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George Jensen Kunzelman
University of the Pacific; McGeorge School of Law

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United States of America v. Robert Chestman: Construing the Fiduciary Relationship Element Under the Insider Trading Rules

In *United States v. Chestman*,[1] the Second Circuit Court of Appeals held that in order for Rule 14e-3 of the Securities and Exchange Act of 1934 to be valid, the rule must be read to require a fiduciary relationship between the illegal trader and the party harmed.[2] Sections 14(e) and 10(b) of the Securities and Exchange Act of 1934 are intended to forbid a wide range of fraudulent practices that relate to the buying and selling of any security, including trading while in possession of material, nonpublic information.[3] *Chestman* resolves an inconsistency between Rule 10b-5 and Rule 14e-3 of the Securities and Exchange Act.[4] The inconsistency arises because section 10(b) and Rule 10b-5 require a fiduciary relationship[5] between the parties to securities exchanges, while based upon the type of security transaction at hand section 14(e) and Rule 14e-3 may not.[6] Because Rule 14e-3 as written does not include a fiduciary element, *Chestman* found that Rule 14e-3 is inconsistent with the basic policy of insider trading laws, such as Rule 10b-5, which seek to prevent fraud upon the securities market.[7] The purpose of this Note is to examine the *Chestman*

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1. 903 F.2d 75 (2nd Cir. 1990) *reconsid. granted*, Fed. Sec. L. Rep. P. 95439 (2nd Cir., Aug. 24, 1990) (CCH).
2. *See infra* notes 124-149 and accompanying text (examining the promulgation of Rule 14e-3).
3. *See* H.R. REP. NO. 910, 100th Cong., 2d Sess. 8, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6051 (intent of Sections 14(e) and 10(b)).
4. *See infra* notes 124-149 and accompanying text (discussing the decision that Rule 14e-3 must include a fiduciary relationship within its elements in order to be a valid rule).
5. *See* BLACK'S LAW DICTIONARY 564 (5th ed. 1979) (definition of a fiduciary relationship).
6. *See infra* notes 32-76 and accompanying text (examining the difference between Rule 10b-5 and Rule 14e-3).
7. *See infra* notes 24-25 and accompanying text (discussion of the underlying policy of the insider trading rules).

decision and whether Rule 14e-3 should be interpreted as requiring a fiduciary relationship.[8] Part I of this Note discusses the development of the insider trading laws.[9] Part II reviews the Second Circuit Court of Appeal's panel decision in *Chestman.*[10] Part III concludes that Rule 14e-3 should contain a fiduciary relationship element and discusses the legal ramifications stemming from the Second Circuit's holding in *Chestman.*[11]

I. LEGAL BACKGROUND

A. *History of Insider Trading Regulation--Federal Statutory Law*

This Note will examine Section 10(b) of the Securities and Exchange Act of 1934,[12] Rule 10b-5 promulgated thereunder,[13] Section 14(e) of the Securities and Exchange Act of 1934,[14] and

8. *See infra* notes 111-149 and accompanying text (the decision of the Second Circuit Court of Appeals regarding whether a fiduciary relationship is required under Rule 14e-3).

9. *See infra* notes 12-77 and accompanying text (structure of the insider trading laws).

10. *See infra* notes 111-149 and accompanying text (discussing the Chestman decision).

11. *See infra* notes 150-152 and accompanying text (discussing the future effects of the decision in *United States v. Chestman*).

12. 15 U.S.C. § 78j(b) (1988). Section 10(b) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, (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.

13. 17 C.F.R. § 240.10b-5 (1990). Rule 10b-5 states:

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

Id.

14. 15 U.S.C. § 78(n)e (1988). Section 14(e) states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any

Rule 14e-3 promulgated thereunder.[15] These rules have been used to prevent a wide variety of insider trading by individuals who could otherwise take advantage of information unknown to other investors.[16] Such an advantage could be gained if, for example, people buy or sell their securities at a higher or lower price than they would have obtained had they been apprised of the confidential, material information that the other party possessed.[17] Theoretically, these investors are hurt by the financial loss they would not have suffered had they known of the inside information.[18] The person with the inside information gains an advantage by presumably buying the securities at a price lower

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> fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Id.

15. 17 C.F.R. § 240.14e-3 (1990). Rule 14e-3 states:

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

Id. Rule 14e-3 provides exceptions. *Id.* Persons other than natural persons who can show: (1) that the person who made the investment decision for such person to act on a security did not know of the material, nonpublic information; and (2) that person had used one or more policies to ensure that he or she would not violate Rule 14e-3 are excepted. *Id.* Policies may be those which: (1) restrict purchases, or sales of such securities; and (2) forbid such persons from having knowledge of such information. *Id.* The following transactions do not constitute violations of Rule 14e-3: (1) Purchases of any security which are made on behalf of the offering person, or (2) any person selling any security to the offering person. *Id.*

16. *See* LANGEVOORT, INSIDER TRADING REGULATION, §1.02 at 7-14, (1989) (discussing the reasons for insider trading regulation).

17. *Id.*

18. *Id.*

than that at which an informed seller would have sold the security.[19]

Prohibiting the use of inside information may also enhance corporate confidentiality.[20] The corporation may wish to keep a certain development secret in order to enhance the corporation's value, and the rules keep insiders from exploiting and drawing attention to this information.[21] There is also the temptation to delay the release of valuable insider information because insiders wish to trade on the information before it is released to the public.[22] The insider trading laws attempt to remove this temptation.[23]

The aforementioned justifications can be summarized by stating that it is simply unfair to allow those who are entrusted with the power to run a corporation to act in their own self-interest and to the detriment of the security holders' interests which they are obligated to protect.[24] Fair play is a major tenet of our American culture and these rules attempt to assure to all persons trading in the securities market that no one in an advantageous position will be allowed to misuse any information gained from that position.[25]

B. Administrative Authority: The SEC's Rule-making Authority

Administrative agencies' powers are statutorily granted by Congress.[26] Congress granted the Securities and Exchange Commission (SEC) the power to promulgate Rule 10b-5 and 14e-3 in Sections 10(b) and 14(e) respectively.[27] The statute itself creates, as well as limits, the power of the agency to make rules.[28]

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19. *Id.* §1.02 at 8.
20. *Id.* §1.02 at 10. Trading on the secret information of a corporation may attract attention to a wide variety of interests which the corporation did not wish to reveal. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* §1.02 at 12.
25. *Id.* §1.02 at 12-14.
26. SCHWARTZ, ADMINISTRATIVE LAW §4.3 151 (1984).
27. *See supra notes* 12-15 and accompanying text (discussing Sections 10(b) and 14(e)).
28. SCHWARTZ, *supra* note 26, §4.3 at 153.

So long as the SEC acts within the statute, the rules the agency produces are valid, however, if the agency acts outside of the statutory grant, then the rule is invalid.[29]

C. Case Law

The insider trading laws have been interpreted by the courts to prohibit three types of transactions by persons in possession of inside information.[30]

1. The Abstain or Disclose Theory

The abstain or disclose theory finds a violation of the insider trading laws when an insider[31] trades in the securities of a corporation while possessing material nonpublic information while owing a fiduciary duty to the person at the other end of the transaction.[32] This theory was developed in two milestone Supreme Court cases, *Chiarella v. United States*[33] and *Dirks v. Securities and Exchange Commission.*[34]

In *Chiarella*, the Supreme Court of the United States held that section 10(b) of the Securities Exchange Act of 1934 was designed to prevent fraud in connection with the act of trading securities.[35]

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29. *Id.* §4.3 at 151. The power to adopt rules given to an administrative agency is not the power to make law. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976). The authority granted is the power to make regulations and to carry into effect congressional will as stated by the statute. *Id.* The scope of the rule adopted may not go beyond the power given to the administrative agency under the statute. *Id.*

30. LANGEVOORT, *supra* note 16, §1.02 at 14.

31. An insider is a person who has a fiduciary relationship with certain traders in the market. *Id* §3.02 at 70.

32. *See id.* at §3.01 69-70 (discussing the elements of Rule 10b-5 in the context of misappropriating information from an employer to whom a fiduciary duty was owed).

33. 445 U.S. 222 (1980).

34. 463 U.S. 646 (1983). *See* LANGEVOORT, *supra* note 16, §2.03 at 47-57, (discussing the *Chiarella* decision).

35. Chiarella v. United States, 445 U.S. 222, 232 (1980). In this case, Vincent F. Chiarella was a mark-up man for a financial printer. *Id.* at 224. Chiarella printed documents which announced corporate takeover bids, however the names of the corporations were removed from the documents. *Id.* Chiarella was somehow able to discern the target companies' names from the documents and subsequently traded in those companies' stocks based on that knowledge. *Id.* Chiarella was indicted and convicted at the trial level, and the Court of Appeals for the Second Circuit affirmed. *Id.* The

The decision established that, in order to violate section 10(b) and Rule 10b-5, there must be a fiduciary relationship between the parties to the securities transaction, even though this relationship is not expressly required by the text of Rule 10b-5.[36] The Court found that an insider, by reason of his or her relationship with the entity, has access to information which was intended to be useable for corporate purposes only, and the Court stated that it would be unfair to allow an insider to have the advantage of this information in trading with that corporation's shareholders.[37] Thus, a fiduciary relationship between a corporate insider and the corporations shareholders is a premise upon which *Chiarella* and *Dirks* are based.[38]

When a fiduciary relationship between the buyer and seller of a security is found, an affirmative duty arises to either disclose material, nonpublic information or refrain from trading.[39] Those who do not have a fiduciary relationship do not have a duty to disclose any information, and will not violate Rule 10b-5 by trading on inside information.[40] In *Chiarella*, the defendant had no duty to the corporations in whose stocks he traded because he had no prior relationship with those corporations or their shareholders.[41] The defendant used factors disclosed on nameless takeover bids to ascertain the identity of corporations whose stock he expected to be taken over.[42] Since the fiduciary element of the Rule 10b-5 charge was not proven, Chiarella was not required to abstain from trading or disclose the information upon which he was trading.[43]

Supreme Court reversed. *Id.* The Supreme Court stated that fraud is a necessary element upon which to base a conviction and that in order to find fraud, an affirmative relationship to speak is a prerequisite. *Id.* at 231. The Court found that Chiarella had no relationship to the companies whose stocks he traded because he had no prior dealings with them, and mere possession of nonpublic market information does create a fiduciary relationship. *Id.* at 232.

36. *Id.* at 230.
37. *Id.* at 227 (citing Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).
38. *Id.*
39. *Id.* at 230-31.
40. *Id.* at 227-28.
41. *Id.* at 231.
42. *Id.*
43. *Id.*

After *Chiarella*, the Supreme Court decided *Dirks v. Securities and Exchange Commission*,[44] which extended section 10(b) liability to tippees[45] of the insider.[46] A tipper-tippee situation arises where the tipper knowingly conveys confidential, material information to the tippee, with the intention of gleaning some sort of personal or pecuniary benefit from the act of tipping.[47] The tippee's liability is derivative of the insider tipper's liability, therefore if the tipper has no duty to the shareholders of the insider's corporation the tippee has no duty as well.[48] That is, after *Dirks*, a tippee will only be held liable if the insider, the tipper, breached his or her fiduciary duty and the tippee knew of the tipper's breach of duty.[49] The *Dirks* court reasoned that a tippee should no more be able to use inside information than an insider, when the tippee knew or should have known that the information came from an insider.[50] The tipper should not be able to accomplish indirectly, by giving inside information to tippees to trade on and gaining some kind of benefit, that which the tipper could not legally accomplish directly by trading on the inside information.[51]

The tippee normally has no direct relationship to the company whose stocks are traded, whereas usually the insider does, so the tippee must inherit his or her duty from the insider.[52] The tippee

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44. 463 U.S. 646 (1983).

45. Tippee liability occurs where an insider gives inside information to another, intending to benefit personally, thereby breaching a fiduciary relationship. LANGEVOORT, *supra* note 16, §4.01 at 99. The tippee must know of or have reason to know of the breach. *Id.*

46. *Dirks v. Securities and Exchange Comm'n*, 463 U.S. 646, 649-50. Dirks was an officer of a broker-dealer firm and specialized in analyzing insurance company securities for institutional investors. *Id.* Dirks was involved in an investigation of the financial stability of a corporation. *Id.* Although neither Dirks nor the company for which he worked traded these stocks, Dirks discussed the problem freely with other investors with whom he was acquainted. *Id.* The individuals to whom Dirks passed this information could be held liable as tippees of Dirks, if Dirks had breached a fiduciary relationship to the corporation whose stocks were traded. *Id.* at 654-664. Dirks had no preexisting relationship to the company at the time he revealed the information to the investors and, as there was no primary breach, no derivative breaches of tippees could follow. *Id.* at 665-667.

47. *Id.* at 659.

48. *Id.* at 654-64.

49. *Id.* at 660.

50. *Id.* at 659.

51. *Id.*

52. *Id.* at 660-61.

assumes the fiduciary relationship of the tipper by reason of the improper disclosure of the information in breach of the insider's independent relationship with the shareholder.[53] Thus, if a tipper breaches his or her fiduciary relationship by disclosing inside information to a tippee, the tippee must either abstain from trading on the information or disclose the information before trading upon it.[54] It appears that because the SEC developed Rule 14e-3 shortly after the *Chiarella* decision, the SEC was attempting to circumvent the fiduciary requirement developed in *Chiarella*.[55]

2. *The Misappropriation Theory*

Under the misappropriation theory, a Rule 10b-5 violation occurs where an individual, not owing a fiduciary duty to shareholders, trades any security through the secret conversion of information entrusted to the trader for his or her personal use.[56] Under the misappropriation theory, liability is based on the defendant's misappropriation and personal use of corporate information, thus, the basis of liability is misuse, not a fiduciary's fraudulent failure to disclose, as in the abstain or disclose theory.[57] It must be shown that the defendant knew that the information was of a confidential nature before liability can be imposed, otherwise the defendant does not breach a duty to his or her source of information.[58] This theory was intended to cover the situations not encompassed by the abstain or disclose theory, such as in *Chiarella*, where the Court found that the defendant misused information, but did not have a fiduciary relationship with the shareholders whose shares he purchased.[59] The misappropriation theory was also meant to cover the cases in which the insider did not breach any fiduciary relationship by tipping another, but

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53. *Id.* at 661.
54. *Id.* at 665.
55. LANGEVOORT, *supra* note 16, §7.01 at 181. *See supra* notes 35-43 (discussing the fiduciary requirement of *Chiarella*).
56. *See Langevoort, supra note 16* (analyzing the misappropriation theory).
57. *Id.*
58. United States v. Reed, 601 F. Supp. 685, 703 (S.D.N.Y. 1985).
59. Langevoort, *supra* note 16, §6.02 at 148.

misused the information to the detriment of unknowing shareholders.[60] In *United States v. Carpenter*[61] the defendants were found guilty of misappropriating material nonpublic information from their employer, the *Wall Street Journal*.[62] However, the Supreme Court was evenly split regarding the convictions of the defendants and so, it cannot be stated that the misappropriation theory is accepted by the Supreme Court at this time.[63] The employees would use information to be contained in future stories and the time at which they were to be printed, to facilitate their own trading in the securities of the companies which were the subject of the stories.[64] This information was understood by the employees to be of a confidential nature.[65] The defendants argued that since they owed no duty of confidentiality to the corporations or the stockholders whose stocks they traded, they could not be found guilty of violating Rule 10b-5.[66] The court stated that this was too narrow a reading of the rule, and that the misappropriation theory is broader, applying to fraudulent appropriation of other persons property right entrusted by that person to another.[67] The court stated that the defendants' convictions were predicated upon the improper conversion of information.[68] The court found that the defendants had stolen

60. *Id.*

61. 484 U.S. 19 (1987).

62. *Id.*

63. *Id.* at 24.

64. *Id* at 23. One of the defendants was one of the authors of a *Wall Street Journal* column in the newspaper called the "Heard on the Street." *Id.* These columns were influential and read by most readers. *Id.* The defendants would use securities related information, which had not been released to the public, to buy and sell securities. *Id.*

65. *Id.* All new employees were given an information manual when they began to work for the *Wall Street Journal*, which stated that all news information was confidential. *Id.*

66. *Id.* at 27.

67. *Id.* at 27. There is no requirement that the trader be an insider or that he commit the fraud upon the buyer or seller of the security. *Id.* The only requirement is that the trading is based on improperly gained information, regardless of the source of the information. *Id.* United States v. Newsman, 664 F.2d 12 (2d Cir. 1981).

68. *Id.* at 28. It is not the mere use of information which is not available to other traders which is the basis of the misappropriation theory, it is the type of conduct which was used to develop the information for use in connection with the trading of securities. *Id.* "[O]ne may not gain such advantage by conduct constituting secreting, stealing, purloining or otherwise misappropriating material nonpublic information in breach of an employer-imposed fiduciary relationship of

information which their employer had informed them was confidential, and had thus misappropriated the information.[69] Further, the court stated that because this fraud and deceit was exercised upon their employer and was in connection with a securities transaction, the defendants' acts were a violation of Rule 10b-5 under the misappropriation theory.[70]

3. *Rule 14e-3*

Rule 14e-3 states that one who is in possession of material nonpublic information in connection with a tender offer and who trades in the stocks of the target company, violates the rule.[71] As written, there is no explicit fiduciary duty requirement under this rule. Consequently, Rule 14e-3 prohibits trades with an offeree corporation's shareholders even though there is no fiduciary relationship with such shareholder. In *Securities and Exchange Commission v. Musella*[72] the court found the defendant guilty of violating Rule 14e-3 even though there was no fiduciary relationship.[73] The court first found a Rule 10b-5 violation, and then went on to state that since Rule 14e-3 had the same elements as Rule 10b-5, less the fiduciary element, the defendants were also guilty of the Rule 14e-3 charge.[74]

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confidentiality." United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

69. *Carpenter*, 484 U.S. at 27-28.

70. *Id.*

71. *See* 17 C.F.R. 240.14e-3 (1990). *See also* LANGEVOORT, *supra* note 16, §7.01-7.05 at 181-98. Rule 14e-3 states as follows: a person possessing material information relating to a tender offer is prohibited from trading the target company securities if (1) the tender offeror has begun to take or taken a substantial step toward commencement of the bid; (2) the possessor of the information knows or has reason to know that the information was acquired from the tender offeror or the target company; and (3) the possessor of the information knows or has reason to know that the information is nonpublic. *Id.* §7.01 at 181.

72. 578 F. Supp. 425 (S.D.N.Y. 1984).

73. *Id.* at 443.

74. *Id.* The defendants in this case were given material nonpublic information from an insider who was familiar with tender offers which were to take place. *Id.* The defendants traded on the information, thereby violating their inherited fiduciary relationship under tippee liability. *Id.* Based on the foregoing facts, the court found that the defendants violated Rule 10b-5. *Id.*

The abstain and disclose theory makes an insider liable for trading on inside information and requires the defendant to breach a fiduciary duty to the shareholder as a prerequisite for liability.[75] On the other hand, Rule 14e-3 is intended to stop the same activity in the tender offer context, but as interpreted by the courts prior to *Chestman*, does not require such a fiduciary relationship for there to be a violation of the Rule.[76] The next section will analyze the *Chestman* opinion. Part III will then determine the significance of the *Chestman* decision and explore the legal ramifications this decision could have in the future.[77]

II. The Case

In the plurality opinion in *United States v. Chestman*, a panel of the Second Circuit Court of Appeals sought to clarify the requirements for a Rule 14e-3 violation. The three judges each took a different view as to whether Rule 14e-3 was valid, since the Security and Exchange Commission's promulgation of Rule 14e-3 lacked a fiduciary relationship among its elements.[78] *Chestman* held that the SEC could not enlarge the scope of section 14(e) by changing the meaning of fraud in the context of a tender offer by failing to include a fiduciary relationship element.[79] The panel held that the person obtaining the inside information owed and breached a fiduciary relationship to the person from whom the information was obtained in order to find a violation of Rule 14e-3.[80]

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75. *See supra* notes 32-70 and accompanying text (discussing Rule 10b-5).

76. *See supra* notes 71-75 and accompanying text (discussing Rule 14e-3).

77. *See infra* notes 149-152 and accompanying text (discussing the legal ramifications and conclusions drawn from the *Chestman* decision).

78. *Chestman*, 903 F.2d at 86.

79. *Chestman*, 903 F.2d at 84. *See infra* notes 78-149 and accompanying text (analyzing the Second Circuit Court of Appeals decision).

80. *Chestman*, 903 F.2d at 84. *See infra* notes 78-149 and accompanying text (analyzing the Second Circuit Court of Appeals decision).

A. The Facts

Robert Chestman worked as a stockbroker and financial advisor for the brokerage house of Gruntal & Co.[81] Keith Loeb met with Chestman in 1982 to discuss setting up some brokerage accounts at Gruntal & Co. and to consolidate Loeb's various accounts.[82] The intent of this discussion was to consolidate Loeb's holdings in Waldbaum, Inc.[83] Waldbaum is a public company and its shares are traded in the over-the-counter market.[84] During their discussions Loeb told Chestman that Loeb's wife was the niece of Ira Waldbaum, the president and holder of a controlling block of stock in Waldbaum.[85] Chestman performed several transactions for Loeb involving Waldbaum's restricted and common stock.[86] In November, 1986, Ira Waldbaum negotiated with the Great Atlantic and Pacific Tea Company, Inc. for the sale of Waldbaum to Great Atlantic.[87] On November 21, 1986 Great Atlantic and Waldbaum executed a stock purchase agreement which mandated that Ira Waldbaum tender a controlling block of Waldbaum stock to Great Atlantic, and that Great Atlantic pay fifty dollars per share to Ira Waldbaum.[88] Ira Waldbaum told his sister (Loeb's mother-in-law) that Waldbaum would tender her shares of Waldbaum stock as part of the tender offer, but that she should tell no one of this transaction, fearing such disclosure could ruin the sale.[89] Loeb's wife tried to call her mother on November 24, but was unable to reach her because her mother was turning over her shares to Ira Waldbaum at that time.[90] Later that same day Loeb's wife spoke with her mother and was told of the sale agreement between

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81. *Chestman*, 903 F.2d at 77.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.*

Waldbaum and Great Atlantic.[91] Loeb's wife was cautioned not to tell anyone, except her husband, because it might ruin the sale.[92] Later, Loeb's wife imparted this knowledge to Loeb, again with the caution that the information was to remain confidential or the sale could be ruined.[93] Between 9:00 a.m. and 10:30 a.m. on the morning of November 26, Loeb told Chestman that he had accurate information indicating Waldbaum stock was to be sold at a price substantially higher than the market price.[94] At that time Chestman refused to give Loeb any advice on what action, if any, to take.[95] That same day, Chestman purchased 3,000 shares of Waldbaum stock at $24.65 per share for himself and another 8,000 shares at prices ranging from $25.75 and $26.00 per share.[96] Of the 8,000 shares purchased, 1,000 were for Loeb, and the other 7,000 shares were for Chestman's various discretionary accounts.[97] As a result of a subsequent SEC investigation, the SEC entered into an agreement by which Loeb was forced to disgorge his profits from the 1,000 share purchase and pay a fine.[98]

Chestman appeared before the SEC, claiming that he had not spoken to Loeb before Chestman made the 1,000 share purchase, and that this purchase, and the ones which followed, were made upon Chestman's independent research.[99] The SEC began investigating Chestman's trades.[100] The SEC filed suit against Chestman and obtained convictions for ten counts of securities fraud under Rule 10b-5, ten counts of mail fraud, ten counts of

91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.* at 77-78.
98. *Id.* at 78.
99. *Id.*
100. *Id.*

fraud regarding the tender offer under section 14(e) and Rule 14e-3, and one count of perjury in connection with Chestman's testimony before the SEC.[101]

B. The Second Circuit's Opinion

The panel decision of the Second Circuit Court of Appeals reversed the district court, overruling Chestman's convictions on all counts.[102]

1. The Rule 10b-5 Convictions

A determinative element of a Rule 10b-5 violation requires the defendant to have obtained the information traded on through a breach of a fiduciary relationship.[103] In this case, the Second Circuit found no evidence indicating that Chestman had breached any fiduciary relationship by revealing the information of the tender offer between Great Atlantic and Waldbaum, since he was not in possession of confidential information.[104] The SEC was unable to show that Chestman had any knowledge, constructive or otherwise, of Loeb's duty to keep silent about the tender offer.[105] The court stated that it could not impute knowledge of

101. *Id.*

102. *Id.* at 84.

103. *Id.* at 79. *See supra* notes 36-40 and accompanying text (discussing the fiduciary relationship element of Rule 10b-5).

104. *Chestman*, 903 F.2d at 79. The attenuated passage of the information through the Waldbaum family members had stripped the information of its confidentiality, with no evidence presented by the SEC to the contrary. *Id.*

105. *Id.* The United States failed to show Chestman knew of the pledges of secrecy between Ira Waldbaum and his sister, and between Waldbaum's daughter and her husband. *Id.* The court hypothesized that even if it were assumed that Chestman had knowledge of the confidentiality of the information, there was not any evidence that Loeb had accepted this relationship and therefore the required chain of confidentiality could not be demonstrated. *Id. Compare* United States v. Reed, 601 F.Supp. 685 (S.D.N.Y. 1985) (demonstrating when a family relationship becomes enough to create a confidentiality chain of trust) *with* United States v. Chestman, 903 F.2d 75 (2nd Cir. 1990) (a family relationship was not sufficient to create a chain or trust and confidentiality). The son misappropriated from his father nonpublic, confidential information about a merger of two companies. *Reed*, 601 F. Supp. at 699. Factors to be considered in determining the existence of a confidential relationship are: (1) The difference in the positions of the parties; (2) the trust which one party has in the other; (3) reliance; and (4) level of dominance. *Id.* at 703-08.

confidentiality to Chestman because the information was passed in such an indirect fashion.[106] The Supreme Court in *Dirks*, applying the fiduciary relationship requirement to the tipper-tippee situation, stated that in a Section 10(b) and a Rule 10b-5 case, the tippee, in this case Chestman, must have knowledge of the breach by the tipper, in this case Loeb, to be held liable.[107] Because there was no such showing made in this case, the panel reversed the Rule 10b-5 securities fraud charges under the abstain or disclose theory.[108] This is so because Chestman owed no fiduciary duty to the corporation whose shares he traded, since he did not know of the breach by Loeb.[109] Thus, Chestman neither had to disclose the information of the tender offer nor abstain from trading on the information, and thus he did not violate Rule 10b-5.[110]

2. *The Section 14(e) and Rule 14e-3 Convictions*

Each of the three panel judges presented different views regarding the Section 14(e) and Rule 14e-3 convictions.[111] Judge Miner would have affirmed the Section 14(e) and Rule 14e-3 convictions.[112] Judges Mahoney and Carman both agreed that the 14-3 violations should be reversed, however, each judge cited different reasons.[113]

As a defense to the Section 14(e) and Rule 14e-3 convictions, Chestman asserted that, in promulgating Rule 14e-3, the SEC went beyond its rule-making authority under section 14(e) by imposing liability without requiring a showing a fiduciary relationship.[114] In response to this argument, Judge Miner stated that rules which

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106. *Chestman*, 903 F.2d at 79.

107. *Id.* (citing Dirks v. Securities and Exchange Commission, 463 U.S. 646, 660 (1983)).

108. *Id.* at 80. *See supra* notes 31-55 and accompanying text (discussing the abstain or disclose theory).

109. *Id.*

110. *Id.*

111. *Id.* at 82-88.

112. *Id.* at 84.

113. *Id.* at 86 (Mahoney, J., concurring in part and dissenting in part), *id.* at 86 (Carman, J., concurring in part and dissenting in part).

114. *Id.* at 83.

are not consistent with or which hinder congressional policy may be rejected.[115] Rule 14e-3, the judge stated, follows Congress' policy of protecting persons who invest in and take part in tender offers by preventing manipulative acts.[116] Judge Miner found consistency between the congressional policy in section 14(e) and Rule 14e-3, since Rule 14e-3 protects parties involved in tender offers by disallowing any use or possession of inside information in a tender offer context.[117] Although Rule 14e-3 is void of an explicit fiduciary relationship, imposing such a requirement is not inconsistent with or offensive to the congressional policy.[118] Judge Miner reasoned that because the object of Rule 14e-3 is to deter insiders from converting their knowledge to profits, the fact that Rule 14e-3 does not require a fiduciary relationship will act as a more formidable deterrent since a fiduciary relationship will not have to be proven.[119] Additionally, Judge Miner noted that Rule 14e-3 is particularly directed at tender offers, not to trading on inside information in general, and thus does not have to be equal to Rule 10b-5.[120]

Chestman continued his challenge to the validity of Rule 14e-3 by asserting that, since Rule 14e-3 was modeled after section 10(b) and Rule 10b-5, Rule 14e-3 should be consistent with those provisions, and liability should be found only where a fiduciary or confidential relationship exists, since section 10(b) and Rule 10b-5 require such a relationship.[121] Judge Miner found that while Rule 14e-3 may be modeled after section 10b and Rule 10b-5, there is no requirement that Rule 14e-3 be modeled after the earlier provisions, because the SEC is empowered to regulate any activity, deceptive or nondeceptive.[122] Because Judge Miner found that

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115. *Id.* at 83. (quoting Federal Election Comm'n v. Democratic Senatorial Campaign Comm'n., 454 U.S. 27, 32 (1981)).

116. *Id.*

117. *Id.* Rule 14e-3 disallows the possession and use of inside information in connection with a tender offer by persons other than the tender offeror or the target company. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.* at 82.

Rule 14e-3 does not have to follow the mold of the earlier provisions, he found the creation of Rule 14e-3 did not go beyond the rule-making authority of the SEC.[123]

Judge Mahoney joined in the reversal of the Rule 10b-5 charge, but took exception to Judge Miner's finding that in creating Rule 14e-3 the SEC acted within the bounds of its congressional authority to make rules regulating insider trading.[124] Judge Mahoney focused on the second sentence of section 14(e) which states "[t]he commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."[125] This sentence granted the SEC authority to make rules controlling insider trading.[126] Judge Mahoney stated that the findings which were made in *Chiarella* as to Rule 10b-5 are applicable to section 14(e) in a general sense, because Rule 14e-3 was modeled upon the general anti-fraud structure and policy of Rule 10b-5.[127] Thus, because the *Chiarella* court interpreted similar language in Rule 10b-5 to require a fiduciary relationship in order to be valid, a similar requirement should be extended to Rule 14e-3.[128] Judge Mahoney stated that the SEC has basically rewritten the law by defining the term "fraudulent" in Rule 14e-3 without requiring a fiduciary element, since fraud has historically required an element of a fiduciary relationship.[129]

The Supreme Court in *Schreiber v. Burlington Northern, Inc.*[130] stated that the powers granted to the SEC did not empower the agency to change the meaning of the word

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123. *Id.*

124. *Id.* at 84 (Mahoney, J., concurring in part and dissenting in part).

125. *Id.* (Mahoney, J., concurring in part and dissenting in part) (citing 15 U.S.C. § 78n(e) (1988)).

126. *Id.* at 85 (Mahoney, J., concurring in part and dissenting in part).

127. *Id.* (Mahoney, J., concurring in part and dissenting in part). *See* Connecticut Nat'l Bank v. Fluor Corp., 808 F.2d 957, 961 (2nd Cir. 1987) (prior case law has found the principles of Rule 10b-5 applicable to section 14(e) violations).

128. *Chestman*, 903 F.2d at 85-86 (Mahoney J., concurring in part and dissenting in part).

129. *Id.* (Mahoney, J., concurring in part and dissenting in part).

130. 472 U.S. 1 (1985).

"manipulative," which is included in Rule 10b-5.[131] Since the *Schreiber* Court held that the SEC had no power to change the word "manipulative" itself, Judge Mahoney believed that the SEC should not be able to change the other substantive words in the rule either, including "fraudulent" or "deceptive."[132] The Supreme Court of the United States has explicitly stated that the authority given to administrative agencies, such as the SEC, is not the power to make law through the adoption of rules that exceed the scope of the underlying statute.[133]

Judge Mahoney further stated that the casual references in the House Reports on Rule 14e-3 did not indicate an acceptance of the failure to include a fiduciary relationship, but in fact the reports explicitly state that the underlying case law interpretations of the insider trading rules were to remain unchanged.[134] Therefore, Rule 14e-3 was an invalid exercise of the rulemaking authority of the SEC since the rule made a substantive change in the law by failing to include a fiduciary relationship as a necessary element of the term "fraudulent."[135]

Judge Carman concurred with Judge Miner's decision as to the Rule 10b-5 violations, however Judge Carman joined Judge Mahoney in dissent as to the Rule 14e-3 violation.[136] Judge Carman agreed with Judge Mahoney in finding that if the SEC failed to include a fiduciary element in Rule 14e-3 it would constitute a violation of its rule-making authority because the SEC would then have redefined fraud, which its authority does not encompass.[137] Judge Carman, however, unlike Judge Mahoney,

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131. *Id.* at 10, n.10. *See* 17 C.F.R. § 240.10b-5 (1990).

132. *Chestman*, 903 F.2d at 86, (Mahoney, J., concurring in part and dissenting in part).

133. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213 (1976).

134. *Chestman*, 903 F.2d at 86, (Mahoney, J., concurring in part and dissenting in part) (citing H. R. REP. No. 100-910, 100th Cong., 2d Sess. 7, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6051).

135. *Id.* (Mahoney, J., concurring in part and dissenting in part).

136. *Id.* (Carman, J., concurring in part and dissenting in part).

137. *Id.* (Carman, J., concurring in part and dissenting in part). "Congress directed only that the SEC prescribed means reasonably designed to prevent fraudulent, deceptive or manipulative acts and practices by rules and regulations." *Id. See* 15 U.S.C. § 78n(e) (1988) (provides the authorization for the SEC to promulgate rules and regulations to regulate acts and practices which are fraudulent, deceptive, or manipulative). The reach of a rule should not be allowed to go beyond the powers

decided not to read the rule to textually require a fiduciary relationship, since such a textual element is just not there.[138] Further, Judge Carman did not find the rule to be inconsistent with the SEC's power, since administrative agencies, such as the SEC, are entitled to a presumption of regularity in the way they carry out their duties, and it is presumed that administrative agencies will act properly and according to law when exercising their statutorily granted powers.[139] To support this finding, Judge Carman went on to state that, since the promulgation of Rule 14e-3 came soon after *Chiarella*, the SEC knew the rule would be interpreted to include the common elements constituting fraud, including a fiduciary relationship.[140] Because a fiduciary relationship is a basic part of Rule 10b-5, promulgated to control insider trading, and because Rule 10b-5 is based on the same substantive elements of law as Rule 14e-3, Judge Carman reasoned that in promulgating Rule 14e-3 the SEC intended a fiduciary relationship to be required, just as one is required in Rule 10b-5.[141] Under Judge Carman's interpretation, the SEC has not exceeded its congressional authority to enact rules and regulations.[142] Since it must be presumed that the SEC meant to include the fiduciary element in Rule 14e-3, the SEC would not have rewritten the

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statutorily granted to the SEC. *Cf.* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976). Redefining the meaning of "fraud" would exceed the authority granted in section 14(e). *Chestman*, 903 F.2d at 87 (Carman, J. concurring in part and dissenting in part).

138. *Chestman*, 903 F.2d at 87 (Carman, J., concurring in part and dissenting in part).

139. *Id.* (Carman, J., concurring in part and dissenting in part) (citing FCC v. Schreiber, 381 U.S. 279, 296 (1965).

140. *Id.* (Carman, J., concurring in part and dissenting in part). The act of fraud requires scienter, a state of mind which having the intent to deceive, manipulate, or defraud and a breach of a relationship. *Id. See* Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983) (defining scienter). The Court determined in *Chiarella* that a disclosure relationship is created where one party has information the other party has a right to know of because of a fiduciary relationship or other type of relationship of trust and confidence between the parties. Chiarella v. United States, 445 U.S. 222, 230 (1979). Judge Carman seems to be saying that, since the Supreme Court decided in *Chiarella* that a fiduciary relationship must be an element of Rule 10b-5, which is based on fraudulent, manipulative and deceptive acts, rules developed on those same principles must include a fiduciary element and thus Rule 14e-3 should be interpreted as requiring a fiduciary relationship even though the text of the rule does not. Chestman, 903 F.2d at 87 (Carman, J., concurring in part and dissenting in part).

141. *Id.*

142. *Id.* (Carman, J., concurring in part and dissenting in part).

requirements of fraud, thus hindering Congress' policies toward the regulation of the insider trading activity.[143]

III. LEGAL RAMIFICATIONS

Since *Chestman* was a plurality decision, no one judge's opinion can be held to be the definitive word on the status of Rule 14e-3. However, two of the judges, Judge Mahoney and Judge Carman, agreed that in order to be a valid rule, 14e-3 needs to have a fiduciary relationship included among its elements.[144] Thus, after the *Chestman* decision, the elements of a 14e-3 violation, at least in the Second Circuit are: (1) That the person trading in the security be someone other than the tender offeror;[145] (2) that a tender offer has begun or a substantial step toward that end has been taken;[146] (3) that the possessor of the information knows or has reason to know that the information came from the tender offeror or the target company;[147] (4) that the possessor of the information knows or has reason to know that the information is nonpublic;[148] and, as stated in *Chestman* (5) that the possessor of the information owes the person with whom they are trading a fiduciary or similar duty of trust and confidence, and has breached that duty.[149]

The holding in *United States v. Chestman* makes Rule 14e-3 consistent with other insider trading rules. This redefinition of the SEC's rule to include a fiduciary relationship will make it harder to convict an insider under Rule 14e-3, because the government must prove a fiduciary element which it otherwise would not have had to prove. Thus, fewer convictions under Rule 14e-3 will probably result. Although more difficult to prosecute, the inclusion

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143. *See supra* notes 16-25 and accompanying text (discussion of the policies for insider trading laws).

144. *Chestman*, 903 F.2d at 84 (Mahoney, J., concurring in part and dissenting in part), *id.* at 87 (Carman, J., concurring in part and dissenting in part).

145. 17 C.F.R. § 240.14e-3 (1990).

146. *Id.*

147. *Id.*

148. *Id.*

149. *Chestman*, 903 F.2d at 75 (2nd Cir. 1990).

of a fiduciary element is proper since the element is consistent with the congressional policy of regulating insider trading. Without the fiduciary relationship element, mere possession of the information would be enough to find a violation of Rule 14e-3. The policy of Congress is to stop persons who occupy positions which allow them special access to information or those who wrongfully possess and use the information to trade. The policy of the insider trading laws is not meant to deter those persons who come to possess information by accident. The failure to include a fiduciary relationship in the Rule may prevent indecision for those traders who have information but are not fiduciaries. This indecision is not beneficial to the market because it will make investors leery of trades which could be beneficial to the U.S. economy. Thus, the inclusion of the fiduciary element is in keeping with the policy of guarding the stock market against only those who would trade in violation of a clearly defined fiduciary duty.

IV. CONCLUSION

One of the reasons Congress created the SEC was to regulate insider trading within the construction of the law as Congress determines it.[150] The Second Circuit's decision, that a fiduciary relationship must be found in order to impose liability under Rule 14e-3, is consistent with the prior decisions interpreting the insider trading laws.[151] Additionally, the *Chestman* decision is supported by the underlying rationale of the insider trading regulations, which seems to boil down to the simple desire for ultimate fairness in the system.[152]

George Jensen Kunzelman

150. *See supra* notes 26-29 and accompanying text (discussing administrative rule-making authority).

151. *See supra* notes 16-25 and accompanying text (discussing the aims of the insider trading laws).

152. *See supra* notes 24-25 and accompanying text (discussing the underlying policy of the insider trading laws).