

# To Catch a Thief: The Misappropriation Theory and Securities Fraud

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# TO CATCH A THIEF: THE MISAPPROPRIATION THEORY AND SECURITIES FRAUD

## I. INTRODUCTION

The term "insider trading" describes the illegal use of confidential, material<sup>1</sup> information by an individual for personal profit in the stock market. This illegal use of information constitutes a form of fraud which has become a widespread problem in the securities market in recent years.<sup>2</sup> Available evidence indicates that insider trading is the most common violation of the federal securities laws.<sup>3</sup>

Insider trading is a destructive act which threatens economic growth and stability in the nation's capital markets by undermining investor confidence.<sup>4</sup> Not only is the illegal act a deprivation of investors' fair value of their investments, but it is unethical and unfair.<sup>5</sup> Trading on the basis of confidential, material information has a detrimental impact on the securities market. Accordingly, the anti-fraud provisions of the federal securities laws have been construed to proscribe, in certain instances, such trading.

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1. Material information is information that a reasonable investor would consider important in making an investment decision. *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-49 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

2. Although the problem of insider trading is not new, in recent years the extent of this type of securities fraud has become more apparent. A primary reason for the dramatic rise in the incidences of insider trading has been an increase in the number of merger and tender offers which lead to immediate and dramatic price movements in the stock of the target corporation. Insiders trading on confidential, material information reap enormous profits if the underlying stock increases in value as a result of a tender offer announcement or other news. See 130 CONG. REC. H7759 (daily ed. July 25, 1984) (statement of Rep. Wirth) [hereinafter CONG. REC.].

3. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 6 n.17 (1980). In addition to the fact that the practice of insider trading itself seems to incur relatively modest costs, the business community views insider trading as reprehensible only under very special circumstances. *Id.*

4. Although a small number of free-market economists suggest that insider trading harms no one and is an effective means of rewarding entrepreneurs, see, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113 (Nov.-Dec. 1966), this argument is not widely accepted. See, e.g., Schotland, *Unsafe at Any Price: A Reply to Manne. Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967); Longstreth, *Halting Insider Trading*, N.Y. Times, Apr. 12, 1984, at A27, col. 1.

5. See Longstreth, *supra* note 4, at A27, col. 1.

The scope of the prohibition against insider trading has been determined by judicial and administrative construction of Section 10(b) of the Securities Exchange Act of 1934<sup>6</sup> (the Act). Initially, the prohibition was broadly construed to prevent incidences of insider trading. However, in 1980 the United States Supreme Court restricted the reach of the anti-fraud provisions of the Act with respect to insider trading.<sup>7</sup> According to the Supreme Court's recent articulation, an insider with confidential, material information is under no duty to disclose the information or refrain from trading unless there is a relationship of trust and confidence between parties involved in the transaction.<sup>8</sup> Absent such a relationship, a person with inside information may profit from the use of such information in securities transactions.

The Supreme Court's recent restriction on the scope of the prohibition of insider trading directly conflicts with the Securities and Exchange Commission's (SEC) current increase in enforcement and criminal proceedings against individuals illegally using confidential, material information.<sup>9</sup> As a response to the Supreme Court's frustration of its attempt to prohibit insider trading, the SEC has responded with novel theories for actionable violations of the securities laws.<sup>10</sup> The most con-

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6. 15 U.S.C. § 78j(b) (1976). The pertinent portion of § 10(b) of the Securities Exchange Act of 1934 provides:

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:

(b) To 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.

*Id.*

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

8. *Id.* at 230. For purposes of this Comment, a relationship of trust and confidence is considered a fiduciary relationship.

9. The recent years have seen a sharp increase in the number of insider trading cases. Twenty insider trading cases were initiated in 1985, thirty in 1986, and more are expected in 1987. Special Report, 19 SEC. REG. & L. REP. (BNA) 102 (Jan. 16, 1987).

10. Painter, *How to Control Insider Trading*, 73 A.B.A. J. 38 (Mar. 1, 1987).

trouversial new theory put forth by the SEC is what has been deemed the "misappropriation theory."<sup>11</sup>

In essence, the theory asserts that anyone who misappropriates information from an employer, or another source, and trades on the basis of that information is violating the anti-fraud provisions of the Act. The theory circumvents the requirements of a fiduciary relationship between the parties to a transaction by finding fraud in the improper procurement of inside information.

This theory has been embraced by the SEC in its enforcement and criminal proceedings,<sup>12</sup> and has received support in federal appellate courts. It is unknown whether the Supreme Court will sustain a version of the misappropriation theory,<sup>13</sup> however, the theory is currently being reviewed by the Court.<sup>14</sup> Absent a firm endorsement of the theory from the Supreme Court, the SEC will be divested of yet another tool it can utilize in its increasing efforts to prevent fraud in the securities market.<sup>15</sup>

The first part of this Comment discusses the development of the prohibition against insider trading under the federal securities laws. This Comment then specifically focuses on the

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11. The term "misappropriation theory" had its genesis in *Chiarella*, 445 U.S. at 222. See *infra* notes 84-140 and accompanying text for an outline of the development of the theory.

12. This Comment will discuss the misappropriation theory and its application in enforcement and in criminal proceedings. The applicability of the theory to private actions for damages under § 10(b) and Rule 10b-5 is beyond the scope of this Comment.

13. This Comment proposes a version of the theory consistent with the Second Circuit Court of Appeals' version put forth in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) as the appropriate standard for liability under § 10(b) and Rule 10b-5. See *infra* notes 103-18 and accompanying text. An alternative "absolute duty" version was put forth by Chief Justice Warren Burger in *Chiarella*, 445 U.S. at 243-45 (Burger, C.J., dissenting). See *infra* notes 85-89 and accompanying text. Two other commentators have put forth versions of a misappropriation theory which have yet to be fully adopted by a court. See Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

14. *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'g sub nom. United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), *cert. granted*, 107 S. Ct. 666 (Dec. 15, 1986).

15. In an effort to increase its prevention efforts against insider trading, the SEC has started a trend towards criminalizing federal securities laws. See Criminal Prosecutions Insider Trading Questions Are Probed by Panelists at ABA, 18 SEC. REG. & L. REP. (BNA) 1202 (Aug. 15, 1986).

development of the misappropriation theory, presenting its different versions and applications in recent cases. Next, the substantive merits of the theory are critiqued and the policy supporting an adoption of the misappropriation theory are put forth. Finally, this Comment concludes with an assertion that the misappropriation theory is a proper standard for finding securities fraud, and therefore is worthy of endorsement by the Supreme Court.

## II. PROHIBITION OF INSIDER TRADING

### A. *The Securities Exchange Act of 1934*

Congress enacted the Securities Exchange Act of 1934 in response to unethical trading practices which contributed to the Stock Market Crash of 1929.<sup>16</sup> The Act was designed primarily as a mechanism to regulate sales and purchases of securities,<sup>17</sup> and to protect investors against manipulation and deception in the stock market.<sup>18</sup>

Two provisions of the Act place insider trading within its domain:<sup>19</sup> section 16(b) and, as it evolved, section 10(b). Section 16(b) applies only to limited types of transactions, presents a narrow description of insiders, and does not grant the SEC authority to enforce liability thereunder.<sup>20</sup> Section 10(b), however, is a general anti-fraud provision which has developed into a broad and far-reaching statute with respect to insider trading.<sup>21</sup>

#### 1. Section 10(b)

Under section 10(b), the SEC was vested with general regulatory powers over securities transactions. The SEC gained

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16. See Brudney, *supra* note 13, at 334-35 in which the author states, "[t]here is no doubt that Congress believed that a system of disclosure was the minimum necessary nostrum for [restoring trust in the securities markets] after the market disasters of 1929 and 1930 . . ." *Id.* See also *Securities & Exch. Comm'n v. Capital Gains Bureau*, 375 U.S. 180, 186 (1963).

17. 78 CONG. REC. § 2271 (1934).

18. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194-214 (1976) for an extensive analysis of the language and history of § 10(b).

19. R. POSNER & K. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 118 (1980).

20. 15 U.S.C. § 78p(b) (1976).

21. See *supra* note 6.

express authority to proscribe rules necessary and appropriate in the public interest to prohibit any manipulative or deceptive device utilized by any person in relation to securities transactions.<sup>22</sup>

Nothing in the language of section 10(b) defines or prohibits insider trading.<sup>23</sup> Rather, the loose language of the statute presents the SEC with the opportunity to use its broad power to inhibit incidences of fraud and deceit, leaving precise definitions of the substantive elements of a section 10(b) violation up to judicial interpretation.<sup>24</sup> Unfortunately, the ambiguous language of the statute and reliance on judicial construction has failed to produce consistent and definite rules regarding insider trading.<sup>25</sup>

## 2. The Purpose of Section 10(b)

Although the legislative history of section 10(b) is "bereft of any explicit explanation of Congress' intent . . ."<sup>26</sup> section 10(b) and the rules promulgated thereunder have been considered "catchalls" to prohibit any cunning device used to manipulate the market itself for personal gain.<sup>27</sup> Since its initial enactment, the basic goals of the provision have been "[t]o provide fair and honest mechanisms for the pricing of securi-

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22. *Id.*

23. There has been considerable debate over the issue of whether Congress should legislate specific rules defining exactly what are the clear boundaries of acceptable conduct for insider trading. Congress recently opted for leaving the definitions of insider trading to the evolving case law in the area. See CONG. REC., *supra* note 2. The SEC is in favor of keeping the definitions of insider trading vague. See Williams, "What's Legal-And What's Not," FORTUNE Dec. 22, 1986, at 36.

24. Congress left to the courts the difficult task of interpreting legislatively defined but broadly stated principles insofar as they apply in particular cases. *United States v. Carpenter*, 791 F.2d 1024, 1027 (2d Cir. 1986) *aff'g sub nom.* *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), *cert. granted*, 107 S. Ct. 666 (Dec. 15, 1986).

25. The current scheme prohibiting insider trading has been "noisy, random, slow-moving, and vague, thus resulting in a lack of sufficient deterrence." Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L. J. 263, 301 (1981).

26. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976) (opinion asserts that the legislative history of the Act gives no direct guidance as to the scope of § 10(b)).

27. The "catchall" verbiage is often used by courts reviewing the purpose of § 10(b) and Rule 10b-5. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 766 (1975) (Blackmun, J., dissenting); *Herpich v. Wallace*, 430 F.2d 792, 801 (5th Cir. 1970); *Securities & Exch. Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

ties, to assure that dealing in securities is fair and without undue preferences or advantages among investors . . . and to provide, to the maximum degree practicable, markets that are open and orderly."<sup>28</sup>

### B. SEC Rule 10b-5

In 1942, the SEC utilized its rule-making power granted by section 10(b) to promulgate Rule 10b-5.<sup>29</sup> Like section 10(b), Rule 10b-5 does not define or specifically prohibit insider trading. Rather, the Rule proscribes any person from making "affirmative misrepresentations, half-truths or omissions in connection with a purchase or sale of securities."<sup>30</sup> Despite its modest beginnings,<sup>31</sup> the Rule has developed into the primary tool utilized by the SEC to combat fraud in the securities market.<sup>32</sup>

In terms of the insider trading prohibition under Rule 10b-5, the original drafters expressed the view that the legal doctrine be inventive and result-oriented; flexible enough to reach a broad range of abuses and encourage fair play in the securities market.<sup>33</sup> Rule 10b-5, along with the anti-fraud provisions of the Act, were designed to remove the philosophy of

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28. These objectives were reiterated by Congress when it amended the Act in 1975. See sec. Acts Amendments of 1975, Pub. L. No. 94-29, 179, 322-23.

29. 17 C.F.R. § 240, 10b-5. Rule 10b-5 provides:

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.

*Id.*

30. Note, *An Outsider Who Misappropriates Confidential Information May Be Charged With Securities Fraud*: United States v. Newman, 31 DE PAUL L. REV. 849, 850 (1982).

31. R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 877 (1986).

32. "Rule 10b-5 has since become an important policing device in controlling insiders trading on the basis of nonpublic information." H. BLOOMENTHAL, SECURITIES LAW HANDBOOK 349 (1986-87).

33. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1279 (1984).

*caveat emptor* and to replace it with a philosophy of disclosure in order to promote fairness and equity in securities transactions.<sup>34</sup>

The early applications of section 10(b) and Rule 10b-5 resulted in an expansive interpretation of the anti-fraud provisions. Rule 10b-5 was applied to many types of transactions, while the doctrines which would have limited the scope of liability under Rule 10b-5 were continuously rejected.<sup>35</sup> It was not until recently that the Supreme Court narrowed the scope of Rule 10b-5 despite the fact that the SEC had increased its insider trading enforcement and criminal proceedings,<sup>36</sup> and that Congress had passed legislation imposing severe penalties for incidences of insider trading.<sup>37</sup>

### C. Development of Rule 10b-5 Liability

#### 1. Early Applications: Common Law Principles

In order for Rule 10b-5 to apply to a suspect transaction, there must be fraud.<sup>38</sup> In order for fraud to be based on non-disclosure, there must be an obligation to disclose.<sup>39</sup> Therefore, the crucial question in the initial interpretation of Rule 10b-5 was at what point the obligation, or duty, to disclose arises.

The early cases involving Rule 10b-5 utilized the common law approach to fraud and found that a duty to disclose arises when a relationship of trust and confidence was established between the parties to a transaction.<sup>40</sup> Absent a fiduciary relationship between the transacting parties, trading without dis-

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34. Securities & Exch. Comm'n v. Capital Gains Bureau, 375 U.S. 180, 186 (1963).

35. R. HAMILTON, *supra* note 31.

36. See Special Report, *supra* note 9.

37. Securities Exchange Act § 21(d)(2), was added by The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984). The Act created an additional remedy that the SEC may seek in insider trading cases, up to three times the profit gained or loss avoided as a result of such unlawful purchase or sale. *Id.*

38. See Note, *Federal Securities Regulation - Rule 10b-5 - Misappropriation of Confidential Takeover Information From an Investment Banking Firm and Its Clients for the Purpose of Purchasing Shares of the Target Companies Constitutes a Criminal Violation of Rule 10b-5*, 27 VILL. L. REV. 1329, 1333 n.22 (1981-82) for an outline of the common law tort action of fraud and its application to securities fraud.

39. See Note, *Insider Trading - The Extension of The Duty to Disclose Material Insider Information*, 58 NOTRE DAME L. REV. 132-41 (1982) for a discussion of the development of the duty to disclose under Rule 10b-5.

40. See generally Note, *supra* note 30, at 852-55.



closing material, nonpublic information was not fraud, and therefore, not an actionable violation of the securities laws. The most significant flaw in the common law approach to Rule 10b-5 liability was that it failed to recognize silence as a fraudulent act.<sup>41</sup>

## 2. *In re Cady, Roberts & Co.* — Inherent Unfairness

The first statement that trading on nonpublic, material information without disclosure constituted a violation of Rule 10b-5 was asserted in *In re Cady, Roberts & Co.*,<sup>42</sup> a 1961 administrative proceeding. In *Cady, Roberts*, a director of a corporation informed his broker-partner during a recess of the corporation's directors meeting that the corporation intended to reduce its stock dividends.<sup>43</sup> The broker used this material information to his advantage by selling thousands of shares in the open market prior to the announcement of the dividend reduction.<sup>44</sup> The broker's trading was found to be a violation of Rule 10b-5.<sup>45</sup>

Noting that the anti-fraud provisions are phrased in terms of *any person*,<sup>46</sup> the *Cady, Roberts* court reasoned that the broker's obligation to disclose arose because material facts were known to him by virtue of his position, and not known by the party with whom he dealt.<sup>47</sup> The court rejected the argument that an obligation to disclose applied only to traditional corporate insiders.<sup>48</sup>

The *Cady, Roberts* court found that a duty to disclose under Rule 10b-5 arises when two elements are present:

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41. *Id.* at 854.

42. 40 S.E.C. 907 (1961).

43. *Id.* at 909.

44. *Id.* In total 7,000 shares were sold. *Id.* After the reduction was made public, the shares dropped over six points in value during the day. *Id.* at 909-10.

45. *Id.* at 911. In addition to § 10(b) claims, the SEC found the activities of the defendants violative of § 17(a) of the Act. *Id.*

46. *Id.* The SEC stated "[t]hese antifraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others." *Id.*

47. *Id.*

48. *Id.* at 912. Corporate insiders are traditionally considered to be officers, directors and controlling shareholders. But as the SEC has stated, "[t]hese three groups . . . do not exhaust the classes of persons upon whom there is such an obligation." *Id.*

[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.<sup>49</sup>

The impact of the *Cady, Roberts* decision was to present courts with a flexible test to expand the class of persons subject to the insider trading prohibition under section 10(b) and Rule 10b-5.<sup>50</sup> After *Cady, Roberts* courts no longer relied solely on the common law concept of fraud to interpret the substantive elements of a section 10(b) violation, but rather looked for a relationship giving rise to a duty to disclose,<sup>51</sup> coupled with inherent unfairness in the transaction.<sup>52</sup>

### 3. *Securities & Exchange Commission v. Texas Gulf Sulphur Co.* — Equal Access to Information

The expansion of the scope of Rule 10b-5 which began in *Cady, Roberts* culminated with the Second Circuit Court of Appeals' landmark decision of *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*<sup>53</sup> in 1968. The *Texas Gulf Sulphur* decision premised the duty to disclose confidential, material information on the *mere possession* of such information and in doing so shifted the focus of Rule 10b-5 liability away from a special relationship between the parties to a transaction.<sup>54</sup>

In *Texas Gulf Sulphur*, corporate officers and directors purchased a large block of stock in their corporation without disclosing their knowledge of the corporation's successful

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49. *Id.* In putting forth such an analytical test the SEC opined, "[o]ur task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited." *Id.*

50. Comment, *Outsider Trading After Dirks v. SEC*, 18 GA. L. REV. 593, 600 (1984).

51. *Cady, Roberts*, 40 S.E.C. at 912.

52. *Id.*

53. 401 F.2d 833 (2d Cir.1968).

54. See Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771, 1773 (1984) (emphasis added). The *Texas Gulf Sulphur* decision "clearly changed the character of the analysis from an inquiry into the fiduciary duties to one premised on the notion that all investors trade equally and none should have an informational advantage over the other." *Id.*

mineral strike to the selling shareholders.<sup>55</sup> After the news of the strike was made public, the officers and directors sold their stock at the elevated market prices and realized substantial gains.<sup>56</sup> These activities were held to be violative of section 10 (b) and Rule 10b-5.<sup>57</sup>

The *Texas Gulf Sulphur* court focused almost exclusively on the fairness element put forth in the two-prong test of *Cady, Roberts*<sup>58</sup> and interpreted Rule 10b-5 as follows:

[A]nyone 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 it is unavailable to those with whom he is dealing . . . ."<sup>59</sup>

The court further asserted that Rule 10b-5 liability was based on a policy of all investors having "relatively equal access to material information."<sup>60</sup> The *Texas Gulf Sulphur* opinion has been construed as extending a duty to disclose beyond an insider in a fiduciary relationship to anyone possessing material information.<sup>61</sup>

The approach giving rise to liability under Rule 10b-5 in *Texas Gulf Sulphur* obviously created a far more expansive result than the approach developed in *Cady, Roberts*. The two decisions illustrate the divergent philosophies as to what triggers the duty to disclose confidential, material information under Rule 10b-5: The fiduciary theory and the information theory.<sup>62</sup> Which philosophy is utilized, as evidenced by subse-

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55. *Texas Gulf Sulphur*, 401 F.2d at 847. There were 4,300 shares involved in the transactions. The price of the stock, on the day of the transactions, was six points less than on the day of the announcement. A month after the announcement the stock was selling at a price 28 points higher than the pre-announcement price. *Id.*

56. *Id.*

57. *Id.* at 852. In arriving at its holding, the court was critical of the conduct of the defendants, as is evidenced by the court's statement, "[s]uch inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected." *Id.*

58. See *supra* notes 42-52 and accompanying text.

59. *Texas Gulf Sulphur*, 401 F.2d at 848 (citation omitted).

60. *Id.*

61. See Note, *supra* note 39, at 135.

62. The identification of a "fiduciary" theory and an "information" theory was put forth by Judge Wright in *Dirks v. Securities & Exch. Comm'n*, 681 F.2d 824, 835 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983). The case law under § 10(b) has often resulted in a tension between the two theories. *Id.* at 834-35.

quent decisions, determines the extent of the duty.<sup>63</sup> After *Texas Gulf Sulphur* it seemed that the information theory would dictate the extent of Rule 10b-5 liability.<sup>64</sup> However, in recent years, the Supreme Court has reverted to the fiduciary theory as a guide for ascertaining the scope of the insider trading prohibition.<sup>65</sup>

#### 4. *Chiarella v. United States*: A Restriction of Rule 10b-5 Liability

In 1980, the Supreme Court took steps to narrow liability under Rule 10b-5 in *Chiarella v. United States*.<sup>66</sup> The defendant in the action was a "mark-up" man for a financial printer.<sup>67</sup> Clients of the printer were corporations involved in acquiring target corporations through mergers and takeovers.<sup>68</sup> Because of the need for secrecy involved in such acquisitions, names were omitted from the documents until the final printing.<sup>69</sup> However, the defendant was able to deduce the names of the target corporations and used the information to purchase stock in the targets prior to the takeover announcements.<sup>70</sup> Once the announcements of the takeovers were made, the defendant sold the stock at a substantial profit.<sup>71</sup>

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63. A court choosing the fiduciary theory will extend the duty only to traders in a relationship of trust with the corporation. A person outside this relationship, but who possesses inside information, can thus trade freely. A court choosing the information theory will prohibit the same person from trading without disclosing. The duty will extend to all traders with inside information whether or not they have a relationship of trust with the corporation. Note, *supra* note 39, at 137-38.

64. The information theory, which emphasizes access to information and the unfairness inherent in information advantages guided courts in what has been deemed the "Expansion Era" in securities fraud. See 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 7.5 (1986).

65. The use of fiduciary criteria for § 10(b) liability is the hallmark of the recent "Contraction Era" in securities fraud. *Id.*

66. 445 U.S. 222 (1980).

67. *Id.* at 224.

68. *Id.*

69. *Id.*

70. The defendant in the action conceded that he knew his conduct was wrong and that he and his co-workers in the print shop were warned by their employer that actions of this kind were improper and forbidden. *Id.* at 246.

71. In slightly more than 14 months the defendant realized a gain of more than \$30,000. *Chiarella*, 445 U.S. at 224 (Blackmun, J., dissenting).

The government brought a criminal action<sup>72</sup> against the mark-up man, and the district court found the defendant had violated section 10(b) and Rule 10b-5.<sup>73</sup> The Second Circuit Court of Appeals affirmed the conviction.<sup>74</sup> The defendant sought and was granted review by the United States Supreme Court.

The Supreme Court reversed the convictions<sup>75</sup> and rejected the theory that mere possession of confidential, material information created a duty to disclose under section 10(b) and Rule 10b-5.<sup>76</sup> According to the *Chiarella* majority, in order for a duty to disclose to be present there must exist a relationship of trust and confidence between parties to a transaction.<sup>77</sup> Since the defendant was not an agent, fiduciary, or one in whom the sellers had placed their trust and confidence at the time of the transaction, the Supreme Court held that the printer was under no obligation to disclose his knowledge of the impending takeovers prior to the transactions.<sup>78</sup> His trading activities were held not to be in violation of section 10(b) and Rule 10b-5.

In *Chiarella*, the Supreme Court resurrected the philosophy of fiduciary standards<sup>79</sup> as a prerequisite to liability under Rule 10b-5, and in doing so substantially limited the scope of the Rule. However, the Court never addressed the government's principal argument: that an employee's act of misappropriating an employer's confidential information in itself constituted securities fraud.<sup>80</sup> The *Chiarella* majority stated

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72. The action instituted by the SEC was the first criminal action under § 10(b).

73. *United States v. Chiarella*, 450 F. Supp. 95, 97 (S.D.N.Y. 1978).

74. *United States v. Chiarella*, 588 F.2d 1358, 1373 (2d Cir. 1978).

75. *Chiarella*, 445 U.S. at 225.

76. *Id.* at 235. The Court pronounced, "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information." *Id.*

77. *Id.* at 232.

78. The Court found the petitioner was a complete stranger to the sellers with whom he dealt through the impersonal securities market. *Id.* at 232-33.

79. See *supra* notes 62-65 and accompanying text.

80. The government's principal argument was that the petitioner's secret conversion of confidential material information from the corporations that retained his employer as a printing firm, and use of that information to purchase securities from uninformed investors violated § 10(b) and Rule 10b-5. Brief for Respondent at 23, *Chiarella v. United States*, 588 F.2d 1358 (2d Cir. 1979) (No. 78-1202), *rev'd*, 445 U.S. 222 (1980) [hereinafter Brief].

that it "[n]eed not decide whether this theory has merit for it was not submitted to the jury."<sup>81</sup> Thus, the *Chiarella* decision left unresolved the issue of whether the conversion of confidential information could constitute securities fraud.<sup>82</sup>

The *Chiarella* decision presented an irony. Although its holding limited the scope of section 10(b) and Rule 10b-5 in traditional insider trading cases, it provided an avenue of expansion for Rule 10b-5 liability. After *Chiarella*, persons who wrongfully procured information regarding securities became the subject of securities fraud actions.<sup>83</sup>

### III. THE MISAPPROPRIATION THEORY

#### A. Origins

In its simplest form, the misappropriation theory states that a person who buys or sells securities on the basis of material, nonpublic information that he converted from another is guilty of securities fraud.<sup>84</sup> The theory has received much support in the seven years since the *Chiarella*<sup>85</sup> decision as the SEC works to bring all types of fraudulent activities within the reach of Rule 10b-5.

The original proponent of the misappropriation theory was Chief Justice Warren Burger. He maintained that the jury instructions at the trial level in *Chiarella* properly charged a violation of section 10(b) and Rule 10b-5,<sup>86</sup> therefore, he addressed the government's misappropriation theory in his dissenting opinion. Burger asserted that irrespective of the absence of a fiduciary relationship between the parties to a transaction, the act of misappropriation of confidential infor-

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81. *Chiarella*, 445 U.S. at 236.

82. See Aldave, *Misappropriation: A General Theory Of Liability For Trading On Nonpublic Information*, 13 HOFSTRA L. REV. 101, 114 (1984).

83. See *infra* notes 92-140 and accompanying text.

84. Aldave, *supra* note 82, at 114. This broad statement of the theory is criticized as being "too imprecise to be evaluated meaningfully [as] it evades the critical question of what constitutes the prohibited fraud." *Id.* See *infra* notes 141-64 and accompanying text.

85. *United States v. Chiarella*, 445 U.S. 222 (1980).

86. *Id.* at 239 (Burger, C. J., dissenting).

mation creates an absolute duty on the misappropriator to disclose the information before trading.<sup>87</sup>

Chief Justice Burger's dissent noted that although traditionally there is no duty to disclose in arm's length transactions,<sup>88</sup> "the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."<sup>89</sup> Burger concluded his opinion by stating that the defendant in *Chiarella* had "misappropriated - stole to put it bluntly - valuable non-public information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates section 10(b) and Rule 10b-5."<sup>90</sup>

Despite the fact that the merits of the misappropriation theory were not addressed by the majority opinion in *Chiarella*, in addition to Chief Justice Burger, four other Justices indicated a willingness to accept the misappropriation theory in some form.<sup>91</sup> After *Chiarella*<sup>92</sup> the validity of the

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87. Chief Justice Burger stated he "would read § 10 (b) and rule 10 b-5 . . . to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240.

88. *Id.* at 239.

89. *Id.* The rule that Chief Justice Burger put forth was originally contemplated by W. Page Keeton who asserted:

[T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part. . . . *Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information . . . .*

Keeton, *Fraud - Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936) (emphasis added).

90. *Chiarella*, 445 U.S. at 245.

91. *See id.* at 238 (Stevens, J., concurring) (reasonable arguments could be made for the acceptance or rejection of the government's argument); *Id.* at 239 (Brennan, J., concurring) (a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information); *Id.* at 245-46 (Blackmun, J., dissenting) (agreed substantially with Burger's dissent on § 10(b) liability and was joined by Justice Marshall).

92. After *Chiarella*, the SEC promulgated Rule 14e-3, 17 C.F.R. § 240.14e-3(a), which specifically focuses on the problem of insider trading in connection with tender offers. The Rule mandates an obligation to disclose or refrain from trading for any person with inside information regarding a tender offer. *See Note, Securities Regulation-Absent an Affirmative Duty to Disclose, Criminal Liability for Non-Disclosure Under Rule 10b-5 Will Not Be Found*, 3 WHITTIER L. REV. 129, 149 (1981). Although the

theory seemed apparent despite the fact that proper legal standards for its application had yet to be established.

*B. Applications of the Misappropriation Theory  
Since Chiarella*

Soon after the *Chiarella* decision, the SEC stated:

[T]he *Chiarella* court did not resolve whether trading while in possession of material nonpublic market information misappropriated or obtained or used by unlawful means violates Rule 10b-5. The Commission continues to believe that such conduct undermines the integrity of, and investor confidence in, the securities markets, and that persons who unlawfully obtain or misappropriate material nonpublic information violate Rule 10b-5 when they trade on such information.<sup>93</sup>

The misappropriation theory has been a powerful tool for the SEC in recent years. Despite the fact that it is a new and innovative approach to securities fraud, the theory has been accepted as a meritorious basis for liability under the federal securities laws.

1. A Second Acknowledgement from the Supreme Court

The misappropriation theory received limited support from the Supreme Court in its 1983 decision of *Dirks v. Securities Exchange Commission*.<sup>94</sup> In *Dirks*, the defendant was a securities analyst who was informed by a former employee of a corporation that the corporation's assets were grossly overstated.<sup>95</sup> He conducted his own investigations of the wrongdoings, and openly discussed his findings with clients who in turn sold their securities in the corporation.<sup>96</sup>

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rule is intended to circumvent the holding of *Chiarella*, its effectiveness is minimal because the holding of *Chiarella* is not limited to tender offer situations. See Note, *supra* note 38, at 1342.

93. Securities Exchange Act Release No. 17120 [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,646, 83,456 (1980).

94. 463 U.S. 646 (1983).

95. *Id.* at 649. The overstated assets were a result of fraudulent corporate practices. *Id.*

96. Neither the petitioner nor his firm owned or traded any of the suspect corporation's stock personally, but clients and investors who received confidential information from the petitioner liquidated securities in excess of 16 million dollars as a result of receiving information from the petitioner. *Id.*



Despite the defendant's independent efforts to expose the scandal, the SEC censured the defendant for violation of Rule 10b-5 because his communication of material, nonpublic information to persons he knew were likely to trade was fraudulent.<sup>97</sup> The court of appeals dismissed the petition for review.<sup>98</sup> However, the United States Supreme Court reversed the decision, finding no actionable violation of Rule 10b-5 in the defendant's conduct.<sup>99</sup>

The *Dirks* decision was consistent with the *Chiarella* approach to limiting the scope<sup>100</sup> of Rule 10b-5 by placing fiduciary requirements on the duty to disclose.<sup>101</sup> Nevertheless, the decision also indicated the Supreme Court's acceptance of the proposition that misappropriation of confidential information is actionable under Rule 10b-5. The *Dirks* majority opinion stated that the defendant did not "misappropriate or illegally obtain the information about [the corporation],"<sup>102</sup> inferring that had the defendant misappropriated the information at issue, there would have been grounds for liability under the securities laws.

## 2. *United States v. Newman*: The Second Circuit's Resolution to the Misappropriation Theory

The majority opinion in *Chiarella* left the resolution of whether the conversion of confidential information constitutes securities fraud "wisely for another day."<sup>103</sup> For the Second Circuit Court of Appeals, that day came in *United States v. Newman*.<sup>104</sup>

In *Newman*, two employees of investment banking firms representing corporations involved in takeovers conspired with an employee of a New York brokerage firm to convey to

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97. 21 S.E.C. 1401, 1407 (1981).

98. *Dirks*, 681 F.2d 824, 846 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646, 652 (1983).

99. 463 U.S. at 652.

100. *See supra* notes 66-83 and accompanying text.

101. The *Dirks* action involved an insider tippee's liability under § 10(b) and Rule 10b-5. A tippee is one who receives confidential information from an insider. *See* 3 A. BROMBERG & L. LOWENFALS, *supra* note 64, at § 7.5. Liability for a tippee attaches only when the insider's tip constitutes a breach of the insider's fiduciary duty. *Dirks*, 463 U.S. at 661.

102. *Dirks*, 463 U.S. at 665.

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

104. 664 F.2d 12, 16 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

the broker their employer's confidential information about the identities of their client's target corporations.<sup>105</sup> The stockbroker enlisted the assistance of others to secretly use the confidential information to purchase stock in the targets prior to the takeovers.<sup>106</sup> After the announcement of the takeovers, the brokers sold the stock for a profit and shared the gains with their co-conspirators.<sup>107</sup>

The defendant was indicted on securities fraud violations,<sup>108</sup> but the district court dismissed the allegations, reasoning that no unequivocal statement proscribing the defendant's conduct existed in the federal securities laws to indicate to a person of ordinary intelligence that the conduct was unlawful.<sup>109</sup> The district court also found that the acts of misappropriation of confidential information were not in themselves deceptive practices violating section 10(b) and Rule 10b-5.<sup>110</sup>

The Second Circuit Court of Appeals reversed the dismissal of the indictment.<sup>111</sup> The court of appeals held that the conspiracy to misappropriate the confidential information of the investment banking firms was in itself a deceptive practice amounting to securities fraud.<sup>112</sup> The *Newman* court cited

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105. *Id.* at 15. The confidential information included plans about mergers, tender offers, and takeover bids. *Id.*

106. *Id.* For purposes of avoiding detection, the purchases and receipts were spread among brokers and foreign accounts. *Id.*

107. *Id.*

108. *Id.* In addition to the allegations of securities fraud, the indictment included charges of mail fraud and conspiracy. *Id.* at 14. The Second Circuit Court of Appeals reversed the district court's judgment as to the allegations of mail fraud and conspiracy as well as to the securities fraud. *Id.* at 15.

109. *United States v. Courtois* [1981 Transfer Binder], Fed. Sec. L. Rep. (CCH) § 98,024 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

110. *Id.*

111. *Newman*, 664 F.2d at 14.

112. *Id.* at 17. In reaching its decision the court relied on several federal appeals courts' decisions in which other areas of the law have found "deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful." *Id.* at 18. *See, e.g., United States v. Kent*, 608 F.2d 542 (5th Cir. 1979) (it is fraud to steal oil company's maps and well reports), *cert. denied*, 446 U.S. 936 (1980); *United States v. Girard*, 601 F.2d 69 (2d Cir. 1979) (theft and sale of government information is fraud), *cert. denied*, 444 U.S. 871 (1979); *Abbott v. United States*, 239 F.2d 310 (5th Cir. 1956) (theft of maps and use of mails constituted fraud); *United States v. Buckner*, 108 F.2d 921 (2d Cir. 1940) (conversion of bondholder's money is fraud), *cert. denied*, 309 U.S. 669 (1940).

Chief Justice Burger's dissent in *Chiarella* as persuasive authority<sup>113</sup> and further opined,

[h]ad [the defendants] used similar deceptive practices to mulct [their employers] of cash or securities, it could hardly be argued that those companies had not been defrauded. By sullyng the reputations of [their] employers as safe repositories of client confidences [the defendants] . . . defrauded those employers as surely as if they took their money.<sup>114</sup>

Having concluded that the defendant's conduct was a deceptive practice under section 10(b) and Rule 10b-5, the court addressed the issue of whether such conduct was in connection with a purchase or sale of securities,<sup>115</sup> a necessary element of securities fraud under Rule 10b-5. By establishing that the defendant's *sole purpose* of the scheme was to purchase stock in the corporations which were takeover targets, the court asserted that the fraud was sufficiently connected to a sale.<sup>116</sup> The court also found that in a criminal proceeding under Rule 10b-5, the requirement that the fraud be perpetrated on a purchaser or seller was not necessary.<sup>117</sup> Thus, the court concluded that the defendant's conduct constituted securities fraud.<sup>118</sup> The *Newman* decision was denied certiorari by the Supreme Court.<sup>119</sup>

### 3. Other Applications of the Misappropriation Theory

The SEC has continued to apply the misappropriation theory to suspect securities market activity. In *Securities & Exchange Commission v. Lund*<sup>120</sup> and *Securities & Exchange*

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113. *Newman*, 664 F.2d at 17. The court analogized the conduct of the "connivers" in the case with that of the defendants in *Chiarella*. *Id.*

114. *Id.* (citation omitted). In addition to the harm to an employer of a misappropriator, the *Newman* court found that the conduct of the appellants harmed the employer's clients as the stock the clients planned to purchase was "artificially inflated through purchases by purloiners of confidential information." *Id.*

115. *Id.* at 18.

116. *Id.* See also *infra* notes 165-74 and accompanying text.

117. *Newman*, 664 F.2d at 17. The court noted, "[t]he district court's statement that fraud [be] perpetrated upon purchasers or sellers of securities [as] a 'requisite element under the securities laws' is . . . an overbroad and incorrect summary of the law." *Id.*

118. *Id.* at 16.

119. *Newman*, 464 U.S. 863 (1983).

120. 570 F. Supp. 1397 (C.D. Cal. 1983).

*Commission v. Materia*<sup>121</sup> the theory was successfully utilized to sustain injunctions. In *Lund*, the misappropriation theory was one of three used to impose liability on an employee of a corporation who used the corporation's confidential information regarding a pending joint venture to personally profit in a securities transaction.<sup>122</sup> The *Materia* action involved a printer using information in a manner very similar to the defendant in *Chiarella*.<sup>123</sup> The use of the misappropriation theory resulted in an imposition of an injunction against the defendant.<sup>124</sup>

The most recent, and perhaps the most interesting case involving the misappropriation theory is *United States v. Carpenter*.<sup>125</sup> The facts in *Carpenter* involve a writer for the Wall Street Journal's "Heard on the Street" column, an influential investment column which includes both negative and positive information about securities.<sup>126</sup> Although the column does not include corporate inside information, it does have an effect on the price of stock featured in the column.<sup>127</sup> The writer, along with a stockbroker and other co-conspirators, utilized the writer's advance knowledge regarding the content and timing of the "Heard on the Street" articles and traded in securities to be featured in the column. The conspirators shared the profits realized from the trade.<sup>128</sup>

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121. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

122. *Lund*, 570 F. Supp. at 1402. The two alternative theories for liability put forth by the government to sustain the injunction were that the defendant was a tippee with a derivative duty to disclose, and that he had a fiduciary relationship with the issuer of the stock in which he traded. This final theory was the basis for the conviction. *Id.*

123. See *supra* notes 66-71 and accompanying text. The defendant in *Materia* was a copy reader employed by a financial printer. He was able to deduce information regarding his employer's client's takeover targets in four instances and traded on the basis of such information. *Materia*, 745 F.2d at 199. The *Materia* court found the defendant had defrauded his employer by damaging its reputation. *Id.* at 201-02.

124. 745 F.2d at 200.

125. 791 F.2d 1024 (2d Cir. 1986), *aff'g sub nom.* United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), *cert. granted*, 107 S. Ct. 666 (1986).

126. *Winans*, 612 F. Supp. at 829. "[The] column . . . is a daily market gossip feature, which highlights a stock or group of stocks and analyzes notable volumes of trading." *Id.* at 830.

127. The district court found that the column did have an impact on the securities market, though the extent of the impact was found to be difficult to measure. *Id.*

128. The amount of the profits realized from the scheme was almost \$690,000. *Id.* at 834.

The district court found that the Wall Street Journal's employee had misappropriated the information from his employer contrary to the policy of the Journal.<sup>129</sup> The district court asserted, "[w]hat made the conduct here a fraud was that [the employee] knew he was not supposed to leak the timing or contents of his articles or trade on that knowledge."<sup>130</sup> The validity of the misappropriation theory was fundamental to the conviction of the employee, as the facts present indicated that there was no fiduciary relationship between the employee and the transacting parties.<sup>131</sup>

The Second Circuit Court of Appeals affirmed the conviction of the conspirators,<sup>132</sup> holding that section 10(b) and Rule 10b-5 prohibited an employee from unlawfully misappropriating confidential, material information from his employer.<sup>133</sup> The court of appeals rejected the appellant's narrow interpretation of *Newman*<sup>134</sup> and *Materia*<sup>135</sup> to be that the misappropriation theory requires a duty of confidentiality to an employer *and* a third party, in order for a violation to be established.<sup>136</sup> Rather, according to the Second Circuit Court of Appeals under the theory, "[i]t is sufficient that the fraud was committed upon [the] employer."<sup>137</sup>

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129. The Wall Street Journal had a conflict of interest policy which specifically prohibited the purchase or sale of securities based on information concerning an article that an employee knows will appear in the Journal. The policy also prohibits an employee from disclosing the paper's future contents to anyone outside the company. *Id.* at 830.

130. *Id.* at 842.

131. See H. BLOOMENTHAL, *supra* note 32, at 367. Since no duty to disclose was alleged in the indictment, the decision necessarily rested upon the misappropriation theory alone. *Id.*

132. *Carpenter*, 791 F.2d at 1036.

133. *Id.* at 1034.

134. See *supra* notes 103-19 and accompanying text.

135. See *supra* notes 121, 123-24 and accompanying text.

136. The *Carpenter* court stated,

[a]ppellants read *Newman* and *Materia* and interpret the misappropriation theory too narrowly. Notwithstanding the existence of corporate clients of the employers in *Newman* and *Materia*, the misappropriation theory more broadly proscribes the conversion by 'insiders' or *others* of material non-public information in connection with the purchase or sale of securities.

*Carpenter*, 791 F.2d at 1029 (emphasis added).

137. *Id.* at 1032. The court found that without a doubt, the fraud and deceit of the scheme was perpetrated upon "any person" as required by § 10(b) and Rule 10b-5. *Id.*

The convicted conspirators filed a *certiorari* petition with the United States Supreme Court on September 15, 1986.<sup>138</sup> The Supreme Court granted review<sup>139</sup> of the convictions on December 15, 1986, despite objections from the SEC and the Department of Justice.<sup>140</sup> Seven years after the *Chiarella* decision endorsed some version of the theory,<sup>141</sup> the Supreme Court will affirmatively discuss the misappropriation theory in *United States v. Carpenter*, and determine its fate as a predicate for liability under the federal securities laws.

#### IV. CRITIQUE OF THE MISAPPROPRIATION THEORY

##### A. Substantive Analysis

Clearly, the misappropriation theory is in its infancy and is not solid law.<sup>142</sup> A firm endorsement of a version of the theory which presents an analytical framework consistent with precedent is necessary to make the theory an effective enforcement tool to prevent fraud in the securities market. The Supreme Court should seize the opportunity presented by *United States v. Carpenter*<sup>143</sup> to broadly construe section 10 (b) and Rule 10b-5 as proscribing the act of misappropriation. By clearly articulating a definitive standard for the misappropriation of confidential information, the Court will prevent further abusive conduct in securities transactions by prohibiting the conversion of confidential information for personal gain.

In order to find fraud in the act of misappropriation of an employer's confidential information, the existence of a fiduciary relationship between the transacting parties is not necessary. Rule 10b-5 liability predicated on a fiduciary

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138. See *Misappropriation Theory to be Tested in Wall Street Journal Insider Action*, 18 SEC. REG. & L. REP. (BNA) 1808 (Dec. 19, 1986) [hereinafter *Misappropriation Theory*].

139. See *Summary of Orders*, 55 U.S.L.W. 3420-21 (Dec. 16, 1986).

140. See *Misappropriation Theory*, *supra* note 138, at 1808-09. A primary objection made by the government to the Supreme Court's review of the misappropriation theory was that the *Carpenter* case involved legal issues which have not received wide judicial consideration. *Id.*

141. See *supra* note 90 and accompanying text.

142. See *Langevoort*, *supra* note 33, at 1295.

143. 791 F.2d 1024 (2d Cir. 1986), *aff'g sub nom.* *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), *cert. granted*, 107 S. Ct. 666 (1986).

relationship, as required by the *Chiarella v. United States*<sup>144</sup> decision, is applicable only to traditional insider trading cases — ones in which a corporate insider or his tippee<sup>145</sup> perpetrates fraud upon the shareholders in breach of a corporate duty.<sup>146</sup>

Since fraud obtained by an act of misappropriation substantially differs from traditional insider fraud, the development of the misappropriation theory should not be constrained by the *Chiarella* doctrine. Rather, by properly focusing on the employee-employer relationship, considering Rule 10b-5 precedent dealing with misappropriation of property, and construing the pertinent statute and rule in a manner which would fulfill their purpose, the misappropriation theory becomes a logical basis for securities fraud violations.

Since its inception, the theory has been the subject of much controversy. Its present unsettled state puts forth three major points which require clarification: (1) what actions by an employee constitute the fraud necessary to bring the employee's conduct within the reach of the anti-fraud statutes; (2) how the act of misappropriation is sufficiently connected to the purchase or sale of securities; and (3) what harm must be sustained to make the misappropriation of confidential information actionable under section 10(b) and Rule 10b-5.

### 1. Fraud on the Employer: Cases and the Proper Standard

As noted above, section 10(b) and Rule 10b-5 are considered "catch-all" provisions of the securities laws,<sup>147</sup> but what they must catch is fraud.<sup>148</sup> From the onset, proponents of the theory have put forth different versions, yet none have clearly articulated exactly what conduct constitutes fraud.

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144. 445 U.S. 222 (1980).

145. See *supra* note 100 and accompanying text.

146. In *Winans* the district court made it clear that it considered the misappropriation theory a separate legal theory when it stated, "[t]he essential point is that the misuse of corporate inside information is not the only type of fraud that the securities laws cover." *United States v. Winans*, 612 F. Supp. 827, 841 (S.D.N.Y. 1985), *aff'd sub nom. United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *cert. granted*, 107 S. Ct. 666 (1986).

147. See *supra* note 27 and accompanying text.

148. *Chiarella*, 445 U.S. 226 (1980) (Burger, C.J., dissenting).

Chief Justice Burger's "absolute duty" version of the theory finds fraud in an employee's failure to disclose the material information to the individual *with whom the misappropriator trades*.<sup>149</sup> However, given that Burger's version of the theory is inconsistent with the misappropriation theory's emphasis on the employee-employer relationship, his finding of fraud on the purchaser or seller of securities fails to resolve why an employee's act of misappropriation constitutes fraud on his employer.

Subsequent decisions based on the misappropriation theory have not embraced the Chief Justice's "absolute duty" approach.<sup>150</sup> Instead, fraud has been found in the employee's conversion and use of the employer's information for personal gain. In *United States v. Newman*,<sup>151</sup> the Second Circuit Court of Appeals chose to "spend little time on the issue of fraud and deceit"<sup>152</sup> in arriving at its decision that the employee's wrongful use of his employer's confidential information was in itself an act of deception.<sup>153</sup> A fundamental flaw of the *Newman* decision is that it failed to take the critical analytical step of addressing why an employee's breach of his fiduciary duty to his employer constituted securities fraud.

The Second Circuit Court of Appeals failed to remedy the *Newman* analytical flaw in *United States v. Carpenter*, although the decision does allude to a basis by which an employee's breach of his fiduciary duty should be considered fraud.<sup>154</sup> The *Carpenter* court made it clear that the conspirators used *secret acts* to give rise to reasonable expectations of personal profits.<sup>155</sup> Secret acts, viewed as deception on the employer, coupled with an employee's breach of fiduciary

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149. *Id.* at 245.

150. See Aldave, *supra* note 82, at 115. The reasons put forth in this source for the rejection of Chief Justice Burger's version of the theory is that it is unconvincing and inconsistent with precedent. *Id.* at 115-16. However, rejection of the Chief Justice's view of the misappropriation theory does not necessarily imply that persons who misappropriate confidential information are free to use it in trading securities. *Id.* at 117.

151. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

152. *Id.* at 17.

153. *Id.* The court's only elaboration concerning the issue of why the appellee's conduct was fraudulent was its statement: "[t]he wrong-doing charged against appellee and his cohorts was not simply internal corporate mismanagement." *Id.*

154. See *Carpenter*, 791 F.2d at 1031-32.

155. *Id.* at 1031 (emphasis added).



duty, constitute the fraud required by section 10(b) and Rule 10b-5.

Critics of the expansion of Rule 10b-5 to cover an act of misappropriation question the elevation of an employee's breach of his fiduciary duty into the actionable realm of securities law.<sup>156</sup> Opponents of the theory assert that such conduct is best addressed under state corporate and agency law.<sup>157</sup> However, when precedent interpreting the scope and purpose of Rule 10b-5 is considered, the assertion that the conduct of misappropriation is best addressed by other areas of substantive law is logically rebutted.

In *Santa Fe Industries Inc. v. Green*,<sup>158</sup> the Supreme Court addressed the issue of whether a breach of a fiduciary duty was actionable under section 10(b) and Rule 10b-5. In finding that the claim was not actionable,<sup>159</sup> the court put forth the test for an actionable breach of fiduciary duty: "[a] claim of fraud and fiduciary breach . . . states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."<sup>160</sup>

By incorporating the *Santa Fe Industries* test into the misappropriation theory, the requirement that fraud be based on a fiduciary breach will be consistent with other theories of liability under Rule 10b-5. Only certain types of fiduciary breaches will be actionable under the rule; those breaches which present manipulation or deception.

The act of misappropriation clearly satisfies the manipulation or deception requirements put forth in *Santa Fe Industries*. The conduct entails a secret scheme to steal valuable corporate property in the form of information.<sup>161</sup> An em-

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156. Note, *Trading on Confidential Information - Chiarella Takes An Encore*: United States v. Newman, 56 ST. JOHN'S L. REV. 727, 736 (1982). See generally A. BROMBERG & L. LOWENFELS, *supra* note 64, at § 7.5(513); Comment, *The Misappropriation Theory: Too Much of a Good Thing?*, 17 PAC. L.J. 111, 123-27 (1985).

157. See Note, *supra* note 30, at 866-67. This commentator asserts that an act of misappropriation can be properly sanctioned under state agency principles. *Id.*

158. 430 U.S. 462 (1977). The action involved a shareholder alleging a fraudulent underevaluation of stock in connection with a corporate merger. *Id.* at 462-63.

159. *Id.* at 463.

160. *Id.* at 473-74 (emphasis added).

161. The notion that information is a form of property worthy of protection is not new to the law. It is one rationale which has provided guidance in some situations

ployer is deceived by the conduct of its employee who implicitly represents to the employer that he would not convert the information for his own use. The employee's actions constitute a deliberate portrayal of a false impression to gain personal profits.<sup>162</sup> Under such a scheme, there is no question that an employer is duped into believing that he will receive the sole and full benefits of the confidential information.<sup>163</sup> This type of deceptive activity should be prohibited by the securities laws.

The conclusion that an employee's secret scheme to misappropriate confidential information from an employer is an act of deception prohibited under section 10(b) and Rule 10b-5 is consistent with other Rule 10b-5 cases discussing misappropriation of corporate tangibles. Prior cases have held that the misappropriation of cash or securities is actionable under Rule 10b-5.<sup>164</sup> By viewing confidential information as business property, earlier Rule 10b-5 precedent will properly control. As the Second Circuit Court of Appeals stated in *Carpenter*, "an employee's use of information obtained in a breach of a duty of confidentiality by conduct constituting secreting, stealing, and purloining constitutes chicanery and foul play, rendering such conduct unlawful under section 10 (b) and Rule 10b-5."<sup>165</sup>

## 2. In Connection with a Purchase or Sale of Securities

In order to satisfy section 10(b) and Rule 10b-5, a fraudulent scheme must be sufficiently connected to the purchase or sale of securities. Critics of the theory assert that it is flawed

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arising under the anti-fraud provisions of the securities laws. See generally Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 814-15 (1980).

162. See *United States v. Proctor & Gamble Co.*, 47 F. Supp. 676 (D. Mass. 1942). The court in *Proctor & Gamble* stated, "[t]he employee, in using the employment relationship for the express purpose of carrying out of a scheme to obtain his employer's confidential information . . . would be guilty of deliberately producing a false impression on his employer in order to cheat him. Such conduct would constitute a positive fraud . . . ." *Id.* at 678. (citations omitted).

163. See *Superintendent of Ins. v. Banker's Life & Casualty Co.*, 404 U.S. 6, 9 (1971).

164. See *id.* (misappropriation of cash proceeds); *Mansbach v. Prescott Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) (conversion of bonds); *United States v. Brown*, 555 F.2d 336 (2d Cir. 1977) (conversion of stock).

165. *Carpenter*, 791 F.2d at 1031.

because the fraud in an employee's misappropriation of confidential information is not "in connection with" a purchase or sale of securities.<sup>166</sup> This criticism is based on a notion that fraud connected with the purchase or sale of securities *must* be perpetrated on a purchaser or seller of securities. However, this specific requirement does not apply to SEC enforcement or criminal proceedings under the anti-fraud provision.<sup>167</sup>

Rather, the requirement that fraud be perpetrated on a purchaser or seller of securities is a judicially created limitation used to determine a plaintiff's standing to sue in a Rule 10b-5 private action for damages.<sup>168</sup> When the plain language of Rule 10b-5 and precedent mandating a flexible construction of the "in connection with" requirement are considered, it is apparent that the act of misappropriation and subsequent trading on such information satisfy the "in connection with" requirement of the rule.

Rule 10b-5 prohibits fraudulent or deceitful acts upon *any* person in connection with the purchase or sale of *any* security. This broad language has been interpreted to require only that the fraud have a logical relation to the purchase or sale of *any* security.

In *Superintendent of Insurance v. Bankers Life & Casualty Co.*,<sup>169</sup> the Supreme Court put forth the "touching the purchase or sale" standard for the "in connection with" requirement of Rule 10b-5. Under such a standard, when an injury is a result of a deceptive theory or fraudulent practice touching the purchase or sale of securities, the requisite nexus between the fraud and the purchase or sale is established.<sup>170</sup>

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166. See, e.g., Block & Burton, *Securities Litigation*, 10 SEC. L.J. 350, 353-54 (1983). One problem in fitting outsider trading within Section 10(b) lies in the requirement that the fraud be in connection with a purchase or sale of securities. *Id.*

167. *Newman*, 664 F.2d at 17. See also *supra* notes 115-17 and accompanying text.

168. See *supra* note 17 and accompanying text. An implied right to a private action for damages under § 10(b) was established in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

169. 404 U.S. 6, 12 (1971).

170. *Id.* at 12-13. The *Banker's Life* court stated:

[W]e do not read § 10(b) . . . narrowly . . . [I]t is not "limited to preserving the integrity of the securities markets," though that purpose is included. Section 10 (b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10 (b). . . .

*Id.* at 12. (citation omitted).

The manner in which the Second Circuit Court of Appeals has treated the "in connection with" requirement of the securities laws' anti-fraud provisions is consistent with the liberal test put forth in *Bankers Life*. In *Newman*, the court rejected a defense that the scheme of misappropriation had no connection to a purchase or sale of securities, finding rather that the defendant's *sole purpose* in the misappropriation of confidential information was to purchase shares of the target corporations.<sup>171</sup> By focusing on the ultimate purpose of the fraudulent scheme, the *Newman* court found that the actions of the defendant fulfilled the standard set forth in *Bankers Life*.<sup>172</sup>

In *Carpenter* the Second Circuit Court of Appeals reaffirmed its view that the act of misappropriation satisfied the wide breadth of the *Bankers Life* standard. The court stated: "the use of the misappropriated information for the financial benefit of the [appellant] and to the financial detriment of those investors with whom the appellants traded supports the conclusion that appellants' fraud was 'in connection with' the purchase or sale of securities under section 10(b) and Rule 10b-5."<sup>173</sup> The *Carpenter* court further stated that "[t]he misappropriated information regarding the timing and content of certain . . . [financial] columns had no value whatsoever [to appellants] except 'in connection with' [their] subsequent purchase[s] [and sales] of securities."<sup>174</sup>

The value of misappropriated information is not realized until the information is utilized in a securities transaction. Instances of misappropriation present fraudulent activities in which the sole purpose of the scheme is to "reap instant no-risk profits in the stock market."<sup>175</sup> When the sole purpose of a fraudulent scheme is to gain information to be used in a purchase or sale of securities, the fraud goes beyond simply the touch test of *Bankers Life*, and is *directly* connected to a purchase or sale. Therefore, an employee's misappropriation and use of confidential information through the vehicle of the

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171. 664 F.2d at 18 (emphasis added).

172. *Id.*

173. *Carpenter*, 791 F.2d at 1032.

174. *Id.* at 1033.

175. *Securities & Exch. Comm'n v. Materia*, 745 F.2d 197, 203 (2d cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

securities market sufficiently satisfies this requirement of Rule 10b-5.

### 3. The Harm from Misappropriation

The harm perpetrated by the fraud of misappropriation is not complete until someone is injured.<sup>176</sup> In an enforcement of criminal action under Rule 10b-5, the government is not required to establish actual economic injury incurred by securities investors. Rather, the government's burden is to establish that there is potential for some injury to occur.<sup>177</sup> Since the act of misappropriation presents potential for two distinct parties to suffer harm, the theory complies with the requirements of Rule 10b-5 in enforcement and criminal proceedings.

The primary injury which will result from an act of misappropriation is to the employer. When an employee secretly converts confidential information for his own use, a firm is deprived of its decision to maximize the value of the information as the value of secret information is reduced upon conversion.<sup>178</sup> The firm is harmed as the cost and effort committed to keeping the information secret is wasted. Direct economic injury may result as the act of misappropriation injures the reputation of the firm in the business community.<sup>179</sup> Other businesses requiring protection of their business information will cease to be associated with a corporation in which there have been acts of misappropriation by an employee.

In addition, public investors are potentially harmed by an act of misappropriation. Although investors make independent stock investment decisions unaware of the abusive use of confidential information by employees misappropriating infor-

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176. See Aldave, *supra* note 82, at 120. The damage occurs and Rule 10b-5 is violated when the misappropriator or his tippee uses the information in connection with the purchase or sale of any security. *Id.*

177. United States v. Johnson, 496 F.2d 1131, 1135 (5th Cir. 1974). "[I]t is not necessary that the government prove that anyone was actually defrauded in order to show a violation of [the securities laws]. . . ." *Id.* (citation omitted).

178. See Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 11 SUP. CT. REV. 309 (1981) for a legal and economic analysis of ownership rights in information.

179. The difficulty in assessing exact damages under the misappropriation theory is discussed in Note, *Rule 10b-5 Developments - Theories of Liability*, 39 WASH. & LEE L. REV. 969, 981-82 (1982).

mation, this does not mean they are unharmed by the unlawful gain or a trading advantage.<sup>180</sup> When an employee converts confidential information in the stock market, investors are deprived of the fair market value of their investments.<sup>181</sup>

### B. Policy Analysis

The United States Supreme Court's future decision regarding the validity of the misappropriation theory is "likely to establish important law regarding the definition of insider trading. In the long run, the court's decision . . . may have a greater impact on . . . the law of insider trading than [any recent developments]."<sup>182</sup> Therefore, a declaration from the Supreme Court that the act of misappropriation is securities fraud will have a lasting impact and serve to fulfill the purposes and policies underlying the anti-fraud provisions of the securities law.

Like constitutions and common law lines of decisions, statutes, especially broad statutes, such as the anti-fraud provisions of the Act, are not static.<sup>183</sup> Statutes can and should reach out to solve problems as they arise, and do so in a manner grounded upon principle and policy.<sup>184</sup> The substantive principles supporting an endorsement of the misappropriation theory have been put forth above, and as a matter of policy, it is now suggested that the theory be endorsed by the Supreme Court.

Embodied in section 10(b) of the Act is the fundamental policy to promote "[t]he highest ethical standards . . . in every facet of the securities industry."<sup>185</sup> To achieve such ideals, the scope of the Act has been construed to encompass any "ma-

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180. See CONG. REC., *supra* note 2.

181. The victims of the fraud are ultimately the investors. See Aldave, *supra* note 82, at 121.

182. 19 SEC. REG. & L. REP. (BNA) 85-86 (Jan. 16, 1987) (opinion of SEC Commissioner Joseph Grundfest).

183. Branson, *supra* note 25, at 287.

184. *Id.* at 288.

185. Securities & Exch. Comm'n v. Captial Gains Bureau Inc., 375 U.S. 180, 186-87 (1963). In *Capital Gains* the Supreme Court stated, "[i]t requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry." *Id.* at 186 (citation omitted).

nipulative and deceptive practices" which serve no useful function.<sup>186</sup> The wrongful acquisition and subsequent trading on the basis of confidential information has no useful function, and therefore, as a matter of policy is an appropriate predicate for a violation of section 10(b) and Rule 10b-5. An endorsement of the theory will result in a more effective enforcement campaign against insider trading, encourage legitimate business activities while deterring fraudulent ones, and ultimately restore investor confidence in the nation's securities markets.

### 1. Deterrence

Until very recently, insider trading had been a no-risk venture. The potential for immense profits, when compared to a slim chance of criminal sanctions, traditionally was a powerful lure to such activity.<sup>187</sup> Despite the recent Wall Street arrests,<sup>188</sup> the SEC is still in need of tools to effectively deter individuals with access to confidential information from profiting illegally in the securities market.

The misappropriation theory is a necessary tool by which the SEC can prevent the wrongful conversion of information by *anyone*. It has already "provided the SEC with significant leverage in settlement negotiations and has allowed [the Commission] to extract consent decrees and [profit] disgorgement in a variety of cases."<sup>189</sup> It should be validated by the Supreme Court as it will continue to bring illegal activity in the securities market under control.

Many people involved in insider trading are market professionals. In order to stop their wrongful gains, the securities laws must put these sophisticated parties on notice that their wrongful conduct will not be tolerated and runs the risk of severe consequences. The Insider Trading Sanctions Act of

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186. Securities & Exch. Comm'n v. Materia, 745 F.2d 197, 201 (2d Cir. 1984), cert. denied 471 U.S. 1053 (1985).

187. See CONG. REC., *supra* note 2. See also Dooley, *supra* note 3, at 5.

188. See *New Arrests on Wall Street*, NEWSWEEK, Feb. 23, 1987, at 49 [hereinafter *New Arrests*].

189. Phillips & Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 90 (1984) (footnote omitted). "Despite recognition that the ultimate validity of the misappropriation theory is still in doubt, . . . lower court successes with the theory have encouraged the SEC to seek 'new frontiers' to conquer with this theory." *Id.*

1984,<sup>190</sup> which did not address the substantial elements of a section 10(b) violation, embodied such a philosophy as it increased the sanctions for illegal insider trading.<sup>191</sup> The Court should follow Congress' lead in working towards deterring future incidences of insider trading. A failure to do so will allow fraudulent activity to prevail at the expense of employers, their clients and investors at large. However, even if the Court refuses to endorse the misappropriation theory, Congress may intervene as the Insider Trading Act of 1987,<sup>192</sup> currently under review in the Senate, provides a clear statutory predicate or liability under the misappropriation theory.

## 2. Legitimate Informational Advantages

The misappropriation theory fits neatly into the current securities regulatory scheme. It is consistent with the notion of fairness embodied in the Act, while it outlaws fraudulent conduct. Properly understood and applied, it serves to prohibit trading on the basis of information that an employee or other wrongdoer converts for his own use in a deceptive breach of fiduciary duty. There is no reason to suggest that the theory will interfere with areas of legitimate business activity.

There are certain types of bonafide economic activity which justify, in limited and regulated instances, the use of confidential information in securities transactions. Tender offerors, market specialists, arbitrageurs, and institutional investors may be permitted to use inside information in connection with their bona fide business activities.<sup>193</sup> The policy for allowing an exception to the insider trading prohibition for these parties is that their activities serve the market in a legitimate manner.<sup>194</sup> The misappropriation theory complements the policy of allowing professionals conducting legitimate ac-

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190. See Securities Exchange Act § 21(d)(2)(a). See also *supra* note 37 and accompanying text.

191. *Id.*

192. See *D'Amato Proposes Insider Trading Bill with Definition of Insider Trading*, 19 SEC. REG. & L. REP. (BNA) 86 (Jan. 16, 1987).

193. See 15 U.S.C. § 78m(d)(1) (1976) (tender offeror exception); § 78(k)(b) (specialist exception); see *id.* at § 78(k)(a)(1)(A) - (D) (block traders exception).

194. As Senator Williams noted, a balancing of interests was behind the exception to the insider trading prohibition in tender offer situations. He stated prior to the enactment of the legislation, "I have taken extreme care . . . to balance the scales equally to



tivities certain limited informational advantages. In addition, the misappropriation theory does not interfere with informational advantages gained through special skills, intuition, or fortune.<sup>195</sup> It simply prohibits a game in which an opponent has loaded dice.<sup>196</sup> Therefore, when an informational advantage is not gained via a bonafide activity, it will be the proper subject of the securities laws.

### 3. Investor Confidence

Investor confidence in the securities market is vital to strong and stable capital formation in the nation's economy. Confidence in the market is a major tenet of the securities laws. Nevertheless, the recent publicity concerning the incidences of insider trading and the substantial profits that can be realized by wrongdoers<sup>197</sup> is putting investor confidence at risk. Investors currently fear that they are being deprived of the fair value of their investments when insiders illegally use confidential information. As a result, investment alternatives other than the stock market may be selected and our nation's economic growth and stability may suffer.

An endorsement of the misappropriation theory will serve to reassure investors that the securities market is honest and fair. It will bolster public confidence in the integrity of the market<sup>198</sup> at a time in which investor confidence is ebbing. It will also reassure the investing public that the Supreme Court is supporting the SEC and Congress in their efforts to prevent securities fraud.

## V. CONCLUSION

Individuals who deceptively misappropriate confidential information from an employer and subsequently trade it for personal profit are ingenious and conniving. They exploit positions of trust and confidence for their own personal advantage. From such conduct there is no social gain.

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protect the legitimate interests of the corporation, management and shareholders . . . ." 13 CONG. REC. 854 (1967).

195. See Keeton, *supra* note 89, at 25.

196. See Aldave, *supra* note 82, at 123.

197. Net profit estimates for some inside traders have been in the millions of dollars. See *New Arrests*, *supra* note 188, at 48-49.

198. See Aldave, *supra* note 82, at 125.

Simply because the fraud connected with an act of misappropriation is not the usual type of fraud involved in insider trading does not mean that the conduct is outside the realm of the federal securities laws. Novel or atypical methods of fraud should not provide immunity. The fact that there is no previously litigated action precisely on point constitutes "a tribute to the cupidity and ingenuity of the malefactors," but should not provide an escape from the sanctions.<sup>199</sup>

The misappropriation theory is a proper standard by which section 10(b) and Rule 10b-5 liability can be found. It is legally sound, consistent with precedent, and promotes the notion of fairness sought by the federal securities laws. Therefore, the theory is worthy of a final, affirmative endorsement from the Supreme Court.

BARBARA J. FINIGAN

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199. This point was raised by the government in its brief to the Supreme Court. See Brief, *supra* note 80, at 51.