COMMENTS

ROUNDING THE PEG TO FIT THE HOLE: A PROPOSED REGULATORY REFORM OF THE MISAPPROPRIATION THEORY

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† B.S. 1991, University of California, Irvine; J.D. Candidate 1996, University of Pennsylvania. First, I thank God for giving me the ability, intelligence, and tenacity to complete this project. I would like to acknowledge Professor Leo Katz of the University of Pennsylvania Law School for his assistance and suggestions in selecting this topic and Professor William Tyson of the Wharton School for introducing me to the topic of securities regulation. I thank Professor Katz, Professor Tyson, Craig Lehner, and Michael Manasse for their ideas, guidance, and criticism on this project. I also express gratitude to my *Law Review* peers for their careful and tireless editing; in particular I thank Laura Boschken. This Comment is dedicated to my parents, Bob and Donna, whose unconditional love and support have provided the foundation for all I have achieved, Carlos Carossino for encouraging me in my decision to enter law school, and Alisha English, who has continued to love and support me despite an unconscionable amount of neglect throughout my legal education and the writing of this Comment.

INTRODUCTION

Ritz Travel is a travel agency catering to celebrities, important diplomats, and executives in key positions at several Fortune 500 companies.[1] To provide a level of service that will attract such clientele, the travel agency has implemented several policies and procedures governing its employees' conduct. Included in these procedures is a strict rule of confidentiality that prohibits any employee from discussing the travel plans of a client with anyone outside the agency. Due to its policies, Ritz Travel has been remarkably successful for a number of years.

While watching the news at home one day, Matt Pilfer, an employee at Ritz, learned that Flight 97, a transcontinental flight from Armond, New York to Los Angeles, had just crashed and that there were no survivors. Pilfer immediately recalled that he had ticketed Lou Gerstner, Chairman and CEO of IBM, on that flight. Pilfer happened to own thirty shares of IBM. Realizing that

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[1] This hypothetical, while completely fictional, is based on a compendium of cases decided under the antifraud provisions of the Securities Exchange Act of 1934 ("Exchange Act"), Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78*ll* (1994)).

IBM's stock would probably drop in response to the death of Gerstner, Pilfer rushed to the phone to contact his broker before the flight's passenger list was publicly announced. Pilfer placed an order to sell all thirty shares of IBM. After the public announcement that Lou Gerstner had died, IBM stock dropped $10 per share.

Adam Skinner, a portfolio manager, happened to be at the airport the day Lou Gerstner boarded Flight 97. Skinner immediately recognized Gerstner and wondered why he would be traveling to Los Angeles. Always alert to potential market developments, Skinner noted Gerstner's flight number and destination. Upon learning that Flight 97 had crashed, and speculating that the price of IBM stock would fall, Skinner immediately placed orders for his own account and the accounts of several customers to sell IBM short.[2] Skinner made profits and commissions in excess of $100,000 on the sale.

Under the matrix of current securities regulation, have Pilfer and Skinner violated any securities laws? The answer, perhaps surprisingly, is that although both traded on the same information, Pilfer, the travel agent, has engaged in insider trading while Skinner, the securities analyst, has not.

During the 1980s, insider trading violations[3] became more numerous and more public. The highly publicized prosecutions of such notable figures as Ivan Boesky, Dennis Levine, and Ilan Reich made "insider trading" a household term.[4] In 1988, the General

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[2] Short selling occurs when an investor borrows stock from a broker with a promise to pay back the same amount of stock. The investor then sells the stock on the market at today's price. If the price of the stock declines, then the investor pays the broker back with stock that is worth less than that which was borrowed. The investor makes a profit as the stock price declines because the profit is the difference between the price at which the investor sold the stock and the price at which stock is purchased to repay the broker. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITY REGULATION 699-700 (3d ed. 1995).

[3] The term "insider trading" has never been explicitly defined in the federal securities laws. Congress deliberated over whether to include a definition in the Insider Trading Sanctions Act of 1984, but ultimately determined that the existing substantive law, as developed by the courts, was adequately clear. *See Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 33-39 (1984). Additionally, the Securities and Exchange Commission ("SEC" or "Commission") determined that fashioning a definition of insider trading would be "too daunting a task." Karl Groskaufmanis, *The SEC's Enforcement Nose Dive*, LEGAL TIMES, Dec. 16, 1991, at 21, 22. The concern was that any definition would limit the Commission's enforcement powers when responding to future unanticipated situations. *See id.*

[4] Ivan Boesky, an arbitrageur who traded illegally on the basis of inside

Accounting Office reported that the number of opportunities for insider trading had sharply increased.[5] Although Congress,[6] the Securities and Exchange Commission ("SEC" or "Commission"),[7]

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information obtained through bribes, was allegedly fined $100 million by the SEC. *See* Steven Brill, *Can Boesky's Sweetheart Plea Bargain Be Undone*, AM. LAW., Dec. 1987, at 3, *available in* LEXIS, News Library, Amlawr File. Dennis Levine, a former executive at the now defunct investment banking firm of Drexel Burnham Lambert, paid $11.6 million in a settlement with the SEC in which Levine pled guilty to insider trading charges. *See* Barbara Bradley, *Feds Unleash Half of Assault on Drexel*, CHRISTIAN SCI. MONITOR, Sept. 19, 1988, at 1, *available in* LEXIS, News Library, Arcnws File; George L. Fleming, *A Decade of Debt and Greed: Roaring '80's Draws Unsettling Parallels*, ST. PETERSBURG TIMES, Dec. 19, 1988, at 15 (book review), *available in* LEXIS, Regnws Library, Flnws File. Ilan Reich, one member of Levine's inner circle and a partner at the prestigious New York Law firm of Wachtell, Lipton, Rosen & Katz, supplied inside information to Levine on pending deals. *See id.* Reich never accepted any money for the information that he divulged to Levine. *See id.* Nevertheless, Reich ended up paying $485,000 in civil penalties and serving 366 days in prison with five years probation, ruining a career in which he was earning $500,000 per year at the age of 32. *See id.*

[5] *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION EFFORTS TO DETECT, INVESTIGATE, AND DETER INSIDER TRADING 3 (1988) (describing the large number of corporate events, such as mergers and acquisitions, and the large number of people with knowledge of those events as presenting opportunities for huge profits as a result of trading on inside information).

[6] Regulation of insider trading at the federal level began with the passage of § 16(b) of the Exchange Act. *See* 15 U.S.C. § 78p (1994) (regulating short-swing trading by insiders and requiring disgorgement to the corporation of any profits acquired from such trading). Until 1961, when the Commission developed Rule 10b-5, *see* 17 C.F.R. § 240.10b-5 (1995), § 16(b) constituted the sole federal regulation of insider trading. *See* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 319 (1989) (discussing intensified efforts to repeal § 16(b) after the development of Rule 10b-5). The provision narrowly defines an insider as a holder of 10% of a corporation's shares or as a director or an officer of a corporation. *See* Exchange Act § 16(b), 15 U.S.C. § 78p(a). The definition of persons subject to regulation under insider trading statutes today has been significantly broadened. *See infra* part II.C.

More recently, Congress acted again to regulate insider trading in the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.) and the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, sec. 5, § 20A, 102 Stat. 4677, 4680 (codified as amended at 15 U.S.C. § 78t-1 (1994)) (amending the Exchange Act).

[7] *See* 17 C.F.R. §§ 240.10b-5, .14e-3 (1995) (promulgating Rules 10b-5 and 14e-3 under the Securities Exchange Act of 1934). Rule 10b-5 proscribes the use of any manipulative or deceptive devices in connection with the purchase or sale of any security. This language encompasses unauthorized trading on the basis of material nonpublic information. Rule 14e-3 regulates securities transactions in the context of a tender offer.

and the Stock Exchanges[8] have addressed the problem numerous times, insider trading continues to be pervasive.

In 1993, Robert Freeman, a former Goldman Sachs executive, agreed to disgorge $1.1 million in profits obtained in transactions involving the leveraged buyout of Beatrice Companies.[9] His transactions were allegedly based on material nonpublic information.[10] The SEC also successfully litigated an action against Martin Sloate, a stockbroker who purchased securities on the basis of tips he received from a psychiatrist who was treating the wife of Sanford Weill, then CEO of Shearson Loeb Rhodes.[11] In the widely publicized case against "Crazy Eddie" Antar,[12] the SEC recovered more than $8 million that Antar had held illegally outside the United States.[13] The SEC also recovered additional funds that Antar had tried to shelter in the names of his wife and children.[14] The SEC, in testimony before Congress, alleged that in one case an individual was able to realize a $430,000 profit in forty-eight hours by purchasing approximately $3000 in call options of a corporation that would later be the subject of a takeover proposal.[15]

These examples illustrate the heavy sanctions levied against inside traders and the continuing practice of engaging in insider trading notwithstanding its illegality. According to the results of one study, a certain number of inside transactions accompany all material corporate events, dramatically affecting the price of companies' stock.[16] Even given the tremendous potential for personal liability, however, "the law concerning the trading of

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[8] *See* NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL §§ 202.01-202.06, 307.00, 309.00 (1983 & Supp. 10 1995); AMERICAN STOCK EXCHANGE, COMPANY GUIDE 4-2 to 4-10 (1992) (discussing exchange disclosure policies).

[9] *See* Freeman, SEC Litigation Release No. 13663, 1993 WL 190409, at *1 (June 7, 1993).

[10] *See id.*

[11] *See* SEC v. Willis, 825 F. Supp. 617, 618 (S.D.N.Y. 1993) (holding that trading on such information constitutes a Rule 10b-5 violation). For a further discussion of this case, see *infra* notes 360-83 and accompanying text.

[12] SEC v. Antar, 831 F. Supp. 380, 397 (D.N.J. 1993) (finding that Antar wrongfully sold his company's stock after he had personally caused the company's financial results to be fraudulently overstated).

[13] *See id.* at 401-02.

[14] *See id.* at 403.

[15] *See* HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING SANCTIONS ACT OF 1984, H.R. REP. NO. 355, 98th Cong., 1st Sess. 5 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2278.

[16] *See generally* Arthur S. Keown & John M. Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981) (discussing evidence of excess returns earned by investors in acquired firms prior to mergers).

securities on the basis of [inside] information is unsettled because the applicable statutes and cases have failed to define clearly who is prohibited from trading."[17] Admittedly, insider trading is difficult to define comprehensively, but the term is probably best described as "the purchase or sale of securities on the basis of material, nonpublic information."[18] While the traditional vision of insider trading involves an insider to a corporation[19] trading on information that is not available to the public, noninsiders[20] are also inclined to attempt to profit by trading on the basis of material[21] nonpublic information.[22]

Rule 10b-5, promulgated by the SEC in 1942 as an exercise of the rulemaking power granted by section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"),[23] is the basic federal

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[17] Carlos J. Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. CORP. L. 793, 794-95 (1988).

[18] C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 3 (1991).

[19] A corporate insider is defined by § 1603(b) of the Federal Securities Code as:

> (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his relationship or former relationship to the issuer, knows a material fact about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person within § 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person.

FED. SEC. CODE § 1603(b) (American Law Inst. Supp. 1981).

[20] The term "noninsider" encompasses both quasi-insiders and outsiders. A quasi-insider is a person who obtains confidential information from a corporation because of a relationship of trust and confidence between the quasi-insider and the corporation. *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983). Examples of quasi-insiders include underwriters, attorneys, accountants, engineers, and consultants to a corporation. *See id.*

Outsiders generally are under no obligation to refrain from trading on the basis of material nonpublic information or to disclose such information unless some other confidential or fiduciary relationship exists. *See* Chiarella v. United States, 445 U.S. 222, 239 (1980).

[21] Material information is that which a reasonable investor would consider important in making an investment decision. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

[22] *See Chiarella*, 445 U.S. 222; SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981); United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). For a discussion of these cases, see *infra* parts II.B and II.C.

[23] *See* 15 U.S.C. § 78j(b) (1994). Section 10(b) provides that:

> 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 . . .

antifraud provision used to regulate the securities markets.[24] Through judicial interpretation, the courts have expanded the scope of Rule 10b-5[25] to the point that it is now referred to as the "catch-all"[26] provision for fraud. The courts and the SEC have broadened application of the rule even further, however, to regulate not only fraudulent practices in securities transactions, but also all trading on the basis of material nonpublic information where no fraud has occurred.[27] As Rule 10b-5 does not itself define insider trading or even specifically outlaw it, the courts and the Commission have felt free to find liability in situations that offend notions of fair play, where no other theory on which to base a remedy is available.[28]

The basis for liability under Rule 10b-5 was founded upon common law notions of fraud.[29] At common law, silence regarding facts that were not available to another party was not considered fraud unless the first party had a duty to speak that arose out of a

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(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.

[24] *See* Donald C. Langevoort, *Fraud and Deception By Securities Professionals*, 61 TEX. L. REV. 1247, 1292 (1983).

[25] Rule 10b-5 provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

[26] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (noting that a spokesman for the drafters of Rule 10b-5 "rightly" described the section as a "catchall" clause).

[27] *See infra* part II.B.

[28] *See* Edmund W. Kitch, *A Federal Vision of Securities Laws*, 70 VA. L. REV. 857, 859-62 (1984).

[29] *See* Chiarella v. United States, 445 U.S. 222, 227-28 (1980). At common law a fraud or deceit action typically required proof of (1) a misrepresentation, (2) "scienter" with regard to the falsity of the representation, (3) intent to induce reliance on the misrepresentation, (4) justifiable reliance on the part of the plaintiff, and (5) damage that was proximately caused by the reliance. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 105, at 728 (5th ed. 1984).

special relationship or unless other special facts were present.[30] Accordingly, courts traditionally required a breach of a fiduciary duty or similar relationship before liability for trading on the basis of material nonpublic information would attach.[31] Strict adherence to such a requirement, however, would allow outsiders who have no fiduciary duty or relationship of trust that extends to the corporation to trade in the market on material nonpublic information.

To address this problem, federal prosecutors and the courts developed the misappropriation theory, asserting that investor confidence in the integrity of the securities markets can be maintained only if Rule 10b-5 is broadly interpreted.[32] The misappropriation theory does not require that the purchaser or seller of securities be defrauded. Instead, the theory states that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."[33] It is under this theory that Matt Pilfer in the opening hypothetical was indicted for insider trading. Pilfer breached a duty to his employer, Ritz Travel, by using confidential information, properly obtained in the course of his employment, improperly as a basis for his trades and thereby violated Rule 10b-5.

Part I of this Comment discusses the operation of the securities markets and the theoretical effects of insider trading on those markets. Using this background, Part I explores the principles that have driven the development and application of laws regulating the securities markets. Part II analyzes the legislative, regulatory, and judicial development of traditional insider trading laws. It then discusses the divergence between traditional insider trading laws as implemented and the rationales that they purport to satisfy. Part II also examines how courts have attempted to align the principles behind the regulation of the securities markets with the laws as implemented by applying a new theory of liability—the misappropriation theory. The use of the misappropriation theory and why it is ineffectual as a weapon in the SEC's and Justice Department's

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[30] *See* Peter Tiersma, *The Language of Silence*, 48 RUTGERS L. REV. 1, 51 (1995).

[31] *See Chiarella*, 445 U.S. at 232 (holding that there can be no duty to disclose if the person who traded on material nonpublic information was "not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers had placed their trust and confidence").

[32] *See id.* at 235-36.

[33] *Id.* at 239 (Brennan, J., concurring).

arsenals in their attack on insider trading is then explained. Part III proposes that the SEC adopt a new regulatory rule that will abolish application of the misappropriation theory. The new rule will instead structure the regulation of the securities markets in a way that addresses the harms of insider trading and yet seeks to ensure that capital markets remain efficient. Such a rule would not focus on the source of the information, as courts do when they apply the misappropriation theory, but would instead clearly define those people who are prohibited from trading on the basis of material nonpublic information, eliminating the confusion of the current system.

I. THE FUNCTIONS AND MECHANISMS OF THE SECURITIES MARKETS AND THE CORRESPONDING EFFECTS OF INSIDER TRADING

A. *Efficient Capital Markets?*

An analysis of basic market theory is necessary to understand the perceived harms of insider trading. This understanding is important because the courts and the Commission have provided remedies based upon these perceived harms to shield investors from those who trade illegally on the basis of nonpublic information. The Efficient Capital Market Hypothesis ("ECMH") is a theory that provides a foundation for many of the arguments that insider trading is in fact a harmful activity. The ECMH provides that "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business."[34] For example, if a share of Pepsi Co. is trading for $36, that price is the true value of Pepsi Co. given all information known about Pepsi Co.'s business prospects and growth opportunities. As long as there are a sufficient number of investors analyzing the available information, the price of the security will always trend towards its true value.

Both Congress[35] and the Supreme Court[36] have accepted that the stock market is an efficient market. The efficiency of the stock

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[34] Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986).

[35] *See* H.R. REP. NO. 355, *supra* note 15, at 2, 22 ("[P]rices of the vast majority of actively traded securities reflect available information about companies and the economy."), *reprinted in* 1984 U.S.C.C.A.N. at 2294.

[36] *See* Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988) (noting that commentators have applauded the "fraud-on-the-market" theory because investors rely on the valuation process performed by the market).

market is also supported by a comprehensive array of empirical research.[37] In the stock market, investors rely on the integrity and efficiency of the market's pricing mechanisms to price correctly the securities traded so that they will be guided to invest capital resources in the most efficient manner.[38] Efficient pricing mechanisms are classified into three different categories, the weak form, the strong form, and the semistrong form.[39]

1. The Weak Form

The weak form of efficient pricing assumes that "prices fully reflect all information contained in the historical pattern of market prices."[40] Thus, an investor cannot predict future prices by analyzing past pricing patterns; stock price movements simply follow a random walk[41] where today's price is the market's best estimate of what the stock will trade at tomorrow, although the two prices are mutually independent.[42] As a result, no advantage will be achieved by speculation based on past prices as other investors have already anticipated any pricing pattern and accounted for it in their trading.[43] This form of the ECMH is not particularly relevant to the

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[37] *See, e.g.*, EUGENE F. FAMA, FOUNDATIONS OF FINANCE, PORTFOLIO DECISIONS AND SECURITIES 133-68 (1976) (discussing empirical research and economic framework that tend to support the existence of an efficient stock market); KENNETH GARBADE, SECURITIES MARKETS 241-49 (1982) (discussing weak-form efficiency, in which knowledge of the past pattern of securities prices does not improve an investor's ability to forecast future stock returns).

[38] *See, e.g.*, Roger J. Dennis, *Risk Arbitrageurs and the Market for Corporate Control*, 37 HASTINGS L.J. 409, 417 (1985) (book review).

[39] Eugene Fama is credited with the first proposal and full elaboration of the ECMH in three forms. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); *cf.* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593 (1984) (arguing that the trichotomy of weak, semistrong, and strong forms of market efficiency should be viewed as "an approximation of an underlying relationship between how broadly information is initially distributed, and the particular market mechanism").

[40] JAMES D. COX, FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW 181 (1980), *reprinted in* LEWIS D. SOLOMON ET AL., CORPORATIONS: LAW AND POLICY 1172 (2d ed. 1988).

[41] A random walk in prices indicates no pattern; successive changes in value are wholly independent of past prices. For example, when flipping a coin the odds of getting heads is 50%, regardless of the pattern of heads or tails in previous flips.

[42] *See generally* M.G. Kendall, *The Analysis of Economic Time-Series, Part I. Prices*, 116 J. ROYAL STAT. SOC'Y (Series A) 11 (1953) (analyzing price trends in time-series).

[43] There can be no advantage because, as soon as investors perceive a pricing trend and predict a future price, they will be willing to pay that price, discounted to the present value. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF

the problem of insider trading because those trading on inside information are not basing their investment decision on pricing patterns but on material information that is not available to the market.

2. The Strong Form

The strong form of the ECMH asserts that the market takes into account all public and nonpublic information in determining the price of a security.[44] Nonpublic information is that which would normally be available only to corporate insiders such as directors and officers. Public information is all information generally available to investors, including past pricing information and information made available to the public through formal or informal disclosures.[45] If this form of the ECMH were correct, there would be no advantage to trading on inside information as the market already would have reflected the information in the price of the stock. There is, however, evidence that the market is not completely efficient with regard to inside information.[46]

3. The Semistrong Form

The semistrong form of the ECMH states that a security's price reflects only publicly available information regarding the value of that security.[47] The implication is that profitable trading strategies or arbitrage opportunities are not presented by the use of already public information.[48] Additionally, given that the market correctly

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CORPORATE FINANCE 294 fig. 13-3 (4th ed. 1991). The price of the security will thus fully incorporate any future prices.

[44] *See* JAMES H. LORIE & MARY HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 97 (1973).

[45] *See* Jeffery N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 771 (1985). But note that, "[t]he availability of information is a function of its distribution among traders in a given market. Different 'bits' of information are more or less 'available' depending on how many traders are aware of them." Gilson & Kraakman, *supra* note 39, at 558.

[46] *See* SOLOMON ET AL., *supra* note 40, at 1175 (discussing evidence that is inconsistent with the strong form of market efficiency); Jerome B. Baesel & Garry R. Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. FIN. & QUANTITATIVE ANALYSIS 553, 563-69 (1979) (showing empirically that insiders do achieve returns in excess of the market).

[47] *See* GARBADE, *supra* note 37, at 249-59.

[48] For an analysis of studies concluding that traders cannot obtain abnormal returns on a security by trading on publicly released information, see THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY 198-204

values securities, investors cannot consistently achieve greater returns than the market unless they utilize information that is not publicly available.[49]

The semistrong form of the ECMH has been the most widely received.[50] In *Basic Inc. v. Levinson*,[51] the Supreme Court, although not explicitly, accepted the semistrong form.[52] The implications of the semistrong form of the ECMH for insider trading are clear. Those investors who possess nonpublic information that the market has not yet factored into the price of a stock will estimate the true value of the particular stock better than other investors in the market. Consequently, investors with nonpublic information will be able to earn higher returns as compared with their less-informed counterparts. Because the market will eventually conform its evaluation of the stock's value to the "true value" of the stock upon public release of the once-nonpublic information, those who made advantageous trades on the basis of that information prior to its release will be better off.

Assuming, arguendo, that the empirical evidence supporting the Court's reasoning in *Basic* is correct,[53] the perceived inefficien-

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(1979).

[49] *See* BREALEY & MYERS, *supra* note 43, at 295 (noting that in the semistrong efficient market theory defined by Harry Roberts, all publicly available information is accurately reflected in stock prices); *see also* James M. Patell & Mark A. Wolfson, *The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividend Announcements*, 13 J. FIN. ECON. 223, 223-52 (1984) (finding that information announced on the broad tape with regard to earnings and dividends is mostly reflected in the price of the stock within five to fifteen minutes).

[50] *See* Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 YALE L.J. 577, 610 (1992). Courts that have adopted the fraud-on-the-market theory have alluded to studies establishing the validity of the semistrong form of the ECMH. *See* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 910 (1989).

[51] 485 U.S. 224 (1988).

[52] The Court stated that it did not intend to "conclusively . . . adopt any particular theory of how quickly and completely publicly available information is reflected in market price." *Id.* at 248 n.28. The Court went on to adopt the fraud-on-the-market theory, however, which provides that investors may be wronged if information is not made public when there is a duty to disclose. *See id.* at 241-45. The fraud-on-the-market theory is incompatible with the strong form of the ECMH because, under the strong form, the nondisclosure of inside information would not affect market price. *See supra* part I.A.2.

[53] *See generally* Ray Ball & Philip Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. ACCT. RES. 159 (1968) (testing whether net income is predicted by security prices); Fama, *supra* note 39, at 383 (discussing evidence of the efficiency of capital markets); Eugene F. Fama et al., *The Adjustment of Stock Prices to New*

cies and possible benefits of permitting insider trading may be explored.

B. *Is Insider Trading Harmful Anyway?*

To analyze the effectiveness of current insider trading regulation, and in particular the validity of the misappropriation theory, the objectives of regulating insider trading must be defined. There are several possible reasons for insider trading regulation, but these reasons generally fall into two distinct categories. The first category is promoting economic efficiency in the capital markets.[54] The second is providing markets that are fundamentally fair to both insiders and outsiders.[55] Insofar as insider trading is simply wrong because of its inherent unfairness,[56] or because it detrimentally impacts the efficient operation of securities markets, punishment of the wrongdoers and disgorgement of their unfair profits become important aims of the regulatory system.

1. Economic Efficiency

To determine properly the scope and shape of insider trading regulation, an analysis of the effects of insider trading on market efficiency must be conducted in which the perceived costs are weighed against any benefits of such trading.[57] If a market is efficient, the price at which shares are bought and sold will be an

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Information, 10 INT'L ECON. REV. 1 (1969) (suggesting that the market successfully anticipates high returns in the months leading up to a stock split); George Foster, *Stock Market Reaction to Estimates of Earnings Per Share By Company Officials*, 11 J. ACCT. RES. 25, 35 (1973) (noting an empirically observed, rapid adjustment of stock prices to publicly stated estimates of annual earnings per share by company officials).

[54] *See* Gilson & Kraakman, *supra* note 39, at 597-609 (discussing some of the ways in which market efficiency is adversely affected by insider trading).

[55] *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 220-21 (1991) (discussing the unfairness of allowing insiders to trade on information to which outsiders are unable to gain access).

[56] *See generally* Leo Katz, *Crime, Consent, and Insider Trading*, 5 J. CONTEMP. LEGAL ISSUES 217 (1994) (providing an argument in support of the inherent unfairness of insider trading, even if investors consent).

[57] There is a tension between requiring immediate full disclosure of all material information, which will improve the efficiency of the market, and protecting the legitimate interests of shareholders by keeping certain information confidential. The *Basic* Court recognized that "'silence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time.'" Basic Inc. v. Levinson, 485 U.S. 224, 235 (1988) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1177 (7th Cir.), *cert. denied*, 484 U.S. 853 (1987)). Nevertheless, the Court refused to allow materially false disclosures even if such statements would maximize shareholder value. *See id.*

accurate reflection of the true underlying value of the stock.[58] Investors will then be properly guided in their capital investment decisions by the price of the security.[59] Conversely, investing scarce resources in a security that does not accurately reflect its true value is an inefficient use of capital as the return will not be commensurate with the risk.[60]

Inaccurate stock prices also create societal costs. "When companies raise capital at inaccurate prices, existing shareholders derive gains to the extent that new investors overpay for their shares, and suffer losses to the extent that new investors underpay."[61] If by issuing overpriced securities a corporation will obtain benefits for existing shareholders that exceed the losses from a project, the company will proceed to raise capital for an unprofitable project. Likewise, a corporation will refrain from issuing securities for a profitable project if the losses from selling those

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[58] *See supra* part I.A.

[59] Investors are guided by the price of the security in the investment of their capital because they seek a return that is commensurate with the risk associated with a given investment. The Capital Asset Pricing Model ("CAPM") provides that a security will give a return of

$$r = r_f + \beta\,(r_m - r_f)$$

where r = the expected return on the investment.
β = the correlation of the security's price movement with that of the market. β reflects the risk of the investment.
r_m = the return on the market.
r_f = the return on a risk-free investment.

The price at which a company's stock should trade is defined as the discounted value of the income from future dividends or

$$P_o = \sum_{n=1}^{n=\infty} \frac{DIVID_n}{(1+r)^n}$$

where DIVID = the dividend paid.
n = the period at which dividends are paid.
r = the discount rate.

Therefore, if the price of a stock is not commensurate with the perceived risk for that investment, investors will act quickly either to purchase or sell that stock until the price is brought into line with the expected return. *See* BREALEY & MYERS, *supra* note 43, at 50, 165.

[60] *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1006 (1992) (noting that "[i]naccurate stock prices . . . can lead to an inefficient allocation of capital").

[61] *Id.*

shares at a bargain price will exceed the project's profits. When stock prices accurately reflect the underlying value of a security, however, new investors pay exactly what the shares are worth and are able to evaluate their investment decisions on the merits. Therefore, on the corporate level, as demonstrated at the individual level, inaccurate stock prices will lead to the inefficient allocation of capital.[62] Given the importance of market efficiency, it is surprising that the net effect of insider trading on the efficiency of the marketplace remains unsettled. A brief overview of the debate surrounding this controversy follows.

a. *Arguments That Deregulating Insider Trading Will Increase Market Efficiency*

Some commentators claim that allowing insiders to trade on nonpublic information actually may be beneficial.[63] They contend that allowing insiders to trade on nonpublic information promotes the efficiency of capital markets by signalling the true value of a company's stock to the market without explicitly disclosing information that cannot feasibly be made public.[64] This signalling is beneficial in a situation where "an announcement would destroy the value of the information, would be too expensive, not believable, or—owing to the uncertainty of the information—would subject the firm to massive damage liability if it turned out ex post to be incorrect."[65] The mechanism by which this "signalling" takes place

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[62] *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866-68 (1983) (arguing that insider trading can be an effective method of communicating information which in turn leads to accurate share prices which guide efficient capital investment).

[63] *See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET at vii (1966) (positing that the rewards of insider trading may flow to those who are responsible for producing the news as a desirable form of compensation); Carlton & Fischel, *supra* note 62, at 869-72 (proposing that insider trading by managers reduces agency costs, obviates renegotiation of salaries, and provides valuable information about prospective managers); Ronald A. Dye, *Insider Trading and Incentives*, 57 J. BUS. 295, 297 (1984) (demonstrating that "the desirability of inside trading depends on the distributional relationship among the inside information held by management, the manager's effort, and the output of the firm that employs him" and that under certain assumptions, the firm's managers and owners may benefit by permitting the manager to trade on inside information).

[64] *See* Carlton & Fischel, *supra* note 62, at 857-58, 866, 868.

[65] *Id.* at 868. For example, in Basic Inc. v. Levinson, 485 U.S. 224 (1988), the defendant corporation issued three false public statements alleging that it was not engaging in merger negotiations. *See id.* at 227. The purpose for doing so was to avoid pricing itself out of the market for a Combustion Engineering tender offer. *See*

can be illustrated by example.[66] Suppose an insider knows of favorable corporate information that has not yet been released to the public. This insider would be willing to purchase shares at the high end of the market, knowing that they are actually worth more than the purchase price. Such an action would contribute to an uptrend of the stock price, even under a weak form of the ECMH, because the purchase price would be public information that investors would discount into the price they are willing to pay for the security.[67] Therefore, when the news was actually released to the public, some of that information would already be reflected in the price of the stock.

This argument is hampered, however, by empirical evidence that indicates that trading by insiders on nonpublic information does not have a significant impact on market prices.[68] The reason for this phenomenon is that the price of any security is simply a reflection of risks and returns for which the market offers many substitutes.[69]

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id. at 227-28. In general, a tender offer occurs when an acquiring company offers to buy a certain percentage of the outstanding shares of its target at a premium to the market. The SEC has established eight factors that characterize a tender offer. These include:

> (1) active and widespread solicitation of public shareholders; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) offer open only for a limited period of time; (7) offeree subjected to pressure to sell his or her stock; and (8) public announcement of a purchasing program precedes or accompanies rapid accumulation of the target's securities.

LOSS & SELIGMAN, *supra* note 2, at 515. For further discussion of the definition of a tender offer and the unique scheme of regulation of tender offers established under the federal securities laws, see William C. Tyson & Andrew A. August, *The Williams Act After RICO: Has the Balance Tipped in Favor of Incumbent Management?*, 35 HASTINGS L.J. 53 (1983). Early notice to the market that a tender offer was being considered would have increased the price of Basic's stock such that Combustion Engineering could no longer finance the deal. *See Basic*, 485 U.S. at 227-28 n.4 (following rumors of merger negotiators that Basic stock was trading at new highs). Notice to the public would have destroyed the value of the information if it had meant that the merger could no longer be consummated.

[66] *See* MANNE, *supra* note 63, at 161 (noting that if "full disclosure were made of a corporation's intention to buy a certain number of shares, the stock price would immediately jump almost to the level indicated by the value of this news").

[67] *See supra* part I.A.1.

[68] *See* Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1446 (1967).

[69] For a discussion of this mechanism as stated by the Capital Asset Pricing Model, see *supra* note 59.

The supply, or float, is all securities offering similar risks and returns between which investors would be indifferent.[70] Accordingly, unless the volume of the insider's trade is extremely large, the change in the float caused by the trade "is simply too small to have any but a transitory, and probably insignificant, impact on the price of the security."[71] The insider's trade would change the market's evaluation of the security's risk and return, and hence its price, only if the market believed that the insider had private information not previously factored into the price of the security.[72] This pricing mechanism would be effective, however, only if the market was aware of the insider's identity.[73] Yet, the market usually will learn the identity of the trader only after the inside information has been disclosed to the public; namely, when the SEC publishes the insider trading reports under section 16(a) of the Exchange Act, well after the ten to forty days in which the trade is required to be disclosed to the Commission.[74]

A second argument in favor of deregulating insider trading is that such trading is a more adequate means of compensating entrepreneurs within the company than traditional forms of compensation.[75] Professor Manne was one of the first to argue that only insider trading "readily allows corporate entrepreneurs to market their innovations"[76] because the wage market cannot adequately and accurately compensate an entrepreneur whose function "is to make new combinations of productive factors."[77] A compensation structure that permits insider trading will encourage insiders to create favorable conditions for the corporation knowing that an increase in share value will translate into a direct personal profit.[78] The insider will be able to purchase stock in anticipation of the improved financial condition, wait until the market revalues the stock, and sell at a profit. Of course, outside investors will also benefit from the price increase.[79]

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[70] *See* Gilson & Kraakman, *supra* note 39, at 630.

[71] *Id.*

[72] *See id.* at 629-34.

[73] *See id.* at 630.

[74] *See* 15 U.S.C. § 78p (1994); Gilson & Kraakman, *supra* note 39, at 632.

[75] Manne claims that a "rule allowing insiders to trade freely may be fundamental to the survival of our corporate system." MANNE, *supra* note 63, at 110.

[76] *Id.* at 138.

[77] *Id.* at 116.

[78] *See* Michael J. Chmiel, Note, *The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action*, 1990 U. ILL. L. REV. 645, 648.

[79] "Compensating managers in this fashion increases the size of the pie, and thus

Critics, however, point out that most inside traders are lower-level functionaries who have no real impact on the firm's profits, whether or not they have additional motivation.[80] Therefore, this special insider trading compensation can be inefficient due to being overinclusive. An additional concern is that such a compensation scheme would encourage executives to focus on increasing their own prosperity without regard for their fiduciary duties to the shareholders.[81] Furthermore, several compensation schemes already exist that make remuneration contingent upon entrepreneurial contributions. These include stock options, stock appreciation rights, and bonuses based upon the company's profits.[82] Referring to these more efficient types of compensation schemes, the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*[83] repudiated the argument that deregulation of insider trading would provide a legitimate form of corporate compensation. The court found that "the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occur[s]" when insiders freely trade on material nonpublic information.[84]

A third argument in favor of deregulation attacks the wisdom of a broad prohibition against insider trading on the basis of economic analysis. The argument is that "the harm caused by insider trading can be objectively measured and that so measured it does not cause any detectable injury to investors."[85] As the "odds against any long-term investor's being hurt by an insider trading on undisclosed

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outsiders as well as insiders profit from the incentives managers are given to increase the value of the firm." Carlton & Fischel, *supra* note 62, at 881. A corollary is that risk averse executives will have an incentive to take more risks, providing investors with a higher return, *see supra* note 59, if they are able to sell short on the basis of inside information and cover any losses to which they would otherwise be personally exposed.

[80] *See, e.g.*, ROBERT CLARK, CORPORATE LAW 279 (1986).

[81] *See* Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 46-49 (1986) (arguing that insider trading is an inefficient form of compensation because the benefit to the insider is based not on the value of his contribution but on the amount of his investment).

[82] *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *cf.* Bainbridge, *supra* note 81, at 46-49 (arguing that these compensation schemes are not adequate for corporate compensation).

[83] 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[84] *Id.* at 851.

[85] Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 55 (1980).

information is almost infinitesimally small,"[86] why should Congress, through the SEC, expend a vast amount of resources and energy policing a prohibition on insider trading? The answer lies in what are perceived to be the harms caused by insider trading.

b. *Arguments That Regulating Insider Trading Will Increase Market Efficiency*

Several arguments have been advanced that provide a basis for the regulation of trading on material nonpublic information. First, permitting insiders to trade on the basis of inside information will discourage legitimate research and analysis because of the presence in the market of insiders who possess an overwhelming informational advantage as a consequence of their positions in the corporation.[87]

Second, insiders who are able to trade freely on nonpublic information will have an incentive to focus their efforts on the advancement of their own welfare. In directing their efforts to improving their own position, they will spend less time advancing shareholder wealth. Where their objectives and those of the corporation diverge, the efficient operation of the firm is sacrificed.[88]

Third, allowing trades that are based on inside information provides bad incentives. An insider who is able to profit on both bad and good information has an incentive to damage the corporation, a task that is arguably easier than increasing the market value of the company.[89] Such harm is a breach of the fiduciary duty

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[86] MANNE, *supra* note 63, at 110.

[87] *See* Gilson & Kraakman, *supra* note 39, at 622. This effect may be a result of the "Efficiency Paradox." The paradox states that as a market becomes perfectly efficient with respect to certain information, one cannot earn an abnormal return on the acquisition of that information. As no one will earn a superior return on information obtained through research and analysis, the market will become inefficient again. If, however, insiders are permitted to trade on material nonpublic information, the market will be perfectly efficient with respect to that information and there will never be an incentive for research and analysis. Thus, trades by insiders maintain the perfect efficiency of the market. *See id.* at 622-23. This phenomenon can also be understood by recalling that when insiders are permitted to trade on nonpublic information, the market will tend toward strong-form efficiency. *See supra* part I.A.2. A market that is efficient in the strong form discounts all public and *nonpublic* information into the price of the security, making superior returns unattainable. *See supra* part I.A.2.

[88] *See supra* note 81 and accompanying text.

[89] *See* LOSS & SELIGMAN, *supra* note 2, at 762.

owed to the stockholders of the company[90] and directly diminishes shareholder wealth.

Fourth, the corporate insider who is permitted to trade on the basis of material nonpublic information will have an incentive to delay the release of positive information until he has had ample time to acquire all the shares of the corporation's stock that he can afford.[91] As discussed above,[92] this delay of information will decrease the efficiency of the market, causing investors to invest their scarce capital resources poorly. When information is widely and quickly disseminated to the market, investors' allocation of resources will ideally achieve "Pareto optimality."[93] Under Pareto optimality, no other allocation of resources would result in any one person's being better off without causing harm to another.[94] When information is kept from the market, however, a semistrong form of the ECMH dictates that a lower level of optimality is necessarily achieved.[95]

The corporate insider who is able to trade on material nonpublic information may try to manipulate the market through the timing of press releases in another way: by waiting to make a release when its effect will be to increase market volatility.[96] The more volatile the market, the more the insider will have to gain, whether he is trading on good or bad news.[97] This again will lead to an inefficient market because the proper allocation of resources depends upon prices that reflect the underlying value of the security.[98]

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[90] *See* United States v. Chestman, 947 F.2d 551, 568-69 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

> One acts in a "fiduciary capacity" when "the business which he transacts, or the money or property which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part."

Id. (quoting BLACK'S LAW DICTIONARY 564 (5th ed. 1979)).

[91] *See* William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 886 (1987).

[92] *See supra* note 60 and accompanying text.

[93] *See* LOSS & SELIGMAN, *supra* note 2, at 762.

[94] *See* Joel Seligman, *The Reformation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1119 (1985).

[95] *See supra* part I.A.3.

[96] *See* LOSS & SELIGMAN, *supra* note 2, at 762.

[97] *See supra* note 59.

[98] *See* Kahan, *supra* note 60, at 1005-08.

2. Fundamental Unfairness

In addition to the potentially detrimental effects on market efficiency, allowing investors to trade when they are in possession of inside information is fundamentally unfair to those who are without the benefit of the information and cannot legally obtain it. The SEC used this rationale in the seminal case *In re Cady, Roberts & Co.*[99] to establish liability for trading on undisclosed inside information. The SEC proclaimed that one purpose of the securities laws is to eliminate the "use of inside information for personal advantage."[100] "[T]he obligation [to disclose] rests on . . . the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[101] This concern for the fundamental unfairness of trading on inside information appears to be innate; somewhat like the standard reaction to a person who plays poker with a marked deck.

The inequity is that deregulation would give the insider a "lawful monopoly on access to the information involved . . . which cannot be competed away."[102] Still, few would argue that it is improper for an investor who has gained superior information as a result of diligent analysis and assiduous investigation to trade on the basis of that information.[103] Market analysts, for example, expend tremendous resources to obtain information far superior to that possessed by the average small investor.[104] Should analysts be precluded

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[99] 40 S.E.C. 907, 912 (1961).

[100] *Id.* at 912 n.15.

[101] *Id.* at 912.

[102] Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979).

[103] By contrast, Joel Seligman argues that Congress, through legislation, should adopt a "parity-of-information" theory to ensure that small investors are not systematically taken advantage of by those in possession of superior information. *See* Seligman, *supra* note 94, at 1137-40. The parity-of-information theory requires that all investors trade on the basis of equal information. Accordingly, the theory would "preclude anyone who possessed material nonpublic information from trading before the information was effectively disseminated to the public" without regard for whether the possessor of the information obtained it through analysis and research or from inside sources. *Id.* at 1087. For now the Supreme Court, however, has rejected any such parity-of-information theory. *See* Chiarella v. United States, 445 U.S. 222, 233 (1980) (stating that "neither the Congress nor the Commission ever has adopted a parity-of-information rule"). Furthermore, the Court has expressly recognized the important function that market analysts perform in making securities markets more efficient. *See* Dirks v. SEC, 463 U.S. 646, 658 (1983).

[104] *See* Brudney, *supra* note 102, at 360 (noting that there is a "systematic

from trading because of their informational advantage? An argument in favor of preclusion is that the loss experienced by the average investor does not depend on whether a party with better information attained it through his position as a corporate insider or because he had greater resources. But casting the net of securities regulation so broadly as to interdict trading on mere informational imbalances would tend to create inefficient markets.[105] Instead, the law should provide clear guidance as to which informational disparities will be tolerated, or even encouraged, and which will produce liability.

Beyond a general feeling of inherent unfairness, however, permitting the overreaching of outside traders by those in possession of material nonpublic information translates into concrete harm to corporations and investors. This harm manifests itself in two major ways. First, the integrity of the securities markets depends heavily on investors' confidence that the market is not "rigged" against them.[106] If investors believe that others in the market consistently have access to superior information concerning the true value of securities, they may be reluctant to participate in the market.[107] This boycott on the market would lead to fewer

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inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence").

[105] *See Dirks*, 463 U.S. at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives material, nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.").

[106] When enacting the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress noted that "the Committee views these steps as an essential ingredient in a program to restore the confidence of the public in the fairness and integrity of our securities markets. . . . Small [investors] will be . . . reluctant to invest in the market if [they] feel[] it is rigged against [them]." H.R. REP. NO. 910, 100th Cong., 2d Sess. 7-8 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044-45.

[107] The reluctance of investors to participate will increase the cost of capital. *See* Brudney, *supra* note 102, at 335 ("A concomitant benefit from the expected restoration of investor faith in the market would be a reduction in the cost of capital by reason of eliminating the higher risk premiums required by investors to compensate for their fear of overreaching."). Gilson and Kraakman illustrate this point with an example of a general contractor who bids on a construction project. The general contractor's bid is based on information provided by a subcontractor as to when the job will be completed. If the general contractor estimates that there is a 50% chance that the subcontractor will not complete the work on time, and the resulting delay will cost $100,000, the general contractor must increase his bid by $50,000 to reflect the perceived inaccuracy in the subcontractor's bid. *See* Gilson & Kraakman, *supra* note 39, at 595-96. Likewise, if an investor believes there is a chance the person with whom he is dealing can better value the security due to superior (or inside) information, the investor must increase the price at which he will sell the

investors in the market. As a result, firms would have to offer higher returns to entice the same amount of capital investment.[108] Ultimately firms would incur a direct cost that is unrelated to the actual risk of the market.

Advocates of deregulation point out, however, that despite an increase in insider trading prosecutions and an attendant increase in publicity surrounding insider trading, there has been no significant decrease in the number of investors participating in the securities markets.[109] Even if investors perceive the stock market as somewhat unfair, they have not chosen to stop investing, perhaps because there is no place else that they can receive better protection.[110] But the fact that investors have limited investment alternatives is not a reason for the law to abandon them by retiring all attempts to provide equitable securities markets.

Second, even if investors are not presented with other options, they will face higher transaction costs in a market that permits trading on nonpublic information.[111] Markets operate through specialists, or market makers, who ensure the smooth functioning of the market when buy orders and sell orders are not evenly matched.[112] The market maker maintains an inventory of a limited number of stocks and is exposed to the risk that the value of his inventory can depreciate before it can be sold.[113] The specialist's profits are determined by the volume of shares traded multiplied by the spread[114] of his trades. Like other investors, if

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security by the product of that chance and the value of the information. This argument assumes that the investor is risk neutral; if the investor is risk averse, he will also demand a risk premium, further inflating the price of the security. *See id.* at 596 n.137.

[108] *See* Brudney, *supra* note 102, at 335.

[109] *See* Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 354 (1988).

[110] *See id.* This lack of choice is demonstrated by the laws in Japan, which until recently allowed, and even encouraged, the use of inside information. *See* Tomoko Akashi, Note, *Regulation of Insider Trading in Japan*, 89 COLUM. L. REV. 1296, 1296 (1989).

[111] *See* Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 396-99 (1989).

[112] *See id.* at 396.

[113] *See id.* at 396-97 & n.75. Anabtawi identifies three risks faced by the specialist. First, there is the capital cost of merely maintaining an inventory of cash and securities. Second, there is the risk that the specialist's inventory will depreciate due to lack of demand. Finally, the specialist risks trading against those who have superior information. This final risk increases as more people enter the market with material nonpublic information. *See id.* at 397.

[114] The spread is the difference between the bid price (price at which the specialist

the specialist believes that investors in the market have superior information, he will demand a greater return to compensate for the risk that the person he is trading against is better able to value the securities.[115] The only way for the specialist to obtain this greater return is to increase the spread.[116] As a result, fewer traders will be willing to purchase the securities, and the liquidity of the market will decrease.[117] The increase in spreads also means that when a firm issues stock, it will obtain a lower bid price from the market maker.[118] To obtain the same capital infusion that it would have had, had the spread been unaffected, the firm will issue more shares.[119] Thus, the cost of capital is again increased.[120]

Given the perceived inefficiencies and unfairness of failing to regulate those who trade on the basis of material nonpublic information and the inefficiencies created through overregulation what goals should the federal securities law aspire to achieve?

3. Goals of Insider Trading Regulation

Some of the arguments for and against the deregulation of insider trading weigh the inefficiencies of pursuing an overbroad policy of prohibition against those market inefficiencies created by not regulating at all.[121] Others suggest that insider trading is simply unfair to outsiders in the market.[122] Although it is not entirely clear whether insider trading is harmful,[123] it seems clear,

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buys from traders) and the ask price (price at which the specialist sells to traders). *See* Brad M. Barber et al., *The Fraud-on-the-Market Theory and the Indicators of Common Stocks' Efficiency*, 19 J. CORP. L. 285, 300 (1994).

[115] *See supra* note 108 and accompanying text.

[116] *See* William K.S. 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, 1239 (1981) (stating that "after selling to an inside trader, a specialist . . . might increase price quotations; after buying from an inside trader, a specialist . . . might decrease his prices").

[117] As the spread increases, an investor must have a greater expectation of the security's future price before purchasing, because he must cover the spread before he makes a profit. *See* Anabtawi, *supra* note 111, at 397.

[118] *See id.*

[119] *See id.* (suggesting that instead of issuing more shares, a corporation may choose to increase its level of debt financing and derive a smaller proportion of funds from equity).

[120] *See id.*

[121] *See supra* part I.B.1.

[122] *See supra* part I.B.2.

[123] *See* Anabtawi, *supra* note 111, at 395 ("A serious difficulty with this price efficiency rationale for insider trading is that illegal insider trading has not been shown empirically to have any significant effect on share prices."); Carlton & Fischel,

under today's securities laws, that the regulation of insider trading in the securities markets will be vigorously pursued by the SEC and the Justice Department for some time to come.[124] Most of the jurisprudence generated by Rule 10b-5 presumes that insider trading has detrimental effects on the market and on investors.[125] Given this presumption, the law governing insider trading must seek to limit the inefficiencies created by market regulation and protect investors from unfair informational imbalances. In doing so, however, these laws must also provide bright-line, understandable rules. They should establish "'minimal guidelines to govern law enforcement.'"[126] Otherwise a "statute may permit 'a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections.'"[127] But the courts have not always adhered to these goals in developing today's securities laws, especially in formulating the misappropriation theory. Judge Winter of the Second Circuit stated:

> The legal rules governing insider trading under Section 10(b) are based solely on administrative and judicial caselaw. This caselaw establishes that some trading on material nonpublic information is illegal and some is not. The line between the two is less than clear. Although Congress has enhanced the penalties for illegal insider trading [in the Insider Trading Sanctions Act of 1984], it has not defined the criteria by which legal insider trading is separated from illegal trading.[128]

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supra note 62, at 859 (questioning why, if insider trading is harmful, empirical evidence demonstrates that insider trading is widespread, highly profitable, and has met little resistance from firms).

[124] *See* Fisch, *supra* note 55, at 228.

[125] Courts point to the unfairness to shareholders, the harm to the corporation due to a loss of confidence in the securities markets, and the fact that insider trading may hinder market efficiency as reasons for upholding regulation. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 765-67 (1974) (Blackmun, J., dissenting) ("'Manipulators who have in the past had a comparatively free hand to befuddle and fool the public . . . are to be curbed . . . .'" (quoting 78 CONG. REC. 2271 (1934))); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-52 (2d Cir. 1968) (en banc) ("The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions."), *cert. denied*, 394 U.S. 976 (1969).

[126] Kolender v. Lawson, 461 U.S. 352, 358 (1983) (quoting Smith v. Goguen, 415 U.S. 566, 574 (1974)).

[127] *Id.* (quoting *Goguen*, 415 U.S. at 575).

[128] United States v. Chestman, 947 F.2d 551, 572 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) (citation omitted), *cert. denied*, 503 U.S. 1004 (1992).

The following Part discusses how the legal analysis of the Commission and the courts has left a hole in the regulation of insider trading; a hole that many courts have attempted to fill with a square peg—the misappropriation theory.

II. CONGRESS, THE COMMISSION, AND THE COURTS: GRAPPLING WITH INSIDER TRADING

A. *Overview of Insider Trading*

Given the press-generated publicity over the Boesky's, Levine's, and Reich's of the securities world[129] and the propagation of public interest in the topic as evidenced in the late 1980s by movies such as *Wall Street*,[130] it is surprising that the federal securities laws do not expressly prohibit insider trading. Only sections 16, 20A, and 21A of the Exchange Act directly address the trading of securities by insiders.

Section 16(b) requires statutory insiders[131] to disgorge any profits earned through short-term trading.[132] Section 16(c) wholly prohibits statutory insiders from engaging in certain types of trades.[133] Liability under section 16, however, is not premised on the misuse of inside information. Instead, "[f]or the purpose of preventing the unfair use of information which may have been obtained . . . by reason of [a] relationship to the issuer," the section imposes strict liability on the basis of short-term trading only.[134] Thus, an insider whose trades are separated by more than the statutory six-month period does not violate section 16 even if that trade was based on inside information.[135]

Section 20A[136] provides a private cause of action for those who

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[129] *See supra* note 4 and accompanying text.

[130] WALL STREET (Twentieth Century Fox 1987). The movie depicts a stockbroker, Bud Fox, who becomes embroiled in an insider trading scandal after meeting Gordon Gekko, a high-powered, extremely successful, but ruthless broker whose philosophy is that "[g]reed, for want of a better word, is good. Greed is right. Greed works." The movie eventually demonstrates that Gekko's greed results in tangible harm to those companies and investors that he manipulates.

[131] Section 16(b) defines insiders as directors, officers, and 10% shareholders of the corporation. *See* Exchange Act § 16(b), 15 U.S.C. § 78p(a) (1994).

[132] *See* 15 U.S.C. § 78p(b).

[133] *See* 15 U.S.C. § 78p(c).

[134] 15 U.S.C. § 78p(b).

[135] *See id.*

[136] Insider Trading and Securities Fraud Enforcement Act of 1988 § 20A, 15 U.S.C. § 78t-1 (1994).

trade in the market contemporaneously with an inside trader. Although the section addresses insider trading, it does not make insider trading illegal. It merely permits private actions against those who violate other statutory, regulatory, or court-defined restrictions.[137]

Section 21A provides the SEC with the authority to bring an action for civil penalties against anyone who engages in insider trading.[138] Like section 20A, section 21A does not make insider trading illegal nor does it explicitly define insider trading. Instead, section 21A merely addresses the SEC's ability to impose civil penalties on inside traders.[139]

Under what theory then is insider trading illegal? The courts and the Commission have concluded that insider trading is encompassed within the language of the general antifraud provision,[140] section 10(b) of the Exchange Act and SEC Rule 10b-5, which prohibits fraud and deception in connection with the purchase or sale of securities.[141] The Supreme Court views the

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[137] Section 20A states: "Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable . . . ." *Id.*

[138] *See* Insider Trading and Securities Fraud Enforcement Act of 1988 § 21A, 15 U.S.C. § 78u-1(a)(1)(A) (1994) ("Whenever it shall appear to the Commission that any person has violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information . . . the Commission may bring an action . . . to impose, a civil penalty . . . .").

[139] *See id.*

[140] *See supra* notes 23, 25.

[141] *See* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). In holding that trading on the basis of inside information is a violation of the securities laws, the Commission stated:

> [O]ne of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions. Consistent with this objective, . . . Section 10(b) of the Exchange Act and Rule 10b-5, . . . are broad remedial provisions aimed at reaching misleading or deceptive activities.

Id. at 910; *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968) (en banc) (setting forth a broad definition of acts and persons covered by Rule 10b-5 in the context of a rich ore strike), *cert. denied*, 394 U.S. 976 (1969); Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967) (applying a broad definition of insiders to a plan by buyers to resell shares of stock at a much higher price); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa.) (using a liberal construction of Rule 10b-5 in finding a private right of action in the context of a contract to sell a company's assets with as yet unrecognized value), *supplemented by* 83 F. Supp. 613 (E.D. Pa. 1947); Speed v. Transamerica Corp., 71 F. Supp. 457, 457-58 (D. Del. 1947) (finding that an officer violated § 10(b) by buying the plaintiff's stock with foreknowledge that the company's inventory would increase in value).

legal effect of the insider's silence with regard to the information to be a fraudulent omission under certain circumstances even though section 10(b) "does not state whether silence may constitute a manipulative or deceptive device."[142] Based on notions of common law fraud, however, the Court has limited the application of section 10(b) and Rule 10b-5 to those instances in which the insider has a duty to speak.[143] As at common law, the Court reasoned that a misrepresentation had to consist of an affirmative misstatement, and only in limited circumstances could an omission be used as grounds for liability.[144] When no duty compels disclosure by the person trading on the basis of material nonpublic information, no securities fraud and, therefore, no violation of Rule 10b-5 has occurred.[145]

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[142] Chiarella v. United States, 445 U.S. 222, 226 (1980).

[143] *See id.* at 228 ("But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when there is a duty to do so.").

[144] *See id.* at 227-28. The Second Restatement of Torts states the common law rule as follows:

> One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, *if, but only if, he is under a duty* to the other to exercise reasonable care to disclose the matter in question.

RESTATEMENT (SECOND) OF TORTS § 551(1) (1977) (emphasis added).

[145] Traditionally, the plaintiff in a common law deceit action has the burden of proving that he justifiably relied to his detriment on a misrepresentation of a material fact that the defendant made with knowledge or reckless disregard of its falsity with the intent that the plaintiff rely. *See* STUART M. SPEISER ET AL., THE AMERICAN LAW OF TORTS § 32:18 n.87 (1992). In defining the elements of fraud, courts have varied widely as to the number of, and description of, the elements that comprise the deceit action. When comparing each court's description in total, however, there is an overall similarity. *See id.* § 32:18. One court defined the elements as follows:

(1) There must be a representation;
(2) That representation must be false;
(3) It must have to do with a past or present fact;
(4) That fact must be material;
(5) It must be susceptible of knowledge;
(6) The representor must know it to be false, or in the alternative, must assert it as of his own knowledge without knowledge;
(7) The representor must intend to have the other person induced to act, or justified in acting upon it;
(8) That person must be so induced to act or so justified in acting;
(9) The person's action must be in reliance upon the representation;
(10) That person must suffer damage;
(11) That damage must be attributable to the misrepresentation, that is, the statement must be the proximate cause of the injury.

Id. § 32:18 n.88 (citing Yost v. Millhouse, 373 N.W.2d 826, 829-30 (Minn. Ct. App. 1985)). At common law, a duty to disclose has been recognized under the following

The requirement of a duty has provoked considerable judicial searching for a breach of duty in cases where there intuitively should be a remedy, but where common law notions of fraud fall short. Thus far, the courts have developed two distinct bases of liability for securities laws violations: traditional theory and the misappropriation theory. Traditional theory applies to the classic insider trading case of a corporate officer who uses information received in a corporate capacity to trade for his own account.[146] The misappropriation theory is used inadequately to fill the judicially created hole resulting from the narrow construction of current traditional theory.[147]

B. *Insiders, Outsiders, and Fiduciary Duties: The Development of Traditional Theory*

Traditional theory bases a violation of section 10(b) by a corporate insider on the premise that the insider breaches his state law fiduciary[148] obligation to the corporation and its shareholders when he trades on the basis of material nonpublic information.[149] The classic example is the director who learns that his corporation

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circumstances: (1) all material facts must be disclosed when there is a fiduciary or similar relationship of trust and confidence between the parties; (2) superior material information concerning a transaction must be disclosed when the other party cannot reasonably discover the information and is under a mistaken belief with regard to it; (3) all material facts that have been concealed by an affirmative effort must be disclosed; (4) statements made in good faith that are later discovered to be false must be corrected; (5) all material facts must be disclosed if anything is said; and (6) all material facts must be disclosed as required by statute. *See id.* § 32:68.

[146] *See infra* part II.B.

[147] *See infra* part II.C.

[148] A fiduciary relationship is one that

> involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty bound not to appropriate the property for his own use.

United States v. Chestman, 947 F.2d 551, 569 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

[149] The theory is that directors, officers, and controlling shareholders are effectively trustees of the corporation and thereby owe fiduciary duties to it. *See, e.g.*, Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers . . . owe to one another . . . the duty of finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length[] are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place.").

will have better than predicted earnings for the quarter. In response, he purchases shares of his company's stock at the current market price, knowing that once the revised earnings are announced the price of his company's shares is likely to increase. Traditional theory finds that the director has breached his fiduciary duty to the shareholders who sold him their shares by purchasing the stock at a price lower than the shareholders would have demanded had they known of the revised earnings.

Although a more tenuous proposition, another example that implicates traditional theory involves a director who learns of bad news that will affect the company he serves. In response to this news, the director sells stock that he owns on the open market to investors who would not have paid the high market price if they had been aware of the information that the director possessed.[150] The director thus avoids a loss at the expense of other shareholders when the information is ultimately made public.

The current philosophy that defines the application of traditional insider trading theory in particular situations results from many years of judicial explication of Rule 10b-5. To understand this philosophy, the history of Rule 10b-5 and the development of traditional theory must be examined.

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[150] This proposition is more tenuous because the director does not stand in a fiduciary relationship with the purchasers until after the sale is completed and the investors become owners of the company's stock. Therefore, a strict application of the traditional theory would find that no fiduciary relationship existed at the time of the trade and, accordingly, there was no duty to reveal the information. The courts have rejected this strict approach, however, and found a violation in such circumstances. *See Chestman*, 947 F.2d at 573-74 (Winters, J., concurring in part and dissenting in part) (arguing that an insider's duty is not limited to existing stockholders); Diamond v. Oreamuno, 248 N.E.2d 910, 914 (N.Y. 1969) (holding directors liable for selling stock in their company in anticipation of bad news); Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (holding that insiders must disclose material information to persons with whom they deal). Judge Winters explained:

> We cannot accept respondents' contention that an insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. This approach is too narrow. It ignores the plight of the buying public—wholly unprotected from the misuse of special information. . . . Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.

Chestman, 947 F.2d at 573-74.

1. The Dubious History of Rule 10b-5

As noted, Rule 10b-5 is the primary general antifraud provision used to regulate insider trading.[151] Yet the rule had modest beginnings. The SEC adopted it after only cursory review and discussion to respond quickly to a situation not then addressed by the securities laws. The president of a company had made negative false statements regarding the financial viability of his company in order to lower the share price of the company's stock.[152] Knowing that the share price would significantly increase when the company's earnings report reflecting the corporation's true value was published, he purchased shares on the open market at a bargain price.[153] In responding to this specific situation, the commissioners never anticipated that the rule would become the "catch-all" provision for fraud. They were not focused on insiders who remained silent about a company's position when trading while in the possession of material nonpublic information, and they certainly did not foresee the private right of action that the courts have since implied.[154] Their response to the problem at hand was a broadly worded rule that has remained unchanged since its promulgation.

In enacting section 10(b), Congress intended to guard against fraudulent market manipulation such as that which led to the stock market crash of 1929.[155] The development and scope of Rule 10b-5, however, was unplanned. "[I]t is difficult to think of another

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[151] *See supra* note 24 and accompanying text.

[152] *See* American Bar Ass'n Section of Corp., Banking & Business Law, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922-23 (1967) [hereinafter *Securities Laws Conference*] (comments of Milton V. Freeman).

[153] *See id.*

[154] *See* Kardon v. National Gypsum Co., 73 F. Supp. 798, 802 (E.D. Pa.) (holding that, while the statute and the Rule "do[] not even provide in express terms for a remedy . . . the existence of a remedy is implicit under the general principles of the law"), *supplemented by* 83 F. Supp. 613 (E.D. Pa. 1947). Freeman described the development of the rule as follows:

> I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end .... We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

LOSS & SELIGMAN, *supra* note 2, at 778-79; *Securities Laws Conference*, *supra* note 152, at 922.

[155] *See* WILLIAM H. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 1-6 (1968).

instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking, and judicial processes has produced so much from so little."[156]

The legislative history of section 10(b) is scant, and for that reason the courts have found that a determination whether Congress contemplated a provision as broad as Rule 10b-5 is difficult to make.[157] At least one commentator has noted, however, that if "Congress wanted to promulgate a prohibition of such generality, it could have done so and eliminate the intermediate requirement of a Commission regulation. The rule as promulgated drew upon no specific expertise of the SEC."[158] Consequently, section 10(b)'s generality has meant that its substance comes from the ad hoc adjudication of the courts and the SEC.

2. Early Interpretation and the Supreme Court's Limitation of Rule 10b-5

The checkered history of Rule 10b-5 is most logically divided into two periods. Until 1975, the Rule's scope continually expanded as it was applied to new types of transactions, and any proposed limiting doctrines were usually rejected by the courts.[159] Beginning in 1975, the Supreme Court significantly narrowed the scope of the rule, confining its application to narrower areas and providing a fertile ground for litigation over the boundaries of those areas.[160]

One of the first steps toward expansion was a judicial determination that, although the express language of section 10(b) and Rule 10b-5 did not create a private right of action, defrauded persons could obtain a private remedy using these regulations to rescind a securities transaction.[161] In *Kardon v. National Gypsum Co.*, the plaintiffs, Morris and Eugene Kardon, and the defendants, Leon and William Slavin, each owned one fourth of the stock of two paper companies, Western Board and Paper Co. and Michigan Paper Stock Co.[162] All of the parties were officers of the companies and

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[156] LOSS & SELIGMAN, *supra* note 2, at 777.

[157] *See* Chiarella v. United States, 445 U.S. 222, 226 (1980).

[158] Kitch, *supra* note 28, at 861.

[159] *See* LOSS & SELIGMAN, *supra* note 2, at 780.

[160] *See id.*

[161] *See* Kardon v. National Gypsum Co., 73 F. Supp 798, 800 (E.D. Pa.), *supplemented by* 83 F. Supp. 613 (E.D. Pa. 1947).

[162] *See id.*

together constituted the entire Board of Directors of each of the two companies.[163] Unbeknownst to the Kardons, Leon Slavin had negotiated an agreement to sell Western Board and Paper to National Gypsum for $1,500,000.[164] Prior to consummating the sale, the Slavins purchased the Kardons' stock in this company for a discounted $504,000 with the knowledge that the price of the stock would go up as soon as the sale was announced.[165] At the meeting at which the sale of the stock was consummated, Leon Slavin affirmatively represented that he had not made any agreement for the sale of either of the companies.[166] The Kardons did not learn until later of the negotiations with National Gypsum and certainly would not have sold their stock at such a low price had they known about the arrangement.[167] The district court held that, although the Exchange Act "does not . . . provide in express terms for a remedy, . . . the existence of a remedy is implicit under general principles of the law."[168]

Kardon is significant because the provision for a private right of action in a case of insider trading creates a federal forum for garden-variety common law fraud, provided that the fraud takes place in the securities markets.[169] Common law fraud is typically an area of little national or federal interest and is traditionally within the purview of state, not federal, courts.[170] Even the doctrines later adopted by the Supreme Court limiting the application of Rule 10b-5[171] do not affect the availability of the private-right-of-action rule for *Kardon*-type cases.[172]

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[163] *See id.*

[164] *See id.* at 800-01.

[165] *See id.* at 801.

[166] *See id.*

[167] *See id.* at 800.

[168] *Id.* at 802.

[169] *See* Joseph A. Grundfest, *Desimplifying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 990 n.132 (1994); *supra* note 145 (discussing the elements of common law fraud). Plaintiffs view a federal forum as preferable to state court for many reasons, some of which include nationwide service of process under § 27 of the Exchange Act, *see* 15 U.S.C. 78aa (1994), the more liberal discovery provisions of the Federal Rules of Civil Procedure, and a belief that federal judges are more sympathetic to plaintiffs than are state judges. *See* ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 917 (5th ed. 1994). "Further, the state security-for-expenses statutes for derivative suits [are] inapplicable to rule 10b-5 suits, and hence a plaintiff [can] avoid posting an expensive bond simply by framing his complaint under that rule." *Id.*

[170] *See* HAMILTON, *supra* note 169, at 917.

[171] *See infra* notes 215-29 and accompanying text.

[172] *See* Grundfest, *supra* note 169, at 189-91.

The SEC first expanded the scope of Rule 10b-5 to reach beyond the confines of the traditional definition of "corporate insider"[173] in its seminal opinion, *In re Cady, Roberts & Co.*[174] On November 25, 1959, the Board of the Curtiss-Wright Corporation met to set the fourth-quarter dividend for the year.[175] During the first three quarters the Board had declared a $0.625 dividend, but decided that the fourth-quarter dividend should be reduced to $0.375.[176] At approximately 11:00 a.m., the Board approved disclosure of the dividend to the New York Stock Exchange, but there was a delay in transmitting the information due to a typing problem.[177] The announcement did not appear on the Dow Jones ticker tape until 11:48 a.m. and was not delivered to the Exchange until 12:29 p.m.[178] During a recess of the Board meeting, and prior to Dow Jones's receipt of the information, J. Cheever Cowdin, a Curtiss-Wright director, notified Robert Gintel, a broker at Cady, Roberts & Co., that the Board had cut the dividend.[179] Prior to the dissemination of the news to the public, Gintel sold 7000 shares of Curtiss-Wright Stock.[180] In his opinion, SEC Chairman Cary declared that the conduct engaged in by Cowdin and Gintel was just the type of fraudulent and manipulative conduct that Congress sought to proscribe in enacting section 17(a) of the Securities Act of 1933[181] and section 10(b) of the Exchange Act to protect investors.[182] Robert Gintel's conduct was prohibited, however, even though he was not a traditional insider of the corporation. The Commission stated:

> We have already noted that anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do

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[173] Traditional corporate insiders are directors, officers, employees who obtain information in the course of their employment, and majority shareholders who have a fiduciary duty to a corporation by nature of their large stockholdings. *See* FLETCHER, *supra* note 18, at 213-21, 227-29.

[174] 40 S.E.C. 907 (1961).

[175] *See id.* at 909.

[176] *See id.*

[177] *See id.*

[178] *See id.*

[179] *See id.*

[180] *See id.*

[181] 15 U.S.C. § 77q(a) (1994).

[182] *See Cady, Roberts*, 40 S.E.C. at 911.

> not exhaust the classes of persons upon whom there is such an obligation.[183]

Instead, the Commission ruled that an individual's duty to disclose material nonpublic information prior to trading on the basis of that information, otherwise known as a rule of "disclose or abstain," is based on two principal elements: (1) a relationship between the trader and the inside source of the information such that the information is intended only for a corporate purpose and not for the insider's own benefit; and (2) the inherent unfairness of the trader taking advantage of that information knowing that it is unavailable to others in the market.[184] That is, those whose position gave them access to material nonpublic corporate information would have a duty to disclose that information or abstain from trading.[185]

The opinion in *Cady, Roberts* significantly broadened the category of people who have a duty to refrain from trading on material nonpublic information. After the opinion, liability under Rule 10b-5 could be based on the fact that an investor had access to material nonpublic information, traded on that inside information without first disclosing it, and thereby took advantage of those with whom the investor dealt. This would be so even if that investor was not a statutory insider, as Gintel was not.[186] The "fairness" theory of *Cady, Roberts* finds its rationale in the goal of achieving "[a] sense of integrity and fairness in the market [which is not possible] if the system countenances transactions in which one party has inside information unavailable to the other."[187]

Expanding on *Cady, Roberts*'s fairness theory, the Second Circuit, sitting en banc, declared that Rule 10b-5 and the disclose-or-abstain rule announced in *Cady, Roberts* are applicable to those who are not traditional corporate insiders.[188] In *SEC v. Texas Gulf Sulphur Co.*,[189] Texas Gulf Sulphur ("TGS"), a mining company, had been conducting geophysical surveys in eastern Canada for a number of

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[183] *Id.* at 912.

[184] *See id.*

[185] *See id.* at 911.

[186] *See id.* at 912.

[187] *The Supreme Court, 1982 Term–Federal Statutes and Regulations*, 97 HARV. L. REV. 230, 291-92 (1983).

[188] *See* Alan R. Bromberg, *Corporate Information:* Texas Gulf Sulphur *and Its Implications*, 22 SW. L.J. 731, 739-40 (1968).

[189] 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

years.[190] In November of 1963, a test hole, K-55-1, near Timmins, Ontario produced indications of very high concentrations of copper, zinc, and silver.[191] This discovery ultimately uncovered one of the largest copper/zinc deposits in North America.[192] In response to these test results, the President of TGS, Claude O. Stephens, instructed that leases on adjacent land parcels be purchased so that the company could expand its ownership of the mineral rights in the deposit.[193] To facilitate the acquisition of these leases, Stephens instructed the geological exploration group to keep the test results confidential, even from other officers and directors of the corporation.[194] Before TGS released the news of the strike to the public, various TGS employees, including four members of the geological team, the President, the Executive Vice President, the general council, a director, and several people who had received tips from a TGS officer bought TGS stock and call options on the market.[195] From the period before K-55-1 was drilled to shortly after TGS finally made a formal press release outlining the magnitude of the strike, the price of the company's stock more than tripled.[196]

The Second Circuit held that the disclose-or-abstain rule espoused in *Cady, Roberts* was a legitimate method of arresting insider trading.[197] The court expanded application of the rule, however, to "anyone in possession of material inside information."[198] Thus, if a trader in possession of material inside information is precluded from disclosure due to a corporate confidence or simply chooses not to disclose, he must abstain from trading. The court expunged the requirement of a special relationship giving access to the inside information as a basis for liability, citing congressional intent evidenced by Rule 10b-5 "that all investors trading on impersonal exchanges have relatively equal access to material information."[199] Therefore, after *Texas Gulf Sulphur*, any access to nonpublic material information carried with it a corresponding duty to disclose or abstain. This duty would apply

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[190] *See id.* at 843.
[191] *See id.*
[192] *See id.* at 850.
[193] *See id.* at 843.
[194] *See id.*
[195] *See id.* at 844.
[196] *See id.* at 847.
[197] *See id.* at 848.
[198] *Id.*
[199] *Id.*

whether the investor directly received the information from a corporate insider or simply overheard it in passing on the street.[200]

The implementation of the policy in *Texas Gulf Sulphur* approaches adoption of a "parity-of-information" theory.[201] If every investor who is in possession of material nonpublic information has a duty to disclose that information prior to trading,[202] and if markets are efficient with respect to public information,[203] all investors will be trading in reliance on the same information. In adopting this approach, the Second Circuit was expressing a primary concern with the basic problems of unfairness and lack of investor confidence in the market that tolerance of insider trading creates[204]—concerns that the Commission had cited as the underpinnings of insider trading regulation.[205]

The *Texas Gulf Sulphur* court's decision, however, went too far. In *Cady, Roberts*, the Commission advocated adopting an "equal-access theory."[206] An equal-access theory seeks to ensure that

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[200] The court limited its holding somewhat by stating that

> [t]he only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

Id. at 849.

[201] A theory that encourages trades in which all investors rely on the same information is known as a parity-of-information theory. *See* Chiarella v. United States, 445 U.S. 222, 231-34 (1980). Such a theory would hold that a duty to disclose would "arise from the mere possession of nonpublic market information." *Id.* at 235. This theory of liability was rejected by the Supreme Court. *See id.* at 233-35.

[202] *See Texas Gulf Sulphur*, 401 F.2d at 848.

[203] *See supra* part I.A.3.

[204] *See Texas Gulf Sulphur*, 401 F.2d at 848 (finding that the purpose of § 10(b) was to "prevent inequitable and unfair practices and to insure fairness in securities transactions generally").

[205] *See supra* part I.B.

[206] *See* Cady, Roberts & Co., 40 S.E.C. 907, 914 (1961). Professor Brudney was one of the first to suggest application of an "equality-of-access" theory to govern the legality of insider trading. The theory is based on the "conception of 'unfairness' in the *Cady, Roberts* opinion on a premise of investor expectations regarding the relative accessibility of *corporate* information in market participants." Brudney, *supra* note 102, at 353-54. The theory provides that "[p]ersons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their . . . advantage through trading in affected securities." Chiarella v. United States, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting). As a result, the theory would

> deny an informational advantage to those who seek to use otherwise nonpublic information which they are precluded by legal restrictions from

through diligence, investigation, and analysis all investors will have access to the same information. It does not seek to ensure that each investor in a transaction actually rely on the same information.[207] Courts eventually began to point out a problem with the parity-of-information theory as advocated in *Texas Gulf Sulphur*. The policy of imposing on investors an over-inclusive duty to disclose deters the free flow of information.[208] The Supreme Court believed that the detrimental effect of requiring full disclosure outweighed the benefits it provided.[209] Security analysts and other market participants whose job it is to ferret out information should be permitted to trade on that information without having to disclose it to their trading counterparts.[210] Adopting such a policy provides incentives to unearth information not known by the markets, which investors will then discount into the price of the security, providing more accurate stock valuations by the market.[211]

The high point in the expansion of Rule 10b-5 is perhaps marked by *Affiliated Ute Citizens v. United States*.[212] In this case, the Supreme Court held that if a Rule 10b-5 civil action involves a failure to disclose rather than an affirmative misrepresentation, "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important . . . ."[213] At common law, proof of reliance is a crucial element in proving an action for fraud.[214] The Court's removal of this

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> disclosing to public investors. And it may appropriately extend to those who, while not precluded by law from waiving their informational advantage, derive it from sources who will not make it public, so that the public cannot lawfully obtain it.

Brudney, *supra* note 102, at 355.

[207] *Cf. supra* note 201.

[208] In Dirks v. SEC, 463 U.S. 646 (1983), the Court asserted that, "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Id.* at 658.

[209] *See id.*

[210] *See id.* at 658-59.

[211] *See* Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 BROOK. L. REV. 149, 153 n.18 (1993) (book review).

[212] 406 U.S. 128 (1972).

[213] *Id.* at 153-54.

[214] The plaintiff must show that he justifiably relied on the defendant's misrepresentation and that the defendant intended to induce the plaintiff's reliance on that misrepresentation. *See supra* note 29 (setting forth the elements of common

requirement reflected the flexibility that it was willing to read into Rule 10b-5. Under Chief Justice Warren Burger, however, the Court eventually began to narrow significantly the scope of Rule 10b-5.

In *Blue Chip Stamps v. Manor Drug Stores*,[215] the Court limited the private right of action established in *Kardon*[216] for Rule 10b-5 cases to only those defrauded investors who actually purchased or sold securities.[217] Thus, the Court found that Rule 10b-5 is aimed only at *injury suffered in connection with the purchase or sale of securities*.[218] The insider who trades on the basis of material nonpublic information also has breached a fiduciary duty to the shareholders who have not transacted in the stock of the corporation, but according to *Blue Chip Stamps*, the connection between the fraud and the insider transaction is insufficient for a Rule 10b-5 claim. The Court foreclosed any notion that every breach of fiduciary duty is sufficient to support a claim of securities fraud.

Two years after it began to narrow the private right of action under Rule 10b-5, the Burger Court attacked the substantive applicability of the Rule in *Santa Fe Industries, Inc. v. Green*.[219] Santa Fe Industries owned 95% of the stock of Kirby Lumber.[220] Pursuant to applicable Delaware short-form merger provisions, a parent corporation that owns 90% of the stock of a subsidiary may cash out the minority shareholders without their consent or without giving advance notice.[221] A minority stockholder dissatisfied with the terms of the merger, however, may then petition the Delaware Court of Chancery for an appraisal of the fair value of the stock.[222] Santa Fe Industries complied with all of the terms of the short-form merger statute.[223] The minority shareholders were

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law fraud).

[215] 421 U.S. 723 (1975).

[216] *See supra* notes 161-72 and accompanying text.

[217] *See Blue Chip Stamps*, 421 U.S. at 731-49. Citing concern that Rule 10b-5 was being abused and causing unwarranted "vexatious litigation," the Court excluded those investors who relied by refraining from purchasing or selling stock in response to a defendant's misrepresentation, therefore subsequently missing profits or taking a loss when the true value of the stock was revealed. *See id.* at 740-41.

[218] *See id.* at 747.

[219] 430 U.S. 462 (1977).

[220] *See id.* at 465.

[221] *See* DEL. CODE ANN. tit. 8, § 253 (1974 & Supp. 1995).

[222] *See* DEL. CODE ANN. tit. 8, § 262.

[223] *See Santa Fe Indus.*, 430 U.S. at 466.

dissatisfied, however, with the purchase price of $150 per share.[224] Instead of petitioning the Delaware Chancery Court, however, they opted to commence an action in federal court.[225] The shareholders alleged a violation of Rule 10b-5 on the theory that their stock was unfairly undervalued by Santa Fe Industries and that the merger served no valid business purpose except to freeze out the minority shareholders.[226]

Reasoning that section 10(b) was intended to provide a remedy for transactions in which investors had been defrauded, the Court rejected the minority shareholders' arguments, holding that "the transaction, if carried out as alleged in the complaint, was neither deceptive nor manipulative and therefore did not violate either § 10(b) of the Act or Rule 10b-5."[227] Instead, the Court held that the fundamental purpose of the antifraud provisions of the Exchange Act is to implement a "philosophy of full disclosure."[228] When full and fair disclosure has occurred, "the fairness of the terms of the transaction is at most a tangential concern of the statute."[229]

The early cases interpreting Rule 10b-5 such as *Cady, Roberts* and *Santa Fe Industries* provided a substructure for the Court on which it could construct the framework that today makes up traditional insider trading theory. The landmark case of *Chiarella v. United States*[230] provided the first girder in this framework.

3. The Breach of Duty Requirement

In *Chiarella*, the Supreme Court finally addressed the issue of an individual's duty to disclose material nonpublic information. It abrogated any notion that either the parity-of-information theory[231] or the equal-access theory[232] could provide a basis for Rule 10b-5 liability.[233] Ostensibly adopting the rationale set forth in *Cady, Roberts*,[234] the Court maintained that a duty to disclose must

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[224] *See id.*
[225] *See id.* at 467.
[226] *See id.* at 465-70.
[227] *Id.* at 474.
[228] *Id.* at 478.
[229] *Id.*
[230] 445 U.S. 222 (1980).
[231] *See supra* note 201.
[232] *See supra* note 206.
[233] *See Chiarella*, 445 U.S. at 231 n.14.
[234] 40 S.E.C. 907 (1961); *see also supra* text accompanying note 184 (setting forth

be based on the common law requirement for fraud: the existence of a fiduciary or similar relationship of trust and confidence between the seller and purchaser of securities.[235]

Vincent Chiarella was a "markup man" for Pandick Press, a financial printing company, and as a result of his employment had access to confidential information regarding pending tender offers.[236] Offering corporations would bring documents to Chiarella's employer for printing in preparation for disclosure to the public.[237] Despite the efforts of the offering corporations to blank out the names of the target corporations, Chiarella was often able to ascertain the identities of the target corporations before they were publicly announced.[238] In five instances, Chiarella made trades in the stock of the target corporation, without disclosure, before the news of the tender offer or merger was divulged.[239] As a result of his trades, Chiarella was able to obtain in excess of $30,000 in profits.[240]

Although Chiarella was an outsider to the target corporations in which he traded securities, and although his employer had no relationship with those corporations nor owed a duty to the corporations under any legal theory, Chiarella was investigated, indicted, and found guilty of violating Rule 10b-5.[241] On appeal, the Second Circuit affirmed the conviction, holding that Chiarella knew that the information he possessed was nonpublic and that trading while in possession of nonpublic information violates Rule 10b-5.[242] The Supreme Court disagreed and overturned the conviction.[243] The majority of the Court, adhering to a traditional notion of insider trading, held that when trading on material nonpublic information, failure to disclose that information prior to trading is fraudulent only when there is a duty to disclose.[244]

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the principal elements of the disclose-or-abstain rule).

[235] *See Chiarella*, 445 U.S. at 235 ("When 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 nonpublic market information.").

[236] *See id.* at 224.

[237] *See id.*

[238] *See id.*

[239] *See id.*

[240] *See id.*

[241] *See* Chiarella, No. 77-2534, 1977 SEC LEXIS 1674, at *2 (May 25, 1977).

[242] *See* United States v. Chiarella, 588 F.2d 1358, 1368 (2d Cir. 1978).

[243] *See Chiarella*, 445 U.S. at 222.

[244] *See id.* at 235.

Mere possession of material nonpublic information does not produce a duty to disclose nor to refrain from trading.[245] Because Chiarella had no prior dealings with the shareholders of the target corporations and had no other relationship with them, his failure to disclose the information on which he traded did not constitute fraud.[246]

The *Chiarella* Court narrowed the analysis of *Cady, Roberts* and *Texas Gulf Sulphur*,[247] to require a breach of a fiduciary duty or similar relationship of trust and confidence by a "person in whom the sellers had placed their trust and confidence" to support liability.[248] One rationale for this holding is that the Court was concerned that requiring analysts and traders to fully investigate the source of the information on which they trade in order to prevent prosecution would prohibit rapid trading on "rumors, hearsay, and other common sources of information."[249] Furthermore, Justice Powell asserted that finding Rule 10b-5 liability under the equal-access theory suffered from two defects. First, although it may be unfair that certain individuals in the market have superior access to information, *Santa Fe Industries* held that not every instance of financial unfairness constitutes fraud.[250] Second, adoption of the equal-access theory would recognize a "general duty between all participants in market transactions to forgo actions based on material nonpublic information."[251]

The current state of traditional insider trading theory is demarcated by the holdings in *Chiarella* and *Dirks v. SEC*.[252] *Dirks*

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[245] The Court stated, "[w]e hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets." *Id.*

[246] *See id.* at 232.

[247] Referring to the equal-access theory, the Court stated: "We see no basis for applying such a new and different theory of liability in this case." *Id.* at 234. For a discussion of the equal access theory, see *supra* note 206. For a discussion of *Cady, Roberts* and *Texas Gulf Sulphur*, see *supra* notes 174-211 and accompanying text.

[248] *Chiarella*, 445 U.S. at 232. The Court believed that recognizing a general duty of disclosure where one party had possession of material nonpublic information would be to read the Exchange Act "'more broadly than [the] language and the statutory scheme reasonably permit.'" *Id.* at 234 (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978)).

[249] Fisch, *supra* note 55, at 182.

[250] *See Chiarella*, 445 U.S. at 232. For a discussion of *Santa Fe Industries*, see *supra* notes 219-29 and accompanying text.

[251] *Chiarella*, 445 U.S. at 233.

[252] 463 U.S. 646 (1983).

reaffirmed the *Chiarella* holding, which limited the scope of Rule 10b-5 to instances involving the breach of a fiduciary duty or other special relationship of trust and confidence, and then defined those situations in which Rule 10b-5 would encompass trades by tippees of *Chiarella*-type holders of material nonpublic information.

Raymond Dirks was an officer of Delafield Childs, Inc., a New York registered broker-dealer firm serving institutional investors.[253] Dirks specialized in insurance company stocks and was highly respected for his knowledge.[254] In early 1973, Ronald Secrist was fired from his job as an officer at Bankers National, a New Jersey life insurance company.[255] Four years earlier, Bankers National had been acquired by Equity Funding of America, a diversified company selling primarily life insurance and mutual funds.[256] Shortly after being fired, Secrist called Dirks to inform him that Equity Funding had vastly overstated its assets as a result of several fraudulent corporate practices,[257] including the creation of phony policies.[258] To investigate the allegations, Dirks flew to Los Angeles and interviewed several Equity Funding employees, some of whom were willing to corroborate Secrist's charges.[259] While in Los Angeles, Dirks was in contact with a number of investors and analysts, both to try to obtain any information they might have about the fraud and because the investors and analysts were clients or potential clients of Dirks.[260] Dirks openly discussed the investigation and his findings with anyone who asked.[261] Dirks also contacted the Los Angeles bureau chief for the *Wall Street Journal*, William Blundell, and kept him up to date on the status of the investigation.[262] Blundell did not believe that such a massive fraud could go undetected, however, and thought that publishing such damaging hearsay would be libelous.[263] As a result of speaking with Dirks, several investors quickly began liquidating their positions in Equity Funding stock, selling close to $15.5 million worth of stock and $1 million of convertible deben-

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[253] *See* Dirks v. SEC, 681 F.2d 824, 829 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).
[254] *See id.*
[255] *See id.*
[256] *See id.*
[257] *See* Dirks v. SEC, 463 U.S. 646, 649 (1983).
[258] *See Dirks*, 681 F.2d at 829.
[259] *See Dirks*, 463 U.S. at 649.
[260] *See Dirks*, 681 F.2d at 831.
[261] *See id.*
[262] *See id.*
[263] *See Dirks*, 463 U.S. at 649-50.

tures before the New York Stock Exchange halted trading to investigate the abnormal trading in the company.[264] Only then did the SEC file a complaint against Equity Funding and the *Wall Street Journal* print a front-page story.[265] Judge Wright stated that "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding."[266]

Nevertheless, the SEC charged and convicted Dirks of violations of the antifraud provisions of the securities laws for disclosing information from his investigation to investors.[267] The SEC based his conviction on the assertion that "[w]here 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."[268] The United States Court of Appeals for the District of Columbia Circuit affirmed Dirks's conviction,[269] but the Supreme Court reversed.[270]

The Court's opinion began by stating that there is no duty to disclose when the person who traded, "'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers . . . had placed their trust and confidence.'"[271] The Court then explicitly rejected the SEC's position that a tippee inherits the *Cady, Roberts* duty[272] whenever he knowingly receives inside information from an insider who by virtue of his position would have been barred from trading.[273] Yet again, the Court expressed its belief that an overbroad interpretation of the antifraud provisions, such as that of the SEC, would inhibit the role of market analysts in preserving the efficiency of the market.[274] Analysts

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[264] *See Dirks*, 681 F.2d at 831.

[265] *See Dirks*, 463 U.S. at 650.

[266] *Dirks*, 681 F.2d at 829.

[267] *See Dirks*, 463 U.S. at 650-51.

[268] Dirks, Exchange Act Release No. 17,480, 21 S.E.C. Docket 1401, 1407 (Jan. 22, 1981) [hereinafter Dirks Release] (footnote omitted) (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).

[269] *See Dirks*, 681 F.2d at 846.

[270] *See Dirks*, 463 U.S. at 667.

[271] *Id.* at 654 (quoting *Chiarella*, 445 U.S. at 232 (first, second, and third alterations in original)).

[272] *See supra* text accompanying note 184.

[273] *See Dirks*, 463 U.S. at 657-58.

[274] *See id.* at 658. "'The value to the entire market of [analysts'] efforts cannot be

often meet with insiders and other company employees to gather information from which they are able to assess the market value of a corporation's securities. Because they would knowingly be receiving information from a corporate insider, analysts would constantly have to verify if the information was already public, or could be legitimately made public, or face the censure of the SEC.[275]

Instead, the Court determined that tippees can only inherit the *Cady, Roberts* duty when they receive information improperly or for a confidential corporate purpose.[276] The Court announced that a tippee will be deemed to have improperly received the information only if two conditions are met. First, the insider must have breached a fiduciary duty to the shareholders in disclosing the information to the tippee.[277] Recognizing that insiders often disclose information to analysts consistent with shareholder interests, the Court limited a breach of fiduciary duty to those instances in which the insider made the disclosure for a direct, or indirect, personal benefit.[278] This personal benefit includes both "pecuniary gain or a reputational benefit that will translate into future earnings."[279] Second, the tippee will be subject to a duty to disclose or abstain only if he is aware, or reasonably should be aware, of the insider's breach.[280] The Court then concluded that because Secrist had not given Dirks the information for his personal benefit, but merely to expose the fraud occurring at Equity Funding, Dirks had not inherited a fiduciary duty to the shareholders.[281]

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gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.'" *Id.* at 658 n.17 (quoting Dirks Release, *supra* note 268, at 1406 (alterations in original)).

[275] *See supra* note 249 and accompanying text.

[276] *Dirks*, 463 U.S. at 660.

[277] *See id.*

[278] *See id.* at 662. The Court based this requirement on the language in *Cady, Roberts* that the purpose of the securities laws is to eliminate the "'use of inside information for personal advantage.'" *Id.* (quoting *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)).

[279] *Id.* at 663. The Court went on to provide examples of instances in which it would be presumed that the information was tipped for a personal benefit: (1) where the relationship between the insider and the tippee suggests a quid pro quo and (2) a gift of the information to a family member or friend (because this is no different than the insider trading himself and giving the profits to the family member). *See id.* at 664.

[280] *See id.* at 660.

[281] *See id.* at 666-67.

The *Dirks* Court staunchly stood by the established doctrine of insider liability based on a breach of fiduciary duty or similar relationship of trust and confidence, but expanded its scope to tippees who facilitate a fraud after an insider's breach.

In dictum, the *Dirks* Court further expanded liability to an additional group of tippees known as "quasi-insiders," those who have received information for a corporate purpose.[282]

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.[283]

Although no true fiduciary duty exists between tippees or quasi-insiders and corporate shareholders, the *Dirks* Court again expressed its willingness to expand liability beyond traditional corporate insiders. This indicates that the Court was willing to place more emphasis on effecting the purposes of Rule 10b-5 than on adhering to constricted notions of fiduciary duties. The Court, however, clearly indicated the necessity for workable boundaries under an expanded theory of traditional liability.[284]

4. The *Chiarella-Dirks* Hole

The Court's decisions construing the traditional theory of insider trading have substantially limited the areas encompassed by section 10(b) and Rule 10b-5. The Court has attempted to define the circumstances under which liability for trading on the basis of material inside information will attach, and to limit those situations to instances in which there has been a breach of fiduciary duty or

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[282] *See id.* at 655 n.14.

[283] *Id.*

[284] *See id.* ("For such a duty to be imposed [on quasi-insiders] the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty."); *see also id.* at 665 ("But to determine whether the disclosure itself 'deceive[s], manipulate[s], or defraud[s]' shareholders . . . the initial inquiry is whether there has been a breach of duty by the insider. This requires the courts to focus on *objective* criteria . . . ." (citation omitted) (emphasis added) (first, second, and third alterations in original)).

of a similar relationship of trust and confidence.[285] In doing so, the Supreme Court has attempted to provide clear guidance as to who holds the *Cady, Roberts* duty to disclose or abstain from trading.[286]

First, those who hold a fiduciary duty to a corporation's shareholders, also known as true insiders, are subject to the *Cady, Roberts* duty.[287] To ensure that insider trading law is expansive enough to promote investor confidence in the capital markets, the Supreme Court has taken a broad view of the type of relationship with a corporation that will impart a fiduciary or other relationship of trust and confidence. All persons who enjoy "a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose,"[288] are presumed to share a fiduciary relationship with the shareholders. In *Dirks*, the Court assumed that the employees, many of whom were not directors or officers, who gave inside information to Dirks were subject to a fiduciary duty.[289] In *Chiarella*, the Court reaffirmed the SEC's position that a special relationship of trust and confidence exists between "shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[290]

Second, under *Dirks*, tippees who improperly receive corporate information from a true insider and trade on that basis derivatively breach the *Cady, Roberts* duty.[291] This prevents true insiders from circumventing application of the antifraud provisions of the securities laws. For example, suppose that Claude O. Stephens in Texas Gulf Sulphur[292] agreed with a CEO at another company to keep each other apprised of material events within their respective corporations. Although Stephens as a true insider could not trade on news of the mine strike, without a restriction on tippee trading he could notify the other CEO who could trade. Stephens would

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[285] *See* Chiarella v. United States, 445 U.S. 222, 232 (1980).

[286] *See supra* note 184 and accompanying text.

[287] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[288] *Id.*

[289] *See* Dirks v. SEC, 463 U.S. 646, 666 (1983).

[290] Chiarella v. United States, 445 U.S. 222, 228 (1980) (citing Brophy v. Cities Serv. Co., 70 A.2d 5, 7 (Del. Ch. 1949) (holding that an employee of the corporation who bought stock in the company on the basis of inside information breached a duty to the corporate shareholders)).

[291] *See Dirks*, 463 U.S. at 664; *supra* note 184 and accompanying text.

[292] *See supra* notes 189-211 and accompanying text.

then reap future gains when his tippee "paid him back" with information about the other company.

Third, the Court added an additional group, "quasi-insiders," to those who are under the duty to disclose or abstain from trading.[293] The Court apparently perceived a need to prohibit outsiders to the corporation to whom corporate information was disclosed for a proper purpose from trading on that information.

The structure of traditional insider trading theory, however, fails to address trading by outsiders on the basis of material nonpublic information who do not breach a duty to the corporation in which they trade.[294] But in such situations fairness dictates that a penalty still ought to apply. An employee of a computer chip manufacturer, Intel, for example, may learn during the course of his employment that Intel has discovered a cheaper way to produce computer chips that will lower the production costs of computer manufacturers, such as Dell Computers. The employee would not be liable under traditional theory for trading in Dell stock prior to dissemination of this information to the public, however, because the employee is not in a fiduciary relationship with the stockholders of Dell Computers. Furthermore, under traditional theory Vincent Chiarella was not liable when he "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence,"[295] because he owed no fiduciary duty to those with whom he traded in the market.[296] The failure of traditional theory to address these situations has left a void in the securities laws. As a result, the traditional theory's emphasis on the necessity of a fiduciary relationship has become the linchpin in the current drive toward redefining insider trading. Permitting Chiarella, a corporate outsider, to escape from the disclose-or-abstain rule hastened the development of a surrogate approach, the misappropriation theory, to reach those who secretly trade on

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[293] *See Dirks*, 463 U.S. at 665 n.14.

[294] *See* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (holding that an outsider who traded on material nonpublic information was not liable under the *Dirks* standard because he was an eavesdropper and the information was not disclosed for the benefit of the insider).

[295] Chiarella v. United States, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting).

[296] *See* Anne Hunter, Note, *Does Rule 10b-5 Cover Misappropriators? A Look at the United States Supreme Court's Indecision in* United States v. Carpenter, 18 SW. U. L. REV. 79, 87-88 (1988).

another's market information, but who are not covered by traditional theory.

C. *The Hole the Misappropriation Theory Seeks to Fill*

1. Definition of the Misappropriation Theory

Commentators generally credit Chief Justice Burger with first proposing application of the misappropriation theory[297] in his dissent in *Chiarella v. United States*.[298] Burger agreed that an omission is fraudulent only when there is a duty to disclose.[299] Such a rule is necessary, he argues, because it "permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting."[300] To hold that mere possession of nonpublic information produces a duty to disclose that information or refrain from trading would stifle these socially desirable activities.[301] Permitting trades on the basis of information that is obtained through "unlawful means," however, is bereft of socially desirable incentives.[302] The Chief Justice reasoned that in these circumstances, application of the misappropriation theory would create a duty to disclose.[303] He concluded that Chiarella would be found guilty of securities fraud under such a theory.[304] Under Burger's interpretation of Rule 10b-5, "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[305] It is irrelevant whether the duty held by the trader runs to the issuer of the securities.

The form of the misappropriation theory actually adopted by lower courts, however, is more accurately stated as follows: "[I]t is

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[297] *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1196 (1995).

[298] 445 U.S. at 239-45 (Burger, C.J., dissenting).

[299] *See id.* at 239-40 (Burger, C.J., dissenting).

[300] *See id.* at 240 (Burger, C.J., dissenting).

[301] *See id.* at 242-43 (Burger, C.J., dissenting).

[302] *Id.*

[303] *See id.*

[304] *See id.* The majority refused to find Chiarella guilty under the misappropriation theory because they felt that it had not been properly submitted for consideration by the jury at trial. *See id.* at 223. *But cf. id.* at 243 (Burger, C.J., dissenting) (arguing that the jury instructions were sufficient for application of the theory).

[305] *Id.* at 240 (Burger, C.J., dissenting).

a fraud in connection with the purchase or sale of a security—and therefore a violation of Rule 10b-5—for a person to trade in securities in breach of fiduciary duty by secretly converting for personal use information that has been entrusted to him."[306] The difference between the two formulations, although a technical one, is that under Burger's theory the trader assumes the *Cady, Roberts* duty to disclose or refrain from trading.[307] Under the formulation actually adopted by the courts, however, the trader commits fraud only when he either trades on information improperly obtained or improperly trades on information properly obtained.[308]

2. Application of the Misappropriation Theory

Federal prosecutors and judges recognized that the failure of the securities laws to encompass *all* trading on material nonpublic information creates a perception of injustice.[309] Into this gap in

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[306] DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION § 6.01, at 6-1 (1993). The Ninth Circuit defined the misappropriation theory as follows:

> Rule 10b-5 is violated when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.

SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

[307] *See supra* note 184 and accompanying text.

[308] *See* Donald C. Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1294 n.101 (1984). Langevoort pointed out that

> [t]he misappropriation theory is in distinct contrast to the rationale suggested by Chief Justice Burger in his dissent in *Chiarella*. Burger's theory is that a person who misappropriates information comes under a duty to disclose the information to anyone with whom he trades. This theory has not received affirmative judicial recognition.

Id. (citations omitted).

[309] *See* United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981) (formulating the indictment to remedy the *Chiarella* deficiency); *see also* Ronald F. Kidd, *Insider Trading: The Misappropriation Theory Versus an "Access to Information" Perspective*, 18 DEL. J. CORP. L. 101, 117 (1993) (noting that the failure of the federal securities laws to encompass all outsider trading creates a perception of extreme unfairness and injustice in the financial markets); Note, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1734 (1992) (suggesting that courts developed the misappropriation theory as a reaction to the *Chiarella* decision).

Perhaps Justice Blackmun put it best in his *Chiarella* dissent when he observed that "[t]he Court continues to pursue a course, charted in certain recent decisions, designed to transform § 10(b) from an intentionally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all too often makes investment in

securities regulation the Second Circuit infused the misappropriation theory. The theory was first employed to impose Rule 10b-5 liability in 1981.[310] In a later case, the Second Circuit reaffirmed application of the theory in a situation remarkably similar to that in *Chiarella*. In *SEC v. Materia*,[311] Materia was also employed by a financial printer but was a "copyholder" who read drafts of prospectuses and other financial documents aloud to a proofreader.[312] The proofreader would then check page proofs against the copy received from the client.[313] Because he was an avid market watcher, Materia was able to deduce the identities of four tender offer targets despite the fact that their names had been omitted from the documents.[314] Using this information, Materia purchased stock in the target companies before the tender offers were publicly announced.[315] Within days of the public announcements, he sold his holdings for significant gains.[316]

The *Materia* court announced that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5."[317] Citing section 395 of the Restatement (Second) of Agency,[318] the court maintained that by misappropriating informa-

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securities a needlessly risky business for the uninitiated investor." Chiarella v. United States, 445 U.S. 222, 246 (1980) (Blackmun, J., dissenting). "The common theme of the misappropriation cases is the sense that it is unfair to allow people to buy or sell securities based on information that they acquired under questionable circumstances, or information that they received entirely appropriately, but was not theirs to use for their own personal gain." Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 144 (1995).

[310] *See Newman*, 664 F.2d at 16 (finding a Rule 10b-5 violation despite the fact that information was gained from an investment bank that did not hold shares of the traded company's stock).

[311] 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

[312] *See id.* at 199.

[313] *See id.*

[314] *See id.*

[315] *See id.*

[316] Materia's trades netted him nearly $100,000. *See id.* at 200.

[317] *Id.* at 203.

[318] The section states that

> an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency . . . .

RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

tion from his employer, Materia "perpetrated a fraud" which gave rise to a duty to refrain from trading.[319]

Although the Supreme Court has yet to rule definitively on the validity of the misappropriation theory as applied to Rule 10b-5, the theory has been adopted by the Second, Seventh, and Ninth Circuits,[320] but has recently been rejected by the Fourth Circuit.[321] Even so, when the Court had the opportunity to address application of the misappropriation theory in *Carpenter v. United States*[322] it failed to do so and instead based liability on the federal mail and wire fraud statutes.[323]

In *Carpenter*, Foster Winans, a reporter for the *Wall Street Journal*, was responsible for a daily column entitled "Heard on the Street."[324] The column presented a selection of stocks and made recommendations with regard to investment possibilities.[325] The market price of stocks analyzed in the column were regularly affected because of the perceived quality and integrity of the column and its analysis.[326] Winans was familiar with the official *Journal* policy that prior to publication the contents of the column were the *Journal*'s confidential property.[327] Nevertheless, Winans gave advance information as to the contents of the column to several friends, allowing them to place trades on that basis.[328] Winans and his accomplices together obtained some $690,000 in profits.[329]

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[319] *Materia*, 745 F.2d at 202.

[320] *See* United States v. Cherif, 943 F.2d 692, 696 (7th Cir. 1991) (employing the misappropriation theory as applied to mail fraud), *cert. denied*, 503 U.S. 961 (1992); SEC v. Clark, 915 F.2d 439, 441 (9th Cir. 1990) (affirming the district court's application of the misappropriation theory to find Rule 10b-5 liability); *Materia*, 745 F.2d at 202 (holding that the misappropriation of nonpublic information "falls squarely within the 'fraud or deceit' language of . . . Rule [10b-5]").

[321] *See* United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) (rejecting application of the misappropriation theory to a West Virginia Lottery Director who traded on information that the lottery would award two key contracts prior to its public announcement).

[322] 484 U.S. 19 (1987).

[323] *See id.* at 24 (affirming the lower court's convictions under the mail and wire fraud statutes by a majority of the Court, but affirming the convictions under the securities laws only because the Court was evenly divided).

[324] *See id.* at 22.

[325] *See id.*

[326] *See id.*

[327] *See id.* at 23.

[328] *See id.*

[329] *See id.*

Winans was charged with federal mail and wire fraud violations as well as with Rule 10b-5 violations.[330] The latter charge stemmed from his breach of a contractual duty to his employer by "misappropriating prepublication information . . . that had been gained in the course of his employment under the understanding that it would not be revealed in advance of publication."[331] Although the *Journal* was not a buyer or seller of the stocks traded and had not traded in the market, the fraud was nevertheless considered to be "in connection with" the purchase or sale of securities under Rule 10b-5.[332] The district court reasoned that Winans's scheme was developed with the purpose to buy and sell securities in advance of the column's publication.[333] The Second Circuit affirmed Winans's conviction on the theory that Winans had misappropriated property (that is, information) from the *Journal* in violation of a work rule.[334] The Supreme Court unanimously affirmed the Second Circuit convictions for violations of the mail and wire fraud statutes,[335] but was "evenly divided with respect to the convictions under the securities laws and for that reason affirm[ed] the judgment below on those counts."[336]

Citing the Court's flaccid decision, one commentator stated that, "while the Court's indecision gave prosecutors a boost by not removing a weapon from their arsenal, it left insider trading law just as nebulous as before."[337] Accordingly, the affirmance carries little precedential weight,[338] for although

> the conspiracy was: (1) aimed directly at the securities market; (2) the corporation whose information was misappropriated was the preeminent financial newspaper in the world; and, (3) the defendants actually made over $690,000 in insider profits, there were still only four votes on the Supreme Court to sustain the conviction![339]

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[330] *See id.*

[331] *Id.* at 24.

[332] *See id.*

[333] *See id.*

[334] *See id.* at 28.

[335] The defendant was charged with violation of § 1343 as well as § 1341 of 18 U.S.C. *See id.* at 24.

[336] *Id.*

[337] Hunter, *supra* note 296, at 79.

[338] *See* United States v. Chestman, 947 F.2d 551, 566 n.3 (2d Cir. 1991) (en banc) ("Supreme Court support for the misappropriation theory is still unclear."), *cert. denied*, 503 U.S. 1004 (1992).

[339] Richard Neely, *Insider Trading Prosecutions Under the Misappropriation Theory:*

Even so, because the Court was willing to transmogrify the act of embezzlement into an act of fraud on the person from whom the information was purloined, it, even if implicitly, indicated that the misappropriation theory may be a viable legal theory.[340]

After *Carpenter*, the element of a "'fiduciary or other similar relation of trust and confidence'"[341] takes on new importance. This is because a "fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a 'similar relationship of trust and confidence' is construed liberally."[342] The concern for this breadth of interpretation is heightened because whereas fiduciary relationships in the field of shareholder relations are clearly circumscribed,[343] fiduciary relationships in other settings are "anything but clear."[344] The *Carpenter* decision placed no limits on the application of the misappropriation theory and suggests that virtually anyone who trades on material nonpublic information may fall within the scope of section 10(b).

In 1992, the Second Circuit, sitting en banc, revisited the misappropriation theory. The court's principal concern in *United States v. Chestman*[345] was to determine "what constitutes a fiduciary or similar relationship of trust and confidence in the context of Rule 10b-5."[346] Even following this case, the answer remains far from clear.

Robert Chestman was a broker who traded on nonpublic information about a forthcoming tender offer for the stock of

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New York's Joke on Heartland America, 1994 WL 267860, at *19. Neely is a justice (and former chief justice) of the West Virginia Supreme Court of Appeals. His article tries to read between the lines of the confidential 4-4 vote of the Supreme Court: "I called Justice White and asked whether the vote was confidential or simply had not been reported. That, according to Justice White, the vote was confidential tells me that the Justices somehow intuited that a court-generated 'misappropriation theory' is a slippery slope . . . ." *Id.*

[340] *See Carpenter*, 484 U.S. at 27 ("The concept of 'fraud' includes the act of embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'" (quoting Grin v. Shine, 187 U.S. 181, 189 (1902))).

[341] Chiarella v. United States, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

[342] *Chestman*, 947 F.2d at 567 (quoting without citation).

[343] *See id.*

[344] *Id.*

[345] 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

[346] *Id.* at 567.

Waldbaum, Inc., a large supermarket chain.[347] Chestman had received the information from Keith Loeb who was married to the niece of Ira Waldbaum, the controlling shareholder of Waldbaum, Inc.[348] Waldbaum told his sister, Shirley Witkin, three of his children, and a nephew that he had agreed to sell the corporation to Great Atlantic and Pacific Tea Company, Inc. ("A & P"), admonishing them to keep the news confidential.[349] Witkin in turn told her daughter, who then revealed it to her husband.[350] Between Loeb and Chestman there was no breach of trust or theft of information.

Accordingly, the court stated that Chestman's convictions under Rule 10b-5 could not be sustained unless "(1) Keith Loeb breached a duty owed to the Waldbaum family or Susan Loeb based on a fiduciary or similar relationship of trust and confidence, and (2) Chestman knew that Loeb had done so."[351] With five judges on the panel dissenting, the sharply divided court reversed Chestman's conviction under Rule 10b-5, holding that a "fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information."[352] Furthermore the court found that a familial relationship is itself not enough to establish a confidential relationship.[353] Instead, a "'similar relationship of trust and confidence' . . . must be the functional equivalent of a fiduciary relationship."[354] Beyond this, however, the court offered no guidance as to what relationships would be encompassed within the term "fiduciary."

Although the court was concerned that its "efforts to construe Rule 10b-5 [may] lose method and predictability, taking over 'the whole corporate universe,'"[355] it broadened the misappropriation theory immeasurably by encompassing "fiduciary breaches of any sort."[356] The court did point out that it had limited application of the misappropriation theory to the context of employment relationships, but that district courts in the Second Circuit had

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[347] *See id.* at 555.
[348] *See id.*
[349] *See id.*
[350] *See id.*
[351] *Id.* at 564.
[352] *Id.* at 567.
[353] *See id.* at 568.
[354] *Id.* (citation omitted).
[355] *Id.* at 567 (quoting United States v. Chiarella, 588 F.2d 1358, 1377 (2d Cir. 1978) (Meskill, J., dissenting), *rev'd*, 445 U.S. 222 (1980)).
[356] *Id.*

applied it to even broader circumstances.[357] Still, the court was willing to say that where any fiduciary relationship existed, the misappropriation theory could be applied. Accordingly, under the misappropriation theory after *Chestman* there is no requirement that (1) the "buyer or seller of securities be defrauded"[358] or (2) the fiduciary duty be limited to the "confined sphere of fiduciary/shareholder relations."[359]

Following *Chestman*, it seemed as though any breach of a fiduciary relationship or a relationship that was the functional equivalent would serve as a basis for application of the misappropriation theory. This assertion was tested and proved correct in *United States v. Willis*.[360]

Sanford I. Weill was CEO of Shearson Loeb Rhodes from 1970 to 1981.[361] In 1981, Weill sold his controlling interest in Shearson to the American Express Company and became president of American Express.[362] By October of 1985, Weill was interested in becoming CEO of BankAmerica, and as part of that effort secured a commitment from Shearson to invest $1 billion in BankAmerica.[363] The investment was contingent upon Weill's success in his endeavor.[364] During the negotiation period with BankAmerica, Weill often discussed his efforts to become CEO with his wife, Joan Weill.[365] At the time, Joan Weill was seeing a psychiatrist, Robert Willis.[366] Mrs. Weill told Dr. Willis both about her husband's efforts to become CEO of BankAmerica and about the contemplated Shearson investment.[367] Before this information

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[357] *See id.* at 566 (citing United States v. Reed, 601 F. Supp. 685 (S.D.N.Y) (holding that a son may breach a fiduciary duty to his father, a corporate director), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985)).

[358] *Id.*

[359] *Id.* at 567.

[360] 737 F. Supp. 269 (S.D.N.Y. 1990), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). The *Willis* case resulted in two separate opinions from the district court involving Dr. Willis as a defendant. The first opinion, United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990), denied a motion that the indictment against Dr. Willis be dismissed. This opinion provides the facts of the case. The second opinion, United States v. Willis, 778 F. Supp. 205 (S.D.N.Y. 1991), denies a second motion that the indictment against Dr. Willis be dismissed following the en banc decision in *Chestman*, 947 F.2d 551.

[361] *See Willis*, 737 F. Supp. at 270.

[362] *See id.*

[363] *See id.*

[364] *See id.*

[365] *See id.*

[366] *See id.* at 271.

[367] *See id.*

became public, Dr. Willis purchased 13,000 shares of BankAmerica and subsequently sold them at a profit of $27,475.79 after BankAmerica announced that Weill was interested in becoming CEO.[368]

The government's indictment charged that Dr. Willis had breached his physician-patient duty of confidentiality by misappropriating material nonpublic business information for his own benefit and that he had illegally traded on the basis of that information.[369] According to the government, this breach was a fraud upon Mrs. Weill in connection with the purchase of securities and therefore was a violation of section 10(b).[370] The court found that the relationship between Dr. Willis and Mrs. Weill was a sufficient predicate upon which to found a misappropriation theory of liability. The court stated that "[i]t is difficult to imagine a relationship that requires a higher degree of trust and confidence than the traditional relationship of physician and patient."[371] Dr. Willis initially pled guilty to the charges, but later filed a motion to withdraw his plea and moved to have the indictment dismissed following the *Chestman* decision.[372]

Willis contended that the indictment did not allege that Mrs. Weill, his patient, had suffered any damages.[373] The court rejected this argument. The court found that a patient has a cause of action against a psychiatrist who improperly discloses information and also has a property interest in a continuing course of treatment which is jeopardized by such disclosures.[374] Consequently, the court found that Mrs. Weill had been harmed. After having said this, however, the court indicated that a finding of such harm was not required for liability because "[i]n any event, the Second Circuit ha[d] clearly and concisely stated 'that one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5.'"[375]

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[368] *See id.*

[369] *See id.* at 272.

[370] *See id.*

[371] *Id.* The court went on to point out that the Hippocratic oath concludes: "'Whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even apart therefrom, which ought not be noised abroad, I will keep silence thereon, counting such things to be as sacred secrets.'" *Id.* (quoting 15 ENCYCLOPEDIA BRITANNICA 95a (1971)).

[372] *See* United States v. Willis, 778 F. Supp. 205, 206 (S.D.N.Y. 1991).

[373] *See Willis*, 737 F. Supp. at 274.

[374] *See id.*

[375] *Id.* at 274-75 (quoting SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984), *cert.*

In his motion to dismiss, Dr. Willis also contended that application of the misappropriation theory was limited in *Chestman* to "fiduciary relationships that exist within the context of shareholder relations or implicate the securities markets."[376] He contended that because the physician-patient relationship, although perhaps fiduciary in nature, does not implicate either of these requirements, a misappropriation theory of liability could not be sustained.[377] The court rejected this argument, stating that the *Chestman* court was concerned only with excluding from liability "amorphous relationships of trust and confidence that are not inherently fiduciary and well recognized as such."[378] The court argued that *Chestman* did not limit application of the misappropriation theory only to those situations in which a breach of a fiduciary relationship implicating the securities markets occurs.[379] Because the physician-patient relationship has all the characteristics of a "paradigmatic fiduciary relationship,"[380] the court found that a breach of that relationship could well serve as a basis for liability under the misappropriation theory.[381]

The misappropriation theory of liability was necessary to convict Willis because Mrs. Weill did not breach a duty of trust and confidence to her husband or the shareholders of BankAmerica when she revealed the information to Dr. Willis. Therefore, a charge of insider liability under traditional theory would not have withstood Dr. Willis's motion to dismiss.[382] The *Willis* decision demonstrates, however, that the harm under misappropriation theory is often well removed from the securities market. The asserted harm to Mrs. Weill, that she would have to find another psychiatrist and may need further treatment to overcome a possible mistrust in psychiatrists that this incident may have created, is wholly unrelated to any securities transaction. "Today, aggrieved parties under Section 10(b) have

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denied, 471 U.S. 1053 (1985)).

[376] *Willis*, 778 F. Supp. at 208.

[377] *See id.*

[378] *Id.* at 209.

[379] *See id.* at 208-09.

[380] United States v. Chestman, 947 F.2d 551, 569 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992). A "paradigmatic fiduciary relationship" involves two characteristics: discretionary authority and dependency. *See id.*

[381] *See Willis*, 778 F. Supp. at 209.

[382] *See supra* part I.B.

been transformed from 'the investing public' to 'the victims of the theft.'"[383]

The end product of judicial wrangling with Rule 10b-5 bears virtually no resemblance to the concept of insider trading formulated in *Cady, Roberts*, the linchpin in the development of section 10(b) and Rule 10b-5. In *Cady, Roberts*, SEC Chairman Cary asserted that "one of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions."[384] But the courts have cast the net of Rule 10b-5 so broadly that its central focus is no longer "the plight of the buying public—wholly unprotected from the misuse of special information."[385] The focus is instead on the source of the information and on its damages. "The theory grieves for the one wounded by the theft. But who receives the damages award? Who is made whole? Not the wounded one, but an unmentioned, unknown, ignored third party. Do not the 'misappropriation' courts realize the incongruity?"[386]

3. A Doctrine That Is Confused and Confusing: Criticisms of the Misappropriation Theory

The divergence of the courts' formulation of the misappropriation theory from the objectives of the securities laws has led to many criticisms of the theory. Recently, the Fourth Circuit forcefully and convincingly split with the precedent established by its sister circuits, rejecting the validity of the misappropriation theory in *United States v. Bryan*.[387] Bryan, the director of the West Virginia lottery, manipulated the lottery procedures for awarding contracts to companies that supplied services to the lottery.[388] Prior to the contract awards being announced, Bryan purchased stock in a company that the lottery had selected to receive an

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[383] David C. Bayne, S.J., *The Insider's Natural Law Duty:* Chestman *and the 'Misappropriation Theory'*, 43 KAN. L. REV. 79, 151 (1994) (quoted without citation).

[384] Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

[385] *Id.* at 913.

[386] Bayne, *supra* note 383, at 151.

[387] 58 F.3d 933 (4th Cir. 1995). In a companion case, United States v. ReBrook, 58 F.3d 961 (4th Cir. 1995), *cert. denied*, 116 S. Ct. 431 (1995), the court made clear that its rejection of the misappropriation theory was categorical and complete, stating that it "rejected the misappropriation theory as envisioned by [its] sister circuits in whole, not simply as applied to the particular facts in *Bryan*." *Id.* at 966.

[388] *See Bryan*, 58 F.3d at 937.

exclusive contract as a result of Bryan's manipulations.[389] Bryan was convicted of securities fraud in violation of section 10(b) through application of the misappropriation theory because he had improperly used confidential information that belonged to the lottery for his own enrichment.[390]

On appeal, the Fourth Circuit held that misappropriation theory could not be reconciled with the language or purposes of section 10(b) or Rule 10b-5.[391] The court went on to effectively unravel the interpretive twine that had ensnared other courts searching for a theory of liability in similar cases.

> Section 10(b) . . . prohibits only the use of deception, in the form of material misrepresentations or omissions, to induce action or inaction by purchasers or sellers of securities, or that affects others with a vested interest in a securities transaction. In contravention of this established principle, the misappropriation theory authorizes criminal conviction for simple breaches of fiduciary duty and similar relationships of trust and confidence, whether or not the breaches entail deception within the meaning of section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities . . . . Finding no authority for such an expansion of securities fraud liability—indeed, finding the theory irreconcilable with applicable Supreme Court precedent—we reject application of the theory in this circuit.[392]

The court defined those transactions that would be within the penumbra of section 10(b) liability, finding that "the section is primarily if not exclusively concerned with the deception of purchasers and sellers of securities, but at most extends to purchasers and sellers, other investors, and persons with a similar stake in an actual or proposed securities transaction."[393] A long list of criticisms can be added to this recent judicial condemnation of misappropriation theory; criticisms that could be obviated if the SEC would adopt a rule that would replace judicial application of the theory.

The most obvious problem with misappropriation theory is that when material nonpublic information is obtained *without a breach of duty*, there is no obligation to disclose or refrain from trading.[394] In circumstances similar to those in *Materia*,[395]

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[389] *See id.* at 939.
[390] *See id.* at 936.
[391] *See id.* at 944.
[392] *Id.*
[393] *Id.* at 946.
[394] *See supra* part II.C.1.

had the printing house not promulgated a formal work rule requiring the confidentiality of information obtained during the course of employment, no liability would have attached.[396] Similarly, in *Carpenter*,[397] had the *Wall Street Journal*, the owner of the information in the column, traded in securities prior to publication, it would not have faced Rule 10b-5 liability.[398] It is even more anomalous that in *Willis*,[399] had Mrs. Weill told her hairdresser of her husband's efforts to become CEO and the hairdresser had then traded on the information, no liability would attach. The hairdresser could not be a tippee because Mrs. Weill had no direct duty to the shareholders of BankAmerica herself nor an indirect duty through her husband. Furthermore, the hairdresser would not have obtained the information in breach of a fiduciary-type duty, for although a hairdresser's clients may discuss many things that they expect the hairdresser to keep confidential, no one could seriously argue that a fiduciary relationship exists. It violates basic tenets of justice that identical actions, performed with the same level of culpability, would be treated differently by the law. Moreover, the effects of the misappropriation theory contravene the policies of securities regulations and threaten market integrity.[400]

The misappropriation theory as it stands today fails to provide a bright-line rule. Furthermore, the level of duty that must be breached is unclear. When the misappropriation theory is applied to impose criminal liability, concerns of vagueness and the requirements of the Ex Post Facto Clause[401] are of special

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[395] SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). For a discussion of this case, see *supra* notes 311-19 and accompanying text.

[396] *See* Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 114-15, 122 (1984) (noting that misappropriation theory is not applicable to one who steals information without an explicit duty).

[397] United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987). For a discussion of this case, see *supra* notes 322-44 and accompanying text.

[398] The Court of Appeals in *Carpenter* denounced "secreting, stealing, [or] purloining" information, but held that such conduct is a 10b-5 violation only in the presence of a breach of duty. *See Carpenter*, 791 F.2d at 1031.

[399] United States v. Willis, 773 F. Supp. 269 (S.D.N.Y. 1990), *appeal dismissed*, 778 F. Supp. 205 (S.D.N.Y. 1991). For a discussion of this case, see *supra* notes 360-83 and accompanying text.

[400] *See* Stefanie A. Boinski, Note, 60 TEMP. L.Q. 215, 236-39 (1987).

[401] U.S. CONST. art. I, § 9. "A law is unconstitutionally 'ex post facto' if it deprives the defendant of a defense to criminal liability that he had prior to enactment of the

importance.[402] "Unless courts can figure out a way to give an ambiguous criminal statute an authoritative judicial gloss in advance, it is not for the federal courts to try to develop the appropriate 'new paradigm' for criminal insider trading."[403] Although the Ex Post Facto clause is not relevant in civil proceedings,[404] the same concerns of notice are still applicable. As the *Dirks* Court stated, "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous."[405]

In addition, when misappropriation theory is applied, the breach of duty is to the source of the information, not to the party on the other side of the trade. In *Chiarella*, the Court was very clear in holding that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*."[406] Thus, while claiming to adhere to a strict interpretation of common law fraud which requires a relationship between the parties,[407] misappropriation theory abandons the common law in allowing a breach of duty owed to some other person to serve as the basis of the violation.

Finally, it is only through considerable legal gymnastics that the misappropriation theory leaps from the requirement of finding a breach of a duty unrelated to the market, to a holding that causation of remote and indirect harm to investors in the market is the basis for Rule 10b-5 liability. Because misappropriation theory is drawn within the *Chiarella* doctrine,[408] courts are forced to search for irrelevant duties in order to find liability. The proponents of the theory point to the language of Rule 10b-5 that prohibits "fraud or deceit upon any person" when "in connection with the purchase or sale of any security."[409] But the "connection" between fraud on a source of information unrelated to

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law." BLACK'S LAW DICTIONARY 580 (6th ed. 1990).

[402] *See* Neely, *supra* note 339, at *12.

[403] *Id.* at *11.

[404] *See id.*

[405] Dirks v. SEC, 463 U.S. 646, 664 n.24 (1983).

[406] Chiarella v. United States, 445 U.S. 222, 230 (1980) (emphasis added).

[407] *See supra* note 145.

[408] *Chiarella* stands for the proposition that only those who have a fiduciary duty or stand in a similar relationship of trust and confidence to the shareholders of the corporation in whose stock they trade are bound by a duty to disclose any material nonpublic information on which their trade is based. *See Chiarella*, 445 U.S. at 235.

[409] 17 C.F.R. § 240.10b-5 (1995).

the market and a subsequent trade on the basis of nonpublic information causing harm to investors in the market seems too attenuated.[410] Furthermore, misappropriation theory uses the breach of a duty as the basis for finding fraud.[411] For instance, in *Carpenter*,[412] Foster Winans did not alter the contents of his articles, so there was no deception or manipulation of the public, only a theft of information from his employer.[413] This breach was enough, however, for the Second Circuit to wield section 10(b) as one aspect of a "'comprehensive yet open-ended statutory scheme, capable of ongoing adaptation and refinement.'"[414] Such a scheme is directly antithetical to the holding in *Santa Fe Industries, Inc. v. Green*,[415] however, in which the Court was unwilling to find the mere breach of a fiduciary duty sufficient to sustain a violation of section 10(b).[416] As the Fourth Circuit recently pointed out:

> [B]y its own terms, the misappropriation theory does not even require deception, but rather allows the imposition of liability upon the mere breach of a fiduciary relationship or similar relationship of trust and confidence. Such a theory obviously cannot be squared with the holding of *Santa Fe Industries* that a breach of fiduciary duty, even in connection with a purchase or sale of securities, does not give rise to liability under section 10(b), absent deception.[417]

Securities regulations should not focus on a breach of a duty in acquiring information, but should instead emphasize regulation of the unfair use of that information.[418] Otherwise, the effect of the securities laws is to criminalize employee work rules and other duties unrelated to the efficient functioning of the market.

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[410] *See* Kenny & Thebaut, *supra* note 309, at 183 n.290 (citing DANIEL FISCHEL, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION 51 (1995)).

[411] *See* United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987) ("It is sufficient that the fraud was committed upon Winans's employer.").

[412] For a discussion of this case, see *supra* notes 322-44 and accompanying text.

[413] *See Carpenter*, 791 F.2d at 1026.

[414] *Id.* at 1036 (quoting SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)).

[415] 430 U.S. 462 (1977).

[416] *See id.* at 472-74.

[417] United States v. Bryan, 58 F.3d 933, 949 (4th Cir. 1995).

[418] *See* Dennis J. Block & Nancy E. Barton, *Securities Litigation: Insider Trading–The Need for Legislation*, 10 SEC. REG. L.J. 350, 371 (1983) (arguing for exceptions to a general prohibition against trading on material nonpublic information).

Furthermore, the theft of information from the information source, while being unethical and reprehensible, is neither fraud nor deceit unless it involves an affirmative misstatement or a material omission.[419] It is somewhat ironic that the courts fastidiously go about applying the language of Rule 10b-5 and the requirements of *Chiarella*[420] to prosecute securities violations, and yet fail to recognize that misappropriation is not fraud; it is theft.

Although the courts may not recognize misappropriation as a theft, they have realized that no link exists between the party to whom the breach relates and those who are actually injured by the trade. In *Moss v. Morgan Stanley, Inc.*,[421] the Second Circuit held that an investor who trades against an insider who misappropriated information from his corporation does not have a private cause of action pursuant to the misappropriation theory.[422] The court held that the insider does not acquire a duty to disclose to the market as a result of misappropriating the information.[423] Instead, the court maintained that the breach of duty to an employer would establish only a ground for criminal prosecution by the SEC.[424] This holding demonstrates the ludicrous nature of the connection between the information misappropriated and the trade. The goal of the securities laws, the protection of investors, becomes merely derivative as the harm combated is one that lands upon noninvestors.

4. More Recent Federal Legislation

Congress passed the Insider Trading Sanctions Act of 1984 ("ITSA")[425] in response to increasing violations of the Exchange Act.[426] The ITSA subjects violators to disgorgement of up to three times the profits received from the illegal trade.[427]

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[419] *See* SPEISER ET AL., *supra* note 145, § 32:18.

[420] Chiarella v. United States, 445 U.S. 222, 225-35 (1980) (noting that an affirmative duty to disclose material inside information arises from a relationship of trust and confidence between the parties to a transaction). For a further discussion of *Chiarella*, see *supra* notes 231-52 and accompanying text.

[421] 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

[422] *See id.* at 16.

[423] *See id.* "As defendants owed no duty of disclosure to plaintiff Moss, they committed no 'fraud' in purchasing shares of Deseret stock." *Id.*

[424] *See id.* at 13.

[425] Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (1994)).

[426] *See* Laura Ryan, Comment, *Rule 14e-3's Disclose or Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449, 492-93 (1991).

[427] 15 U.S.C § 78u-1(a)(2) (originally codified at 15 U.S.C. 78u, but amended by

To provide "greater deterrence, detection and punishment of violations of insider trading,"[428] Congress subsequently enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA").[429] When an investor has purchased or sold securities while in possession of material nonpublic information "through the facilities of a national securities exchange" or through a broker-dealer, the SEC may commence an action.[430] The ITSFEA amended section 20A of the 1934 Act to provide a private cause of action under the misappropriation theory in specific response to the *Moss* decision.[431] In light of the express private right of action that these two statutes give to contemporaneous traders in the market, it is more important now that Congress, or the SEC under its rulemaking powers, develop a bright-line definition of insider trading. In *United States v. Chestman*,[432] Judge Newman questioned the SEC: "'If you're as concerned as you say, why don't you promulgate a rule telling us what insider trading is?'"[433] The reply, "'It is too daunting a task to define fraud.'"[434]

III. THE BETTER WAY TO FILL THE HOLE: A REGULATORY SOLUTION

Cases such as *Chiarella*,[435] *Carpenter*,[436] and *Materia*[437] demonstrate that certain uses of illegally obtained material nonpublic

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ITSFEA in 1988).

[428] HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND S.E.C. FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 910, 100th Cong., 2d Sess. 9-10, *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 [hereinafter INSIDER TRADING REPORT].

[429] Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended at 15 U.S.C. § 78u-1 (1994)).

[430] 15 U.S.C. § 78u-1(a)(1).

[431] *See* INSIDER TRADING REPORT, *supra* note 428, at 7 (noting that the ITSFEA "embodies a series of statutory changes the Committee views as necessary to enhance deterrence against insider trading"), *reprinted in* 1988 U.S.C.C.A.N. at 6044.

[432] 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

[433] Deborah Squiers, *En Banc Review of Key Securities Ruling*, N.Y. L.J., Nov. 13, 1990, at 1, 2; *see also* Mitchell Pacelle & Ellen J. Pollock, *Insider Trading Case Gets Rare Review By Full Appeals Court*, WALL ST. J., Nov. 12, 1990, at B5 (discussing the Second Circuit's review of *Chestman*).

[434] Karl A. Groskaufmanis, *Chestman Revisited: The Slow Death of Fraud*, INSIGHTS, Jan. 1992, at 12, *available in* LEXIS, News Library, Arcnws File.

[435] Chiarella v. United States, 445 U.S. 222 (1980). For a discussion of this case, see *supra* notes 231-52 and accompanying text.

[436] Carpenter v. United States, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987). For a discussion of this case, see *supra* notes 322-44 and accompanying text.

[437] SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). For a discussion of this case, see *supra* notes 311-19 and accompanying text.

information and improper uses of legally obtained information are unfair to investors in the securities markets. Clearly, the defendants in these cases should be punished because their "informational advantage [was] obtained by conversion and not by legitimate economic activity that society seeks to encourage."[438] In cases such as these, an expansive interpretation of Rule 10b-5 may in fact be the best solution. Although the "misappropriation theory may be an ill-fitting invention . . . the result it achieves—imposing a measure of fair play in the markets that was lost in the doctrinal rigidity of *Chiarella*'s abstain or disclose approach—accords with the investor confidence building intent of the securities laws generally."[439] However, this rule was "not designed to combat *every* unfair situation accompanying securities transactions."[440] The desire of the judiciary to craft a tool in the absence of a clear definition of insider trading by the SEC that would produce liability in the circumstances of these cases has led to an inadequate and unworkable doctrine. Concerns about investor confidence can be more effectively addressed through the adoption of a new rule that provides clear guidance to the investor.

To promote efficient capital markets, regulation of insider trading must maintain an incentive for the thorough analysis of information.[441] The parity-of-information theory announced in *Texas Gulf Sulphur*,[442] requiring that all traders have equivalent information, clearly was too broad.[443] Even an equal-access theory, requiring that all investors have at least equal access to information, even if all are not equally informed, was rejected by the Court in *Chiarella*.[444]

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[438] *Chiarella*, 445 U.S. at 242 n.3.

[439] Langevoort, *supra* note 308, at 1297-98.

[440] Edward Douma, Comment, *The Misappropriation Theory: Too Much of a Good Thing?*, 17 PAC. L.J. 111, 127 (1985).

[441] It is only through the gathering and analysis of information that the market is able to correctly price a security. When all available information is discounted into the price of a security, the market is efficient as to that security in the semistrong form. *See supra* part I.A.3; *see also* Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451, 451 (1995) ("[A]n efficient market responds to and incorporates new information into stock prices.").

[442] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). For a discussion of this case, see *supra* notes 189-211 and accompanying text.

[443] *See* Chiarella v. United States, 445 U.S. 222, 233 (1980) (noting that "neither Congress nor the Commission ever has adopted a parity-of-information rule").

[444] *See id.* at 235 n.20; *supra* note 248 and accompanying text.

Yet, a refusal to adopt either a parity-of-information or equal-access theory to govern insider trading will undermine investor confidence in the market if individuals who are routinely able to obtain inside information are permitted to trade on that basis.[445] Investors will compensate for the risk that others in the market are more effectively able to value securities by demanding higher returns, resulting in increased transaction costs, both for individuals and corporations.[446] To rectify these inefficiencies, a regulatory definition of insider trading must be broad enough to encompass activities that undermine investor confidence. However, the misappropriation theory is not the proper peg to fill the hole.

The misappropriation theory attempts to achieve an equitable result by holding outsiders who breach a duty and trade on the basis of nonpublic information liable.[447] In so doing, the theory is unevenly applied to equally culpable actors.[448] To compound matters, the misappropriation theory is defined insufficiently to place law-abiding investors on notice, resulting in traders being criminally convicted for activities that at the time "present[ed] judicial issues of first impression."[449] The ultimate result, however, may be that investors will be hesitant to act on information that originates from an unknown source; an outcome similar to that achieved by implementing the parity-of-information theory.[450] Accordingly, a regulatory definition of insider trading must encompass like actions and must provide a bright-line rule for liability.

The Commission should use its rulemaking power under section 10(b) of the Exchange Act[451] to define more clearly those actions that constitute fraud in connection with a securities transaction; particularly those in which a traditional corporate fiduciary relationship is absent. The new rule should "'focus on policing insiders and what they do . . . rather than on policing information *per se* and its possession.'"[452] In other words, by defining which

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[445] *See* INSIDER TRADING REPORT, *supra* note 428, at 14, *reprinted in* 1988 U.S.C.C.A.N at 6051.

[446] *See supra* part I.B.1.b.

[447] *See supra* part II.C.1.

[448] *See supra* part II.C.3.

[449] Fisch, *supra* note 55, at 181; *see also supra* part II.C.3.

[450] *See supra* note 201.

[451] *See supra* note 23.

[452] Dirks v. SEC, 463 U.S. 646, 663 (1983) (quoting Investors Mgmt. Co., 44 S.E.C. 633, 648 (1971)).

individuals are not able to take advantage of material nonpublic information, the definition will provide bright-line rules.

Those who are unable to trade on the basis of inside information should be those for whom the possession of the information provides bad incentives:[453] those who are able to delay the issuance of the information so that they will have the opportunity to trade; those who are able to control the performance of the corporation so that they can purposefully cause a poor performance and subsequently profit on the bad news; those who are in a position to manipulate market prices through the publication of financial information or by affecting the performance of another corporation, for example, by cancelling an important contract. It logically follows that tippees of these people should also be precluded from trading to prevent the type of quid pro quo arrangement that concerned the Court in *Dirks*.[454]

The courts have now effectively identified those individuals that are included within the definition of a traditional insider consistent with the language of section 10(b) and Rule 10b-5.[455] Attempting to codify this exhaustive interpretive history would add little to the field of insider trading regulation. As this Comment has demonstrated, however, the courts have failed to develop a workable rule to regulate trading by those who do not fit within the definition of a traditional insider. Currently, traditional-theory insiders include those who have fiduciary duties to, or a similar relationship with, a corporation and its shareholders and the tippees of those insiders.[456] This includes directors, officers, and the beneficial owner of more than ten percent of any class of equity security of the corporation.[457] Section 3(a)(7)

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[453] *See supra* part I.B.1.b-.2.

[454] *See supra* notes 277-84 and accompanying text.

[455] The traditional theory of insider trading rests upon the Supreme Court's decisions in *Chiarella* and *Dirks*.

[456] This theory provides that a person violates Rule 10b-5 if he purchases or sells securities on the basis of material nonpublic information and if that person "(1) owes a fiduciary or similar duty to the other party to the transaction; (2) . . . is an insider of the corporation in whose shares he trades, and thus owes a fiduciary duty to the corporation's shareholders; or (3) . . . is a tippee who received his information from an insider of the corporation and knows or should know that the insider breached a fiduciary duty in disclosing the information to him." SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

[457] The language of § 16(a), regarding the traditional holders of fiduciary duties, is as follows:

> Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted

of the Exchange Act defines a director as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."[458] An officer is a "president, vice-president, secretary, treasury or principal financial officer, . . . and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated."[459] Traditional-theory insiders also include employees of a company who obtain material nonpublic information about their employer by virtue of their employment. Even though they may not have formal fiduciary duties to the corporation, employees are included within the definition of traditional insider because they are encompassed within the language of *Chiarella*, which includes those who share "'a similar relation of trust and confidence'" with the corporation within its definition of "insider."[460]

The new category of insider should be added to those insiders already covered by the traditional theory currently encompassed

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> security) which is registered pursuant to section 78*l* of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or the effective date of a registration statement filed pursuant to section 78*l*(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and if such security is registered on a national securities exchange, also with the exchange), of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and, if such security is registered on a national securities exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

Exchange Act § 16(a), 15 U.S.C. § 78p(a) (1994).

[458] 15 U.S.C. § 78c(a)(7) (1994).

[459] 17 C.F.R. § 240.3b-2 (1995). An administrative view announced that:

> Generally, it is not difficult to identify a company's principal officers by their traditional titles and functions. However, an employee who does not possess a title may nevertheless be an officer because of the significant functions he performs; similarly, an employee who holds a title may nonetheless not be an officer because his functions and duties are insignificant, despite his formal position. The staff gnerally [sic] takes the view that anyone holding an appropriate title is an officer for purposes of Section 16(a).

Interpretive Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18,114, 23 S.E.C. Docket 856, 860-61 (Sept. 24, 1981).

[460] Chiarella v. United States, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

within the *Chiarella* and *Dirks* holdings in determining liability for insider trading.[461] Accordingly, the new definition should codify the solution to the problem that the courts have attempted to address via the misappropriation theory. The new definition should not fully adopt the judicial morass that resulted in the misappropriation theory, however. Instead, the rule should be tailored to address the principles that undergirded the development of securities regulation.[462]

To begin, the new definition should include those who are defined in *Dirks* as quasi-insiders:[463] those who are employed by the corporation or have another contractual relationship with the corporation by which they receive material nonpublic information. Specifically, this classification would include lawyers, investment bankers, underwriters, accountants, and consultants who are given corporate information for the purpose of advising management or providing other services to the corporation.[464] These people obtain information by virtue of a structural position within the market[465] and should not be able to exploit that advantage.

A second tier of insider that should be covered by the scope of the new rule would include those persons who are employed or associated with companies that provide information or services relating to the securities markets; for example, television stations, newspapers, producers of financial newsletters, and financial printers. Any of these persons who receive inside information from their employer or in the course of their employment should be prohibited from trading on the basis of that information. This approach would establish an equal-access theory[466] of insider trading only as to those whose employers have predefined ties to the securities markets. These are the people with whom the misappropriation theory has been predominately concerned.[467] They are in a position that is unique in that they are more than just innocent bystanders who happen to overhear a conversation. They are, in effect, in a posi-

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[461] *See supra* parts II.B.3-.4.
[462] *See* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).
[463] Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).
[464] *See id.*
[465] *See* Chiarella v. United States, 445 U.S. 222, 251 (1980).
[466] *See supra* note 206.
[467] *See supra* part II.C.2.

tion similar to that of the quasi-insider defined in *Dirks*,[468] because they too have obtained information by virtue of a structural position within the market. Their position just happens to be one removed from a fiduciary relationship to the corporate stockholders.

Finally, it should be a violation of the new rule for any of the above-named groups to tip; that is, to relay the inside information to others who otherwise would be permitted to trade. Again, under the *Dirks* rationale, tippees of those covered under the new rule would also be prohibited from trading.[469]

How would this proposal affect the court decisions that have applied or proposed application of the misappropriation theory discussed earlier?[470] Defendants such as Chiarella, Materia, and Winans would all be precluded from trading on any material nonpublic information that they learned from their employer or in the course of their employment. Defendants in the position of Dr. Willis, or Mrs. Weill's hairdresser in the proposed hypothetical,[471] however, would not be precluded from trading on inside information unless they had a preexisting relationship with the corporate shareholders. That is, these defendants would be able to trade unless they occupied some other position or filled some other role that would make them a corporate insider under the *Chiarella* analysis. Their position in the market is closer to that of the innocent bystander who overhears a conversation, or the tippee who sustains no liability because the "tip" does not fall within the *Dirks* definition of a tip that carries with it a fiduciary duty to shareholders.[472] Accordingly, liability should not attach to them because the relationship between them and their "tipper" is unrelated to the securities market.

Likewise, Matt Pilfer, the travel agent introduced in the opening hypothetical, would not be liable under the new regulatory definition. Pilfer is not employed by a company that provides information or services relating to the securities markets, nor does he owe any fiduciary duties to the shareholders of IBM.

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[468] *See Dirks*, 463 U.S. at 655 n.14.

[469] *See supra* notes 276-84 and accompanying text.

[470] *See supra* part II.C.2.

[471] *See supra* note 399 and accompanying text.

[472] *See Dirks*, 463 U.S. at 662 ("[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.").

CONCLUSION

It appears that Congress, the SEC, and commentators are beginning to agree that a regulatory definition of insider trading is necessary.[473] In attempting to define this so-far elusive activity, however, Congress and the courts should not focus on the source of the information, but should instead analyze the status of the parties within the market. Doing so will provide a bright-line rule that gives traders adequate notice, will promote the free flow of information to the market, and will continue to provide incentives for analysts to ferret out information and attempt to successfully arbitrage securities based on superior information.

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[473] *See* Fisch, *supra* note 55, at 235.