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Chiarella v. United States and its Indelible Impact on Insider Trading Law

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ARTICLE: CHIARELLA V. UNITED STATES AND ITS INDELIBLE IMPACT ON INSIDER TRADING LAW

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Reporter

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* C. Ben Dutton Professor of Law, Indiana University Maurer School of Law--Bloomington. This essay has benefited from comments by Judge Jed Rakoff, John S. Siffert, Dean Austen Parrish, and Professors Donald Langevoort, Adam Pritchard, Margaret Sachs, and Robert Thompson, as well as from my fellow participants at the IU Maurer School of Law Summer Faculty Scholarship Series, the Southeastern Association of Law Schools Conference 2019 discussion group on "Insider Trading Stories," and the Tennessee Journal of Law and Policy's symposium "Insider Trading: Stories from the Attorneys," held on November 15, 2019. I am also truly grateful to reference librarian Jennifer Morgan, of the IU Jerome Hall Law Library, for her excellent research assistance.

Text

[*7] Insider trading cases, which are typically prosecuted as securities fraud, carry a mystique rarely present in securities litigation. As a former U.S. Attorney for the Southern District of New York once observed, the cases involve "basically cops and robbers. . . . [d]id you get the information and did you trade on it?"¹ It is no wonder that each insider trading case featured in this symposium presents a captivating story. But for two distinct reasons, *Chiarella v. United States*² occupies a special place in history. It was the first prosecution under the federal securities laws for the crime of insider trading. And the U.S. Supreme Court's iconic holding--regarding the circumstances under which insider trading constitutes securities fraud--not only profoundly changed the law in 1980 but also continues to define insider trading's contours right up to the present day.

Chiarella's facts are straightforward and memorable. The defendant was employed by a financial printing firm hired to publish announcements of takeover bids. On several occasions he managed to deduce from code names the identities of the actual companies, and **[*8]** then used that confidential information to surreptitiously purchase stock in the acquisition targets.³ After settling a civil securities fraud action brought by the Securities and Exchange Commission, Chiarella was indicted in New York federal court for criminal securities fraud, found guilty by a jury, and unsuccessfully appealed to the Second Circuit. The Supreme Court, however, overturned his conviction.⁴

¹ Stephen Labaton and David Leonhardt, *Whispers Inside. Thunder Outside*, N.Y. TIMES, June 30, 2002 at C1 (quoting Otto Obermaier, former U.S. Attorney for the Southern District of New York).

² 445 U.S. 222 (1980).

³ *Id.* at 224.

⁴ *Id.* at 225.

While the case is famous, important aspects of *Chiarella* have gone unnoticed or been long since forgotten. This essay sets out to explore these aspects in order to better understand how a seemingly mundane SEC settlement involving just over \$ 30,000 in ill-gotten gains morphed into a groundbreaking insider trading prosecution and Supreme Court decision. The exploration draws from a close analysis of the civil and criminal litigation record as well as interviews with most of the principal attorneys involved in the case at its various stages, all of whom went on to extraordinary careers in public service, private practice, or law teaching (with many toggling between two or all three). This distinguished cadre includes: Stanley S. Arkin, Judge Frank H. Easterbrook, Ralph C. Ferrara, Robert B. Fiske, Jr., Paul Gonson, Professor Donald C. Langevoort, Judge Jed S. Rakoff, Lee S. Richards III, John S. Siffert, and John "Rusty" Wing, and extends as well to their remembrances of Stephen Shapiro.

Insider trading law in the U.S. is routinely depicted as "judge-made" or "judicially created."⁵The [*9] description is apposite. Although Congress statutorily authorized the SEC rule prohibiting "fraud in connection with the purchase or sale of any security," it is courts that must determine, as a matter of federal common law, whether securities trading on the basis of material nonpublic information constitutes a "deceptive device or contrivance" under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act),⁶ and thus a "fraud" within Rule 10b-5's prohibition.⁷ But the description also leaves unacknowledged the essential role of the SEC, DOJ, and defense attorneys in framing the arguments on which the judicial rulings are based.

Nowhere have attorneys influenced the development of insider trading law more profoundly than in the various phases of the *Chiarella* litigation. This story therefore suggests, with no hint of exaggeration, that *Chiarella's* indelible impact results as much from the case's lawyering as from the ruling announced by the Court in its landmark decision.

A. The Path to the First Criminal Conviction for Insider Trading

1. Pandick Press, Vincent Chiarella, and the SEC Settlement

Pandick Press, Inc., located in New York City, regularly provided printing services to corporations and their legal and financial advisers. On multiple occasions in 1975 and 1976, law firms and investments banks for acquiring companies hired the printer to publish announcements relating to impending takeovers. Pandick adhered to standard industry protocol by using code names to identify both its acquisition-company [*10] customer and the target company up until the night of the final printing.⁸

Vincent Chiarella, who was 47 years old at the time, had moved his way up to the position of "mark-up man" during his more than two decades of employment at Pandick.⁹ He was also, as it turns out, an avid stock trader, who regularly spoke with his securities broker. In connection with his work on a mark-up assignment in September 1975 and four such assignments in 1976, Chiarella managed to decipher the identity of the actual companies involved in upcoming transactions, based on other facts provided in the takeover materials.¹⁰ He then secretly used that confidential information to purchase stock in the acquisition targets, and within days or

⁵ See, e.g., Tom McParland, *Judicial Inconsistency Frustrates Purposes of Insider Trading Law, Rakoff Says*, Law.com (Feb. 28, 2020), <https://www.law.com/newyorklawjournal/2020/02/28/judicial-inconsistency-frustrates-purpose-of-insider-trading-law-rakoff-says/> (quoting Judge Jed Rakoff's observation that the insider trading prohibition has "really been judge-made law, almost from the very outset").

⁶ 15 U.S.C. 78j(b).

⁷ 17 C.F.R. § 240.10b-5.

⁸ *United States v. Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978).

⁹ Brief for Respondent at 4, *Chiarella v. United States*, 445 U.S. 222 (1979) (No. 78-1202) (hereinafter *Chiarella* Government Brief).

¹⁰ *Id.* at 7.

sometimes even hours after his stock purchases, the acquiring companies made their public announcement. On each occasion the target stock's price rose sharply, and each time Chiarella sold his shares immediately. Chiarella's sizable profits were possible only because several of his purchases were for substantial amounts of target stock. His stock purchases in two of the targets, for example, amounted to approximately one-half of each stock's total daily trading volume.¹¹ Those large volume purchases on the cusp of takeover announcements caught the attention of the New York Stock Exchange, which referred the suspicious activity to the SEC.¹²

The SEC opened an investigation into Chiarella's trading activities in early 1977, and instituted a civil [*11] enforcement action in the SDNY a few months later.¹³ The complaint charged Chiarella with violating Exchange Act Section 10(b) and Rule 10b-5 by purchasing shares in three tender offer targets (Sprague Electronic Company; Booth Newspapers, Inc.; and Food Town Stores, Inc.) and a fourth company, Riviana Foods, that had been the target of a merger.¹⁴ The complaint further alleged that Chiarella made these stock purchases "without disclosing the material, non-public information he had obtained in connection with his employment,"¹⁵ and thus engaged in a "deceit upon the purchasers and sellers of such securities,"¹⁶ resulting in a combined profit of \$ 29,248.¹⁷

[*12] The SEC announced a settlement with Chiarella on the same day it filed the complaint against him,¹⁸ but that disposition was only for purposes of the SEC's civil enforcement authority.¹⁹ Without admitting or denying the SEC's charges against him, Chiarella consented to the issuance of a federal court order enjoining him from future securities law violations and agreed to disgorge his trading profits to the shareholders who had sold him target stock.²⁰ At the time, such injunctive and ancillary equitable remedies were the only relief available to the SEC in a civil insider trading case.²¹ Congress had yet to enact the Insider Trading Sanctions Act of

¹¹ See *id.* at 9 (citing Trial Transcript).

¹² SEC v. Chiarella, Lit. Rel. No. 79357, 1977 SEC Lexis 1674 (May 24, 1977) (hereinafter *Chiarella* Lit. Rel.).

¹³ See Complaint, Civ. Action 77-2534, SEC v. Chiarella (filed May 16, 1977, SDNY, Goettel, J.) The complaint, obtained from the SEC through a request under the Freedom of Information Act (FOIA), is now available in the SEC Historical Society's Virtual Museum and Archive, at http://www.sechistorical.org/collection/papers/1970/1977_0516_Chiarella_Complaint_SDNY.pdf.

¹⁴ See *Chiarella* SEC Complaint, *supra* note 13, at PP 13, 19, 25, 30. In connection with Chiarella's stock purchases in tender-offer targets, the SEC also charged him with violating Exchange Act Section 14(e), a general provision prohibiting fraudulent, deceptive and manipulative practices in connection with tender offers. More than three years later, the SEC adopted a tender-offer specific insider trading prohibition. See *infra* note 132 (discussing SEC Rule 14e-3).

¹⁵ *Chiarella* SEC Complaint, *supra* note 13, PP 13, 19, 25, 30.

¹⁶ *Id.* at P 9.

¹⁷ *Id.* at PP 15, 21, 27, 32. Irwin Borowski, Richard S. Kraut, and Peter M. Sullivan were the attorneys who worked on the Chiarella matter in the SEC's main (Washington, D.C.) office, and William D. Moran was the NY Office's Regional Administrator. See Docket Sheet, SEC v. Chiarella, 77 Civ. 2534 (SDNY, Goettel, J.), available at http://www.sechistorical.org/collection/papers/1970/1977_0523_SDNY_Docket_Sheet.pdf.

¹⁸ See *Chiarella* Lit. Rel., *supra* note 12. See also *S.E.C. Says Typesetter Improperly Used Data*, N.Y. TIMES, May 24, 1977 at 61.

¹⁹ See *id.* See also 17 C.F.R. § 202.5(f) (stating the SEC policy "that settlements of any civil enforcement matter may not, expressly or impliedly, extend to any criminal charges that have been, or may be, brought against any such person or any recommendation with respect thereto" and observing that criminal proceedings may be instituted only by "the Attorney General and representatives of the Department of Justice").

²⁰ *Chiarella* Lit. Rel., *supra* note 12.

²¹ See *Chiarella* SEC Complaint, *supra* note 13, at I-IV.

1984, which authorizes the SEC to seek court-ordered penalties of up to three times the profit made or loss avoided by an insider trading defendant.²² Pandick Press also administered a punishment of its own: the company fired Chiarella from his position the very same day that the SEC announced the settlement.

[*13] Chiarella was hardly the first worker at a financial printing firm who found himself under SEC scrutiny. In 1974, the SEC filed a complaint, which it ultimately settled, against three employees at Sorg Printing Company, Inc., who had likewise engaged in securities trading based on confidential takeover information.²³ As the Second Circuit emphasized, the SEC settlement decree in *Sorg* "aroused widespread concern in the financial printing industry" and prompted most printers (including Pandick) to post signs in the workplace forbidding employees "to use any information learned from a customer's copy."²⁴ The signs' warnings, which also were included as notices on the back of timeclock punch-cards and in union newspapers, advised workers that misuse of such information could render them liable for "criminal penalties of 5 years in jail and \$ 10,000 for each offense."²⁵ In between its enforcement actions against the Sorg employees and Chiarella, the SEC filed at least three other actions against printer workers, and obtained consent decrees imposing injunctive and disgorgement remedies.²⁶ As the *Wall Street Journal* and *New York Times* did on those prior occasions,²⁷ the newspapers reported on Chiarella's SEC settlement.²⁸

[*14] 2. The Criminal Indictment

On January 4, 1978, less than eight months after the settlement of the SEC's civil case, the U.S. Attorney for the Southern District of New York indicted Chiarella on 17 counts of willful and knowing misuse of material, nonpublic information in violation of Exchange Act § 10(b) and Rule 10b-5,²⁹ pursuant to the criminal liability provision in Exchange Act § 32(a).³⁰ Counts 3 through 17 of the indictment roughly tracked the SEC complaint's allegations concerning Chiarella's purchases of shares in Riviana, Food Town, Booth, and Sprague.

²² Insider Trading Sanctions Act of 1984 § 2A, Pub. L. No. 98-376, 98 Stat. 1264 (subsequently amended and re-codified at Exchange Act § 21A(a), 15 U.S.C. 78u-1(a)).

²³ See *SEC v. Sorg Printing Co.*, Lit. Rel. No. 6488, 1974 SEC Lexis 2778 (Aug. 21, 1974) (announcing complaint). See also *SEC v. Sorg Printing Co.*, Fed. Sec. L. Rep P 95,034, 1975 U.S. Dist. Lexis 13121 (S.D.N.Y. 1975) (observing that the three employees "have consented to the entry of a preliminary injunction," but granting the printing company's motion for summary judgment because it was neither "an aider or abettor" nor "secondarily liable on a theory of respondeat superior").

²⁴ *Chiarella*, 588 F.2d at 1369.

²⁵ *Id.* (quoting workplace signs at Pandick Press).

²⁶ See *id.* (citing *SEC v. Primar Typographers, Inc.*, Fed Sec L. Rep. P 95,734 (S.D.N.Y. 1976); *SEC v. Ayoub*, Fed. Sec. L. Rep. P 95,567 (S.D.N.Y. 1976)). See also *SEC v. Smith et al.*, Lit. Release No. 7420, 1976 SEC Lexis 1539 (June 1, 1976) (announcing consent order against three employees of Bowne & Co.).

²⁷ See, e.g., *SEC Charges 3 Employees of Bowne & Co., A Printer, With Trading on Insider Data*, WALL ST. J., May 25, 1976 at 12; *SEC Charges 2 Brokers, Printer Violated Insider-Trading Rules in Unitek Shares*, WALL ST. J., May 18, 1976 at 5 (reporting on complaint filed in Ayoud et al.); Felix Belair, Jr., *S.E.C. Charges Misuse of Data*, N.Y. TIMES, Aug. 22, 1974 at 53 (reporting on Song employees complaint).

²⁸ *Printing Employee Charged With Gaining from Tender Offer Bid*, WALL ST. J., May 24, 1977 at 8; *S.E.C. Says Typesetter Improperly Used Data*, N.Y. TIMES, May 24, 1977 at 61.

²⁹ See Arnold Lubasch, *Printer is Indicted on Charges of Using Inside Data*, N.Y. TIMES, Jan. 5, 1978 at D5.

³⁰ 15 U.S.C. 78ff.

³¹Counts 1 and 2 raised new allegations charging Chiarella with unlawful purchases in the stock of USM Corporation, generating an additional \$ 1019 in profits. ³²

John S. Siffert was the Assistant U.S. Attorney who successfully tried the case to a jury and argued in the Second Circuit on appeal. Siffert reported to John **[*15]** "Rusty" Wing, the Chief of the Securities and Business Fraud Unit, and Robert B. Fiske, Jr., the U.S. Attorney. As Siffert's preparation for Chiarella's trial was underway, Wing left the SDNY to join the firm of Weil, Gotshal, and Jed Rakoff succeeded Wing as the Fraud Unit Chief. Siffert was not, however, the AUSA who worked with the grand jury. Rather, Siffert took over the case from John A. Lowe, who left the SDNY for private practice a few weeks after Chiarella's indictment. ³³It may have been the press reports about the SEC settlement that caught Lowe's attention and prompted the criminal investigation. ³⁴

Then-U.S. Attorney Fiske, now a senior counsel and retired partner at the Davis Polk law firm, remembers well the SDNY Office's rationale for instituting a criminal insider trading prosecution against Chiarella. Fiske, who describes his U.S. Attorney **[*16]** leadership as "hands-on," ³⁵had been aware of the prior SEC enforcement actions against workers in the printing industry. He attributed the reoccurring illegality to the inadequacy of existing civil remedies -- injunctions and disgorgement were simply not serving as deterrents that outweighed the temptation faced by some workers to convert customer information into personal trading profits. ³⁶Fiske was also cognizant of the efforts undertaken by the financial printing industry to educate workers that trading securities on the basis of customer information would violate the federal securities laws and subject offenders to criminal prosecution. And to his knowledge, no other financial service sector at the time, including investment banks and law firms, went to the same lengths to warn their employees about insider trading. In Fiske's view, criminal prosecution was warranted because Chiarella had used customer information to purchase acquisition-target stock notwithstanding "overwhelmingly powerful notice" of the consequences. ³⁷Siffert likewise recalls contemporaneous discussions in which Fiske emphasized to him the perniciousness of the printing industry's insider-trading problem as well as the incremental steps taken by the SEC and the industry itself prior to Chiarella's indictment. ³⁸

³¹ See Indictment, United States v. Chiarella, No. 78 Cr. 2 (S.D.N.Y., Jan. 4, 1978, Owen, J.), available at http://www.sechistorical.org/collection/papers/1970/1978_0101_Chiarella_Indictment_SDNY.pdf.

³² *Id.*

³³ Telephone interview with John S. Siffert, Co-Founding Partner, Lankler Siffert Wohl (Sept. 6, 2019).

³⁴ See *Roundtable on Enforcement* at 104, SEC HISTORICAL SOCIETY (Sept. 25, 2002), <http://www.sechistorical.org/collection/programs/enforcementTranscript.pdf> (statement by former SEC Solicitor Paul Gonson suggesting that an AUSA "had read about the settlement in the newspaper . . . and indicted Mr. Chiarella for the action the SEC had settled"). *But see* JESSE EISINGER, *THE CHICKENSHIT CLUB: WHY THE JUSTICE DEPARTMENT FAILS TO PROSECUTE EXECUTIVES* 77 (2017) (book passage attributing the origins of Chiarella's criminal prosecution to a telephone referral from SEC Enforcement Director Stanley Sporkin to Jed Rakoff). It is unlikely that the criminal case arose from Sporkin's encouragement. Jed Rakoff, who became Chief of the SDNY's Securities and Business Fraud Unit after the preparation for Chiarella's criminal trial had already begun, was not involved in the indictment decision. Interview with the Honorable Jed Rakoff, SDNY District Judge (Oct. 30, 2019). And neither Robert Fiske nor Rusty Wing recalls Sporkin referring the matter to them. Telephone interview with Robert B. Fiske, Jr., Senior Counsel, Davis Polk & Wardwell (Oct. 28, 2019); Siffert Telephone interview, *supra* note 33.

³⁵ See ROBERT B. FISKE JR., *PROSECUTOR, DEFENDER, COUNSELOR: A MEMOIR* 80 (2014).

³⁶ Fiske telephone interview, *supra* note 34.

³⁷ *Id.*

³⁸ Siffert interview, *supra* note 33.

A pause here is useful for counterfactual speculation. As the U.S. Attorney, Fiske allowed higher-level review of preliminary indictment decisions if so requested by defense counsel, including his own review as a final appeal.³⁹ But Stanley Arkin, the attorney who represented Chiarella during the criminal trial and through his successful petition to the Supreme Court, [*17] was not involved in the case at the preliminary stage. Had the timing been otherwise, Arkin believes that he would have been able to mount a persuasive case against an indictment.⁴⁰ Now a legend in the white-collar defense bar known for his tenacity, Arkin at the time was building a premier small law firm practice, which he has maintained for more than fifty years, except for a four-year stint in the early 1990s as a partner at the firm of Chadbourne & Parke.⁴¹

While criminal liability for insider trading would be a powerful deterrent, the government's decision to press forward in a contested proceeding risked establishing an adverse precedent that could apply in civil insider trading cases as well. Because Chiarella had no pre-existing relationship with the acquisition targets or their shareholders, the criminal prosecution had to be built on untilled soil. From a securities-law development perspective, fewer risks would have been posed with an inaugural criminal insider trading action against a traditional insider of the issuing corporation rather than an "outsider" like Chiarella. A criminal prosecution of that type would have been a natural follow-up to *SEC v. Texas Gulf Sulphur*,⁴² the landmark Second Circuit decision from a decade earlier that held directors, officers, and employees of a mining company liable under Section 10(b) and Rule 10b-5 for their purchases of stock in the company based on material nonpublic information concerning a valuable ore strike.⁴³ To be sure, the *en banc* opinion included a statement that "anyone in possession of material inside information must either disclose it to [*18] the investing public. . .or. . .must abstain from trading in or recommending [such] securities."⁴⁴ But that broad statement was technically dictum and was never the basis of a post- *TGS* court holding.⁴⁵ The risk of an unfavorable precedent also could have been reduced by initiating Rule 10b-5 "outsider trading" charges in a litigated SEC enforcement action, rather than in a criminal action with the defendant's imprisonment as a possible outcome. That is, building upon the discussion of "improperly obtained" informational asymmetries in Commissioner Richard Smith's *In re Investors Management Co.* concurrence,⁴⁶ the SEC could have urged courts to recognize a Rule 10b-5 duty owed to all securities issuers "not to steal or knowingly receive stolen goods or exercise dominion over goods known to be owned by others . . . even without the presence of a special [insider] relationship."⁴⁷

3. The Motion to Dismiss and the Jury Trial

³⁹ FISKE, *supra* note 35, at 80.

⁴⁰ Interview with Stanley S. Arkin, founding member of Arkin Solbakken (Oct. 30, 2019).

⁴¹ See Peter Truell, *Riding Shotgun for Wall Street; Combative Lawyer for Aggressive Brokers is in Demand*, N.Y. TIMES, Feb. 18, 1998 at D1.

⁴² *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (1968), cert. denied, 394 U.S. 979 (1969).

⁴³ *Id.* at 847-48.

⁴⁴ *Id.* at 848.

⁴⁵ See Donald C. Langevoort, *From Texas Gulf Sulphur to Chiarella: A Tale of Two Duties*, 71 S.M.U. L. REV. 835, 843, 841 (2018) (concluding that in the decade following *TGS*, Rule 10b-5's duty to disclose or abstain "was clearly becoming status-based, not possession-based," but acknowledging the concurrences in *SEC v. Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968) and the "smatterings of [other] evidence that market egalitarianism was a serious judicial philosophy").

⁴⁶ *In re Inv'rs Mgmt. Co.*, 44 S.E.C. 633, 650 (1971) (Smith, Comm'r, concurring in the result).

⁴⁷ *Id.* at 650 n.2.

In addition to a defendant who had been warned repeatedly about the possible criminal repercussions of insider trading, the prosecutors in *Chiarella* had what is often difficult to obtain in an insider trading case: tangible (as opposed to circumstantial) evidence that securities were purchased on the basis of material [*19] nonpublic information. Specifically, Chiarella signed a statement on his application to the NY Department of Labor for unemployment benefits admitting that he was discharged from Pandick "for misusing confidential information and that 'the allegation is true.'" ⁴⁸

The strength of the government's evidence, however, did not deter Arkin from seeking SDNY District Judge Richard Owen's dismissal of the indictment on the ground that it failed to state a criminal offense, or alternatively, for an order dismissing the indictment "in the interest of justice." ⁴⁹Arkin's principal argument was that Chiarella's "actions did not constitute even a civil violation of § 10(b)--and Rule 10b-5--much less a criminal violation" because Chiarella "was not in a fiduciary relationship as to anyone so that he had no duty of disclosure prior to purchasing shares in the target corporation." ⁵⁰But in the end of March 1978, Judge Owen ruled otherwise, concluding that the government had adequately stated a claim for two separate but related frauds in connection with Chiarella's stock purchases. First, Chiarella was charged with committing a "fraud upon the acquiring corporations whose plans and [*20] information [Chiarella] took while he was setting them in type." ⁵¹Judge Owen noted here that "the analogy of embezzlement by a bank employee immediately springs to mind, and, of course, embezzlement implies fraudulent conduct." ⁵²In addition, Judge Owen held that, if proven, "Chiarella's failure to disclose his purloined information to the sellers whose stock he purchased constituted an 'inherent unfairness' and a 'deceptive device' in connection with his purchases." ⁵³

Chiarella's week-long trial commenced in April 1978. AUSA Siffert introduced into evidence the workplace signs as well as the warning notices in union newsletters and on Chiarella's time-clock punch-cards. Siffert also called nine witnesses for the government, including an investigator in the SEC's New York Regional Office, Carmine Asselta, and former shareholders in the target companies' stock who testified that they were unaware of the impending takeover at the time of their sales and would not have sold had the information been disclosed to them. Because the SEC's civil case against Chiarella was settled at the complaint stage, it was Siffert and Asselta who gathered almost all of the prosecution's evidence, and Asselta also prepared the stock price charts for the jury that highlighted Chiarella's substantial trading gains. ⁵⁴In defending against the securities fraud charges, Arkin offered Chiarella's direct testimony and sought to convince the jury that while Chiarella was aware that his use of customer information violated company rules, "he did not believe that his actions were unlawful." ⁵⁵Among other justifications for his conduct, Arkin maintained that Chiarella was "well aware that it was the common [*21] practice of prospective tender offerors to purchase shares on the open market prior to the announcement of

⁴⁸ *Chiarella*, 588 F.2d at 1372 (quoting statement, and ultimately ruling on appeal that any state-created privilege pertaining to statements made in applying for unemployment benefits was not controlling in a federal criminal proceeding).

⁴⁹ *United States v. Chiarella*, 450 F. Supp. 95, 95-96 (S.D.N.Y. 1978).

⁵⁰ *Id.* at 96. Arkin continued to emphasize this fiduciary-focused interpretation of Rule 10b-5's insider trading prohibition at every stage of the litigation. See, e.g., Brief for the Petitioner at 21-22, *Chiarella v. United States*, filed June 28, 1979 (describing the "essence of the common law rule [for] a tort action for fraud by silence [as lying] where one party to a business transaction fails to disclose facts material to the transaction that the other party is entitled to know because of a fiduciary or other special relation of trust and confidence between them") (citing cases and ALI Restatement of the Law 2d, Torts § 551(2)(a)).

⁵¹ *Chiarella*, 450 F. Supp. at 97.

⁵² *Id.* at 96.

⁵³ *Id.* at 97 (quoting *In re Cady Roberts*, 40 S.E.C. 907, 912 (1961) and the text of Exchange Act § 10(b)).

⁵⁴ Telephone interview of John S. Siffert, *supra* note 33.

⁵⁵ Brief for the Petitioner, *supra* note 50, at 7.

their tender offer plans." ⁵⁶As Chiarella stated it in his testimony: "I was doing the same thing that they were doing and I had no intention of doing anything wrong with that." ⁵⁷Chiarella also repeatedly denied having read any of Pandick Press's multiple notices with explicit warnings of the criminal consequences, notwithstanding his acknowledgment on cross-examination by Siffert that he would have passed the workplace signs when he clocked in and out more than 640 times. ⁵⁸The charges to the jury centered on Chiarella's nondisclosures to the sellers of the targets' stock. Although Siffert had requested a separate charge that Chiarella had also defrauded the offering companies, Judge Owen rejected the request, apparently siding with Arkin's position that any reference "to an alleged fraud on the offering company would be inappropriate as a substantial variance from what the grand jury allowed." ⁵⁹

A jury convicted Chiarella of all 17 counts of securities fraud under Rule 10b-5. ⁶⁰A month later, Judge Owen sentenced him to concurrent terms of one year on most of the counts, which were suspended following one month of imprisonment and a probationary term of five years. ⁶¹At the sentencing hearing, Judge Owen found that Chiarella's testimony that he had not read the workplace notices "was perjury beyond a reasonable doubt." ⁶²One can speculate as to whether the jury would **[*22]** have convicted Chiarella had he acknowledged reading the workplace notices and admitted to disregarding them--perhaps viewing the warnings as a scare tactic by an employer that sought to encourage compliance with workplace rules. On the other hand, Siffert extracted on cross-examination two other key statements that could have convinced a jury beyond a reasonable doubt that Chiarella acted both knowingly and willfully: when Siffert asked if he knew it was against the law to trade on insider information Chiarella said "I didn't know it was a criminal law. . . . It was a violation as far as I knew;" and Chiarella admitted that he knew use of insider information "was against the SEC." ⁶³

4. The Second Circuit's Ruling on Appeal

The Second Circuit's decision upholding Chiarella's conviction is often depicted as an "equal access to information" approach to Rule 10b-5 insider trading liability. ⁶⁴It is an approach that is difficult to reconcile with the doctrine of common law fraud, which loosely governs judicial interpretations of Rule 10b-5. ⁶⁵Under the common law, in the absence of a duty to disclose, a person's mere silence about material facts in a business transaction does not constitute a fraud. In other words, the principle of *caveat emptor* generally applies to securities trading.

⁵⁶ *Id.* at 8.

⁵⁷ *Id.* (quoting trial transcript at R. 492).

⁵⁸ *Chiarella*, 588 F.2d at 1369.

⁵⁹ See Transcript of Chiarella Charging Conference, April 1978, available at http://www.sechistorical.org/collection/papers/1970/1978_1231_Chiarella_Charging_Conf_SDNY.pdf.

⁶⁰ See *US Convicts Printer for Securities Fraud*, N.Y. TIMES, Apr. 11, 1978 at 57.

⁶¹ See *Chiarella* Government Brief, *supra* note 9, at 4.

⁶² *Chiarella*, 588 F.2d at 1369-70 n. 18.

⁶³ See *Chiarella* Government Brief, *supra* note 9, at 11 (quoting Trial Transcript at 515-16).

⁶⁴ See *infra* notes 109-10 and accompanying text (quoting Justice Powell's statements in *Chiarella*).

⁶⁵ See *Basic, Inc. v. Levinson*, 485 U.S. 224, 253 (1988) (White, J., concurring in part and dissenting in part) (emphasizing that "[i]n general, the case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit").

[*23] But a close reading of the Second Circuit's November 1978 opinion shows that the appellate court did not affirm Chiarella's Rule 10b-5 conviction based on the breach of a generalized disclosure duty arising from a securities trader's mere possession of material nonpublic information. Instead, the Second Circuit held more narrowly that "[a]nyone--corporate insider or not--who *regularly receives* material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."⁶⁶ And the Second Circuit explicitly stated that it was " *not* to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose."⁶⁷ As Professor Donald Langevoort has recently emphasized, the Second Circuit's approach in *Chiarella* was "status-based" and constituted "an effort to prevent abuse--wrongfully exploiting the status of regular access to information by knowing that the information was not theirs for the taking."⁶⁸

B. Lawyer Advocacy: Framing the Issues

1. Chiarella's Petition for Certiorari and the Government's Opposition

After unsuccessful motions for a Second Circuit rehearing or a rehearing *en banc*, Arkin filed Chiarella's petition for certiorari in early February 1979.⁶⁹ The first and principal question presented to the Court was:

[*24] Does the purchaser of stock in the open market who fails to disclose material, nonpublic information about the issuer of the stock violate Section 10(b) of the Securities Exchange Act and Rule 10b-5 where the purchaser has no fiduciary relationship with the issuer and where the information was obtained from and created by a source wholly outside and unrelated to the issuer?⁷⁰

The petition also presented a question concerning the constitutional due process implications of the "Second Circuit's retroactive application of its new and expansive interpretation" of the statutory prohibitions. In addition, Chiarella appealed on issues related to the trial court's jury instruction on the requisite intent for criminal securities fraud and its ruling admitting into evidence Chiarella's signed statement from his NY State application for unemployment benefits.⁷¹

The Solicitor General's Office filed its brief in opposition at the end of March 1979.⁷² Given that the government was opposing a petition from the first person ever sentenced to prison for a Rule 10b-5 insider trading violation, its opposition brief was surprisingly concise. The brief's argument section ran just over seven pages (in contrast to Stanley Arkin's twenty pages of client advocacy). It is likewise surprising that the Second Circuit's "regularly receives" limitation appeared [*25] nowhere in the government's brief. Instead, the brief advanced the broad dictum from the Second Circuit's 1971 *Texas Gulf Sulphur* decision, which observed that "Section 10(b) and

⁶⁶ *Chiarella*, 588 F.2d at 1365 (emphasis added).

⁶⁷ *Id.* at 1366 (emphasis added).

⁶⁸ Langevoort, *supra* note 45, at 846.

⁶⁹ Petition for Writ of Certiorari, *Chiarella v. United States*, No. 78-1202 (filed Feb. 2, 1979), available at http://www.sechistorical.org/collection/papers/1970/1979_0202_Chiarella_Cert_Petition_SupCt.pdf. Arkin's law partner, Mark S. Arisohn, was co-counsel on the certiorari petition, *see id.*, and the Supreme Court litigation, with Arthur T. Cambouris's assistance on the Merits Brief. *Supra* note 50.

⁷⁰ *Id.* at 2.

⁷¹ *Id.*

⁷² Brief for the United States in Opposition to Certiorari, *Chiarella v. United States*, No. 78-1202 (Mar. 29, 1979) (filed by Solicitor General Wade McCree, Assistant Attorney General Philip Heymann, and DOJ Attorneys Sidney Glazer and Sara Criscitelli), available at http://www.sechistorical.org/collection/papers/1970/1979_0329_Chiarella_Opp_Cert_SupCt.pdf

Rule 10b-5 have long been interpreted to protect 'the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.'" ⁷³Had the government's opposition brief tracked more closely the Second Circuit's actual holding in *Chiarella*, which effectively imposed a disclosure duty only on securities market participants and their agents, it is possible that the case would not have garnered the four votes necessary for the Court's grant of certiorari.

2. The Solicitor General's Misappropriation Theory Arguments

Once the Supreme Court granted Chiarella's petition for certiorari in May 1979, ⁷⁴both the intensity and the substance of the government's advocacy changed. This transformation can be attributed to the then-Deputy Solicitor General Frank Easterbrook, who described his "portfolio [as] essentially all miscellaneous civil litigation that included antitrust and securities." ⁷⁵As Judge Easterbrook remembers it, his reaction to the government's equal access argument was that it did not make sense:

What? Huh? How can that possibly be right? . . . I mean if you didn't have a rule that people could trade on different [*26] amounts of information, there's no incentive to collect the information. If there's no incentive to collect the information, markets won't be efficient. So I looked at that, and I said, "This can't possibly be right," and handed the papers off to Steve Shapiro who was then an assistant and who was going to succeed me as the economic deputy in a few months. ⁷⁶

Easterbrook also vividly recalls his office's strategy for proceeding with the case. Notwithstanding its refusal to defend Chiarella's conviction on any type of equal access grounds, Easterbrook felt strongly that an argument based on property rights could be successful:

[W]e were willing to defend the conviction on a different argument,. . . which was that information about what transactions you were going to engage in, in securities markets, is property. Everybody understands that copyrights and patents and other trade secrets and trademarks and so on are species of property. Well, there's absolutely no reason why a bidder in a case like this couldn't have property rights in information. . . .

So Steve and I proposed [an argument based on] a misappropriation of property rights. . . . And all you need was fraud in connection with the purchase or sale of securities. There was the necessary connection, . . . This was fraud, and that could be the basis of a conviction...

So there we were. We took that as the line, and the case was briefed during [*27] the period just as I was about to go out the door and hand the case over to Steve. But Steve and I worked on the brief together, and I then vamoosed. I think Steve argued the case himself when the time came. . . . ⁷⁷

More recently, in a tribute to Stephen Shapiro's legacy, Easterbrook described the *Chiarella* brief's misappropriation approach as playing "the long game." ⁷⁸And indeed it was a long game, as the Court waited

⁷³ *Id.* at 5 (quoting *Texas Gulf Sulphur*, 401 F.2d at 847-48).

⁷⁴ *Chiarella v. United States*, 441 U.S. 942 (cert. granted, May 14, 1979).

⁷⁵ Dr. Kenneth Durr, *Oral History--The Honorable Frank Easterbrook* at 5, SEC HISTORICAL SOCIETY (Jan.13, 2011), http://www.sechistorical.org/collection/oral-histories/20110113_Easterbrook_Frank_T.pdf.

⁷⁶ *Id.* at 13.

⁷⁷ *Id.* at 14-16.

⁷⁸ Kathy Agonis, *Steve Shapiro's Legacy in the Courtroom and Beyond*, THE CIRCUIT RIDER at 5 (Nov. 2018) (discussing Judge Easterbrook's recollections regarding the merit briefs and oral argument in *Chiarella*).

more than 17 years to rule on the validity of an insider trading theory rooted in a defendant's misappropriation of property:

But [the Court] never came to a conclusion on [the misappropriation theory] because . . . [the Court] didn't think it had been preserved. . . . So nothing could happen on that because Steve and I had made it up, no getting around that, sorry. ⁷⁹

To be sure, the government brief's misappropriation approach tracked one of the Rule 10b-5 liability theories advanced by Judge Owen, when he denied Chiarella's motion to dismiss the indictment, ⁸⁰as well as the "stolen goods" analogy suggested in Commissioner Smith's *Investment Management* [*28] concurrence. ⁸¹But Judge Easterbrook can rightly lay claim to the development of a property-rights rationale that justifies reading Section 10(b) and Rule 10b-5 to prohibit the use of misappropriated information in securities transactions. ⁸²Although several securities law scholars continue to advance the Easterbrook view that property-rights protection offers the most convincing policy justification for a federal insider trading prohibition, ⁸³others (including myself) bolster our readings of the statutory text with policy arguments instead directed at fostering market integrity and promoting investor confidence in the securities markets. ⁸⁴

The arguments in the Solicitor General's brief in *Chiarella* ultimately resulted from a collaborative effort. The SEC's Principal Associate General Counsel Paul Gonson worked closely with Shapiro and Deputy Solicitor [*29] General Kenneth Geller to develop an initial draft. ⁸⁵Shapiro also sought input from AUSA John Siffert and included him with the SG's attorneys on the brief. Shapiro, who subsequently founded and led the Mayer Brown law firm's appellate practice group, is remembered as a brilliant and inspirational attorney, whose generosity of spirit ensured a place for Gonson and Siffert at the government's counsel table at the Supreme Court oral argument. ⁸⁶

Due in large part to Shapiro's ingenuity, the government's brief advanced two distinct versions of a Rule 10b-5 misappropriation theory. That is, the government argued that Chiarella had "committed fraud against both the

⁷⁹ *Oral History*--The Honorable Frank Easterbrook, *supra* note 75, at 16; see *infra* note 122 and accompanying text (discussing the Court's 1997 decision in *United States v. O'Hagan*).

⁸⁰ See *supra* note 51 and accompanying text (quoting Judge Owen's holding that the indictment stated a claim that Chiarella defrauded "the acquiring corporations whose plans and information he took while he was setting them in type").

⁸¹ See *supra* note 47 and accompanying text. Prior to *Investment Management*, courts in insider-trading claims brought under state law had also begun to recognize a corporation's property interest in its own material nonpublic information. See, e.g., *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498 (1969) (holding that "a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation").

⁸² See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. CT. REV. (1981).

⁸³ See, e.g., JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* (1991); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995).

⁸⁴ See Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1264-70 (1998) (discussing the competing rationales for the federal insider-trading prohibition).

⁸⁵ Telephone Interview with Paul Gonson, SEC Solicitor 1979-1999 (Aug.19, 2019).

⁸⁶ Telephone interview with Siffert, *supra* note 33; Telephone interview with Gonson, *supra* note 85.

acquiring corporations whose information he converted *and* the investors who sold him securities in ignorance of forthcoming market events of critical importance."⁸⁷Specifically, the government contended that Chiarella's "secret conversion of confidential information operated as a fraud on the corporation that entrusted him with that information"⁸⁸and also that his "purchases of securities based on material nonpublic information obtained by misappropriation constituted fraud on the sellers of those securities."⁸⁹The support for this second argument, which grounded the Rule 10b-5 disclosure duty in wrongfully obtained informational asymmetries, was drawn from the common law, and in particular from the English case of *Phillips v. Homfray*.⁹⁰That 1871 English decision discarded the *caveat emptor* principle when the [*30] purchaser in a real estate transaction had obtained his informational advantage through an unlawful trespass on the seller's land.⁹¹The government's brief also provided an economic basis for the recognition of a common law disclosure duty in instances involving wrongfully acquired information.⁹²

The Second Circuit's "regular access" approach to insider trading liability was thus essentially orphaned at this critical stage of the *Chiarella* litigation.⁹³Indeed, the government's brief expressly sided with the Securities Industry Association's *amicus curiae* concern that a liability focus on persons who regularly receive material nonpublic information might be misconstrued to suggest that "mere possession . . .of confidential market information precludes market professionals (such as market makers, specialists, arbitrageurs, and block traders) from carrying on their normal business activities."⁹⁴And that government-SIA alliance left the Court without an advocate "pointing out the consequences of [a] 'fiduciary duty only' test" and pushing for an alternative theory of liability based on one's structural access to material, nonpublic information.⁹⁵

[*21] 3. Chiarella's Reply Brief

In his client's reply brief, Stanley Arkin called out the government for adopting "a new theory" that effectively "abandoned" the "regular access to market information" basis on which the Second Circuit affirmed Chiarella's conviction.⁹⁶And in Arkin's view, that Second Circuit "regular access" approach was itself an implicit rejection of what he contended was the district court's reasoning that "Chiarella was under the same duty as a classic 'insider' to disclose material, nonpublic information to selling stockholders."⁹⁷After setting out arguments addressed to the merits of each of the government's misappropriation theories (namely, the fraud-on-the-source theory lacked the requisite "in connection with" nexus to a securities transaction, and the fraud-on-investors theory lacked adequate precedent),⁹⁸the reply brief argued that the government's proposed new interpretation of

⁸⁷ *Chiarella* Government Brief, *supra* note 9, at 24 (emphasis added).

⁸⁸ *Id.* at 28.

⁸⁹ *Id.* at 38-39.

⁹⁰ 6 Ch. App. 770 (Eng. 1871).

⁹¹ *Chiarella* Government Brief, *supra* note 9, at 41 (citing *Phillips v. Homfray*, 6 Ch. App. 770 (Eng. 1871)).

⁹² *Id.* at 42 (citing Anthony Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEG. STUD. 1, 9 (1978)).

⁹³ See Langevoort, *supra* note 45, at 847 (observing that the government "essentially bet all the marbles on treating Chiarella's behavior as a misappropriation, and hence a fraud").

⁹⁴ *Chiarella* Government Brief, *supra* note 9, at 70-71 n. 48 (discussing Brief *Amicus Curiae* of the Securities Industry Association, *Chiarella v. United States*, filed June 29, 1979).

⁹⁵ Langevoort, *supra* note 45, at 847.

⁹⁶ Petitioner's Reply Brief at 2 (filed Oct. 31, 1979), *Chiarella v. United States*, 445 U.S. 222 (1980).

⁹⁷ *Id.*

Rule 10b-5 "cannot be employed to uphold these convictions,' because the jury that convicted Chiarella was never charged that it must find facts now essential."⁹⁹Specifically, the reply contended that "there was no charge about a failure to disclose to the offeror corporation (the non-disclosure charge given had to do with the selling shareholders); nor was there a charge requiring a finding that Chiarella tortiously acquired his information."¹⁰⁰

[*32] 4. The Oral Arguments Before the Supreme Court

The Supreme Court heard oral arguments in the *Chiarella* case on November 5, 1979, and Arkin and Shapiro each made masterful presentations that were punctuated by the justices' probing questions.¹⁰¹Underscoring the arguments set out in their merit briefs, Arkin emphasized that Chiarella bore "no fiduciary relation to [any] prospective seller" of target stock.¹⁰²Shapiro, in turn, highlighted that Chiarella's "use of converted non-public market information to enrich himself in the stock market without disclosure to anyone was a deceptive device within the prohibition of the statute and the rule."¹⁰³

In the course of the questioning, Chief Justice Burger lodged hypotheticals at Arkin concerning securities trading on the basis of misappropriated information by court-house personnel including a judge's secretary and a court's bailiff.¹⁰⁴It is likely that Burger had in mind a "leaking" scandal in the Court's own print shop just seven months prior, involving a typesetter who was reportedly fired for sharing with a journalist "premature word of court decisions."¹⁰⁵

[*33] The oral argument also gave Justice Powell the opportunity to foreshadow his subsequent tipper/tippee liability ruling in *Dirks v. SEC*.¹⁰⁶Powell asked Shapiro about the Rule 10b-5 liability consequences for an investment analyst who advises his client to buy an issuer's securities after having paid "a visit to a corporation [to] obtain[] more current estimates for the year than are available generally."¹⁰⁷That securities-analysts colloquy continued for several minutes with Justice Rehnquist interjecting questions as well. Justice Powell emphatically rejected Shapiro's suggestion that investment research fits within a conventional tipper/tippee paradigm, observing

⁹⁸ *Id.* at 1-9.

⁹⁹ *Id.* at 10 (quoting *Rewis v. United States*, 401 U.S. 808, 814 (1971)).

¹⁰⁰ *Id.* (citing trial court's jury instructions).

¹⁰¹ Oral Argument, *Chiarella v. United States*, 445 U.S. 222 (1980) (No. 78-1202), Oyez, <https://www.oyez.org/cases/1979/78-1202> (hereinafter *Chiarella* Oral Argument).

¹⁰² *Id.* at 00:01:00-15.

¹⁰³ *Id.* at 00:33:17-30.

¹⁰⁴ *Id.* at 00:16:05-12.

¹⁰⁵ Richard Carelli, *Burger Fires Printing Aide After News Leak*, WASH. POST, Apr. 25, 1979 at A4 (referencing "a stormy confrontation in Burger's chambers, during which Burger accused the employee of 'leaking' information" to [an] ABC correspondent"). Notably, in his *Chiarella* dissent, the Chief Justice contended that "Congress cannot have intended one standard of fair dealing for 'white collar' insiders and another for the 'blue collar' level." *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J. dissenting). As reflected in correspondence with one of his law clerks, Justice Harry Blackmun was "not sure [he] like[d] the blue-collar/white collar comment" in Burger's dissent and "suspected this comes rather close to [the Chief's] justified annoyance at the several leaks that have taken place with respect to the Court's work on several occasions. . .". See Memorandum from Justice Harry Blackmun to Mark Rahdert re: *Chiarella v. United States* (Feb. 4, 1980), available at http://www.sechistorical.org/collection/papers/1980/1980_0204_BlackmunDecision.pdf.

¹⁰⁶ 463 U.S. 646 (1983).

¹⁰⁷ *Chiarella* Oral Argument *supra* note 101, at 00:44:23-40.

that "corporate executives . . . talk about [their] company all the time" and that "[t]he country is full of analysts and investment advisers who try to understand what is going on in corporations." ¹⁰⁸

C. The *Chiarella* Decision and Its Aftermath

1. The Supreme Court's Opinion

At this point the *Chiarella* story becomes familiar again, although several new observations are warranted. In place of what Justice Powell categorized as the Second [*34] Circuit's "equal access" approach to insider trading liability, the Court entrenched what came to be known as the "classical theory." ¹⁰⁹As Arkin's merits brief had urged, the majority construed insider trading liability under Section 10(b) and Rule 10b-5 to turn on the breach of "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." ¹¹⁰Accordingly, Chiarella's conviction had to be vacated because he had "no prior dealings" with the shareholders whose stock he purchased. As the Court emphasized, "[h]e was not their agent, he was not a fiduciary, [and he was] in fact a complete stranger who dealt with the sellers only through impersonal market transactions." ¹¹¹Powell's approach in *Chiarella* was no doubt fueled by his own legal experience with counseling corporate officials and his particular "distaste for the abuse of trust of insider trading." ¹¹²But it is also clear that the fiduciary limitation emphasized by Arkin in his brief and at oral argument readily provided a doctrinal pathway that allowed the Court to announce a broad prohibition of [*35] insider trading by officers, directors, and other agents of an issuing corporation (as well as their tippees) while allowing Chiarella to trade with impunity. ¹¹³

The *Chiarella* majority also did not rule on the validity of either of the government's misappropriation theories because, as Arkin had urged, it concluded that neither theory had been properly presented to the jury as an independent basis for finding a Rule 10b-5 violation. ¹¹⁴A misappropriation theory alternative, however, was discussed by five justices in separate concurring or dissenting opinions, four of whom agreed with the government

¹⁰⁸ *Id.* at 00:47:12-36.

¹⁰⁹ *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

¹¹⁰ *Id.* at 229. As Stanley Arkin had suggested in Petitioner's Merits Brief, *see supra* note 50, Justice Powell's majority opinion invoked the fiduciary-based exception in § 551(2)(a) of the Restatement 2nd of Torts--with no reference to any of the other four common law bases for recognizing affirmative disclosure obligations in business transactions. *See Chiarella*, 445 U.S. at 228. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 Iowa L. Rev. 1315, 1325 (2009) (calling attention to Justice Blackmun's observation that the fifth exception in the Restatement "would have supported a disclosure duty 'where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair'" (quoting *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting.))

¹¹¹ *Chiarella*, 445 U.S. at 233.

¹¹² A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L. J. 841, 947 (2003).

¹¹³ A.C. Pritchard & Robert B. Thompson, *Securities Law in the Sixties: The Supreme Court, the Second Circuit, and the Triumph of Purpose over Text*, 94 NOTRE DAME L. REV. 371, 402-03 (2018) (observing that Powell seized upon "traditional notions of fiduciary duty as [a] doctrinal tool to confine the SEC's aggressive interpretations").

¹¹⁴ *Chiarella*, 445 U.S. at 229.

that persons who unlawfully misappropriate information owe a disclosure duty to the investors with whom they trade.¹¹⁵

It was Chief Justice Burger's dissenting opinion in *Chiarella* that most clearly elucidated a broad "fraud-on-investors" misappropriation theory. He opined that:

[*36] As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. This rule 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. But the policies that underlie the rule should also limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.¹¹⁶

To support his view of the requirements at common law, Chief Justice Burger quoted or cited many of the Government brief's primary sources.¹¹⁷ Maintaining that the district court's instructions to the jury charged "misappropriation with sufficient precision," Burger concluded that *Chiarella* owed the target shareholders a duty to disclose or to refrain from trading by virtue of the fact that he "misappropriated--stole to put it bluntly--valuable nonpublic information entrusted to him in the utmost confidence."¹¹⁸ This disclosure duty would therefore apply regardless of whether the misappropriator stood in a relationship of trust and confidence with the information's source.

The fifth member of the Court inclined toward a misappropriation approach was Justice John Paul Stevens, who favored instead the government's "fraud-on-the-source" theory. He maintained that "[r]espectable arguments could be made" that *Chiarella*'s action [*37] constituted a fraud on the acquiring companies that entrusted confidential tender offer information to his employer, and that this deception occurred "in connection with the purchase or sale of any security."¹¹⁹ Justice Stevens's concurring opinion, and the favorable statements he made during the *Chiarella* oral argument,¹²⁰ thus provided support for a narrower approach that would predicate the Rule 10b-5 fraud on a fiduciary's secret self-serving use of information belonging to a principal. Justice Stevens deemed the Court wise for "leav[ing] the resolution of this issue for another day."¹²¹ That day came in 1997 when the Court decided *United States v. O'Hagan*,¹²² a criminal insider trading action against a law firm partner who had purchased target-company stock based on confidential information that he misappropriated from his firm and its acquiring-company client. With a six justice majority, the *O'Hagan* Court resoundingly endorsed a fraud-on-the-source misappropriation theory, with a fiduciary principle at its core.

¹¹⁵ See *id.* at 238-39 (Brennan, J., concurring in the judgment) (endorsing a broad misappropriation theory, but agreeing with the majority that misappropriation instructions had not been presented to the jury); *id.* at 239-43 (Burger, C.J., dissenting) (endorsing a broad version of the misappropriation theory and contending that the theory was properly presented to the jury); *id.* at 245-46 (Blackmun, J., joined by Marshall, J., dissenting) (endorsing an equal access approach--citing Victor Brudney, *Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979) but noting that *Chiarella*'s trading on misappropriated confidential information "is the most dramatic evidence that [he] was guilty of fraud").

¹¹⁶ *Id.* at 239-40.

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 245.

¹¹⁹ *Chiarella*, 445 U.S. at 238 (Stevens, J. concurring).

¹²⁰ *Chiarella* Oral Argument, *supra* note 101, at 00:49:15-35.

¹²¹ *Chiarella*, 445 U.S. at 238 (Stevens, J. concurring).

¹²² 521 U.S. 642 (1997).

2. The SEC's Response to the *Chiarella* Decision

Despite their disappointment with the Court's decision to reverse *Chiarella*'s conviction, SEC officials, particularly those in the Office of the General Counsel, found much to like in Justice Powell's majority opinion. They were especially gratified by the Court's strong endorsement of *In re Cady Roberts*, the SEC's 1961 decision in an administrative proceeding against a broker who had purchased stock based on material nonpublic information relayed to him by a director of the issuing corporation.¹²³ They were likewise encouraged by the [*38] Court's willingness to uphold the Second Circuit's reasoning in *Texas Gulf Sulphur*, at least insofar as it applied to traditional insiders, who owe duties of trust and confidence to the corporation's shareholders.¹²⁴ SEC officials were also heartened with the majority's determination to leave open the validity of both misappropriation theories that the government had raised in its brief.¹²⁵

Notwithstanding those bright spots in the *Chiarella* opinion, SEC officials also perceived some disquiet from the justices over the fact that neither Congress nor the SEC had expressly prohibited insider trading through lawmaking or rulemaking. Indeed, Justice Powell included in his opinion an ominous footnote questioning whether any broader approach to insider trading liability would give "either criminal or civil defendants . . . fair notice that they have engaged in illegal activity."¹²⁶ Ralph Ferrara, the SEC's General Counsel, determined that the timing was right to swiftly move forward with a rulemaking solution that would provide securities traders with helpful clarity while strengthening the SEC's ability to react to future trading abuses by outsider traders like *Chiarella*.¹²⁷

SEC Associate General Counsel Robert Pozen and Special Counsel Donald Langevoort thereafter worked with Ferrara to propose the Commission expressly adopt an insider trading rule. The rule would not only build upon the precedents in *Cady Roberts*, *Texas Gulf Sulphur*,¹²⁸ and *Chiarella*, but would also incorporate the two misappropriation theories that were outlined in Justice Stevens and Chief Justice Burger's opinions. The result was unofficially dubbed "Rule 10b-X," a trifurcated rule that would prohibit securities trading while in possession of material nonpublic information: (1) in breach of a duty of trust and confidence that is owed to the securities issuer or its shareholders; (2) in breach of a duty of trust and confidence that is owed to the source of the material nonpublic information; or (3) in breach of a disclosure duty that is owed to traders on the other side of a transaction because the information was obtained through fraud, deception, or other unlawful means.¹²⁸ The proposed rule would likewise have prohibited such persons from advising others respecting the purchase or sale of securities.

Rule 10b-X, however, never made it past the Commission-proposal stage. The Office of the General Counsel proposed the rule for Commission action in early May 1980--less than two months after the Court's *Chiarella* decision.¹²⁹ But the Enforcement Division offered its own proposal, and the Divisions of Corporation Finance, Investment Management, and Market Regulation jointly proposed to the Commission a third alternative. The Commission instead determined to move forward with a broad insider trading prohibition that applied only in the context of material nonpublic information pertaining to a tender offer. That prohibition, drafted initially by the Division

¹²³ *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

¹²⁴ Telephone Interview with Donald Langevoort, Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center (Sept. 5, 2019).

¹²⁵ Gonson telephone interview, *supra* note 85.

¹²⁶ *Chiarella*, 445 U.S. at 235 n. 20.

¹²⁷ Interview with Ralph Ferrara, Partner, Proskauer Rose LLP (Nov. 18, 2019); Donna Nagy, *Oral History--Professor Donald Langevoort* at 25-26, SEC HISTORICAL SOCIETY (Feb. 11, 2020), http://www.sechistorical.org/collection/oral-histories/OralHistories_DonLangevoort_T.pdf.

¹²⁸ *Id.*

¹²⁹ *Id.*

of Corporation Finance and ultimately codified as Rule 14e-3, had been in the works for many years,¹³⁰ and was published for public comment six months prior to the [*40] *Chiarella* decision.¹³¹ Getting Rule 14e-3 to the finish line became the SEC's top insider-trading rulemaking priority, and several months later the Commission voted to adopt the rule.¹³² Nearly twenty years elapsed before the SEC would again take up rulemaking in the area of insider trading--with projects far more limited in scope.¹³³

3. The Fate of the Dual Misappropriation Theories

With four justices supporting a broad fraud-on-investors version of the misappropriation theory, and only one justice endorsing the narrower fraud-on-the-source version, the broader approach was arguably the one better positioned for judicial acceptance. But like SEC rulemaking in the wake of the *Chiarella* decision, the narrower approach was the one that advanced, first in dozens of lower court civil and criminal cases beginning with *United States v. Newman*,¹³⁴ and then in 1997 before the Supreme Court in *O'Hagan*.¹³⁵ The why and the how constitutes the final part of this *Chiarella* story.

The tipping and trading activity in *Newman* provided the first post-*Chiarella* opportunity to seek a court ruling in a misappropriation case against outsiders [*41] who did not owe duties of trust and confidence to the issuing corporation's shareholders. Prior to the indictment's presentation to the grand jury in February 1981, AUSA Lee Richards sought input from the SEC.¹³⁶ With assistance from SEC Special Counsel Donald Langevoort, Richards crafted an indictment that included explicit misappropriation charges against Jacques Courtois and Adrian Antoniu, the investment bankers who had tipped confidential takeover related information to several trading co-conspirators, including James Mitchell Newman, a securities broker.¹³⁷ Using Justice Stevens's concurrence in *Chiarella* as a guide, Richards also took care to explicitly reference the duties of trust and confidence that Courtois and Antoniu owed to their respective employers, Morgan Stanley and Kuhn, Loeb, as well as to categorize the investment bankers' tipping and Newman's trading as a Rule 10b-5 fraud against their firms and their firms' acquiring-company clients.¹³⁸ Chief Justice Burger's fraud-on-investors misappropriation theory, however, "was deliberately not pursued in *Newman*" principally because "[i]t was considered too confusing to present to the jury in tandem with the fraud on the source theory."¹³⁹ Not only was the fraud-on-the-source theory deemed the simpler of the two to explain, it was also favored by Richards because it retained *Chiarella*'s focus on fiduciary disclosure duties and could be supported with a battery of related precedents from mail and wire fraud prosecutions.¹⁴⁰ [*42] After the Second Circuit upheld the indictment in its 1981 ruling (the indictment

¹³⁰ John Huber, *Oral History--Richard Rowe* at 33-34, SEC HISTORICAL SOCIETY (May 24, 2004), <http://www.sechistorical.org/collection/oral-histories/rowe052404Tanscript.pdf>.

¹³¹ Exchange Act Release No. 34-16385, 44 Fed. Reg. 70349 (Nov. 19, 1979).

¹³² Adoption of Rule 14e-3, Exchange Act Release No. 34-17120, 45 Fed. Reg. 60410 (September 4, 1980).

¹³³ See Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,319, at 83,692 (Aug. 15, 2000) (adopting Rule 10b5-1's affirmative defenses for pre-existing trading plans and Rule 10b5-2's enumeration of circumstances that qualify for the fraud-on-the-source misappropriation theory).

¹³⁴ 664 F.2d 12 (2d Cir. 1981).

¹³⁵ See *supra* note 122 and accompanying text.

¹³⁶ Telephone interview with Lee S. Richards III, co-founding partner, Richards Kibbe & Orbe LLP (Feb. 14, 2020).

¹³⁷ *United States v. Courtois et al.* Indictment (S 81 Cr. 53, Feb. 1981), available at http://www.sechistorical.org/collection/papers/1980/1981_0101_Newman_Indictment.pdf.

¹³⁸ *Id.*

¹³⁹ Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 883 (1995).

charged violations of the mail fraud and conspiracy statutes, in addition to Rule 10b-5),¹⁴¹ the case proceeded to a five-week trial, and Richards successfully obtained convictions against all of the *Newman* defendants who had not previously pled guilty.¹⁴²

To be sure, *Newman's* (and, years later, *O'Hagan's*) fraud-on-the-source misappropriation approach to Rule 10b-5 liability plugged many of the gaping holes left open by the classical theory articulated by Justice Powell in *Chiarella*. But the fraud-on-the-source theory leaves substantial gaps of its own that would be filled with a broader misappropriation theory recognizing disclosure duties owed to opposite-side traders when information has been improperly obtained. For instance, if the government in *O'Hagan* had set out to play "the long game" by advancing Chief Justice Burger's theory alongside of its fiduciary-focused fraud-on-the source misappropriation theory, the Deputy Solicitor General's oral argument would not have conceded Rule 10b-5's inability to reach a non-fiduciary thief who "stole [a] lawyer's briefcase" and traded securities on its confidential information.¹⁴³ Nor would [*43] federal courts today have to expand fiduciary principles almost beyond recognition to prevent other misappropriators and their tippees from being unjustly enriched from their knowing use of wrongfully obtained information.¹⁴⁴ Viewing contemporaneous traders as the actual parties defrauded by a misappropriator's deception also avoids the perception that the fraud-on-the-source theory is merely a pretext for employing the *Chiarella*-rejected equal access approach.¹⁴⁵

[*44] Had circumstances been otherwise, the SEC may well have championed a broader misappropriation theory in its own civil insider trading actions. But in the initial aftermath of *Chiarella*, the SEC's outsider-trading misappropriation cases were settled rather than litigated, as civil insider trading actions were apt to do,

¹⁴⁰ Richards telephone interview, *supra* note 136.

¹⁴¹ See *United States v. Newman*, 664 F.2d 12, 14 (2d. Cir 1981).

¹⁴² JAMES B. STEWART, *THE PROSECUTORS* 134-83 (1987) (recounting the SDNY's investigation and prosecution of "insider trading at Morgan Stanley"). The district court's post-conviction rulings were affirmed on appeal, 722 F.2d 729 (2d Cir. 1983), and the Supreme Court denied certiorari. See *Newman v. United States*, 464 U.S. 683 (1983) (referencing statement from Justice Powell that he would have granted certiorari),

¹⁴³ Oral Argument at 00:03:10-20, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), <https://www.oyez.org/cases/1996/96-842> (last visited Mar 3, 2020) at 00:03:10-20 (hypothetical question posed by Justice Sandra O'Connor). Cf. *SEC v. Dorozhko*, 574 F.3d 42, 51 (2d Cir. 2009) (distinguishing between a Rule 10b-5 insider trading claim involving active deception such as "misrepresenting one's identity in order to gain access to information that is otherwise off limits," from one involving "mere theft" such as exploiting a weakness in an electronic code to gain unauthorized access into a computer).

¹⁴⁴ See Nagy, *supra* note 110, at 1340-48 (discussing the "growing number of courts [that] simply disregard [the Supreme Court's] fiduciary dictate when it forecloses liability against a defendant who has traded securities based on wrongfully acquired information").

¹⁴⁵ See *id.* at 1375 (discussing scholarly criticism directed at *O'Hagan's* misappropriation theory). The government's brief in *O'Hagan* made no mention of an alternative misappropriation theory--a fact noted in Justice Ginsburg's majority opinion. *O'Hagan*, 521 U.S. at 655 n. 6 (referencing the Burger approach and observing that "[t]he Government does not propose that we adopt a misappropriation theory of that breadth"). But "the long game" does appear to have been in mind a decade earlier in *Carpenter v. United States*, 484 U.S. 19 (1987), an insider trading and tipping case prosecuted on the theory that a *Wall Street Journal* reporter's misappropriation of information from his forthcoming columns deceived and defrauded his newspaper-employer within the meaning of Rule 10b-5. In a footnote in its merit brief in *Carpenter*, the government set out what it described as "Chief Justice Burger's legal theory" and argued that because "the government plainly alleged and proved" the secret fraudulent use of the information misappropriated from the *Journal*, it was unnecessary "for the indictment to explicate the legal theory that such conduct violates the securities laws because of its effect on other investors and the integrity of the market." Brief for the United States, *Carpenter v. United States* (No. 86-422) at n.40. While the Court was unanimous in upholding the defendants' convictions for mail and wire fraud, the Court was "evenly divided" (4-4) on the defendants' Rule 10b-5 convictions and simply "affirm[ed] the judgment below on those counts." *Carpenter*, 484 U.S. at 52.

¹⁴⁶particularly at a time when the SEC lacked statutory authority to seek court-ordered monetary penalties. ¹⁴⁷The SEC did, however, concisely reference the broader misappropriation theory in the *amicus* brief it filed in support of the government in *Newman*. ¹⁴⁸It then, once again as an *amicus* in the Second Circuit, set out a full-throttled argument in *Moss v. Morgan Stanley*, ¹⁴⁹a Rule 10b-5 private action by an investor who had unwittingly sold target stock at the same time that Newman was purchasing that stock based on the confidential takeover information that Courtois and Antoniu had misappropriated. ¹⁵⁰The SEC's *amicus* brief supported the plaintiff's entitlement to damages and urged **[*45]** acceptance of the fraud-on-investors misappropriation theory "left open" in *Chiarella*. ¹⁵¹But the appellate court upheld the district court's order dismissing the case, concluding that the selling shareholder had not been deceived and defrauded by the defendants because, under the majority opinion in *Chiarella*, "defendants owed no duty of disclosure to plaintiff Moss." ¹⁵²Although Congress effectively overturned that result a few years later by amending the Exchange Act to provide contemporaneous traders, in both classical and misappropriation theory cases, with an express right of action under Section 20A, ¹⁵³ *Moss's* holding that shareholders are not owed a disclosure duty by an outsider trading on misappropriated information continued to be cited with approval. ¹⁵⁴After the SEC's **[*46]** *amicus* loss in *Moss*, and against the backdrop of several litigation fraud-on-the-source victories--beginning with *SEC v. Materia* (involving yet another printer-employee misappropriation), ¹⁵⁵the SEC's prior allegiance to the broader misappropriation theory soon faded away.

Because the Supreme Court has never been asked directly to rule upon the validity of Chief Justice Burger's misappropriation approach to insider trading liability, the theory is technically "left open" to this day. But while lower federal courts can still broaden their reading of the common law in Rule 10b-5 cases to recognize disclosure obligations in situations involving wrongfully obtained information, the chances that an individual district judge or

¹⁴⁶ See, e.g., *SEC v. Wyman*, Lit. Rel. 9311, 22 SEC Docket 391 (SDNY Feb. 20, 1981) (consent order involving trading in target stock based on information alleged to have been misappropriated by a paralegal at the acquiring company's law firm) (cited in Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 49 (1982)).

¹⁴⁷ See *supra* note 21 and accompanying text.

¹⁴⁸ See Brief for the SEC as *Amicus Curiae* at 26 n. 33, *United States v. Newman* (81-1225) (filed June 29, 1981), available at http://www.sechistorical.org/collection/papers/1980/1981_0629_SEC_Amicus_Curiae_Newman.pdf.

¹⁴⁹ 719 F.2d 5 (2d Cir. 1983).

¹⁵⁰ *Id.*

¹⁵¹ Brief of the Securities Exchange Commission, *Amicus Curiae*, at 1-22, *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983) (No. 83-7120) (filed April 4, 1983), available at 1983 WL 486617.

¹⁵² *Moss*, 719 F.2d at 16.

¹⁵³ 15 U.S.C. § 78u-1.

¹⁵⁴ See *SEC v. Clark*, 915 F.2d 439, 445 n.8 (9th Cir. 1990) (noting that "the Second Circuit correctly rejected Chief Justice Burger's version of the misappropriation theory as contrary to the holdings in *Chiarella* and *Dirks*") (citing *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 16 (2d Cir. 1983)). *But see* *United States v. Carpenter*, 791 F.2d 1024, 1034 (2d Cir. 1986) *aff'd by an equally divided Court*, 484 U.S. 19 (1987). Without so much as mentioning *Moss's* holding three years earlier, the Second Circuit maintained that because the reporter and his tippees breached a duty of confidentiality owed to the *Wall Street Journal*, these defendants "had a corollary duty, which they breached, under section 10(b) and Rule 10b-5, to abstain from trading in securities on the basis of the misappropriated information or to do so only upon making adequate disclosure to those with whom they traded." *Carpenter*, 791 F.2d at 1034 (emphasis added). Because Judge Walter Mansfield sat on both panels and voted with the majority each time, the tension between *Moss's* holding and *Carpenter's* recognition of a "corollary duty" is particularly confounding.

¹⁵⁵ *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984).

appellate court panel would do so is remote. The Court itself declined that opportunity recently in *Salman v. United States*,¹⁵⁶ preferring instead to issue a unanimous decision that only further entrenched its prior classical and misappropriation approaches.¹⁵⁷

The best solution to this quandary would be for lawmakers to enact an explicit insider trading prohibition that would unmoor the offense from its current fraud-based rubric. And Congress is already halfway there: by a landslide vote (410-13) in December 2019, the House of Representatives passed an artfully crafted bill that would prohibit securities trading while a **[*47]** person is aware of "wrongfully obtained" material nonpublic information.¹⁵⁸ But the proposed legislation is logjammed in the Senate--perhaps indefinitely, if past is prologue.¹⁵⁹ Thus, *Chiarella's* indelible impact on insider trading law could well continue for generations to come.

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¹⁵⁶ *Salman v. United States*, 137 S.Ct. 420 (2016) (affirming Rule 10b-5 conviction of a tippee who purchased securities on the basis of information that he knew had been misappropriated from his brother-in-law's investment bank employer and the bank's clients).

¹⁵⁷ See Eric C. Chaffee, *The Supreme Court as Museum Curator: Securities Regulation and the Roberts Court*, 67 CASE W. RES. L. REV. 847, 863 (2018) (lamenting that *Salman* offered the Court an "opportunity to remake federal securities regulation in the area of insider trading, and once again the Court chose to preserve the status quo created by existing precedent"). See also Langevoort, *supra* note 45; Nagy, *supra* notes 84 and 110 (favoring Chief Justice Burger's approach).

¹⁵⁸ Insider Trading Prohibition Act, HR 2534, 116th Cong (introduced by Rep. Jim Himes (D-Conn.) and passed by the US House of Representatives, December 5, 2019).

¹⁵⁹ See *id.* (referred to the US Senate Committee on Banking, Housing, and Urban Affairs on December 9, 2019). HR 2534's language builds from similar legislative efforts in the 1980s, which were ultimately abandoned. See Nagy, *supra* note 110, at 1367-68 (discussing the proposed "Insider Trading Proscriptions Act of 1987," among other unsuccessful attempts at legislative reform).