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THE INSIDER TRADING DOCTRINE: A NEED FOR LEGISLATIVE REPAIR

*Richard M. Phillips**
and
*Robert J. Zutz**

INTRODUCTION

The so-called insider trading doctrine, as judicially developed under the antifraud provisions of the federal securities laws,¹ restricts the use of material, nonpublic information in connection with the purchase or sale of securities.² It is based on the premise that the use of such information undermines investor expectations of fairness and equal opportunity that are a foundation of public confidence in our securities markets.³ Under the insider trading doctrine, the courts and the Securities and Exchange Commission (SEC) have held that trading on the basis of inside information, under certain circumstances, is a "fraud" in violation of the general antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act) and Rule 10b-5 thereunder.⁴

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1. See *infra* note 3. The antifraud provisions of the Securities Exchange Act of 1934 do not specifically prohibit insider trading. The insider trading doctrine was developed by the courts under the general antifraud provisions of the Act to prevent corporate "insiders," including officers, directors, and controlling stockholders, from using material, nonpublic information for manipulative or deceptive purposes.

2. For a concise summary of the judicial development of the insider trading doctrine, see *Dirks v. SEC*, 463 U.S. 646, 653-54 (1983); *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980); and *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 & n.13 (1961).

3. See, e.g., *Chiarella*, 445 U.S. at 227-29; *United States v. Brown*, 555 F.2d 336, 339 (2d Cir. 1977); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968).

4. Section 10(b) of the 1934 Act, 15 U.S.C. § 78j (1976), provides in pertinent part that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange — (b) To use or employ, in connection with the

The term "insider trading doctrine," however, is a misnomer. Courts and the SEC have applied that doctrine not only to officers, directors and employees of publicly-held corporations, but also to any person, even corporate strangers, in possession of material, non-public information affecting those corporations and their securities.⁵ However, two recent Supreme Court decisions, *Dirks v. SEC*⁶ and *Chiarella v. United States*,⁷ have seriously limited the ability of the SEC and the courts to apply the insider trading doctrine to persons who are not corporate insiders and do not otherwise owe a fiduciary duty to the corporation and its shareholders. If the rationale of those decisions is followed in the courts, much trading of securities on the basis of inside information will be outside the prohibitions of the federal securities laws.⁸ If reasonably complete prohibitions against the unfair use of inside information are indeed essential to maintaining the integrity of our markets, legislative repair to the foundation of the insider trading doctrine is essential.

In *Dirks* and *Chiarella* the Supreme Court explicitly recognized that Section 10(b) and Rule 10b-5 prohibit insiders from trading in

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 (1984), promulgated by the SEC pursuant to Section 10(b), provides:

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

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

5. See *infra* text accompanying notes 51-81.

6. 463 U.S. 646 (1983).

7. 445 U.S. 222 (1980).

8. In Congressional testimony, John S.R. Shad, Chairman of the SEC, acknowledged this adverse impact of *Dirks* and *Chiarella*:

In terms of the weaknesses of the present law, I would say our concerns are that the long-term trend of the courts has been to steadily refine the definition [of insider trading] and in doing so in some respects to narrow the application of the provisions of the securities laws that enable us to bring these cases.

The Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 98th Cong., 2d Sess. 33 (1984) [hereinafter cited as Senate ITSA Hearings].

securities of their own corporations through the use of material, non-public information.⁹ These decisions clearly affirmed that corporate insiders have a duty to disclose or refrain from trading on the basis of material, nonpublic information relating to the securities of their corporations.¹⁰ However, *Chiarella* and *Dirks* severely limited the application of this duty to other persons, including corporate outsiders — commonly known as “tippees” — who trade on the basis of inside information obtained from corporate sources.¹¹

In *Chiarella*, the Supreme Court squarely rejected the notion that Rule 10b-5 imposes trading prohibitions on all persons who possess material, nonpublic information which they know or should know came from a corporate insider.¹² The Court emphasized that insider trading liability is not predicated on possession of nonpublic information, but on a breach of fiduciary duty to the corporation and its shareholders by a corporate insider.¹³ Accordingly, the Court reversed the conviction of a financial printer who, based on information acquired in the course of his employment, had traded the securities of companies which were targets of proposed tender offers. The Court reasoned that “no 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, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.”¹⁴ The Court noted that since neither the language nor the legislative history of Section 10(b) supported the formulation of such a broad duty, affirming the printer’s conviction would entail a “radical” departure from established doctrine.¹⁵

Dirks further rejected the SEC argument that the fiduciary duty theory of *Chiarella* applies only to market information, i.e., information affecting the price of securities which emanates from outside the corporation that issued the securities being traded.¹⁶ Instead, the Court confirmed its disavowal of the possession theory, and reaffirmed the fiduciary duty test as the foundation of the insider trading doctrine regardless of whether the information emanates from market sources outside the corporation or from internal

9. *Dirks*, 463 U.S. at 653-54; *Chiarella*, 445 U.S. at 229-30.

10. *Dirks*, 463 U.S. at 653-54; *Chiarella*, 445 U.S. at 229-30.

11. *Dirks*, 463 U.S. at 655-64; *Chiarella*, 445 U.S. at 232-34.

12. 445 U.S. at 232-35.

13. *Id.*

14. *Id.* at 232-33.

15. *Id.* at 233.

16. 463 U.S. at 655-64.

corporate sources.¹⁷ Moreover, while *Dirks* recognized that the insider trading doctrine imposed a duty on corporate insiders, it held that the insiders can breach that duty only if they personally benefit from the improper trading in the securities of their corporations.¹⁸ They can derive such benefits not only from their own trading, but also from the trading of their tippees,¹⁹ but the Court held that liability for such tippee trading requires proof that: (1) the tippee knew that the information was material, nonpublic and disclosed in breach of the insider's fiduciary duty to the corporation or its shareholders, and (2) the insider must have realized or expected to realize a personal gain by making the disclosure.²⁰

The fiduciary duty/benefit test of *Dirks* and *Chiarella* severely limits the scope of tippee liability under the insider trading doctrine. When a corporate insider is trading, the benefit to the insider and the breach of fiduciary duty is obvious. But insiders commonly realize no benefit from trading by tippees. Indeed, in many, if not most, cases of tippee trading, the insider is unaware of the trading. Thus, it is often very difficult to show benefit to the insider from tippee trading. Similarly, it is often much easier to prove that an insider knows that information is material and nonpublic than to prove such knowledge on the part of a tippee, or to establish that the tippee knew the insider was breaching a duty when he divulged the information. Yet absent proof of these elements, neither the insider nor the tippee will be liable for the tippee's trading on the basis of inside information.

The ultimate effectiveness of Rule 10b-5 as a deterrent to tippee trading in the new world created by *Chiarella* and *Dirks* is not yet settled. There is now a wide range of conduct that clearly offends basic concepts of fairness but exists outside the narrowed parameters of the insider trading doctrine as set forth by the Supreme Court. Indeed, the *Dirks* decision acknowledges that its limitations on tippee liability may well be inconsistent with prevailing standards of fairness. As the Court stated, certain trading based on material, nonpublic information may constitute behavior which "fall[s] below ethical standards of conduct. But . . . there may be 'significant distinctions between actual legal obligations and ethical ideals.'"²¹

17. *Id.*

18. *Id.*

19. *Id.* at 663-64.

20. *Id.* at 660-64.

21. *Id.* at 661 n.21 (quoting SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. pt.1, at 237-38 (1963)).

Ironically, the Supreme Court's contraction of the insider trading doctrine coincides with an intensified SEC enforcement concern over insider trading abuses. This concern is reflected in a dramatic increase in the number of SEC enforcement actions against insider trading. In 1984, the Commission reported that in the prior two years it had initiated more than one third of all proceedings alleging insider trading violations brought during its 50-year history.²² This increase in SEC enforcement activity may reflect a growing incidence of insider trading, resulting, in part, from two factors. One is the increase in corporate takeovers through tender offers, mergers and similar forms of acquisition; in such situations, announcement of a corporate takeover usually causes large and rapid increases in the value of the target company's stock, thereby providing a ready opportunity for quick profits for persons with advance notice. Secondly, the expansion of trading in standardized option contracts greatly minimizes the risk and enhances the profitability of insider trading. The purchase of options rather than the underlying securities provides tremendous leverage, thus enabling a trader to reap very large, short-term profits from a small investment made on the basis of inside information such as an imminent tender offer or other corporate takeover.²³

Notwithstanding the serious questions raised by *Dirks* and *Chiarella* with respect to insider controls over tippee trading, the SEC and some commentators thus far have eschewed resort to legislative relief.²⁴ They continue to believe that Rule 10b-5 may yet be up to this challenge.²⁵ Indeed, with one exception, the SEC expressly rejected a possible legislative resolution²⁶ to the issues raised by

22. *Senate ITSA Hearings*, *supra* note 8, at 16.

23. *See Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 19-20 (1983) [hereinafter cited as *House ITSA Hearings*]; Address by Daniel L. Goelzer, SEC News (Sept. 28, 1983), at 7 (available in the office of the *Hofstra Law Review*) [hereinafter cited as Goelzer Speech].

24. For instance, shortly after *Dirks* was decided, the SEC's General Counsel stated that "I do not see that [decision] as a setback to the Commission's insider trading enforcement program." Goelzer Speech, *supra* note 23, at 7. *See also* Levine & Marshall, *Dirks in the Lower Courts*, 17 REV. SEC. REG. 897 (May 23, 1984) ("lower court opinions since *Dirks* . . . are sufficiently expansive to permit the courts to continue to prohibit most instances of insider trading").

25. *Id.* For instance, the SEC asserts that of the thirty-four insider trading cases it brought in the two years prior to *Dirks*, only one would have been affected by this decision. *But see In re Wentz & Bynum*, [1984] FED. SEC. L. REP. (CCH) ¶ 83,629 (SEC 1984).

26. *See infra* note 31.

Dirks and *Chiarella* in connection with enactment of the Insider Trading Sanctions Act (ITSA).²⁷ The Act, which became law in August 1984, implements an SEC recommendation to authorize the Commission to seek penalty payments of up to three times the amount of profit realized or loss avoided as a result of prohibited trading.²⁸ The Commission's rationale for this legislation is that previously available insider trading sanctions — disgorgement of profits and an injunction against future violations — were inadequate to deter potential violators from the large profits that can be quickly realized, often at minimum risk of loss.²⁹ At the very last moment, the ITSA legislation was amended to make clear that the insider trading doctrine applied to options and other kinds of derivative securities.³⁰ In all other respects, at the insistence of the SEC, the ITSA was drafted to effect no substantive change in the insider trading doctrine in response to *Dirks* and *Chiarella*.³¹ Therefore, if Rule 10b-5 as interpreted by *Dirks* and *Chiarella* applies only to trading by corporate insiders and to tippee trading that benefits insiders, then the treble damage deterrent of ITSA does not operate against much of the inside trading by tippees.

The ITSA and the SEC ignore the fact that the foundation of insider trading prohibitions — the general antifraud provisions of Section 10(b) and Rule 10b-5 — is poorly suited to serve as the basis for controls over tippee trading. By their very terms, Section 10(b) and Rule 10b-5 are not directed at insider trading per se, but at fraud.³² The *Dirks* and *Chiarella* decisions rigidly conform the

27. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered subsections of 15 U.S.C.A. § 78 (Supp. (1984))).

28. *Id.* at § 2(A)(ii), located at 15 U.S.C.A. § 78u (Supp. 1984).

29. *House ITSA Hearings*, *supra* note 23, at 100.

30. Section 5 of the ITSA adds the following new provision to Section 20 of the 1934 Act:

(d) Wherever communicating, or purchasing or selling a security while in possession of material, nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this title, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.

Insider Trading Sanctions Act of 1984, *supra* note 27. Section 5 of the Act is at 15 U.S.C.A. § 78t (Supp. 1984). § 5 at 1265.

31. *House ITSA Hearings*, *supra* note 23, at 98-100.

32. In addition to Section 10(b) and Rule 10b-5, other fraud provisions of the federal securities laws apply to insider trading. Specifically, Section 17(a) of the Securities Act of

insider trading doctrine to this fraud context by holding that trading on the basis of material, nonpublic information constitutes fraud only where there is a duty to speak, and by limiting that duty largely to those who owe a fiduciary duty to the issuer of the securities being traded and its shareholders.³³ In so doing, these decisions confirm the use of that doctrine as a control over insider misconduct.³⁴ Yet the federal securities laws are investor protection statutes, and their primary purpose is not to police insiders, but to protect market participants from unfair trading and other abuses.³⁵ This goal cannot be met as long as the insider trading doctrine is confined to fraud. As the Supreme Court has stated, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."³⁶ Accordingly, legislation designed to strip insider trading restrictions from the rubric of fraud, and to place them on a new foundation, is needed if the doctrine is to serve effectively as a control over tippee trading on the basis of material, nonpublic information.

I. THE RISE AND FALL OF TIPPEE LIABILITY UNDER RULE 10b-5

The insider trading doctrine is probably the best known and most widely publicized feature of federal securities regulation. Indeed, the courts have identified the prevention of insider trading abuses as "[o]ne of the primary purposes" of the 1934 Act.³⁷ Yet, the federal securities statutes and their legislative history provide little guidance in discerning the parameters of prohibited trading.

Throughout the federal securities laws, only Section 16(b) of the 1934 Act explicitly regulates trading by insiders.³⁸ Section 16(b)

1933, 15 U.S.C. § 77q(a)(1981), has been used in connection with the sale of securities; Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1981), has been applied to investment advisors; and Section 14(e) of the 1934 Act, 15 U.S.C. § 78 n(e) (1981), (and Rule 14e-3 thereunder, 17 C.F.R. § 240, at 14e-3 (1984)) has been applied in connection with tender offers. However, each of these is a general antifraud provision containing language very similar to Section 10(b) and Rule 10b-5 and adds little to the coverage of insider trading abuses.

33. *Chiarella*, 445 U.S. at 231-35; *Dirks*, 463 U.S. at 655-64.

34. The *Dirks* decision explicitly observes that "[i]t is important in this type of case to focus on policing insiders and what they do . . . rather than on policing information *per se* and its possession." 463 U.S. at 662-63. (quoting the concurring opinion of Commissioner Smith in *Investors Management Co.*, 44 S.E.C. 633, 648 (1971)).

35. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

36. *Chiarella*, 445 U.S. at 232.

37. *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951). See also *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974).

38. Section 16b of the 1934 Act, 15 U.S.C. § 78p(b) (1981), provides:

(b) For the purpose of preventing the unfair use of information which may

provides that any officer, director or ten percent beneficial owner of an issuer must surrender to the issuer all "short swing" profits realized through any purchase and sale of the issuer's securities within a six month period.³⁹ Section 16(b) operates automatically against transactions covered by its provisions without requiring evidence of actual misuse of inside information or even trading while in possession of such information.⁴⁰ However, Section 16(b) has a very narrow application. It does not encompass trades not coupled with an offsetting transaction within six months. Most importantly, Section 16(b) applies only to officers, directors and ten percent shareholders. Thus, it does not even cover all insiders, much less outside tippees who trade on the basis of inside information.

In the absence of additional specific statutory prohibitions, the insider trading doctrine is almost entirely the creature of judicial development based on the very general proscriptions of the antifraud provisions of Section 10(b) and Rule 10b-5 of the 1934 Act. The courts have predicated Rule 10b-5 fraud liability on a judicially constructed duty imposed on certain persons in possession of material, nonpublic information to either disclose that information or abstain from trading in securities on the basis of such information.⁴¹ The language of Section 10(b) and Rule 10b-5 does not speak in terms of insider trading. Nor does the legislative history of Section 10(b) give

have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

39. *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232, 243-50 (1976); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591 (1973).

40. *Kern County Land Co.*, 411 U.S. at 595.

41. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 847-48 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *In re Cady Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

any indication, let alone guidelines, of what types of insider trading would be considered a manipulative or deceptive practice within the purview of this provision. In short, the breadth of Section 10(b) and Rule 10b-5 and their ability to encompass insider trading are matched by their vagueness in defining what conduct is prohibited, a fact demonstrated in the judicial decisions that have shaped the insider trading doctrine.

This lack of legislative direction has left the SEC and the courts with the task of fashioning the elements and parameters of the relationship between insider trading and fraud under Section 10(b). Not surprisingly, the insider trading doctrine has developed in several phases, and the last phase — the *Chiarella* and *Dirks* decisions — appears to have returned the doctrine full circle.

A. *The First Phase — The Fiduciary Duty Standard*

Early decisions under Rule 10b-5 based the notion of insider trading liability largely on the concept of the fiduciary duty of corporate insiders not to favor their own interests over those of the corporation or its shareholders. Accordingly, the courts held that insiders owe a duty of trust to refrain from trading in their corporation's securities on the basis of material, nonpublic information derived from their corporate relationships unless that information was available to those with whom they were trading.

In *Kardon v. National Gypsum Co.*,⁴² for example, the court found that several directors of a corporation had purchased stock from shareholders without disclosing that they had negotiated a sale of the company's assets to outsiders at a higher price than that paid to the shareholders. In deciding that the defendants had violated Rule 10b-5, the court stated that "the broad terms of the Act are to be made effective in a case like the present one through application of well known and well established equitable principles governing fiduciary relationships."⁴³ It found that the defendants had breached this duty, and thus committed fraud, by buying stock without disclosing to the plaintiffs the sale of company assets.⁴⁴

A fiduciary relationship theory also served as the basis for the court's finding of a Rule 10b-5 violation in *Speed v. Transamerica Corporation*.⁴⁵ Plaintiffs there alleged that Transamerica, the major-

42. 73 F. Supp. 798 (E.D. Pa. 1947).

43. *Id.* at 803.

44. *Id.* at 802.

45. 99 F. Supp. 808 (D. Del. 1951).

ity shareholder of Axton-Fisher Tobacco Company (Axton), had purchased Axton stock from them without disclosing that Axton's inventory was significantly undervalued and that the defendant had planned to reap the benefits of the undervalued inventory through a merger with Axton.⁴⁶ The court held that the failure of Transamerica to disclose to the selling shareholders these material facts, which it knew by virtue of its inside position, was unlawful.⁴⁷ The court specifically found that Transamerica had a duty to disclose because the fiduciary duty of a corporate insider precluded it from utilizing its position to take unfair advantage of the uninformed minority shareholders.⁴⁸

These early insider trading cases and their progeny used Rule 10b-5 to impose a fiduciary duty of disclosure on corporate insiders in the context of face-to-face transactions with minority shareholders. The courts had more difficulty in applying the fiduciary duty standard to insider transactions executed through the impersonal marketplace,⁴⁹ and to transactions by outside tippees based on information provided by insiders or tippees of insiders.⁵⁰

B. *The Second Phase — The Possession Theory*

The courts and the SEC were able to encompass a wider range of conduct within the scope of the Rule 10b-5 insider trading doctrine only by changing the doctrine's theoretical underpinnings. They did so by expanding the basis for liability from the relatively narrow fiduciary duty owed by insiders to their corporation and its shareholders to a broader theory based on the mere possession of material, nonpublic information.

The shift began with the SEC's administrative decision in *In re Cady, Roberts & Co.*⁵¹ In that case, a registered representative of Cady, Roberts, a registered broker-dealer firm, had sold shares of Curtiss-Wright Corporation owned by his wife and his clients after learning from a Curtiss-Wright director, prior to public disclosure, of an impending decrease in the regular Curtiss-Wright dividend.⁵² Unlike the director who had disclosed the information, the registered

46. *Id.* at 812-14.

47. *Id.* at 828-29.

48. *Id.* at 829.

49. See *Slavin v. Germantown Fire Ins. Co.*, 174 F.2d 799, 808-09 (3d Cir. 1949).

50. *In re Calton Crescent, Inc.*, 173 F.2d 944, 950-51 (2d Cir.), *aff'd sub nom. Manufacturers Trust Co. v. Becker*, 338 U.S. 304 (1949).

51. 40 S.E.C. 907 (1961).

52. *Id.* at 909.

representative had no fiduciary duty to the company or its shareholders. Nevertheless, the SEC held that the Rule 10b-5 obligation to disclose or refrain from trading was not limited to traditional insiders because there is "inherent unfairness involved where [any] party takes advantage of [inside] information knowing it is unavailable to those with whom he is dealing."⁵³ Accordingly, the SEC determined that upon receiving material, nonpublic information from the Curtiss-Wright director, the registered representative became subject to "the responsibilities of those commonly referred to as 'insiders'"⁵⁴ and thus violated Rule 10b-5 by trading prior to disclosure of that information.⁵⁵

The Commission's emphasis on "inherent unfairness" was embraced by the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*,⁵⁶ the first significant insider trading court decision after *Cady, Roberts*. Texas Gulf Sulphur (TGS) had extracted core samples indicating extremely rich mineral and ore deposits. TGS sought to keep this information confidential while securing the mineral rights in the surrounding area.⁵⁷ Indeed, to quell rumors of this find, it even issued a false press release that understated the test results.⁵⁸ Throughout this period TGS insiders and their tippees purchased TGS stock and executed stock options issued by TGS without disclosing accurate information regarding the core samples.⁵⁹

In finding violations of Rule 10b-5, the Second Circuit adopted the approach of *Cady, Roberts*. The court went far beyond the fiduciary duty test of *Kardon* and *Speed* to extend Rule 10b-5 insider trading prohibitions to any person in possession of material, nonpublic information.⁶⁰ It pronounced the following standard:

[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . , or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.⁶¹

53. *Id.* at 912.

54. *Id.*

55. *Id.* at 912-14.

56. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

57. *Id.* at 843.

58. *Id.* at 845.

59. *Id.* at 846-47.

60. *Id.* at 848.

61. *Id.*

Most significantly, the court shifted the policy objective of the insider trading doctrine under Rule 10b-5 from the prevention of insider misconduct to the promotion of equal access to equal information by all investors, explaining that

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 The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," *i.e.*, the investing public.⁶²

The Rule 10b-5 duty to disclose or abstain applied not merely to insiders, the court explained, but to "anyone in possession" of such information.⁶³

The SEC seized upon the *Texas Gulf Sulphur* possession theory to serve notice of the insider trading ban to the financial community in *Investors Management Co.*⁶⁴ In that case Merrill Lynch, a prospective underwriter for Douglas Aircraft Company, learned that Douglas' unpublished quarterly report would show substantially reduced earnings and estimates.⁶⁵ Registered representatives of Merrill Lynch conveyed this information to institutional clients, many of whom sold their Douglas stock and avoided a market loss when the earnings decline became public.⁶⁶

In upholding a finding that the institutional investors were liable as tippees under Rule 10b-5 for trading on the basis of inside information, the SEC stated that Rule 10b-5 liability did not require a preexisting fiduciary duty between the tippees and market purchasers of Douglas stock.⁶⁷ It also specifically rejected the notion that the tippee must have a "special relationship" with the corporation or the inside source or, in absence of such a relationship, that the tippee must know that the information had been disclosed in a breach of fiduciary duty by the insider.⁶⁸ Instead, it imposed Rule 10b-5 liabil-

62. *Id.* (citations omitted).

63. *Id.*

64. 44 S.E.C. 633 (1971).

65. *Id.* at 636-37.

66. *Id.* at 637-39.

67. *Id.* at 643-44.

68. *Id.* at 643.

ity on the basis of findings that material, nonpublic information was a substantial factor in an investment decision when the trader had knowledge or reason to know that the information emanated from an inside corporate source.⁶⁹

The possession theory perhaps reached its zenith in 1978 in the Second Circuit's decision in *United States v. Chiarella*.⁷⁰ Chiarella, in the course of his employment with a financial printer, learned of several imminent tender offers by clients of his employer.⁷¹ He bought stock in the target companies and sold these shares at a profit shortly after the tender offers were announced.⁷² Upon disclosure of this trading practice, Chiarella's employment was terminated, he consented to an injunction and disgorgement of his profits, and he was indicted and convicted of violating Rule 10b-5.⁷³

On appeal from his conviction Chiarella maintained that because he was not an insider of the target companies and had no relationship with them, he owed no fiduciary duty to those companies or their shareholders.⁷⁴ Thus, he argued, he had no duty to disclose or abstain from trading.⁷⁵ In fact, Chiarella's information could not be traced to any insider of the targets.⁷⁶ Rather, it related to a hostile tender offer. It was so-called "market information," involving the market for securities and not information from the company issuing the securities to which the information related.⁷⁷

The Second Circuit rejected Chiarella's contentions and upheld the conviction.⁷⁸ It found that Chiarella's relationship to the target companies or their shareholders was not central to its analysis.⁷⁹ Instead, the court focused upon the "unfair advantage" that Chiarella obtained from the use of nonpublic information entrusted to him in the course of his employment.⁸⁰ It concluded that "[a]nyone — corporate insider or not — who regularly receives material nonpublic

69. *Id.* at 644.

70. 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

71. *Id.* at 1362-63.

72. *Id.* at 1363.

73. *Id.* at 1364.

74. *Id.*

75. *Id.*

76. *Id.* at 1364-65.

77. For a definition of "market information," see *id.* at 1365 n.8. See also *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 10-11 n.9 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984).

78. 588 F.2d at 1365, 1367-73.

79. *Id.* at 1365.

80. *Id.*

information may not use that information to trade in securities without incurring an affirmative duty to disclose.”⁸¹ Until the Supreme Court spoke to the issue two years later, the Second Circuit’s “possession” theory appeared to vastly broaden the scope of the insider trading prohibition.

C. *The Third Phase — The Full Circle Return to the Fiduciary Duty Standard*

Prior to its 1980 review of the Second Circuit’s decision in *Chiarella*, the Supreme Court had never ruled on the insider trading doctrine. In *Chiarella v. United States*,⁸² the Court rejected the equal access theory in favor of a breach of fiduciary duty analysis. It held that the mere existence of an “unfair advantage” does not give rise to liability under Rule 10b-5.⁸³ Rather, such liability must be premised upon a duty to disclose nonpublic information that arises “from a relationship of trust and confidence between the parties to a transaction.”⁸⁴ The Court found no relationship between *Chiarella* and those with whom he traded because *Chiarella* was not their agent, a fiduciary, or a person in whom they had placed their trust.⁸⁵ Rather, he was a complete stranger who dealt with the sellers only through impersonal market transactions.⁸⁶ Accordingly, the Court reversed *Chiarella*’s conviction.

Chiarella explicitly disavowed the possession theory by holding “that a duty to disclose . . . does not arise from the mere possession of nonpublic market information.”⁸⁷ In so doing, the Court made no attempt to distinguish nearly twenty years of prior conflicting law enunciated in the decisions of the lower courts.⁸⁸ Moreover, while referring to tippee liability,⁸⁹ the Court did not explicitly set broad standards for resolving the issues relating to that liability. Accordingly, the opinion gave the SEC the latitude to argue that the fiduci-

81. *Id.* (emphasis in original).

82. 445 U.S. 222 (1980).

83. *Id.* at 232-35.

84. *Id.* at 230.

85. *Id.* at 232-33.

86. *Id.* at 230-35.

87. *Id.* at 235.

88. In fact, the Supreme Court seriously mischaracterized the *Cady, Roberts* decision which clearly was premised on the unfairness of insider trading and provided the foundation for *Texas Gulf Sulphur Co.* and its progeny. See *supra* notes 51-55. *Chiarella* improperly interpreted *Cady, Roberts* as holding that insider trading was unfair only for those having trust relationships with the other parties to their transactions. 445 U.S. at 226-29.

89. 445 U.S. at 230 n.12.

ary test of *Chiarella* was limited to insider trading based on market information, and that the Court's decision should have little practical effect on insider trading cases involving information from corporate sources. The SEC continued to enforce the insider trading doctrine in other than market information cases without regard to *Chiarella's* rejection of the possession theory.⁹⁰ And it dealt with insider trading abuses in connection with tender offers — the most important type of market information in insider trading cases — by incorporating the possession theory into newly adopted Rule 14e-3.⁹¹ That rule prohibits trading by any person in possession of material nonpublic information regarding a tender offer once a substantial step towards commencement of the offer has been made.⁹²

In 1983, however, in *Dirks v. SEC*,⁹³ the Supreme Court destroyed the SEC's notion that the possession theory had any viability as a foundation for the insider trading doctrine. *Dirks* involved highly material, nonpublic information from an inside corporate source.

Raymond Dirks was employed by a brokerage firm as an analyst specializing in insurance securities.⁹⁴ He received information from a former officer of Equity Funding Corporation of America indicating that the reported assets of the company were vastly overstated as the result of fraudulent accounting practices. The former officer urged Dirks to verify the fraud and to expose it. Dirks did just that, primarily by speaking with other former and present Equity

90. See, e.g., Brief for the SEC at 22-23, *Dirks v. SEC*, 463 U.S. 646 (1983).

91. 17 C.F.R. § 240.14e-3 (1984). Rule 14e-3 provides, in relevant part:

(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.

92. *Id.*

93. 463 U.S. 646 (1983).

94. *Id.* at 648.

Funding officers. While investigating and corroborating the charges of fraud, he openly discussed the information he had obtained with clients and investors. Some of Dirks' clients, including five investment advisers who liquidated holdings of more than \$16 million, sold their Equity Funding securities on the basis of the information received from him.⁹⁵ During the course of this trading, the price of Equity Funding stock dropped from \$26 to less than \$15 per share; ultimately, after exposure of the fraud, the company went into receivership.⁹⁶

In an administrative proceeding, the SEC found that Dirks had violated Rule 10b-5 and other antifraud provisions of the federal securities laws by giving his clients the inside information he had received from the former Equity Funding officer and confirmed by his investigation.⁹⁷ The Court of Appeals for the District of Columbia Circuit upheld the SEC's finding on the ground that the obligation of corporate fiduciaries to refrain from trading on the basis of material, nonpublic information was inherited by all to whom they disclosed the information before it had been publicly disseminated.⁹⁸ Alternatively, the court held that Dirks, as an employee of a broker-dealer, had violated his professional obligations to the SEC and to the public, independently of any obligations he acquired as a result of receiving such information.⁹⁹

Upon petition by Dirks, the Supreme Court granted *certiorari*.¹⁰⁰ Expanding upon *Chiarella*, the Court reversed the findings of violation by Dirks.¹⁰¹ The Court squarely upheld the application of the insider trading doctrine to corporate insiders who benefit from trading in the securities of their corporation on the basis of material, nonpublic information.¹⁰² The *Dirks* Court did so, however, by reconfirming the rationale of *Chiarella*. As in *Chiarella*, *Dirks* held that such persons are liable under Rule 10b-5 not because they possess inside information, but because they have a fiduciary duty to the

95. *Id.* at 649.

96. *Id.* at 650.

97. Securities Exchange Act Release No. 17480 (January 22, 1981), 21 SEC Docket 1401.

98. 681 F.2d 824, 839 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

99. 681 F.2d at 840. The Commission did not use this alternative theory of liability in its own decision, or argue it to the Court of Appeals or to the Supreme Court. *See* Brief for the SEC at 21, n.27 in *Dirks v. SEC*, 463 U.S. 646 (1983).

100. 459 U.S. 1014 (1982).

101. 463 U.S. at 652.

102. *Id.* at 653-59.

corporation and its shareholders. The Court thus upheld the broad applicability of the fiduciary duty theory of insider trading liability and the rejection of the possession standard as first enunciated in *Chiarella*.

After affirming the basic principles of *Chiarella*, *Dirks* articulated the circumstances in which tippees are liable under Rule 10b-5 for trading on inside information. The Court held that a “tippee’s duty to disclose or abstain is derivative” from the insider’s duty.¹⁰³ “[S]ome tippees must assume an insider’s duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. For Rule 10b-5 purposes,” the Court explained, “the insider’s disclosure is improper only where it would violate his *Cady, Roberts* duty.”¹⁰⁴ In other words, a tippee’s trading is actionable under Rule 10b-5 “only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”¹⁰⁵

As *Dirks* made clear, there can be no tippee liability unless the tippee acquired the information improperly through an insider’s breach of his fiduciary duty to his corporation and his shareholders, and the tippee knows or should know that there has been a breach.¹⁰⁶ Under *Dirks*, the test for finding a breach of fiduciary duty “is whether the insider personally will benefit, directly or indirectly, from his disclosure.”¹⁰⁷ Absent such personal gain, the insider does not breach his fiduciary duty by disclosure of material, nonpublic information to persons who either trade on that information or divulge it to others who trade, and neither the insider nor the tippee is subject to liability under Rule 10b-5. Thus, as a practical matter,

103. *Id.* at 659.

104. *Id.* at 660 (emphasis in original).

105. *Id.*

106. The “should know” standard suggests that mere negligence may suffice to fulfill the knowledge requirement on the part of the tippees. Yet a negligence standard is contrary to the scienter requirement in the Court’s holdings in both *Aaron v. SEC*, 446 U.S. 680, 694 (1980) (holding that knowledge is necessary to violate § 10(b) and Rule 10b-5) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (requiring “intentional or willful conduct designed to deceive or defraud investors” in order to violate § 10(b) and Rule 10b-5). While recklessness may meet the scienter requirement, mere negligence does not meet this test. In *Dirks*, the Supreme Court expressly reaffirmed the standard expressed in both *Hochfelder* and *Aaron*. 463 U.S. at 663 n.23. The *Dirks* Court did not focus on the scienter issue because, in finding no breach of fiduciary duty by the corporate insider, the Court was not required to proceed with an inquiry into the tippee’s duty to disclose or abstain. *Id.*

107. *Id.* at 662.

Dirks limited insider trading liability to corporate insiders and tippees whose trading is beneficial to the insider.

The *Dirks* decision sought to mitigate the impact of its fiduciary duty/benefit test by adopting broad definitions of both the concept of an insider and the concept of personal benefit or gain. Justice Powell, in his majority opinion, observed that an insider can breach his fiduciary duty even if the benefit received by him as a result of disclosures is an indirect, rather than a direct, pecuniary gain, noting that "reputational benefit that will translate into future earnings" can form a sufficient basis to establish a breach of duty, and that evidence of "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient" can also satisfy the test.¹⁰⁸ Indeed, Justice Powell indicated that the mere intent to make "a gift of confidential information to a trading relative or friend" can suffice.¹⁰⁹ In such a case, the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."¹¹⁰

The *Dirks* opinion also broadened the definition of an insider by creating a class of constructive or temporary insiders. The court observed that, unlike insiders, the typical tippee has no fiduciary duty to the tipper's company or its shareholders.¹¹¹ Nonetheless, the Court stated, "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders."¹¹² The opinion emphasized that this constructive insider theory is fully consistent with the fiduciary duty test because such persons "have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corpo-

108. *Id.* at 664. See *SEC v. Gaspar*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,004 at 90,979 (S.D.N.Y. Apr. 15, 1985).

109. *Id.* As a result of this standard, the insider benefit requirement often invites inquiry into very personal relationships that are unrelated to investor protection. A notable example is the SEC's allegation that a former Deputy Secretary of Defense, Paul Thayer, realized a personal benefit when he tipped material, nonpublic information to his receptionist with whom he had a "private personal relationship." N.Y. Times, Mar. 5, 1985, at A1, col. 1, D2, col. 3. Thayer pleaded guilty to a charge that he obstructed justice by giving false testimony to the SEC during its investigation of his alleged participation in an illegal insider trading scheme. N.Y. Times, Mar. 5, 1985, at A1, col. 1.

110. 463 U.S. at 664.

111. *Id.* at 655.

112. *Id.* at 655 n.14.

rate purposes.”¹¹³ As a result,

[w]hen such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than as a tippee For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.¹¹⁴

Despite the mitigating effects of the Court’s broad definitions of “insider” and “personal benefit,” *Dirks* sharply limits tippee liability for trading on the basis of material, nonpublic information. In substantial part, the decision appears to have been motivated by a desire to protect the role of financial analysts in the marketplace. The Supreme Court found that “[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.”¹¹⁵ The analysts’ judgments generally are made available only to clients who have paid for that information. Accordingly, as the Supreme Court recognized, the fruits of an analyst’s labors are, by their very nature, unavailable for simultaneous dissemination to the general public. Indeed, if analysts were required to disclose information in their possession to the market without giving advance notice of their work to clients, there would be little incentive for investors to pay for analysts’ services. Correspondingly, there would be little incentive for analysts to perform their traditional role.

The SEC, in its own administrative decision in *Dirks*, also recognized the importance to the securities market of motivated and capable analysts who investigate and analyze issuers and their securities. The SEC stated that “market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst’s work redounds to the benefit of all investors.”¹¹⁶ But the Supreme Court found the SEC’s limitations on what information analysts could obtain from insiders and use to advise clients was imprecise and unduly restrictive.¹¹⁷

Accordingly, the Court’s decision in *Dirks* removes many of the

113. *Id.*

114. *Id.* (footnote omitted).

115. 463 U.S. at 658.

116. 21 SEC Docket at 1406.

117. 463 U.S. at 658 n.17.

hazards created by the SEC's application of the insider trading doctrine to communications between corporate officials and securities analysts. Such persons no longer need communicate with each other at the peril of hindsight judgments as to the materiality of any non-public information that may be disclosed. Rather, securities analysts are free to use any information they obtain from corporate officials unless they know or have reason to know that the disclosure was made by the corporate official for personal gain and in breach of his duty to the corporation and its shareholders.

The Supreme Court's decisions in *Dirks* and *Chiarella*, however, go far beyond elimination of impediments to the discharge of the analyst's professional responsibility. Absent an element of personal gain to the insider, the analyst, like any other tippee, is free under *Dirks* to reap personal profit from trading on the basis of material, nonpublic information obtained from an insider. Whenever an insider discloses nonpublic information to an outsider for a legitimate business purpose, it is clear that the insider has not breached a duty and does not expect to benefit from the outsider's trading based on that information. Indeed, absent some type of personal relationship¹¹⁸ or profit-splitting by a tippee with an insider,¹¹⁹ it will often be very difficult to prove that the tip benefitted the insider and constituted a breach of duty.

Dirks and *Chiarella* also opened another major gap in the insider trading doctrine since they raised a serious question as to whether trading in options on the basis of material, nonpublic information can give rise to insider trading liability under Rule 10b-5 even when the trading is by a corporate insider. Such trading may not satisfy the Supreme Court's fiduciary duty test because insiders owe no apparent duty to persons trading in options who are not stockholders and do not even hold a security issued by the corporation.¹²⁰ This gap is particularly troublesome because much of the recent rise in insider trading has been attributed to the growth in option trading.¹²¹ The gap became more real than theoretical when two courts, partly on the basis of the Supreme Court's rationale in *Chiarella*, held that option trading was substantially outside the in-

118. See, e.g., SEC v. Thayer, No. 84 Civ. 0066, (S.D.N.Y., filed Jan. 5, 1984).

119. See, e.g., SEC v. Brant, No. 84 Civ. 3470 (S.D.N.Y., filed May 17, 1984).

120. Laventhall v. General Dynamics Corp., 704 F.2d 407, 411-12. (8th Cir.), cert. denied, 104 S. Ct. 150 (1983).

121. See Goelzer Speech, *supra* note 23 at 7.

sider trading doctrine.¹²² This gap was closed by the enactment of the ITSA in 1984.¹²³

The insider trading doctrine as limited by the Supreme Court's decisions in *Dirks* and *Chiarella* also fails to reach market information or other information not originating from the issuer of the securities being traded. For example, insiders of a corporation planning a cash merger with another corporation do not owe a fiduciary duty to that other corporation and its shareholders. Thus, these insiders, under the *Dirks* and *Chiarella* decisions, are seemingly free under Rule 10b-5 to buy the other corporation's stock prior to public announcement of the merger without liability under insider trading doctrine. Similarly, the insiders of one company, which is about to place a major order with a second company, would not be proscribed by the insider trading doctrine from purchasing securities in the second company, despite any impact that the order will have on the price of that company's securities. Thus, the return to the fiduciary duty standard in *Chiarella* and *Dirks* has opened the door to a variety of situations in which trading based upon material, nonpublic information may not be subject to liability under Section 10(b) and Rule 10b-5.

II. RESPONSES TO *Dirks* and *Chiarella*

With the reemergence in *Dirks* and *Chiarella* of a fiduciary

122. See *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), cert. denied, 104 S. Ct. 150 (1983); *In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983) (option holders lack standing to sue corporate insiders based upon insider trading and nondisclosure of material, nonpublic information). But see *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981) (although corporate insiders owe no fiduciary duty to an options trader who brought action against a corporation, corporate insiders, and insiders' tippees, the trader does have standing to assert a civil claim for damages due to the insiders' breach of fiduciary duties).

In *Laventhall*, a pre-*Dirks* decision, General Dynamics made substantial purchases on its own behalf in its own stock shortly before announcing its first cash dividend in eight years. The day after the announcement, its stock price increased by more than ten percent. 704 F.2d at 409. A class action was subsequently filed against General Dynamics on behalf of all persons selling General Dynamics call options during the period of the company's stock purchases. The Eighth Circuit Court of Appeals stated as follows:

[P]laintiff fails to demonstrate that General Dynamics as an insider owed any special duty to the plaintiff who merely held an option to buy General Dynamics' stock from a third party. There simply existed no relationship of trust and confidence between the parties.

Id. at 411-12 (emphasis added). In the absence of a relationship of trust and confidence between the parties to the transactions as required by *Chiarella*, the Court dismissed the lawsuit.

Id. at 414-15.

123. See *supra* text accompanying notes 27-30.

duty analysis, the basis for Rule 10b-5 insider trading liability has now travelled full circle from fiduciary duty to possession to fiduciary duty. The insider trading doctrine mainly survives as a control over insider misconduct; unlike the possession test, it does not protect market participants generally by promoting the objective of equal access to material information by all such participants. As a result, the scope of liability, particularly tippee liability for insider trading, unquestionably has narrowed.

Despite the consequences of *Dirks* and *Chiarella*, the SEC has strongly resisted efforts to incorporate a statutory definition of prohibited trading into the ITSA,¹²⁴ although a properly oriented definition could have remedied many of the problems raised by these Supreme Court decisions. The Commission's reticence is hardly surprising, since historically it has preferred to deal with issues on a case-by-case basis in the context of administrative proceedings over which it has control, or even in the context of judicial proceedings where its advocacy, particularly when based on carefully selected cases, has been most effective.¹²⁵

In lieu of legislation, the SEC has sought to thwart the full impact of *Dirks* and *Chiarella* by relying on newly fashioned theories of liability molded to fit within the framework of the Rule 10b-5 breach of duty doctrine, as well as on new Rule 14e-3,¹²⁶ which is specifically directed at tender offers. While this approach has met with significant success in the courts,¹²⁷ it does not extend the insider trading doctrine to many situations involving clearly unfair use of inside information by tippees.

A. *The Misappropriation Theory*

The misappropriation theory is clearly the most important of the SEC theories designed to clear the high hurdles created by *Dirks* and *Chiarella*. In his dissenting opinion in *Chiarella*, Chief Justice Burger endorsed the misappropriation theory as a means to surmount these hurdles.¹²⁸ He argued that any person who unlawfully obtains material, nonpublic information or, after lawfully obtaining such information, illegally converts it to his personal use, is guilty of misappropriation and cannot avoid a duty to disclose that informa-

124. *House ITSA Hearings*, *supra* note 23, at 98-100.

125. *See* Goelzer Speech, *supra* note 23, at 13-20.

126. 17 C.F.R. § 240.14e-3 (1984). *See supra* note 91.

127. *See infra* text accompanying notes 130-51.

128. 445 U.S. at 240 (Burger, C.J., dissenting).

tion or refrain from trading.¹²⁹

The SEC and lower courts have quickly embraced this theory in finding violations of Rule 10b-5 in trading by persons who were not traditional corporate insiders.¹³⁰ Prior to *Dirks*, the Second Circuit applied the misappropriation theory to reverse the dismissal of a criminal indictment in *United States v. Newman*.¹³¹ Newman and several accomplices had purchased the stock of merger and tender offer targets on the basis of nonpublic information received from employees of an investment banking firm representing the acquiring companies.¹³² The lower court dismissed the indictment because Newman had not breached a duty to, and thereby defrauded, any seller of securities,¹³³ but the Second Circuit disagreed on the basis of the misappropriation theory.¹³⁴ It found that Newman had breached a duty to and defrauded his employer, by harming its reputation as a "safe reposit[or] of client confidences", and his employer's clients, by artificially inflating target company prices through purchases based on "purloin[ed] . . . confidential information".¹³⁵ Citing Chief Justice Burger's misappropriation theory, the court determined that these frauds gave rise to a duty to disclose or refrain from trading.¹³⁶

Similarly, in 1982, in *O'Connor & Associates v. Dean Witter Reynolds, Inc.*,¹³⁷ a district court used the misappropriation theory to encompass option trading by tippees within the ambit of Rule 10b-5.¹³⁸ In *O'Connor*, an options seller alleged that unknown insiders of the takeover target had disclosed the impending takeover to

129. *Id.* at 240-45. Justice Brennan, while concurring in the judgment, joined in this part of the Chief Justice's dissent. *Id.* at 239. Justices Blackmun and Marshall, in a separate dissent, expressed "agree[ment] with much" of Chief Justice Burger's misappropriation argument, although they would have sustained Chiarella's conviction on other grounds. *Id.* at 245-46.

130. *See infra* text accompanying notes 131-51.

131. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983).

132. 664 F.2d at 15.

133. *Id.* at 14.

134. *Id.* at 17-19.

135. *Id.* at 17.

136. *See id.* at 17-18. Subsequent to *Dirks*, the misappropriation theory was used successfully to sustain a criminal indictment in *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985).

137. 529 F. Supp. 1179 (S.D.N.Y. 1981).

138. Three years after the first *O'Connor* decision, the same court rejected another motion for dismissal in the *O'Connor* case. 600 F. Supp. 702 (S.D.N.Y. 1985). This new motion was based upon the decision in *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984). *See infra* text accompanying notes 167-72.

customers and registered representatives of two broker-dealers. Citing *Chiarella*, certain of the broker-defendants moved to dismiss the complaint.¹³⁹ They argued that insiders, much less themselves as alleged tippees, had no fiduciary relationship to traders in options, since the options, in contrast to the underlying securities, were not issued by the target company; absent such a special relationship, they argued, they had no duty to disclose.¹⁴⁰ Using the *Newman* rationale, the court denied this motion and held that because insiders purportedly “breached fiduciary duties owed to other parties, the alleged conduct constituted a fraudulent practice within the meaning of federal securities laws.”¹⁴¹ The court further found that because the tippees’ information was “tainted” by a breach of duty by one or more insiders, the tippees also violated Rule 10b-5.¹⁴²

Since *Dirks*, the misappropriation theory has also successfully served as the basis for liability in circumstances nearly identical to those in *Chiarella*. In *SEC v. Materia*¹⁴³ the court denied a motion to dismiss an SEC action against a proofreader for a financial printer, who had traded on the basis of confidential material information obtained in the course of his employment.¹⁴⁴ Relying upon *Newman*, the court held that the defendant’s breach of his common law fiduciary duty of loyalty and trust to his employer would give rise to liability under Rule 10b-5.¹⁴⁵

The SEC also has successfully used the misappropriation theory after *Dirks* to apply Rule 10b-5 to insider trading not only by employees, but also by tippees of the employee who had profited to-

139. 529 F. Supp. at 1183.

140. *Id.*

141. *Id.* at 1185.

142. *Id.* at 1187. The *O'Connor* decision does not comport with the requirements of *Dirks*. In *O'Connor*, the court simply assumed that the insiders had breached their fiduciary duty to their respective corporations. *Id.* at 1185. In fact, there was no allegation of personal gain on the part of insiders sufficient to meet the *Dirks* test of a breach of fiduciary duty. *Id.* Moreover, subsequent court decisions have demonstrated that the viability of the misappropriation theory in the context of options trading is less than secure. See *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 104 S. Ct. 150 (1983); *In re McDonnell Douglas Corp. Sec. Litig.*, 567 F. Supp. 126 (E.D. Mo. 1983). However, newly adopted Section 20(d) of the 1934 Act substantially obviates these concerns. See *supra* note 30.

143. [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,526, at 97,025 (S.D.N.Y. Sept. 26, 1983, *amended* Oct. 14, 1983), *aff'd* 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 105 S. Ct. 2112 (1985).

144. *Id.* at 97,028.

145. *Id.* at 97,027-28. Ultimately, *Materia* was found to be liable and ordered to disgorge the profits he realized from his illicit trading. [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,583, at 97,285 (S.D.N.Y. Dec. 5, 1983).

gether with the employee from trading on the basis of the misappropriated information. In *SEC v. Musella*,¹⁴⁶ a district court issued an injunction against, and froze the assets of, two tippees of an office manager of a major New York City law firm.¹⁴⁷ The office manager had disclosed to other defendants material, nonpublic market information regarding merger and acquisition plans of the law firm's clients.¹⁴⁸ Applying the *Newman* analysis, the court determined that the manager breached a duty to both his law firm and its clients not to trade on the basis of the misappropriated information.¹⁴⁹ Moreover, the court held, this "duty [was] inherited by any tippees [of the manager] who knew or should have known that the information was improperly obtained."¹⁵⁰ The *Musella* court explained its analysis as follows:

From *Newman*, *O'Conner*, and *Materia*, the general principle emerges that Rule 10b-5 liability may be imposed on those who trade on the basis of material nonpublic information tainted by the breach of an insider's fiduciary duty, regardless of whether that duty runs to the sellers of the securities involved. By endorsing the alternative "misappropriation" theory of Rule 10b-5 liability . . . the Second Circuit gave legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the source of the information undermine the prophylactic intent of the securities laws.¹⁵¹

The willingness of courts to apply an "inheritance" theory to tippees of a misappropriating employee gives the misappropriation theory broad significance. *Dirks*, however, undercuts the validity of this application. The Supreme Court in *Dirks* squarely rejected

146. 578 F. Supp. 425 (S.D.N.Y. 1984).

147. *Id.* at 445.

148. *Id.* at 431.

149. *Id.* at 438-39. In *Musella*, the defendant, as an employee of the law firm, may have been a constructive insider of the law firm's clients and the use of confidential information in trading by the employee and his cohorts may have constituted a breach of fiduciary duty within the meaning of the *Dirks* test. But the Court's decision was based on the misappropriation theory and not the constructive insider concept.

150. *Id.* at 439.

151. *Id.* at 438 (citation omitted). See also *SEC v. Karanzalis*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,415, at 98,059 (S.D.N.Y. Apr. 5, 1984), ¶ 91,513, at 98,591 (S.D.N.Y. June 4, 1984), where the Commission has obtained temporary restraining orders freezing assets of employees of another major New York City law firm and their tippees on the basis of allegations that these employees misappropriated information concerning proposed tender offers and business combinations involving the firm's clients.

“[t]he SEC’s position . . . that a tippee ‘inherits’ the *Cady, Roberts* obligation to shareholders whenever he receives inside information from an insider.”¹⁵² If tippees of an insider who knowingly receive inside information do not automatically inherit the duty to disclose or refrain from trading, it is difficult to find that tippees of an outsider inherit that duty.

Nevertheless, acceptance of the misappropriation theory by the lower courts has provided the SEC with significant leverage in settlement negotiations¹⁵³ and has allowed it to extract consent decrees and disgorgement in a variety of cases. Despite recognition that the ultimate validity of the misappropriation theory is still in doubt,¹⁵⁴ these lower court successes apparently have encouraged the Commission to seek new frontiers to conquer with this theory. The SEC has sought to give this theory its broadest extension in *SEC v. Brant*.¹⁵⁵ In *Brant*, the Commission is suing to enjoin from violations of the antifraud provisions of the 1934 Act a former *Wall Street Journal* reporter, R. Foster Winans, Jr. and his tippees who allegedly traded securities on the basis of articles about to be published in the *Journal* that would affect the market for those securities.¹⁵⁶ In order to satisfy the duty requirement of *Chiarella* and *Dirks*, the SEC alleged that the reporter breached a duty not only to the *Journal* and its parent company, but also to the readers of the columns written by the reporter.¹⁵⁷

The *Brant* case highlights the unsuitability of the misappropriation theory to serve the objectives of the antifraud provisions of the federal securities laws. The misappropriation theory is premised on the breach of duty that occurs when an employee converts to his personal use confidential information entrusted to him in the course

152. 463 U.S. at 655-56.

153. See *supra* text accompanying notes 129-51.

154. *Id.* Daniel L. Goelzer, the Commission’s General Counsel, has stated that “the main weakness” of the current law under *Dirks* and *Chiarella* is that “we don’t know whether the Supreme Court will definitely sustain the misappropriation theory.” *Senate ITSA Hearings, supra* note 8, at 34.

155. *SEC v. Brant*, No. 84 Civ. 3470 (S.D.N.Y. filed May 17, 1984). See Henry, *Impropriety or Criminality*, *Time*, Sept. 10, 1984, at 45; *Wall St. J.*, Oct. 11, 1984, at 2, col. 2.

156. Henry, *supra* note 155 at 45. *Brant*, one of Winans’ tippees, consented to the entry of such an injunction and agreed to disgorge profits obtained from the alleged fraud. [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,571 at 98,924. Based largely on Brant’s testimony, Winans, along with two other defendants, was convicted of multiple criminal infractions. *United States v. Winans* 612 F. Supp. 827 (S.D.N.Y. 1985).

157. *SEC v. Brant*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,483 at 98,410 (S.D.N.Y. May 17, 1984).

of his employment.¹⁵⁸ That breach of duty to the employer may well be actionable under state law, but the purpose of the antifraud provisions is to protect investors, not employers.

To protect investors, Rule 10b-5 imposes a fiduciary duty in the relationship between an insider and the corporation's shareholders. That fiduciary duty, however, differs from the duty imposed by the employer/employee relationship. The insider who has possession of material, nonpublic information has a duty to disclose that information or abstain from trading on the basis of it.¹⁵⁹ Insider trading violates Rule 10b-5 because it is a fraud to keep silent when there is a duty to speak.¹⁶⁰

The employee's duty to his employer, however, has nothing to do with a duty to speak. It is, instead, a duty to refrain from using confidential information entrusted to him by his employer.¹⁶¹ Disclosure by the employee would aggravate the breach of duty to the employer, not cure it. Moreover, to suggest, as does the misappropriation theory, that a breach of fiduciary duty, unaccompanied by a failure to disclose, is a violation of Rule 10b-5, squarely conflicts with the Supreme Court's decision in *Santa Fe Industries v. Green*.¹⁶² The Court there held that a corporate insider's breach of fiduciary duty not involving an element of deception, misrepresentation or nondisclosure is not actionable under the antifraud provisions of the federal securities laws.¹⁶³

The misappropriation theory is thus a misconceived effort to broaden the narrow focus of the insider trading doctrine mandated by *Dirks*. Under *Dirks* that doctrine focuses "'on policing insiders and what they do . . . rather than on policing information *per se* and its possession.'"¹⁶⁴ But the misappropriation theory entirely ignores the tippee liability test articulated by *Dirks* which requires that an insider receive some personal benefit from the disclosure of inside information to a tippee. In the misappropriation cases, no such argument can be made,¹⁶⁵ and for this reason the misappropriation

158. See *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981).

159. *Cady, Roberts*, 40 S.E.C. at 911.

160. *Chiarella*, 445 U.S. at 230.

161. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *infra* text accompanying note 170.

162. 430 U.S. 462 (1977).

163. *Id.* at 474-77.

164. 463 U.S. at 663 (quoting *Investors Management Co.*, 44 S.E.C. 633, 648 (Smith C., concurring)).

165. Some commentators, including the General Counsel and Solicitor of the SEC, have

theory cannot satisfy the *Dirks* test.¹⁶⁶

Moreover, the focus of the misappropriation theory—protection of the employer rather than protection of the investors—produces anomalous results. For instance, in *Moss v. Morgan Stanley Inc.*,¹⁶⁷ arising out of facts similar to those in *Newman*,¹⁶⁸ the Second Circuit held that the misappropriation theory could not support an implied cause of action under Rule 10b-5 in favor of purchasers and sellers of securities.¹⁶⁹ The court, without either affirming or disavowing its pre-*Dirks* decision in *Newman*, stated that nothing in the *Newman* opinion “suggests that an employee’s duty to ‘abstain or disclose’ with respect to his employer should be stretched to encompass an employee’s ‘duty of disclosure’ to the general public.”¹⁷⁰ The Second Circuit thus agreed with the district court that “[t]here is no ‘duty in the air’ to which any plaintiff can attach his claim.”¹⁷¹ It found that application of the misappropriation theory to private lawsuits would provide plaintiffs with “a windfall recovery simply to discourage tortious conduct by securities purchasers.”¹⁷²

Accordingly, there are at least three major problems with the misappropriation theory. First, it is misfocused on protecting employers and the like, rather than on protecting investors. Second, it is inconsistent with the rationale of *Dirks*, and thus subject to rejection by appellate courts outside the Second Circuit, and by the Supreme Court. Third, it is inapplicable to private actions.¹⁷³ Moreover, the misappropriation theory does not apply to the many situations where

suggested that the *Dirks* decision has actually “implicitly . . . approved” the misappropriation theory by noting that *Dirks* did not “misappropriate or illegally obtain” his information. Goelzer Speech, *supra* note 23, at 12 (quoting *Dirks*, 463 U.S. at 665; Gonson & Butler, *In Wake of ‘Dirks’, Courts Debate Definition of ‘Insider’*, Legal Times, Apr. 2, 1984, at 20, col. 2. Such a conclusion simply is not warranted.

166. Even prior to *Dirks*, there were serious reservations concerning the viability of the misappropriation theory. As John Fedders, then the Director of the SEC’s Division of Enforcement, observed three months before the *Dirks* decision, “[u]ntil the Supreme Court confirms the misappropriation theory, there’s always some concern on our part in pleading cases using the misappropriation theory.” *Senate ITSA Hearings, supra* note 8, at 33.

167. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984).

168. See *supra* text accompanying notes 131-36.

169. 719 F.2d at 16.

170. *Id.* at 13.

171. *Id.* (quoting from the district court opinion, 553 F. Supp. 1347, 1353 (S.D.N.Y. 1983)).

172. *Id.* at 16.

173. Daniel L. Goelzer, the SEC’s General Counsel, has stated that a “principal defect” in current law under the insider trading doctrine is “that, in the misappropriation context, the injured investors have no private right of action to recover.” *Senate ITSA Hearings, supra* note 8, at 34.

tippees receive information without misappropriation and knowingly use it in the trading of securities. Thus, it falls far short of reaching many tippees who take unfair advantage of inside information in connection with the purchase or sale of securities.

B. *Constructive Insiders*

The SEC has also successfully employed the constructive insider concept enunciated by the Court in *Dirks*. This concept received extremely broad application in *SEC v. Lund*.¹⁷⁴ In that case Lund had received material, nonpublic information from an insider of P&F Industries, Inc. (P&F) in discussing a possible joint venture between P&F and a company headed by Lund.¹⁷⁵ Lund never accepted the joint venture proposal, but, based upon this information, he purchased P&F stock.¹⁷⁶ The court concluded that Lund was a "temporary insider" of P&F, subject to the duty to disclose or refrain from trading because he knew or should have known that the information he received was confidential and made available only for corporate purposes, not for his personal gain.¹⁷⁷

It is doubtful that the Supreme Court intended the constructive insider concept to be used so broadly. *Dirks* indicated only that the concept applied to professionals such as underwriters, accountants, lawyers, and consultants who are "working for the corporation."¹⁷⁸ In a true sense, these persons are temporarily employed by the corporation, and thereby subject to many of the same duties as permanent employees. If the constructive insider concept is limited to professional consultants, it is relatively easy to import a fiduciary duty into that professional relationship. Lund, in contrast, never occupied such a professional status.¹⁷⁹ Since he had not entered into a professional or, indeed, any relationship with P&F,¹⁸⁰ there is little basis for imposing on Lund a fiduciary duty with respect to the information acquired in his arms-length discussion with the president of P&F concerning a possible joint venture.

The decision in *Lund* is also inconsistent with *Walton v. Mor-*

174. 570 F. Supp. 1397 (C.D. Cal. 1983).

175. *Id.* at 1399-1400.

176. *Id.* at 1400.

177. *Id.* at 1403.

178. 463 U.S. at 655 n.14. *Dirks* does not specify whether employees of a law, accounting, or investment banking firm are included within the constructive insider concept, or whether this concept applies only to principals of the firms.

179. 570 F. Supp. at 1399.

180. *Id.*

gan Stanley & Co.¹⁸¹ which the Supreme Court cited with approval in *Dirks*.¹⁸² In *Walton*, Morgan Stanley, an investment banking firm, was engaged by Kennecott Copper Corporation to find a company for Kennecott to acquire.¹⁸³ Morgan Stanley approached Olinkraft, Inc., which cooperated with Morgan Stanley's request for confidential internal earnings projections. In doing so, Olinkraft specifically notified Morgan Stanley that the information was highly confidential, was to be used only in connection with a possible bid by Kennecott, and was to be returned in the event that a bid was not made or did not succeed.¹⁸⁴ After Kennecott decided not to make a bid, Morgan Stanley purchased a substantial block of Olinkraft stock for its own account based on its conclusion, derived from the Olinkraft projections, that a bid would ultimately be made by someone else.¹⁸⁵ Morgan Stanley then disclosed the confidential Olinkraft information to another client in order to induce it to make a tender offer for the Olinkraft shares.¹⁸⁶ An offer was made and accepted, and Morgan Stanley reaped substantial profits from the sale of its holdings.¹⁸⁷

Alleging that Morgan Stanley had become a fiduciary of Olinkraft upon receipt of the confidential information, an Olinkraft shareholder brought a derivative suit to recover Morgan Stanley's profits.¹⁸⁸ The Second Circuit held, however, that mere arms-length negotiations between two independent parties creates no such relationship.¹⁸⁹ The court concluded that although Olinkraft had placed its trust in Morgan Stanley, Morgan Stanley owed no duty to honor that confidence absent an actual agreement to the contrary.¹⁹⁰

Dirks cited *Walton* with approval in the context of its determination that mere disclosure of confidential information cannot impose a fiduciary duty on the recipient and thereby create the basis for a "derivative breach" by the tippee.¹⁹¹ Accordingly, in the light of *Dirks*, the *Lund* decision does not appear to be on firm footing.

181. 623 F.2d 796 (2d Cir. 1980).

182. 463 U.S. at 662 n.22.

183. 623 F.2d at 797.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* at 798.

188. *Id.* at 797.

189. *Id.* at 799.

190. *Id.*

191. *See* 463 U.S. at 662 n.22.

Dirks, although stretching the concept of the corporate insider, does not seek to extend it to everyone who receives nonpublic information. Consequently, the constructive insider theory is an ineffective rationale for extending the insider trading doctrine.

C. Rule 14e-3

The adoption of Rule 14e-3¹⁹² represents the SEC's most direct response to the restrictions imposed by *Chiarella*. This rule makes it unlawful, once substantial steps to commence a tender offer have been taken, for any person to trade in securities of the target while in possession of material information relating to the tender offer with knowledge or reason to know that such information is nonpublic and was acquired from insiders of the offeror or target. Rule 14e-3 thus imposes a duty to abstain from trading solely on the basis of knowing possession of material, nonpublic information relating to tender offers. A fiduciary duty or other confidential relationship to the other party to the transaction is not an element of the Rule 14e-3 requirement to refrain from trading.¹⁹³

Because Rule 14e-3 clearly embodies the possession test rejected by the Supreme Court in *Dirks* and *Chiarella*, those decisions raise a significant question as to the rule's validity. The rule was adopted pursuant to Section 14(e), which is similar in language to both Section 10(b) and Rule 10b-5. Section 10(b) authorizes the SEC to adopt rules prohibiting fraud "in connection with"¹⁹⁴ the purchase or sale of a security, while Section 14(e) authorizes the SEC to write rules prohibiting fraud or prescribing means necessary to prevent fraud "in connection with"¹⁹⁵ tender offers. Accordingly, the Supreme Court's ruling that trading while in possession of inside information does not, in and of itself, constitute fraud for purposes of Rule 10b-5 is likely to be equally applicable to Rule 14e-3.

While the Section 14(e) "authority to prescribe" means "necessary to prevent fraud" is broader than the Section 10(b) "authority to prohibit fraud," the rules adopted under both sections must be

192. 17 C.F.R. § 240.14e-3 (1984). *See supra* note 91.

193. *Cf.* 445 U.S. at 234-35. In *Chiarella*, the Court did lend some support to a distinction between Section 10(b) and Rule 14(e) by referring to the SEC's recognition that action under Section 10(b) "would rest on a 'somewhat different theory' than that previously used to regulate insider trading as fraudulent activity." *Id.* at 234. However, this observation is a meager rebuttal compared to the primary findings of law in *Dirks* and *Chiarella*.

194. 15 U.S.C. § 78j(b) (1981).

195. 15 U.S.C. § 78n(e) (1981).

directed against fraud.¹⁹⁶ If, as *Dirks* and *Chiarella* emphasize, a finding of fraud under Section 10(b) in an insider trading case requires a fiduciary relationship or other confidential relationship between an insider and the purchaser or seller of the securities, then the same requirement would seem applicable to the imposition of insider trading liability under Section 14(e). Absent such a relationship, there is no fraud or deception under Section 14(e). Consequently, although post *Chiarella* and *Dirks* court decisions continue to apply Rule 14e-3,¹⁹⁷ this rule appears to transgress the SEC's rulemaking authority granted by Congress in Section 14(e).

The SEC can be expected to continue its efforts to resist contraction of the insider trading doctrine by expanding the application of such devices as the misappropriation theory,¹⁹⁸ the constructive insider concept,¹⁹⁹ and Rule 14e-3.²⁰⁰ But these devices are at odds with the rationale of *Dirks* and *Chiarella*. The SEC may well experience further success in the lower courts due to the practical concerns of judges over the glaring gaps in the present insider trading doctrine caused by the fiduciary duty/benefit test of *Dirks* and *Chiarella*. But it seems clear that the misappropriation theory and the rationale of Rule 14e-3 are sharply at odds with this test, and that the SEC's success may be short-lived.

Moreover, these devices cannot cover a tippee in a non-tender offer situation where the tippee does not misappropriate information, is not an actual or constructive insider, and does not benefit by his trading. Such activity, though, often contravenes basic notions of ethical fairness on which confidence in the securities markets rests. Continuing reliance on alternative theories of liability to avoid the implications of *Dirks* and *Chiarella* is likely to lead to an uncertain, confusing and incomplete application of the insider trading doctrine. In any event, it is highly questionable whether successful prosecution in the lower courts will be accepted in the Supreme Court.

III. A NEW STATUTORY FOUNDATION FOR THE INSIDER TRADING DOCTRINE

Dirks and *Chiarella* sharply contract the scope of tippee liabil-

196. Compare 15 U.S.C. § 78j (1981) with 15 U.S.C. § 78n(e) (1981).

197. See, e.g., SEC v. Musella, 578 F. Supp. 425, 443-44 (S.D.N.Y. 1984); SEC v. Wallis, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,562 at 98,845 (May 31, 1984).

198. See *supra* text accompanying notes 128-73.

199. See *supra* text accompanying notes 174-91.

200. See *supra* text accompanying notes 192-96.

ity under Rule 10b-5 for trading on the basis of material, nonpublic information. In part, this limitation reflects the Supreme Court's determination that the proper focus of Rule 10b-5 is the policing of conduct by traditional corporate insiders rather than the use of inside information. Unfortunately, the present insider trading doctrine leaves significant gaps in the regulation of trading even by insiders.

A far better answer to the problem begins with the recognition that the present statutory scheme underlying the insider trading doctrine is inadequate to achieve its objective. Apart from Section 16 of the 1934 Act,²⁰¹ the antifraud provisions currently are the only mechanism for policing trading on the basis of material, nonpublic information. The limitations of *Dirks* and *Chiarella* may be consistent with the traditional precepts of fraud, but they are not consistent with ethical precepts of fairness in the trading of securities. If the Supreme Court's willingness to tolerate insider trading prohibitions that fall far short of prevailing ethical notions of fairness is not acceptable, the solution lies in establishing a statutory basis for the insider trading doctrine outside of the fraud context.

A. *The Flaws of the Possession Standard*

Since the possession standard inhibits appropriate actions by financial analysts, maintains unrealistic standards of broad dissemination, and fails to distinguish between different methods of information gathering, it should not be used as a legislative solution. The standard imposes a duty on all persons in possession of material, nonpublic information to disclose that information or to refrain from trading.²⁰² The scope of a pure possession standard is too broad. Indeed, its very breadth may have contributed to its downfall. It forces the financial community and others to rely exclusively on the information that corporate managers choose to disclose in required SEC reports, press releases and shareholder communications. It leaves no room for financial analysts and others who use their initiative and perceptiveness to ferret out, through proper means, information that corporate managers have chosen not to publicly disseminate. As the Supreme Court recognized in *Dirks*, the possession theory, in the name of simplistic equality of access, serves to impede the gathering of information material to investment decisions.²⁰³ This inhibiting effect is in large part responsible for rejection of the possession stan-

201. 15 U.S.C. § 78p (1981).

202. See *supra* text accompanying notes 51-81.

203. 463 U.S. 646, 663 (1983).

dard by the Supreme Court. Codification of the possession standard would ignore these legitimate concerns of the Court and the financial community regarding the adverse effects of an overly broad insider trading doctrine.

The possession standard also places insiders and market-makers of thinly traded securities in a difficult, if not untenable, position. It precludes them from trading on the basis of material information prior to public disclosure. But "public disclosure" typically has been defined to require broad dissemination "in a manner sufficient to insure its availability to the investing public."²⁰⁴ Information concerning thinly traded securities, though, often does not have broad enough investor interest to obtain such dissemination. In such circumstances, market-makers and other persons with knowledge of that information are in a quandary. They cannot trade until the information receives adequate dissemination, but they are not in a position to disseminate the information.

Application of the possession theory is also particularly troublesome in the context of market information. On one hand, trading on the basis of this material, nonpublic market information, such as information relating to a tender offer, may be unfair on the part of those who obtain that information by nature of a special relationship to the target or attacking company or their insiders. Much market information, however, is available to those who originate the information or who gather it through their own efforts, and those persons should be allowed to trade on the basis of such information. Unfortunately, the possession theory does not adequately distinguish between the different circumstances through which knowledge of market information is acquired.

B. *Codification of the Misappropriation Theory*

There are also major disadvantages to perpetuating the misappropriation theory. Most importantly, the misappropriation theory focuses on a breach of duty to employers, a concern that is unrelated to the goal of investor protection.²⁰⁵ For example, in *Brant*, the SEC has asserted that the *Journal* reporter violated a duty not only to his employer, but also to the *Journal's* readers.²⁰⁶ This argument has

204. See *Investors Management Co.*, 44 S.E.C. at 643, n.22; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), *cert. denied* 394 U.S. 976 (1969); see also 5 A. JACOBS, *THE IMPACT OF RULE 10B-5* § 66.02[g], at 3-370 n. 9 (rev. ed. 1980).

205. See *supra* text accompanying notes 158-61.

206. See *supra* text accompanying notes 155-57.

raised widespread concern that the SEC is attempting to regulate journalists in violation of the constitutional right to free speech under the first amendment. Those who oppose the SEC's charge maintain that while the alleged conduct may well have violated journalistic codes of ethics, there is simply no basis for asserting a duty owed to *Journal* readers that is enforceable by Rule 10b-5. Regardless of the merits of this claim, the issue is far removed from the purpose of the insider trading doctrine.

Any statutory restructuring of the insider trading doctrine should be designed to avoid focusing upon tangential issues such as those raised in *Brant*. The protection of newspaper readers or employers has no relevance to the federal securities laws. Rather, the main focus of the insider trading doctrine should be on protecting investors from persons who trade based on unfair informational advantages. A codification of the misappropriation theory would fall short of protecting investors from insider trading.

C. *An Unfair Informational Advantage Standard*

The preferable legislative alternative is to enact a statute specifically designed to achieve the underlying objective of the insider trading doctrine. The main rationale for the doctrine has been that insider trading undermines the expectation of fairness needed to maintain investor confidence in our securities markets.²⁰⁷ Accordingly, a new statutory provision should be directed at prohibiting trading in securities based upon unfair informational advantages.

Under an unfair use of nonpublic information standard, mere possession of material, nonpublic information would not be a basis for liability. Rather, liability would require a showing that the trader acquired material, nonpublic information through a business, personal or other special relationship, and used that information for an improper purpose. Insiders of corporations clearly would have the special relationship necessary to bring them within the ambit of the statutory prohibition. Similarly, lawyers, accountants, investment bankers, commercial bankers, financial printers and similar persons who acquire nonpublic information in the course of their business relationships also would be prohibited from profiting from that information or divulging it to other persons who are likely to misuse it. Finally, personal friends and relatives of persons with special relationships would also be subject to the prohibitions against trading on

207. See *supra* text accompanying note 3.

the basis of unfair informational advantage.

On the other hand, absent unusual circumstances, financial analysts would be free to use any information legally acquired by them in connection with their business activities. The analyst's use of such information for personal trading profits, however, would be subject to the statutory prohibition. Similarly, market-makers and other members of the financial community who normally receive information regarding corporate events would not be subject to the statutory prohibition unless particular circumstances demonstrated preferential treatment on the basis of a special relationship.

In our view, a statute prohibiting unfair use of material, non-public information is necessary in order to encompass the many areas of trading that are not or may not be covered by the *Dirks* and *Chiarella* fiduciary duty/benefit test. At the same time, such a standard would give the courts sufficient flexibility to distinguish trading by persons who have not taken improper advantage of a special relationship under circumstances that would create an unfair use of the information for personal profit. The proposed standard would serve the objectives of the insider trading doctrine while not discouraging initiative in the gathering of material information on the part of the financial community and other investors.