Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?

Joan K. Martin
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Insider trading, the buying or selling of securities based on an
illegal informational advantage, has increased significantly during

1 See 3 A. Bromberg & L. Lowenfels, Securities Fraud and Commodities Fraud §
7.4(100) (Nov. 1984). “Insider trading,” which has become a term of art in securities law,
denotes prohibited securities trading utilizing material nonpublic information when the
trader has a duty to disclose the information or refrain from trading, whether he is an “in-
side” or a “tippee.” See Dirks v. SEC, 463 U.S. 646, 654-58 (1983); Chiarella v. United
States, 445 U.S. 222, 227-29 & n.12 (1980). Although the prohibition of such trading has its
roots in common law principles governing fraudulent nondisclosure in business transactions,
see infra notes 14-23 and accompanying text, the current parameters of the prohibition and
the delineation of insider and tippee status were developed by administrative and judicial
interpretations of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)
(1982), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1986). See Chiarella,
445 U.S. at 226-30; Diamond v. Oreamuno, 24 N.Y.2d 494, 502, 248 N.E.2d 910,

“Insiders” were traditionally limited to corporate officers, directors, or majority share-
§ 16(b), 15 U.S.C. § 78p(a) (1982). Currently, however, the term applies to individuals in a
position of trust and confidence which provides them with access to material information
not available to the public and intended for corporate purposes only. See Chiarella, 445
U.S. at 228; In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); infra notes 37-56 and
accompanying text (discussion of administrative and judicial expansion of insider status).
“Tippees,” recipients of information from an insider, are forbidden to trade if they know or
have reason to know the insider breached a fiduciary duty in revealing the information for
personal gain. See Dirks, 463 U.S. at 660, 663; 5 A. Jacobs, Litigation and Practice Under
Rule 10b-5 § 164 (1986); infra notes 63-69 and accompanying text. “Information” has been
judicially defined as “material” if there is a substantial likelihood that a reasonable investor
would consider it important in making an investment decision, see T.S.C. Indus., Inc. v.
Northway, Inc., 426 U.S. 438, 449 (1976); Kripke, Rule 10b-5 Liability and “Material”
Facts, 46 N.Y.U. L. Rev. 1061, 1066-70 (1971), and includes both corporate information that
relates to the internal business affairs of a corporation and market information that pertains
to the market for securities rather than the securities’ intrinsic value. See Chiarella, 445
U.S. at 231; Barry, The Economics of Outside Information and Rule 10b-5, 129 U. Pa. L.
the 1980’s with a concomitant increase in the Securities and Exchange Commission’s campaign against such activity. While SEC sanctions against insider trading have met with widespread approval, Supreme Court decisions have limited the SEC’s power to

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2 See The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess. 33 (1984). During the hearings, then SEC Chairman John Shad reported on the increased number of proceedings which have alleged insider trading violations. Id. at 33-34. Commentators have noted the sharp increase in insider trading actions by the SEC since 1970, yet expressed doubts that such trading has been significantly affected, even by successful prosecutions. See 3 A. Bromberg & L. Lowenfels, supra note 1, at § 7.4(144) (Nov. 1994); Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 2, 74-83 (1980); Illegal Insider Trading Seems to Be on Rise: Ethics Issues Muddled, Wall St. J., Mar. 2, 1984, at 1, col. 6.

Recent SEC investigations, which have resulted in criminal indictments, millions of dollars in disgorgement orders, and civil penalties against Wall Street investment banker Dennis Levine and arbitrager Ivan Boesky, underscore SEC determination to pursue those guilty of insider trading. See Stewart & Hertzberg, Fall of Ivan F. Boesky Leads to Broader Probe of Insider Information, Wall St. J., Nov. 17, 1986, at 1, col. 6; Obermaier, Who’s an Insider? What's His Insider?, N.Y.L.J., July 1, 1986, at 2, col. 1. Justice Department officials and SEC spokespeople have stated their determination to continue and to expand investigations based on the Levine and Boesky revelations. See Kilborn, U.S. Said to Issue Subpoenas Linked to Boesky Trading, N.Y. Times, Nov. 17, 1986, at A1, col. 1. As part of its continuing investigation, the SEC has issued numerous subpoenas and instituted actions against others accused of insider trading, including a former senior executive at an investment banking firm who has pleaded guilty to the charges. See Gilpin, Companies Study Insider Violations, N.Y. Times, Feb. 18, 1987, at D7, col. 1; Sterngold, U.S. Expanding Insider Inquiry, Sources Say, N.Y. Times, Feb. 17, 1987, at D1, col. 6. Additionally, individuals, corporations, and a major New York corporate law firm have instituted private actions for damages, relying on information revealed by Boesky. See Yashihashi, Goldman, Kidder Cited in Unocal Insider Suit, N.Y. Times, Apr. 15, 1987, at D1, col. 1; Glaberson, A Wall St. Firm Breaks Ranks, N.Y. Times, Apr. 12, 1987, § 3 (Business), at 1, col. 2; Wise, Class Actions Rising in Boesky Case, N.Y.L.J., Nov. 25, 1986, at 1, col. 2.

2 See, e.g., Eichler v. Berner, 472 U.S. 299, 312-19 (1985) (referring to “egregious” conduct of insiders and need to encourage SEC efforts to deter insider trading); Prokesh, Executives Favor Curbs on “Raiders,” N.Y. Times, Nov. 24, 1986, at D1, col. 1 (business leaders view indictment of Ivan Boesky as beneficial); Arkin, Insider Trading—Distinguishing Unequal Advantage from Fraud, N.Y.L.J., June 19, 1986, at 1, col. 3 (favorable public reaction to SEC campaign). The favorable reaction to the SEC campaign against insider trading is based primarily on traditional notions of fair play, a rationale reinforced by the objective of federal securities legislation to protect investors, and the widely held belief that insider trading is nothing more than a means of cheating innocent investors. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976); W. Painter, The Federal Securities Code and Corporate Disclosure § 244 (1949); ABA COMMITTEE REPORT. The SEC has consistently invoked the unfairness of insider trading in support of its position; the courts and Congress have long endorsed this rationale. See Chiarella, 445 U.S. at 222 (citing
pursue and penalize insider trading by market outsiders and their


Conversely, some commentators argue that insider trading is beneficial to corporate and market efficiency because it dispenses information quickly into the marketplace and provides incentives for corporate managers. See H. MANNE, INSIDER TRADING AND THE STOCK MARKET, 80-83 (1966); Carlton & Fischel, The Regulation of Insider Trading, 35 STAN. L. REV. 857, 866-72 (1983); Dooley, supra note 2, at 72. Professor Manne, whose work has generated wide debate regarding the policy basis for insider trading, further maintains that restricting insider trading ignores objective goals of allocative efficiency, and that investors would be better served by a system which permits stock prices to move toward "true" values. See H. MANNE, supra, at 2-4, 59-75, 99-103. Others have suggested that the SEC program and attendant publicity may reduce investor confidence and that the costs of waging an effective program may outweigh the benefits. See Branson, Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading, 30 EMORY L.J. 263, 300-01 (1981); Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEGAL STUD. 801, 812, 818 (1980).


Notwithstanding these debates, the vast majority of commentators and scholars are agreed that prohibition of insider trading is justified by the need to safeguard the integrity and fairness of the marketplace and to protect private investors. See Brudney, supra, at 355-56; Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 627-643 (1984); Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5, 54 S. CAL. L. REV. 1217, 1248, 1321 (1981).

* "Outsiders" are those who gain access to material nonpublic information although they have no direct or temporary relationship to the corporate issuer or stockholders whose stock is traded. See Aldave, Misappropriation: A General Theory for Trading on Nonpublic Information, 13 HOFSTRA L. REV. 101, 112 (1984).
The Court has held that section 10(b) of the Securities Exchange Act of 1934, the statutory basis for the prohibition of insider trading, is ingrained with common law fraud principles. Consequently, the Court has barred any expansion of SEC Rule 10b-5, the regulation that activates the anti-fraud provisions of

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Footnotes:

5 See Chiarella, 445 U.S. 222, 231-35 (1980). The Chiarella Court held that a market outsider, who had no fiduciary relationship with the shareholders from whom he purchased stock, had not violated section 10(b) or Rule 10b-5 since he did not have a duty to disclose before trading. See id.; infra notes 57-62 and accompanying text. Three years later, in Dirks v. SEC, 463 U.S. 646 (1983), the Court held that a tippee violates section 10(b) and Rule 10b-5 only if the insider breached a fiduciary obligation for personal gain and if the tippee knew or had reason to know of the breach. See Dirks, 463 U.S. at 660-63; infra notes 63-69 and accompanying text.


> 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.

7 See Chiarella, 445 U.S. at 227-30. The Chiarella Court relied on the statutory language and the legislative, administrative, and judicial history of section 10(b) and Rule 10b-5 for its finding that violations must be predicated on the common law requirement of a breach of the duty to disclose or refrain from trading arising from a fiduciary relationship. See id. at 231-35. The Court later reaffirmed this holding in Dirks, 463 U.S. at 654.

In previous cases, when considering elements necessary for section 10(b) violations, the Supreme Court consistently assumed that the traditional elements of the common law action for fraudulent nondisclosure must be met. The Court stated that mere internal corporate mismanagement does not constitute the fraud necessary for a violation of section 10(b). See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971). Subsequently, the Court delineated the common law deceit elements of materiality, causation, and reliance as they apply in a private cause of action pursuant to a section 10(b) violation. See Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972). Moreover, the Court emphasized the need to establish scienter and manipulation or deception during the breach of a fiduciary relationship as requisites to liability under section 10(b) and Rule 10b-5. See Aaron v. SEC, 446 U.S. 680, 701-02 (1980) (allegation of scienter necessary for SEC civil action); Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977) (fraud claim lies if alleged conduct viewable as manipulative or deceptive); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). See also Anderson, Fraud, Fiduciaries and Insider Trading, 10 Hofstra L. Rev. 341, 342-51 (1982) (discussing Court’s imposition of common law misrepresentation requirements for violation of section 10(b) and Rule 10b-5).

8 17 C.F.R. § 240.10b-5 (1986). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
section 10(b), beyond its statutory mandate. In particular, the Supreme Court has stated that for nondisclosure of information in securities transactions to constitute fraudulent misrepresentation, a relationship of trust and confidence must exist before either a duty to disclose the information or abstain from trading arises. In response to these restrictions on Rule 10b-5, the SEC and the Second Circuit have advocated a misappropriation of information theory. Under this theory, an employee breaches the fiduciary duty of confidentiality to the employer by converting material nonpublic information for private use in securities market trading and thereby commits the requisite fraud for a Rule 10b-5 violation. The Second Circuit has recently extended the theory to encompass the misappropriation of information from an employer who had no interest in the securities market.

This Note will address the conflict between the Second Circuit and the Supreme Court with respect to Rule 10b-5 liability. First, the common law governing fraudulent nondisclosure will be discussed, together with the administrative and judicial movement away from common law principles after the promulgation of Rule 10b-5. The Supreme Court's affirmance of the common law basis of section 10(b) will be presented as a logical outgrowth of previous

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

See Chiarella, 445 U.S. at 234-35; Ernst & Ernst, 425 U.S. at 213-14; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring). While noting that "administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)," the Chiarella Court stressed that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Chiarella, 445 U.S. at 230.


See Carpenter, 791 F.2d at 1034; Materia, 745 F.2d at 199; Newman, 664 F.2d at 15-16; infra notes 78-97 and accompanying text (discussion of these cases).

See Carpenter, 791 F.2d at 1028-29 (discussed infra notes 90-97 and accompanying text).
case law. The origins and development of the misappropriation theory will be evaluated in light of both the Supreme Court restrictions on Rule 10b-5 liability and the general objectives of securities anti-fraud legislation. Finally, this Note will suggest that current application of the theory by the Second Circuit does not comport with Supreme Court guidelines or effectuate the major objectives of the securities laws.

**Common Law Nondisclosure and Fiduciary Principles**

Prior to the enactment of federal securities legislation, the common law action for deceit had evolved as the appropriate remedy for fraudulent misrepresentation. However, it was generally unavailable for the nondisclosure of material information in business transactions. Such nondisclosure was actionable only when a fiduciary relationship existed that imposed a duty to speak upon

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14 See 5 A. Jacobs, *supra* note 1, § 2.01(a) (remedy for misrepresentation limited to deceit or rescission action); W. Prosser & W. Keeton, *The Law of Torts* § 105, at 728 (5th ed. 1984) (deceit action is common law remedy for misrepresentation); Winfield, *Province of the Law of Tort* 13-14 (1931) (same). In a deceit action, the plaintiff must prove that the defendant falsely represented a material fact with the knowledge of its falsity (scienter), and with an intention to induce plaintiff to act or refrain from acting in reliance on the misrepresentation. Further, the plaintiff must show justifiable reliance on the representation and damages as the result of that reliance. W. Prosser & W. Keeton, *supra*, § 105, at 728; Restatement (Second) of Torts § 525 (1977). Although these elements primarily apply to actions for damages or rescission arising from affirmative misrepresentation, the Supreme Court has also required that they be satisfied in actions based on fraudulent nondisclosure. The information must be material to the transaction, see *supra* note 1, and the defendant must have acted with scienter. See Aaron v. SEC, 446 U.S. 680, 701-02 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Causation in fact is subsumed from the obligation to disclose and withholding of a material fact, and reliance is presumed from the prohibited trading. See Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153-54 (1972).

15 See W. Prosser & W. Keeton, *supra* note 14, § 106, at 737; Langevoort, *supra* note 3, at 5-7. This position drew early support from Chief Justice John Marshall in Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178, 195 (1817). This case involved a New Orleans tobacco merchant who purchased tobacco without informing the vendee that American and British commissioners had signed a treaty at Ghent which would materially affect the price of tobacco by lifting the blockade of the American port. See *id.* at 182-83. In a six sentence opinion, Chief Justice Marshall upheld the then prevailing doctrine of caveat emptor. Chief Justice Marshall stated that a merchant is under no obligation to communicate information exclusively within his knowledge, even if the information would affect the price of the commodity being sold and added: “[i]t would be difficult to circumscribe the contrary doctrine . . . where the means of intelligence are equally accessible to both parties.” *Id.* at 194. This view reflected and reinforced the belief that a party to a business transaction was free to profit from his diligence and business acumen and was under no obligation to share the fruits of his industry and skill. See Keeton, *Fraud—Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1, 31 (1936).
the parties to the transaction. In applying traditional fiduciary relationship requirements to securities transactions, courts developed three views. The majority view held that corporate officers and directors owed a fiduciary duty to the corporate entity and shareholders only in their dealings on behalf of the corporation. Therefore, in private trading, no fiduciary relationship existed and corporate insiders were under no obligation to disclose material nonpublic information before trading. The minority view held that the corporate insider served as the “quasi-trustee” of the shareholder’s interest, thereby establishing a relationship which imposed the full panoply of fiduciary obligations, including the duty to disclose material information before trading in face-to-face transactions with existing shareholders. Under an intermediate

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18 See Chenery Corp. v. SEC, 128 F.2d 303, 308 (D.C. Cir. 1942); Crowell v. Jackson, 53 N.J.L. 656, 657, 23 A. 426, 427 (1891); Hun v. Cary, 82 N.Y. 65, 71 (1880). This view arose from the doctrine of caveat emptor and is predicated on the belief that shareholders have “constructive knowledge” of the corporation’s affairs since they have access to the corporate books. See Walsh v. Goulden, 130 Mich. 531, 540, 90 N.W. 406, 410 (1902). In addition, a stockholder dealing with a corporate officer or director can inquire as to whether the official has any confidential, material information and if he responds untruthfully, bring an action for fraudulent misrepresentation. See Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943), aff’d per curiam, 151 F.2d 534 (3d Cir. 1945).

20 See Oliver v. Oliver, 118 Ga. 362, 367, 45 S.E. 232, 23-34 (1902); Hotchkiss v. Fischer, 136 Kan. 530, 536-37, 16 P.2d 531, 534-35 (1932). In developing the minority view, courts rejected the “constructive knowledge” basis of the majority view as being unrealistic and stated that, when trading in securities of their own large, publicly held corporations, officers and directors are “quasi-trustees” with respect to the individual stockholder’s shares in face-to-face transactions. See Oliver, 118 Ga. at 367, 45 S.E. at 233; Note, Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief, 55 St. John’s L. Rev. 93, 98 (1980). Further, if an officer or director undertakes to disclose information regarding the status of the corporation, he is bound to explain the possible ramifications to the share-
view, the "special facts" doctrine, the corporate insider’s possession of information that could significantly affect the value of the stockholder’s shares and could not be ascertained through examination of the corporation’s books created a fiduciary relationship and an obligation to disclose the information before trading. Although most jurisdictions officially adhered to the majority position, courts increasingly employed the "special facts" doctrine to establish a fiduciary obligation in face-to-face transactions. Under this approach, however, the insider owed no duty to disclose his privy information either in impersonal stock exchange transactions.

21 See Strong v. Repide, 213 U.S. 419, 431 (1909); Buckley v. Buckley, 230 Mich. 504, 509, 202 N.W. 955, 956 (1925). In Strong, which gave rise to the "special facts" doctrine, the plaintiff was a former shareholder of a Philippine sugar company who was induced to sell her shares to the defendant, a director and owner of three-fourths of the shares. See Strong, 213 U.S. at 421. The defendant did not reveal his identity as the purchaser of the shares, nor the nearly completed negotiations for the sale of the corporation’s land, which would have significantly increased the value of the shares. Id. at 422. The Court concluded that the "special circumstances" of the case, including the fact that the defendant was a director in charge of operations, a majority shareholder, and the chief negotiator for the sale of the land, were sufficient to hold that the defendant had a duty to reveal material information when purchasing shares from other stockholders. Id. at 431. By 1925, the "special facts" were delineated as any “fact or condition enhancing the value of the stock, known by the officer or officers, not known by the stockholder, and not to be ascertained by an inspection of the books.” Buckley, 230 Mich. at 508, 202 N.W. at 956. As applied by the courts, the doctrine rests on a combination of the status of the defendant as a corporate officer or director and his possession of material nonpublic information. See id.

22 The trend toward imposing a duty to disclose material nonpublic information in face-to-face transactions between corporate officers or directors and shareholders was foreshadowed in a case which applied the majority view. See Goodwin, 284 Mass. at 362, 186 N.E. at 660. Although holding that the corporate defendant had no obligation to disclose the information he possessed, the court indicated that the result might have been different had the defendant sought out the shareholders in order to purchase their stock. See id. The court thus acknowledged that a corporate officer’s or director’s possession of “special facts” imposed at least the duty to refrain from affirmatively exploiting his informational advantage in dealings with existing shareholders. Id.

As the majority rule substantially merged into the “special facts” doctrine, the “facts” were expanded to include the knowledge of corporate officers and directors regarding important transactions such as prospective mergers or other corporate reorganizations, probable liquidation, agreements with third parties to buy large blocks of stock, and impending declarations of high dividends. See Arlinghaus v. Ritenour, 622 F.2d 629, 636 (2d Cir. 1980), cert. denied, 449 U.S. 1013 (1981) and New York cases cited therein; Agatucci v. Corradi, 327 Ill. App. 153, 157-58, 63 N.E.2d 630, 632 (1945); H. BALLANTINE, supra note 17, at 213.
tions or to purchasers who were not already shareholders.23

SEcurities LEGISLATION AND EARLY ADAPTATION OF COMMON LAW FIDUCIARY PRINCIPLES

The Securities Act of 193324 ("1933 Act") and the Securities Exchange Act of 193425 ("1934 Act") sought to restore investor confidence in the securities markets in the aftermath of the stock market crash of 1929 by substituting a philosophy of full disclosure for the philosophy of caveat emptor.26 In response to revelations

23 See Gratz v. Clauthon, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951); 3 L. Loss, SECURITIES REGULATION 1455 (2d ed. 1961). In Gratz, Judge Learned Hand acknowledged that a corporate officer's or director's fiduciary relationship had been traditionally limited to the corporation and existing shareholders, but nevertheless extended the relationship to include persons previously not shareholders of the corporation. See id.; Chiarella v. United States, 445 U.S. 222, 227 n.8 (1980). Furthermore, there was no duty of disclosure if a majority shareholder dealt with a minority shareholder. See Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943), aff'd per curiam, 151 F.2d 534 (3d Cir. 1945). Although not expressly decided, the court in Goodwin strongly suggested that an officer or director trading in an impersonal stock exchange has no duty to disclose. See Goodwin v. Agassiz, 283 Mass. 358, 362-63, 186 N.E. 659, 661 (1933); Note, Insider Trading at Common Law, 51 U. CHI. L. REV. 838, 859 (1984).


26 See S. REP. No. 47, 73d Cong., 1st Sess. 6-7 (1933), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 Item 17 (J. Ellenberger & E. Mahar comp. 1973) [hereinafter LEGISLATIVE HISTORY]. In recommending federal securities legislation, President Franklin Roosevelt stated:

This proposal adds to the ancient rule of caveat emptor, the further doctrine

"Let the seller also beware." It puts the burden of telling the whole truth on the seller.

What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.

Id. at Item 3. While considering the proposed legislation, Congress was made acutely aware of the speculative methods used by those possessing inside information to the detriment of the investing public. See S. REP. No. 792, 73d Cong., 2d Sess. 3 (1934), reprinted in 5 LEGISLATIVE HISTORY, supra, at Item 17. Official investigations into the stock market had revealed "widespread fraud, manipulation, and victimization of public investors by concealment of relevant information." 1 A. Bromberg & L. Lowenfels, supra note 1, § 2.2(110) (Oct. 1979); see generally S. REP. No. 1455, 73d Cong., 2d Sess. (1934), reprinted in 5 LEGISLATIVE HISTORY, supra, at Item 21 (official summary of the investigation). Among the practices of special concern to Congress were those by corporate insiders and controlling stockholders who had betrayed their fiduciary duties by using inside information for their own advantage. See S. REP. No. 792, supra, at 9; S. REP. No. 1455, supra, at 55-68; H.R. REP. No. 1383, 73d Cong., 2d Sess 11, 13-14, reprinted in 5 LEGISLATIVE HISTORY, supra, at Item 18. In enacting the 1933 and 1934 Acts, Congress sought to avoid repetition of these speculative practices, preserve market integrity, and protect private investors. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195, 198 (1976); SEN. REP. No. 792, supra, at 9; H.R. REP. No. 1383, supra, at 2-7,
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regarding pervasive market manipulation, Congress included antifraud provisions in both Acts. The broadest proscriptions in this regard are found in section 17(a) of the 1933 Act and section 10(b) of the 1934 Act. Since section 17(a) is limited to the sale or offer for sale of securities, section 10(b), which broadly prohibits the use of "any manipulative or deceptive device" in both the purchase and sale of securities, has provided the statutory basis for the proscriptions of insider trading. However, section 10(b) remained


The major anti-fraud provisions in the 1933 Act are sections 11, 12, and 17(a). 15 U.S.C. §§ 77k, 77l, 77q(a) (1982). Those in the 1934 Act are sections 9, 10(b), 15(c)(1) and (2), and 16(b). 15 U.S.C. §§ 78i, 78j(b), 78o(c)(1), (2), 78p(b) (1982). Of these provisions, only section 17(a) of the 1933 Act and sections 10(b) and 16(b) of the 1934 Act are germane to consideration of insider trading. See 15 U.S.C. §§ 77q(a), 78j(b), 78p(b) (1982).

President Roosevelt, in writing to the Chairman of the Banking and Currency Committee regarding the bill that was to become the 1934 Act, emphasized the need for legislation which would prevent "the terrible conditions of the years following 1929," and provide the government with the power to police the securities industry. See S. Rep. No. 792, supra note 26, at 2.

See 15 U.S.C. §§ 77q(a), 78j(b) (1982). For the text of section 10(b), see supra note 6.

Section 17(a) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.


See supra notes 6 and 28 for the texts of sections 10(b) and 17(a). Although these provisions do not specifically prohibit insider trading, see 15 U.S.C. §§ 77q(a), 78j(b) (1982), they have been administratively and judicially interpreted as encompassing such activity. See, e.g., Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151-52 (1972) (bank employees liable under section 10(b) for failure to disclose material information regarding stock value); In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (brokerage firm liable for trading on basis of material information received from insider pursuant to sections 17(a), 10(b), and Rule 10b-5).

The only specific statutory prohibition of insider trading is in section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1982). However, this section is limited to corporate officers, directors, and holders of more than ten percent of a corporation's registered securities who complete a purchase-sale or sale-purchase transaction in the corporation's equity securities within a six-month period. See id.; 15 U.S.C. § 78p(a) (1982) (10% shareholders). Section 16(b) is self-executing and provides for a private cause of action by or on behalf of the issuer to recover any profit realized by the insider. See 15 U.S.C. § 78p(b) (1982). It does not,
relatively dormant until the SEC promulgated Rule 10b-5 pursuant to its rule-making power.\(^{30}\)

Rule 10b-5 was promulgated specifically to close "a loophole in the protection against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."\(^{31}\) Modeled after section 17(a) of the 1933 Act, Rule 10b-

however, cover single transactions (that is, only a purchase or only a sale) or encompass trading on material nonpublic information by insiders other than those specifically designated in the statute. \(\text{See id. For a discussion of section 16(b)'s provisions, see 2 L. Loss, supra note 23, at 1040-90 (1961 & Supp. 1969); 5 A. Jacobs, supra note 1, § 3.02(g), at 1-133 to 1-144. While section 17(a) of the 1933 Act is not as limited as section 16(b) of the 1934 Act, compare 15 U.S.C. § 77q(a) (1982) (section 17(a)) with 15 U.S.C. §78p(b) (1982) (section 16(b)), it is directed at the sale or offer for sale of securities. See 15 U.S.C. § 77q(a) (1982). As Professor Loss has pointed out, even if the language could be interpreted to include purchasers of securities, the SEC has used it only against sellers. See L. Loss, Fundamentals of Securities Regulation 801 (1983).}

Section 10(b) of the 1934 Act, however, encompasses both the purchase and sale of securities, yet contains no limitations such as those found in section 16(b) as to the parties covered by its proscriptions or to the time period during which the forbidden activity must occur. \(\text{See 15 U.S.C. § 78j(b) (1982). Additionally, section 10(b) covers single transactions. See id.; supra note 6 (text of section). Although section 10(b) does not contain a provision for a private cause of action, one has been judicially created in order to effectuate the purpose of the statute and is not limited to recovery by or on behalf of the issuing corporation. See Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983); Kardon v. National Gypsum Co., 73 F. Supp 798, 800 (E.D. Pa. 1947). However, section 16(b) was a factor in Judge Augustus Hand's determination that the coverage of section 10(b) did not extend to fraudulent mismanagement of corporate affairs and that the section protected only buyers and sellers of securities. See Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir.), cert. denied, 343 U.S. 956 (1952).}

The limited legislative history available pertaining to section 10(b) provides little guidance as to the scope of its prohibitions. \(\text{See Chiarella v. United States, 445 U.S. 222, 226 (1980). In explaining the original version of the section, a government spokesman briefly summed up its purpose as being a "catch-all clause" giving the Commission authority to deal with new manipulative practices, adding, "Subsection [(b)] says, 'Thou shalt not devise any other cunning devices.'" Stock Exchange Regulation: Hearings on H.R. 7852 & H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934), reprinted in 8 Legislative History, supra note 28, at Item 23 (statement of Thomas Corcoran). After going through the congressional revision process with only minor changes and little controversy, see 1 A. Bromberg & L. Lowenfels, supra note 1, § 2.2(310)- (331) (Oct. 1979), section 10(b) emerged as a broad prohibition of "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, supra note 28, at 6. However, section 10(b) is not self-activating and requires the promulgation of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78j(b) (1982).

\(^{30}\) See 1 A. Bromberg & L. Lowenfels, supra note 1, § 2.2(510) (Oct. 1983 & Oct. 1979) (summary of rules under section 10(b)). Prior to 1942, the SEC had promulgated rules under the section but they were generally limited in applicability and did not provide the means to prohibit or penalize insider trading. See id.; see also supra note 8 (text of Rule 10b-5); infra notes 31-33 and accompanying text (Rule's history and purpose).

5 was broadened to encompass the purchase as well as the sale of securities. Few academics or securities market participants foresaw the far-reaching impact it was to have as the SEC’s major weapon against insider trading.

In early cases brought under Rule 10b-5, the courts held that the proscribed behavior must at least meet the minimum common law requirements for fraudulent nondisclosure. At the same time, for forty-four years, courts and commentators have debated the meaning and scope of Rule 10b-5. It has been referred to as “plain, concise and unambiguous” by one court, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 96 (10th Cir., cert. denied, 404 U.S. 1004 (1971), and as “a judicial oak which has grown from little more than a legislative acorn” by another. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975). Professor Loss has termed it “a horse of dubious pedigree but very fleet of foot,” L. Loss, supra note 29, at 820, while another commentator has termed it “the mysterious and ubiquitous rule 10b-5.” Kitch, A Federal Vision of the Securities Laws, 70 Va. L. Rev. 857, 859 (1984). From its modest beginning, Rule 10b-5 has become the SEC’s major weapon in its battle against insider trading. The interaction of legislation, administrative rule-making, and the judicial process has produced an entire body of securities law which is still developing and changing. See, e.g., A. Jacobs, Litigation and Practice Under Rule 10b-5 (1983) (multi-volume work devoted to Rule 10b-5).

23 See supra notes 8 and 28 (texts of Rule 10b-5 and section 17(a)). The changes made in adapting section 17(a) broadened the scope of Rule 10b-5 by using less specific language to delineate the proscribed behavior and by making it applicable to “fraud or deceit upon any person, in connection with the purchase or sale of any security.” See supra note 8 (text of Rule 10b-5); see also General Discussion, American Bar Association Conference on Codification of the Federal Securities Laws (Nov. 18-19, 1966), reprinted in 22 Bus. Law 793, 922-23 (1967) [hereinafter ABA Conference] (remarks of Milton Freeman, co-drafter of Rule 10b-5). Two staff attorneys, frustrated at the SEC’s inability to penalize the unethical behavior of a company official who was purchasing company stock at deflated prices by misrepresenting the company’s financial status to shareholders, hastily drafted the Rule to activate section 10(b)’s prohibitions. Id. The only comment made during the staff meeting at which the Commission summarily adopted the Rule was “Well . . . we are against fraud, aren’t we?” Id. Professor Manne has attacked the promulgation of the Rule as procedurally infirm, see Manne, Insider Trading and the Administrative Process, 35 Geo. Wash. L. Rev. 473 (1973), and Professor Loss has referred to the procedure as “backdoor jurisprudence with a vengeance.” Loss, History of S.E.C. Legislative Programs and Suggestions for a Code, in ABA Conference, supra, at 796. Rule 10b-5 was held to be constitutionally sound in Speed v. Transamerica Corp., 99 F. Supp. 808, 831-32 (D. Del. 1951). See 5 A. Jacobs, supra note 1, § 66.02 (judicial acceptance of Rule).

however, the judiciary agreed that securities anti-fraud legislation was intended to expand the parameters of existing legal remedies. In an effort to effectuate the perceived aims of securities legislation while adhering to common law principles, courts opted to impose fiduciary obligations on corporate insiders through adoption of the “special facts” or “trusteeship” doctrines.

**Expansion of Common Law Fiduciary Principles**

For almost twenty years after the promulgation of Rule 10b-5, courts limited their focus to the activities of corporate insiders trading on the basis of material corporate information. Insider fi-

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36 See Charles Hughes & Co., 139 F.2d at 437. Judge Clark stated that there was “no difference between express representation on the one hand and implied misrepresentation or concealment on the other,” and rejected the caveat emptor doctrine. Id. In doing so, Judge Clark noted that “[t]he essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do,” and that the silence of the defendants thereby constituted fraud under section 17(a) of the 1933 Act. Id. at 437-38. The court further held that the brokerage company, primarily selling stock to single women and widows, was “under a special duty... not to take advantage of its customers' ignorance of market conditions,” based on the confidential relationship established between them. Id. at 437. This holding differed significantly from the majority view, as it imposed fiduciary obligations on the sellers through the use of the “special facts” and “quasi-trustee” doctrines. See supra notes 20-23 and accompanying text.

Four years later, in a case involving corporate officers and directors who purchased corporate stock without disclosing material information in their possession, a district court imposed liability under section 10(b) and Rule 10b-5, holding the defendants to the fiduciary obligations of a trustee. See Kardon v. National Gypsum Co., 73 F. Supp. 798, 803 (E.D. Pa. 1947). In doing so, Judge Kirkpatrick also established the first private cause of action under a “liberal construction” of section 10(b) and Rule 10b-5 in order to effectuate securities legislation through “application of well known and well-established equitable principles governing fiduciary relationships.” See id. at 800-03. Subsequently, in Speed v. Transamerica, Chief Judge Leahy upheld a Rule 10b-5 action and significantly expanded the common law parameters of fiduciary relationships by imposing trustee fiduciary duties on majority shareholders in transactions with minority shareholders. See Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951). Chief Judge Leahy acknowledged that no such obligation existed at common law. See id. These decisions established that corporate insiders, which now included majority shareholders, would be held to fiduciary obligation standards in dealings with corporate shareholders under either the “special facts” or “trusteeship” view in order to effectuate what the judiciary had determined was the remedial objective of Rule 10b-5.

37 See L. Loss, supra note 29, at 802 (noting limited use of Rule 10b-5 in early years after promulgation); Phillips & Zutz, The Insider Trading Doctrine: A Need for Legislative
Insider trading obligations encompassed trading with both purchasers and sellers of the issuing company's securities in face-to-face transactions and impersonal transactions on national exchanges. In an effort to prohibit unfair trading by nontraditional insiders, the SEC expanded the definition of insiders. In 1961, then SEC Chairman William Cary, writing for the Commission in In re Cady, Roberts & Co., emphasized that Rule 10b-5 restricts the trading activities of "any person" who has a relationship that allows access to material nonpublic information and expressly based the decision on the "inherent unfairness" of insider trading.40 Under the Cady, Roberts delineation of insider trading, the insider need no longer be a corporate official, director, or controlling shareholder. The list of insiders having a fiduciary obligation to disclose or abstain from trading was extended to include "those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities."41

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38 See Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.) (protection of section 16(b) extended to buyers not prior beneficiaries), cert. denied, 341 U.S. 920 (1951). Beginning in 1943, the SEC and the lower courts systematically adapted and expanded common law fraud principles. The rationale for such expansion was that Congress intended to adopt the most progressive common law principles in enacting securities anti-fraud legislation. After first adopting the "trusteeship" or "special facts" view regarding the fiduciary obligations of corporate insiders, see supra notes 20-23 and accompanying text, the courts extended the obligation to buyers of securities who were not previous owners of corporation stock and thus were not considered beneficiaries under the common law. At the same time, courts confirmed that buyers and sellers had a private cause of action for damages arising from the insider's trading. See, e.g., Ellis v. Carter, 291 F.2d 270, 273-74 (9th Cir. 1961) (according equal rights to buyers and sellers under Rule 10b-5, including private cause of action); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952) (private cause of action limited to purchasers or sellers of securities), cert. denied, 343 U.S. 956 (1953); Fischman v. Raytheon, 188 F.2d 783, 787 (2d Cir. 1951) (buyer has right to implied cause of action when fraud shown).


40 Id. at 912.

41 Id. Chairman Cary set forth a two-pronged test for imposition of the duty to disclose beyond the traditional corporate insiders:

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

Id. Chairman Cary advocated an interpretation of securities laws which incorporated...
Elimination of the Fiduciary Relationship Requirement

In the years following Cady, Roberts, the SEC and the courts moved steadily away from the narrow application of fiduciary obligations imposed at common law. In SEC v. Texas Gulf Sulphur Co., the Second Circuit defined the function of Rule 10b-5 as ensuring that all investors have equal access to material information regardless of whether traditional or "special facts" fiduciary concepts were applicable. Adopting the Cady, Roberts delineation of insider status, the court held that anyone in possession of inside information must either disclose it to the investing public or refrain from trading.

broader anti-fraud concepts than those at common law and reaffirmed the expansion of common law liability to encompass transactions by insiders with purchasers who were not previous shareholders. See id. at 911-12.


Impetus for the movement was provided by the Supreme Court's liberal approach to statutory construction in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). In an action brought under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1982), Justice Goldberg, writing for the Court, rejected the Second Circuit's interpretation of the anti-fraud section of this Act, 15 U.S.C. § 80b-6 (1982), as being limited by traditional common law fraud and deceit requirements. Capital Gains, 375 U.S. at 192. Instead, he emphasized that a "fundamental purpose" of securities legislation was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." Id. at 186 (footnote omitted). After a discussion of the common law and fraudulent securities transactions by fiduciaries, Justice Goldberg further stated that Congress, aware of relaxations in the common law, intended that securities anti-fraud legislation be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." Id. at 195. Justice Goldberg's words have been quoted extensively as courts continued to expand the scope of Rule 10b-5. See Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972); United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974).

See supra note 41 for the Cady, Roberts text.

Texas Gulf Sulphur, 401 F.2d at 848. The case centered on misleading press releases regarding copper, zinc, and silver deposits in Canadian land owned by the corporation. Id. at 843-47. The court declared that:

anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.
After the decision in *Texas Gulf Sulphur*, the courts, with the full support of the SEC, expanded the list of insiders and transactions covered by Rule 10b-5 and further relaxed common law requirements for fraudulent nondisclosure while emphasizing the goal of achieving fairness and equal access to information for all investors in the securities markets. In *United States v. Chiarella*, the Second Circuit, in its discussion of the duty to disclose or abstain from trading, made no reference to the existence of a fiduciary relationship. A printer's markup man had deciphered the names of companies targeted for tender offers by the printer's corporate employer and then traded in the target company's securities prior to the release of the information. The Second Circuit affirmed the conviction of Chiarella and held that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information ... without incurring an affirmative duty to disclose." While Rule 10b-5...
was intended as a means of prohibiting and penalizing corporate insiders’ fraudulent purchases of securities, the Second Circuit utilized it to ensure equal access to all material information regarding the purchase or sale of securities.\(^5\) Anyone who failed to disclose material nonpublic information before trading could face not only sanctions imposed by the SEC,\(^5\) but also criminal prosecution\(^5\) and liability for damages in private litigation.\(^5\) Imposition of the duty to disclose required only that the person in possession of the information “regularly” receive it.\(^5\)

**Fiduciary Requirements Reinstated: Chiarella and Dirks**

The Supreme Court considered the substantive reach of Rule 10b-5 for the first time when it reviewed the Second Circuit’s *Chiarella* decision.\(^6\) Relying on the need for authority in the enabling statute for the proscriptions of Rule 10b-5, the Court af...

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5. *Id.* at 1366, 1373. Although traditional analysis would conclude that Chiarella was an outsider, the court labelled him a “market insider” on the basis of his continuing access to the target company names; it was held irrelevant that he was not an insider of the target companies in whose stock he traded. *Id.* at 1365-66. The court relied on traditional concepts of the need for fairness, market integrity, and equity in securities transactions. *Id.* at 1365.

\(^5\) See *id.* at 1362 (Congress “created a system providing equal access to the information necessary for reasoned and intelligent investment decisions”). *But see id.* at 1373-78 (Meskill, J., dissenting) (criticizing unwarranted expansion of Rule 10b-5 to encompass Chiarella). The belief that the securities laws were intended to insure equal access to material information developed steadily in the courts from the enactment of Rule 10b-5. *See, e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 828 (D. Del. 1951) (duty to disclose an attempt to provide equalization of bargaining position). It was first stated definitively in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).


\(^6\) See Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983). The Court recognized the existence of an implied private cause of action for damaged buyers and sellers under section 10(b) and Rule 10b-5. *Id.*

\(^6\) See United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev’d*, 445 U.S. 222 (1980). Chief Judge Kaufman, writing for the court, stated that the test to determine insider status was whether the individual had “regular access to market information.” *Id.* The court gave no further indication of the parameters of the test, leaving determination to be made by the courts on a case-by-case basis. *Id.* at 1365-66.

firmed the common law underpinnings of section 10(b). Justice Powell, writing for the majority, stated that mere possession of material nonpublic information does not impose an obligation to disclose or a duty to refrain from trading. Instead, the Court insisted that such a duty arises from a relationship of trust and confidence between parties to a business transaction. The Court held that since section 10(b) aims to prevent fraud, and that non-disclosure can be fraudulent only when there is a duty to speak, a relationship that gives rise to a duty to disclose must exist before Rule 10b-5 can be violated. The Court thus affirmed the interpretation of violative insider trading first articulated by the SEC almost twenty years earlier in *Cady, Roberts* and rejected the Second Circuit's equal access approach.

Three years after *Chiarella*, the Supreme Court considered the issue of tippee liability in *Dirks v. SEC*. The *Chiarella* holding

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58 Id. at 234-35. The Court stated: “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.” Id.
59 Id. at 235. In effect, the Court rejected the lower court's delineation of the parameters of insider trading violations. Id. at 231-33.
60 Id. at 230.
61 Id. at 235.
62 Id. at 223, 236-37; *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961). The Court cited *Cady, Roberts* at length, indicating approval of its fiduciary relationship requirement between “shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.” *Chiarella*, 445 U.S. at 228.

In response to the decision in *Chiarella*, the SEC adopted Rule 14e-3, 17 C.F.R. § 240.14e-3 (1986), which prohibits the purchase or sale of securities of target companies in tender offer situations by anyone possessing material nonpublic information relating to an offer that has commenced or toward which a substantial step has been taken. Rule 14e-3 requires that the person in possession of the information know that it was acquired from the offeror, the issuer of the target securities or any officer, director, partner or employee or person acting on behalf of the offeror or issuer. *Id.; see Pub. L. No. 91-567, 84 Stat. 1496, 1497-98 (1970) (codified at 15 U.S.C. § 78n(d)(1) (1982)) (amending Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968)).

63 Tippee liability was first established by the SEC in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The tippee brokerage firm received the information on which it traded from its employee, Cowdin, who was also a director of the issuing corporation. *Id. at 909 & n.4*. Cowdin thus breached his duty of confidentiality by revealing the information. *See id. at 909, 912. However, the emphasis in *Cady, Roberts* was on expanding the category of insiders, *see id. at 912-13, and it was not until 1968 and 1971 that the issues raised by the “tipping” of material nonpublic information were specifically addressed. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633 (1971). Building on the references to tipper and tippee liability in *Texas Gulf Sulphur*, 401 F.2d at 852, 856, the SEC held that the tipper of information was liable under Rule 10b-5 even if he did not actually trade in securities and also imposed liability on the tippee who received and traded on the information. *See Investors Management*, 44 S.E.C. at 642-47; *In re Merrill Lynch, Pierce, Fenner & Smith*, 43 S.E.C.
was extended to encompass the tippees of insiders. The Court held that the tippee’s duty to disclose derives from the tipper’s obligation, which arises from his fiduciary relationship with the corporate source of the information. Further, the Court required that the tippee must know or have reason to know that the tipper has breached a fiduciary obligation by revealing the information. Finally, the Court stated that whether the insider’s tip constitutes a breach depends upon whether the insider receives a direct or indirect personal benefit. The Dirks Court reaffirmed the view that violations of Rule 10b-5 must be predicated on the existence of a fiduciary relationship and require scienter on the part of both the tipper and the tippee.

933, 936 (1968). The test for tippee liability was that the information be confidential and material and that the tippee “knew or had reason to know that the information was . . . obtained improperly by selective revelation or otherwise.” See Investors Management, 44 S.E.C. at 649. Commissioner Smith took issue with this test and stated that the tippee’s knowledge that the insider tipper was breaching a fiduciary duty must be established. See id. at 643 (Smith, Comm’r, concurring). Subsequently, the Second Circuit implicitly gave judicial approval to the doctrine of tippee liability as stated by the SEC. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 239-40 (2d Cir. 1974).

Id. at 657-58. The Court, in its discussion of tippee liability, relied on footnote 12 in Chiarella which read: “The tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.” Chiarella, 445 U.S. at 230 n.12 (citation omitted). See Dirks, 463 U.S. at 659-61, 667.

Dirks, an officer of a broker-dealer firm, received information concerning fraudulent corporate practices from a former officer of Equity Funding of America and unsuccessfully attempted to expose the fraud. Dirks, 463 U.S. at 648-49. He then informed some clients and investors who sold their stock based on his information, causing the price to drop. Id. at 649-50.

Id. at 659 (citations omitted).

Id. at 660. The Dirks Court’s emphasis on the tippee’s knowledge drew on Commissioner Smith’s concurrence in In re Investors Management Co., 44 S.E.C. 633, 650 (1971) (Smith, Comm’r, concurring). See Dirks, 463 U.S. at 660 & n.19; see also supra note 63 (tippee liability).

Dirks, 463 U.S. at 662. The Court stated that whether there has been a breach of duty by the insider-tipper depends on “whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.” Id. at 663. This indicates the Court’s desire to limit the personal gain to financial benefits derived from securities transactions. See id. at 664.

See Dirks, 463 U.S. at 660-63; Aaron v. SEC, 446 U.S. 680, 691 (1980) (requiring scienter in section 10(b) civil actions). In a footnote, the Court also enlarged the scope of those considered to be tippers to include those who enter into a “special confidential relationship” and “are given access to information solely for a corporate purpose.” Dirks, 463 U.S. at 655 n.14. Such persons are considered to be “temporary” insiders, and the Court specifically included underwriters, accountants, lawyers, or consultants working for the corporation in this category. See id. The Court’s statement has been expanded to include anyone who may be considered a “temporary” or “constructive” insider. See, e.g., SEC v. Tome,
Some commentators have expressed disapproval and surprise at the Court’s return to the narrow application of common law principles governing fraudulent misrepresentation in both Chiarella and Dirks. The Supreme Court has continually emphasized that section 10(b) intended to prevent common law fraud, as buttressed by the language of the statute and its legislative history. In limiting the applicability of Rule 10b-5 to fraudulent nondisclosure, the Court has stated that it is neither empowered to rewrite legislation nor to expand the reaches of the rule beyond the language of the enabling statute. Under the most expansive view of common law requirements for establishing nondisclosure as fraudulent misrepresentation, a relationship of trust and confidence must exist before a duty arises to disclose material nonpublic information in a business transaction. It is maintained that


The Court reversed Dirks’ conviction on the grounds that he did not possess the derivative duty to disclose information before trading. See Dirks, 463 U.S. at 665-67. The insider from whom Dirks received the information had not breached his fiduciary duty to the corporate employer or the shareholders because he had no motive of personal gain in attempting to expose the fraud. See id. at 667. Further, Dirks did not solicit or use the information for personal gain. Id. at 665-66. Under the Dirks ruling, then, those tippees who accidentally or inadvertently overhear material nonpublic information with no breach by the insider are free to trade on the basis of the information. Dirks also does not reach the surreptitious eavesdropper because there is no breach by the unknowing insider. Cf. Wang, supra note 3, at 1289 (eavesdropper does not breach fiduciary duty under Chiarella). For a discussion of the impact of Dirks, see generally Note, The Supreme Court’s Highwire Act: Balancing SEC Enforcement and Market Efficiency in Dirks v. SEC, 45 U. Prrr. L. Rev. 923 (1984).

70 See generally Aldave, supra note 4, at 121-25 (advocating adoption of misappropriation theory to avoid Chiarella and Dirks restrictions); Anderson, supra note 7, at 354-56 (critical of Court’s imposition of common law misrepresentation).

71 See Chiarella, 445 U.S. at 226. The Court further emphasized that this result is supported by the legislative history and language of the statute. See id. at 226, 235; see also Santa Fe Indus. v. Green, 430 U.S. 462, 472-74 (1977) (nothing in legislative history warrants extending section 10(b) to encompass fraud which does not include deception or manipulation); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749-55 (1975) (language and legislative history of section 10(b) limits private cause of action to purchasers or sellers of securities).

72 See Blue Chip Stamps, 421 U.S. at 748-49 & 756 (Powell, J., concurring). Justice Powell stated: “The starting point in every case involving construction of a statute is the language itself.” Id. at 756 (Powell, J., concurring). Noting that the Court was being asked to extend section 10(b) to include the offer to sell any security, Justice Powell then added: “Before a court properly could consider taking such liberty with statutory language there should be, at least, unmistakable support in the history and structure of the legislation. None exists in this case.” Id. (Powell, J., concurring).

73 See supra note 20 and accompanying text.
the Second Circuit’s elimination of the most basic requirement for a finding of fraudulent nondisclosure was incongruous with prior Supreme Court rulings, and the Court’s refusal to sanction the total abandonment of the fiduciary relationship requirement was a logical and consistent application of prior constructions of the purpose of section 10(b) and the scope of Rule 10b-5.

**The Misappropriation Theory Alternative**

In response to the limitations imposed by the Supreme Court, the SEC and the Second Circuit have advocated a misappropriation theory to impose criminal and civil liability on nontraditional insiders and tippees. The government first advanced this theory in *Chiarella* when it argued that Chiarella had breached a duty to the acquiring corporations by misappropriating information entrusted to his employer and therefore had committed fraud upon both the entrusting corporate client and the sellers of the target companies’ securities.  

Writing for the majority, Justice Powell concluded that, because the theory had not been submitted to the jury, the issue was not properly before the Court. However, four Justices indicated varying degrees of acceptance of the misappropriation theory.

Based on this indication of support for the misappropriation theory in *Chiarella*, the government advanced the theory in *United States v. Newman.* In *Newman*, the government alleged that employees of two investment banking firms, aided and abetted by Newman, had violated Rule 10b-5 by misappropriating and

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74 See *Chiarella*, 445 U.S. at 235-37.
75 Id. at 236-37.
76 See id. at 238-51. In a concurrence, Justice Stevens indicated that the theory could form the basis of an action for fraud upon the acquiring corporations, but noted that they would be unable to recover damages since they were neither buyers nor sellers of the traded securities. *Id.* at 238 (Stevens, J., concurring). Chief Justice Burger and Justice Brennan would have imposed liability on Chiarella on the theory that anyone who misappropriates material nonpublic information has an affirmative duty to either disclose or refrain from trading. *Id.* at 239-45 (Burger, C.J., dissenting); *id.* at 238-39 (Brennan, J., concurring in judgment). While acknowledging the validity of the misappropriation theory, Justices Blackmun and Marshall would have upheld the conviction under a broad interpretation of section 10(b) as prohibiting anyone from trading on the basis of material information not legally available to the general investing public. *Id.* at 251 (Blackmun, J., dissenting). This theory of Rule 10b-5 liability had been suggested by Professor Brudney, who posited that those having an “unerodable informational advantage” should be precluded from trading on the basis of that advantage. Brudney, *supra* note 3, at 360-61.
trading on confidential information relating to the acquisitions and tender offers of corporate clients of the banking firms. In reversing the district court's dismissal of the criminal indictments, the Second Circuit judicially approved the misappropriation theory. The court found that the employees' breach of their duty of confidentiality to their employers and the subsequent trading satisfied the requirements laid down in Chiarella for Rule 10b-5 liability. The conspirators had damaged the reputations of the investment banking firms and defrauded the bidders by artificially inflating the market price of the stock; additionally, the court implied that the damage extended to those from whom the defendants had purchased stock. However, in a subsequent private action for damages against one of the banking firms by a seller of the target securities, the Second Circuit held that because there was no fiduciary relationship between the corporate clients and the sellers, there was no derivative relationship between the banking firm or its employees and the sellers. Thus, the court held, there was no duty to disclose and no cause of action available to the sellers.

Four years later, in SEC v. Materia, the Second Circuit held that Materia, a copyreader employed by a financial printer, had defrauded his employer and violated Rule 10b-5 by misappropriating confidential information concerning proposed tender offers of the printer's corporate clients for the purpose of trading in the se-

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78 Id. at 16. The district court, relying on the Supreme Court holding in Chiarella had dismissed the indictment on the grounds that since neither Newman nor the employees had any fiduciary relationship with the purchasers or sellers of stock in the target companies, there was no duty to disclose before trading and hence no violation of securities laws. See id. at 14-15.

79 The Newman court quoted Chief Justice Burger's statement that Chiarella "misappropriated—stole, to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence." See Newman, 664 F.2d at 17 (quoting Chiarella, 445 U.S. at 245 (Burger, C.J., dissenting)). The court further stated that the defendants had defrauded the employers "as surely as if they took their money." Newman, 664 F.2d at 17.

80 Id. at 18-19. The court also held that the purchaser or seller requirement for standing in a private cause of action was unnecessary in a SEC action for injunctive relief. Id. at 17.

81 Id. at 17-18. The Newman court also stated that sufficient notice as to the illegality of the actions charged was provided by Rule 10b-5's proscriptions of fraudulent and deceptive devices. Id. at 19.


83 Id. at 16.

84 Id. at 13.

The court again emphasized the breach of confidentiality and damage to the reputation of the employer and similar damages to the corporate clients through inflation of the price of the target securities. However, the court acknowledged that Materia's duty did not extend to the sellers of the securities even though they had been damaged by his actions.

THE MISAPPROPRIATION THEORY EXPANDED: United States v. Carpenter

The Second Circuit significantly expanded its application of the misappropriation theory in United States v. Carpenter. A di-

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86 See id. at 199-201. Prior to Materia, the district court had used the misappropriation theory in SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (mem.). In Musella, the court held that the tippees of a New York law firm employee had violated Rule 10b-5 by trading on material nonpublic information which he had misappropriated from his employer. Id. at 438-39. The tippee's liability was derived from the breach of the employee's duty of confidentiality to the law firm and through it to the firm's corporate clients. Id. at 439. However, the court rejected the SEC contention that the law firm had acquired a fiduciary duty to the shareholders of the target corporations. Id. at 437. Relying on the Second Circuit's holding in Newman and the district court's holding in Materia, the court stated that "distinctions premised on the source of the information undermine the prophylactic intent of the securities laws." Id. at 438.

87 Materia, 745 F.2d at 202. In the statements of Justices Powell and Stevens in Chiarella regarding the misappropriation theory, the emphasis was on the misappropriator's duty to the corporate clients of the employer, the acquiring corporation. See Chiarella v. United States, 445 U.S. 222, 232-33, 237 (1980) (Stevens, J., concurring). Under common law agency principles, the employee is the subagent of the employer, who is the agent of the principal; thus, the employee owes the same fiduciary duties to the acquiring corporation as the agent, and therefore is precluded under agency law from using confidential information entrusted to the agent. See RESTATEMENT (SECOND) OF AGENCY § 405 (1958); 1 F. MEACHEM, LAW OF AGENCY §§ 1189, 1191, 1209, 1224 (2d ed. 1914). Unauthorized use of the principal's property by the agent requires that any profit be held in constructive trust for the principal whether harmed or not. See RESTATEMENT (SECOND) OF AGENCY § 388 & comment c (1958); RESTATEMENT OF RESTITUTION § 201(2) (1937). The misappropriation theory, as interpreted by Justices Powell and Stevens in Chiarella, thus parallels agency concepts. See Chiarella, 445 U.S. at 233, 237 (Stevens, J., concurring). Agency has been accepted as the basis for requiring a fiduciary relationship before imposition of the duty to disclose or abstain as delineated in securities law. See Langevoort, supra note 3, at 19 (imposition of duty to disclose federal analogue of agency law). Agency law was cited by the Second Circuit in support of its finding that Chiarella had breached a fiduciary duty to his employer and the acquiring corporations. See United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980); see also SEC v. Tome, 638 F. Supp. 596, 623 (S.D.N.Y. 1986) (common law agency principles apply to section 10(b) and Rule 10b-5 violations). The application of agency principles to Newman and Materia provides the direct relationship between the misappropriator and a corporate trader.

88 Materia, 745 F.2d at 203 (acknowledging ruling in Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983); cert. denied, 465 U.S. 1025 (1984)).

89 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986). Prior to the Carpenter...
vided court affirmed the criminal conviction of a *Wall Street Journal* financial reporter, R. Foster Winans, who revealed the publication schedule and contents of the *Journal*’s “Heard on the Street” columns to a broker-dealer, who in turn traded prior to publication in the stock of the companies to be discussed in the articles.90 There was no claim that Winans, whom the court characterized as a market outsider, improperly altered the content of the columns or that the information constituted confidential corporate or market information since it was available to the public generally.91 In addition, neither the *Journal* nor its parent company, Dow Jones

decision, the Southern District of New York employed the misappropriation theory in a case involving a son's use of information received from his father. See United States v. Reed, 601 F. Supp. 689, 699-703 (S.D.N.Y.), rev'd in part, 773 F.2d 477 (2d Cir. 1985) In Reed, the father, a member of the board of directors of a corporation considering a merger proposal, revealed material information about the proposal to his son, who traded on the basis of the information. *Id.* at 690-91. The court acknowledged that the father had no motive of personal gain and that no derivative tippee liability existed under the *Dirks* test. *Id.* at 699. However, relying on the Second Circuit decisions in *Newman* and *Matera*, the court held that the son could be held liable for violating section 10(b) under the misappropriation theory, since the father had revealed the information based on a relationship of trust and confidence. *Id.* at 703. The court stated that misappropriation of secret information “for personal aggrandizement in breach of such a relationship constitutes fraud.” *Id.* at 700.


It is generally agreed that a member of the financial press has no fiduciary relationship with the general readership and thus owes no duty to disclose or abstain from trading in the securities about which he writes. See Peskind, *supra*, at 85; Note, *The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters*, 38 STAN. L. REV. 1549, 1558 (1986). In its original complaint, the government had posited that Winans was under a duty to disclose his trading under a general duty-to-readership theory, but it dropped this allegation before the case was tried in the district court. See United States v. Winans, 612 F. Supp. 827, 840 n.7 (S.D.N.Y. 1985), aff'd, 791 F.2d 1024 (2d Cir. 1986).

The Ninth Circuit has held that a financial columnist violated section 10(b) and Rule 10b-5 by scalping. See *Zweig* v. *Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979). The *Zweig* court acknowledged that the columnist’s relationship to the public was not a fiduciary one under the common law, but nonetheless held that under the facts of the case, the columnist had a duty to his readers to reveal his stock holdings and any intent to buy or sell, citing a “flexible duty” standard. *Id.* at 1268. The viability of the *Zweig* holding, referred to by the *Carpenter* court, has been seriously undercut by the Supreme Court’s reinforcement of common law fiduciary relationship principles in *Chiarella*. See *Lowe* v. SEC, 472 U.S. 181, 225-26 n.9 (1985) (White, J., concurring).

91 See *Carpenter*, 791 F.2d at 1031-32.
& Co., engaged in securities trading or had corporate clients who were the source of the information in the columns. Instead, the court relied on Winans’ knowing violation of the Journal’s policy forbidding employee use of confidential information and the acknowledged impact of the “Heard” columns on the market price of securities. The court ruled that Winans had misappropriated material information and traded upon it, and that the reporter’s duty of confidentiality to the Journal resulted in a “corollary duty” to disclose the information to those with whom he and his co-defendants traded or abstain from trading.

The misappropriation theory, as applied by the Carpenter court, presupposes that the misappropriation of market-sensitive information from an employer, combined with subsequent trading in the securities market on the basis of the information satisfies the requirements for Rule 10b-5 liability, regardless of whether any fiduciary relationship exists between the misappropriator and a market participant. In addition, the Second Circuit imposed a

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9 Id. at 1029. The court adopted a broad interpretation of the misappropriation theory as proscribing “the conversion by ‘insiders’ or others of material non-public information in connection with the purchase or sale of securities.” Id. (emphasis omitted).

92 Id. at 1025, 1031-32. The court acknowledged that the individuals supplying the information for the column and the Journal itself could have traded on the basis of that information. Id. at 1033. See Wang, supra note 3, at 1296.

94 Id. at 1034. The court stated:

The misappropriation theory, as applied by the Carpenter court, presupposes that the misappropriation of market-sensitive information from an employer, combined with subsequent trading in the securities market on the basis of the information satisfies the requirements for Rule 10b-5 liability, regardless of whether any fiduciary relationship exists between the misappropriator and a market participant. In addition, the Second Circuit imposed a
general duty to disclose or abstain similar to that earlier enunciated in its *Chiarella* decision. It is submitted that there are significant deficiencies in this application of the theory which run contrary to Supreme Court precedent and the main goal of securities anti-fraud legislation, protection of investors.

**CONFLICTS WITH SUPREME COURT RULINGS**

The basic precept of the misappropriation theory is that an employee's breach of the duty of confidentiality to the employer constitutes the fraud necessary for a Rule 10b-5 violation. However, the Supreme Court has held that not every breach of a fiduciary duty constitutes the fraud necessary to violate Rule 10b-5. In *Santa Fe Industries v. Green*, the Court stated that the breach must be accompanied by deception, manipulation or nondisclosure relating to the purchase or sale of securities. Even if an employee's breach constitutes a form of fraud, such fraudulent breach may pertain to a duty owed to someone other than the purchaser or seller of securities. If the misappropriator deceives the share-tender offer and thereafter traded in the securities of the target company. *Id.* at 599. The court acknowledged that Tome could not be found guilty of violating Rule 10b-5 under the Dirks test of derivative liability since Bronfman, the officer, had no motive of personal gain. *Id.* at 617. However, Judge Pollack did not rely solely on the misappropriation theory. *See id.* at 620. Tome was held to be a "temporary" insider under the language of footnote 14 in Dirks because he had acted as a consultant to Seagram. *Id.* at 620-21 (citing Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)). Tome exemplifies the reliance on the misappropriation theory, particularly in Rule 10b-5 actions arising out of tender offer situations. *See id.* at 619. In Tome, as in *Newman* and *Materia*, a fiduciary duty unquestionably ran to the corporation involved in the tender offer. *See id.* at 620-22. These cases are easily distinguishable from *Carpenter* where no such duty existed. As applied in Tome, the theory reflects a more limited approach than was employed in *Carpenter*. In addition, *Tome* was an SEC enforcement action resulting in injunctive relief and disgorgement of profits, *see Tome*, 638 F. Supp. at 599, while *Carpenter* was a criminal action instituted after a settlement with the SEC regarding disgorgement. *See Carpenter*, 791 F.2d at 1025-26.

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96 See *Carpenter*, 791 F.2d at 1034; *supra* note 51 and accompanying text (Second Circuit's imposition of general duty either to disclose or to abstain from trading in United States v. Chiarella, 688 F.2d 1358, 1365 (1978), rev'd, 445 U.S. 222 (1980)).
97 See *supra* notes 94-95 and accompanying text.
99 *Id.* at 473-76.
100 See *Carpenter*, 791 F.2d at 1029, 1032. The *Carpenter* court emphasized that it was not necessary that there be a breach of a duty to either a corporate issuer or shareholder of securities to constitute a violation of Rule 10b-5 under the misappropriation theory. *Id.* But see *id.* at 1038-37 (Miner, J., dissenting in part) (application of theory to defendants for securities fraud constitutes unwarranted extension of liability under section 10(b) and Rule 10b-5). The Second Circuit has held that the misappropriation theory cannot be employed to sustain a private cause of action under Rule 10b-5 because there was no breach of duty to
holder by failing to disclose material nonpublic information, such deception does not occur in conjunction with the breach of a fiduciary obligation since no fiduciary relationship exists between the misappropriator and the shareholders. Therefore, it is questionable whether the misappropriation theory by itself satisfies the requirements of *Santa Fe*.

The Second Circuit's current application of the misappropriation theory also conflicts with the Supreme Court's requirement that the duty to disclose or abstain from trading arises only out of a relationship of trust and confidence between parties to a transaction. Under the misappropriation theory as applied in *Carpenter*, the misappropriator owes a duty to disclose to the shareholders of the traded securities even though he had no fiduciary relationship with them. In *Chiarella*, the Supreme Court specifically rejected imposing such a general duty to disclose, stating, "[w]e know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relationship to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale."

Favorable references to the misappropriation theory by some Supreme Court Justices indicates a willingness to find a fiduciary obligation owed to corporate clients who are market participants as a sufficient basis for assessing a Rule 10b-5 violation. The theory

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102 See, e.g., *Hiler, Dirks v. SEC—A Study in Cause and Effect*, 43 Md. L. Rev. 292, 326 & n.139 (1984) (misappropriation does not fulfill *Santa Fe* requirements); *Phillips & Zutz, supra* note 37, at 91 (no deception or manipulation as required by *Santa Fe*); *Note, supra* note 90, at 1561 (deception should be connected to deceived person's decision to trade).
104 See *supra* notes 95-99 and accompanying text.
106 See *Eichler v. Berner*, 472 U.S. 299, 313 n.22 (1985) (tippee may be liable for misappropriating or illegally obtaining information); *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1982) (indicating that tippee liability may be predicated on illegally or improperly obtained infor-
as presented to the Court in Chiarella and as employed by the Second Circuit in both Materia and Newman emphasized the direct link between the misappropriator and the corporate clients who purchased securities in the target companies. In Carpenter, however, there was no corporate client to whom Winans owed any duty. The court did not indicate how the duty to disclose to the shareholders arose out of Winan's fiduciary relationship with his employer or its parent company, neither of whom had any relationship with the corporate issuers of the stock, the shareholders, or the corporations who had generated the information. The court simply stated that Winans' breach gave rise to a "corollary duty" to disclose to those shareholders or abstain from trading. It is asserted that the Second Circuit's imposition of a general duty to disclose contravenes the Supreme Court's fiduciary relationship requirement.

Another discrepancy between the Supreme Court's current position regarding Rule 10b-5 violations and the Second Circuit's expansive use of the misappropriation theory relates to establishing tippee liability under the derivative liability test of Dirks. Under Dirks, a tippee's liability for trading on the basis of material non-public information is dependent on his having received the information; supra note 76 (apparent endorsement of misappropriation theory by Chief Justice Burger and Justices Brennan, Marshall, and Blackmun in Chiarella). The footnote references in Eichler and Dirks merely leave open consideration of the theory, but do not endorse it. It is very likely that these references advocate application of the theory to situations such as Chiarella, Newman, and Materia involving fiduciary obligations to corporations which had generated material, confidential information regarding target companies and where securities were traded in those companies. Both Materia and Newman fit into the Chiarella pattern, and the Supreme Court denied certiorari to both. Materia v. SEC, 471 U.S. 1053 (1985); Newman v. United States, 464 U.S. 863 (1983).


108 See supra notes 75-89 and accompanying text.

109 See Carpenter, 791 F.2d at 1034.

110 See Chiarella, 445 U.S. at 235 (when allegation of fraud based on nondisclosure, no fraud absent duty to speak); Aldave, supra note 4, at 112-16 (questioning existence of duty to disclose and noting Chiarella Court rejected duty to entire marketplace); Langvoort, supra note 3, at 50 (suggesting exclusivity of Chiarella majority's delineation of pre-existing fiduciary duty as source of disclosure obligation).

111 See supra notes 86-89 and accompanying text.
mation from a tipper who breached a fiduciary duty by revealing the information for personal gain. Utilizing the misappropriation theory to impose liability upon tippees ignores the personal gain requirement since the insider, whether it be an investment banking firm or a financial newspaper, has no motive of personal gain in revealing the information. The Second Circuit's expansive approach to tippee liability implies that anyone who receives material nonpublic information and uses it to trade in the securities markets commits a violation of Rule 10b-5, regardless of the benefit to the tipper. However, this very result was rejected by the Supreme Court in Dirks. It is submitted that such an expansive application of Rule 10b-5 fails to provide adequate notice as to which trading activities violate securities laws.

In Dirks, the Supreme Court noted that market analysts provide an important service to the investment community and that their ability to function would be inhibited by a blanket prohibition such as that suggested by the Second Circuit in Chiarella and the District of Columbia Circuit in Dirks. The Court stated that requiring a motive of personal gain on the part of the tipper would allow analysts to function without fear of violating Rule 10b-5. In requiring that a financial reporter either disclose or refrain from trading, the Second Circuit failed to indicate the parameters of the prohibition. Carpenter has left many issues unresolved, including whether a financial commentator must include a disclaimer re-

118 See id.
119 See Note, supra note 90, at 1562. By definition, the misappropriation theory involves information legitimately entrusted to employees by employers. In addition, the corporate source of the information has a legitimate business purpose in entrusting the employer with the confidential information. See Note, supra note 69, at 943 (recipient of information has obligation to evaluate motive of source and may safely use information entrusted for appropriate purpose).
114 Dirks, 463 U.S. at 662-64. The Carpenter court's application of the misappropriation theory provides a further anomaly in that the employer and the sources of the information for the "Heard" columns could have traded on the information, but the tippee-misappropriator Winans could not. See Carpenter, 791 F.2d at 1032; Wang, supra note 3, at 1296. This directly contradicts Dirks which noted the significance of the fact that neither Dirks nor his insider source of the information traded in the securities of the company involved. Dirks, 463 U.S. at 666. See also supra note 62 (development of tippee liability predicated on tipper's preclusion from tipping).
115 See Dirks, 463 U.S. at 659-59, 662-63.
116 See id. at 662-64.
117 See Carpenter, 791 F.2d at 1034; supra note 95; see also Kostelanetz & Scott, supra note 3, at 1, col. 3 (expressing concern with increase in criminal actions and possible lack of proper notice of what conduct is criminal); NYC BAR COMMITTEE REPORT, supra note 3 (law not properly drawn to impose criminal penalties).
regarding his stock holding before reporting favorably or unfavorably on such stocks.\textsuperscript{118}

**CONFLICTS WITH SECURITIES LAWS**

The Supreme Court and lower federal and state courts have consistently held that a major aim of securities legislation is to protect the investing public from unfair manipulation of the securities markets.\textsuperscript{119} Civil and criminal cases brought under Rule 10b-5 likewise emphasize the protection of investors as one of the primary functions of the rule and section 10(b).\textsuperscript{120} Because the misap-

\textsuperscript{118} See Carpenter, 719 F.2d at 1034; supra note 93. Some commentators and press organizations have expressed concern over the decision’s possible impact on first amendment rights. See, e.g., Note, Financial Reporters, the Securities Laws and the First Amendment: Where to Draw the Line, 53 Fordham L. Rev. 1035, 1051-54 (1985) (SEC action has disturbing first amendment ramifications). But see, e.g., Note, The SEC’s Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory, 52 Brooklyn L. Rev. 43, 81-86 (1986) (regulation of reporter’s activities not violative of first amendment rights). While discussion of the possible first amendment issues raised by the Carpenter decision is beyond the scope of this Note, the Supreme Court’s previous holding in Lowe v. SEC, 472 U.S. 181 (1985), indicates the current Court’s attitude toward restraints on financial writers and securities violations. The holding in Lowe focused on an unregistered financial newsletter publisher’s exemption from the provisions of the Investment Advisers Act, 15 U.S.C. §§ 80b-1 to 80b-21 (1982). The Court seemed anxious to establish liberal standards for the Act’s press exemption, 15 U.S.C. § 80b-2(a)(11)(D) (1982), thus removing the financial newsletter from the reach of an SEC injunction prohibiting publication and precluding consideration of the first amendment issue of prior restraints. Lowe, 472 U.S. at 203-11. In concurrence, Justice White, joined by Chief Justice Burger and Justice Rehnquist, believed that the Court should have considered the constitutional issue and indicated that any blanket pre-publication ban by the SEC would constitute prior restraint. See id. at 211, 235 (White, J., concurring in result). Justice White asserted that a flat prohibition of publication such as requested by the SEC, is presumptively invalid and may be sustained only under the most extraordinary circumstances. Id. at 234 (White, J., concurring in result). Further, the Justice noted that even “commercial speech” is concerned, restraints are permissible only when “narrowly tailored to advance a legitimate government interest.” Id. (White, J., concurring in result). Although requiring a financial reporter to disclose or abstain from trading is clearly not as restrictive as the SEC action Justice White stated as being unconstitutional in Lowe, it is submitted that even such minimal restraint on the editorial decisions of a reporter and a publisher is not justified by the government’s need to enforce securities laws since the present prohibition against insider trading exemplified in Carpenter is not “narrowly tailored to advance a legitimate government interest.”

\textsuperscript{119} See, e.g., Eichler v. Berner, 472 U.S. 299, 315 (1985) (stating primary objective of securities laws to be protection of investing public and national economy); Dirks, 463 U.S. at 662 (citing with approval Cady, Roberts statement that purpose of securities laws to protect investing public); Carpenter, 791 F.2d at 1032 (protection of investors major purpose of section 10(b) and Rule 10b-5).

\textsuperscript{120} See Dirks, 463 U.S. at 653; Chiarella, 445 U.S. at 227. The Supreme Court has affirmed the Cady, Roberts interpretation of Rule 10b-5 as protecting the unknowing investor from the inherent unfairness of insider trading. See Chiarella, 445 U.S. at 227.
appropriation theory relies on the damage done to employers rather than to investors, Rule 10b-5 has been improperly utilized as a vehicle to protect the reputations of employers.\textsuperscript{121} An employee's fraudulent breach of the duty of confidentiality constitutes a fraud against the employer, not against investors in the market.\textsuperscript{122} Even if trading on the basis of the misappropriated information ultimately results in harm to private investors, as the Second Circuit maintains,\textsuperscript{123} such investors have no standing to sue because the misappropriator has no fiduciary relationship with the purchasers and sellers with whom he trades.\textsuperscript{124} It is submitted that the misappropriation theory erroneously focuses on protection of corporate entities and employers rather than investors. Although safeguarding the integrity of the marketplace may be an important function of securities laws, the major thrust of securities legislation has been and continues to be the need to protect the investing public.\textsuperscript{125}

A further inequity resulting from the Second Circuit's current use of the misappropriation theory stems from conditioning the employee's breach on whether the employer has a policy that prohibits employee use of confidential information and whether that policy was communicated to the employee.\textsuperscript{126} This leads to an anomalous result when no policy forbidding the trading exists, since the misappropriator may then trade with impunity from possible securities law violations even though he has used what the Second Circuit has deemed a forbidden informational advantage when prohibited by the employer.\textsuperscript{127} As one commentator noted,

\begin{itemize}
  \item See, e.g., Aldave, supra note 4, at 235 (aim of securities laws to protect investors, not employers); Phillips & Zutz, supra note 37, at 91 (anti-fraud legislation protects investors; breach of duty to employer actionable under state law).
  \item There was no claim in \textit{Neuman, Materia, or Carpenter} that the defendants had perpetrated a fraud against investors. Rather, the emphasis was on the fraud against the employers as being sufficient to support a Rule 10b-5 claim.
  \item See \textit{Carpenter}, 791 F.2d at 1032.
  \item See supra notes 121-122 and accompanying text.
  \item See \textit{Carpenter}, 791 F.2d at 1026 (employee found to know of newspaper’s policy); \textit{Materia}, 745 F.2d at 202 (lower court found that Materia knew of employer’s confidentiality policy); \textit{Neuman}, 664 F.2d at 15 (investment banking firms’ employees took “confidential” information). There can be no breach of the employee’s duty of confidentiality if he has permission to use the information. \textit{Restatement (Second) of Agency} § 395 (1958).
  \item See \textit{Carpenter}, 791 F.2d at 1026. The \textit{Carpenter} court found it significant that Winans knew of the \textit{Journal’s} policy forbidding the use of any information gleaned while in its
\end{itemize}
“[i]f the employer bans such transactions, the misappropriation turns a violation of a company rule into a federal crime.” It is urged that the disparity between public and private enforcement of policies against insider trading demonstrates the need for clarification of the misappropriation theory as a predicate for liability under section 10(b) and Rule 10b-5.

THE NEED FOR CLARITY

Modern developments in the securities field have increased outsiders’ opportunities to garner huge profits by capitalizing on their access to material confidential information, particularly in the area of mergers, tender offers and acquisitions. Faced with the Supreme Court’s imposition of common law fraud requirements for liability under section 10(b) and Rule 10b-5, the SEC and the Second Circuit have endorsed and applied the misappropriation theory to penalize such activity. The issue, however, is not whether the trading by outsiders with access to material nonpublic information should be deterred and punished, but rather to what extent the misappropriation theory constitutes an appropriate vehicle for doing so under existing statutory and case law. At present there are conflicting opinions regarding the efficacy of this theory. The Supreme Court has granted certiorari in the Carpenter employment. Id. This raises two questions. First, should Winans have been convicted of securities fraud if he could have demonstrated that he did not know of the Journal policy? If not, he could have traded with impunity although he still would have had the knowledge which the court held unfair. Id. at 1032. Secondly, if the Journal had not had such a policy, could Winans have traded with impunity with the same unfair informational advantage? Under the present application of the misappropriation theory, the answer would be yes. Liability for violating Rule 10b-5 would thus depend on whether the employer has a policy of confidentiality and whether the employee is made aware of that policy. This could easily result in inequitable enforcement of prohibitions against insider trading. For example, if the Journal maintains its present policy and informs employees of that policy, the employees may not use the confidential information as the basis for trading without incurring the affirmative obligation to disclose or abstain from trading. However, if another newspaper does not have such a policy, its employees may use the information they gather, including publication schedules, as the basis for the purchase or sale of securities. It is submitted that this dependence on the business policies of employers in order to enforce Rule 10b-5’s proscriptions against insider trading is an inequitable and ineffective method of enforcing securities laws.

126 Wang, supra note 3, at 1296.
case and will presumably attempt to resolve many of these questions.\(^3\) In addition, many clarifying suggestions have been set forth by commentators,\(^3\) and Congress is currently considering the need for new legislation to expand the scope of prohibitions against insider trading.\(^3\)

Circuit maintain that the theory is a statutorily sound means of applying the strictures of Rule 10b-5 in compliance with Supreme Court rulings. However, numerous commentators, including one of the draftsmen of Rule 10b-5, are uneasy regarding the use of the misappropriation theory. See Freeman, \textit{supra} note 33, at 228-29. At present, the Second Circuit's expansive application of the misappropriation theory remains the primary source of the law regarding its use.

\(^1\) Carpenter v. United States, 107 S. Ct. 666 (1986). If the Supreme Court affirms the Second Circuit's broad application of the misappropriation theory, it will signal the Court's withdrawal from its current position regarding common law fiduciary principles and a willingness to allow a broad construction of the scope of Rule 10b-5. Conversely, complete rejection of the theory by the Court will indicate its desire to require strict adherence to common law principles governing fraudulent nondisclosure as laid down in \textit{Chiarella} and \textit{Dirks}. If the Court rejects the broad holding in \textit{Carpenter} but accepts a limited application of the theory, as seems likely, a significant deficiency in the theory remains unless the Court withdraws the required fiduciary relationship and allows imposition of the duty to disclose. For example, the Supreme Court may limit the validity of the theory to situations involving misappropriation of confidential material information from employers engaged in market transactions or whose clients generated the information for market purposes. However, if the Court does so hold, private investors harmed by the prohibited trading will not be able to recover in private actions against either the misappropriator or the source of the information under current law. See \textit{supra} notes 81-83 and accompanying text.


\(^3\) See Proxmire Plans Inquiry, N.Y. Times, Nov. 24, 1986, at D6, col. 6 (chairman of Senate Banking Committee to start investigation, consider new legislation). Congressional approval of the SEC program against insider trading was demonstrated by its passage of the Insider Trading Sanctions Act of 1984 ("ITSA"), which empowers the SEC to seek civil
While developing injustices in the securities field may require re-evaluation of securities anti-fraud legislation, it is submitted that the Second Circuit's expansion of the misappropriation theory is an inappropriate means of achieving this end. Imposing liability on a financial reporter who has violated a fiduciary duty to his employer erroneously converts anti-fraud legislation into a vehicle for protecting employers who are not involved in market transactions. Such activity may violate ethical notions of fairness and integrity, but it does not satisfy Supreme Court requirements for securities fraud and represents an inappropriate administrative and judicial expansion of existing law.

It is further suggested that the most significant deficiency in current statutory and case law regarding insider trading is the lack of a remedy for private investors defrauded by traders with whom they have no fiduciary relationship. Despite recent SEC successes in exposing and penalizing insider trading, private investors still find themselves without a remedy when no fiduciary relationship exists between the insider and the defrauded investor. Thus, Congress should focus its attention on providing a private remedy to such defrauded investors, rather than legislatively adopting the Second Circuit's current application of the misappropriation theory.

**CONCLUSION**

The Supreme Court's interpretation of the substantive reach of section 10(b) and the scope of Rule 10b-5 has evolved logically...
and in a manner consistent with the goals underlying such legislation. In sum, the Court has sought to protect the investing public without unduly restricting market activity, while remaining within the confines of the enabling statute and the common law principles from which it arose.

Federal legislation should not attempt to remedy every inequity in the securities market. Likewise, not all insider trading that violates moral or ethical principles violates current securities laws. Common law agency principles can adequately protect the confidential information of employers without using federal securities laws in a manner for which they were neither designed nor intended. Rather than seeking to judicially create a remedy where none was statutorily foreseen, the Supreme Court should emphatically reject the current unwarranted expansion of the misappropriation theory. At the same time, Congress should address the major problem facing defrauded private investors: the lack of an effective private remedy where no fiduciary relationship exists with the inside trader.

Joan K. Martin

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136 See, e.g., Comment, supra note 37, at 1156. In assessing the future efficacy of Rule 10b-5 in ensuring market fairness one commentator warned "that the ignorant may lose out to the shrewd is due largely to the fact that God did not create all men equal, a situation for which Congress and the Securities Acts have not supplied a remedy." Id.