirks*' objective personal benefit standard is confusing, but defending it because it "helps the tippee know where he stands," that is, the tippee who provides a benefit to the tipper knows that the tipper is acting selfishly).

137 *See infra* notes 159–75 and accompanying text (discussing the requirement of *Dirks* and *Salman* that a gratuitous tip, to be actionable, must be to a relative or friend, and *Martoma*, which contradicts those decisions by rejecting the relative-or-friend limitation).

138 17 C.F.R. § 240.10b-5 (2016).

139 *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (holding that the intent to deceive is an element of a Rule 10b-5 violation); *In re* Ikon Office Sols., Inc., 277 F.3d 658, 667 (3d Cir. 2002) (explaining that mere negligence does not establish scienter); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc) (holding that the standard of "highly unreasonable" conduct meets the scienter requirement announced in *Hochfelder*);

formidable. In *SEC v. Obus*,[140] the Second Circuit spelled them out. First, a tipper must provide the tip deliberately or recklessly.[141] Second, the tipper must know or have reason to know that the information is material and nonpublic.[142] Third, the tipper must know or have reason to know that by providing the tip, he violates a fiduciary duty.[143] Fourth, a tippee must know that the information is material and nonpublic.[144] Fifth, a tippee must know or have reason to know that trading on the information would constitute a breach of fiduciary duty on the part of a tipper, which could be established by a tippee's or remote tippee's knowledge that the tipper received a benefit.[145] All these layers of intent create a thicket of requirements that plaintiffs may find impenetrable.

4. Eavesdropping

The personal benefit and scienter requirements create a loophole for eavesdroppers. In *SEC v. Switzer*,[146] Barry Switzer, the football coach at the University of Oklahoma, was attending a track meet in which his son was a participant.[147] When he arrived at the meet, he ran into an acquaintance, George Platt, a director of Phoenix Resources.[148] Switzer and Platt greeted each other and occasionally interacted, but they did not sit together.[149] At some point during the day, Switzer overheard Platt mention to his wife that Phoenix might liquidate its assets.[150] Before this inside information became public, Switzer shared it with friends, who, along with Switzer, traded on this information and made substantial gains.[151] The district court generously found that Switzer had inadvertently overheard the Platt conversation, and that "Platt did not receive any direct or indirect pecuniary gain nor any reputational

---

Sanders v. Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977) (noting that the degree of recklessness necessary to meet the scienter element of Rule 10b-5 is different in kind from negligence and is more akin to the intent to deceive).

140 693 F.3d 276 (2d Cir. 2012).

141 *Id.* at 286.

142 *Id.*

143 *Id.*

144 *Id.* at 287.

145 *Id.* at 287–88; *see also* United States v. Salman, 792 F.3d 1087, 1092 (9th Cir. 2015), *aff'd*, 137 S. Ct. 420 (2016) (holding that, to commit unlawful insider trading, a tippee must know that a tipper has breached a fiduciary duty to the source of the information); United States v. Falcone, 257 F.3d 226, 234 (2d Cir. 2001) (holding in a case alleging misappropriation that the government had to establish that the recipients of inside information knew or had reason to know that the insider breached a fiduciary duty to the source).

146 590 F. Supp. 756 (W.D. Okla. 1984).

147 *Id.* at 761.

148 *Id.*

149 *Id.*

150 *Id.* at 762.

151 *Id.* at 762–63.

benefit likely to translate into future earnings . . . ."[152] Nor, said the court, did Switzer or any remote tippees know or have reason to know that the information was material and nonpublic, or that Platt's transmission of the information constituted a breach of fiduciary duty.[153] Thus, neither Platt, nor Switzer, nor Switzer's remote-tippee friends were liable.[154]

Putting aside the dubious findings of the *Switzer* court, reasonable people may differ on whether the law should permit an eavesdropper to profit from overheard information. The equality principle does not provide a clear-cut answer. Suppose a customer in a restaurant overhears Jamie Dimon, CEO of J.P. Morgan, say to a companion that the underwriting arm of the organization has landed several IPOs, which should result in tens of millions of dollars of underwriting fees. One might argue that everyone had equal access to the restaurant but did not have the luck to be at the right place at the right time. Thus, the eavesdropper's trades did not violate the equality principle. Others might contend, on the other hand, that the eavesdropper was in a position that afforded unique access to nonpublic information. Thus, by trading on the information, the eavesdropper violated the equality principle. There are other practical and policy considerations. Allowing an eavesdropper to profit from such information might erode public confidence in the securities markets, particularly because those benefiting from intentional tips might escape liability by professing innocence. Determining the truth in any such case might prove a daunting task.[155] Whether the law should permit eavesdroppers to trade on overheard information is grist for a worthwhile policy debate. The equality principle may not provide a definitive answer, but that principle opens the issue for discussion. Section 10(b) precludes such a discussion because eavesdropping does not ordinarily involve a deception.

5. Market Professionals

Insofar as the Court championed *legitimate* research efforts of market professionals, the Court was correct. The equality principle protects equality of access, not equality of outcome. For example,

---

152 *Id.* at 764.

153 *Id.*

154 *Id.* at 766. The court stated, as a separate ground for exonerating all the defendants, that none knew or had reason to know that the information they received was material and nonpublic. *Id.*

155 *See* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 371 (5th ed. 2009) (commenting that "[t]he task of proving such a motive in many cases must rest on circumstantial evidence and may be troublesome").

suppose that during Enron's rein as a darling of Wall Street, a securities analyst engaged an auditing team to dissect Enron's balance sheet. Astute auditors might have suspected Enron's deceptive use of special purpose entities to transfer liabilities off Enron's books. Questioning Enron's internal accountants might have confirmed Enron's fraudulent use of these dummy companies. Without receiving an express "tip," the auditors and analyst might acquire inside information. As the Supreme Court recognized, such probing research is praiseworthy, and promotes vibrant securities markets.[156] Trading on such information should not be unlawful. But the *Dirks* Court went further than legitimizing in-depth research.[157] It stated that analysts who uncover inside information may disclose it to clients while withholding the information from release to the public.[158]

D. Salman v. United States*: An Affirmation of* Dirks

The Supreme Court granted Salman's petition for a writ of certiorari to resolve a conflict between the Second and Ninth Circuits.[159] In *United States v. Newman*,[160] the Second Circuit, misconstruing *Dirks*, stated that when a tipper communicates inside information to a friend or relative the inference of a benefit within the meaning of *Dirks* is

---

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

157 *Id.* at 658–59.

158 *Id.* The Supreme Court noted:

> It is commonplace for analysts to "ferret out and analyze information," and this is often done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

Id. at 659–60 (citation omitted). This pronouncement may have gone too far in condoning if not encouraging informational asymmetries. After the *Dirks* decision, the SEC curtailed some of the informational advantages that analysts enjoyed. Originally promulgated in 2000, Regulation FD requires the simultaneous public disclosure of nonpublic, material information intentionally conveyed to analysts or other participants in the securities markets. 17 C.F.R. § 243.100(a)(1) (2011). From time to time possible violations of Regulation FD have created controversy in the securities markets. For example, Tim Cook, CEO of Apple, privately emailed TV celebrity Jim Cramer that Apple's mid-quarter performance was strong despite rumors of flagging sales in China. *See* Jennifer Booton, *Apple CEO Tim Cook May Have Violated SEC Rules with Jim Cramer Email*, MARKETWATCH (Aug. 24, 2015, 4:46 PM), http://www.marketwatch.com/story/apple-ceo-tim-cook-may-have-violated-sec-rules-with-jim-cramer-email-2015-08-24. Securities experts warned that, despite Cramer's public disclosure of this communication on his TV program, *Mad Money*, this communication may nevertheless have violated Regulation FD. *Id.*

159 Salman v. United States, 137 S. Ct. 420 (2016).

160 773 F.3d 438 (2014), *cert. denied*, 136 S. Ct. 242 (2015).

permissible only if the exchange of information results in at least a potential monetary or other valuable benefit to the tipper.[161] The Ninth Circuit, applying *Dirks* correctly, held that when a tipper communicates inside information to a friend or relative, a benefit to the tipper is presumed.[162]

Salman was a typical insider trading case, involving a remote tippee. An investment banker for Citigroup, Maher Kara was privy to confidential information of mergers and acquisitions in the healthcare industry.[163] Maher was close to his older brother, Michael, and often shared confidential information with him.[164] Michael, in turn, fed some of this information to Salman, his brother-in-law.[165] Salman traded on this information and split $1.5 million in profits with another relative who traded on Salman's behalf.[166]

A unanimous Supreme Court had no trouble in affirming the Ninth Circuit's ruling, holding that a tip to a friend or relative by its very nature confers a benefit on the tipper.[167] The Court explained, "[m]aking a gift of inside information to a relative like Michael is little different from trading on the information, obtaining the profits, and doling them out to the trading relative. The tipper benefits either way."[168]

This justification is unpersuasive because it would apply equally to any tippee, whether or not a friend or relative. For example, assume the CEO of a major entertainment conglomerate has just learned that three of his company's summer movies generated blockbuster revenues. The next day he delivers his daughter to summer camp, meets the parents of another camper, and he tells them the staggering numbers. He generously suggests that, before the information is revealed to the public, they buy as much stock as they can afford. They gleefully take his advice and make a killing. Viewed from a purely analytical rather than an emotional standpoint, the rationale of *Salman* would seem to apply to this situation. By providing the inside information to the camper's parents who traded on and profited from the information, the CEO was in the same position as he would have been if he had traded on the information himself and doled out the profits to the parents.

---

161 *Newman*, 773 F.3d at 452. The Second Circuit stated: the inference of a benefit to the tipper of information to a friend or relative "is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Id.*

162 United States v. Salman, 792 F.3d 1087, 1092 (2015).

163 *Salman*, 137 S. Ct. at 424.

164 *Id.*

165 *Id.*

166 *Id.*

167 *Id.* at 427.

168 *Id.* at 428.

The implicit rationale for the *Salman* rule is that the tipper has an emotional relationship with a friend or relative that is absent with a stranger or mere acquaintance. A close relationship evokes generosity and cooperation. Moreover, the very idea that someone may freely provide inside information to a son, daughter, or college buddy strikes one as objectionable because of the emotional *quid pro quo*. Providing the information to a stranger, though also troubling, does not jangle as much in the mind. Finally, when someone shares inside information with a friend or relative, there is always the specter of the collusive sharing of profits or some other future payback.[169]

A sensible legal framework would prohibit any tip of inside information, regardless of the relationship of the tipper to the tippee. Any tippee, whether a husband or wife, a friend, or a stranger encountered by chance in the park should not have access to material, nonpublic information. The nature of the relationship between the tipper and the tippee is irrelevant; the denial of equal access to other market participants should be determinative.

Recognizing the flaw in the Supreme Court's rationale for distinguishing between gifts to relatives and friends, on the one hand, and gifts to anyone else, on the other hand, the Second Circuit held, in *United States v. Martoma*,[170] that any gratuitous tip triggers liability as long as the tipper knew, or, in a civil case, had reason to know that the tippee would trade on the information.[171] *Martoma* is a welcome development because it comports with the equality principle, but it clashes with *Dirks* and *Salman*, both of which limit liability for gratuitous tips to those made to relatives or friends.[172] One might therefore question whether *Martoma* will survive further scrutiny, either by the Second Circuit en banc, the Second Circuit in subsequent decisions, or by the Supreme Court.[173]

169 As Justice Breyer observed at the oral argument of the Salman case, "to help a close family member is like helping yourself." Transcript of Oral Argument at 8, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628).

170 No. 14-3599, 2017 WL 3611518, at *25 (2d Cir. Aug. 23, 2017). This case involved nonpublic information that Dr. Sidney Gilman and Dr. Joel Ross provided to Mathew Martoma, a portfolio manager at S.A.C. Capital Advisors. The information concerned the efficacy of bapineuzumab, a drug under development for the treatment of Alzheimer's disease. *Id.* at *1. Based on Dr. Gilman's disclosure of disappointing results of the drug's clinical trial, Martoma divested his company of holdings in Elan and Wyeth, the two companies with financial interests in the drug, and took positions betting against the value of the shares of those companies. *Id.* at *2.

171 *Id.* at *8. Chief Judge Katzmann emphasized in the majority opinion that *Dirks* did not directly address whether a gift to someone other than a relative or friend might constitute a "benefit." *Id.* at *6. The dissent, however, demonstrated that both *Dirks* and *Salman* foreclosed with painstaking specificity the possibility that the benefit requirement might be met by a gift to a non-relative or mere acquaintance. *Id.* at *25–26 (Pooler, J., dissenting).

172 *Salman*, 137 S. Ct. at 427; Dirks v. SEC, 463 U.S. 646, 664 (1983).

173 See Carmen Germaine, *2nd Circ. Ends Newman Relationship Test, but for How Long?*,

The equality principle should have guided the development of insider trading law. Regrettably, Congress and the Supreme Court have veered away from that principle. Instead they have established a confounding body of law based on the antifraud provisions. In doing so, they have relied heavily on the concept of breach of fiduciary duty, applying that concept in overly complex and arbitrary ways. The result is a body of law plagued with flaws.

An equality principle has guided the development of employment opportunity law under Title VII. This equality principle is analogous to the principle that should have guided the development of insider trading law. The history of Title VII law has been bumpy because of tensions between Congress and Supreme Court decisions, and because of changes in the composition of the Court.[174] Nevertheless, Title VII, though perhaps somewhat bruised, has emerged with a set of foundational rules that are sensible and workable, and most importantly effective in implementing its equality principle.[175] Although the fundamental rules of Title VII should not be superimposed onto insider trading law blindly, they provide useful guideposts. Part III explores how the most effective rules of Title VII might inform lawmakers on how to improve the law of insider trading.

III. THE LESSONS OF TITLE VII

There are two major branches of civil rights law under Title VII. The first, disparate treatment, proscribes intentional discrimination against protected classes.[176] The second, disparate impact, makes certain instances of discrimination unlawful even if not motivated by discriminatory intent.[177] Both of these branches are instructive to those

LAW360 (Aug. 23, 2017, 10:43 PM), https://www.law360.com/articles/957178 (questioning the durability of the *Martoma* decision); Peter J. Henning, *In a Boon to Prosecutors, Insider Trading Ruling Is Reshaped*, N.Y. TIMES (Aug. 24, 2017), https://www.nytimes.com/2017/08/24/business/dealbook/insider-trading-mathew-martoma-appeal.html?mcubz=0 (noting that en banc review is uncommon, but suggesting that the Second Circuit may use subsequent cases to limit the Martoma decision).

174 *See infra* Part III (discussing the history of disparate-treatment and disparate-impact law).

175 *See infra* Part III (noting the shortcomings of many of the judicial interpretations of Title VII).

176 *See* Desert Palace, Inc. v. Costa, 539 U.S. 90, 98–100 (2003) (holding that the mixed-motive analysis applies to all disparate-treatment cases whether based on circumstantial or direct evidence); *see also* Kenneth R. Davis, *The Stumbling Three-Step, Burden-Shifting Approach in Employment Discrimination Cases*, 61 BROOK. L. REV. 703 (1995) (analyzing the methods of proving disparate-treatment cases).

177 *See* Griggs v. Duke Power Co., 401 U.S. 424 (1971) (establishing the disparate impact theory of employment discrimination); *see also* Kenneth R. Davis, *Wheel of Fortune: A Critique of the "Manifest Imbalance" Requirement for Race-Conscious Affirmative Action Under Title VII*, 43 GA. L. REV. 993, 1019 n.146 (2009) (discussing disparate impact law).

who wish to restructure federal insider trading law.

A. *Disparate-Treatment Theory: Intentional Discrimination*

Depending on its composition, the Supreme Court has vacillated in its commitment to the equality principle of Title VII.[178] In *Price Waterhouse v. Hopkins*,[179] the Court adopted a minimal causation standard for disparate-treatment cases. This standard eased the burden of proof on victims of workplace discrimination.

1. *Price Waterhouse v. Hopkins*: The Motivating Factor Test

In *Price Waterhouse*, Ann Hopkins, a senior manager in Price Waterhouse, a prestigious accounting firm, was eligible for partnership.[180] Despite Hopkins's outstanding record of performance punctuated by her significant role in securing a lucrative government contract, the firm denied her application for partnership ostensibly

---

178 A striking example of the Supreme Court's perfidy is the devolution of the three-step, burden-shifting framework established in *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973), for disparate-treatment cases. Step one, under this framework, required the plaintiffs to prove a prima facie case by a preponderance of the evidence. *Id.* at 802. In a refusal-to-hire case, the elements of a prima facie case were (i) the plaintiff is a member of a protected class, (ii) the plaintiff was qualified for the job and applied for it, (iii) the employer denied plaintiff the job, and (iv) the job remained open and the defendant continued to seek applicants with the plaintiff's qualifications. *Id.* Step two required the defendant simply to articulate one or more nondiscriminatory reasons for its refusal to hire the plaintiff. *Id.* at 802–03. Step three provided the plaintiff with two alternative routes to prove discrimination: either to disprove the articulated step two reason or reasons, or to prove with other evidence that discriminatory intent motivated the defendant's refusal to hire the plaintiff. *Id.* at 804. In *Texas Department of Community Affairs v. Burdine*, 450 U.S. 248 (1981), the Court clarified *McDonnell Douglas* by confirming that the defendant's burden at step two was merely one of production, not persuasion, and that the ultimate burden to prove discrimination resided with the plaintiff. *Id.* at 254. It is regrettable that in *St. Mary's Honor Center v. Hicks*, 509 U.S. 502 (1993), the Court eviscerated *McDonnell Douglas*'s burden-shifting approach. The Court held that if the plaintiff disproved the defendant's step-two reason or reasons, the finder of fact was permitted, but not compelled, to infer unlawful discriminatory intent. *Id.* at 511; *see also* Mark S. Brodin, *The Demise of Circumstantial Proof in Employment Discrimination Litigation:* St. Mary's Honor Center v. Hicks*, Pretext, and the "Personality" Excuse*, 18 BERKELEY J. EMP. & LAB. L. 183, 229 (1997) (stating that *Hicks* contradicted *McDonnell Douglas* by rejecting the proposition that disproving defendant's step-two reasons conclusively established discrimination); Henry L. Chambers, Jr., *Getting It Right: Uncertainty and Error in the New Disparate Treatment Paradigm*, 60 ALB. L. REV. 1, 40 (1996) (recognizing that *Hicks* rewrote *McDonnell Douglas* and made it more difficult for plaintiffs to prevail); Kenneth R. Davis, *Price-Fixing: Refining the* Price Waterhouse *Standard and Individual Disparate Treatment Law*, 31 FLA. ST. U. L. REV. 859, 869 (2004) (criticizing *Hicks* for defeating the purpose of the *McDonnell Douglas* framework and rendering the framework ineffectual).

179 490 U.S. 228 (1989), *superseded by statute*, Civil Rights Act of 1990, S. 2104, 101st Cong. (1990), *as stated in* Landgraf v. USI Film Products, 511 U.S. 244, 251 (1994).

180 *Price Waterhouse*, 490 U.S. at 233.

because of her harsh treatment of the firm's staff.[181] At the district court level, Judge Gesell found, however, that sex-stereotyping as well as her abrasiveness influenced the decision to deny her partnership.[182]

The firm's denial of Hopkins's partnership application therefore rested on both a discriminatory and nondiscriminatory reason. The task before the Supreme Court was to determine the relevant causation standard for liability under Title VII, when both a discriminatory and nondiscriminatory factor played a role in the adverse employment decision.[183] The Court's analysis of this "mixed-motive" case began with the language of the statute.[184] Title VII prohibits employers from discriminating in the "compensation, terms, conditions, or privileges of employment, *because of* . . . sex . . . ."[185] The Court considered whether Congress intended the phrase "because of" to require but-for causation or a lesser degree of causation.[186] After reviewing legislative history and other provisions of Title VII, a plurality of the Court concluded that Congress intended to establish broad protections for victims of discrimination.[187] The plurality therefore held that, if discriminatory intent was merely a motivating or contributing factor for the adverse employment action, the employer had committed a prima facie violation of Title VII.[188]

---

181 *Id.* at 233–35.

182 *Id.* at 236. One partner described Hopkins as "macho," and another said that she "overcompensated for being a woman." Yet another suggested that she go to "charm school," and others criticized her for using foul language. Thomas Beyer, the partner who informed Hopkins that the firm had denied her partnership application, told her that she could enhance her chances for advancement if she were to "'walk more femininely, talk more femininely, dress more femininely, wear make-up, have her hair styled, and wear jewelry.'" *Id.* at 235 (citation omitted).

183 *Id.* at 238.

184 *Id.* at 240.

185 *Id.* at 262 (O'Connor J., concurring) (emphasis added) (quoting 42 U.S.C. § 2000e-2(a) (2012)).

186 *Id.* at 240–41 (majority opinion).

187 *Id.* at 242–43.

188 *Id.* at 242. Justice O'Connor argued that to shift the burden of persuasion to the defendant, the plaintiff had to submit direct, rather than circumstantial, evidence that discriminatory intent was a substantial factor, not merely a contributing factor, that led to the adverse employment action. *Id.* at 276 (O'Connor, J., concurring). As Justice Kennedy observed, the standard Justice O'Connor articulated became the rule of the case because her vote, along with the four votes of the plurality, constituted a majority of the Court. *Id.* at 280 (Kennedy, J., dissenting). Joined by Chief Justice Rehnquist and Justice Scalia, Justice Kennedy argued that but-for causation was the appropriate standard for disparate treatment cases. *Id.* at 282 (Kennedy, J., dissenting). Justice White believed that *Mt. Healthy City School District Board of Education v. Doyle*, 429 U.S. 274 (1977) answered the causation issue presented in *Price Waterhouse*. 490 U.S. at 258 (White, J., concurring). In *Mt. Healthy*, a school board refused to rehire a public school teacher for two reasons. *See id.* One reason was permissible, while the other violated the teacher's First Amendment rights. *Id.* at 258–59. If the Supreme Court applied the "same-decision" defense in *Mt. Healthy*, Justice White would have avoided semantic debates about but-for causation and affirmative defenses, relying simply on the holding of that case. *Id.* at 259.

2. The Civil Rights Act of 1991: Codification and Modification

The Civil Rights Act of 1991 (1991 Act)[189] codified the "motivating factor" test adopted in *Price Waterhouse*.[190] Congress, however, tipped the scale further in the plaintiff's favor by modifying a second prong in the ruling of the *Price Waterhouse* Court.[191]

The plurality of the *Price Waterhouse* Court established "the same decision" defense. If an employer showed that it would have taken the same adverse action absent discrimination, this defense completely exonerated the employer.[192] Congress weakened this defense by declaring that such a showing would merely limit the remedies available to the victim.[193]

Congress's codification of both a low causation standard in disparate treatment cases and an attenuated same-decision defense support the equality principle. Taken together, these two enactments create a legal framework intolerant of even the subtlest forms of invidious discrimination in the workplace. This minimalist approach to establishing liability under Title VII provides a conceptual model for insider trading law. To promote the equality principle in the arena of insider trading, the scope of liability for trading on inside information should be expansive. This approach calls for the elimination of extraneous preconditions to liability such as breach of fiduciary duty to the source of the information and a benefit to a tipper. On a more fundamental level, this approach calls for discarding any requirement of fraud. This approach might go even further, arguably eliminating the requirement that the party trading on inside information knew or had

189 Pub. L. 102-166, 105 Stat. 1071.

190 Section 107 of the 1991 Act provides: "[e]xcept as otherwise provided in this subchapter, an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, even though other factors also motivated the practice." Pub. L. 102-166, § 107, 105 Stat. 1071, 1075–76 (codified as amended at 42 U.S.C. § 2000e-2(m) (2012)). The remedy, however, depends on whether the nondiscriminatory motive was a sufficient cause for the challenged employment practice. *See* 42 U.S.C. § 2000e-5(g)(2)(B). That subsection provides:

> On a claim in which an individual proves a violation under section 2000e-2(m) of this title and a respondent demonstrates that the respondent would have taken the same action in the absence of the impermissible motivating factor, the court-- (i) may grant declaratory relief, injunctive relief (except as provided in clause (ii)), and attorney's fees and costs demonstrated to be directly attributable only to the pursuit of a claim under section 2000e-2(m) of this title; and (ii) shall not award damages or issue an order requiring any admission, reinstatement, hiring, promotion, or payment, described in subparagraph (A).

Id.

191 *Price Waterhouse*, 490 U.S. at 244–45.

192 *Id.*

193 *See supra* note 190.

reason to know that the information was nonpublic.[194]

Title VII provides an even stronger argument for a stricter approach to insider trading law. The wellspring for that argument is *Griggs v. Duke Power Co.*[195]

B. *Disparate-Impact Theory: Strict Liability*

Early in the history of Title VII, the Supreme Court rendered the *Griggs* decision.[196] Until *Griggs*, many believed that Title VII prohibited only intentionally-discriminatory employment practices.[197] This landmark case announced that Title VII also forbade unintentional discrimination that results from facially-neutral employment practices.[198]

The complaint in *Griggs* alleged that Duke Power discriminated against African American employees at its Dan River Plant.[199] This plant was organized into five operating departments: (1) labor, (2) coal handling, (3) operations, (4) maintenance, and (5) laboratory and test.[200] African American employees worked exclusively in the labor department, which was the lowest paying of the five departments.[201] In 1955, Duke Power initiated the requirement of a high school diploma for new hires in any department other than the labor department.[202] Spurred by passage of the 1964 Civil Rights Act, Duke Power abandoned its formal policy of restricting African Americans to jobs in the labor department, but it simultaneously made a high school diploma a requirement for transfer from labor to any other department.[203] On July 2, 1965, the very day that Title VII became effective, Duke Power instituted an additional requirement.[204] To qualify for a job in any department other than labor, a new applicant had to achieve satisfactory scores on two standardized aptitude tests: the Wonderlic Personnel Test

---

194 *See infra* Section III.B.2 (discussing whether knowledge that information is nonpublic should be an element of an insider trading violation, and concluding that such knowledge should not be an element).

195 401 U.S. 424 (1971).

196 *Id.*

197 *Id.* at 428. The Supreme Court noted that this case presented an issue of first impression to the Court of Appeals: whether Title VII prohibits discriminatory outcomes only when motivated by discriminatory intent. *Id.* The Court of Appeals concluded that, absent a showing of intent, Duke Power had not violated Title VII. *Id.* at 429.

198 *Id.* at 431.

199 *Id.* at 427.

200 *Id.*

201 *Id.*

202 *Id.*

203 *Id.*

204 *Id.* at 427–28.

and the Bennett Mechanical Comprehension Test.[205] The requisite scores for new applicants or incumbents seeking transfer approximated the mean for high school graduates.[206]

An incumbent employee wishing to transfer from labor to another department did not have to pass either of these aptitude tests, though he still needed a high school diploma.[207] Duke Power instituted yet another policy change in September 1965 when it began to permit employees who passed the two aptitude tests to transfer from the labor and coal handling departments to jobs in the other three higher-paying departments, even if those workers did not have a high school diploma.[208]

The issue was whether, absent proof of discriminatory intent, Duke Power had violated Title VII by engaging in employment practices that had disproportionately negative effects on African American job applicants and incumbent African American workers seeking transfer.[209] The Supreme Court began its analysis by stating the overarching equality principle: "[t]he objective of Congress in the enactment of Title VII is plain from the language of the statute. It was to achieve equality of employment opportunities and remove barriers that have operated in the past to favor an identifiable group of white employees over other employees."[210] The Court clarified the scope of Title VII's equality principle, noting that "Congress did not intend by Title VII, however, to guarantee a job to every person regardless of qualifications. In short, the Act does not command that any person be hired simply because he was formerly the subject of discrimination, or because he is a member of a minority group."[211] Encapsulating Title VII's equality principle, the Court emphasized, "[d]iscriminatory preference for any group, minority or majority, is precisely and only what Congress has proscribed."[212]

The objective of Title VII is equality of employment opportunity but not equality of job acquisition.[213] This policy is reminiscent of the

---

205 *Id.* at 428.
206 *Id.*
207 *Id.*
208 *Id.*
209 *Id.* at 429.
210 *Id.* at 429–30.
211 *Id.* at 430–31.
212 *Id.* at 431.
213 In *Smith v. City of Jackson*, 544 U.S. 228, 240 (2005), the Supreme Court extended disparate-impact theory to age-discrimination cases. The Court's plurality based its ruling on the textual similarities between Title VII and the Age Discrimination in Employment Act. *Id.* at 228–29. It also noted that the EEOC had taken the position that the disparate-impact theory applies to age-discrimination cases. *Id.* at 239. Finally, it found support for its decision in the "Reasonable Factors Other than Age" (RFOA) defense, which provides that an employment action is lawful if based on "reasonable factors other than age." *Id.* at 238. The Court reasoned that the RFOA defense could not refer to disparate treatment because if an employer acted on a

equality principle that applies to insider trading: equality of access to material, nonpublic information, but not equality of the acquisition of such information. The principles articulated in *Griggs*, which provide a receptive framework for workplace discrimination claims, therefore provide guidance on how to improve insider trading law.[214] The central holding of the *Griggs* Court is of particular importance. The Court recognized that "Congress directed the thrust of the Act to the consequences of employment practices, not simply the motivation."[215] Reinforcing this viewpoint, the Court declared that Title VII "proscribe[d] not only overt discrimination but also practices that are fair in form, but discriminatory in operation."[216] These sweeping pronouncements provided the foundation for disparate-impact theory, a doctrine of strict liability.

1. The Analogy of Disparate Impact to Insider Trading Law

The lesson for insider trading law is clear. To effectuate the equality principle of insider trading, the law should follow a form of strict liability analogous to disparate impact. This approach would call for the drastic alteration of current law.

Under existing insider trading law, a plaintiff must meet the numerous scienter requirements of section 10(b).[217] By imposing these requirements, courts jam certain insider trading abuses into the section 10(b) mold, but such analytical contortions add superfluous elements into the liability mix. Scienter or at least some element of mental culpability is necessary to establish criminality because of the *mens rea* requirement. Even in criminal cases, however, the only scienter requirement should be that the accused knew the information was material and nonpublic. Requiring proof of breach of fiduciary duty to the source of the information creates pointless hurdles to culpability. It follows that such requirements have no place in civil cases. The equality principle calls for the elimination of these needless hurdles. It simply

factor other than age, the employer did not have discriminatory intent and therefore, would not be liable for disparate treatment without the necessity of spelling out an additional defense. *Id.* The Court therefore concluded that the defense referred to disparate impact. *Id.* at 238–39. Justice O'Connor, joined by Justices Kennedy and Thomas, argued that the RFOA defense was merely a safe harbor that codifies the "legitimate nondiscriminatory reason" justification that the courts had long recognized. *Id.* at 252 (O'Connor, J., concurring).

214 *See* Connecticut v. Teal, 457 U.S. 440, 451 (1982) (rejecting the "bottom line" defense, which would have exonerated defendants from liability if the net effect of a multi-step selection process did not result in disparate impact, and holding that if any phase of a multi-step process produces disparate impact, the defendant has violated Title VII).

215 Griggs v. Duke Power Co., 401 U.S. 424, 432 (1971).

216 *Id.* at 431.

217 *See supra* notes 138–46 and accompanying text (analyzing the scienter requirements of an insider trading violation).

requires that all parties have equal access to inside information, regardless of any breach of fiduciary duty. As in *Griggs*, it calls for the imposition of strict liability in civil cases.

Because the Supreme Court is saddled with section 10(b) as its foremost weapon against unlawful insider trading, it has limited leverage to effect meaningful change. Furthermore, *stare decisis* hamstrings the Court, which has wrought a series of decisions that have adopted and perpetuated an interpretation of section 10(b) antithetical to the equality principle. The burden to change insider trading law therefore falls to Congress.

2. Knowledge That Information Is Nonpublic

Even if the law dispenses with breach of fiduciary duty or any form of deception as an element of unlawful insider trading, one might still question whether a party trading on inside information should be liable civilly if the party did not know or have reason to know that the information was nonpublic. One might argue that the law should hold such a person blameless. On the other hand, one might contend that an innocent state of mind is merely a factor that would mitigate the remedy. Discrimination law follows the mitigation approach. Compensatory and punitive damages are among the remedies for victims of disparate treatment, but these remedies are unavailable to victims of disparate impact.[218] *Watson v. Fort Worth Bank & Trust*[219] provides support for adopting the discrimination law's mitigation model in insider trading law. *Watson* suggests that in civil cases the law should forbid trading on inside information, even if the trader did not know or have reason to know that the information was nonpublic.

In *Watson*, Clara Watson, an employee of Forth Worth Bank, applied for and was denied a number of promotions, all of which went to white applicants.[220] The issue before the Court was whether disparate-impact analysis applied to subjective selection criteria.[221] Sensitive to the Bank's argument that the difficulties in defending against such a lawsuit might induce a defendant to adopt quotas to avoid liability,[222] a plurality of the Court held nevertheless that subjective criteria came within the ambit of disparate-impact analysis.[223]

---

[218] *See* 42 U.S.C. § 1981a(a)(1) (2012) (limiting awards of compensatory and punitive damages to disparate-treatment violations).

[219] 487 U.S. 977 (1988).

[220] *Id.* at 982.

[221] *Id.*

[222] *Id.* at 989.

[223] *Id.* at 990. Justice Blackmun, joined by Justices Brennan and Marshall, pointed out that the plurality departed from previous precedent by asserting that the defendant bore only the

The Court's rationale is noteworthy. It reasoned that, when exercising subjectivity in making employment decisions, supervisors might revert to discriminatory motives, whether consciously or subconsciously.[224] To combat subtle and virtually undetectable instances of discriminatory intent, disparate-impact theory provided plaintiffs unable to prove disparate treatment with a fallback position.[225]

This prophylactic view of disparate-impact theory has implications for insider trading law. One who has traded on inside information might deny that he or she knew that the information was nonpublic or perhaps even material. As in employment discrimination cases, the outcome should not depend on the difficulty in proving intent. To prove that a trader knew that information was nonpublic could be a daunting proposition. Trading on inside information should therefore be subject to strict liability. If the plaintiff cannot prove that the trader knew the information was nonpublic, the law should provide a lenient remedy. For example, in such a case the sole remedy might be payment of the profits resulting from the trade to the counterparty. Those who traded knowingly on inside information should be subject to SEC penalties, statutory penalties, and punitive damages in private lawsuits. They should also face criminal prosecution by the DOJ.

3. The "Business Necessity" Defense

The *Griggs* Court recognized that an employment practice may have a disproportionate impact on African Americans or any other protected class, and yet legitimate business needs might justify using that employment practice.[226] This "business necessity" defense requires that the challenged employment practice relates to job performance.[227] Thus, for example, assume that in 1965 an employer advertised numerous openings for CPA positions. Because of limited educational opportunities for African Americans during that era, none of the many

burden of production of evidence supporting a business necessity defense, but that the burden of persuasion shifted to the plaintiff. *Id.* at 1000–01 (Blackmun, J., concurring). Justice Stevens believed that the plurality had unwisely announced new evidentiary standards for disparate-impact cases generally. *Id.* at 1011 (Stevens, J., concurring). Justice Kennedy took no part in the decision. *Id.* at 1000.

[224] *Id.* at 990 (majority opinion).

[225] *Id.* at 990–91.

[226] Griggs v. Duke Power Co., 401 U.S. 424, 431 (1971).

[227] *Id.*; *see also* N.Y.C. Transit Auth. v. Beazer, 440 U.S. 568, 577, 587 (1979) (rejecting plaintiffs' statistical showing that the Transit Authority's policy of refusing to employ people taking methadone had a disparate impact on African Americans, and accepting defendant's proof of job relatedness to establish business necessity despite a weak evidentiary showing); Dothard v. Rawlinson, 433 U.S. 321, 332 (1977) (holding that Alabama did not prove job-performance relatedness where it excluded women from correctional counselor positions in the state penitentiary system because of weight and height requirements).

African American applicants had a suitable accounting background. The business necessity defense would permit the employer to offer the positions to white applicants. Notably, such was not the case, in *Griggs*.[228] The Court stressed that Duke Power had not conducted a meaningful study to support the use of the tests or the requirement of a high school diploma.[229] Rather, a vice-president of the company admitted that Duke Power instituted these measures based simply on the company's judgment that their use would improve the quality of Duke Power's workforce.[230] Perhaps even more damaging to Duke Power's attempt to establish "business necessity," incumbent employees who had neither a high school diploma nor had taken the requisite tests performed satisfactorily in jobs denied to African American applicants because they could not meet those very criteria.[231]

a. The Burden of Persuasion

The Supreme Court reaffirmed its commitment to a robust interpretation of disparate-impact theory in *Albemarle Paper Co. v. Moody*.[232] In this class action, present and former African American employees of Albemarle, a manufacturer of paper products, challenged Albemarle's use of two tests for advancement of incumbent workers in skilled job categories.[233] One test was the Revised Beta Examination, which ostensibly measured nonverbal intelligence, and the other was the same Wonderlic Test, used by Duke Power.[234] Shortly before trial, Albemarle hired an industrial psychologist to assess whether the tests were sufficiently performance-related to comport with *Griggs*.[235] A blow to Albemarle's attempt to justify its use of these tests was the inability of many of its high-ranking white employees to pass them.[236]

Citing *Griggs*, the *Albemarle* Court fixed the burden of proving business necessity on Albemarle.[237] Though the industrial psychologist concluded that the tests correlated with job performance,[238] the Court

---

228 *Griggs*, 401 U.S. at 431.

229 *Id.*

230 *Id.*

231 *Id.* at 431–32.

232 422 U.S. 405 (1975).

233 *Id.* at 409–10.

234 *Id.* at 410–11.

235 *Id.* at 411. The Court was clearly suspicious of Albemarle's good faith, remarking that the industrial psychologist was engaged "on the eve of trial." *Id.*

236 *Id.* at 434.

237 *Id.* at 425 (citing Griggs v. Duke Power Co., 401 U.S. 424, 432 (1971)) (holding that the employer bears "the burden of showing that any given requirement [has] a manifest relationship to the employment in question."); *see also* Dothard v. Rawlinson, 433 U.S. 321, 329 (1977) (fixing the burden of persuasion on the defendant to prove the business necessity defense).

238 *Id.* at 411.

held the validation study insufficient to prove business necessity.[239] The Court cited four reasons for rejecting the psychologist's determination.[240] First, the study showed significant statistical relationships between job performance and only three of the eight lines of skilled jobs.[241] Second, Albemarle supervisors who evaluated job performance in the study used vague, subjective criteria.[242] Third, the study focused mainly on high-level jobs to the exclusion of lower-level jobs.[243] Fourth, the study measured the performance of experienced white workers to the exclusion of inexperienced African American workers.[244]

Albemarle bolstered the equality principle of Title VII by upholding the disparate-impact analysis first expressed in *Griggs*.[245] It is unfortunate that when the Court fell into the hands of a new majority, it retreated from its commitment to disparate-impact theory.[246] In *Wards Cove Packing Co. v. Atonio*,[247] Wards Cove operated canneries in remote locations in Alaska.[248] Filipinos and Native Alaskans predominantly filled the low-paying, unskilled cannery jobs.[249] White workers predominantly filled the higher-paying skilled positions.[250] Wards Cove provided housing and meals for its employees,[251] but segregated the white workers from the nonwhite workers by providing separate facilities.[252] Justice Stevens described these conditions as "bear[ing] an unsettling resemblance to aspects of a plantation economy."[253]

The nonwhite workers alleged that Wards Cove used criteria to hire and promote employees that had a disparate impact on nonwhites.[254] Wards Cove interposed a business necessity defense.[255]

The Supreme Court assaulted the viability of the disparate-impact

---

239 *Id.* at 431.
240 *Id.* at 431–35.
241 *Id.* at 431–32.
242 *Id.* at 432–33.
243 *Id.* at 433–34.
244 *Id.* at 435.
245 Chief Justice Burger argued that the validation study met the requirements of *Griggs*, and that the majority relied too heavily on EEOC guidelines. *Id.* at 451–52 (Burger, C.J., concurring and dissenting in part). Justice Blackmun agreed with the Chief Justice that the Court had deferred unjustifiably on EEOC guidelines. *Id.* at 453 (Blackmun, J., concurring).
246 Wards Cove Packing Co. v. Atonio, 490 U.S. 642 (1989).
247 *Id.*
248 *Id.* at 646.
249 *Id.* at 647.
250 *Id.*
251 *Id.*
252 *Id.*
253 *Id.* at 663 n.4 (Stevens, J., dissenting).
254 *Id.* at 647–48 (majority opinion) (the plaintiffs alleged claims for both disparate treatment and disparate impact).
255 *Id.* at 649.

claims on two critical fronts.[256] First, the Court ruled that, rather than relying on the bottom line resulting from a multi-tiered selection process, plaintiffs had to show that a specific practice caused disparate impact.[257] Second, the Court ruled that Wards Cove merely bore the burden of production to support its business necessity defense.[258] Once it met this burden, the plaintiffs bore the burden of persuasion to disprove the defense.[259]

Congress reacted swiftly. It passed the Civil Rights Act of 1991,[260] partly to overrule *Wards Cove*. The 1991 Act permitted plaintiffs to rely on bottom line statistics if separate elements in the decision-making process were "not capable of separation."[261] In addition, the 1991 Act returned the burden of persuasion for the business necessity defense to the defendant.[262]

---

256 Justice Blackmun argued that the majority set back the fight against racial discrimination by (1) redistributing the burden of proof, (2) barring the use of internal workforce comparisons, and (3) requiring proof of which discrete practice caused a disparate impact, even where it was impossible for plaintiffs to make such a showing. *Id.* at 661–62 (Blackmun, J., dissenting). Justice Stevens also objected to the shift in the burden of proving business necessity, and the majority's rejection of "bottom line" proof. *Id.* at 671–72 (Stevens, J., dissenting). He also asserted that the district court had not made an adequate finding of the relevant labor market, and absent such a finding, he argued that the gross imbalance of the racial composition of the Wards Cove workforce raised serious questions of discrimination. *Id.* at 673.

257 *Id.* at 657 (majority opinion).

258 *Id.* at 659. The Court cited the plurality opinion in *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 997 (1988), to support the proposition that the plaintiff bears the burden of persuasion. *Wards Cove*, 490 U.S. at 659. The *Watson* plurality stated: "[a]lthough we have said that an employer has 'the burden of showing that any given requirement must have a manifest relationship to the employment in question,' such a formulation should not be interpreted as implying that the ultimate burden of proof can be shifted to the defendant." *Watson*, 487 U.S. at 997 (quoting Griggs v. Duke Power Co., 401 U.S. 424, 432 (1971)).

259 *Wards Cove*, 490 U.S. at 660.

260 Pub. L. 102-166, 105 Stat. 1071 (1991).

261 § 105, 105 Stat. at 1074 (codified as amended at 42 U.S.C. § 2000e-2(k)(1)(B)(i) (2012)). This section provides:

> With respect to demonstrating that a particular employment practice causes a disparate impact . . . the complaining party shall demonstrate that each particular challenged employment practice causes a disparate impact, except that if the complaining party can demonstrate to the court that the elements of a respondent's decisionmaking process are not capable of separation for analysis, the decisionmaking process may be analyzed as one employment practice.

Id.

262 42 U.S.C. § 2000e-2(k)(1)(A)(i). This section provides:

> An unlawful employment practice based on disparate impact is established under this subchapter only if . . . a complaining party demonstrates that a respondent uses a particular employment practice that causes a disparate impact on the basis of race, color, religion, sex, or national origin and the *respondent fails to demonstrate* that the challenged practice is job related for the position in question and consistent with business necessity . . . .

Id. (emphasis added).

By enacting this law, Congress restored the proper balance to disparate-impact cases. Whether business necessity justifies a challenged employment practice is an issue separate from whether an employment practice has a disproportionate impact on a protected class. Therefore, it would seem that "business necessity" is most properly classified as an affirmative defense, and accordingly the defendant should carry the burden of persuasion.[263] A prima facie case of disparate impact should simply require a meaningful statistical showing that an employment practice has a disproportionate, negative impact on a protected class. Nothing more should be required, and, as a result of the 1991 Act, nothing more is required.

b. The Analogy of the Business Necessity Defense to Insider Trading

There is a parallel to the business necessity defense in the context of insider trading. This parallel concerns the acquisition of information by securities analysts. Insider trading law should accommodate if not reward legitimate research efforts. As the Supreme Court noted in *Dirks*, uncovering valuable trading information is the job of investment advisers and the research departments of investment firms.[264] The service that they provide to retail and institutional investors, whether by recommendations or discretionary trading, is vital to vibrant securities markets.[265] There is a scene in the film *Wall Street*[266] where Bud Fox and Gordon Gekko, without getting a tip from anyone, deduce from the movements of a high-powered investor that a corporate takeover is imminent. They trade on this knowledge and score outsized gains. Though Bud and Gordon believed that they had violated the law, they had not. Nor should such conduct be unlawful. The law should not penalize those who profit from probing research and astute observations. If hard work and shrewd calculation unearth material, nonpublic information, the equality principle raises no objection to its use for profit. There is no issue of unequal access in such a case, and, as noted, the equality principle does not aspire to equality of outcomes. Anyone charged with unlawful insider trading could interpose the affirmative defense that he acquired the information through legitimate research efforts. The burden of proving this defense would be on the defendant.[267]

SEC v. Texas Gulf Sulphur Co.[268] is an insider trading case with a

---

263 31A C.J.S. *Evidence* § 197 (2016) (stating the burden of persuasion of an affirmative defense falls on the party asserting that defense).

264 *See* Dirks v. SEC, 463 U.S. 646, 658–59 (1983).

265 *Id.*

266 WALL STREET (Twentieth Century Fox 1987).

267 *See supra* Section III.B.3.a (discussing the burden of proof for affirmative defenses).

268 401 F.2d 833 (2d Cir. 1968).

fact pattern that one may vary to illustrate the affirmative defense. In the facts of the actual case, Texas Gulf Sulphur, which was engaged in mining and drilling operations in Ontario, Canada, made a major copper and zinc strike.[269] The company delayed public disclosure of news of the strike while company insiders traded unlawfully on the information.[270] Suppose, however, that, before public disclosure of the strike, a securities analyst traveled to the site of Texas Gulf Sulphur's operations. The heightened level of activity at the drilling site led the analyst to suspect or even conclude that the company had made a major strike. With the permission of a foreman, the analyst might even take an ore sample and have it assayed. The analyst then trades on the information. Such a factual scenario fits within the affirmative defense.

The defense might apply in a more questionable situation. Assume a foreman at drilling site did not know that the company was withholding information of the strike from the public. Based on his observations, the analyst asks the foreman to disclose whether the company has made a strike. The foreman confirms that he has hit rich deposits of zinc and copper ore. One might reasonably argue that the foreman conveyed prohibited inside information triggering the disclose-or-abstain rule because the analyst received information denied to the public. One might argue, however, that the equality principle would permit the analyst to trade on the information. The foreman's confirmation did not come as a tip in the usual sense. Rather, independent research of the analyst laid the groundwork for his inquiry. Anyone could have shown the initiative of trekking to Ontario, observing the accelerated rate of drilling operations, and deducing the company's strike of the motherlode. It is arguable that the law should not inhibit such initiative. The equality principle allows for a debate over conflicting policies: whether such conduct promotes healthy securities markets or injures them by undermining investor confidence. It would seem, however, that this debate could not take place under existing law because the Supreme Court has apparently blessed such behavior.[271]

A third variation would have the analyst visit the drilling site, conclude that the company had struck valuable mineral deposits, and seek and receive confirmation from the CEO. The equality principle would seem to deny the analyst the right to trade the company's stock because the CEO deliberately withheld the information from the public. The appearance of conspiratorial conduct, if ultimately disclosed publicly, might spur distrust of the markets. Nevertheless, the analyst's

[269] *Id.* at 843–44.

[270] *Id.* at 846–47.

[271] *See* Dirks v. SEC, 463 U.S. 646, 659–60 (1983) (extending broad latitude to market professionals who acquire inside information).

research provided the catalyst that led to the disclosure. This fact pattern illustrates the need to balance the equality principle with the need to promote legitimate research efforts of securities professionals. Before addressing such questions, however, Congress must first enact a law that follows the equality principle.

4. *Ricci v. DeStefano*: The Death of Disparate Impact?

The most recent chapter in the ebb and flow of disparate-impact theory came with *Ricci v. DeStefano*,[272] a case where the Supreme Court confronted a conflict between a disparate-treatment claim and a threatened disparate-impact claim. In *Ricci*, New Haven firefighters took an examination to qualify for promotions.[273] Because white candidates outscored minority candidates on the examination, minority candidates threatened a disparate-impact lawsuit.[274] New Haven responded by discarding the examination results.[275] But New Haven found itself on a seesaw of potential liability. A number of white candidates and one Hispanic candidate, all of whom would have been promoted based on their examination scores, sued New Haven for disparate treatment.[276] New Haven's principal defense was that if it had not discarded the examination scores minority candidates would have sued for disparate impact.[277]

The Court held that, for the city to prevail, it would have to "demonstrate a strong basis in evidence that, had it not taken the action, it would have been liable under the disparate-impact statute."[278] The record, however, did not substantiate that New Haven could meet the

[272] 557 U.S. 557 (2009).

[273] *Id.* at 562.

[274] *Id.*

[275] *Id.*

[276] *Id.* at 562–63.

[277] *Id.* at 563.

[278] *Id.* Justice Ginsburg, joined by Justices Stevens, Souter, and Breyer, argued that the majority ruling clashed with Title VII's statutory design. *Id.* at 625 (Ginsburg, J., dissenting). She argued that the majority ignored "a strong basis in evidence" in the record, which demonstrated that New Haven's tests were seriously flawed. *Id.* at 608. She also believed that the strong-basis-in-evidence theory imposed too great a burden on employers. *Id.* at 628–29. Under her standard, when an employer rejects an employment criterion because the employer has reasonable doubts about the criterion's validity, the employer's rejection of that criterion cannot constitute discrimination under Title VII. *Id.* at 625–26. The only burden on the employer to justify its rejection of the criterion is the employer's good-cause belief that the criterion did not meet the business necessity defense. *Id.*; *see also* Henry L. Chambers, Jr., *The Supreme Court Chipping Away at Title VII: Strengthening It or Killing It?* 74 LA. L. REV. 1161, 1178–80 (2014) (arguing that the *Ricci* decision showed the Supreme Court's hostility toward disparate impact theory, and fearing that *Ricci* may presage curtailment of that theory).

strong-basis-in-evidence test.[279] The Court therefore confirmed the order of summary judgment in favor of the plaintiffs.[280]

One might see *Ricci* as signaling the demise of disparate-impact theory. The strong-basis-in-evidence standard places a heavy burden on employers to justify their defense against a charge of disparate treatment. An employer's inability to meet this burden might well result in disparate-impact discrimination against minorities. The Court, however, limited its holding to atypical situations where employers not only adopted and used selection criteria, but also invalidated the results.[281] It seems that disparate-impact theory will survive.[282] One may hope that, despite its bumpy ride, disparate-impact theory will inform Congress on how to improve the beleaguered state of insider trading law.

CONCLUSION

Dissatisfaction with federal insider trading law runs wide and deep. Two scholars lambast the current regime as "a theoretical mess,"[283] and another as "astonishingly dysfunctional."[284] A fourth has decried this area of law as a "jurisprudential scandal,"[285] and yet another laments that insider trading law is in "crisis."[286] Applying section 10(b) to address the problems posed by insider trading is like trying to drive a car across a river. The vehicle is not suited for the task. Section 10(b) is an antifraud provision, and it has performed effectively in punishing those engaged in deceptive securities transactions. Congress, however, never intended section 10(b) to address securities abuses that do not involve fraud. Insider trading falls into that category. Tweaking the existing regime will not get us anywhere. We need a new approach.

The starting point is the foundational policy that drives—or at least should drive—insider trading law. That policy aspires to achieve equal access of all market participants to material, nonpublic information.

---

279 *Ricci*, 557 U.S. at 585.

280 *Id.* at 592.

281 *Id.* at 585.

282 *See* Melissa Hart, *From* Wards Cove *to* Ricci*: Struggling Against the "Built-In Headwinds" of a Skeptical Court*, 46 WAKE FOREST L. REV. 261, 277 (2011) (noting that *Ricci* did not change disparate impact law fundamentally).

283 Strudler & Orts, *supra* note 7, at 379.

284 Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1493 (1999).

285 Jeanne L. Schroeder, *Taking Stock: Insider and Outsider Trading by Congress*, 5 WM. & MARY BUS. L. REV. 159, 163–64 (2014) (criticizing the practice of congresspersons to trade with impunity on inside information).

286 Kim, *supra* note 22, at 1008. *But see* Peter J. Henning, *What's So Bad About Insider Trading Law?*, 70 BUS. LAW. 751, 775 (2015) (concluding that "the current insider trading edifice works fairly well as a legal doctrine . . .").

Equal access, however, does not guarantee equal outcomes. Those who gain an informational advantage through research and ingenuity should be free to profit from their efforts.

The policy of equal access but not equal outcomes is an expression of the equality principle. The law of equal employment opportunity law is based on an analogous policy. Those in protected classes are entitled to equal employment opportunities, but like participants in the securities markets they are not entitled to equal outcomes. Employment discrimination must be eradicated, but jobs, promotions, and other employment benefits must be earned.

Based on Title VII, the law of equal employment opportunity has developed effective approaches to advance its equality principle. Some of the lessons of employment discrimination law might serve as guideposts pointing toward a new insider trading regime. In particular, lawmakers might borrow from disparate-impact theory. This theory prohibits employment discrimination, even if based on facially neutral practices.[287] In other words, disparate impact theory holds employers to a standard of strict liability. Adapting this theory to insider trading law would clear the "theoretical mess"[288] and end the "dysfunction,"[289] the "scandal,"[290] and the "crisis."[291] Fraud, deception, and breach of fiduciary duty would have no place in the new framework. To establish a violation, one would not have to show that a tipper received a reputational or monetary benefit from the tippee. Nor would scienter be an element of a civil violation. If someone who had traded on inside information proved ignorance that information was nonpublic, the remedy would adjust to account for an innocent state of mind.[292] This approach would also provide an affirmative defense. If someone traded on material, nonpublic information acquired from bona fide research efforts, that person would not be liable for unlawful trading. This defense would promote the vitality of capital markets by exempting from liability securities analysts and other market professionals who acquire inside information through legitimate means.

Section 10(b) and Rule 10b-5 have led us in the wrong direction. The Supreme Court has taken us to a dead end. The equality principle will get us on the right road. We need to get going, and Congress is in the driver's seat.

---

287 *See* Griggs v. Duke Power Co., 401 U.S. 424, 429 (1971).

288 Strudler & Orts, *supra* note 7, at 379.

289 Prakash, *supra* note 284, at 1493.

290 Schroeder, *supra* note 285, at 163.

291 Kim, *supra* note 22, at 1008.

292 *See* 42 U.S.C. § 1981a(a)(1) (2012) (providing that awards of compensatory and punitive damages apply to disparate-treatment claims but not disparate-impact claims).