

California Law Review

VOL. 70

JANUARY 1982

NO. 1

Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement

Donald C. Langevoort†

The prohibition against “insider trading”—the rule that certain persons with knowledge of material, nonpublic information about a company’s stock must either disclose that information or refrain from trading—is now a tenet of antifraud ideology under the federal securities laws. Though the prohibition has been criticized by economic theorists as a hopeless moralism that ignores the objective goals of allocative efficiency,¹ the rule’s validity has been accepted as a matter of law by the courts and the Securities and Exchange Commission.²

† Assistant Professor of Law, Vanderbilt University. B.A. 1973, University of Virginia; J.D. 1976, Harvard Law School. Formerly Special Counsel, United States Securities and Exchange Commission. The views expressed in this Article are solely those of the author and do not necessarily reflect those of the SEC or its staff. The Commission as a matter of course disclaims responsibility for the publications of its current and former staff members.

1. See H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Wu, *An Economist Looks at Section 16(b) of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968). This view rests principally on the idea that permitting insiders to trade is the optimal means of causing the market price of a security to move toward its “true” value, *i.e.*, the price that would prevail if all material information about the issuer were public. Moreover, permitting insider trading would allegedly be an incentive to insiders. This view has been extensively criticized for various reasons, including the suggestion that the abstain-or-disclose rule itself promotes allocative efficiency by operating to encourage prompt and effective public disclosure by insiders and issuers. *E.g.*, W. PAINTER, *THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE* § 5.10 (1979); Schotland, *Unsafe-at-Any Price: A Reply to Manne*, 53 VA. L. REV. 1425 (1967). For a comprehensive discussion of the issue, see Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979). A separate justification for the rule is that it promotes investor confidence in the securities marketplace—a point emphasized in the legislative history of the securities laws—and thus capital formation generally. See W. PAINTER, *supra*, at 59-63, 249.

2. Although there are outstanding issues relating to the scope of the prohibition, many of which are discussed *infra*, the judicial acceptance of the prohibition itself is no longer open to serious question. See generally 2 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COM-*

Justifiable or not on the basis of sophisticated functional considerations, its acceptance seems to rest more on the strongly held intuition that insider trading is unfair.³ Persons in a position to have special access to confidential information bearing on the value of a security are perceived as being unjustly enriched when they trade with others who are unable to discover that information.

While rooted in common law concepts⁴ and state corporations law,⁵ the law of insider trading has developed principally under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder.⁶ That development has occurred even

MODITIES FRAUD (1979); 5 A. JACOBS, *THE IMPACT OF RULE 10b-5* § 66.02 (rev. ed. 1978); 6 L. LOSS, *SECURITIES REGULATION* (2d ed. 1969). Whatever the extent of insider trading, the business community is largely united in publicly denouncing such conduct. For a comparative law perspective, see B. RIDER & H. FFRENCH, *THE REGULATION OF INSIDER TRADING* (1979).

3. But see Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 809 (1980) (pure fairness rationale has "surprisingly little substance"; Scott proposes a rationale of protecting corporate confidentiality). Whatever the merits of the functional approaches to the abstain-or-disclose rule, the motivation for administrative and judicial efforts in establishing the rule is the intuition of unfairness. See, e.g., Ferber, *The Case Against Insider Trading*, 23 VAND. L. REV. 621, 622 (1970); Loss, *The Fiduciary Concept as Applied to Trading by Corporate Insiders in the United States*, 33 MOD. L. REV. 34, 36 (1970). Given the rule's judicial acceptance, this Article will assume the validity of the rule's fairness objective and inquire into the limits of the rule, leaving to others the largely unresolvable debate as to the merits of the rule itself. A separate issue, also beyond the scope of this Article, is the extent to which enforcement of the prohibition is cost-justified. See Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); Scott, *supra*, at 918.

4. See notes 10-23 and accompanying text *infra*.

5. In *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the New York Court of Appeals held an insider liable to his corporation for profits made as a result of trading on the basis of material nonpublic information, deriving this directly from common law agency principles. See RESTATEMENT (SECOND) OF AGENCY § 388 & Comment c (1957). See also *Thomas v. Roblin Indus. Inc.*, 520 F.2d 1393 (3d Cir. 1975); *Schein v. Chasen*, 478 F.2d 817 (2d Cir. 1973), *vacated sub nom. Leliman Bros. v. Schein*, 416 U.S. 386 (1974); *Davidge v. White*, 377 F. Supp. 1084 (S.D.N.Y. 1974); *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1948). But see *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978) (holding that no recovery may be had by the corporation without a showing that it had actually been injured by the insider trading); *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975) (same).

Unlike strict trustees, corporate insiders are permitted to trade in corporate securities. See, e.g., *Jacobson v. Yaschick*, 249 S.C. 577, 155 S.E.2d 601 (1967). This is based on the recognition that conflicts of interest are not generally present vis-a-vis the corporation itself, since purchases or sales of shares of the corporation do not directly affect the operations or assets of the company. Hence, unless the corporation is also in the market for its own shares, it has little interest in insider trading, see, e.g., *Katz Corp. v. T.H. Canty & Co.*, 168 Conn. 201, 207, 362 A.2d 975, 980 (1975), even if the insider commits a fraud in trading, see *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978); *Steven v. Hale-Haas Corp.*, 249 Wis. 205, 221, 23 N.W.2d 620, 628 (1946). *Diamond v. Oreamuno* responded to this by noting the issuer's interest in its "integrity" in the market for its shares. 24 N.Y.2d at 499, 248 N.E.2d at 912, 301 N.Y.S.2d at 82. This clearly stretches the interest concept, though perhaps such stretching is justified if one concludes that (1) insider trading should be deterred and (2) no purchaser or seller—the person directly disadvantaged—is available to bring suit. This point is separate from the company's interest in the confidentiality of its information, which is only rarely threatened by insider trading, since insider trading is usually done secretly.

6. Section 10, 15 U.S.C. § 78 (1976), reads in pertinent part:

though neither the rule nor the statutory provision expressly prohibits insider trading.⁷ Rather, the law is almost entirely the product of judicial and administrative construction. Considering its origins, it should not be surprising that the contours of the law should be somewhat ill-defined, even if the core misconduct it addresses has been largely agreed upon.

In *Chiarella v. United States*,⁸ the Supreme Court for the first time confronted the law of insider trading under rule 10b-5. While reversing *Chiarella's* conviction on the facts presented, the Court took the opportunity, in elaborate dicta, to offer its own understanding of the law on this subject. While apparently reaffirming the law's basic premises, the Court has raised questions about the validity of many assumptions as to what is prohibited. In particular, *Chiarella* has made the fiduciary principle a consideration of utmost importance.

This Article will consider the post-*Chiarella* law of insider trading. Part I reviews the pre-*Chiarella* law, both federal and state, particularly the theories courts had developed to address issues such as who owed a duty of disclosure, to whom and under what circumstances it was owed, and what remedies were available. Next, Part II discusses *Chiarella* itself and how the majority opinion and the other opinions mesh with prior doctrine. This Article suggests that although the majority opinion

It shall be unlawful for any person, directly or indirectly, by 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 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.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1980), provides:

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

- (1) to employ any device, scheme, or artifice to defraud,
 - (2) 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
 - (3) 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.

7. Section 16(b) of the Securities Exchange Act, 15 U.S.C. § 78p(b) (1976), prohibits short-selling profits by certain insiders, a rule designed to reach certain insider trading practices. Liability does not depend on any showing that the insider actually possessed any material nonpublic information. Because of its relatively narrow scope, it does not provide an effective remedy for the full range of insider trading abuses. However, it does evidence a congressional policy against insider trading, and the section is limited because of difficulties of proof rather than a judgment that trading not expressly covered should be permitted. See *Diamond v. Oreamuno*, 24 N.Y.2d 494, 502, 248 N.E.2d 910, 914, 301 N.Y.S.2d 78, 84-85 (1969).

8. 445 U.S. 222 (1980).

clearly limits the applicability of rule 10b-5 with respect to trading by a person with an informational advantage over others in the marketplace, the Court's emphasis on fiduciary duty leaves substantial flexibility for applying that rule in future cases, even under the traditional approach. In that light, Part III returns to the major interpretive issues relating to insider trading to see how *Chiarella* might affect their resolution. Finally, Part IV analyzes the so-called "misappropriation" theories not reached by the *Chiarella* Court, to determine the extent to which it is possible to apply rule 10b-5 to outsider trading.

I

THE LAW BEFORE *CHIARELLA*

The pre-*Chiarella* development of insider trading law has been the subject of substantial scholarly and judicial analysis.⁹ Although little purpose would be served by delving deeply into the area yet again, a review is helpful to an understanding of the principal issues that the courts and the SEC had confronted before *Chiarella*.

A. Insider as Fiduciary

It is especially useful, in light of the *Chiarella* Court's fiduciary duty emphasis, to begin with a small group of common law cases of insider trading in the early part of this century.¹⁰ Typically, the plaintiff sought to extend the tort of misrepresentation to reach material nondisclosures of corporate information in transactions involving a corporate official of the issuer. For instance, in *Strong v. Repide*,¹¹ a former shareholder of a Philippine sugar company had been induced to sell her shares to a person who (unknown to her) was the company's general manager and knew that the company was about to enter an extremely profitable contract with the Philippine government. The Supreme Court granted rescission under what has become known as the "special facts" doctrine. Although tort law generally prohibits only affirmative misrepresentations and half-truths and does not create an affirmative duty to offer all material information, the special facts of

9. See authorities cited in notes 1-3 *supra*. See also, e.g., Cary, *Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1965); Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939 (1962); Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973); Hetherington, *Insider Trading and the Logic of the Law*, 1967 WIS. L. REV. 720; Note, *Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief*, 55 ST. JOHN'S L. REV. 93 (1980).

10. These cases are noted in W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 714-17 (5th ed. 1980). See also N. LATTIN, *CORPORATIONS* § 81 (2d ed. 1971); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 1014-18 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 740-46 (1956).

11. 213 U.S. 419 (1909).

this case, such as the defendant's insider position and the significance of the information, compelled disclosure. This rule was refined and expanded in later cases to place on all corporate officers and directors a general obligation of affirmative disclosure when dealing with shareholders, in recognition of the fiduciary status that exists between them.¹² In time, it also became an established principle of federal law under rule 10b-5 that insiders owed a fiduciary duty of disclosure when engaged in face-to-face purchases or sales.¹³

While these holdings were not universally accepted,¹⁴ they clearly indicated a trend (observable elsewhere in corporate law as well)¹⁵ toward treating the insider as a fiduciary for the shareholders as well as for the company. Given such a duty, insiders could not take advantage of fellow shareholders by buying stock while privy to information that the securities were significantly more (or less) valuable than the shareholder believed. Thus, the common law rule operates somewhat like a shareholders' equal protection clause, ensuring ordinary shareholders the same opportunity as insiders to make their investment decisions with access to material, nonpublic information.

The fiduciary principle is often described in terms of an actual expectation of fair dealing arising from a relationship of trust and confidence, but a careful reading of these cases reveals a broader principle. While some of the early cases do involve an actual expectation,¹⁶ recovery has never been limited to instances of misplaced reliance in bargaining. Instead, the affirmative disclosure rule established in these cases is best seen as the legal judgment that a person in a position of responsibility for the property or welfare of another should act in that capacity solely for the best interest of the beneficiary—in other words, a rule derived from the fiduciary's duty of loyalty.¹⁷ Thus, even where

12. *E.g.*, *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Sampson v. Hunt*, 222 Kan. 268, 564 P.2d 489 (1977); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1933); *Adelman v. Conotti Corp.*, 215 Va. 782, 790, 213 S.E.2d 774, 779 (1975). It is a general tort rule that affirmative disclosure is required where the parties stand in a fiduciary relationship. *See* W. PROSSER, *THE LAW OF TORTS* § 106 (4th ed. 1971); *RESTATEMENT (SECOND) OF TORTS* § 551 (1977).

13. *E.g.*, *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951).

14. *E.g.*, *Clayton v. James B. Clow & Sons*, 212 F. Supp. 482, 579-83 (N.D. Ill. 1962) (discussion of older cases); *Hooker v. Midland Steel Corp.*, 215 Ill. 444, 74 N.E. 445 (1905). *See generally* Note, *supra* note 9, at 97-99. However, it is now open to question whether the general rule permitting nondisclosure is applicable, at least when the nonpublic information is significant. *See* W. CARY & M. EISENBERG, *supra* note 10, at 715-16.

15. *See* cases cited note 76 *infra*.

16. *E.g.*, *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1933) (widow seeking advice of corporate officer). *See also* James & Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 491 (1978) (suggesting actual reliance as basis for rule).

17. Any more functional approach would be open to question. *See* *Oliver v. Oliver*, 118 Ga. 362, 367, 45 S.E. 232, 233-34 (1903) (emphasis on fiduciary status). *See generally* Leech, *supra* note 10, at 745-47; Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949). That the fiduciary

the insider does not solicit the transaction or bargain about price, the duty of loyalty compels the fiduciary to place the interests of the shareholder above his own by sharing the corporate information.¹⁸ It should come as no surprise that the duty of affirmative disclosure rests heavily on an unjust enrichment principle and blends into the broader doctrine

relationship applies even where the parties do not trust each other is reasonably well established. See *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); D. DOBBS, REMEDIES 681 (1973) ("A stockholder in a corporation may totally distrust his directors and regard them as a pack of ill-begotten thieves, but he is nevertheless entitled to the performance of their fiduciary obligations.") This point is particularly relevant in the corporate context, where shareholders have little role in the selection of the fiduciary.

The functional justification for imposing fiduciary obligations is based on the idea of "agency costs." Socially desirable relationships will be facilitated by general rules governing the fiduciary's behavior, by reducing the need for contractual restrictions on the fiduciary's discretion. See Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738, 758-61 (1978); Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 999-1000 (1981); Jensen & Meckling, *Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 337-38 (1976). The extent to which this would justify the common law disclosure rule is problematic, however. See Dooley, *supra* note 3, at 64-66. From the corporation's standpoint, there is rarely direct harm resulting from the insider's sale or purchase, and what harm might result can be addressed by giving a remedy to the entity itself. See note 5 *supra*; Scott, *supra* note 3, at 818. In terms of shareholder protection, it could be argued that investor confidence in the firm is diminished by a sense that insiders will consistently profit in transactions with shareholders based on their access to nondisclosed material information. This has some appeal in the closely held corporation, where the market for company shares may be dominated by insiders. In addition, in the close corporation there is no formal mechanism for disclosure of corporate information as there is for publicly held corporations. Nevertheless, the shareholder can protect himself by demanding full disclosure in the bargaining process and foregoing the trade if unsatisfied. The agency cost rationale is apposite primarily to discretionary behavior by the fiduciary, rather than to face-to-face transactions. See Anderson, *supra*, at 757-58.

That being said, it does not follow that the common law rule is not justifiable. See Dooley, *supra* note 3, at 64. Justification depends on a judgment that the shareholder's interest in receiving full value for his shares is a legally protectable one. Given that assumption, the law can use a disclosure rule as a means of removing the incentive to "cheat" in the negotiations by exploiting the bargaining inequality. See Anderson, *supra*, at 760. Nonetheless, it must be acknowledged that the tort rule compelling insider disclosure in face-to-face bargaining situations is not entirely functional in nature; it rests more on an unwillingness to accept a result that enriches the corporate fiduciary at the expense of the shareholder-beneficiary where the advantage results from the fiduciary status. The same rationale (and rule) applies to any contract-based transaction between principal and agent, or trustee and beneficiary. See Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 34 L.Q. REV. 472, 486-87 (1968).

18. See *List v. Fashion Park Inc.*, 340 F.2d 457, 461-62 (2d Cir. 1965) (no communication necessary between buyer and seller); *Bruce v. Rosenberg*, 463 F. Supp. 673, 675 (W.D. Wis. 1979) ("The insider's duty of disclosure arises when he does not initiate the securities transaction The transaction does not become fair merely because the insider is the offeree."). But cf. *Hafner v. Forest Labs.*, 345 F.2d 167 (2d Cir. 1965) (no breach in failing to disclose information pursuant to stock repurchase at set price). The harder question would come if a shareholder offers shares to an insider pursuant to the terms of an "option of first refusal" agreement after having received an outside offer. There, if the insider refuses to deal, the investor will nonetheless be "injured," since he will be relegated to the initial deal. Courts probably would look to whether causation was present (*i.e.*, would the plaintiff have done anything differently had there been disclosure). Compare *St. Louis Trust Co. v. Merrill, Lynch, Pierce, Fenner & Smith*, 562 F.2d 1040 (8th Cir. 1977), with *Ayres v. Merrill, Lynch, Pierce, Fenner & Smith*, 538 F.2d 532 (2d Cir.), *cert. denied*, 429 U.S. 1010 (1976).

of constructive fraud.¹⁹

Where the insider purchases without disclosure, he gains wealth above that which would occur had there been full disclosure; the shareholder loses by the same amount. The problem is to decide who should profit from the increase in corporate value owing to undisclosed good news or bear the cost of a decrease in value resulting from adverse information.²⁰ Apart from the argument that insiders deserve such an advantage as part of their compensation, the intuitive answer is that these benefits and costs, being the product of the enterprise, should be shared equally rather than allocated to the fiduciary.²¹ While in face-to-face situations the shareholder can ask the insider to disclose any material nonpublic information, the fiduciary principle removes the burden of inquiry from the shareholder in order to prevent the fiduciary's enrichment when the shareholder has been less than diligent. It achieves this through the law of fraud, by forcing the insider to disclose the information if he is to trade at all.

B. *Fraud on the Marketplace*

While the fiduciary principle was workable in face-to-face dealings between insiders and shareholders,²² the "special facts" and "fiduciary" theories for compelling disclosure are unsuited to an institutional, anonymous marketplace, such as the New York Stock Exchange. Because persons neither know nor care who their buyers or sellers are, there is no bargaining similar to that in face-to-face transactions. Moreover, given the essential independence of buyer and seller decisions, causation and injury are difficult to trace. This led the first state court that considered the question to reject the applicability of the insider's affirmative disclosure obligation in a stock exchange transaction.²³ A shareholder's expectation of fair dealing when determining a

19. See D. DOBBS, *supra* note 17, at 684; Brudney, *supra* note 1, at 338, 344. The doctrine of constructive fraud is a broad equitable principle, not limited to negligent deception. As stated by the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*: "[F]raud, indeed, in the sense of a court of equity, properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." 375 U.S. 180, 194 (1963) (quoting from *Moore v. Crawford*, 130 U.S. 122, 128 (1888)).

20. It is unnecessary to call this a "property right" belonging to the corporation or its shareholders. Such information, unlike the typical corporate asset or even a corporate opportunity, is nonexclusive in the sense that its use by the insider does not necessarily deprive the owner of it or put the insider in a position of competing with the corporation. See Dooley, *supra* note 3, at 64-66. Rather, it is an opportunity to profit in anticipation of disclosure to which no one, not even the corporation, is exclusively entitled and which disappears completely when it is shared with all.

21. See Anderson, *supra* note 17, at 760-61.

22. There, some notion of "inducement" is present, a triggering element in the law of misrepresentation. See RESTATEMENT (SECOND) OF TORTS § 525 (1977).

23. *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933). The court did not rest its

price with the insider-fiduciary appeared to have little relevance to a shareholder who did not even know the identity of the other party to the transaction.

Yet that result left insiders free, it seemed, to reap profits (or avoid losses) by taking advantage of their information in trading on an exchange. It was left to the SEC in its 1961 *Cady, Roberts & Co.* decision to declare that insider trading in the impersonal market violated rule 10b-5.²⁴ The Commission rested its conclusion as to the need for disclosure on two elements: (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose and (2) the unfairness of allowing a corporate insider or tippee to take advantage of that information by trading without disclosure.²⁵

Cady, Roberts contains little discussion of how it is that, absent any real inducement of shareholder trading, such unfair conduct becomes fraud. Instead, the decision implicitly relies on the insider's duty to act affirmatively to prevent the other party's disadvantageous trade, apparently based on the duty of loyalty. In theory, had disclosure been made to the public, marketplace buyers or sellers would not have traded (at least not at that price). By so stating the duty to disclose and resulting marketplace harm, the unfair conduct could be treated as a fraud, which would satisfy the statutory prerequisite for rule 10b-5 liability. However, this analysis involves some fiction, since had the insider simply abstained (as was his or her principal obligation), most marketplace buyers or sellers would have traded just the same, so that deception and resulting harm are difficult to find.²⁶ Nevertheless, it

decision purely on duty to disclose grounds; it also questioned whether the information was material. An early commentary on the relationship between these common law cases and rule 10b-5 is Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

24. 40 S.E.C. 907 (1961). *Cady, Roberts* involved a tip from a member of the board of directors of the Curtiss-Wright Corporation to a broker-dealer regarding a decision by the board to reduce the company's dividends. The broker-dealer was held liable for selling Curtiss-Wright shares on the basis of the tip. See generally 6 L. Loss, *supra* note 2, at 3588-89; Daum & Phillips, *supra* note 9.

25. 40 S.E.C. at 912 & n.15.

26. See notes 142-46 and accompanying text *infra*; Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1381 (1965) (as a result of this reasoning, the fraud requirement is effectively ignored). It is interesting to note that, almost until *Cady, Roberts*, the SEC itself apparently questioned whether open-market insider trading could be reached under 10b-5, given the lack of any apparent deception. See *Hearings on S. 2054 Before the Senate Comm. on Banking and Currency*, 84th Cong., 1st Sess. 1185-86 (1955), discussed in W. PAINTER, *supra* note 1, at 221-23.

It is not wholly accurate to say that all buyers or sellers would have traded in any event, notwithstanding the insider's trading. Any significant purchase or sale will, by adding to demand or supply, push the price toward an equilibrium point, *i.e.*, the price necessary to induce investors to be on the other side of the trades. It is extremely difficult, however, to determine whether any

provided the only remedy for open-market insider trading.

This reasoning was soon given a judicial imprimatur in *SEC v. Texas Gulf Sulphur Co.*²⁷ There, company officials bought TGS stock on the New York Stock Exchange, knowing of a copper strike well before that information was known even to the company's full board of directors. The court said that "[w]hether predicated on traditional fiduciary concepts . . . or the 'special facts' doctrine [citing *Strong v. Repide*], the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."²⁸ Beyond that, the court found it unnecessary to determine precisely who had been defrauded, apparently assuming that a fraud "on the marketplace" was enough to support an SEC injunctive action. The court ordered the defendants to disgorge their ill-gained profits to a court-supervised fund.²⁹

C. Liability of Tippees and Other Outsiders

Rule 10b-5 liability was not limited, however, to trading by insiders themselves. So-called "tippee" liability was established as well.³⁰ In *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith*,³¹ the Second Circuit imposed liability on certain institutional investors who were given information about an impending decline in Douglas Aircraft Company earnings and sold before the information became public. The information had passed properly from Douglas to Merrill Lynch in the course of Merrill Lynch's preparation for an underwriting of Douglas debentures. Merrill Lynch then gave the confidential information to certain of its favored institutional clients. The court found that these tippees, too, were subject to the abstain-or-disclose rule, reasoning that such persons were subject to the same duties as the traditional insider by virtue of their special access to inside information resulting from their

given investor decided to trade solely because of the insider trading activity or whether he would have traded anyway. See Dooley, *supra* note 3, at 35. See generally Note, *The Measurement of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974). Indeed, the insider's trades may be covered entirely out of an exchange specialist's inventory.

27. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). See generally Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 SW. L.J. 731 (1968); Fleischer, *Securities Trading and Corporate Information Practices: the Implications of the Texas Gulf Sulphur Proceedings*, 51 VA. L. REV. 1271 (1965); Ruder, *Texas Gulf Sulphur—The Second Round: Privy and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968).

28. 401 F.2d at 848.

29. See *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

30. *Cady, Roberts* itself was a tippee case. See note 24 *supra*.

31. 495 F.2d 228 (2d Cir. 1974).

insider contacts.³²

Shapiro was also significant because it involved a private suit for damages. Thus, the court had to decide who had standing to sue the insiders in a private action under rule 10b-5. In other words, the court had to decide to whom the duty to disclose was owed. The court, compelled by the logic of *Cady, Roberts* and *Texas Gulf Sulphur*, concluded that since the only effective disclosure called for in a marketplace trading situation is public disclosure—*i.e.*, disclosure to the entire marketplace—the class of persons who bought Douglas stock between the date of defendant's trading and date of public disclosure could demonstrate the requisite injury and its causal connection to defendant's breach.³³ This reasoning has since been strongly criticized by the Sixth Circuit as not only artificial but harsh insofar as the award of damages to the marketplace under any compensatory measure would be far in excess of any profits made by the defendant.³⁴ Moreover, its effect apparently has been curtailed substantially by a Second Circuit decision on the measure of damages such a class can recover.³⁵ Still, *Shapiro* underscored the *in terrorem* potential of the insider-trading prohibition under rule 10b-5.

Once the law of insider trading was expanded to include tippees (as well as tippees of tippees), however, the "fiduciary duty" source of the law was called into question.³⁶ Much as the *Texas Gulf Sulphur* court had suggested, the law could be perceived as dealing directly with the unfairness inherent in informational imbalances by prohibiting any trading on unshared material information except insofar as that advantage was attributable solely to the trader's superior foresight or skill.³⁷ While questions relating to the nature and source of the duty and to whom it was owed remained troubling, this was secondary to the desire

32. *Id.* at 237.

33. *Id.* at 238-41. Defendants were tipping and/or trading throughout this period. The court did not reach the measure of damages, suggesting that the trial court might have to limit the amount of damages recoverable so as not to create an award oppressive in relation to the nature of defendant's conduct. *Id.* at 242.

34. *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (damages not recoverable by plaintiff class absent showing of actual injury resulting from defendant's conduct); see Rapp, *Fridrich v. Bradford and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary*, 38 OHIO ST. L.J. 67 (1977).

35. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (measure of damages limited to tippee's profit in a tipper liability case). See notes 151-56 and accompanying text *infra*.

36. *E.g.*, Brudney, *supra* note 1, at 354-56.

37. *Id.* It is well recognized that the discovery of information and its assimilation into the marketplace can be a valuable public service. See, *e.g.*, *Investors Management Co.*, 44 S.E.C. 633, 648-49 (1971) (Comm'r Smith, concurring). Hence, the abstain-or-disclose prohibition should not be read so as to discourage legitimate investment analysis. Professor Brudney has suggested that the proper test would bar trading when the person possessing the information has an "unobtainable informational advantage," *i.e.*, a position of access that others could not lawfully obtain. Brudney, *supra* note 1, at 353-68.

clearly expressed in the securities laws: to promote a fair and informed marketplace.

Such a method of promoting fairness in the marketplace raised additional questions. What about material nonpublic outside information? Could an insider of Company *X*, about to award a major contract to Company *Y*, buy stock, not in his own company, but in Company *Y*?³⁸ What about short sales by a law clerk whose judge is about to issue a ruling devastating to the company? Most important, could an insider of a company about to make a tender offer at a substantial premium for the stock of another company go into the market and buy target company stock?³⁹ Thus came *Chiarella*.

II

CHIARELLA

A. Background and Facts

The *Chiarella* case arose from a series of trades that Vincent Chiarella engaged in while employed by Pandick Press. Pandick prepared soliciting materials for bidders in tender offers. Knowing that his conduct was prohibited by his employer, Chiarella broke company codes for the material being printed and determined who the subject companies would be. Before the bid was announced, he purchased subject company shares. The announcement of the bid increased the price of the shares, and Chiarella sold and took his profit.

Chiarella was convicted of a criminal violation of section 10(b) and rule 10b-5.⁴⁰ His conviction was affirmed by the Second Circuit, which held that Chiarella, through his sensitive position as a financial

38. This issue is considered in depth in Fleischer, Mundheim & Murphy, *supra* note 9, at 806-08, with the recognition that the law was apparently moving toward a market egalitarian stance. See also Koeltl & Longstreth, *Market Information Revisited*, 11 REV. SEC. REG. 843 (1978).

39. The SEC had brought a number of actions against persons trading on the basis of news regarding forthcoming tender offers, none of which resulted in a decision on the merits of the rule 10b-5 claim. See, e.g., SEC v. Sorg Printing Co., [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1975).

One major pre-*Chiarella* case closely related to the issue of "outsider" trading is *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979). There, Alex Campbell, a financial columnist, bought stock in a company about which he then wrote a favorable column, causing the price of the stock to rise. He then took his profit. Campbell's liability was affirmed not on pure insider trading grounds—though the case could have been decided that way—but for failure to disclose in his column his conflict of interest, so that readers could decide whether to discount the recommendations for bias. See also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); note 135 *infra*.

40. Chiarella was also investigated by the SEC and consented to an injunction and disgorgement of his profits. SEC v. Chiarella, No. 77 Civ. 2534 GLG (S.D.N.Y. May 24, 1977). See generally Morrison, *Silence is Golden: Trading on Nonpublic Market Information*, 8 SEC. REG. L.J. 211 (1980).

printer, was a market insider, a person whose position gave him regular access to market information. Accordingly, he was prohibited from trading on the basis of material nonpublic information obtained in that capacity.⁴¹ In addition, the fact that the information had been misappropriated was itself a separate basis for finding his actions to be fraudulent.⁴²

Before the Supreme Court, the government emphasized the second position: that Chiarella had misappropriated confidential information from Pandick's customers (the acquiring corporation) and in so doing had defrauded the customer. This, it was urged, was a fraud "in connection with" Chiarella's purchases and sales. The government further argued that his use of misappropriated information for personal gain without public disclosure also operated as a fraud on the uninformed investors who sold him securities. The Court refused to consider these misappropriation arguments because those theories of liability had not been properly presented to the jury. Instead, it concentrated on the primary theory advanced below by the Second Circuit: that Chiarella, as a market insider, owed a duty of disclosure to the sellers of target company shares. Rejecting this theory, the Court reversed Chiarella's conviction.

B. *The Majority Opinion*

In his majority opinion, Justice Powell made it clear that recognizing a fiduciary duty was paramount in resolving the case. Justice Powell began by reviewing the language and legislative history of section 10(b).⁴³ He noted that neither the statute nor rule 10b-5 directly addresses the issue of silence as a basis for liability; instead, the Commission's *Cady, Roberts* decision had broken new ground by finding that corporate insiders breached a duty to the public by taking unfair advantage of their insider status in open-market trading. Nevertheless, the Commission's holding was fully consistent with the common law of misrepresentation, where "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.'"⁴⁴

41. *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). See Note, 8 FORDHAM URB. L.J. 467 (1980); Note, 47 GEO. WASH. L. REV. 965 (1980); Note, 92 HARV. L. REV. 1538 (1979); Comment, *Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and United States v. Chiarella*, 1980 WIS. L. REV. 162.

42. 588 F.2d at 1368 n.14.

43. 445 U.S. at 225-26. See, e.g., *SEC v. Sloan*, 436 U.S. 103 (1978); *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

44. 445 U.S. at 228. Although this unqualified language suggests that the duty arises *only* where there is a fiduciary relationship, the Court's principal citation for its conclusion is the RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976), which lists a number of common law bases for compelling affirmative disclosure in addition to the existence of a fiduciary relationship, in-

Shareholder "trust and confidence" in corporate management thus serves as a basis for prohibiting insider trading under section 10(b). The court noted further that "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material nonpublic information."⁴⁵

But the Court did not limit its rationale to pre-existing fiduciary relationships. In a footnote, the Court observed that tippees of corporate insiders have been charged with a similar duty to refrain from trading. This duty arises from the tippee's "role as participant after the fact in the insider's breach of fiduciary duty."⁴⁶ Similarly, the Court noted, courts have found that an insider owed a duty to persons who bought into the corporation, even though there was no pre-existing duty of disclosure, because that very transaction brought them into such a relationship.⁴⁷

Under these standards, however, Chiarella was not an insider, for he had received no confidential inside information from the company whose shares he bought. The Court therefore held that Chiarella was under no duty of disclosure to the public. Rejecting the Second Circuit's "regular access to market information" test, Justice Powell wrote that that court had "failed to identify a relationship between petitioner and the sellers that could give rise to a duty."⁴⁸ "[N]ot every instance of financial unfairness," he continued, "constitutes fraudulent activity under § 10(b)."⁴⁹ Moreover,

[n]o duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forego

cluding a residual rule compelling disclosure by any person of facts "basic to the transaction" where the other party "because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts." *Id.* § 551(2)(e).

45. 445 U.S. at 230.

46. *Id.* at 230 n.12, citing *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (2d Cir. 1974).

47. 445 U.S. at 227 n.8, citing *Cady, Roberts*, 40 S.E.C. at 913, and *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951), where Judge Learned Hand called it "a sorry distinction" to say that fiduciary duties are owed by insiders in buying from shareholders but not in selling to soon-to-be shareholders. Hand's reasoning was recently followed in *SEC v. Murphy*, 626 F.2d 633, 652 n.23 (9th Cir. 1980), to extend this "incipient shareholder" principle to sales by an issuer in the course of a public distribution of its securities.

48. 445 U.S. at 232.

49. *Id.*

actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent.⁵⁰

Thus, the Court could find no support in the statute for a refrain-or-disclose rule. As the Court observed, "section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," and no such duty arises "from the mere possession of nonpublic market information."⁵¹ Not having a duty under section 10(b), Chiarella could not be convicted.

In part IV of the opinion, Justice Powell turned to the principal argument made by the United States: that Chiarella had fraudulently breached a duty to the acquiring company by misappropriating the confidential information and that this was sufficiently "in connection with" the purchase or sale of a security to base liability under section 10(b). According to the Court, "[t]he breach of this duty is said to support a conviction under § 10(b) for fraud perpetrated upon both the acquiring corporation and the sellers."⁵² The Court held, however, that this theory was not properly submitted to the jury. Consequently, the Court would "not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)."⁵³

C. The Concurring Opinions

1. Justice Stevens' Opinion

Justice Stevens concurred with the Court's view that "[b]efore liability, civil or criminal, may be imposed for a Rule 10b-5 violation, it is necessary to identify the duty that the defendant has breached."⁵⁴ And he agreed "with the Court's determination that petitioner owed no duty of disclosure to the sellers, that his conviction rested on the erroneous premise that he did owe them such a duty, and that the judgment of the Court of Appeals must therefore be reversed."⁵⁵ He clearly sided with the majority on the basic issue of the case. But Justice Stevens took up the question the Court left open in part IV, *i.e.*, "whether the petitioner's breach of his duty of silence—a duty he unquestionably owed

50. *Id.* at 232-33.

51. *Id.* at 234-35.

52. *Id.* at 235-36.

53. *Id.* at 236-37.

54. *Id.* at 237.

55. *Id.*

to his employer and his employer's customers—could give rise to criminal liability under Rule 10b-5.” He seemed receptive to finding liability⁵⁶ but indicated that the issue should be reserved for future resolution.

2. *Justice Brennan's Opinion*

Justice Brennan concurred solely on the basis of the inadequate jury charge with respect to the misappropriation theory. His view was that if properly charged, section 10(b) liability does arise when a person “improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities.”⁵⁷ Since that was the test proposed in Chief Justice Burger's dissent, Justice Brennan was allied with the dissenting Justices in their willingness to recognize a basis for reaching outsider trading under rule 10b-5.

D. *The Dissenting Opinions*

1. *Chief Justice Burger's Dissent*

Chief Justice Burger's view was that section 10(b) liability arises when a person trades on the basis of undisclosed information, “obtained not by superior experience, foresight, or industry, but by some unlawful means.”⁵⁸ The duty not to trade is owed to the public; unlike the theory considered in Justice Stevens' concurrence, it does not rest on defrauding the person from whom the information was obtained and therefore has no fiduciary basis. The Chief Justice found support for this rule in the common law of torts and the language and legislative history of section 10(b) and rule 10b-5, noting that such a rule “follows naturally” from the Commission's *Cady, Roberts* decision.⁵⁹ Thus, “[a]n investor who purchases securities on the basis of misappropriated nonpublic information possesses just such an ‘undue’ trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.”⁶⁰

According to the Chief Justice, “[t]he Court's opinion . . . leaves open [this] question of whether § 10(b) and Rule 10b-5 prohibit trading on misappropriated nonpublic information,” since the issue was dis-

56. *Id.* at 238. As a contrary argument, Justice Stevens noted that under the standing rule established in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), the defrauded company would not have any right to sue, since it was not a purchaser or seller of securities. But, he acknowledged, lack of standing for the defrauded person does not necessarily foreclose a suit altogether, *e.g.*, one brought by the SEC. 445 U.S. at 238 n.1.

57. 445 U.S. at 239.

58. *Id.* at 240.

59. *Id.* at 241.

60. *Id.*

posed of on the jury charge question.⁶¹ The Chief Justice argued that the majority was mistaken in holding that the trial court had not properly instructed the jury on this theory. Moreover, he concluded, even if there was an inadequate charge, it was harmless error.⁶²

2. Justice Blackmun's Dissent

Justice Blackmun, joined by Justice Marshall, would have affirmed the conviction on an even broader basis than the Chief Justice. Justice Blackmun, stressing the purposes of the securities laws, would have found liability for trading where the defendant had "access to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain."⁶³ Justice Blackmun found support for his standard in the development of the special facts doctrine in tort law, applied "in a broader array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair."⁶⁴ He urged that the federal securities laws not fall to the "rear guard" of this development in the law.⁶⁵

III

THE LAW AFTER *CHIARELLA*: INSIDER TRADING

This Article will examine *Chiarella's* impact on the law of insider trading and what it should mean for future cases. Before we examine how the prior law fits with the majority's analysis and determine which aspects of the law require rethinking, an important caveat is in order. The holding of the *Chiarella* case is narrow: a rejection, as a matter of statutory construction, of the idea that mere possession of material, nonpublic information gives rise to a duty to abstain or disclose. While the Court emphasized the "pre-existing duty" notion, arising from the fiduciary relationship of trust or confidence, as the basis of the affirmative disclosure obligation, its opinion need not have meant that this is the exclusive source of the duty.⁶⁶ This is clearly indicated by the majority's reservation for another case of the "misappropriation" theories discussed by Chief Justice Burger and Justice Stevens. In this sense, *Chiarella* in large part may be a pleadings and jury instructions case.⁶⁷

61. *Id.* at 243.

62. *Id.* at 243-45.

63. *Id.* at 247. This structural access test was derived from a recent article by Professor Brudney. See Brudney, *supra* note 1.

64. 445 U.S. at 247-48 (citing RESTATEMENT (SECOND) OF TORTS § 551(e), Comment 1 (1977); James & Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488 (1978)). See note 44 *supra*. This argument was specifically rejected by the majority. 445 U.S. at 228 n.10.

65. 445 U.S. at 248.

66. *Id.* at 235 (holding). As to other possible sources, see note 44 *supra*.

67. On the other hand, it can be argued that the Court developed its elaborate rationale for

At the same time, however, the Court's analysis was carefully drafted to create a framework that will serve as a source of authority for future inside trading cases. Indeed, what is most striking about the Court's opinion is a dissatisfaction with a federal statute and rule, with such severe criminal and civil liability for its violation, that provide no clear indication of what securities-related activity is prohibited.⁶⁸ The opinion is a study in line drawing, arbitrary if need be, and the lower courts and the SEC have acknowledged the significance of those lines in subsequent decisions.⁶⁹ Most important, a duty to disclose—something more than an ad hoc conclusion that fairness requires disclosure in a particular case—will have to be identified before liability can be imposed.

As the following discussion suggests, however, the legal framework offered by the Court for insider trading analysis is not complete, and if taken literally as establishing the outer bounds for insider trading cases, would lead to arbitrary and inconsistent results. Given that the Court's development of the core theory was for the purpose of dismissing the broadest possible articulation of the prohibition, and not to

insider trading merely to demonstrate that the Second Circuit's theory was inconsistent with the prior understanding of the abstain-or-disclose rule. Accordingly, it would be open to the Court to hold that even the bases it suggested for liability in true insider trading cases—e.g., tippee liability—are ultimately without merit. In other words, it is not certain that the Court was endorsing the traditional understanding.

68. See Pitt, *Chiarella Court: Limits on Novel 10b-5 Actions*, Legal Times of Wash., Mar. 31, 1980, at 12, 21-23. The Court made plain its concern with the lack of notice offered by rule 10b-5 in the insider trading context. 445 U.S. at 235 n.20 ("a judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity"). Elsewhere, the Court observed that it would be hesitant to adopt a parity-of-information rule in the absence of any authoritative congressional or SEC guidance on the subject. *Id.* at 233. This represents a shift in interpretation of the securities laws away from the philosophy of construing those laws broadly and flexibly, lest they become a "blueprint for fraud." On the need for broad construction, see *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). This shift probably reflects a growing awareness of the severe consequences of liability under the securities laws, whether in a private or governmental enforcement action. See cases cited in note 43 *supra*; Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977).

This raises the interesting question of whether the SEC could adopt a broader rule moving toward parity-of-information under § 10(b), so long as it provides fair notice. It has done so in the tender offer area, using its somewhat different authority under § 14(e). See text accompanying notes 177-79 *infra*. One can argue that the Court's decision reached to the common law only in the absence of a legislative or administrative answer to the question of when a duty to speak arises, in an effort to provide guidelines for interpretation of the present rule. On the other hand, the Commission's authority under § 10(b) is only definitional, and the Court's opinion in *Chiarella* may suggest that it was establishing the limits of the statute with respect to the duty of affirmative disclosure, see note 201 *infra*, making it difficult for the Commission to act under § 10(b) without appearing to disregard the Supreme Court opinion.

69. E.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980); Raymond L. Dirks, [1981] FED. SEC. L. REP. (CCH) ¶ 82,812 (Jan. 21, 1981).

provide rules governing every future case, strict adherence to the letter of the Court's opinion is not called for. We shall now look at how the basic elements of an insider trading case might be restated, given the general structure suggested by *Chiarella* and the fiduciary principle.

A. *Who Has a Duty to Disclose?*

I. *Corporate Insiders*

As discussed above, the stumbling block for extending the common law duty of fiduciary disclosure to open-market trading cases was the absence of any clear inducement or reliance on the part of the buying or selling shareholders, whose trading was generally independent of the insider's activity.⁷⁰ In an active market for securities, when material information comes into possession of the issuer but is privileged from disclosure due to some need for confidentiality,⁷¹ many investors will trade under mistaken ideas as to the value of those securities. Those fortunate enough to be on the "right" side of the trade receive an unexpected windfall when the information is disclosed; those on the opposite side are disadvantaged. Insider trading activity, unless it is large-scale, makes little practical difference in the impact of nondisclosure.⁷²

In this light, *Chiarella* cannot be read to premise its fiduciary duty of affirmative disclosure on any investor's actual reliance on a relationship of trust and confidence with the insider, or on any more functional

70. See text accompanying notes 22-23 *supra*.

71. The impact of insider trading is extensively discussed in Wang, *Trading on Material Non-public Information on Impersonal Stock Markets: Who is harmed and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1230-45 (1981).

There are, of course, mandatory disclosure requirements under the federal securities laws. In addition, stock exchange listing requirements provide for such disclosure. See, e.g., Brudney, *supra* note 1, at 326-33. But each of these gives the issuer substantial discretion as to the timing of disclosure and the right to withhold material information if it serves a legitimate business need for confidentiality. See *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514, 521 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979). Hence, investors cannot expect that the market price always reflects all material corporate information. It should be noted that pursuant to listing agreements with securities exchanges, the issuer's awareness of insider trading in its stock may create a particularly strong obligation to make affirmative disclosure. See, e.g., NYSE COMPANY MANUAL, Part II, at A-23 (1978).

72. To the extent that insider trading induces other trades that would not otherwise be made, those persons are "injured." See note 26 *supra*. On the other hand, by moving the market price toward its true value, such insider trading mitigates the adverse effect of issuer nondisclosure on other persons who would have bought or sold in any event. That is, the unknowing sellers may get something closer to true value, while the unknowing buyers get less of a windfall. The abstain-or-disclose rule represents a judgment that the likelihood of little or no market impact, coupled with the unjust enrichment that comes from such trading, outweighs any positive impact in this instance.

objectives.⁷³ As we have seen, the common law duty is not so much a means of compensating for misplaced reliance as of preventing unjust enrichment. It neutralizes the insider's informational advantage through the duty to disclose in order to assure that as a fiduciary he does not profit when a beneficiary is disadvantaged.

Here, the basis in equity for the open-market abstain-or-disclose rule is plain. When an insider buys immediately before the announcement of good news or sells just before bad, his profit arises by virtue of his fiduciary status and the resulting access to the nonpublic information that created the opportunity for low-risk wealth. Requiring public disclosure by the insider in the open-market situation furthers a significant objective underlying the fiduciary disclosure rule—that of preventing unjust enrichment. The disclosure requirement is the federal analog to the agency principle that personal profits made from the agent's use of confidential information are held in trust for the benefit of the principal, even where the agent's conduct results in no harm to the principal.⁷⁴ While the Court's summary rejection of a broader ad hoc fairness approach may be questioned, it is now clear that the key to the abstain-or-disclose rule is finding that the person possessing mate-

73. The rule has a different impact in the publicly held corporation than it does on the closely held corporation, as described in note 17 *supra*. It is arguable that investors will demand a higher risk premium (or forego dealing) if they perceive the market to be dominated by insider trading. See Brudney, *supra* note 1, at 356. But in large publicly held companies, the greater risk to investors is the risk of issuer nondisclosure of material information, whether or not accompanied by insider trading. Indeed, if insider trading has a market impact, it moves the market price in the "right" direction. Therefore, the only relevant impact of the abstain-or-disclose rule on the cost of capital results from the perception that the prohibition removes a disincentive to disclosure that would exist if insiders were permitted to take advantage of nondisclosed information. See note 1 *supra*.

One significant consideration with respect to a company with actively traded securities is the extent to which investors must rely on the market to establish a "fair" price by assimilating all relevant corporate information. See generally V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 1059-62 (2d ed. 1979). Unlike a face-to-face transaction, the organized market makes it impossible to bargain based on exchanged information; thus, the abstain-or-disclose rule is the only practicable means of preventing insiders from taking advantage of nondisclosure. See also note 17 *supra*.

74. RESTATEMENT (SECOND) OF AGENCY § 388 & Comment c (1957). As discussed in note 17 *supra*, the common law agency principle is designed to discourage the agent's temptation to harm the principal by acting contrary to his interest. See also Jones, *supra* note 17, at 486-87. That no actual injury is required may simply be a prophylactic rule, designed to avoid difficult factual inquiry and prevent the conflict of interest. See, e.g., Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939). Conflict of interest is also avoided by a fiduciary duty to disclose. See Wendt v. Fischer, 243 N.Y. 439, 154 N.E. 303 (1926). These functional justifications diminish in significance if one concludes that forbearance of insider trading (the true admonition of the rule, since disclosure is often also a breach) has no adverse impact on the trading marketplace. See note 73 *supra*. Then, the disgorgement principle must be seen wholly in unfairness terms. Cf. Federal Sugar Ref. Co. v. U.S. Sugar Equal. Bd. Inc., 268 F. 575, 582 (S.D.N.Y. 1920) (in a disgorgement case, plaintiff need not show a loss corresponding to the defendant's gain).

rial nonpublic information has a fiduciary-like duty to disclose to those with whom he trades.

The insiders who will always have such an obligation are corporate directors, officers, and employees. Each of these acts in an agency (or quasi-agency) capacity, with the corporate entity itself as principal. Hence, such a person owes fiduciary duties of loyalty and care to the corporation⁷⁵ and derivatively to its shareholders.⁷⁶ As a result, most of the pre-*Chiarella* cases brought under rule 10b-5 are not subject to question. The corporate officers and employees in *Texas Gulf Sulphur*, for example, were certainly fiduciaries and the issuer itself will similarly be subject to such obligations.⁷⁷

The same result should apply to other persons who, without a permanent position within the issuer, nonetheless are serving the issuer in a capacity that creates a relationship of trust and confidence with the company. For instance, the issuer's accountant or attorney is subject to

75. See RESTATEMENT (SECOND) OF AGENCY §§ 379, 387-388 (1958). Among the duties placed on the agent are the duty not to profit from the employment relationship and the duty not to use confidential information for personal profit. *Id.* Although not strictly agents (since they are not subject to control by the corporation), directors are held to the same duties of loyalty and care as are officers. *E.g.* *Cohen v. Beneficial Fin. Co.*, 337 U.S. 541, 549 (1949); *W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* 12 (3d ed. 1979). So are employees. In *Brophy v. Cities Serv. Co.*, 31 Del. Ch. 241, 244, 70 A.2d 5, 7 (1949), the court wrote that a "mere employee, not an agent with respect to the matter under consideration, does not ordinarily occupy a position of trust and confidence toward his employer." However, if he acquires secret information in the course of his employment, "he occupies a position of trust and confidence toward it, analogous in most respects to that of a fiduciary, and must govern his actions accordingly." *Id.* (citing *E.I. du Pont de Nemours Powder Co. v. Masland*, 244 U.S. 100, 101 (1917); *Essex Trust Co. v. Enwright*, 214 Mass. 507, 102 N.E. 441 (1913)).

76. See text accompanying notes 11-19 *supra*. See also *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Singer v. Magnavox Corp.*, 380 A.2d 969 (Del. 1977); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). Even courts that do not adopt the strict fiduciary standard, and instead require "special facts" for affirmative disclosure, base that standard in part on the perceived obligation of an officer or director to deal fairly with corporate shareholders. See, *e.g.*, *Chiarella*, 445 U.S. at 228 n.10; *Pepper v. Litton*, 308 U.S. 295, 307 n.15 (1939).

77. *E.g.*, *Kohler v. Kohler Co.*, 319 F.2d 634, 638 (7th Cir. 1963); *Ward LaFrance Trucking Co.*, 13 S.E.C. 373 (1943). See also *A. JACOBS, supra* note 2, § 66.02[a], at 3-331; *Brudney, supra* note 1, at 346. Section 1603(b) of the American Law Institute's proposed Federal Securities Code [hereinafter cited as *FED. SEC. CODE*] defines the primary category of "insider" to include the issuer for abstain-or-disclose purposes. *FED. SEC. CODE* § 1603(b) (1980). Under state law, even some of the courts that rejected the broad insider duty of affirmative disclosure required such disclosure when the insider acted on behalf of the corporation. See *Northern Trust Co. v. Essaness Theatres Corp.*, 348 Ill. App. 134, 108 N.E.2d 493 (1952); *Fleetwood Corp. v. Mirich*, 404 N.E.2d 38, 46 (Ind. Ct. App. 1980). But see *American Gen. Ins. Co. v. Equitable Gen. Corp.*, 493 F. Supp. 721, 743 (E.D. Va. 1980) (duty to disclose arises only when the insider is buying for his own account, not for the corporation). The effect of nondisclosure by the issuer is to allocate the "wealth opportunity" (see note 20 *supra*) among all the remaining shareholders. This favoring of one class appears inequitable, given notions of how corporations should be run. See cases cited in note 76 *supra*.

fiduciary duties, even though not strictly deemed an agent.⁷⁸ Such a person presumably would have a duty to the company's shareholders for insider trading purposes. Thus, a patent attorney who learns that certain events are about to occur is properly barred from trading in his client's securities.⁷⁹ In *Shapiro*, Merrill Lynch, as underwriter for Douglas Aircraft, was properly prohibited from trading in Douglas stock when it learned of the imminent earnings decline.⁸⁰ In each of these situations, the fiduciary's duty of loyalty should prevent him from appropriating the opportunity to profit from the undisclosed information at a time when corporate shareholders are buying or selling based on mistaken assumptions about the company's worth.

A problem arises, however, when a person who is clearly an insider under the foregoing receives the nonpublic information outside the course of activity that makes him a fiduciary. In a recent SEC enforcement action, a director of the Riggs National Bank in Washington was offered a substantial premium for his large, but not controlling, block of stock. The purchaser ultimately used this block as the base for commencement of a tender offer for control of the bank. After agreeing to sell his block, the director went into the market and purchased additional shares, also to be delivered as part of the block. He was enjoined, by consent, from violating rule 10b-5 for not disclosing his sales agreement to the marketplace sellers before buying additional

78. The term "fiduciary" is not subject to precise definition, requiring the court to determine whether there is an expectation of trust and confidence arising from the relationship in question or whether the law should assume such an expectation so as to prevent overreaching. See *Murphy v. Country House Inc.*, 307 Minn. 344, 351-52, 240 N.W.2d 507, 512 (1976); *Cartwright v. Minton*, 318 S.W.2d 449, 453 (Tex. Ct. Civ. App. 1958); Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949). For a discussion of the lawyer as a fiduciary, see V. COUNTRYMAN, T. FINMAN & T. SCHNEYER, *THE LAWYER IN MODERN SOCIETY* ch. 2 (1976). Three recent examples of courts considering whether there is a fiduciary relationship under the *Chiarella* rationale are *SEC v. Miller*, 495 F. Supp. 465, 482 (S.D.N.Y. 1980); *E.D. Warde & Sons v. Colorado Nat'l Bank*, 502 F. Supp. 461 (E.D. Colo. 1980); and *Marrero v. Banco de Roma (Chicago)*, 487 F. Supp. 568 (E.D. La. 1980).

79. See *SEC v. Lerner, David, Littenberg & Samuel*, Litigation Release No. 9049, 19 SEC Docket 1153 (D.D.C. Apr. 2, 1980).

80. 495 F.2d at 237. The question of whether an underwriter acts in a fiduciary capacity is not an easy one, since in many respects the relationship is purely contractual (at least in a firm commitment underwriting). Indeed, that underwriters are to act in an arms-length, almost adversary, capacity is an assumption of the liability scheme of § 11 of the Securities Act of 1933, pursuant to which underwriters are to police the company's disclosures in its registration statement. See *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968). Nonetheless, the underwriter must at an early stage become privy to confidential corporate information that creates the type of relationship—at least with respect to use of that information—on which the imposition of fiduciary responsibility is normally based. If the underwriter were not deemed a fiduciary, liability with respect to its trading on the basis of such information might be based on a tippee liability theory, see text accompanying notes 119-21 *infra*, or a misappropriation theory, see text accompanying notes 176-208 *infra*.

shares.⁸¹

Apart from a question of materiality,⁸² the issue raised by the case was whether the insider must disclose information coming to him in a non-insider capacity. Merely being a large (as opposed to controlling) shareholder did not make the defendant a fiduciary for other shareholders,⁸³ yet that was the capacity in which the offer (and thus the nonpublic information) came to him. The fact that he was a director—his only role that would create fiduciary status—was fortuitous.

Resolution of this problem depends on how one views the fiduciary obligation. As we have seen, the rationale for imposing such a duty is that corporate officers and directors act as quasi-trustees of assets contributed by shareholders or derived from the operations of the issuer.⁸⁴ They must act in the best interests of the corporation in exercising their responsibilities, not for their self-interest. In a passage quoted in *Chiarella*, the *Cady, Roberts* opinion observes that it is fundamentally unfair to allow such persons to profit from information coming to them as a result of carrying out that trust.⁸⁵ The unjust enrichment rationale therefore suggests that the duty to disclose extends only to information received as a result of acting in that fiduciary capacity.⁸⁶ In theory, at least, this is the conclusion more consistent with *Chiarella*.

The opposite argument would be that the shareholders have placed the director in a fiduciary capacity and are entitled to expect from him fair dealing in all activities reasonably related to the fiduciary role, including any trading in the company's securities.⁸⁷ One practical

81. SEC v. Finamerica Corp., SEC. REG. & L. REP. (BNA) No. 594, A-5 (D.D.C. Mar. 11, 1981).

82. See text accompanying note 171 *infra*. Since it was not clear that any other shareholders were invited to participate in the block purchase, how their conduct would have changed as a result of knowing of the agreement is unclear. Perhaps the existence of the agreement would be regarded as evidence of a forthcoming tender offer (which did occur three months later), and thus the agreement would be material.

83. See *Feldman v. Simkins Indus. Inc.*, 492 F. Supp. 839, 845 (N.D. Cal. 1980) (14% shareholder under no duty to disclose or abstain while in possession of "market" information, since that status creates no fiduciary obligation under state law).

84. See text accompanying notes 11-19 *supra*.

85. 40 S.E.C. at 912 & n.15. This derives naturally from the "access" basis for the obligation as well.

86. See also *Wellman v. Dickinson*, 475 F. Supp. 783, 835 (S.D.N.Y. 1979).

87. See *Flynn v. Bass Bros. Ent. Inc.*, 456 F. Supp. 484, 492 (E.D. Pa. 1978) (§ 14(e) case). The pre-*Chiarella* case law on this point is unclear. In *Reed v. Riddle Airlines*, 266 F.2d 314 (5th Cir. 1959), the president and general manager knew that a person with no prior relationship to the corporation had become interested in, and begun a program of, buying stock of the corporation. The court faced the issue of whether the president was compelled to disclose the information to a minority shareholder whose shares he was buying. The court concluded that there is a general duty to disclose all such market-related "knowledge affecting the value of the stock," at least where such information "had come to his knowledge as an 'insider'." *Id.* at 315. That latter qualification supports the narrower reading of the prohibition. However, it is not clear how the

justification for this broader rule is the difficulty in determining the manner in which the information came to the fiduciary.⁸⁸ This broader rule apparently has been accepted by the American Law Institute in its proposed Federal Securities Code, at least with respect to officers and directors of the issuer.⁸⁹ The Code's prohibition would not, however, cover a lawyer who trades in a client's securities based on information that does not come to him as a result of his representation of the client.⁹⁰ Such information would exist, for instance, when a patent attorney for a company learns from one of his partners that a second company is planning a tender offer for the patent law client.

However this source issue is resolved, it seems clear that after *Chiarella* there must be a pre-existing fiduciary duty (or some near equivalent) in order for a person to be deemed an insider. The proposed Code's "position of access" standard is a broad definition of insider that draws no direct support from *Chiarella*.⁹¹ The Court's more limited definition of insider does, however, leave open some very difficult issues. For example, how should courts treat the president of Company *A* who is secretly negotiating a merger with Company *B* (at a premium for *B*) and, confident of the deal's imminence, quietly purchases a block of *B*'s stock? Since the negotiation is arms-length, it may be difficult to find a "relationship of trust and confidence" owing

president obtained the information, and it does not appear that such information was obtained for any corporate purpose. See also *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978).

88. See Brudney, *supra* note 1, at 346; cf. Brudney & Clark, *supra* note 17, at 1009 (corporate opportunity doctrine). In the corporate opportunity area, courts have shown a greater tolerance for allowing an insider to make use of an opportunity that comes to him in his individual capacity, so long as the company has no interest or expectancy in it. See, e.g., *Johnston v. Greene*, 35 Del. Ch. 479, 487, 121 A.2d 919, 923 (Sup. Ct. 1956).

89. FED. SEC. CODE § 1603(a), (b) (1980). The Code would prohibit trading by any insider who knows a nonpublic "fact of special significance," at least so long as the insider is the issuer, or an officer, director, or controlling or controlled person of the issuer, or a tippee of such an insider.

90. *Id.* § 1603(b)(3). The Code includes within the definition of insider a person "who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question." *Id.* (emphasis added). Former fiduciaries, of course, continue to have fiduciary obligations not to misuse information that came into their possession while fiduciaries. See *Thomas v. Roblin Indus., Inc.*, 520 F.2d 1393, 1397 (3d Cir. 1975). Generally, the Code's insider trading prohibition would provide a more coherent and logical set of rules than the current post-*Chiarella* state of the law. Since it is a statutory proposal, it is not limited by the fraud concept or other constraints imposed by § 10(b).

91. Thus, the prior understanding that a position that gives the trading person "access" to corporate information, without more, creates an abstain-or-disclose obligation, see *Investors Mgmt. Co.*, 44 S.E.C. 633, 644 (1971), discussed in Comment, *Investors Management Company and Rule 10b-5—The Tippee At Bay*, 72 COLUM. L. REV. 545 (1972); Note, *Investors Management: Institutional Investors as Tippees*, 119 U. PA. L. REV. 502 (1971), is no longer valid. There must be, under the majority's rationale in *Chiarella*, a direct or attributed fiduciary link between the trader and the purchasers or sellers. But see *Feldman v. Simkins Indus. Inc.*, 492 F. Supp. 839, 844 (N.D. Cal. 1980) (restating access test).

from *A*'s president to *B*'s shareholders.⁹² It is tempting to articulate an "incipient controlling person" role for *A* and its officers, to which fiduciary status could be attributed, especially when the merger is near consummation. Such a result would require an extension of the *Chiarella* rationale; the better approach may be a derivative (tipper-tippee) theory of liability.⁹³

2. *Tippers and Tippees*

As the earlier discussion indicated, it was established prior to *Chiarella* that tippees of insiders—persons who receive confidential corporate information from an insider—should be treated as if they were insiders for purposes of the abstain-or-disclose rule.⁹⁴ This result, recognized since the earliest of the insider-trading cases under section 10(b), was based on the premise that such tippees are advantaged by their access to inside information, so that allowing them to trade on the basis of this information without disclosure would be just as unfair as letting the insider trade under the same circumstances.⁹⁵ These cases did not require that the insider-tipper profit from the tippee's misconduct. For tippee liability, all that needed to be shown was that the tippee knew (or had substantial reason to know) that the information was received from within the company and that it was material and

92. In *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1971), a representative of the acquiring company bought acquiree stock in anticipation of a merger and was held liable under rule 10b-5. "Insider" status was assumed, without discussion—the sole controverted issue being the materiality of the information at the time of trading. See also *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1043 (7th Cir.), cert. denied, 434 U.S. 875 (1977) (though formally representing opposite party, merger broker owed fiduciary duty to other side as well, based on pre-existing relationship).

93. See text accompanying notes 121-24 *infra*. For a discussion of the incipient controlling person notion in the tender offer area, see Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213, 221-22 (1977). Since the information is given in contemplation that the person may become an insider, imposition of fiduciary status may not be extraordinary. This rationale apparently underlies the court's decision in *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 796 (2d Cir. 1969), treating a "white knight" partner in a takeover battle as an insider for duty-to-disclose purposes. See also text accompanying note 119 *infra*. This situation must be distinguished from that where the acquiring company insider is buying acquiree shares based not on any information received from (or developed with) the acquiree, but based on his own company's interest in the acquiree. There, any imposition of an abstain-or-disclose obligation would have to be based on the incipient controlling person being a fiduciary for the potential acquiree (unless the misappropriation theories discussed at notes 176-209 *infra* are used). This step would be a radical one and inconsistent with the case law and the statutory scheme underlying the regulation of corporate takeovers. See *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969); *Staffin v. Greenberg*, 509 F. Supp. 825, 832 (E.D. Pa. 1981); *Brudney*, *supra* note 1, at 371-76.

94. See text accompanying notes 31-32 *supra*.

95. Indeed, the first open-market case under rule 10b-5, *Cady, Roberts*, was a case of tippee trading. See note 24 *supra*. Cf. *Mosser v. Darrow*, 341 U.S. 267, 271 (1957) (trustee liable for profit made by "tippees").

nonpublic. He then took the information with the same obligations as those imposed on a company insider.⁹⁶

In the pre-*Chiarella* cases, the focus was on the tippee as the primary or coequal wrongdoer. At the same time, courts also held the act of tipping, at least if followed by tippee trading, to be fraud within the scope of rule 10b-5.⁹⁷ Tipper liability has been seen in this respect as aiding and abetting, with the insider facilitating the unlawful trading.⁹⁸ At least one court has viewed the tipper as the proximate cause of the violation, responsible for the foreseeable consequences of his act, *i.e.*, the resulting trading.⁹⁹ As a result, the tipper engaged in a fraud, not simply because he communicated the information (for that alone lacks any element of deception), but because he was responsible for the entire course of conduct (the tip plus the consequential trade). Still, the tippee's trade was the sine qua non of 10b-5 liability.¹⁰⁰

In *Chiarella*, the only reference to tipper-tippee liability is in a footnote. Citing *Shapiro*, the Court stated that "[t]ippees' of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know or should know came from a corporate insider."¹⁰¹ The Court continued that "[t]he tippee's obligation has been viewed as arising from his role as a *participant after the fact* in the insider's breach of fiduciary duty."¹⁰² If read in a limiting fashion, this statement raises questions regarding both tipper and tippee liability.

a. Tipper Liability

Notwithstanding the Court's use of the phrase "participant after the fact" in describing the tippee's trading activity, the *Chiarella* foot-

96. Loss, *supra* note 3, at 40.

97. SEC v. Texas Gulf Sulphur Corp., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1972). See generally 5 A. JACOBS, *supra* note 2, §§ 162-167. Other significant tipping cases include SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976); Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973); Investors Mgmt. Co., 44 S.E.C. 633 (1971).

98. See Raymond L. Dirks, [1981] FED. SEC. L. REP. (CCH) ¶ 82,812 (Jan. 22, 1981).

99. SEC v. Lum's, Inc., 365 F. Supp. 1046, 1058 (S.D.N.Y. 1973). This is much the same as the traditional tort law idea that a person who negligently or intentionally sets in motion a sequence of actions that is the proximate cause of an injury is liable as a principal tortfeasor. This differs only in degree from aiding and abetting liability insofar as the tipper is deemed the source—the *primum mobile*—of the fraud, not merely an assistant in its perpetration.

100. But see text accompanying note 103 *infra*.

101. 445 U.S. at 230 n.12.

102. *Id.* (emphasis added) (citing an American Bar Association subcommittee letter to the SEC on insider trading, reprinted in SEC. REG. & L. REP. (BNA) (No. 233) at D-1, D-2 (Jan. 2, 1974)). For instances where this theory had been offered previously, see 6 L. Loss, *supra* note 2, at 1450-53; Fleischer, Mundheim & Murphy, *supra* note 9, at 818 n.76. See also Investors Mgmt. Co., 44 S.E.C. 633, 650 (1971) (Comm'r Smith, concurring).

note should not be read to mean that tipping without resulting trading violates rule 10b-5. The view that such trading is not a requirement for liability does, however, receive support from language in certain SEC and court decisions,¹⁰³ and tipping may be a breach of a duty of confidentiality under state law.¹⁰⁴ Moreover, clause (c) of rule 10b-5 prohibits not only fraudulent conduct, but conduct that "would operate as a fraud," suggesting that tipping would be fraudulent but for the absence of trading.¹⁰⁵ However, it is difficult to see any deception, much less resulting harm, in a tip that does not lead to trading. After all, the primary justification for the abstain-or-disclose rule in open-market trading is avoidance of unjust enrichment, and there must be enrichment before there can be *unjust* enrichment. This conclusion was recently affirmed by the Second Circuit in *Elkind v. Liggett & Myers, Inc.*, with the observation by the court that it is the tippee's conduct that "is the primary and essential element of the offense."¹⁰⁶

Assuming that there is trading, the next question in establishing tipper liability is the purpose of the tip. Insiders might communicate confidential information to others for many reasons, both legitimate and illegitimate. It is now firmly established that a prerequisite to section 10(b) liability is a showing that the defendant acted with scienter in committing the violation, a term that encompasses knowing as well as reckless misconduct.¹⁰⁷ It is safe to say that before a tipper can be held liable, it must be established that (1) he was aware that he was communicating material nonpublic information and (2) he knew or

103. *E.g.*, Faberge Inc., Sec. Exch. Act Rel. No. 10174 (1 SEC Docket 21, 24, May 25, 1973), where the Commission stated: "[T]he fact that the recipient may not effect any transaction after receiving inside information does not absolve the tipper of responsibility under the Rule [10b-5]. That Rule proscribes conduct which not only 'operates' but also 'would operate' as a fraud or deceit upon investors." See *SEC v. Lunn's, Inc.*, 365 F. Supp. 1046, 1058 (S.D.N.Y. 1973). But see *id.* at 1057. See also *Tarasi v. Pittsburg Nat'l Bank*, 555 F.2d 1152, 1161 n.46 (3d Cir. 1977); *SEC v. Glen Alden Corp.*, [1968] FED. SEC. L. REP. (CCH) ¶ 92,280 (S.D.N.Y.) (consent).

104. See note 5 *supra*.

105. As a separate matter, if the SEC were to seek an injunction against a tipper pursuant to § 21(d) of the Securities Exchange Act, 15 U.S.C. § 78u, it need not show a resulting trade, since that statutory provision allows such an action when a person "is engaged or about to engage" (emphasis added) in a violation. Presumably, all that would be required is a showing that resulting trading is substantially likely.

106. 635 F.2d 156, 165-66 (2d Cir. 1980). See also 5 A. JACOBS, *supra* note 2, § 167.

107. *SEC v. Aaron*, 446 U.S. 680 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). On the issue of the meaning of recklessness, compare *Kiernan v. Homeland, Inc.*, 611 F.2d 785, 788 (9th Cir. 1980) (recklessness shown "if they had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort") with *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979) (recklessness must represent "an extreme departure from the standards of ordinary care . . . to the extent that the danger [of misleading] was either known to the defendant or so obvious that the defendant must have been aware of it"). The standard for recklessness may be lower when the defendant is a fiduciary, at least in an aiding and abetting context. See, *e.g.*, *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 95-97 (5th Cir. 1975).

recklessly disregarded a substantial likelihood that the person receiving the information would either trade on the basis of it or pass it on to another for trading purposes.¹⁰⁸

As to the second requirement, it is not necessary to prove that the tipper intended to facilitate trading by the tippee. Following general tort law, tipper liability requires only that the tipper have knowledge of the foreseeable consequences of his actions, that is, that trading would occur. This rule was applied by the Second Circuit in *Elkind* where, in response to questions from an investment analyst, a company official did nothing more than acknowledge the likelihood of an earnings decline. Nonetheless, because the resulting trading was obviously foreseeable in such a situation, the company was held liable.¹⁰⁹

In addition, in light of the emphasis in the *Chiarella* footnote on a breach of fiduciary duty by the insider, if the insider has a legitimate business purpose in communicating the information, there would be no fraudulent misconduct punishable under rule 10b-5. The existence of the business purpose would lead to the conclusion that no breach of fiduciary duty had occurred. To take an example, in a private merger negotiation, an acquiree company insider might tell the acquirer's officials that his board had decided to approve the deal. That would be material inside information from which the acquirer's executives could profit by buying stock of the insider's company.¹¹⁰ Given the legitimate business purpose for the communication, however, the insider would not be held liable even though it was foreseeable to him that others might trade.

Deciding what is a legitimate business purpose will involve some balancing of interests. For example, cultivating relationships with

108. See also *State Teachers Retirement Bd. v. Fluor Corp.*, FED. SEC. L. REP. (CCH) ¶ 98,005 (2d Cir. 1981). This same rule would apply to a non-insider tipper, *i.e.*, a tippee who does not trade, but instead tips someone else who does. The one qualification here would be that the non-insider tippee must be subject to an obligation to abstain or disclose under the standards for tippee liability, discussed in the text at notes 113-33 *infra*.

109. 635 F.2d at 167. The foreseeability test is essentially that adopted by the SEC in new rule 14e-3(c), see text accompanying note 177 *infra*, which has an elaborate anti-tipping prohibition that provides that it is unlawful for a tender offer "insider" to "communicate material, non-public information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of [the trading prohibition]," 17 C.F.R. § 240.14e-3(d)(1)(i). See 45 Fed. Reg. 60,410 (1980). In the view of the SEC, scienter is not a requirement for liability under § 14(e); hence, the foreseeability standard—essentially a negligence approach—is a valid one. See *id.* at 60,413 n.36.

110. This would follow, assuming that the exchange of shares pursuant to the merger would be at a premium over the current market price of the acquiree company's shares. Interestingly, in *Chiarella*, one of the deals that led *Chiarella* to buy was a merger, not a tender offer. See 445 U.S. at 224 n.1. There was no discussion of this as providing an alternative basis for holding *Chiarella* liable; presumably, it would be subject to the same jury instructions concern as was expressed with respect to the misappropriation theories.

financial analysts, while it might be in the corporate best interest, does not justify divulging confidential information to them.¹¹¹ Whatever gain might accrue indirectly to the company's shareholders from the better relationship is outweighed by the unfairness to marketplace buyers and sellers caused by selective disclosure. By contrast, in the merger negotiations situation, the information is not being given for investment advice purposes, and the likelihood of trading is therefore less, while the benefit to the company is far more certain.¹¹²

b. Tippee Liability

The issue of tippee liability under the *Chiarella* rationale is a particularly difficult one. Unlike the trading or tipping insider, the tippee bears no pre-existing fiduciary relationship to the person with whom he trades. The Supreme Court's apparent endorsement of some tippee liability is an indication that it will not adhere strictly to the idea that only fiduciaries are obligated to make disclosures when trading.¹¹³

In its general prohibition of tippee trading, the Court cited *Shapiro*,¹¹⁴ which had based tippee liability on a rather broad theory of access to inside information. However, the language of the *Chiarella* footnote itself suggests a more limited rationale for the prohibition. By characterizing the tippee's role as a "participant after the fact" in the insider's breach of fiduciary duty, the Court seems to be requiring some co-venture between the tipper and tippee before that breach can be attributed to the nonfiduciary tippee. If so, that suggests a very narrow class of tippee-trading cases that fall within the prohibition, *e.g.*, those

111. See *Elkind v. Liggett & Myers*, 635 F.2d 156, 165-66 (2d Cir. 1980). This brings up the question of the nature of the breach of fiduciary duty when an insider tips. A fiduciary is obligated as a general matter not to disclose confidential information. See RESTATEMENT (SECOND) OF AGENCY § 385 (1957). However, this rule is designed principally to protect the corporation from harm arising from disclosure of, for example, trade secrets. Tippee trading does not, in and of itself, usually harm the corporation since the tippee can be expected to keep the information to himself. See note 5 *supra*. The better view is that selective disclosure is itself a breach, because it favors one shareholder (or soon-to-be shareholder) to the detriment of others, a violation of principles of equity and fairness. See note 76 *supra*.

112. This raises the questions of the relationship of this "business judgment" standard to the scienter requirement itself and of the proof needed after *Chiarella* with respect to awareness of his fiduciary duties under the law. Presumably, a showing that the insider knew that he had a legal obligation to refrain from trading need not be an element of the insider's liability. Showing that he was aware of (or recklessly disregarded) the material, confidential nature of the information should be enough, *i.e.*, a demonstration that the information was not available for public use in tipping or trading. On the other hand, a showing that the insider believed in good faith that he was entitled, notwithstanding his fiduciary obligations, to divulge the information, would presumably negate a finding of scienter. Cf. *State Teachers Retirement Bd. v. Fluor Corp.*, 500 F. Supp. 278, 293-94 (S.D.N.Y. 1980) (duty of disclosure), *aff'd in part, rev'd in part*, FED. SEC. L. REP. (CCH) ¶ 98,005 (2d Cir. 1981).

113. See text accompanying notes 46-47 *supra*.

114. 445 U.S. 230 n.12 (citing *Shapiro*, 495 F.2d at 236-37).

where the insider himself benefits from, or has some continuing involvement in, the tippee's trading.

A reading that requires the insider to benefit, however, would be unduly narrow. In *Schein v. Chasen*, a state common law insider-trading case, the Second Circuit held a tippee liable to the issuer for profits made by trading on the basis of confidential corporate information.¹¹⁵ The tippees, certain investment analysts, had been given adverse earnings information by an official of the issuer. The court characterized this simple tipper-tippee relationship as a "common enterprise," and thus invoked the well-established common law principle that charges all participants with liability for a course of action that results in a breach of fiduciary duty by one participant.¹¹⁶ There was no hint that the company insider profited from the trading in any respect. Similarly, under the law of constructive trusts, when a person receives "information with notice that the person imparting it was committing a violation of his duty as a fiduciary, and made a profit through the use of such information, he is accountable for the profit so made."¹¹⁷

These common law principles effectively resolve cases where the insider commits a breach of fiduciary duty by divulging facts and the tippee is aware that he is receiving the information in this fashion. Difficult cases arise, however, when the tipper does not breach a fiduciary duty by passing along inside information or when the tippee does not know that he received inside information.

It is easy to find cases where an insider passes along inside infor-

115. 478 F.2d 817, 822-23 (2d Cir. 1973). The *Chiarella* Court cited for its "participant after the fact" rationale an ABA subcommittee letter to the SEC, note 102 *supra*, which in turn cites *Schein* as its only authority. The *Schein* decision itself was later vacated by the Supreme Court, *Lehman Bros. v. Schein*, 416 U.S. 386 (1974), with instructions that the Second Circuit decide whether the matter should be referred to the Florida Supreme Court on the issue of tippee liability to the corporation. The Florida court rejected the idea that an insider or a tippee must disgorge his profits to the corporation absent a showing of actual injury to the corporation. *Schein v. Chasen*, 313 So. 2d 739, 746-47 (Fla. 1975). See note 5 *supra*.

116. 478 F.2d at 822 (citing *Jackson v. Smith*, 254 U.S. 586, 589 (1921); *Bankers Life & Cas. Co. v. Kirtley*, 338 F.2d 1006, 1013 (8th Cir. 1964); *Sexton v. Sword S.S. Line, Inc.*, 118 F.2d 708, 711 (2d Cir. 1941); *Oil & Gas Ventures v. Kung*, 250 F. Supp. 744 (D.D.C. 1966)). Those cited cases, it should be noted, involved situations where the fiduciary and the others held liable engaged in something akin to a conspiracy for the joint profit of all participants, including the fiduciary. See also *Hunter v. Shell Oil Co.*, 198 F.2d 485, 489 (5th Cir. 1952); *Irving Trust Co. v. Deutsch*, 73 F.2d 121, 125 (2d Cir. 1934); *B.J. McAdams Inc. v. Boggs*, 439 F. Supp. 738, 752 (E.D. Pa. 1977). But see *Ohio Oil Co. v. Sharp*, 135 F.2d 303, 306 (10th Cir. 1943) (no apparent profit by breaching fiduciary); RESTATEMENT (SECOND) OF AGENCY § 312 (1957) (third party liability for causing breach by agent). *Schein* assumes that the mere receipt of confidential information gives the person receiving the information a quasi-fiduciary status, 478 F.2d at 823, a conclusion that may be overbroad, as emphasized by Judge Kaufman in a strong dissent. See note 121 *infra*. Cf. *In re Calton Crescent*, 173 F.2d 944, 951 (2d Cir. 1949) ("'knowingly confederating' means more, in our opinion, than investing one's own funds on a 'tip' received from an officer or director of a debtor") (bankruptcy case).

117. 5 A. SCOTT, THE LAW OF TRUSTS § 506, at 3570 (3d ed. 1967).

mation without breaching a duty. For example, an insider might tell another executive of a valuable opportunity that the insider's company is about to exploit, asking if the other company would be interested in a joint venture.¹¹⁸ This is clearly the communication of material inside information. However, even if the other executive then trades in the stock of the insider's company, it cannot be said that the insider breached any fiduciary duty owed to his company, since there was an obvious business justification for the communication.

In its opinion in *Raymond L. Dirks*,¹¹⁹ the SEC suggested that the proper approach is to attribute the fiduciary duty itself to the tippee whenever he receives confidential information from an insider, whether through a breach of duty or not. The Commission held Dirks, a securities analyst, liable under rule 10b-5 for communicating information to others regarding possible fraud within the Equity Funding Corporation. Equity Funding insiders who were trying to expose the fraud had given this information to Dirks, who selectively disseminated it to investment managers who traded after receiving the inside information. The Commission presumed that the insiders were entitled to disclose the information and therefore committed no breach of fiduciary duty in doing so. Moreover, Dirks was at the same time attempting to bring those facts to public attention. The Commission nonetheless viewed Dirks as "standing in [the] shoes" of the insiders and as assuming their fiduciary duties not to misuse the information by trading for their own benefit.¹²⁰ As a result, the Commission censured Dirks for his activities.

This amounts to a "constructive breach" theory, one going well beyond the rationale offered in the *Chiarella* footnote. The recipient of the nonpublic information, although properly in possession of it, is prohibited from profiting on the basis of information when it would be a breach of fiduciary duty for the insider to profit or assign that profit by tipping. If the insider knows of the tippee's intention to trade or tip, he is obligated to attempt to prevent that conduct. This theory is clearly a step removed from the "common enterprise" approach, and a novel application of fiduciary attribution principles.¹²¹ At the same time, us-

118. See *SEC v. Lund*, SEC. REG. & L. REP. (BNA), No. 590 (D.C. Cal. Jan. 1981), at A-9.

119. [1981] FED. SEC. L. REP. (CCH) ¶ 82,812 (Jan. 22, 1981).

120. *Id.* at 83,948 n.42. See also *Investors Mgmt. Co.*, 44 S.E.C. 633, 643 (1971).

121. This approach is perhaps partially derived from the law of restitution. A person who receives confidential information from another and misappropriates it for personal benefit holds the proceeds of the misappropriation in a constructive trust for the benefit of the person giving him the information. The misappropriator is thus deemed a *trustee ex maleficio*, which could be considered a quasi-fiduciary. The relationship need not involve a pre-existing fiduciary status; that status is created by the grant of the information, e.g. *Cox v. Schnerr*, 172 Cal. 371, 378, 156 P. 509, 513 (1916) ("It applies in every case 'where there has been a confidence reposed which invests the person trusted with an advantage in treating with the person so confiding.'"); *Thompson v.*

ing a constructive breach theory avoids the inconsistent result of permitting tippee *X* to trade on information if the insider had a good reason to pass it along to him while barring tippee *Y* from trading on the same information because there was no business reason for his receiving it. The purposes of the abstain-or-disclose rule do not justify different treatment of tippees *X* and *Y*. Liability for the tippee should also be found where the insider was tricked into giving up the information or where the outsider stole it.¹²² In sum, the basis for imposing tippee liability should be broad enough to cover functionally similar instances of enrichment. The common enterprise theory is a result-oriented means whereby the tippee is treated as a quasi-fiduciary in order to discourage the insider from favoring one investor over the others. A constructive breach theory accomplishes the same result when the insider acts in the corporate interest in communicating with the tippee, but the tippee takes advantage of the situation. Insofar as it is the unfairly advantaged trading that calls for the remedy, it matters little why or how the tippee received access to the issuer's inside information. In terms of unjust enrichment, effect, not intent, is important.

The opposite conclusion, however, was reached by the Second Circuit in a state law context in *Walton v. Morgan Stanley & Co.*¹²³ Morgan Stanley obtained certain confidential information from Olinkraft Corporation to assist a client who was interested in acquiring Olinkraft. That deal did not go through, and Morgan Stanley later allegedly passed the information to a different client in connection with a tender

California Brewing Co., 150 Cal. App. 2d 469, 472-73, 310 P.2d 436, 439-40 (1st Dist. 1957); *Quinn v. Phipps*, 93 Fla. 805, 113 So. 419 (1927) (discussed in *Schein*, 478 F.2d at 823); RESTATEMENT OF TORTS § 757 & Comment b (1938). However, there must be some expectation of trust and confidence with respect to the information imparted, and the person receiving the information must assent at least implicitly to the expectation. See *Hoover v. Cooke*, 566 S.W.2d 19, 26 (Tex. Ct. Civ. App. 1978). This could be the case in merger negotiations (*but see* text accompanying note 123 *infra*), but would not be the case with respect to the usual tip, where the tippee's use of the information is contemplated. On the other hand, it can be argued that this "quasi-fiduciary" principle comes into play only where the person receiving the information uses it to the detriment of the sources of the information. Certainly the cases in the constructive trusts area generally involve the threat of such harm, usually the appropriation of trade or other business secrets. See *Tyler v. Tyler*, 54 R.I. 254, 256, 172 A. 820, 822 (1934); 5 A. SCOTT, *supra* note 117, § 505, at 3567.

122. See *Investors Mgmt. Co.*, 44 S.E.C. 633, 641 n.18 (1971); *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961); *Herbert L. Honohan*, 13 S.E.C. 754 (1943). Even Commissioner Smith, concurring in *Investors Mgmt.*, would allow his "participant in a breach" theory to cover this type of situation. 44 S.E.C. at 650 & n.2. The proposed Federal Securities Code would not cover stolen information in its insider trading prohibition, leaving the case instead (if "egregious") to the general antifraud prohibition. FED. SEC. CODE § 1603, comment 3(b) (1980).

123. 623 F.2d 796 (2d Cir. 1980). The court relied on an earlier, similar holding in *Frigitemp Corp. v. Financial Dynamics Fund*, 524 F.2d 275 (2d Cir. 1975), which was also cited on the "duty to disclose" issue in *Chiarella*, 445 U.S. at 229. The SEC seems to have taken a different position. See *SEC v. Davidowitz*, SEC. REG. & L. REP. (BNA), No. 616, at A-11 (S.D.N.Y. Aug. 6, 1981) (consent) (imposing liability on an accountant to the acquiring firm for purchasing shares of the acquiree corporation).

offer for Olinkraft. In addition, Morgan Stanley's arbitrage department made purchases for its own account. The court held that Morgan Stanley did not owe a fiduciary duty to Olinkraft. Finding that Olinkraft gave the information to Morgan Stanley as the result of arms-length dealing, the court held Morgan Stanley not liable to Olinkraft for its client's profits from trading on the basis of that information. Judge Oakes dissented, arguing that the expectation of confidentiality surrounding Morgan Stanley's receipt of the information charged it with a quasi-fiduciary status.¹²⁴

If the tipper has breached a fiduciary duty, the next issue is the tippee's state of mind in using the information. As noted above, the Supreme Court has made it clear that scienter—some knowing or intentional deception is a prerequisite for section 10(b) liability.¹²⁵ While the conceptual difficulties in finding deception in an insider trading case can be substantial,¹²⁶ the tippee generally will be found to have acted with scienter if he knows that (or acts in reckless disregard of whether) the information is material and nonpublic and that it derives from a confidential source within the company whose shares he then trades.¹²⁷ This will typically be the case when, for instance, the tippee learns directly from a friend or associate on the issuer's board of directors of an imminent earnings decline.¹²⁸

The harder case arises when the tippee is ignorant of the origin of his information, as when there is a chain of tippees. For example, a client of an investment adviser might be told merely that it appears that Company X will be acquired at a substantial premium in a friendly

124. See 623 F.2d at 801 (citing 3 A. SCOTT, THE LAW OF TRUSTS § 505 (1939), a later edition of which is cited in note 117 *supra*).

125. See note 107 and accompanying text *supra*.

126. See text accompanying notes 22-23 *supra*.

127. *Shapiro*, 495 F.2d at 237-38; see Raymond L. Dirks, [1981] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,948-50 (Jan. 22, 1981). See also *State Teachers Retirement Bd. v. Fluor Corp.*, [1981] FED. SEC. L. REP. (CCH) ¶98,005 (2d Cir. 1981). A problem arises when a person trades based on the belief that the actions of a second person indicate that that person possesses material nonpublic information, without any direct communication between the two. For example, a broker might know that (1) a client has access to inside information and (2) the client is unusually successful in making trading profits in the area related to the client's access position. In other words, the broker suspects that the client is engaged in insider trading. If the broker then begins parallel trading, is he liable as well? Even according to the *Chiarella* footnote, there is probably a breach of duty by the insider; unlike the typical case, however, it involves the trading itself, not a tip. The broker's profits derive from this breach of duty. Thus, if the broker is aware that the insider is trading on the basis of confidential information (*i.e.* the requisite scienter), there is a strong argument for liability. See William Fleiss, Sec. Exch. Act Rel. No. 16642 (19 SEC Docket 872, Mar. 25, 1980) (consent); George Mayer, Sec. Exch. Act Rel. No. 14591 (14 SEC Docket 528, Apr. 4, 1978) (consent).

128. The insider himself will be presumed to know that the information is nonpublic. See *SEC v. Monarch Fund*, 608 F.2d 938, 941 (2d Cir. 1979).

merger. Can he then buy stock in Company X without violating rule 10b-5?

Interestingly, in the *Chiarella* footnote, the Supreme Court indicated that tippees have a duty to refrain from trading on confidential information that they "know or should know" came from a corporate insider.¹²⁹ In its post-*Chiarella*, *Dirks* decision, the SEC has apparently adopted this test, which hints of an abandonment of the scienter requirement, since "should know" is akin to a negligence approach.¹³⁰ Even if the Court's phrase is interpreted to suggest a more severe standard, such as recklessness, it is still possible to argue that the tippee violates rule 10b-5 by trading in the hypothetical case in the preceding paragraph. The obvious origin for such information would be the merger negotiations. A person who is aware of that and nonetheless trades without any further inquiry into the source of the information may be found liable for recklessly disregarding the likelihood that such inside corporate information was nonpublic and hence could not properly be acted upon.

On the other hand, a tippee who honestly believes that the information he receives is public or otherwise unrestricted is probably safe from liability. The Second Circuit recently ruled to this effect in *SEC v. Monarch Fund*,¹³¹ finding no evidence that the tippee investment manager had any basis for believing that the information he had received from corporate insiders was confidential. In large part, this was because the information was fairly general and therefore probably not material. In the *Dirks* case, by contrast, respondent argued that because there had already been public rumors about fraud in Equity Funding, the evidence he had about that fraud was public information that he should have been allowed to pass on.¹³² The SEC rejected this argument, drawing a distinction "between the vague public rumors which were then circulating concerning EFCA, and the clearly non-public, explicit inside information which *Dirks* elicited from several present and former employees of EFCA."¹³³

129. 445 U.S. at 230 n.12.

130. [1981] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,945 (Jan. 22, 1981). *But see id.* at 83,949-50 (finding either actual knowledge or recklessness). The issue of what recklessness means is still open. *See* note 107 *supra*. It is arguable that the "should have known" standard implies a reckless disregard of whether the information came from a source within the corporation. If so, it would be consistent with the scienter requirement. This may have been the intent of the Second Circuit in using that standard. *See* 5 A. JACOBS, *supra* note 2, § 63. *But see* Investors Mgmt. Co., 44 S.E.C. 633, 644 (1971) (defining reason to know).

131. 608 F.2d 938, 942 (2d Cir. 1979).

132. [1981] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,948-49 (Jan. 22, 1981).

133. *Id.*

3. Other Fiduciaries

While the insider's duty to disclose recognized by *Chiarella* rests on a fiduciary obligation running from the insider to the issuer and thereby to the issuer's shareholders, the abstain-or-disclose rule is not limited to situations involving the issuer itself. The rule properly applies when any fiduciary buys from or sells to its beneficiary.¹³⁴ Thus, for example, an investment adviser who is trading with his client in any security would be obligated to disclose all material facts about the security; certainly, a relationship of trust and confidence is present in such a situation. This principle is roughly analogous to the concept that a securities professional implicitly represents that he will deal fairly with his client and that he defrauds the client if he does not do so.¹³⁵ Somewhat to this effect is the Supreme Court's holding in *Affiliated Ute Citizens v. United States*,¹³⁶ discussed in *Chiarella*,¹³⁷ where a bank acting as a market maker on behalf of a group of Indians was liable for inducing the Indians to sell their tribal stock without having disclosed the existence of a more favorable non-Indian market.

What if a government official, knowing information that will substantially affect the price of an issuer's securities, trades in those securities? While the official owes no fiduciary duty to the issuer's shareholders *qua* shareholders, those investors could be viewed as members of the broader class—the country's citizens—to whom the official does owe some duty of fair dealing. Like the corporate insider,

134. See RESTATEMENT (SECOND) OF TRUSTS § 170(2); 5 A. SCOTT, *supra* note 117, § 495, at 3533-35.

135. See *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 312 U.S. 786 (1944). Similarly, in *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), the court found a violation of rule 10b-5 in the failure of a broker-dealer to disclose its market maker status to its customers. In *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1269 (9th Cir. 1979), the court discussed the liability of a financial columnist for "scalping" in terms of the columnist's duties to his readers. Locating such a relationship may have been unnecessary, except as a matter of showing foreseeable reliance, and the suggestion that a fiduciary status existed between the columnist and the public would be an overly expansive reading of the law. See *Peskind, Regulation of the Financial Press: A New Dimension to Section 10(b) and Rule 10b-5*, 14 ST. LOUIS U.L.J. 80, 85-86 (1969). On the issue generally, see *Brudney, supra* note 1, at 368-71.

136. 406 U.S. 128 (1972).

137. 445 U.S. at 229-30. In *Affiliated Ute Citizens v. United States*, the defendants purchased shares in their individual capacities directly from the plaintiffs and arranged for the sale of shares to third parties, effectively serving as market makers in the securities. However, they failed to disclose to the sellers at the time of purchase that the current market value of the stock on the resale market was far higher than the sellers believed. The Court held that this failure to disclose market information constituted a violation of the statute and the rule, noting that "[t]he sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market." 406 U.S. at 153. The duty to disclose such market information was clear, since the defendants undertook, as transfer agents of the stock, to act for the sellers in their best interests, when the defendants were in fact making a market in the shares and profiting personally from the transactions. *Id.* at 152-53.

the government official has an advantageous position as compared to the persons whom he is charged with serving. Thus, the principle of preventing unjust enrichment applies as well in the case of a government official. It follows that he should give up any trading profit coming to him because of his fiduciary position when other investors are harmed by the unavailability of the information.¹³⁸ For example, an official of the Federal Reserve Board who by virtue of his position knows of impending interest rate changes could be held liable for violating rule 10b-5 under the *Chiarella* rationale if he profits through securities trading.¹³⁹ A similar result would follow if an SEC official took advantage of confidential information obtained during a private investigation.¹⁴⁰

B. To Whom Do Insiders Owe the Duty?

After establishing a duty of disclosure, courts must face one of the more vexing questions in insider-trading theory: To whom does the trading insider owe his duty under the fiduciary principle? There are only two possible answers. First, the insider might owe the duty solely to the person who actually bought from him or sold to him; that is, privity would be required. Second, the duty might be owed to the entire class of shareholders (or about-to-be shareholders) buying or selling in the marketplace contemporaneously with the insider.¹⁴¹ The question continues to be a lively one, since the *Chiarella* Court did not address the issue and the circuits are in disagreement.

This issue is purely academic in the context of SEC injunctive or administrative proceedings, or criminal actions. Whatever the difficulties in tracing the insider's transactions, in such a proceeding it is

138. See *United States v. Snapp*, 444 U.S. 507 (1980) (per curiam) (discussing the fiduciary obligations of government employees generally). See also *Jersey City v. Hague*, 18 N.J. 584, 115 A.2d 8 (1955). These cases deal with the official's obligation to the state itself, not to individual citizens. Cf. *Harrell v. Powell*, 249 N.C. 244, 106 S.E.2d 160 (1958) (holding no fraud arising from official's failure to disclose). Nonetheless, insofar as the fraud rule arises from the notion that fiduciaries should not profit from inside information when beneficiaries are disadvantaged, the rationale applies here as well. See generally Note, *The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine*, 47 S. CAL. L. REV. 1491 (1974).

139. See *Blyth & Co.*, 43 S.E.C. 1037 (1969) (holding the tippee of the official liable); cf. *United States v. Keane*, 522 F.2d 534, 544-51 (7th Cir. 1975), cert. denied, 424 U.S. 976 (1976), (public official's use of advance inside information is actionable under the mail fraud statute); *United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970) (defendant committed fraud by selling securities he did not own after receiving confidential information), cert. denied, 401 U.S. 955 (1971).

140. Such activity is directly prohibited by statute as well. See Securities Exchange Act of 1934, § 24(b), 15 U.S.C. § 78x (1976).

141. See text accompanying notes 24-29 *supra*. A middle position is that the disclosure must be made to the marketplace as the only practical way of reaching the traders in privity with the insider. See generally 5 A. JACOBS, *supra* note 2, at 3-251; 3 L. LOSS, *supra* note 2, at 1468; Ruder, *supra* note 27, at 446.

enough to say that defendant's nondisclosure results in a breach of duty to some buyer or seller, whether or not identified. Thus, cases such as *Cady, Roberts* and *Texas Gulf Sulphur* do not focus on the issue of identification. The issue is crucial in private actions, however, where it is necessary to identify those injured by the breach. Indeed, in cases involving transactions in the institutional marketplace, the answer to this question will determine whether a private cause of action may be brought at all.

As observed earlier, the Second Circuit in the *Shapiro* case took the view that the insider owed a duty not just to his buyer or seller, but to the entire trading marketplace.¹⁴² Since in the anonymous marketplace the matching of buyers and sellers is arbitrary and fortuitous and the insider stands in no greater fiduciary relationship to his particular buyer or seller than to any other trading shareholder, any narrower duty would be wholly artificial. Assuming this duty, then, the insider's breach "injures" any trader who would not have bought or sold had there been adequate disclosure to the marketplace.

This result was rejected by the Sixth Circuit in *Fridrich v. Bradford*,¹⁴³ specifically on the issue of causation: the duty imposed on an insider is not really an affirmative disclosure obligation; the insider always has the choice, and normally the obligation, instead to *refrain* from trading on the basis of the nondisclosed information. Had the defendants simply refrained from trading, plaintiffs would presumably still have engaged in the trading that allegedly injured them, for the assumption is that the issuer itself was privileged to withhold the information. Thus, in the typical case (where there is an absence of an affirmative inducement of trading and of a market impact resulting from the insider's trades), the causation element needed to establish a right to damages would be lacking.¹⁴⁴

The Sixth Circuit's emphasis on causation, however, seems to prove too much. It suggests that in the typical case no one is deceived—even the person actually in privity with the insider. If so, given the Supreme Court's insistence on deception as a prerequisite to a section 10(b) violation,¹⁴⁵ it raises a question as to whether that section should apply at all to such instances of insider trading.¹⁴⁶ On the other

142. 495 F.2d at 240.

143. 542 F.2d 307, 318-19 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

144. See generally Comment, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299 (1974); Note, *Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864 (1969).

145. *Santa Fe Indus. v. Green*, 430 U.S. 462, 474-77 (1977).

146. *Santa Fe* involved a short form merger where there was no showing of actual deception and there was no formal shareholder involvement in the corporate activity. In subsequent derivative actions, lower courts have found the element of deception in the failure of the controlling

hand, if *Fridrich* acknowledges the possible presence of deception, but only where there is privity, the holding is unduly formalistic. Since section 10(b) and rule 10b-5 were aimed at marketplace abuses,¹⁴⁷ it would be contrary to Congress' intent to place common law limitations on their reach that ignore the realities of the modern securities marketplace.¹⁴⁸ As we have seen, there is nothing novel about basing an affirmative disclosure obligation upon a determination that the duty is the only practicable means of preventing a fiduciary's unjust enrichment. Because the insider owes the same sort of fiduciary duty to each trading shareholder or incipient shareholder, the most realistic conclusion is that the duty of disclosure is owed individually to each shareholder disadvantaged by the lack of information.¹⁴⁹

person to come forward with material information about the plan, so that shareholders can take whatever legal action is necessary to protect the corporate interest. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977), cert. denied, 434 U.S. 1069 (1978); *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978). The duty to abstain or disclose recognized in *Chiarella* has a similar element of deception in that had the insider disclosed publicly, the other trading shareholders would not have been disadvantaged. On the other hand, if the insider had abstained, the "injury" to the shareholders probably would have occurred anyway—unlike (presumably) the situation in *Goldberg* and similar cases. Hence, it is something between actual deception and constructive fraud.

147. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 848; 3 L. Loss, *supra* note 2, at 1767-71.

148. 3 L. Loss, *supra* note 2, at 1767-71. See also Brudney, *supra* note 1, at 326-30. One might even extend this rationale to define the "marketplace" to include any person who is trading in that security by any means (e.g., off-board trading, face-to-face transactions), even though the insider is trading on the exchange. That is to say, the mechanism used by the shareholder is unimportant. What is important is that the shareholder was disadvantaged by lack of information at the same time the insider profited because of his access to it. For instance, a seller of a call option might properly be a plaintiff in an action against a corporation that bought its own securities in the equities marketplace. But see *Laventhall v. General Dynamics Corp.*, No. 80-0305-C(5) (D. Mo. Apr. 6, 1981). This raises the question of whether a similar principle should apply when the insider engages in a face-to-face transaction, with private disclosure to the opposite party, while other shareholders are trading uninformed. The answer probably is no, because presumably the disclosure to the other party means that the insider must pay or receive fair value for the shares. Thus, he is not unjustly enriched. See *Stromfeld v. Great Atl. & Pac. Tea Co.*, 496 F. Supp. 1084, 1088 (S.D.N.Y. 1980); *Maldonado v. Flynn*, 448 F. Supp. 1032, 1039 (S.D.N.Y. 1978), *aff'd in part, rev'd in part*, 597 F.2d 789 (2d Cir. 1979); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 395 (S.D.N.Y. 1967), *aff'd in relevant part*, 405 F.2d 215 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969). On the other hand, the disclosure results in a partial tip to the other party, enabling him to receive more (or pay less) than other shareholders who are similarly selling (or buying) those same securities. See also *SEC v. Herbert Hewitt*, Lit. Rel. 9290 (21 SEC Docket 1788, Feb. 24, 1981) (10b-5 violation by seller of certificate of deposit back to bank before others knew of bank's precarious financial situation).

149. See, e.g., Painter, *supra* note 26, at 1378.

In *Wilson v. Comtech Telecomm., Inc.*, 648 F.2d 88, 94 (2d Cir. 1981), the Second Circuit held that plaintiffs had no standing to sue an insider for trading on material nonpublic information, even though they traded after the alleged insider trading but before the public disclosure of the information. The court held that standing to sue is present only where plaintiffs' trading is "contemporaneous" with defendants' and not, as in that case, where plaintiffs' and defendants' trading was nearly one month apart. See also *Kreindler v. Sambo's Restaurants, Inc.*, [1981] FED. SEC. L. REP. ¶ 98,312 (S.D.N.Y. Sept. 23, 1981) (no standing where plaintiffs' and defendants' trades separated by seven days). This limitation on standing seems both arbitrary and inconsistent

Chiarella casts little light on this question, since the Court concluded that *Chiarella* did not owe a duty of disclosure. Nonetheless, implicit within the Court's articulation of the general theory is the assumption that the insider deceives *someone* by his nondisclosure when he trades. The Court's emphasis on the tort law sources for the duty of affirmative disclosure might suggest that it views rule 10b-5 in this regard as applying solely to fraud on one's own buyer or seller.¹⁵⁰ Without further explanation from the Court, however, there is little reason to depart from the preferable view that the duty owed by the insider is one owed to the entire class of uninformed buyers or sellers.

The more difficult problem, of course, is the resulting measure of damages in a class action brought by such shareholders. In an important post-*Chiarella* decision, *Elkind v. Liggett & Myers, Inc.*,¹⁵¹ the Second Circuit appears to have adopted the rule that this class may recover only the defendant's profits, with that award prorated among the entire class bringing suit.¹⁵² This avoids the "draconian" measure of damages that would accrue if each member of the plaintiff class received the difference between the value of the shares on the date of trading had there been effective disclosure and the price he paid for them (a standard measure of damages).¹⁵³ Such a disgorgement measure, however, seems somewhat at odds with the *Shapiro* rationale. The justification for allowing the entire *Shapiro* class of plaintiffs to sue—particularly in light of the limitation in section 28(a) of the Securities Exchange Act to the recovery of "actual damages"¹⁵⁴—is the conclusion that each plaintiff has been injured—in fact, deceived—by defendant's breach of his

with the *Shapiro* logic. Once the privity requirement is abandoned, there is simply no principled basis for distinguishing between a person trading the day after (or 15 minutes after) the insider and one trading a week later, in terms of injury suffered. Both are equally disadvantaged by the lack of information, and if a finding of deception is justified for the former, it is no less so for the latter. Nor was there any reason to worry about excessive liability resulting from the larger class of plaintiffs, since the court had strongly suggested in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980), that the measure of damages is limited to the amount of defendants' profits, whatever the number of plaintiffs involved. See text accompanying notes 151-56 *infra*.

150. For instance, the Court did speak of "a relationship of trust and confidence between parties to a transaction" as the source for the rule. 445 U.S. at 230 (emphasis added). See Pitt, *supra* note 68, at 21; Wang, *supra* note 71, at 1270-71.

151. 635 F.2d 156 (2d Cir. 1980), discussed in Note, 34 VAND. L. REV. 797 (1981).

152. *Id.* at 168-73. This case involved *tipper* liability for tippee trading. See text accompanying note 109 *supra*.

153. For application of this standard measure of damages, see, e.g., *Harris v. American Inv. Co.*, 523 F.2d 220, 227 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 104-06 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) (cover measure). See generally Note, *supra* note 26, at 371-85.

154. Support for the compensatory measure can also be drawn from the limitation in § 28(a) of the Securities Exchange Act to the recovery of "actual damages." 15 U.S.C. § 78bb(a) (1976). The courts have found ways to introduce the disgorgement concept within the strictures of § 28(a). See, e.g., *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

duty of disclosure to the marketplace as a whole. And if so, each has at least a prima facie entitlement to compensation for that injury. The *Elkind* court's explicit recognition that the fundamental concern of the insider trading prohibition is not so much remedying deception as avoiding unfairness is a candid one. But accepting that conclusion, as the Sixth Circuit did in *Fridrich*, raises the question of how conduct, the basis of which is not deception, falls under section 10(b) in the first place and how an individual marketplace member of the plaintiff class has any standing to sue if he cannot show that he was deceived.¹⁵⁵

On the other hand, the *Elkind* result is fully in keeping with the objective underlying the open-market duty to disclose, that of preventing unjust enrichment. *Elkind* is based on the idea that there can be a compensable fraud on the marketplace that differs in kind from any cumulative fraud on all persons acting in that marketplace. Granting standing to the *Shapiro* class of plaintiffs is little more than a recognition that if the fiduciary's profit is to be taken away, the class—having been disadvantaged, if not deceived—has the greatest entitlement to share the award. The result in *Elkind* is correct in terms of theoretical coherence, even though it skirts a number of troublesome issues.¹⁵⁶

C. *With Respect to What Kinds of Securities Is Insider Trading Prohibited?*

The discussion so far has assumed that the securities affected by the insider trading prohibition are the equity securities of the issuer. There, of course, the fiduciary relationship is easily perceptible, for owners of common stock have long been seen as the ultimate benefi-

155. *Elkind* seeks to reconcile its holding with *Shapiro*, while at the same time stating that "[t]he reason for the 'disclose or abstain' rule is the unfairness in permitting an insider to trade for his own account on the basis of material inside information not available to others." 635 F.2d at 169.

156. The courts have traditionally measured damages in corporate and securities law cases to achieve an equitable result in light of both plaintiff's injury and defendant's conduct. For an example of an apparent result-oriented measure, see *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 781-84 (3d Cir. 1976) ("It was error not to consider the whole picture."). The *Elkind* court based its authority for the disgorgement measure in part on the approach taken in the proposed FED. SEC. CODE § 1708(b)(2)(B). See 635 F.2d at 172. That proposed section was amended after objections from the SEC that a pure disgorgement measure is an inadequate deterrent to insider trading, since chances of detection and liability are small, and the rule would provide simply, that if caught, profits must be returned. The Code now provides the court with discretion to award a measure equal to 150% of defendant's profits (or losses avoided). See FED. SEC. CODE § 1708(b)(4) & Comment (Supp. 1981). Though this change had been made public prior to the *Elkind* decision, it was not referred to therein. In tipper liability, such as *Elkind*, a disgorgement measure is a deterrent, since the tipper has no profit at all. A statement by the SEC filed with the Second Circuit in connection with plaintiffs' motion for reconsideration or rehearing urged that the opinion be modified to limit the holding to tipper liability, leaving open the possibility of a larger award when insider or tippee trading liability was at issue. SEC Statement (Nos. 79-7497, -7519, filed Jan. 15, 1981). The motion for rehearing or reconsideration was denied.

ciaries of the corporate trust. The fiduciary duty rationale begins to stretch, however, if one attempts to apply it to insider trading in other financial instruments.

1. *Debt Securities*

That insiders can trade debt securities on the basis of inside information should be readily apparent. The obvious example is a corporate executive, aware that his company is on the verge of bankruptcy, who sells his bonds or debentures prior to such disclosure. The potential for profit is present as well when the debt securities are selling at a depressed price at a time immediately prior to an announcement of good news relating to the issuer's solvency. While the security is less susceptible to price fluctuations because it is a fixed obligation, this aspect goes to the materiality of the information, not its potential for abuse.¹⁵⁷

Under the *Chiarella* rationale, the question is whether a sufficient fiduciary link can be drawn from the insider to the debtholder. Does the creditor have a claim to equal advantage as does the common shareholder, so that it is improper for the insider to profit when the creditor receives less than fair value (or pays more) because of nondisclosure? Although the debtholder does not share the shareholder's common law status as a corporate trust beneficiary,¹⁵⁸ courts have in certain instances recognized that debtholders are entitled to fair dealing apart from compliance with the debt contract. In *Pepper v. Litton*,¹⁵⁹ for example, the Supreme Court indicated that a majority stockholder is bound by the "fiduciary standards of conduct which he owes the corporation, its stockholders and creditors"—language that suggests the existence of obligations beyond the contractual ones.¹⁶⁰ While such obligations may not exceed the obligation not to act in bad faith in causing harm to the debtholder,¹⁶¹ they may be sufficient to create an abstain-or-disclose rule where the insider is taking advantage of information that would have been material to the buying or selling debtholders.¹⁶²

157. See text accompanying note 168 *infra*.

158. For example, a debenture holder is not permitted to sue derivatively on behalf of the corporation. See, e.g., *Darrow v. Southdown Inc.*, 574 F.2d 1333, 1337 (5th Cir. 1978), *cert. denied*, 439 U.S. 984 (1979).

159. 308 U.S. 295 (1939).

160. *Id.* at 311 (emphasis added). See *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 430-31 (5th Cir. 1980), *aff'd in relevant part*, 642 F.2d 929 (5th Cir. 1981); *Brown v. Presbyterian Ministers Fund*, 484 F.2d 998, 1005 (3d Cir. 1973).

161. See, e.g., *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 431-32 (5th Cir. 1980), *aff'd in relevant part*, 642 F.2d 929 (5th Cir. 1981) (en banc).

162. See L. Loss, *supra* note 2, at 46.

2. Options

Recent allegations of insider trading have focused on a strategy whereby persons who know, for example, of a forthcoming tender offer, purchase large numbers of call options in the target company's stock.¹⁶³ After the information becomes public, the insider exercises his right to purchase the newly valuable underlying stock at the lower contract price.

The conceptual difficulty arising in this type of case is that in a conventional negotiated option contract,¹⁶⁴ the option seller need not own any shares of the issuer of the underlying security.¹⁶⁵ The problem, then, is to find the fiduciary duty owing from the insider to the option writer or seller. One is tempted to argue that the option seller is a type of "incipient shareholder," since his contractual obligation is to deliver shares of the issuer upon exercise of the option. The seller would normally do this, if he does not already own shares, by purchasing issuer shares on the open market, thereby becoming a shareholder. Of course, that is not inevitable, since the option seller may instead sell the contract before the insider decides to exercise the option. There may also be a settlement for cash or a default.

The problem of potential abuse of inside information but no clear line of duty also exists in the opposite type of contract, the put option—the right to sell shares in the future at a set price. The insider could obtain a put option in predisclosure anticipation of a market decline. Here, too, there is no reason to assume that the person in privity with the insider is also a shareholder, or that he will necessarily become one. However, the essence of the put option contract is the right to make the opposite party to the contract a shareholder, and this might provide intuitively (if not logically) a type of fiduciary relationship.

Standardized options traded on an options exchange involve further complications. In that situation, the Options Clearing Corporation is formally the issuer of the option, interposed between the writer and the purchaser of the option as guarantor of both delivery and purchase,¹⁶⁶ but it is difficult to see the OCC as a beneficiary of the

163. See *SEC v. Certain Unknown Purchasers of Stocks & Options of Santa Fe Int'l Corp.* (S.D.N.Y. Oct. 26, 1981), discussed in [1981] SEC. REG. & L. REP. (BNA), at A-1 (Oct. 28, 1981). See also [1981] SEC. REG. & L. REP. (BNA), at A-11-12 (June 17, 1981) (panel discussion).

164. A conventional option is written and traded with brokers and dealers acting as intermediaries. See STAFF OF HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96TH CONG., 1ST SESS., REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKET TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1979) [hereinafter cited as SPECIAL STUDY].

165. "Naked" options are options written by a person not owning the underlying security; "covered" options are those where the person owns the underlying security.

166. SPECIAL STUDY, *supra* note 164, at 73-74. In fact, few standardized options are ever exercised. *Id.* at 75-76 and chart on 77.

issuer's (or its insiders') fiduciary obligations. Instead, it simply facilitates trading among option writers, purchasers, and sellers.

Plainly, a narrow reading of *Chiarella*, foreclosing application of the abstain-or-disclose rule to options trading, would open a large loophole for insiders to profit from confidential information. The options trading marketplace as a whole, however, is a mechanism whereby large numbers of persons *do* effectively commit to buy and sell shares, albeit with prices arrived at well before the ultimate transaction and subject to contingencies. Since options marketplace activity does result in at least some persons becoming shareholders of the issuer and others giving up their issuer shares, there is little basis for distinguishing the derivative (options) market from the primary (share) market for disclosure purposes. Then, the issue of what type of security is subject to the insider-trading prohibition is closely related to the question of to whom the duty of disclosure is owed. If the insider's duty is to the entire marketplace, not circumscribed by a privity requirement, it should follow that options trading on the basis of material nonpublic information is prohibited. It can generally be demonstrated that the marketplace involves sales by some persons who are issuer shareholders (or purchases by persons who become shareholders), so that the fiduciary duty is present at least with respect to those persons.¹⁶⁷

D. *The Nature and Use of the Information*

If a duty on the part of the insider or tippee has been established, the next question is what information triggers that duty. A distinction could be drawn between "corporate" information (information relating to the intrinsic value of the issuer, primarily its business and operations) and "market" information (a residual category of noncorporate information), with the suggestion that the insider trading prohibition extends only to the former.¹⁶⁸ Information coming from the bidder in a planned tender offer is a classic example of market information relating to the subject company's securities.

Even if there were a bright line distinguishing the two types of information, nothing in *Chiarella* suggests that such a distinction

167. The proposed Federal Securities Code was recently revised to deal with this problem. FED. SEC. CODE § 1804(a)(6) (Supp. 1981). In *Laventhal v. General Dynamics Corp.*, No. 80-0305-C(5) (D. Mo. Apr. 6, 1981), however, the court held that a corporation buying its own securities in the equities marketplace owed no fiduciary duty to a seller of a call option, since the corporation purchased no call options.

168. See FED. SEC. CODE § 1603, comment (2)(j) (criticizing any such distinction). On market information and the duty to disclose, see Fleicher, Mundheim & Murphy, *supra* note 9. This distinction is often stated merely to criticize the distinction, and it is difficult to find instances where it has been applied, except as a way of distinguishing between inside and outside information.

should be determinative in establishing the liability of insiders and tippees.¹⁶⁹ Rather, what is important is the existence of the fiduciary duty. Where a corporate director receives confidential notice that another company is planning a takeover bid for his company, he is unfairly advantaged if he then buys additional stock in his company, just as if the confidential information were of an earnings increase.¹⁷⁰ The sole question is whether the information is material; that is, whether it is likely that a reasonable investor's decision to trade at the prevailing market price would be affected by disclosure of such information.¹⁷¹ If so—and if the information came to the insider by virtue of his fiduciary position—that information must be disclosed.

Does the plaintiff in an insider trading case have to prove that the information was the basis for the insider's trading decision? Usually, the information is sufficiently material that the insider's reliance on it can be presumed.¹⁷² A rare case might arise, however, where the insider, knowing material adverse information, is compelled by personal

169. At one point in the majority opinion, Justice Powell writes "[m]oreover, the 'market information' upon which [Chiarella] relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company." 445 U.S. at 231 (footnote omitted). This should not be read to draw a distinction between types of information. It appears intended to emphasize that the information in question did not derive from within the company—the target—in whose shares he traded; thus he was not a party to any breach of fiduciary duty.

There is no clear distinction between types of information. What, for example, of an issuer's own repurchase plans? In *Oppenheimer & Co.*, the SEC defined market information as "information which emanates from noncorporate sources and deals primarily with information concerning or affecting the trading markets for a corporation's securities." [1975-76] FED. SEC. L. REP. (CCH) ¶ 80,551, at 86,415 n.2.

170. See *SEC v. Hall*, [1979-80] FED. SEC. L. REP. (CCH) ¶ 97,292 (D.D.C. Feb. 22, 1980) (special counsel to issuers making tender offers for their own stock purchased stock before the tender offers were announced).

171. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Harkavy v. Apparel Indus. Inc.*, 571 F.2d 737, 741 n.5 (2d Cir. 1978); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977). The proposed Federal Securities Code bases the insider trading prohibition on the insider's knowledge of a "fact of special significance," a concept of "materiality plus." See FED. SEC. CODE §§ 202(56), 1603(a) (1980). A subsequent revision to the Code makes that standard applicable only in private rights of action. See *id.* § 1603(a) (Supp. 1981). It is not clear precisely what practical difference exists between the standards of "material" fact and "fact of special significance." Marketplace materiality—the only concept relevant in open-market trading cases—assumes that the information in question would be of sufficient significance to the average investor so that it would alter his perception of the investment decision, and consequently, a market price impact would be expected. Conversely, the only way the insider profits is if there is such an impact.

172. As a result, in private rights of action cases alleging pure nondisclosure, a showing of reliance is generally dispensed with; reliance (and thus causation) is presumed on a showing of materiality. See *Shapiro v. Merrill, Lynch, Pierce, Fenner and Smith*, 495 F.2d 228, 238-40 (2d Cir. 1974); cf. *Mills v. Electric Auto-lite Co.*, 396 U.S. 375, 385 (1970) (plaintiffs alleging that proxy solicitation for a merger was materially misleading and, hence, violative of § 14a of the Security Exchange Act of 1934 needed to show only that the information was material, not that the defect had a decisive effect on shareholders' vote). But see text accompanying notes 142-46 *supra*.

circumstances to sell his stock. He still has an advantage when he sells at the high predisclosure price, but the link between the trading and the presumed harm—unjust enrichment—is attenuated. The SEC has not been consistent on this issue;¹⁷³ the proposed Federal Securities Code requires only a showing that the insider “know” the information in question.¹⁷⁴ At the very least, a presumption of reliance should be established upon a showing of materiality. Then, the insider may rebut the presumption by demonstrating that he did not trade “on the basis of” such information.¹⁷⁵

IV

“OUTSIDER TRADING” AFTER *CHIARELLA*: THE MISAPPROPRIATION THEORIES

The foregoing discussion illustrates how the *Chiarella* rationale—premised on a pre-existing fiduciary duty owed by the insider to marketplace purchasers or sellers—can be utilized in instances of trading securities of the insider’s own company. The issue posed by *Chiarella*, however, was whether the abstain-or-disclose rule could be applied to a person who trades on the basis of material nonpublic information, derived not from the issuer, but from an independent source about to take action that will substantially affect the market price of the issuer’s securities. The case in *Chiarella* was a typical case of “outsider” trading: trading on the basis of an impending, but still secret, tender offer. Another example would be the executive who buys securities of a company to which his firm is about to award a major contract.¹⁷⁶

Soon after *Chiarella*, the SEC adopted rule 14e-3 to prohibit both insider and outsider trading in connection with a tender offer.¹⁷⁷ The

173. Compare *Sterling Drugs, Inc.*, Sec. Exch. Act Rel. No. 14675, 14 SEC Docket 824, 827 (Apr. 18, 1978) (no showing of reliance required) with *Investors Mgmt. Co.*, 44 S.E.C. 633, 641, 646 (1971) (information must be a “factor”). In his concurring opinion in *Investors Mgmt.*, Commissioner Smith suggested that the information must be a “substantial” factor in the trading decision. *Id.* at 651.

174. FED. SEC. CODE § 1603(a) (1980).

175. The issue becomes more complex where a tippee trades, alleging that other factors besides the tip entered into his decision, particularly where the tip was not “hard” information. For example, in *SEC v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979), the investment analyst based his trading decision on various factors. The court found no obligation to abstain or disclose. By and large, these cases will be disposed of by the determination of whether the information was material. If material, the insider or tippee is barred from trading unless the information played no role in the decision to trade. A separate but related issue is the “Chinese Wall” problem, where an entity trades for its own account while, unknown to the trading department, other employees of the entity have material nonpublic information about that issuer. Which formulation of the abstain-or-disclose rule is chosen will affect the result in such a case. But see FED. SEC. CODE § 202(86)(C)(ii) (recognizing Chinese Wall defense).

176. See Brudney, *supra* note 1, at 339-43; Fleischer, Mundheim & Murphy, *supra* note 9, at 798-809.

177. 17 C.F.R. § 240.14e-3 (1980) provides:

principal authority for this rule, section 14(e) of the Securities Exchange Act of 1934, permits the Commission to define and prescribe means reasonably designed to prevent "fraudulent, deceptive or manipulative acts or practices" in the tender offer process. Although this language is similar to that in rule 10b-5, the Commission did not view *Chiarella* as restricting its ability to reach outsider trading pursuant to its rulemaking authority under section 14(e).¹⁷⁸ Nor did the Commission read *Chiarella* as entirely foreclosing the application of rule 10b-5 to outsider trading.¹⁷⁹ In proceedings involving trading on tender offer information where the events in question occurred prior to the adoption of the rule, the Commission has continued to use rule 10b-5, invoking the "misappropriation" theories suggested by Justice Stevens' concurrence and Chief Justice Burger's dissent in *Chiarella*.¹⁸⁰ As noted above, the majority considered it unnecessary to reach these theories, finding that the jury had not been charged properly with respect to either. Thus, the arguments remain open.

A. Fraud Arising from the Misappropriation Itself

One argument for outsider trading liability has three steps. First, under common law, when a fiduciary obtains confidential information and profits from the use of that information, he breaches a legal duty to the person or entity that gave him the information. So far as trading in securities is concerned, it does not matter that the person given the confidential information is not buying or selling securities that were issued by the source of the information; the duty is breached by any profit, with a constructive trust attaching thereto.¹⁸¹ Second, secret misappropriation of such information for personal use in a manner contrary to the expectations of the person giving the information constitutes a

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

178. See Sec. Exch. Act Rel. No. 34-17120, 45 Fed. Reg. 60,410, at 60,412 (Sept. 12, 1980). See Note, *Trading on Material Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981).

179. Note, *supra* note 178.

180. See text accompanying notes 196, 206 *infra*.

181. See note 74 *supra*.

fraud. Finally, that fraud has a sufficient nexus to the resulting trading in securities by the misappropriator so that the jurisdictional "in connection with" prerequisite of section 10(b) is met. This is a line of reasoning that was urged by the government in *Chiarella*, to the effect that Chiarella defrauded his employer and his employer's clients, the tender offerors, by misappropriating the secret information.¹⁸² There is, of course, a substantial difference between this theory and the abstain-or-disclose rule. Under this theory, it is not claimed that the trader has any obligation to disclose the material nonpublic information to his buyer or seller, much less to the public. To the contrary, the only wrong is with respect to the source of the information.

The novelty of this rationale should not be underestimated. It is agreed that when a person has fiduciary status as to the source of the information, he has a duty not to use the information for his personal gain.¹⁸³ This follows even if his misuse causes no injury to his principal, although some courts would question that extension of the rule.¹⁸⁴ The difficulty comes in perceiving that breach of duty as a fraud.

As noted above, fraud within the meaning of section 10(b) must involve some element of deception.¹⁸⁵ Moreover, rule 10b-5 cases have consistently involved a deception connected to the deceived person's purchase or sale of a security, a decision not to purchase or sell, or some other investment related activity. Each of these points reveals a problem in applying the "fraud on the source" theory.

It is true that in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,¹⁸⁶ the Supreme Court characterized misappropriation as a "garden variety" of fraud.¹⁸⁷ There, the Court held the sole shareholder of a company liable under section 10(b) for converting to his own use the proceeds of his company's sale of bonds. But the key to this holding was the fact that the defendant had induced the company's board of directors to make the sale in order to facilitate the misappropriation.¹⁸⁸ The Court thus found that the board actually had been misled.

By contrast, simple misappropriation of information or use for

182. See Brief for the United States at 28-38, *Chiarella v. United States*, 445 U.S. 222 (1980). This theory had been accepted by the Second Circuit in *Chiarella*. See 588 F.2d at 1368 n.14. It is possible to argue that even a nonfiduciary can obtain information deceptively, so that if he then trades on the basis of the information, his conduct falls under rule 10b-5.

183. Brief for the United States in *Chiarella* (citing RESTATEMENT OF AGENCY §§ 383, 388, 390, 393, 395 & Comments a, c (1933)); 1 F. MEACHEM, LAW OF AGENCY §§ 1189, 1191, 1209, 1224 (2d ed. 1914).

184. See notes 5, 74 *supra*.

185. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471-74 (1977); note 146 *supra*.

186. 404 U.S. 6 (1971).

187. *Id.* at 12-13.

188. *Id.* at 9; see *Santa Fe Indus., Inc. v. Green*, 430 U.S. at 475 n.15.

personal profit is tenuous deception at best. Unlike the owner of converted property, the source of the information is never deprived of its use. While a company may well have an expectation that its agents and employees are not abusing their trust, unless that abuse has included efforts to evade usual supervisory efforts, the law has tended not to treat the simple breach of that trust as a deception.¹⁸⁹ To do so would be to turn almost any breach of fiduciary duty, except one done openly and defiantly, into a fraud.¹⁹⁰

Moreover, even if simple breach were deemed a fraud, it may not be proper to deem it to be "in connection with the purchase or sale of any security" within the coverage of section 10(b). The source of the information is not necessarily defrauded as part of any investment-related activity of its own. It is therefore unlikely, in the typical situation, that the source would be regarded as within the class of persons intended to be protected by section 10(b).¹⁹¹ To this effect, for example,

189. In its brief in *Chiarella*, the government argued that "[a]n agent contemplating a transaction that could infringe these [fiduciary] rules has an unqualified duty to permit his principal to take steps to protect himself" (citing, e.g., RESTATEMENT (SECOND) OF AGENCY, § 395 & Comment c (1957)) and that "[n]on-disclosure by an agent or other fiduciary in such circumstances constitutes deceit." Brief for United States at 35-36. This argument may be overstated. Some element of inducement, i.e., a trick or, at the very least, silence in the face of reliance by the principal on the nonexistence of the breach, seems necessary.

Under the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341-1343, misuse of fiduciary position can be deemed fraudulent to the extent that there is a concealment or nondisclosure that either harms the interests of the principal or threatens such harm. See, e.g., *United States v. Von Barta*, 635 F.2d 999, 1003-06 (2d Cir. 1980); *United States v. Bronston*, SEC. REG. & L. REP. (BNA) No. 619, at A-1 (2d Cir. Aug. 19, 1981). This principle has been applied broadly, particularly with respect to government officials, apparently under the theory that nondisclosure of a conflict of interest (resulting from a bribe, for example) deceives the citizens, who are entitled to have honest officials. See *United States v. Mandel*, 591 F.2d 1347, 1359-60 (4th Cir. 1979). Nonetheless, a mere breach of fiduciary duty (particularly in the corporate context) is not necessarily within the scope of the fraud prohibition. See *United States v. Dixon*, 536 F.2d 1388, 1399-1400 (2d Cir. 1976); *United States v. George*, 477 F.2d 508, 512 (7th Cir. 1973). See also notes 139-40 *supra*.

In *United States v. Buckner*, 108 F.2d 921 (2d Cir.), cert. denied 309 U.S. 669 (1940), the mail fraud statute was used to reach a scheme by members of a bondholders protective committee to use confidential information to profit from trading in the subject bonds. It was clear there that the bondholders themselves were injured. See also *United States v. Dixon*, 536 F.2d at 1399 ("there is abundant authority that a scheme to use a private fiduciary position to obtain pecuniary gain is within the mail fraud statute").

190. See, e.g., *Goldberg v. Meridor*, 567 F.2d 209, 221-25 (2d Cir. 1977) (Meskill, J., dissenting), cert. denied, 434 U.S. 1069 (1978).

191. As a matter of standing to sue, the Supreme Court has limited access to the courts in private actions to purchasers and sellers of securities. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). But that standing rule does not define the limits of § 10(b) in actions by the SEC. See *id.* at 751 n.14. The broader question is the scope of the rule itself, a concern of the Second Circuit in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), which first enunciated the purchaser-seller limitation. Both concerns were the subject of a pre-*Blue Chip* opinion by Judge Stevens in *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654, 658-59 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974). That case articulated a broad rule allowing a suit under § 10(b) to a guarantor-shareholder of a purchasing corporation. The

is *O'Brien v. Continental Illinois National Bank & Trust Co.*,¹⁹² where the Seventh Circuit, relying heavily on *Santa Fe Industries, Inc. v. Green*,¹⁹³ ruled that a nondisclosure of a conflict of interest by Continental to the pension trusts on behalf of which it exercised discretionary investment authority was not a fraud within the scope of rule 10b-5. The trusts had argued that if the bank had disclosed that it was purchasing securities for the trusts in companies for which it was also a major creditor, the trusts would have terminated the agency agreements. The court held that the exercise of supervision over such a fiduciary, and frauds and misrepresentations related solely thereto, was a state law matter outside the concern of the federal securities regulation, even though the defendant bank was clearly buying and selling securities.¹⁹⁴

Notwithstanding these difficulties, there are some outsider trading fact situations for which this misappropriation theory should be available. In a tender offer case, the bidder is planning the acquisition of

test is whether the activity of the defrauded person was related to a purchase or sale decision. *Cf.* *United States v. Naftalin*, 441 U.S. 768 (1979) (purpose of § 17(a) of the Securities Act of 1933 is to protect persons involved in the securities marketplace, so protecting the integrity thereof).

192. 593 F.2d 54 (7th Cir. 1979).

193. *See* note 146 *supra*.

194. One need not accept the result in *O'Brien* to recognize the validity of its general principle. Indeed, the trusts in that case were clearly defrauded in their capacity as investors, even though they had ceded discretionary authority over investment strategy and execution to the bank. *See also* *Lewelling v. First Cal. Co.*, 564 F.2d 1277, 1279-80 (9th Cir. 1977); *Lanning v. Serwold*, 474 F.2d 716, 718-19 (9th Cir. 1972).

More generally, the Supreme Court has recognized the validity of a broad test that a fraud must simply "touch" a purchase or sale of a security to fall within § 10(b). *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971). This idea has been applied to situations involving misappropriation of proceeds of a sale in breach of contract, *e.g.*, *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1094-95 (2d Cir. 1972), and schemes to convert securities themselves, *e.g.*, *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972, 977-79 (S.D.N.Y. 1964). But even here, the defrauded person was injured in his capacity as investor, and the logic of using § 10(b) is apparent. *Cf.* *United States v. Brown*, 555 F.2d 336 (2d Cir. 1977) (§ 17(a)) (defendants convicted even though defrauded party was only a transfer agent and not a purchaser).

Professor Scott urges that a prohibition against insider trading may be justified as a means of protecting corporate privacy. *See* Scott, *supra* note 3, at 817-18. For instance, the trading by the insiders in *Texas Gulf Sulphur* might be seen as feeding the "rumor mill" surrounding the securities market, endangering the company's plans secretly to buy land options in the area surrounding the ore strike. The extent to which this confidentiality interest is within the scope of protection established by § 10(b), however, is problematic for the reasons articulated in *O'Brien*.

One response in attempting to bring the source of the information within the scope of that protection—at least when the source is the issuer of the securities being traded—might be that such trading clouds the integrity and reputation of the issuer and the market for its securities. *See* *Diamond v. Oreamuno*, 24 N.Y.2d 494, 499, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 82 (1969). This interest at least would be related to the purposes underlying the statutory provision. However, one can question the extent to which that alleged harm has any factual basis, noting the alternative means the issuer has of protecting its interests, including state law remedies. *See* note 5 *supra*.

securities and must do so in absolute secrecy.¹⁹⁵ Any leak of the information can imperil the bid, and therefore the bidder usually has security procedures that must be broken in order to breach confidentiality. Furthermore, significant insider trading can injure the bidder to the extent that it drives up the market price of the subject company's shares and forces payment of a higher premium by the bidder or causes the bidder to drop the plan. When a person connected with such bids receives his information on a "need to know" basis, deception occurs when that person violates the bidder's expectation that the information will not be misused and conceals his misuse of it. Since the bidder is engaged in investment related activity, the "in connection with" requirement is met. In one settlement after *Chiarella*, the SEC acted under rule 10b-5 against a stockbroker and his father, who allegedly received information from a paralegal in a law firm regarding two forthcoming tender offers and then bought target company shares.¹⁹⁶ The paralegal was alleged to have fraudulently misappropriated the secret information from the bidders, and her tippees were charged with responsibility for that breach. In such cases, the elements of a cause of action under rule 10b-5 seem to be satisfied.

In *United States v. Newman*,¹⁹⁷ a criminal action under rule 10b-5, the government charged defendants under precisely this misappropriation theory for *Chiarella*-type trading on tender offer information. Sustaining the indictment in the face of an attack on whether fair notice had been provided that such conduct is proscribed by section 10(b), the Second Circuit ruled that defendants' misappropriation of the information defrauded both the employers of two of the defendants (investment bankers) and the employers' clients (the tender offer bidders). The court went so far as to write that "[b]y sully[ing] the reputations of [the] employers as safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money."¹⁹⁸ Also, defendants' own trades were sufficient to satisfy the "in connection with" requirement, quite apart from whether the persons defrauded were making investment related decisions. In these respects, the court's decision is an invitation to an expansive application of rule 10b-5 to any outsider trading that involves an improper obtaining or use of confidential information.

195. See A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING 4-6 (1981).

196. SEC v. Wyman, Lit. Rel. 9311, 22 SEC Docket 391 (S.D.N.Y. Feb. 20, 1981) (consent). One of the tender offers in question did not take place, in part, allegedly, because of a market price rise in the subject company's stock immediately prior to the planned commencement date.

197. [Current] FED. SEC. L. REP. (CCH) ¶ 98,332 (2d Cir. Oct. 30, 1981).

198. *Id.* at 92,052.

B. *Misappropriation as a Fraud on the Marketplace*

A separate misappropriation theory, also urged by the government,¹⁹⁹ was articulated by Chief Justice Burger in *Chiarella*.²⁰⁰ This theory is that while mere access to nonpublic information does not give rise to a duty to disclose to one's purchaser or seller, such a duty arises even without any fiduciary relationship when the defendant has unlawfully misappropriated or converted that information.

Since the majority did not reach the issue of unlawful misappropriation, the only question that arises is to what extent it is consistent with the majority's reasoning. The answer depends on whether or not the majority's pre-existing fiduciary duty rationale is the exclusive source of a disclosure obligation under rule 10b-5. There are some indications in the majority opinion that exclusivity is intended in order to provide clear notice as to when the duty exists.²⁰¹

As discussed above, however, the common law of misrepresentation—from which the Court drew its fiduciary duty rationale—cannot be read as suggesting that *only* a fiduciary relationship leads to an affirmative disclosure duty. The "special facts" doctrine of *Strong v. Repide* is not, as the Court suggested, just a subclass of the fiduciary disclosure rule, but an illustration of a broader trend in the law of torts to require affirmative disclosure of basic facts to a transaction that are peculiarly within the knowledge of one party to the transaction.²⁰²

199. See Brief for the United States at 38-42, *Chiarella v. United States*, 445 U.S. 222 (1980).

200. 445 U.S. at 239-43.

201. As noted above, the majority did not qualify its articulation that the duty to disclose arises when a fiduciary relationship is present, and rejected the dissent's formulation of the "special facts" doctrine as merely a subset of the fiduciary duty characterization. See note 44 *supra*. More generally, unless the majority was assuming that the duty to disclose arises only in a "trust and confidence" context, it is difficult to square its wholesale rejection of the "access" approach to liability.

202. See W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 106 (4th ed. 1971); *RESTATEMENT (SECOND) OF TORTS* § 551(2) & Comments k, l (1977). For an example where a broader rule has been applied in the sale of securities context, see *Kaas v. Privette*, 12 Wash. App. 142, 529 P.2d 23 (1974). See also *First Va. Bancshares v. Benson*, 559 F.2d 1307, 1312-14 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978). Examples of other cases are given in Justice Blackmun's *Chiarella* dissent, 445 U.S. at 248. By and large, these cases deal with a seller of property who knows of defects that are not patent. What the law really reflects is a concept of unilateral mistake of fact, quite apposite when one party trades in securities, knowing material information regarding the value of the stock that is not lawfully available to the other party or to the marketplace as a whole. See Brudney, *supra* note 1, at 353-58. Professor Brudney's use of the terms "unerodable" and "unexploitable" informational advantages is helpful in this respect. However, there is a definitional problem with respect to what is meant by information advantages that others may not "lawfully overcome." For instance, many tips occur not because of any plot or scheme to obtain information, but because an insider gratuitously chooses to give it out. The issuer need not have a business need for confidentiality; the information may simply not yet have been effectively disclosed. *E.g.*, *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 853-54 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The abuse here is selective dissemination or use *per se*, quite apart from whether others could have obtained the same information if they knew where to look.

This is little more than a recognition of a duty of common honesty and good faith. It would be most unfortunate, as Justice Blackmun suggested, if the federal securities law were interpreted in a fashion more rigid and restrictive than the common law from which they derived and which they were designed to expand.²⁰³

Although there is a paucity of case law on the subject, there is some support for the idea that disclosure of material facts is required when the person who knows those facts obtained them unlawfully.²⁰⁴ Such a rule would reach the person who obtains information, for example, by industrial espionage. This turns on the idea that while an across-the-board disclosure obligation would penalize those with "superior foresight, industry or skill," that policy consideration is inapplicable where the person in question obtained the information by illegitimate means.²⁰⁵ It is but a small step to apply the same rule to a person like Chiarella, who may have come into possession of the facts lawfully but misappropriates them for his own profit, or to a person who receives information that he or she knows was misappropriated by someone else. Thus, under this theory, the facts alleged in the paralegal case described above would lead to the legal conclusion that her tippees participated not only in a fraud on the tender offerors but on the trading marketplace as well.²⁰⁶

Acceptance of this version of the misappropriation theory would lead to a wide application of the abstain-or-disclose principle. Any person barred by law—including, but not limited to, the laws of agency and other fiduciary relationships—from obtaining or misusing material

203. See 445 U.S. at 248 (Blackmun, J., dissenting).

204. Thus, it has been suggested that a buyer of property was subject to a duty of full disclosure to the seller when he misappropriated the information that formed the basis for the transaction. See, e.g., G. BOWER & A. TURNER, *THE LAW OF ACTIONABLE MISREPRESENTATION* 107 (1974): "In other words, suppression by a purchaser of facts affecting the value of the property which are not merely within his own knowledge, but the issue of his own volitional wrongful action, is equivalent to a misrepresentation." This principle may underlie the English case of *Phillips v. Homfray*, L.R. 6 Ch. App. 770, 779-80 (1871), where the buyers converted coal from the sellers' property prior to purchasing it: "[T]he case is not merely that the purchasers, being more experienced men, knew the value of the coal better than the vendors, but that the vendors being unable to gain access to the coal, the purchaser took advantage of an unlawful access to it in order to test its value." The court added that the buyer must employ a "legitimate mode of acquiring knowledge" if the rule of caveat emptor is to apply. *Id.* at 780. See also, Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936), pointing out that

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

205. See 445 U.S. at 241-42 (Burger, C.J., dissenting).

206. SEC v. Wyman, Lit. Rel. 9311, 22 SEC Docket 391 (S.D.N.Y. Feb. 20, 1981).

nonpublic information would also be prohibited under rule 10b-5 from profiting on the basis of it. Because the information unlawfully obtained or used need not have been derived from within the company whose shares are traded, rule 10b-5 would apply to misuse of confidential information in tender offer and merger outsider trading cases as well as to simple theft of information. This would bring the law back close to the fairness-based theories that began the federal law of insider trading,²⁰⁷ while avoiding an ad hoc approach to determining liability. As a matter of preventing unjust enrichment, of course, a duty to disclose is clearly called for when the information advantage derives from unlawful acquisition or use of the information.

Of course, there are instances of unfair trading that this theory does not cover. Where, for example, executives of a company about to award a profitable contract to another trade in the other company's stock, they are not misappropriating the information if they trade with the approval of their own company. In addition, in a tender offer situation, "warehousing" is not covered.²⁰⁸ Otherwise, there would be few opportunities for taking advantage of material nonpublic information.

CONCLUSION

The open-market insider trading prohibition does not fit comfortably within the fraud and deception framework of section 10(b) and rule 10b-5.²⁰⁹ Nevertheless, the federal securities laws are the only effective

207. See text accompanying note 24 *supra*.

208. "Warehousing" is a process by which a tender offeror directs other persons to begin purchasing subject company shares in the open market, thereby helping to accumulate a block of shares that will certainly be tendered when the offer commences. See *Cohen v. Colvin*, 266 F. Supp. 677 (S.D.N.Y. 1967). This would be prohibited by rule 14e-3, discussed at text accompanying notes 177-78 *supra*.

209. The proposed Federal Securities Code insider prohibition, it should be noted, applies specifically only to issuer insiders (with a rather broad definition that includes persons with a relationship to the issuer affording them access to inside information) and tippees. See FED. SEC. CODE § 1603(a), (b) (1980). But comment (3)(d) to that section indicates that in sufficiently "egregious" instances of nondisclosure by outsiders, the Code's general antifraud prohibition, § 1602(a)(1), might be invoked. This suggests something of a "special facts" test, or the Restatement (Second) of Tort's "basic" facts disclosure rule, whereby an ad hoc fairness test would be applied, albeit in a rather strict fashion. See note 44 *supra*.

An interesting question is the extent to which § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q (1976), could be used in place of § 10(b). Although the Securities Act is concerned primarily with public distributions of securities, its antifraud prohibition, upon which rule 10b-5 was based, applies to the secondary market as well, prohibiting fraudulent conduct "in the offer or sale" of any security. See *United States v. Naftalin*, 441 U.S. 768 (1979). In this sense it covers at least those situations where the insider is selling securities without disclosure. Sections 17(a)(2) and (3) have been construed so as not to contain any scienter requirement, see *Aaron v. SEC*, 446 U.S. 680 (1980), and the section's broad language prohibiting any "transaction, practice or course of business which operates or would operate as a fraud or deceit" may suggest some room for the concept of equitable or constructive fraud. Cf. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963) (under the Investment Advisers Act of 1940, SEC may compel registered investment

means of remedying what is generally considered to be offensive misconduct. It is not the intent of this Article to suggest that the law should be otherwise, when the history and objectives of the securities laws clearly indicate that insider trading activity is to be condemned.

The *Chiarella* decision reflects the complex interplay of the common law and the securities laws. By resting the duty to disclose on common law fiduciary duty principles, it draws lines that, if applied formalistically, could result in the prohibition having an unfortunately limited reach. Perhaps the best solution is legislative revision along the lines of the Federal Securities Code to remove the prohibition from its uneasy fraud base. Yet within the broad outlines of the Court's rationale, there is room for creative interpretation, permitting the law to continue to develop in accord with perceptions about fairness in the securities marketplace. The flexibility of the fiduciary principle should not be underestimated. This post-*Chiarella* restatement of the law of insider trading, then, should be little more than a tentative working draft.

adviser to disclose practice of purchasing shares of security for his own account shortly before recommending that security for long term investment and then immediately selling his own shares at a profit upon the rise in the market price following the recommendation, since such a practice "operates as a fraud or deceit upon any client or prospective client" within the meaning of the Act). That is not to say that it would necessarily provide a means of reaching outsider trading generally, however; the Court's holding in *Chiarella* that no fraud arises from mere silence absent a duty to speak would apply to § 17(a) as well. On the other hand, a "fraud on the source" theory might be easier to sustain under § 17(a). See note 189 *supra*. Compare Hazen, *A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933*, 64 VA. L. REV. 641, 677-78 (1978), with Note, *Section 17(a) of the Securities Act: An Alternative to the Recently Restricted Rule 10b-5*, 9 RUTGERS-CAMDEN L. REV. 340, 353-54 (1978). It is undecided whether § 17(a) can be the basis of an implied private right of action. Compare *Newman v. Prior*, 518 F.2d 97, 99 (4th Cir. 1975), and *Deinoe v. Dean, Witter & Co.*, [1979-80] FED. SEC. L. REP. (CCH) ¶ 97,282 (D. Alaska Sept. 7, 1979), with *Woods v. Homes & Structures, Inc.* [1980] FED. SEC. L. REP. (CCH) 97,616 (D. Kan. Apr. 22, 1980), and *McFarland v. Memorex Corp.* [1979-80] FED. SEC. L. REP. ¶ 97,368 (N.D. Cal. Jan. 29, 1980). See generally Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEO. L.J. 163 (1979).