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INSIDER TRADING AND THE INSIDER TRADING SANCTIONS ACT OF 1984: NEW WINE INTO NEW BOTTLES?

DAVID M. BRODSKY*

I. INTRODUCTION

On August 10, 1984, President Reagan signed into law the Insider Trading Act of 1984 (Act),[1] almost two years after an earlier version was introduced into the House of Representatives at the request and insistence of the Securities and Exchange Commission (Commission).[2] Although the Act differs in several respects from the first bill introduced,[3] it does give the Commission the weapon it sought against so-called "insider trading"—the trebling of the civil monetary sanction and the increasing of the criminal fine that a court can impose upon a finding that a person or entity has engaged in unlawful trading in violation of the Securities Exchange Act of 1934 (1934 Act).[4] But in light of the suspicion that the Commission's ultimate goal in its acknowledged crusade[5] against insider trading is really to eliminate, under the banner of "unfairness," all trading by persons in possession of material nonpublic information,[6] the Act

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1. P.L. No. 98-376, 98 Stat. 1264 (1984), *reprinted in* 2 FED. SEC. L. REP. (CCH) ¶¶ 20,152R, 20,357, 20,366, 20,474, 20,484, 20,484A, 20,601 (1984) [hereinafter cited as The Act].

2. *See* Memorandum of Securities and Exchange Commission In Support of the Insider Trader Sanctions Act of 1982, *reprinted in* 14 SEC. REG. & L. REP. (BNA) No. 38, 1705-08 (Oct. 1, 1982) [hereinafter cited as Memorandum In Support].

3. *See* H.R. REP. No. 98-355, 98th Cong., 1st Sess., *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 2274 (report of House version of the Act, H.R. 559) [hereinafter cited as HOUSE REPORT]. The House version of the Act, H.R. 559, was passed on September 19, 1983. Subsequently, H.R. 559, as introduced into the Senate, S.910, was amended and finally passed by House and Senate, without a conference. Neither the Senate Banking Committee, nor a Senate-House conference, prepared a report. Instead, the House Report, as amended by Senator D'Amato by floor remarks on June 19, 1984, and as further amended by floor comments of Congressmen Dingell and Broyhill, is the only comprehensive source of the legislative history. *See* 130 CONG. REC. S.8912-14 (daily ed. June 29, 1984); 130 CONG. REC. H.7756-60 (daily ed. July 25, 1984). There were three sets of public hearings on the two bills. *See The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the House Subcomm. on Telecommunications, Consumer Protection, and Finance*, 98th Cong., 1st Sess. (1983) [hereinafter cited as *House Hearings I*]; *The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance, 98th Cong., 2d Sess. (1984) [hereinafter cited as House Hearings II*]; *Hearings on S.910 Before the Senate Subcomm. on Securities*, 98th Cong., 2d Sess. (1984) [hereinafter cited as *Senate Hearings*].

4. 15 U.S.C. §§ 78a-78kk (1982).

5. *See* Address by John R. Fedders to Compliance and Legal Seminar of the Securities Industry Association (Apr. 26, 1982).

6. *See* SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 284 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

raises troubling questions concerning the Act's eventual scope. In particular, the Act fails to answer the following critical questions: (1) what types of persons—insiders, quasi-insiders, outside consultants, tippees, brokers—are subject to the new sanctions?; (2) what acts of such persons constitute the proscribed activity?; (3) what kind of information—corporate or market, or both—is regulated by the Act?; and (4) what is the standard of causation which the Commission must prove to make out a violation of the Act?

The thesis of this article is that the Act may do more than its professed sole objective of not changing the substantive law but only adding a new layer of sanctions. The Act in fact may change the law of "insider trading" in significant respects. Particularly, the definition of the acts, persons, and type of information subject to the new Act, as well as the standard of causation, is far more pressing a problem than before the Act was passed because the risks of misuse of tainted information—civil and criminal—are now so much higher.[7] In addition, since the Act adds to the Commission's arsenal of weapons a sanction akin to a fine or penalty, civil defendants may now be entitled to a jury trial of alleged offenses.[8]

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7. As of February 1, 1984, the Commission had brought over 120 enforcement actions alleging violations of the insider trading proscriptions. Lynch, *The Insider Trading Sanctions Act: New Remedies for the SEC*, 31 Fed. Bar News & J. 166, 167 n.13 (1984). In 1984 there have been several indictments returned against traders involving novel fact situations and themes which have not yet been tested fully in administrative or civil proceedings. *See infra* notes 77-78. Since 1980, over 40 indictments or criminal informations have been filed in the Southern District of New York alone. *See Senate Hearings, supra* note 3, at 41-51.

8. *See* House Report, *supra* note 3, at 16. The House Committee Report states that the Supreme Court has reserved judgment on the question whether the right to a jury trial under the seventh amendment is applicable in government civil penalty actions. *See id.* The House Report relies on the Commission's citation to *Atlas Roofing Co. v. Occupational Safety and Health Review Commission* in which the Court declined to address the question of whether a suit in federal court by the government for civil penalties for violation of a statute is equivalent to a suit at common law. *See* Atlas Roofing Co. v. Occupational Safety and Health Review Comm'n, 430 U.S. 442, 449 n.6 (1977). The Committee indicated that the existence of a right to a jury trial in a penalty action should remain solely a matter of constitutional law and expressed no view on the proper resolution of this constitutional issue. *See* House Report, *supra* note 3, at 16. In fact, the law on this issue is not ambiguous, despite the Commission's aggressive citation of *Atlas Roofing*. An action to recover a statutory penalty generally carries the right to a jury trial. As Judge Friendly stated in *United States v. J.B. Williams Co.*, "There can be no doubt that in general 'there is a right of jury trial when the United States sues . . . to collect a penalty, even though the statute is silent on the right of jury trial.' " United States v. J.B. Williams Co., 498 F.2d 414, 422-23 (2d Cir. 1974) (quoting 5 J. Moore, W. Taggert & J. Wicker, Moore's Federal Practice ¶ 38.31[1], at 38-235-36 (2d ed. 1971)).

In *Hepner v. United States*, the leading case in this area, the Supreme Court found a right to jury trial in an action brought by the United States to collect a penalty pursuant to the Alien Immigration Act. *See* Hepner v. United States, 213 U.S. 103 (1909). The Court held that in a civil action to recover a statutory penalty arising from the commission of a public offense. "[t]he defendant was, of course, entitled to have a jury summoned . . . ." *Id.* at 115. *See* United States v. Regan, 232 U.S. 37, 47 (1914) (reaffirming that in action to recovery penalty for alleged violation of Alien Immigration Act "the defendant was entitled to have the issues tried before a jury"); Brown & Williamson Tobacco Corp. v. Engman, 527 F.2d 1115, 1121 (2d Cir. 1975) (civil penalty under § 5(l) of the Federal Trade Commission Act), *cert. denied,*

II. "INSIDER TRADING" PRIOR TO THE ACT: A SHORT HISTORY OF RULE 10B-5

A. *Origins: Breach of Fiduciary Duty by Corporate Insiders*

Section 10(b) and rule 10b-5 are the principal bases[9] upon which the law of insider trading has been created by the Commission and the courts. Of rule 10b-5, Professor Loss has said that "it is difficult to think of another instance in the entire *corpus juris* in which the interaction of the legislative, administrative rulemaking and judicial processes has produced so much from so little."[10] Rule 10b-5 was adopted in haste by the Commission when, in 1943, it was faced with the case of a corporate president buying his company's shares while simultaneously and falsely telling his company's shareholders that earnings would be poor.[11] The Commission based rule 10b-5 upon the theory that such buying of stock while issuing false statements concerning the value of the stock not only violated basic common law notions of fiduciary duties of officers, but also violated strictures against misrepresentation, *i.e.*, fraud.

The Commission's theory had its roots squarely in common law precedents sanctioned by the Supreme Court as early as 1909 in *Strong v. Repide*,[12] which

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426 U.S. 911 (1976). *See also* Brodsky, *Some Clarification Needed on Who Is an "Inside Trader,"* N.Y.L.J., April 28, 1983, at 1, col. 3.

The rationale for such decisions is that suits for statutory penalties were recognized at common law as part of the action in debt. Accordingly, the right of trial by jury in these cases is protected by the seventh amendment to the Constitution, which provides in pertinent part that "[i]n suits at common law, where the value in controversy shall exceed [$20], the right of trial by jury shall be preserved." U.S. CONST. amend. VII.

Moreover, the fact that the action is brought by the government does not deprive the defendants of their seventh amendment rights. It is well settled that "the right to jury trial exists in actions by the United States where it would in a similar action between private parties." Damsky v. Zavatt, 289 F.2d 46, 51 (2d Cir. 1961). As with the several statutes identified above, the Act creates a civil action to recover civil penalties and, therefore, defendants against whom the Commission seeks sanctions under the Act should have a constitutionally protected right of trial by jury.

9. The analysis of the principal cases involving insider trading will focus exclusively on cases arising under § 10(b) and rule 10b-5. There are, of course, two other provisions of the Act and rules regulating so-called "insider trading," § 16 and, in particular § 16(b), 15 U.S.C. § 78p(b) (1982), dealing with short-swing profits made by insiders, and rule 14e-3, promulgated by the Commission, 17 C.F.R. § 240.14e-3 (1984). An analysis of these important sections is beyond the scope of this article, but there is an extensive body of literature on § 16, *see, e.g.*, Roth and Watterson, *Section 16(b): Business Combination Transactions*, 16 REV. SEC. REG. 822 (1983); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939); *see also* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); and on rule 14e-3, *see, e.g.*, Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" v. Economic Theory*, 37 BUS. LAW. 517 (1982); Peloso, & Krause, *Trading on Inside Information*, 14 REV. SEC. REG. 941, 947-48 (1981); Phillips, *Insider Trading Liability After Dirks*, 16 REV. SEC. REG. 841, 847 (1983); Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291, 306-08 (1983).

10. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 820 (1983).

11. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-13 n.32 (1976); Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967); *see also* Freeman, *The Insider Trading Sanctions Bill—A Neglected Opportunity*, 4 PACE L. REV. 220, 221 (1984).

12. 213 U.S. 419, 431 (1909).

held that a major shareholder and general manager of a company was liable for purchasing a minority shareholder's stock without disclosing the fact that the company's sale of property was about to take place. Since *Strong*, most jurisdictions have found such use of information from *inside* the corporation to violate the fiduciary duties of the miscreant corporate officer. Such use of inside information now was forbidden by rule 10b-5[13] as well.

The early federal decisions dealt with the so-called "traditional insiders"—officers, directors, and controlling shareholders—and spoke generally in terms of fiduciary relationships as well as fairness.[14] In dealing with the early cases, the courts did not analyze with care the particular theory under which liability would be imposed.[15] Thus, common law theories of breaches of fiduciary duty based on either insiders' "special relationships" or "unfairness" were both imported into the federal securities laws and transmuted into federal "fraud."[16]

B. *"Disclose or Abstain"*

When the first case of misuse of inside information came before the Commission, it was prepared to extend such common law theories to persons other than officers, directors, or controlling shareholders who did not have clear fiduciary relationships. The case which arose was *In re Cady, Roberts & Co.*,[17] and involved a director of Curtiss-Wright Corporation (Curtiss-Wright) who learned during performance of his duties as a director that Curtiss-Wright would be reducing its dividend.[18] The director informed a fellow employee of the brokerage firm where both were employed, who sold his client's shares in Curtiss-Wright prior to the release of the dividend information to the general public.[19] The Commission found that persons other than officers, directors, or controlling shareholders had a "special obligation" of disclosure when the following two elements were present:

> [F]irst, the existence of the relationship giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness

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13. *See* Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947); *see also* Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5, 7 (1949) ("[I]f an employee in the course of his employment acquires secret information relating to his employer's business, 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"). *But see* Loss, *supra* note 10, at 870 (Supp. 1984).

14. *See* Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

15. *See* Loss, *supra* note 10, at 825 n.22.

16. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951) ("Some courts have called this [duty of disclosure] a fiduciary duty while others state it is a duty imposed by the 'special circumstances.' ").

17. 40 S.E.C. 907 (1961).

18. *Id.* at 909.

19. *Id.*

involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[20]

The Commission then found that the seller and the seller's firm, Cady, Roberts, had violated rule 10b-5, not only because each had a "special obligation," like that of corporate insiders, not to trade on information derived from a person with access to confidential information arising from a fiduciary relationship, but also because of the "inherent unfairness" of permitting a person with access to such secret information to trade on the basis of it while persons with whom he was trading did not have such access.[21] The Commission reasoned that "intimacy demands restraint lest the uninformed be exploited."[22]

In *Cady, Roberts*, the Commission established the now classic rule against insider trading:

> [I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to disclose in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.[23]

Thus was born the disclose-or-abstain rule, the violation of which, when combined with a duty to disclose, constitutes illegal insider trading.

Four years later, in *SEC v. Texas Gulf Sulphur*,[24] the Commission, relying upon *Cady, Roberts*, brought an injunctive action against Texas Gulf Sulphur (Texas Gulf) and certain of its officers and directors for violations of rule 10b-5. The Commission's claims stemmed from the issuance of press releases and the purchase of shares of Texas Gulf by directors, officers, and others during the period of time that mineral discoveries were taking place in Canada.[25] The Commission's complaint included allegations that the individual defendants, knowing of the mineral discoveries, had engaged in securities transactions on their own behalf and had revealed the drilling information to other persons who relied on the information to purchase Texas Gulf securities.[26]

The district court meticulously analyzed the precedents under the com-

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20. *Id.* at 912.
21. *See id.*
22. *Id.*
23. *Id.* at 911.
24. 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).
25. 258 F. Supp. at 273.
26. *Id.*

mon law and rule 10b-5 and found that insiders subject to the disclosure requirements of section 10(b) and rule 10b-5 may include "employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment," and that a disclose-or-abstain rule was appropriate.[27] The district court, however, would not impose liability on a director who did not himself trade, but who tipped his son-in-law within minutes of a public release concerning the mineral discoveries.[28] The court declined the explicit request by the Commission to fix a reasonable waiting period after an announcement was made during which insiders cannot trade, on the ground that it would be "more appropriately done by the Commission . . . with broad rule-making powers" or by Congress.[29]

On appeal, the Commission convinced the Court of Appeals for the Second Circuit to reverse in part and find the tipper-director liable.[30] The court selectively quoted the *Cady, Roberts* two-pronged test, omitting the portion which provides that a person sought to be charged must have "a relationship giving access" to information.[31] The court instead concluded that "anyone . . . trading for his own account . . . [who] has 'access' " and is in possession of material nonpublic information must either disclose it or abstain from trading in or recommending that others do so while the information remains undisclosed.[32]

More importantly, the court in *Texas Gulf* moved to a parity of information theory based in part on *Cady, Roberts*. On the facts themselves, however, the court, as did the district judge, could have based liability for all defendants, including the so-called "tipper," on a fiduciary duty theory. The court instead reasoned that "[r]ule [10b-5] 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 . . . ."[33] Thus, early in the formative stages of rule 10b-5's application to insider trading, the "special obligation" theory underlying fiduciary duties was broadly linked to an "equal access" theory underlying concepts of fairness.[34]

27. *See id.* at 279; *see also* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232, 234 (1903). ("It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known.").

28. *See* 258 F. Supp. at 289.

29. *Id.*

30. SEC v. Texas Gulf Sulphur, 401 F.2d at 852.

31. *See id.* at 848.

32. *Id.*

33. *Id.* at 848, 851-52.

34. It would not be for twelve years until the Supreme Court dealt an apparently fatal blow to the equal access theory. *See* Chiarella v. United States, 445 U.S. 222 (1980).

C. *Parity of Information Theory*

In 1969 the Commission was ready to expand upon the parity of information, or unfairness, theory, which the Second Circuit had adopted in *Texas Gulf.* It was given its opportunity in facts which produced three notable precedents: *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[35] *In re Investors Management Co., Inc.*,[36] and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith.*[37]

In 1968, the Commission brought administrative proceedings against Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) and certain customers of Merrill Lynch after an investigation revealed that the investment banking firm had received non-public information concerning a drop in the earnings of an airplane company for whom Merrill Lynch was planning to underwrite a debt offering.[38] Merrill Lynch had disclosed that information to select customers of the firm.[39] These customers had sold shares of the airplane company, while Merrill Lynch had continued to buy stock in the airplane company for other customers without disclosing the adverse information.[40] Merrill Lynch offered to settle its proceeding and the Commission accepted the offer, in part because of the firm's showing that it had constructed a wall, later to be known as a "Chinese wall," between the two sides of its firm, underwriting and retail.[41]

In the *Investors Management Co.* proceeding against the sellers tipped by Merrill Lynch, the Commission rejected the argument that Merrill Lynch and, derivatively, the tipped sellers, had no duty to disclose.[42] The duty to disclose information arose, according to the majority of the Commission, when three elements were present: (1) the information acquired is material and nonpublic; (2) the tippee knows that it is nonpublic and was acquired improperly; and (3) "the information [was] a factor in his decision to effect the transaction."[43]

The Commission held that one who obtains possession of such information, which he knows emanates from the corporation, and which places him

35. 43 S.E.C. 933 (1968).

36. 44 S.E.C. 633 (1971). The *Investors Management Co.* decision by the Commission was unique from a procedural context alone. After the hearing examiner had found that the respondents, institutional investors, had willfully violated or aided and abetted violations of, among other things, § 10(b) and rule 10b-5, the Commission on its own motion, when no petition for review was filed, decided that since the "legal issues raised respecting the obligations of persons other than corporate insiders who receive non-public corporate information (sometimes referred to as 'tippees') had significant implications for the securities industry and investing public, we deemed it appropriate to consider those issues and express our views on them." 44 S.E.C. at 635.

37. 495 F.2d 228 (2d Cir. 1974).

38. *See Investors Management Co.*, 44 S.E.C. at 636.

39. *Id.*

40. *Id.* at 636-39.

41. *See Merrill Lynch*, 43 S.E.C. at 938.

42. *See Investors Management Co.*, 44 S.E.C. at 643.

43. *Id.* at 641.

"in a position superior to other investors . . . *thereby acquires a relationship with respect to that information* within the purview and restraints of the antifraud provisions."[44] Thus, according to the Commission, the duty to disclose arose not from a fiduciary relationship, but from possession of the information; therefore, the so-called "remote tippees," those who were tipped by Merrill Lynch's salesmen, were equally culpable.[45] Thus, what had started as an analysis based on two standards, special relationship and unfairness, was reduced to the single issue of unfairness. This mutation did not escape the attention of Commissioner Richard Smith whose concurring opinion in *Investment Management Co.* chastised the Commission majority for focusing on the policing of information and its possession, rather than on the duties owed by, and conduct of, corporate insiders.[46] For Commissioner Smith, the key to Merrill Lynch's and the sellers' liability was not possession of information and trading on that information, but the special relationship between Merrill Lynch and the issuer and the sellers' knowledge of that special relationship as the source of the information.[47]

Unlike *Cady, Roberts, Texas Gulf Sulphur* and the earlier cases, the *Merrill Lynch* trilogy[48] imposed insider trading liability upon a category of outsiders, such as underwriters, who had utilized non-public information received on a confidential basis for purposes beyond what was intended when the information was conveyed. These outsiders were thought to be virtually equivalent to traditional insiders because of their entry into fiduciary relationships with the *issuer* corporation and its shareholders.[49] But, despite virtual equivalence, the fact remains that the Commission had successfully extended the unfairness theory beyond the circle of traditional insiders, and would now begin to grope with groups of outsiders who either could not easily be thought of as virtual equivalents to traditional insiders or who lacked special relationships with issuer corporations or their shareholders.

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44. *Id.* at 644. (Emphasis added).

45. *See id.* at 645. The Commission noted the hearing examiner's exculpation of one investment banking firm because the junior analyst who received the information did not communicate it to his superior who made the investment decision, thus upholding the defense that the sale, even while in possession of the information, was not made "on the basis" of it. *See id.* at 647 n.28; *infra* text accompanying notes 141-43.

46. *See Investors Management Co.*, 44 S.E.C. at 648.

47. *See id.*

48. The third case in the Merrill Lynch trilogy was *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, in which the Second Circuit reaffirmed *Texas Gulf Sulphur* but went beyond it to hold that defendants owed a duty "to all persons" who bought the stock of the airplane company during the period that the sellers were disposing of their stock. Sharipo v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974).

49. *See* Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967) (involving purchases by close friends of issuer's officers and directors, pursuant to secret arrangement to share profits: "in determining whether a person, not a director or officer, is a corporate insider it seems . . . that the test is whether he had such a relationship to the corporation that he had access to information which should be used 'only for a corporate purpose and not for the personal benefit of anyone.' ") (quoting *In re* Cady Roberts & Co., 40 S.E.C. 907, 912 (1961)). After *Dirks v. SEC*, this category would be referred to as "temporary insiders." *See* Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983).

D. *Corporate Outsiders—Market Information*

Just as the Commission and the courts were opening the door of 10b-5 liability to include non-traditional corporate insiders trading on corporate information obtained from the issuer, so too was liability being extended to include persons trading on information not emanating from inside the corporate board room or corporate treasurer's office. This type of information, called "market information," as distinguished from "corporate information," became the subject of intense scrutiny in the late 1960's and 1970's during the ferment in the corporate world arising out of hostile take-overs, proxy fights, and other externally imposed events on the corporation.[50]

Two definitions of "market information" were developed. The first, set forth in a landmark law review article in 1973, defined the term as follows: "Market information refers to information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power."[51] The Commission, however, opted for a broader definition which it articulated in *In the Matter of Oppenheimer & Co.*.[52] The Commission stated that " '[m]arket information' refers to information which emanates from non-corporate sources and deals primarily with information concerning or affecting the trading markets for a corporation's securities."[53] The narrower definition was adopted by the Court of Appeals for the Second Circuit in *Chiarella v. United States*,[54] and then by the Government in its brief to the Supreme Court in *Chiarella*.[55] From the context of the majority opinion in *Chiarella*, it appears that a majority of the Supreme Court favors the narrower formulation.[56]

The *Oppenheimer* case, which gave rise to the broad definition of market information, arose in 1972 in the wake of *Investment Management Co.* The Commission instituted private proceedings against Oppenheimer & Co., an investment banking firm, to determine whether it violated rule 10b-5 by disclosing to several customers that an article, to appear in the *Heard on the Street* column in the following day's *Wall Street Journal*, would refer to the firm's analysis of a particular industry and would adversely affect the market price of a particular common stock which such customers held in their portfolios.[57] The Administrative Law Judge (ALJ) found that the conduct violated rule 10b-5 in that the firm had an obligation, stemming from *Cady, Roberts*, to

50. *See* Keown & Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 THE JOURNAL OF FINANCE 855 (1981).

51. Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973).

52. *See* [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,551, at 86,414 (Apr. 2, 1976).

53. *Id.* at 86,415 n.2.

54. United States v. Chiarella, 588 F.2d 1358, 1365 n.8. (2d Cir. 1978), *rev'd* 445 U.S. 222 (1980).

55. Brief for the United States at 51 n. 34, Chiarella v. United States, 445 U.S. 222 (1980).

56. *See Chiarella*, 445 U.S. at 231 n.13.

57. *See Oppenheimer*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,551, at 86,415.

disclose the information generally or abstain from trading.[58] The ALJ made no attempt to analyze the issues of duties owed to the issuer's shareholders, or the firm's lack of any fiduciary relationship to the issuer. On appeal to the Commission, the ALJ's finding was overturned on the grounds that the record did not justify imposition of liability in a case of first impression.[59] In overruling the finding, however, the Commission went out of its way to assert that "[t]here is today no question that the misuse of undisclosed, material 'market information' can be the basis of antifraud violations."[60]

By 1976, when *Oppenheimer* was decided, the high water point of rule 10b-5 had been reached. In that year, the Supreme Court decided *Ernst & Ernst v. Hochfelder*,[61] which put an end to the theory that negligence would suffice as a culpable state of mind under 10b-5.[62] In 1977, the Court further restricted the use of rule 10b-5 by holding, in *Sante Fe Industries v. Green*,[63] that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, is not a violation of rule 10b-5.[64]

In 1980, in *Chiarella*, the Supreme Court attempted to bring a halt to the parity of information or unfairness theories and firmly reattached rule 10b-5 proscriptions against insider trading to concepts of duty and fiduciary relationships arising out of insiders' relationships to their stockholders.[65] *Chiarella* arose in 1977 when the Commission obtained a consent injunction against Vincent Chiarella, a printer who had acquired access to coded Schedules 13D and had broken the code, had purchased stock in the companies about to be taken over, and had subsequently sold the stock for a profit after the bidding companies publicly announced their takeover intent.[66] In January 1978, in the United States District Court for the Southern District of New York, a seventeen-count indictment was returned against Chiarella for violating section 10(b) and rule 10b-5 by failing to disclose to the shareholders of the target companies the material information he had learned from the coded Schedules 13D, while simultaneously trading on the information.[67] After trial and conviction, the Second Circuit (*per* then Chief Judge Kaufman) affirmed his conviction,[68] upon finding that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[69] The Supreme Court granted certiorari and, by a five to four decision, rejected

58. *See id.* at 86,419-2.

59. *See id.* at 86,415 n.4.

60. *See id.* at 86,415.

61. 425 U.S. 185 (1976).

62. *See id.* at 214-15.

63. 430 U.S. 462 (1977).

64. *See id.* at 476.

65. *See Chiarella*, 445 U.S. at 228.

66. *See id.* at 224, 230.

67. *See* United States v. Chiarella, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,400 (S.D.N.Y. 1978).

68. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978).

69. *See id.* at 1365.

the parity of information theory.[70] The Court concluded that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[71] Thus, since Chiarella was neither an insider nor had a relationship with an insider from which a fiduciary relationship could be inferred, the Court concluded that he owed no duty to the shareholders of the target companies who sold their shares without the benefit of the information he possessed.[72]

E. *Misappropriation Theory is Born*

On appeal to the Supreme Court, the Government in *Chiarella* offered an alternative theory to the Court to sustain Chiarella's conviction, arguing that Chiarella had breached a duty owed to the acquiring corporation when he acted upon information made available to him by virtue of his employment by a company employed by the acquiring corporation.[73] That duty was not accepted by the majority of the Court because, in its view, the theory was not properly presented to the jury.[74] But in a footnote in the majority opinion, the majority attempted to dispose of the dissenting views of Chief Justice Burger, who would have affirmed Chiarella's conviction on the basis that Chiarella had a duty to disclose arising out of the misappropriation of the market information.[75] However, the footnote did not dispose of the issue. Rather, it highlighted the issue and gave the Commission and the Justice Department reason to believe that persons breaching duties to their employers,[76] or indeed, duties even to fathers,[77] or newspaper readers,[78] could be held civilly or criminally liable for trading on material nonpublic information to which they were not legally entitled.

In light of the clarification and narrowing of the law of rule 10b-5 by the *Chiarella* majority, the Burger dissent in *Chiarella* is an important signal

70. *See* Chiarella v. United States, 445 U.S. 222, 233 (1980).

71. *Id.* at 235.

72. *See id.* at 231-34.

73. *See* Brief for the United States at 49-71, Chiarella v. United States, 445 U.S. 222 (1980).

74. *See* 445 U.S. at 236, 237 n.21.

75. *See id.*

76. *See* United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983); *see also* S.E.C. v. Materia, [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,526 (S.D.N.Y. Sept. 26, 1983), *amended*, ¶¶ 99,543 (S.D.N.Y. Oct. 14, 1983), 99,583 S.D.N.Y. Dec. 5, 1983), *aff'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 91,861 (2d Cir. Oct. 1, 1984); SEC v. Musella, [Current] FED. SEC. L. REP. (CCH) ¶ 91,416 (S.D.N.Y. Apr. 5, 1984).

77. *See* United States v. Thomas C. Reed, Indictment No. 84 Crim. 610 (RJW), U.S. District Court, Southern District of New York ("Gordon W. Reed and Thomas C. Reed had a special relationship of trust and confidence . . .").

78. *See* United States v. R. Foster Winans, et al., Indictment No. 84 Crim. 605 (CS), U.S. District Court, Southern District of New York ("[defendant] violated his duties owed to the readers of the Wall Street Journal . . ."). After the indictment was filed, the Government announced it would not prosecute on this theory, but the Commission's prosecution of the parallel civil proceeding, *S.E.C. v. Brandt*, is still proceeding on the duty to readers theory.

that, in the view of as many as four Justices, rule 10b-5 should be read expansively to "reach *any* person engaged in *any* fraudulent scheme."[79] The Chief Justice quoted approvingly *Cady, Roberts'* two-pronged test of "access" and "unfairness"; but, in so doing, the Chief Justice omitted mention of the facts that the person who traded in *Cady, Roberts* was related by employment to a true insider of the issuer, and that the information involved was true corporate information.[80] The Chief Justice's dissent dealt with the distinction between market and corporate information only in passing, by arguing that neither the statute nor the rule made such a distinction.[81] In the Chief Justice's eyes, Chiarella was simply a tippee who illegally gained access to nonpublic information and thereby acquired an "informational advantage" which could not be allowed.[82]

It did not take the Commission or the Justice Department long to test the acceptability of the "misappropriation" theory.[83] In *United States v. Newman*,[84] the government obtained the indictment of James Newman, a tippee of employees of two investment banking firms all of whom were in a conspiracy to trade on the basis of information about pending, but secret, mergers and acquisitions in which their firms were involved.[85]

The lower court dismissed the *Newman* indictment,[86] relying primarily on the authority of *Chiarella*, but, on appeal, the Second Circuit set about to resurrect a broad basis of 10b-5 liability.[87] First, the Second Circuit read *Chiarella* as essentially a decision turning on a question of improper pleading by noting that "[a]s the [Supreme] Court observed, '[t]he jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers.' (Citation omitted.) To remedy the deficiency in *Chiarella*, the Government here has pointed its charge of wrongdoing in a different direction."[88] The indictment charged that Newman aided and abetted the breaches by the two employees of the "duties of honesty, loyalty, and silence" owed to their employers, that such breaches constituted "fraud," and that such fraud, when linked with the purchase of securities, constituted a criminal violation of rule 10b-5.[89] The court disregarded the fact that neither Newman, his cohorts, the investment banking firms nor their clients were under a duty

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79. *See Chiarella*, 445 U.S. at 240 (emphasis in original) (Burger, C.J., dissenting) (Justices Stephens, Brennan and Marshall agreed with the Chief Justice's conclusion.).

80. *See id.* at 241-42.

81. *See id.* at 240-41 n.1.

82. *See id.* at 245.

83. In an almost immediate reaction to *Chiarella*, the Commission promulgated rule 14e-3 to make unlawful the purchase by a tender offeror's tippee of a target company's stock. *See* 17 C.F.R. 240.14e-3 (1984).

84. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983).

85. *See id.* at 15.

86. *See* United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981).

87. *See Newman*, 664 F.2d at 16.

88. *Id.* at 15.

89. *See id.* at 16.

to disclose to the sellers of the target company securities that a take-over was about to occur.[90] The court, however, upheld the validity of the indictment and adopted a broad view of "fraud," relying on the misappropriation theory suggested in the Burger dissent in *Chiarella*,[91] without analyzing how such theory squares with the need to find a duty to disclose to issuer shareholders or how it squares with traditional notions that there need be a purchaser or seller defrauded to create a violation of rule 10b-5.[92]

In light of the stress placed by the *Chiarella* majority upon the need to find such a duty, it is remarkable that the Second Circuit does not once allude to this issue in *Newman*, but instead devotes nearly its entire analysis to justifying its conclusion that the activity of Newman and his cohorts was "fraudulent." But for what purpose is the conduct labelled "fraudulent" and as to whom is the conduct "fraudulent"? In *Newman*, the question of whether of necessity a fraud be perpetrated upon purchasers or sellers under the securities laws was put to one side without evident analysis, as was the thrust of *Sante Fe Industries* and *Chiarella*, that an activity which might be considered "fraud" for some purposes, might not be fraud for purposes of rule 10b-5.[93]

In adopting the dissenting view of Chef Justice Burger in *Chiarella* and avoiding the broader questions raised by the so-called misappropriation theory, the Second Circuit, in *Newman*, extended rule 10b-5 liability to an area well beyond what the Supreme Court had contemplated in *Hochfelder, Sante Fe Industries*, or in *Chiarella*. The essence of rule 10b-5 is deception by a person of a purchaser or seller in connection with the purchase or sale of securities, not simply fraud of some variety "touching" a purchase or sale. Since the misappropriation theory premises liability on a person's possession of information and such person's relationship with the person or entity from whom the information was obtained, and not between the possessor and the purchasers or sellers who may be on the other side of trades, the obvious anomoly exists that the person who trades may be criminally liable but will not be civilly

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90. *See id.*

91. *See Chiarella*, 445 U.S. at 240.

92. *See Newman*, 664 F.2d at 16; *see also* Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

93. The "fraud, therefore 10b-5 violation" analysis not only does violence to *Chiarella* but also to *Santa Fe Industries v. Green*:

> To the extent that . . . the term 'fraud' in Rule 10b-5 [would be used] to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.' " (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 165 (1976)).

Santa Fe Industries v. Green, 430 U.S. 462, 472 (1977). *See also* SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) ("But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry, to whom is he a fiduciary? What obligation does he owe as a fiduciary?").

liable to the persons who purchased or sold without access to the information.[94] This anomaly seems fatal to the misappropriation theory for it deprives the victim of a remedy, dislodges the theory from the roots of issuer-investor protection, and reopens 10b-5 to a potential expansion well beyond insider trading, to encompass all possibilities of "fraud" so long as there is a purchase or sale of securities "touching" the fraud.

To date only the Second Circuit has opined on the misappropriation theory. In that circuit's most recent decision on misappropriation, *SEC v. Materia*,[95] the court again failed to address the question of how the theory could be consistent with *Chiarella*. Judge Kaufman (who authored the sweeping decision in *Chiarella* later reversed by the Supreme Court) once again addressed the question of a printer's liability under rule 10b-5 (and also rule 14e-3) where he "stole information . . . and traded on [it] to his pecuniary advantage [after he had] divine[d] the identities of . . . four tender offer targets."[96] Never mentioning the later-decided *Dirks v. SEC*,[97] only once referring to the substantive holding of *Chiarella*,[98] but, as in *Newman*, relying substantively on Burger's dissent in *Chiarella*,[99] the court reaffirmed its adherence to a broad definition of fraud and deceit, without regard to the lack of a "duty to speak" to selling shareholders, which would preclude civil liability for damages.[100] Relying on a single phrase in the 1934 Senate Report on section 10(b),[101] the court erected and demolished the straw man argument that section 10(b) was "aimed solely at the eradication of fraudulent trading by corporate insiders."[102] The court stated that its decision was not governed by *Chiarella* because *Chiarella* "did not . . . disavow the misappropriation theory,"[103] which was an "alternate basis" for the Second Circuit's affirmance of Chiarella's conviction.[104] However, as the Supreme Court itself observed,[105] the jury in Chiarella's trial was not adequately charged on the misappropriation theory, so the Second Circuit's so-called "alternate basis" was not sufficient to sustain the conviction.

In any case, the Second Circuit then neatly disposed of *Chiarella* altogether. Arguing that the duty analysis relied on in *Moss* stemmed from the need to

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94. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984).

95. [Current] FED. SEC. L. REP. (CCH) ¶ 91,681, at 99,447 (2d Cir. Oct. 1, 1984).

96. *Id.* at 99,447-48.

97. 103 S. Ct. 3255 (1983).

98. *See Chiarella*, 445 U.S. at 235.

99. *See id.* at 239 (Burger, C.J., dissenting).

100. *See* Moss v. Morgan Stanley Inc., 719 F.2d at 12-13.

101. *See* S.E.C. v. Materia, [Current] FED. SEC. L. REP. ¶ 91,681 at 99,449 ("Legislative history to the [1934 Act] makes clear that the antifraud provision was intended to be broad in scope, encompassing all 'manipulative and deceptive practices which have been demonstrated to fulfill no useful function.' S. Rep. No. 792, 73d Cong., 2d Sess. 6, (1934)").

102. *See id.*

103. *Id.* at 99,450.

104. *See id.* (court relies on *Chiarella*, 588 F.2d at 1368 n.14.)

105. *See Chiarella* 445 U.S. at 236-37.

deal with burgeoning private rights of action and such "ancillary issues . . . as standing . . . and whether a defendant has breached a duty to a particular plaintiff,"[106] the court stated, "[a]t the risk of repetition, we stress that such analysis [that defendant owed no duty to selling shareholders] *bears only on the type of question raised in a private suit for damages; it is not relevant to an inquiry into whether the Rule was or was not contravened*" (emphasis added).[107] This argument, of course, omits the highly material fact that *Chiarella* itself was decided on such an analysis of duties to shareholders; if the analysis employed by the Supreme Court majority in reversing a criminal conviction of rule 10b-5 is relevant only in a private claim for damages, then, according to the Second Circuit, *Chiarella* is to be ignored.

Notwithstanding the Second Circuit's unwillingness to examine critically the misappropriation theory, it is clear that the fiduciary duty owed to employers, which Chiarella, Newman's cohorts, and Materia violated, is fundamentally different from the duty, stressed in *Chiarella*, arising out of the insider's relationship to his shareholders. The insider's duty arises out of the "special circumstances" of a person's holding another person's property in trust. When the trustee knows a fact affecting the value of the property he holds in trust, he is obligated to disclose that fact before acting on it for his personal advantage. The alternative to disclosure is silence and non-action. But an employee's duty not to sully his employer's reputation has nothing analytically to do with the duty to disclose or abstain. As the commentators have observed,[108] to whom would the employee disclose without further injuring his employer's interest? Since, with respect to issuer shareholders, the employee holds nothing in trust, the employee owes no duty to such shareholders. If the employee injures his employer's reputation by breaking rules of confidentiality, the employer has civil remedies against the employee. As the Court in *Chiarella* emphasized, where there is "no relationship of trust and confidence between parties to a transaction," there is no duty to disclose or abstain, which has always been the essence of the violation of rule 10b-5.[109]

F. *SEC v. Dirks—Tippee Liability Refined*

Meanwhile, another case was on its way to the Supreme Court which provided the Court with another opportunity to clarify its views on the scope of 10b-5 liability for insider trading. In 1973, while acting as an insurance analyst for a broker-dealer, Raymond Dirks met with and was told by Ronald Secrist, a former employee of Equity Funding Insurance Co. (Equity Funding), that a major fraud was being perpetrated at Equity Funding through the booking of nonexistent insurance policies.[110] Neither Dirks nor the firm

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106. *See Materia*, [Current] FED. SEC. L. REP. ¶ 91,681 at 99,450.

107. *See id.* at 99,451.

108. *See* Loss, *supra* note 10, at 869-70 n.40 (Supp. 1984); Phillips, *Insider Trading Liability After Dirks*, 16 REV. SEC. REG. 841, 845-46 (1983).

109. *See Chiarella*, 445 U.S. at 230.

110. *In re* Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,941, 83,943 (Jan. 22, 1981).

he worked for owned any of the stock of Equity Funding, but during the extensive inquiry he made in order to verify the accuracy of the fraudulent policy story he had been told, he did tell a number of his customers who owned Equity Funding securities of the Equity Funding fraud and they in turn sold.[111] The Commission's investigation into the scandal-ridden company included an inquiry into Dirks' conduct and charged that he had aided and abetted violations of rule 10b-5 by repeating the allegations of fraud to persons who sold Equity Funding securities.[112] The Commission concluded that "where tippees—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading."[113]

The Court of Appeals for the District of Columbia entered judgment against Dirks on the grounds stated in the Commission's opinion.[114] Later, one member of the court issued an opinion stating that "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large."[115] This reasoning was an attempt to fit Dirks, an outsider, into traditional insider garb.

In reversing the lower court, the Supreme Court stressed that it had meant what it said in *Chiarella*; insider trading liability is predicated not on possession of non-public information, but on a breach of fiduciary duty by an issuer's agent, fiduciary, or person in whom the seller's trust and confidence was placed, who traded on the basis of such information for personal gain.[116] The "disclose-or-abstain" rule had previously been applied to direct or indirect tippees of those who are prohibited from trading. In *Cady, Roberts*, the Commission had found a violation by the brokerage firm and its partner for knowingly trading while in possession of information tipped by one of its employees who was a director of the issuer.[117] *Dirks* reaffirmed that analysis of tippee liability, holding that persons who are not corporate insiders are liable only if they trade on information which they know is material, non-public, and given to them in breach of an insider's fiduciary duty to the issuer corporation.[118]

But *Dirks* further refined the analysis by holding that there is a "requirement of a specific relationship between the shareholders and the individual trading on insider information . . . ."[119] Thus, whether there has been a breach of duty by the tipper depends in the first instance on whether the tipper "receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future

111. *See id.* at 83,944.
112. *See id.* at 83,950.
113. *Id.* at 83,945 (quoting *Chiarella v. United States*, 445 U.S. at 230 n.12).
114. *See* Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982).
115. *Id.* at 839.
116. *See Dirks*, 103 S. Ct. at 3263-64.
117. *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
118. *See Dirks*, 103 S. Ct. at 3262-64.
119. *Id.* at 3261.

earnings."[120] The requirement may also be met where the insider, in effect, makes a gift of confidential information to a trading relative or friend.[121] If the tipper has breached a duty, the tippee will be liable if he knew or should have known that there has been a breach.[122] This requirement that the tipper's conduct be found improper was a considerable expansion on prior law, which only focused on whether the insider-tipper had possession of material non-public information and tipped to someone who knew the quality of the information and that it was improper to act on the information.[123] Thus, since Secrist's disclosure to Dirks was not in breach of Secrist's duties to Equity Funding, Dirks was not liable as a tippee.[124]

III. The Insider Trading Sanctions Act—As Passed

With this brief background of the law of insider trading, we turn to an analysis of the Act. As passed, the Act on its face appeared to do no more than what the Commission had requested, add a layer of sanctions to the existing statutory and judicial sanctions of injunction, disgorgement, and other ancillary relief, to beef up the disincentives to insider trading.[125] The Act gives the Commission authority to seek a civil money penalty of up to three times the amount of "profit gained or loss avoided" from a person who violates, or aids and abets a violation of, the federal securities laws by purchasing or selling a security while in possession of material nonpublic information.[126] In addition, responding to statements made at the House and Senate hearings regarding abuses with respect to the use of stock options, the Act also contained a provision making the purchase or sale of a derivative security, such as a put, call, straddle, or option, or a group or index of securities including such security, while in possession of material nonpublic information, equally a violation of the Act as the purchase or sale of the underlying security would be.[127]

The Act does place some limit on liability. For example, the Act provides that no person is subject to the civil sanction solely for aiding and abetting another in a manner "other than by communicating material non-public information."[128] Furthermore, section 20 "control person" liability does not apply to a sanctions action, nor does *respondeat superior* liability.[129] Finally,

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120. *Id.* at 3266.

121. *See id.*

122. *See id.*

123. *See In re* Investors Management, Co., 44 S.E.C. 633, 651.

124. *See Dirks*, 103 S. Ct. at 3267-68.

125. *See* Memorandum In Support, *supra* note 2, at 1706.

126. The Act, *supra* note 1, at § 2A (amending § 21 of 1934 Act). The Act also amends sections of the 1934 Act to increase the criminal fine for criminal violations of the 1934 Act from $10,000 to $100,000, and to give the Commission authority to bring an administrative proceeding against persons who violate § 14 of the Act. *See id.* at §§ 3, 4 (amending § 15(c)(4) of 1934 Act).

127. *See id.* at § 5.

128. *Id.* at § 2B.

129. *See id.*; *see also* House Report, *supra* note 3, at 9.

the Act applies only to transactions on or through the facilities of a national securities exchange or from or through a broker or dealer, and not to any public offering by an issuer of securities other than standardized options.[130]

The Act's language as it relates to primary and secondary liability raises a number of significant questions in light of the three separate and intellectually divergent interpretations of rule 10b-5, as applied to insider trading, which are described above. *First*, what kind of "person" does the Act cover? Does it, for example, cover the financial analyst whose sleuthing and personal relationships with middle-level managers of public companies gives him or her access to bits and pieces of information which, when combined with the analyst's deep understanding of the industry in question, gives the analyst a particular insight into the company and which, when considered in hindsight, might be thought of as material nonpublic information?[131] Does the language codify *Newman*[132] and *Materia*[133] and overturn *Chiarella*[134] so that *any* person who trades while in possession of information acquired and used in breach of obligations owed to others is liable under 10b-5, without regard to duty or relationship to the issuer? Finally, what does the language mean with respect to tippees who bestow no pecuniary relationships on tippers, and who themselves have violated no duty by tipping?

The legislative history of the Act is not helpful in answering these questions, especially since in the post-*Dirks* period, the Commission's spokespersons in interviews stated that *Dirks* would not inhibit their enforcement efforts,[135] and in congressional testimony, asserted that the term "insider trading" included persons who misappropriate information about an issuer.[136] Furthermore, the House Report on the Act expressed the view that a "narrow" construction of *Dirks* was appropriate,[137] and virtually adopted *in haec verba* the Commission's enforcement position on the limited construction of *Dirks* and expanded construction of fraud.[138] The House Report also ignores

130. The Act, *supra* note 1, at § 2A. The Act also contains a five year statute of limitations. *See id.* at § 2D (amending § 21 of 1934 Act).

131. *See* Dirks v. SEC, 103 S. Ct. at 3263; *see also* Chiarella v. United States, 445 U.S. at 233-34 n.16.

132. 664 F.2d 12 (2d Cir. 1981).

133. [Current] FED. SEC. L. REP. (CCH) ¶ 91,681 (2d Cir. 1984).

134. 445 U.S. 222 (1980).

135. *See* 15 SEC. REG. & L. REP. (BNA) No. 27, 1293-94 (July 8, 1983).

136. *See Senate Hearings, supra* note 3, at 15.

137. *See* HOUSE REPORT, *supra* note 3, at 4 ("Underwriters, investment analysts, lawyers, accountants, financial printers, government officials, and others often learn of profit-or-loss forecasts, imminent tender offers, mineral strikes, oil discoveries, lucrative contracts, and product failures before such information is available to the investing public. Insider trading by such persons undermines confidence in the markets in the same manner as trading by corporate insiders. The Supreme Court recently noted that under certain conditions, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, those "outsiders" may be treated as constructive insiders. The Committee agrees with this analysis and expects the Commission to continue to pursue violations by such persons.").

138. *See* Levine, *Insider Trading Act Broadens Enforcement Scope*, Legal Times, Sept. 10, 1984, at 17, col. 4.

the distinctions between market and corporate information.[139] Finally, the House Report cites as an example of a "person" who should be subject to rule 10b-5 a purchaser of securities of a target company armed with secret information derived from the bidder's investment banker.[140] This example is, of course, the case of Chiarella, Newman and Materia. To conclude, as the House Committee does, that "Congress has not sanctioned" such "deceitful misappropriation of information . . . under the federal securities laws"[141] is ominous news for those who take at face value the statement that the Act does not change the state of the law. From these examples, the Act arguably codifies the Burger dissent in *Chiarella*, as well as the Second Circuit's opinions in *Newman* and *Materia.*

Second, the words "while in possession of" may change the generally understood causation standard which the Commission must prove, that the trading was motivated by the material non-public information.[142] The Commission spokespersons at the hearings were quite ambivalent about this question, testifying that the use of the words "while in possession of" did not change the current state of the law,[143] but also using "on the basis of" language to describe current enforcement efforts.[144] Thus, the standard of causation is at least ambiguous, and unfortunately so, because of the importance of this issue to the proper functioning of multi-service investment banking firms that may acquire information from a variety of sources and may trade while in technical possession of it but not because of it.

Third, the "aiding and abetting" language of section 2(B) of the Act purports to limit the applicability of the increased penalty only to those persons who communicate material nonpublic information.[145] It is at the outset noteworthy that as of this date the Supreme Court has declined to address the

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139. *See* HOUSE REPORT, *supra* note 3, at 4.

140. *See id.*

141. *Id.* at 5.

142. *See* 3 JACOBS, Rule 10b-5, ¶ 66.02[c] n.64 (1981); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 n.14 (2d Cir. 1968), *cert. denied*, 394 U.S. 222 (1980); Jefferies & Co. v. Arkus-Duntov, 357 F. Supp. 1206, 1214 (S.D.N.Y. 1973); Blakely v. Lisac, 357 F. Supp. 255, 265, 267 (D. Ore. 1972); *In re* Investors Management Co., 44 S.E.C. 633, 644 (1971); Faberge, Inc., Exchange Act Release No. 10174 (May 25, 1973); Bromberg, *Tippee Risks and Liabilities*, 12 CORP. PRAC. COMMENTATOR 411, 415-18 (1971); *see also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1059 (S.D.N.Y. 1973).

143. *See House Hearings I, supra* note 3, at 49 (testimony of John Fedders, Director of the Division of Enforcement) (stating both that "the proposed legislation . . . does not at the present time at all impact the existing case law with regard to insider trading. . . .[a]nd . . . does not impact the 'based on,' 'in possession of,' or a 'knowing' standard at all" and also that he knew "of no decision where the Court has abandoned the 'in possession theory.' ").

144. *See House Hearings II, supra* note 3, at 36 (statement of John Shad) ("Trading *on the basis of* material nonpublic information—a practice which impairs confidence in the integrity of the securities markets—has been the subject of a number of recent cases. . . .The [Dirks] decision strongly reaffirmed that both insider and tippee trading *on the basis of* nonpublic, material information is prohibited under the federal securities laws . . . . ") (emphasis added).

145. *See* The Act, *supra* note 1, at § 2B.

issue of the applicability of the aiding and abetting theory of liability under the securities laws,[146] so one is struck immediately by the inappropriateness of dealing with that issue through an apparent sanctions-only act.[147] This section could mean that "tippers" of material nonpublic information may be held as "aiders and abettors" and thus subject to treble damages, while other persons who, for example, knowingly aid and abet another's violation by executing the orders of the tippers or performing other acts necessary to enable the tipper to trade, but who do not themselves "communicate material nonpublic information," cannot be held as aiders and abettors.[148] But what of the broker-dealer firm whose agent-broker did, in fact, communicate material nonpublic information in an unauthorized and unsanctioned manner; might not the firm be found liable for treble damages under the so-called exclusion? And what of the broker who, knowing only that his customer has a relationship either with a fiduciary of the issuer or with a fiduciary of a person with market information, "follows" his customer's successful trades by telling his other customers to buy or sell? Could the communication of material nonpublic information alone, without knowledge that the information is of such character, give rise to treble damage liability? Succeeding sections of the so-called exemption do not give greater comfort, even though they do purport to relieve securities firms from "control person" liability, because section 20 is not the exclusive method by which most courts have found securities firms liable for the acts of their errant employee-agents.[149] The doctrine of *respondeat superior* is in fact frequently used and, despite the House Report's assurance that the "Commission would not be permitted to seek the [treble damage] sanction under the theory of *respondeat superior* against an employer solely because his employee or agent violated the law,"[150] the dual concerns are that such a statement does not encompass the full law of *respondeat superior* and that an aggressive and creative Commission Enforcement staff and a receptive court could find that inadequate supervisory procedures were the cause of the violation, thus vitiating the exclusion. Indeed, the House Report refers in a laudatory manner to the Commission's finding of aiding and abetting based upon a failure by a broker-dealer to supervise a violator.[151]

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146. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191-92 n.7 (1976).

147. *See Senate Hearings, supra* note 3, at 129-31 (testimony of Sam Scott Miller for the Securities Industry Association).

148. *See* House Report, *supra* note 3, at 9.

149. *See* Fitzpatrick & Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 Hofstra L. Rev. 1 (1983); *see also* Brief for SEC, Investor Research Corporation v. SEC, 628 F.2d 168 (D.C. Cir.) (expansionist interpretation of *respondeat superior* by Commission staff), *cert. denied*, 449 U.S. 919 (1980); SEC Brief as *amicus curiae* at 5, Smith Barney, Harris Upham & Co., v. Henricksen, 640 F.2d 880 (7th Cir.), *cert. denied*, 454 U.S. 1097 (1981).

150. *See* House Report, *supra* note 3, at 9.

151. *See id.* at 10.

IV. Conclusion

As of this writing, the Act has been used by the Commission in only one of its enforcement actions, *S.E.C. v. Federico Ablan*,[152] a traditional corporate insider trading action, which is, at this writing, being contested. Issues of statutory and consitutional interpretation undoubtedly will be raised when the Commission seeks the enhanced sanctions. The need for additional legislation to cure the many problems now existing because of the confused state of the law, the open conflict among Justices of the Supreme Court, as well as among Court decisions and lower court interpretations, and the number of open questions raised by the Act, could not be more clear. Professor Loss, the reporter of the now-dormant American Law Institute Federal Securities Code, has called for legislation, "going beyond patchwork."[153] Meanwhile, the American Bar Association's Task Force on Insider Trading Regulation has prepared a lengthy analysis of the state of the law, not only under rule 10b-5, but also under section 16 and rule 14e-3, and may itself propose extensive legislation.[154] Such a legislative solution, to be joined in, one would hope, by the Commission, is long overdue.

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152. Civ. No. 84-8532 (S.D.N.Y. 1984); *see* Litigation Release No. 10618, [Current] Fed. Sec. L. Rep. (CCH) ¶ 91,847 (Nov. 27, 1984).

153. *See* Loss, *supra* note 10, at 105 (Supp. 1984).

154. The author is a member of the Task Force and of the sub-committee dealing with legislative proposals relating to § 10b and rule 10b-5.