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CLOSING A LOOPHOLE: INSIDER TRADING IN STANDARDIZED OPTIONS

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A recent Note in the *Journal* took the position that section 10(b) of the Securities Exchange Act of 1934[1] and rule 10b-5[2] should be interpreted broadly to close a loophole that may allow corporate insiders to trade standardized options on the corporation's stock when they cannot trade the stock itself.[3] While it is generally agreed that insiders violate rule 10b-5 if they trade stock on the basis of material nonpublic corporate information, the Note suggested that the rule may not forbid them to trade options on the stock under the same circumstances.[4] There are several theories why insider trading violates rule 10b-5,[5] but the Note argued that by the simple expedient of trading options on common stock rather than the common stock itself, an insider can escape liability under the only theory that the Supreme Court has expressly endorsed.[6]

The key to insider trading law under rule 10b-5 is *Chiarella v. United States*,[7] in which the Supreme Court held that a trader who does not make any misrepresentation does not violate section 10(b) or rule 10b-5 unless his silent trading is deceptive because he violates some duty when he trades.[8] Broadly speaking, there are two reasons that an insider in possession of

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1. 15 U.S.C. § 78j (1982).

2. 17 C.F.R. § 240.10b-5 (1988).

3. Note, *Insiders, Options and the Fiduciary Principle: A Rule 10b-5 Loophole*, 16 FORDHAM URB. L.J. 295 (1988) [hereinafter Note, *Rule 10b-5 Loophole*].

4. *Id.* at 322.

5. *See generally* D. LANGEVOORT, INSIDER TRADING REGULATION (1988) [hereinafter LANGEVOORT].

6. Note, *Rule 10b-5 Loophole*, *supra* note 3, at 324 & n.223 ("no criminal liability, no civil penalties, and no private liability").

7. 445 U.S. 222 (1980).

8. *Id.* at 227-28. The holding follows from the language of § 10(b), which provides for the regulation of manipulative or deceptive devices and contrivances. *See* 15 U.S.C. § 78j (1982).

material nonpublic corporate information might be under a duty not to trade. First, the insider and the other party to the trade may be in a relationship that requires the insider to disclose the information before trading (for example, when an insider is buying from a shareholder of the corporation); second, the insider's trades may constitute misuse or misappropriation of corporate information.

As the Note showed, there is some confusion about the reason an insider cannot trade.[9] The Note argued that it is critical to identify the reason in cases in which insiders trade standardized options while in possession of material nonpublic corporate information, because corporate insiders do not necessarily owe candor to option traders who do not own securities issued by the corporation.[10] If silent trading violates rule 10b-5 only when the trader breaches a duty of candor owed directly to the other party to the trade, insider trading in options will not typically be illegal.[11] On the other hand, if silent trading violates the rule because the trader improperly uses privileged information for private ends, then insider trading in options is illegal.[12] The Note took insider trading in options to be unfair and unjust, and thus concluded that courts should adopt a broad misappropriation theory and hold that insiders owe the general public a duty to speak before trading.[13]

Congress addressed the question of insider trading in options in the Insider Trading Sanctions Act of 1984.[14] The Note looked to the Sanctions Act as a source of congressional policy on insider trading,[15] but it did not fully develop the ramifications of the Act. Along with its more famous civil penalty provision,[16] the Sanctions Act added section 20(d) to the Exchange Act.[17]

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9. *See generally* Note, *Rule 10b-5 Loophole*, *supra* note 3. In *Chiarella*, the Court accepted the proposition that corporate insiders have a fiduciary duty to disclose material corporate information before buying common stock from ignorant shareholders. *Chiarella*, 445 U.S. 227-30. However, the Court declined to decide whether a trader's misuse or misappropriation of confidential information alone could give rise to a violation of § 10(b). *See id.* at 238 (Stevens, J., concurring).

10. *See* Note, *Rule 10b-5 Loophole*, *supra* note 3, at 328-29.

11. *Id.* at 324.

12. *See Chiarella*, 445 U.S. at 238 (Stevens, J., concurring).

13. *See* Note, *Rule 10b-5 Loophole*, *supra* note 3, at 328-29.

14. Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified in scattered sections of 15 U.S.C.).

15. *See* Note, *Rule 10b-5 Loophole*, *supra* note 3, at 302-03.

16. Securities Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2) (Supp. IV 1986).

17. 15 U.S.C. § 78t(d) (Supp. IV 1986).

Section 20(d) declares that it is illegal to buy or sell options while in possession of material nonpublic information if it would be illegal to buy or sell the underlying security.[18] If there was a rule 10b-5 loophole, the Sanctions Act closed it.[19]

It is often hard to say whether a particular case of insider trading is illegal,[20] and there is an ongoing debate over whether insider trading is even wrong.[21] The option problem highlights these issues, and some answers are suggested by the way the Note discussed the problem and by the way Congress addressed it in the Sanctions Act. If insider trading is illegal or wrong simply because insider traders violate duties they owe to corporate security holders, there is little reason to object to insider trading in options. If insider trading in options is objectionable, it may be because insider trading in general is objectionable for some other reason. The Note condemned insider trading in options because the author felt that it is simply unfair for corporate insiders to trade while in possession of material nonpublic information.[22] The fact that Congress made insider trad-

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18. Section 20(d) provides:

> Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule or regulation.

Id.

19. *See generally* Crespi, *Private Rights of Action for Option Position Holders Under Section 20(d) of the Securities Exchange Act*, 16 SEC. REG. L.J. 21 (1988); Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056 (1988); Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959 (1987); Note, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 YALE L.J. 623 (1988) [hereinafter Note, *Standing*].

20. The Note focused on trading by classic insiders, and thus did not address the equally difficult issues of trading by tippees of insiders, and trading by persons who possess material nonpublic information relevant to the value of a corporation's security but who have no special relationship with the corporation.

21. *See* LANGEVOORT, *supra* note 5, at 7-16; Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981); *cf.* LANGEVOORT, *supra* note 5, at 439-64 (legislative developments); *Symposium: Defining 'Insider Trading'*, 39 ALA. L. REV. 337 (1988) (statutory definition).

22. *See* Note, *Rule 10b-5 Loophole*, *supra* note 3, at 328-29.

ing in options illegal suggests that it may be of the same mind.[23]

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23. *See* LANGEVOORT, *supra* note 5, at 100-02; Langevoort, *The Insider Trading Sanctons Act of 1984 and its Effects on Existing Law*, 37 VAND. L. REV. 1273, 1286-98 (1984); Note, *Standing*, *supra* note 19, at 639; *cf.* Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1982) ("[f]or the purpose of preventing the unfair use of information"); Securities Exchange Act § 20A, Pub. L. No. 100-704, sec. 5 (1988) (private action), *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 4677, 4680-81; H.R. REP. No. 910, 100th Cong., 2d Sess. 26-28, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6063-65.