COMMENTS

INSIDER TRADING LIABILITY OF TIPPEES AND QUASI-INSIDERS: CRIME SHOULDN'T PAY

The subject of insider trading[1] has aroused nationwide concern in recent years.[2] In June of 1986, the SEC[3] announced what was

1. Professor Donald Langevoort defines "insider trading" as "a term of art that refers to unlawful trading in securities by persons who possess material nonpublic information about the company whose shares are traded." D. LANGEVOORT, INSIDER TRADING HANDBOOK 3 (1987 ed.). Professor Langevoort notes that the term "insider trading" is misleading in that the prohibition against it applies to a larger class of persons than those traditionally considered corporate insiders. *Id.* He further notes that the definition of "insider trading" is somewhat circular insofar as the term is used to refer only to unlawful trading. *Id.* There are instances where persons who possess material nonpublic information can lawfully trade. *Id.* at 4. For examples, see *infra* text accompanying notes 192-197 (exceptions to liability under this Comment's insider trading legislative proposal).

2. *See* Dentzer, *Greed on Wall Street*, NEWSWEEK, May 26, 1986, at 44-46. There has been a widespread public perception that insider trading is a common practice in the securities markets and there is increased concern on Wall Street that the stock market's reputation might suffer. *See, e.g., Poll Finds Majority Thinks Insider Trading Is Common*, Wall Street J., June 6, 1986, at 3 (according to a Wall Street Journal/NBC News Poll, two out of every three American adults think that insider trading is common).

The public's perception of insider trading abuses probably stems from the attitudes of those involved in the security markets. *See, e.g.,* Dorfman, *Heard on the Street*, Wall Street J., June 22, 1972, at 29, col. 3 (Pacific ed.) ("The ability to earn money through inside information will always be a fact of life in the securities industry."). Nearly twelve years later, one person being investigated for insider trading was quoted as saying, "I don't feel it's unethical. It's the American way." *Illegal Insider Trading Seems to Be on the Rise; Ethics Issues Muddled*, Wall Street J., Mar. 2, 1984, at 2. The article notes that "[t]he enforcers' biggest problem . . . is that information abuse seems to be endemic to the business of buying and selling securities. Information is a currency of Wall Street on nearly equal standing with money." *Id.*

Insider trading has also been the subject of worldwide concern. *See, e.g.,* SEC v. Certain Unknown Purchasers of the Common Stock of Santa Fe Int'l Corp., SEC Litigation Release No. 9484, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,823; SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981); STOCK EXCHANGE LAW AND CORPORATION LAW: REPORT FROM A SYMPOSIUM IN SWEDEN (Roos ed. 1984); Carvalhase and Eizrik, *Disclosure and Insider Trading Regulation Recent Developments in Brazilian Law*, 4 J. COMP. CORP. L. SEC. REG. 395 (1982).

3. The Securities and Exchange Commission (SEC) was created on July 2, 1934 by the Securities Exchange Act of 1934. The Act provides that the SEC shall consist of five members appointed by the President for five-year terms (the term of one Commissioner expires each year), not more than three of whom shall be members of the

then the largest ever disgorgement[4] of insider trading profits, some $11.6 million, by Dennis Levine, a former Wall Street investment banker;[5] and in November of 1986, Ivan Boesky, a noted Wall Street arbitrager,[6] consented to a combination of disgorgement and civil penalty totaling $100 million, to a guilty plea on a felony, and to a permanent bar from the securities industry.[7] The Levine and Boesky scandals have directed unprecedented attention to the problem of insider trading and the ability of the government to conduct successful litigation against those who violate the federal securities laws.[8]

The prohibition against trading on the basis of inside informa-

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same political party. 15 U.S.C. § 78d (1976). The laws administered by the Commission relate in general to the field of securities and finance, and seek to provide protection for investors and the public in their securities transactions.

4. Disgorgement is a remedy whereby the individual gives up any illegal profits obtained through insider trading. Prior to the enactment of the Insider Trading Sanctions Act of 1984, disgorgement of illegal profits had been criticized as an insufficient deterrent because it merely restored a defendant to his original position without extracting a real penalty for his illegal behavior. *See* H.R. REP. No. 355, 98th Cong., 1st Sess. at 2-8 (1983) (describing the background of the Insider Trading Sanctions Act). The Insider Trading Sanctions Act of 1984 merely added subsections to the Securities Exchange Act of 1934 that resolved the inadequate deterrent problem by providing a civil penalty of up to three times the profit gained or loss avoided from insider trading. *Id.* (explaining 15 U.S.C. § 21(2)(A)). An analysis of the various remedies for violations of the federal securities laws is, however, beyond the scope of this Comment.

5. The Levine settlement is noted in 18 Sec. Reg. & L. Rep. (BNA), at 793 (SEC v. Levine, S.D.N.Y., June 5, 1986). Levine was a former executive with Drexel Burnham Lambert, Inc. and obtained approximately $12.6 million in illicit profits from a scheme to secretly trade in the securities of fifty-four companies. *Id.* He allegedly traded securities after obtaining inside information concerning mergers, tender offers, leveraged buyouts and other corporate transactions tending to dramatically increase the price of the securities involved. *Id.* Levine also pleaded guilty to criminal tax evasion, perjury, and securities fraud. *Id.* For a more complete and interesting account of the Levine scandal, see Stone, *Insiders: The Story of Dennis Levine and the Scandal That's Rocking Wall Street*, NEW YORK MAGAZINE, July 28, 1986, at 26.

6. An arbitrager is one who simultaneously purchases and sells the same securities, commodities or foreign exchanges in different markets to profit from unequal prices. WEBSTER'S NEW WORLD DICTIONARY 70 (2d ed. 1986).

7. The Boesky settlement is noted in 18 Sec. Reg. L. Rep. (BNA), at 1969 (SEC v. Boesky, S.D.N.Y., Nov. 14, 1986). Without admitting or denying the SEC allegations, Boesky paid a record $50 million fine and disgorged another $50 million. *Id.* In its complaint, the SEC alleged that Boesky obtained material nonpublic information from Dennis Levine concerning tender offers, mergers and other business combinations or extraordinary corporate transactions. *Id.* The two men then agreed to share in the profits from trading on the basis of that information. *Id.*

8. Professor Langevoort notes that the scandals have had three additional results. D. LANGEVOORT, *supra* note 1, at 2. First, due to the sensitivity of potential liability, there has been a noticeable decline in rumors and trading in advance of important public disclosures. *Id.* at 3. Second, Wall Street's senior executives have shown concern about the ethics of the obsessed, money-hungry, newest generation of investment professionals. *Id.* Finally, there are increasing numbers of persons in the business, financial and legal communities who are seeking a more sophisticated understanding of the law of insider trading. *Id.*

tion has become a fundamental tenet of federal securities law.[9] The

9. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1 (1982). The prohibition is rarely questioned by courts. *See generally* 2 A. BROMBERG & L. LOWENFELS, SECURITIES AND COMMODITIES FRAUD (1979); 5 A. JACOBS, THE IMPACT OF RULE 10b-5 Section 66.02 (rev. ed. 1978); 3 L. LOSS, SECURITIES REGULATIONS 1448-50 (2d ed. 1965).

At least one legal commentator has argued that the best justification for the prohibition against insider trading is the need to protect corporate confidentiality. *See* Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEG. STUD. 801 (1980). Other commentators have suggested that the principal justification for the prohibition against insider trading is that it undermines public confidence in the capital markets. *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334-35 (1979); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 858 (1983); Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 629. Another commentator believes that insider trading impedes corporate decision making. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051 (1982), while two other commentators have concluded that insider trading permits managers to profit from bad news as well as good, thereby creating incentives to take abnormal risks and operate the corporation ineffectively. R. Leftwich & R. Verrecchia, Insider Trading and Managers' Choice Among Risky Projects 20-22 (Aug. 1981) (University of Chicago Graduate School of Business Working Paper 63).

It has also been suggested that insider trading raises a firm's cost of capital. *See* Brudney, *supra*, at 356; Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470, 477-78 (1969). Yet another commentator argues that the justification for Rule 10b-5 is a "business property" theory grounded upon the fiduciary duties between certain individuals and the owners of the information. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, SEC. LAW REV. 177, 179 (1986). The strongest argument for a prohibition against insider trading, however, seems to be the strongly held intuition that insider trading is simply unfair. Several commentators stress the unfairness of insider trading. *See, e.g.*, Ferber, *The Case Against Insider Trading*, 23 VAND. L. REV. 621, 622 (1970); Loss, *The Fiduciary Concept as Applied to Trading by Corporate Insiders in the United States*, 33 MOD. L. REV. 34, 36 (1970). *But see* Scott, *supra*, at 809 (rejecting a pure fairness rationale because it has "surprisingly little substance"). Whatever the extent of insider trading, the business community is largely united in publicly denouncing such conduct. For a comparative law perspective, see B. RIDER & H. FRENCH, THE REGULATION OF INSIDER TRADING (1979).

Many laymen, however, believe that there is nothing wrong with insider trading. An August 1986 poll revealed that 53% of the public would trade if given "insider" information, and 82% thought that most other people would trade under the same circumstances. S. Jackson, *Business Week/Harris Poll: Insider Trading Isn't a Scandal*, Business Week, Aug. 25, 1986, at 74. *See also* Baumhart, *How Ethical Are Businessmen?*, 39 HARV. BUS. REV. 6, 16 (July-Aug. 1961).

Many legal commentators have also questioned the prohibition on insider trading. *See, e.g.*, Carlton & Fischel, *supra*, at 894-95 (challenging the notion that anyone is seriously harmed by insider trading because investment decisions by innocent market participants are probably wholly independent of the insider trading); Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980) (questioning whether enforcement of the prohibition is cost-justified); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981) (in-depth discussion on whether anyone is seriously harmed by insider trading).

Some legal commentators have even suggested that insider trading is socially valuable. *See, e.g.*, H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (insider trading should be permitted because it is the optimal means of causing the market price of a security to move toward its true value, *ie.*, the price that would prevail if all material information about the security were public); Wu, *An Economist Looks at* general prohibition, known as the disclose-or-abstain rule, requires persons in possession of material nonpublic information to either disclose such information prior to trading or refrain from trading.[10] This rule developed primarily as a judicial interpretation of Section 10(b) of the Securities Exchange Act of 1934[11] and Rule 10b-5[12]

Section 16(b) of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260 (1968) (prohibition against insider trading is a hopeless moralism that ignores allocative efficiency). These economists have been extensively criticized in light of the disclose-or-abstain rule, *see* text accompanying *infra* note 10, which arguably promotes allocative efficiency by operating to encourage prompt and effective public disclosure by insiders and issuers. *See e.g.*, W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 5.10 (1979); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967) (criticizing Manne's approval of insider trading). For an overall criticism of all arguments in favor of insider trading, see 130 CONG. REC. H7758-59 (daily ed. July 25, 1984) (Congressman Dingell (D., Michigan) states "[w]e strongly disagree with those who seek to permeate our markets with this type [insider trading generally] of fraud [and] [t]he arguments in favor of insider trading are rubbish").

Judicial approval of the prohibition against insider trading precludes any further discussion herein on the merits of the prohibition. Rather, this Comment assumes that Rule 10b-5 is grounded on notions of fairness and will analyze the scope of the prohibition accordingly.

10. In re Cady, Roberts & Co., 40 S.E.C. 907 (1961). Since the SEC's decision in *Cady, Roberts*, an administrative action brought by the SEC, federal courts have also adopted the disclose-or-abstain rule. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983) (citing *Cady, Roberts*); Chiarella v. United States, 445 U.S. 222, 229 (1980) (noting that a person must have a duty to disclose to be liable); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (insider must disclose all or none); Shapiro v. Merill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-37 (2d Cir. 1974) (applying *Texas Gulf Sulphur Co.* disclose-or-abstain rule); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-49 (2d Cir. 1968) (en banc) (insider must disclose material nonpublic information or abstain from trading), *cert. denied*, 394 U.S. 976 (1969).

11. Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative 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.

12. 17 C.F.R. § 240.10b-5 (1980). The SEC promulgated Rule 10b-5 under the authority of Section 10(b) of the 1934 Act and it has become the predominant antifraud provision in federal securities law. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connections with the purchase or sale of any security.

Hereinafter, Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982) and 17 C.F.R. § 240.10b-5 will be referred to collectively as Rule 10b-5.

Milton Freeman described the Commission's adoption of Rule 10b-5 as follows:

> I think it would be appropriate for me now to make a brief statement of what actually happened when 10b-5 was adopted, where it would be written

promulgated thereunder.[13] The courts, however, have found it difficult to determine which persons are subject to the insider trading prohibition.

This Comment will consider the liability of a person who trades on the basis of material[14] nonpublic[15] corporate information and

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down and be available to everybody, not just the people who are willing to listen to me.

It was one day in the year 1943 [1942], I believe. I was sitting in my office in the SEC building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?"

Freeman, *Administrative Procedure*, 22 Bus. Law. 891, 922 (1967).

13. The law of insider trading developed almost entirely from judicial and administrative creation. Neither the disclose-or-abstain rule nor the statutory provisions of Rule 10b-5 expressly prohibit insider trading. *Cf.* Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) (expressly prohibits shortswing profits by certain insiders). Liability under 16(b), however, does not provide an effective remedy for the full range of insider trader abuses because of its relatively narrow scope. *See* Langevoort, *supra* note 9 (explaining the difference between Rule 10b-5 and section 16(b)).

14. A common definition of "material" information used in insider trading cases is:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act] . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC Industries, Inc. v. Northway, 426 U.S. 438, 449 (1976). Although the *TSC Industries* Court considered materiality in the context of a proxy solicitation, the definition has been adopted for insider trading purposes as well. *See, e.g.*, Harkavy v. Apparel Indus. Inc., 571 F.2d 737, 741 n.5 (2d Cir. 1978) (quoting *TSC* extensively in determining whether certain information was material for an alleged rule 10b-5 violation). Some courts have narrowed the *TSC* definition to focus on whether disclosure of the information would be likely to result in a substantial change in the price of the security. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980); SEC v. Bausch & Lomb Inc., 565 F.2d 8, 18 (2nd Cir. 1977); *see also* SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968) (creation of the "probability-magnitude" test for materiality—assessing the likelihood that an event will occur against its magnitude if it should occur), *cert. denied*, 394 U.S. 976 (1969); In re Wentz, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,629 (Admin. Proc., May 15, 1984) (only a possibility of a price movement in the stock, rather than a substantial certainty); 5A A. Jacobs, Litigation and Practice Under Rule 10b-5 § 61.03 (2d ed. 1985) (explaining that material information includes *any* information that might affect the value of the stock in who is neither a traditional insider[16] nor a fiduciary[17] of the corpora-

question and is not limited to verifiable facts).

For examples of information that courts have found to be material, see *Elkind*, 635 F.2d at 164 (management's expectations that future earnings reports will be better or worse than expected); Lilly v. State Board of Teachers Retirement Board, 608 F.2d 55, 59-60 (2d Cir. 1979) (information destroying prior assumptions held by investors about the company); SEC. v. Lund, 570 F. Supp. 1397, 1401 (C.D. Cal. 1983) (plans or proposals of the issuer of stock to go into a new line of business); Western Hemisphere Group v. Stan West Corp., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,858 (S.D.N.Y. 1984) (information that a company is going public with a new stock issue); SEC v. Hall, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,292 (D.D.C., Feb. 22 1980) (fact of a stock repurchase pursuant to a tender offer). For a more complete discussion of materiality, see Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373 (1984).

15. Information is "nonpublic" if it is not generally available to the investing public. Under the "efficient market hypothesis," once information is in the hands of a significant number of investors, the market price of the security will quickly reflect the consensus view of the significance of the information. D. LANGEVOORT, *supra* note 1, at 168. At that point, the opportunity for profit from insider trading disappears. *Id.* Thus, the test for determining whether information is "nonpublic" is to inquire whether the market has reacted to the information. Generally, the issue is how long the insider must wait after public dissemination of the information before trading on it. *Texas Gulf Sulphur Co.*, 401 F.2d at 854. Deciding how long it takes for information to be reflected in the market price of a security, after public dissemination, can be problematic. *See* D. LANGEVOORT, *supra* note 1, at 169 *citing* Shapiro v. Merill Lynch, Pierce, Fenner & Smith, 353 F. Supp. 264, 279-80 (S.D.N.Y. 1972), *aff'd*, 495 F.2d 228 (2d Cir. 1974) (two minutes after the information is put on the Dow Jones tape is not enough); Patell & Wolfson, *The Intraday Speed of Stock Prices to Earnings and Dividend Announcements*, 13 J. FIN. ECON. 223 (1984) (research indicates that information can be reflected in the market price within hours after public dissemination). Professor Langevoort notes that twenty-four hours after public dissemination in a national medium is a popular rule of thumb. D. LANGEVOORT, *supra* note 1, at 169, *citing* 5A A. JACOBS, *supra* note 14, at § 66.02[g] (1984); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 841-42 n.63 (1983)). In Faberge, Inc., SEC Exchange Act Release No. 10,174 (May 25, 1973), the Commission addressed the question of when information was available to the investing public. The Commission said:

> In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information. Obviously, what constitutes a reasonable waiting period must be dictated by such surrounding circumstances as the form of dissemination and the complexity of the information, *i.e.*, whether it is "readily translatable into investment action" . . . Proper and adequate disclosure . . . can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.

Because the issue of whether information is "nonpublic" is rarely at issue in the typical insider trading case, further discussion of the issue is beyond the scope of this Comment.

16. One definition of "insider" is as follows:

> "Insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in Section 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person . . . .

tion whose shares are traded. Specifically, this Comment will not explore the liability of the obvious traditional corporate insiders, such as officers, directors, controlling shareholders, and employees.[18] Rather, this Comment will focus on the duty of tippees[19] and quasi-insiders[20] to disclose or abstain from trading.[21]

ALI FED. SEC. CODE Section 1603 (1978 Proposed Official Draft).

17. Fiduciaries include accountants, lawyers, investment bankers, underwriters and other similarly situated persons who plainly consent to act on behalf of their clients. *See* Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 884-85 n.3 (S.D. Fla. 1981) (defining insiders as "those persons who by reason of their own position and special relationships with the corporation have access to information not available to those with whom they are dealing"). Like traditional insiders, the liability of fiduciaries is based on fiduciary responsibilities and has been imposed without question in recent years. Thus, the term "fiduciary" is a misnomer in this context because a fiduciary obligation is often imposed on classes of persons who are not strictly termed "fiduciaries."

In a footnote in the *Dirks* case, the Supreme Court observed that underwriters, accountants, attorneys, and consultants working for a corporation assume a fiduciary duty to the shareholders when they legitimately receive material nonpublic information. SEC v. Dirks, 463 U.S. 646, 655 n.14 (1983). "The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic, corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Id.* For examples of cases holding fiduciaries liable under Rule 10b-5, see Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (underwriter was properly prohibited from tipping or trading in Douglas stock when he learned of a decline in projected earnings); SEC v. Tome, 638 F. Supp. 596, 620-23 (S.D.N.Y. 1986) (suggesting that person who was both financial advisor to the corporation and personal confidant to its chief executive officer was a fiduciary); SEC v. Franco, 18 SEC. REG. & L. REP. (BNA) 1274 (D.D.C., Aug. 28, 1986) (public relations advisor as fiduciary); SEC v. Lerner, David, Littenberg & Samuel, SEC Litigation Release No. 9094, 19 S.E.C. Dock. 1153 (D.D.C., Apr. 2, 1980) (patent attorney barred from buying his client's stock).

18. Traditional insiders generally include officers, directors, controlling shareholders and employees. When these classes of individuals trade on the basis of material nonpublic information, courts have attached liability without question in recent years. The Supreme Court has made it clear that a person has an obligation of disclosure to other traders in the marketplace when he stands in a fiduciary relationship with them. *Dirks*, 463 U.S. at 655-56; Chiarella v. United States, 445 U.S. 222, 227 (1980). For a discussion of the limitations resulting from the fiduciary relationship requirement of these decisions, see *infra* notes 100-122 and accompanying text. For a synopsis of the fiduciary obligations of traditional insiders (officers, directors, controlling shareholders, and corporate employees), see D. LANGEVOORT, *supra* note 1, at 81-83.

19. A "tippee" is a person who receives material nonpublic information directly from traditional corporate insiders or fiduciaries. *See supra* notes 16-17 for dicussions of insiders and fiduciaries.

20. Quasi-insiders are certain classes of persons who have "unusual" access to material nonpublic information relating to securities. Such classes of persons may include investment analysts, news reporters, stockbrokers, friends, relatives, and business associates of traditional insiders, and eavesdroppers. This list, however, is by no means exhaustive of the many types of individuals who may acquire material nonpublic corporate information and so become quasi-insiders.

21. The four categories of persons (traditional insiders, fiduciaries, tippees and quasi-insiders) have been distinguished for purposes of this Comment only to illustrate some troubling aspects of our current insider trading law with regard to tippee and quasi-insider liability. The intention of this Comment is to focus on these "gray

Part I examines the historical scope of Rule 10b-5 and explains the fundamental principles that have emerged under the traditional analysis of Rule 10b-5 violations. Next, Part II analyzes the seminal Supreme Court decisions in *Chiarella v. United States*[22] and *SEC v. Dirks*.[23] In particular, this section considers how those opinions limit the scope of Rule 10b-5 and tarnish established fundamental principles with respect to tippees and quasi-insiders who have an informational advantage over others in the marketplace. In that light, Part III discusses various theories that have been developed to address the issue of tippee and quasi-insider liability. This section also underscores the confusion caused by the Supreme Court's failure to adopt one or more of these theories. Finally, Part IV suggests a framework for legislation that would amend the federal securities laws in accordance with the fundamental principles that were the basis of Rule 10b-5 liability prior to *Chiarella* and *Dirks*. Specifically, Congress should adopt a blanket prohibition against all trading on material nonpublic information, and exempt only certain narrowly defined classes of traders from the coverage of the statute.

I. THE HISTORICAL SCOPE OF RULE 10B-5: THE FUNDAMENTAL PRINCIPLES

In order to analyze the scope of Rule 10b-5 as it pertains to the liability of tippees and quasi-insiders, it is helpful to look to the language of the statute itself.[24] Section 10(b) forbids "any person" "directly or indirectly" to "use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules . . . as the Commission may proscribe . . . for the protection of investors."[25] Similarly, Rule 10b-5, promulgated by the Commission pursuant to authority granted by Section 10(b), prohibits "any person" from using "any device, scheme or artifice to defraud" or from "engag[ing] in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person" in connection with a purchase or sale of securities.[26] The Supreme Court has recognized that these proscriptions should be interpreted broadly and that the repeated use of the word "any" is "meant to be inclusive" of the many individuals who might participate in the securities markets.[27]

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areas" of insider trading liability under Rule 10b-5.

22. 445 U.S. 222 (1980).

23. 463 U.S. 646 (1983).

24. Touche, Ross & Co. v. Redington, 442 U.S. 560, 568 (1979) (analysis of Rule 10b-5 violation begins with the language of the statute).

25. *See supra* note 11 for the text of Section 10(b) of the Securities Exchange Act of 1934.

26. *See supra* note 12 for the text of Rule 10b-5.

27. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972).

Despite the broad language in both the statute and the regulation, Rule 10b-5's prohibition on insider trading developed primarily by judicial and administrative interpretation. The first statement that trading on the basis of inside information in the anonymous securities markets might violate Rule 10b-5 appeared in *In re Cady, Roberts & Company*,[28] a case heard by the SEC. In 1959, the price of Curtiss-Wright corporate securities had been rising as a result of a new product announcement. However, on November 25, 1959, the board of directors decided to reduce the company's dividend in the fourth quarter below the amount it had paid in the previous three quarters.

Mr. Cowdin, a board member of Curtiss-Wright as well as a member of the broker-dealer firm of Cady, Roberts and Co., informed one Mr. Gintel of Curtiss-Wright's dividend reduction. Mr. Gintel, a partner at Cady-Roberts, had purchased approximately 11,000 shares of Curtiss-Wright stock in early November. Before the Curtiss-Wright dividend reduction was announced to the investing public, Mr. Gintel sold 2,000 shares of his stock and entered into short sales[29] of 5,000 more. The price of Curtiss-Wright stock then fell sharply after the public learned of the dividend reduction.

Because the case was "one of first impression" and important in the SEC's administration of the Securities Exchange Act,[30] the Commission elaborately explained the legal principles of Rule 10b-5. Chairman Cary's opinion for the Commission broadly stated that Rule 10b-5 is applicable to securities transactions by *any person*.[31] The Commission stressed that officers, directors and controlling stockholders "do not exhaust the classes of persons upon whom there is . . . an obligation"[32] to disclose material nonpublic facts or abstain from trading.

The Commission announced a two-element fairness test for determining, under Rule 10b-5, when purchasers and sellers of securities have a duty to disclose material nonpublic information. First, whether there is a fiduciary or special relationship that gives an individual access, directly or indirectly, to material corporate information.[33] Second, whether it is unfair for a party to use information

28. 40 S.E.C. 907 (1961).

29. Short selling is where an individual borrows stock, resells it, and then repurchases the stock later so that the stock may be returned. The economic gain, if any, is the difference between the sale price and the repurchase price. Interview with Michael Inserra, stock broker at Thomson McKinnon Securities, Inc. (Feb. 22, 1988).

30. *Cady, Roberts*, 40 S.E.C. at 907.

31. *Id.* at 911.

32. *Id.* at 912.

33. *Id.* The Commission defines material corporate information as that which is "intended to be available only for a corporate purpose and not for the benefit of anyone." *Id.* In a footnote, the Commission adds that a significant purpose of the

when he knows that the same information is unavailable to the person with whom he is dealing.[34]

Cady, Roberts thereby established the fundamental principle that Rule 10b-5 applies to a broad range of persons which arguably includes tippees and quasi-insiders.[35] The decision accurately identifies the unfairness of allowing any person to take advantage of insider information by trading without disclosure.[36] The Commission relied on the assumption that, had disclosure been made to the public,[37] the marketplace buyers[38] or sellers would not have traded or at

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Securities Exchange Act of 1934 was to eliminate the idea that the use of inside information for personal gain was a normal emolument of the corporate office. *See* H.R. REP. No. 1383, 73rd Cong., 2d Sess. 13 (1934); S. REP. No. 792, 73rd Cong., 2d Sess. 9 (1934).

34. *Cady, Roberts*, 40 S.E.C. at 912. The Commission adds that when considering the two-element fairness test, it must identify which people have a special relationship with a company and are privy to its internal affairs. *Id.* The Commission concluded that Mr. Gintel had all of the responsibilities and owed all of the duties of those commonly referred to as "insiders". *Id.*

35. Although the Commission never clearly stated who should be subject to the disclose or abstain obligation, its emphasis on access relationships and general unfairness suggested a potentially broad scope for Rule 10b-5. Although the Commission did not classify Mr. Gintel as belonging to any specific class of persons, he could reasonably be viewed as either a tippee or a quasi-insider. Mr Gintel was the recipient of a tip from a true insider, Mr. Cowdin, a director of the corporation whose shares were traded. It should be noted that the Commission's decision that Mr. Gintel was obligated to disclose-or-abstain was contrary to the prior view of the Commission. It had earlier indicated that tippees were *not* liable under Rule 10b-5 for trading on the basis of material nonpublic information. SEC, *Study of the Securities and Exchange Commission: Hearings Before the Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 82d Cong., 2d Sess. 725-26 n.1 (1952) (statement of Peter T. Byrne, Director of Trading and Exchange). Mr. Gintel might also be viewed as a quasi-insider because of his unusual access to the material nonpublic information of Cady, Roberts and Company. Mr. Gintel was able to acquire the material nonpublic information by virtue of his status as a partner of Cady, Roberts and Company and his business association with Mr. Cowdin, a director of the company whose shares were traded. See *supra* note 20 for this author's definition of "quasi-insider".

36. *Cady, Roberts*, 40 S.E.C. at 912. "Unfairness" was the driving force behind the prohibition against trading on the basis of inside information. *See supra* note 9 (origins of insider trading prohibitions). Insider trading is simply an unfair exploitation of information that properly belongs to someone else. *See* Ferber, *supra* note 9, at 623. A recent American Bar Association task force report stated:

> In our society, we traditionally abhor those who refuse to play by the rules, that is, the cheaters and the sneaks. The spitball pitcher or card shark with an ace up his sleeve, may win the game but not our respect. And if we know such a person is in the game, chances are we won't play.

ABA, *Report of the Task Force on the Regulation of Insider Trading, Committee on Federal Regulation of Securities, reprinted* in 4 BUS. LAW. 223, 227 (1985).

37. A vexing question faced in insider trading cases is to whom does the trading insider owe his duty of disclosure. There are only two possible answers. First, the insider might owe a duty solely to the person who actually bought from him or sold to him. Second, the duty might be owed to the entire class of shareholders (or those about to be shareholders) buying or selling in the marketplace contemporaneously with the insider. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (the anonymous marketplace involves arbitrary and fortuitous matching of buyer and sellers and the insider stands in no greater fiduciary relation-

least would not have traded at that price.[39]

In *SEC v. Texas Gulf Sulphur Company*,[40] the Second Circuit Court of Appeals adhered to the fundamental principles expressed

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ship to his particular buyer or seller than to any other trading shareholder; therefore, the insider's breach injures any trader who would not have bought or sold had there been an adequate disclosure to the marketplace). *See generally* 5 A. JACOBS, *supra* note 14, § 3-251; Ruder, Texas Gulf Sulphur — *The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423 (1968).

The issue of to whom the insider owes a duty of disclosure need not be addressed in SEC injunctive and administrative proceedings or in criminal actions. In such a proceeding, the existence of some person, whether or not identified, to whom a duty of disclosure was owed and breached can be presumed. *See* United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *aff'd on remand*, 722 F.2d 729, *cert. denied*, 464 U.S 863 (1983). This Comment considers actions brought by the government or the SEC and will proceed on the assumption that under the disclose-or-abstain rule, a duty is owed to the entire marketplace.

38. The Commission makes it clear that Rule 10b-5 applies to defrauded buyers as well as sellers. *Cady, Roberts*, 40 S.E.C. at 913. "The primary function of Rule 10b-5 was to extend a remedy to a defrauded seller . . . [but] [t]here is no valid reason why persons who *purchase* stock from an . . . [insider] should not have the same protection afforded by disclosure of special information as persons who *sell* stock to them." *Id.* (emphasis in original). *See also* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (action brought by the purchaser of stock); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), *cert. denied*, 365 U.S. 870 (1961) (same). Also, the Commission struck the words "by a purchaser" from the title of Rule 10b-5 so as to read "Employment of manipulative and deceptive devices." 16 C.F.R. § 7928 (1951).

39. Some commentators have suggested that if the insider simply abstains from trading on the basis of insider information (as is his obligation), most marketplace buyers or sellers would still trade just the same, making any deception and resulting harm difficult to find. *See, e.g.*, Carlton & Fischel, *supra* note 9, at 859. For legal commentators who have questioned the insider trading prohibition on grounds that investment decisions are made independent of the insider trading, see *supra* note 9.

It cannot be persuasively argued, however, that all buyers and sellers would have traded regardless of the existence of the insider's trading. It is very difficult to determine whether any given investor decided to trade solely because of the insider trading activity or whether he would have traded anyway. *See* Dooley, *supra* note 9, at 35; Note, *The Measurement of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974).

In analyzing the Wall Street financial community's reaction to the Commission's *Cady, Roberts* decision, one commentator stated that because it was so common to take advantage of the investing public and because the SEC did not actively enforce Rule 10b-5, not a single stockbroker was prosecuted between 1942 and 1961 for the improper use of inside information. J. BROOKS, THE GO-GO YEARS 86-87 (1973). For a complete analysis of the implications of *Cady, Roberts*, see Daum & Phillips, *The Implications of* Cady, Roberts, 17 BUS. LAW. 939 (1962). For a discussion of the historical development of the scope of Rule 10b-5 prior to *Chiarella*, see Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973); Hetherington, *Insider Trading and the Logic of the Law*, 1967 WIS. L. REV. 720; Note, *Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief*, 55 ST. JOHN'S L. REV. 93 (1980); Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1965). For scholarly discussions of the common law cases of insider trading prior to *Cady, Roberts*, see W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 714-17 (5th ed. 1980); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 1014-19 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 740-50 (1956).

40. 401 F.2d 833 (2nd Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

by the Commission in *Cady, Roberts*. The Texas Gulf Sulphur Company made a significant mineral discovery on property it owned near Timmins, Ontario, and ceased drilling for several months so that it could acquire land around the site. During this period, company officers, employees and tippees purchased Texas Gulf Sulphur stock in the open market without disclosing to the investing public the potentially significant discovery. After rumors of the discovery were given prominent attention in the press, Texas Gulf Sulphur released a press announcement stating that the rumors were exaggerated.[41] During the four days after the announcement, company officers, employees and tippees made further purchases of stock before Texas Gulf Sulphur finally disclosed to the investing public that the company had in fact made a significant mineral discovery.

The second circuit, in holding that the purchases of Texas Gulf Sulphur stock violated Rule 10b-5, gave judicial imprimatur to the finding in *Cady, Roberts* that Rule 10b-5 applies to anyone, including a tippee, who trades on the basis of inside information.[42] The court stated that Rule 10b-5 is applicable to anybody possessing inside information even though that person may not, in strict terms, be an insider.[43] Moreover, the court emphasized the most important fundamental principle underlying all insider trading cases: that "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[44] The court ordered the defendants to disgorge their ill-gained profits to a court-supervised fund.[45] Thus, *Texas Gulf Sulphur* set judicial precedent of the fundamental principles underlying Rule 10b-5 and, for the first time, found a tippee liable.

In another leading case, *Investors Management Company*,[46] the Commission deserted the fiduciary or special relationship element announced in *Cady, Roberts*. The Commission imposed 10b-5 liability on certain institutional investors who were given information about an impending decline in Douglas Aircraft Company earnings and who sold their stock before the information was disclosed to the

41. The Texas Gulf Sulphur Company responded to the rumors by announcing that it needed to engage in more extensive drilling before the significance of its findings could be accurately assessed. *Id.* at 845.

42. *Id.* at 848.

43. *Id.* The court continues by stating that anyone in possession of inside information must disclose the information or abstain from trading. *Id.* The court provided a clear and concise interpretation of the disclose-or-abstain rule. See *infra* note 119 for a discussion of this rule.

44. *Texas Gulf Sulphur*, 401 F.2d at 848. The court also emphasized the fairness objective of Rule 10b-5. *Id.*

45. *See* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971), *reh'g denied*, 404 U.S. 1064 (1972).

46. 44 S.E.C. 633 (1971).

investing public. Douglas passed the information to Merrill Lynch, Pierce, Fenner & Smith. The underwriting department of Merrill Lynch passed the information to members of the Merrill Lynch sales department, who then gave the information to certain favored institutional clients.

The Commission held that the sales of Douglas Aircraft securities violated Rule 10b-5 because anyone possessing material non-public information "which he has reason to know emanates from a corporate source, and which by itself placed him in a position superior to other investors, thereby acquires a relationship with respect to that information that is within the purview and restraints of the antifraud provisions."[47] The Commission abandoned *Cady, Roberts'* fiduciary or special relationship requirement[48] and held that if an individual merely has reason to know that the information he possesses is inside information, he is within the purview of Rule 10b-5.[49] Thus, the Commission established a test for liability under Rule 10b-5 which does not depend upon the nature of the relationship between the person purchasing or selling securities and the issuer of those securities.[50]

Three years later, in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,[51] the second circuit followed suit, and explicitly included tippees within the range of persons that must disclose or abstain under Rule 10b-5 regardless of whether there was any fiduciary or special relationship. *Shapiro* involved a private suit for damages that arose out of the same Rule 10b-5 violations as *Investors Management*.[52] The court found that tippees *were* subject to the disclose-or-abstain rule, reasoning that such persons have the same duties as traditional insiders by virtue of their special access to inside

47. *Id.* at 644.

48. For a discussion of the fiduciary relationship requirement of *Cady, Roberts*, see text accompanying note 33.

49. *Investors Management Co.*, 44 S.E.C. at 644.

50. The Commission "reject[ed] the contentions advanced by the respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to the nonpublic information . . . ." *Id.* at 643; *see also* Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 474-76 (1977) (Rule 10b-5 does not encompass misconduct involving a breach of fiduciary duty); Zwieg v. Hearst Corp., 594 F.2d 1261, 1269 (9th Cir. 1979) (although the relationship with the public was not a fiduciary one under the common law, the absence of such a relationship is not dispositive of a Rule 10b-5 claim). *Contra* Dirks v. SEC, 463 U.S. 646 (1983) (basing the duty to disclose or abstain on concepts of fiduciary duty); Chiarella v. United States, 445 U.S. 222 (1980) (same). For a complete discussion of the *Chiarella* and *Dirks* decisions and the impact of those decisions on the finding in *Investors Management Co.*, see *infra* notes 65-122 and accompanying text.

51. 495 F.2d 228 (2d Cir. 1974).

52. The plaintiffs were five individuals who purchased Douglas Aircraft Company stock prior to the public release of Douglas' revised earnings report and without knowledge of the material adverse earnings information. *Id.* at 233.

information.[53] Thus, *Shapiro* strengthened the principles set forth in *Texas Gulf Sulphur* regarding the liability of tippees under Rule 10b-5.

The historical scope of Rule 10b-5 and the fundamental principles that have emerged from the traditional analysis of Rule 10b-5 violations may be summarized as follows: In order to promote fairness,[54] Rule 10b-5 liability attached to any person,[55] including tippees,[56] possessing material information which he had reason to know emanated from a corporate source[57] and which was unavailable to the investing public.[58] Such liability specifically was not limited to fiduciaries or persons occupying special relationships with the issuer or to tippees of such persons.[59] The historical scope of Rule 10b-5, however, has been narrowed in recent years by the Supreme Court's decisions in *Chiarella v. United States*[60] and *SEC v. Dirks*.[61]

II. THE IMPACT OF *Chiarella* AND *Dirks*

A plethora of legal commentary has emerged analyzing the *Chiarella* and *Dirks* decisions.[62] One commentator has concluded

53. *Id.* at 237.

54. *See supra* notes 34, 36 & 44 and accompanying text (fairness objective of Rule 10b-5).

55. *See supra* notes 25-27, 31-32 & 42-43 and accompanying text (explaining the traditional view that Rule 10b-5 applies to *anybody* trading on the basis of inside information).

56. *See supra* notes 35 & 53 and accompanying text (tippees are included in the class of persons who fall within the purview of Rule 10b-5).

57. *See supra* text accompanying notes 47-49 (explaining role of tippee's knowledge of information source plays in determining 10b-5 liability).

58. *See supra* text accompanying note 44 (emphasizing that nonpublic information must be disclosed to comply with the justifiable expectation that all investors have relatively equal access to material information).

59. *See supra* notes 49-50 and accompanying text (rejecting idea that the obligation to disclose or abstain is based on the existence of a fiduciary relationship). For examples of cases liberally interpreting Rule 10b-5, see Cann, *A Duty to Disclose? An Analysis of* Chiarella v. United States, 85 DICK. L. REV. 249, 264 n.91 (1981).

60. 445 U.S. 222 (1980).

61. 463 U.S. 646 (1983).

62. For commentary analyzing the *Chiarella* decision, see generally Bunch, Chiarella: *The Need for Equal Access Under Section 10(b)*, 17 SAN DIEGO L. REV. 725 (1980) (arguing that Chiarella violated rule 10b-5 because the rule requires equal access to material information among purchasers and sellers of securities); Krabacher, *Trading on Market Information: Rule 10b-5 and Market Insiders* - United States v. Chiarella, 34 U. MIAMI L. REV. 159 (1979) (second circuit expanded the definition of insider beyond the traditional categories); Morgan, *The Insider Trading Rules After* Chiarella; *Are They Consistent With Statutory Policy*, 33 HASTINGS L.J. 1407 (1982) (arguing that *Chiarella* applied Rule 10b-5 without considering statutory policy behind the rule); Stern, Chiarella v. United States: *The Supreme Court's Common Law Catch to Market Insider Liability Under 10b-5*, 14 J. MARSHALL L. REV. 847 (1981) (clarifying propositions which survive the *Chiarella* decision).

For commentary analyzing the *Dirks* decision, see generally Luvara, Dirks v. Securities Exchange Commission, 23 DUQ. L. REV. 443 (1985) (agreeing with dissent and encouraging legislature to act); Ratliff, *Securities*: Dirks v. SEC — *When Insiders* that the decisions "exhibit both a lack of understanding and a lack of sophistication regarding the federal framework underlying the law of insider trading."[63] Practically, the decisions have resulted in both private parties and the government finding it difficult to conduct successful litigation against tippees and quasi-insiders.[64] *Chiarella* and *Dirks* highlight disturbing deviations from the fundamental principles that emerged from the traditional analysis of Rule 10b-5 violations.

A. *The* Chiarella *Decision*

Vincent Chiarella was employed as a markup man in the composing room at Pandick Press, a New York printing firm engaged in financial, corporate, legal and general printing. Chiarella's responsibilities included selecting type fonts and page layouts and then passing the manuscript on to be set into type. In the course of his employment, Chiarella handled five particular announcements of corporate takeover bids, four involving tender offers and the other concerning a merger.[65] Although the identities of the target companies were left blank or coded,[66] the documents contained details of

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Talk, Should You Listen?, 37 OKLA. L. REV. 194 (1984) (arguing that *Dirks* restricts disclosure obligation and that future depends on the acceptance of misappropriation theory); Shayer, *The Tips Are for the Taking: The Supreme Court Limits Third Party Liability in* Dirks v. Securities and Exchange Commission, 12 PEPPERDINE L. REV. 93 (1984) (insider trading will increase, SEC enforcement will decrease and investors' confidence in the securities markets will erode).

For a voluminous compilation of legal commentary analyzing both *Chiarella* and *Dirks*, see Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, nn.1-2 (1985).

63. M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 3-11 (1987). For a more critical view of the *Chiarella* decision, see Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341 (1982). Professor Anderson asserts: "This is not a Supreme Court construing a complicated federal statutory scheme with wisdom, craft, and candor; this is a first-year Torts class on a bad day." *Id.* at 376-77.

64. *See, e.g.*, Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983) (shareholder could not show any violations by insiders); SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) (eaves-dropper did not violate Rule 10b-5).

65. United States v. Chiarella, 588 F.2d 1358, 1362-63 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). Section 14(d)(1) of the Securities Exchange Act of 1934 and Rule 14b-1 promulgated thereunder require a company to file a statement (schedule 13(D)) with the SEC disclosing pertinent information when making a tender offer for the stock of another company. Chiarella was an employee of the printer who was preparing the statement prior to their filing with the Commission.

66. A company intending to make a tender offer strives to keep its plan secret because:

> [i]f word of the impending offer becomes public, the price of the stock will rise toward the expected tender price. Thus, the primary inducement to stockholders, an offer to purchase their shares at an attractive price above the market, is lost, and the offeror may be forced to abandon its plans or to raise the offer to a still higher price. The cost of an offer to purchase hundreds of thousands of shares might prove prohibitive if the price had to be increased only a few dollars per share . . . . [I]n spite of all precautions, there have been cases where

the proposed tender offer from which the identity of the target companies could be ascertained. Chiarella was able to deduce the names of the target companies and subsequently purchased their stock in open market trading.[67] Chiarella then sold the stock after the tender offers were announced to the investing public. Over the course of fourteen months, he realized a $30,011.39 profit.[68] Chiarella did not disclose to the investing public the material nonpublic information that he possessed concerning the impending tender offers. Further, none of the persons from whom he purchased shares were aware of the impending tender offer for the stock they owned.[69]

Writing for the majority, Justice Powell held that the nondisclosure of material information constitutes fraud in violation of Rule 10b-5 only when a person is under a duty to disclose[70] and that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."[71] Rather, such a duty arises only when "one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[72] The Court found that the necessary fiduciary relationship did not exist between the sellers of the securities and Chiarella.[73] Justice Powell explained that no duty

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> tender offers have been preceded by leaks and rumors which caused abnormal market problems.

Full Disclosure of Equity Ownership in Corporate Takeover Bids: Hearings on Section 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 72 (1967) (testimony of Donald Calvin, Vice President of the New York Stock Exchange).

In order to protect confidentiality, the offeror company gives the documents to a printing firm with the identity of the offeree company left blank or coded. *See, e.g., Chiarella*, 588 F.2d, 1363 ("when Emhart Corp. sought to purchase control of USM Corp., the documents originally delivered to Pandick read 'Arabia Corp.' and 'USA Corp.' Not until the final press run on the night before release were the true names inserted.").

67. The Court of Appeals described Chiarella as "not merely an ordinary printer, but a knowledgeable stock trader who spoke with his broker as often as ten or fifteen times a day." *Id.* Chiarella entered into 17 purchase transactions for the stock of the target companies. Each purchase was charged as a separate count in his indictment and he was convicted on each count. Chiarella v. United States, 445 U.S. 222, 225 (1980).

68. Chiarella made five transactions as follows: He traded in 300 shares of USM Corp. stock realizing a $1,019.11 profit; 2300 shares of Riviana Foods stock realizing a $8,948.55 profit; 1100 shares of Foodtown Stores stock at a $2,990.30 profit; 100 shares of Booth Newspapers stock at a gain of $914.56; and 3200 shares of Sprague Electric stock realizing $16,138.87 in profit. *Chiarella*, 588 F.2d at 1363 n.3. The prospective offerors on each of the five transactions were Emhart, Colgate-Palmolive, Delhaize Freres, Times-Mirror, and General Cable, respectively. *Id.*

69. *Chiarella*, 445 U.S. at 224.

70. *Id.* at 228, 231.

71. *Id.* at 235.

72. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

73. As subsequently interpreted, factors to be considered in determining whether such a relationship of trust and confidence exists include "the parties' relative access to the information, the benefit to be derived by the defendant from the

could arise from Chiarella's relationship with the sellers of the target company's securities because he had no prior dealings with them.[74] "He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions."[75]

The government offered an employer-employee theory of liability, arguing "that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation."[76] The Court, however, did not decide whether that theory had merit because the trial court had not permitted the government to submit the theory to the jury.[77] The government also argued that Chiarella "misappropriated" information that he procured by virtue of his strategic position and, thus, breached a duty to the acquiring corporation and his employer.[78] The Court also refused to address the viability of this misappropriation theory because the trial court also had not included the theory in the jury instructions.[79] However, in light of the concurring and dissenting opinions,[80] there is reason to believe that at least a plurality, if not a majority, of the Court would adopt some version of an employer-employee or misappropri-

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sale, defendant's awareness of plaintiff's reliance on him in reaching his investment decision, and defendant's role in initiating the purchase or sale." Marrero v. Banco di Roma (Chicago), 487 F. Supp. 568, 574 (E.D. La. 1980). *See also* SEC v. Miller, 495 F. Supp. 465, 482 (S.D.N.Y. 1980) (no relationship of trust and confidence was found where parties did not even know or care with whom they were dealing); E.D. Warde & Sons v. Colo. National Bank, 502 F. Supp. 461, 464 (E.D. Colo. 1980) (relationship of trust and confidence between parties to a transaction is a question of fact).

74. *Chiarella*, 445 U.S. at 232. Justice Powell stated that Chiarella "was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." *Id.*

75. *Id.* at 232-33. Justice Stevens concurred with the Courts' view that "[b]efore liability, civil or criminal, may be imposed for a Rule 10b-5 violation, it is necessary to identify the duty that the defendant has breached." *Id.* at 237 (Stevens, J., concurring). He further agreed that Chiarella owed no duty of disclosure to the sellers of the securities. *Id.*

76. *Id.* at 235. The breach of duty to his employer was arguably said to support a conviction for fraud perpetrated upon both the acquiring corporation and the sellers. For a discussion of the employer-employee theory for imposing a duty on a tippee or quasi-insider, see *infra* notes 147-154 and accompanying text.

77. *Chiarella*, 445 U.S. at 236. In agreeing that the Court wisely leaves the resolution of this issue for another day, Justice Stevens recognized the viability of the employer-employee theory. *Id.* at 237-38 (Stevens, J., concurring). He stated "[t]he Court correctly does not address . . . whether the petitioner's breach of his duty of silence — a duty he unquestionably owed to his employer and to his employer's customers — could give rise to criminal liability under Rule 10b-5. Respectable arguments could be made in support of either position." *Id.* at 238.

78. For a complete discussion of the viability of the misappropriation theory, see *infra* notes 127-139 and accompanying text.

79. *Chiarella*, 445 U.S. at 236-37 & n.21.

80. Justice Powell wrote the opinion, joined by Justices Stewart, White, Rehnquist, and Stevens. Justice Stevens and Brennan concurred, each writing a separate opinion. Chief Justice Burger dissented in a separate opinion as did Justice Blackmun in an opinion which was joined by Justice Marshall.

ation theory if the issue were properly before it.[81]

B. *The* Dirks *Decision*

Three years later, in *SEC v. Dirks*, the Supreme Court extended the principles of *Chiarella*. Raymond Dirks was an officer of a New York broker-dealer firm specializing in the investment analysis of insurance company securities. Dirks was informed by Secrist, a former officer of Equity Funding of America,[82] that the assets of Equity Funding were vastly overstated as a result of fraudulent corporate practices. While investigating the Equity Funding allegations, Dirks openly discussed the information he had obtained with many of his clients and investors. Thereafter, five investment advisors liquidated holdings of more than $16 million[83] in Equity Funding stock before the scandal became public knowledge.[84] The SEC filed a complaint against Equity Funding only after California insurance authorities impounded Equity Funding's records and uncovered evidence of the fraud.[85] The SEC then began an investigation into Dirk's role in the exposure of the fraud. Both an administrative law judge[86] and the

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81. *See, e.g., supra* note 77 (describing Justice Stevens' concurring opinion recognizing an employer-employee theory); *Chiarella*, 445 U.S. at 239 (Brennan, J., concurring) ("a person violates [Section] 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities); *Id.* at 240 (Burger, J., dissenting) ("I would read [Section] 10(b) and Rule 10b-5 . . . to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading"); *Id.* at 245 (Blackmun, J. dissenting) (while agreeing with much of the Chief Justice's rationale, he states "it is unnecessary to rest petitioner's conviction on [such] a 'misappropriation' theory").

82. Equity Funding of America was a diversified corporation primarily engaged in selling life insurance and mutual funds. Dirks v. SEC, 463 U.S. 646, 649 (1983).

83. As is customary in the securities business, Dirks received a commission, in addition to his salary, for transactions above a specified amount that clients directed through his firm. *Id.* at 649 & n.2. In addition, at least one of the investment advisors promised to direct brokerage business to Dirks' firm in return for Dirks' "research." *Id.* at 642 n.2.

84. After Dirks pursued his investigation and divulged the charges made by Secrist, the price of Equity Funding stock fell from $26 per share to less than $15 per share. *Id.* at 650. The sharp decline in Equity Funding stock led the New York Stock Exchange to halt trading on March 27, 1983. *Id.*

85. There was evidence that the SEC had received allegations of fraudulent accounting practices at Equity Funding as early as 1971. *Id.* at 650 & n.3. Moreover, Secrist's charges of fraud were given to the SEC regional office by an official of the California Insurance Department on March 9, 1973. *Id.* at 650 n.3. Dirks himself presented his information directly at the SEC regional office on March 27, 1973 (the same day that the New York Stock Exchange halted trading). *Id.* After the complaint was filed, Equity Funding immediately went into receivership. *Id.* at 650. In addition, many of Equity Funding's officers and directors were indicted when a federal grand jury returned a 105-count indictment against 22 people involved in the scandal. *Id.* at 650 n.4. All defendants were found guilty, either by a plea of guilty or a conviction after trial. *Id.*

86. 21 S.E.C. Docket 1401 (1981).

Court of Appeals for the District of Columbia Circuit[87] found that Dirks aided and abetted Rule 10b-5 violators by repeating the allegations of fraud to members of the investing community.[88]

The Supreme Court disagreed. Justice Powell, writing for the majority,[89] again discussed the importance of the fiduciary relationship.[90] He argued that "[u]nlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships."[91] The Court held that the duty of

87. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

88. The SEC concluded that anytime a person receives confidential information from company insiders, he "stands in the shoes" of the insiders and assumes their fiduciary duties not to misuse the information for their own benefit. 21 S.E.C. Docket at 1407. For a discussion of this "equal access" theory of tippee liability, see *infra* notes 140-146 and accompanying text. After ruling that Dirks was liable for violating rule 10b-5, the SEC recognized that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light." 21 S.E.C. Docket at 1412. Because Dirks reported the fraud allegations to Equity Funding's auditors and sought to have the information published in the Wall Street Journal, the SEC only censured him. *Id.* *See* Section 15 of the Securities Exchange Act, 15 U.S.C. § 78 (b)(4)(E) (providing that SEC may impose certain sanctions, including censure, on any person associated with a registered broker-dealer who has willfully aided or abetted any violation of federal securities laws).

The Court of Appeals for the District of Columbia Circuit affirmed the Commission's finding that Dirks violated Rule 10b-5. In so holding, the court found that Dirks assumed the insider's obligation because "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large." *Dirks*, 681 F.2d at 839. Alternatively, the court concluded that, as an employee of a broker-dealer, Dirks had violated "obligations to the SEC and to the public completely independent of any obligations he acquired" as a result of receiving the information. *Id.* at 840. *But see supra* note 85 (evidence showed SEC already possessed information regarding the fraud).

89. Justice Powell also wrote the opinion in Chiarella v. United States, 445 U.S. 222 (1980).

90. Justice Powell states: "[n]ot to require such a fiduciary relationship, we recognized, would 'depart radically from the established doctrine that duty arises from a specific relationship between two parties.'" *Dirks*, 463 U.S. at 654-55 (quoting *Chiarella*, 445 U.S. at 232-33). Thus, the *Dirks* Court reaffirms the finding in *Chiarella* that "[a] duty [to disclose] arises from the relationship between the parties . . . and not merely from one's ability to acquire information because of his position in the market." *Id.* at 658.

91. *Id.* at 655. The Court, however, notes that under certain circumstances 'outsiders' may become fiduciaries of the shareholders. The Court states in its often cited footnote 14:

> Under 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. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes . . . When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than 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.

Id. at 656 n.14 (citations omitted). For a brief discussion of the liability of traditional tippees to disclose or abstain from trading depends on whether the tipper has himself breached a fiduciary duty to the corporation's shareholders by divulging the information to the tippee.[92] Unless the tippee knows or should know that the tipper has breached his fiduciary duty, no duty to "disclose or abstain" will attach to the tippee.[93]

Dirks makes it necessary to determine whether the insider's "tip" constitutes a breach of the insider's fiduciary duty. The test depends on whether the insider will personally benefit, directly or indirectly, from his disclosure of the inside information.[94] "Absent some personal gain, there is no breach of duty to the stockholders; and absent a breach by the insider, there is no derivative breach [by the tippee]."[95] In applying this test,[96] the courts must:

> focus on objective criteria . . . such as a pecuniary gain or a reputational benefit that will translate into future earnings . . . . There are objective facts and circumstances that often justify such an inference. For example, there may be 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. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[97]

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insiders, see *supra* notes 18 (liability of traditional insiders, i.e., officers, directors, controlling shareholders or employees) and 17 (liability of fiduciaries of the corporation whose shares are traded).

92. *Dirks*, 463 U.S. at 660. The tippee's duty to disclose or abstain is derivative from that of the insider's duty. *Id.* at 659.

93. *Id.* at 660. *See* 3 L. Loss, *supra* note 9, at 1451 ("where a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information") (quoting RESTATEMENT OF RESTITUTION § 201(2) (1937)). The *Dirks* Court cites other authorities expressing the view that tippee liability exists only where there has been a breach of duty by the tipper of which the tippee had knowledge. *See, e.g.*, Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); 5 A. JACOBS, *supra* note 9, § 167 at 7-4; Fleischer, Mundheim & Murphy, *supra* note 39, at 818 n.76. *Cf.* RESTATEMENT (SECOND) OF AGENCY § 312 comment c (1958) ("A person who, with notice that an agent is thereby violating his duty to his principal, receives confidential information from the agent, may be [deemed] . . . a constructive trustee").

The Court did recognize the need for a ban on tippee trading where the tipper and tippee are acting together. *Dirks*, 463 U.S. at 659. The Court stated that in light of the fact that insiders cannot use material nonpublic information to their advantage, they also cannot tip such information to an outsider for the same improper purpose of exploiting the information for personal gain. *Id.* (citing 15 U.S.C. § 78t(b) (making it unlawful to do indirectly "by means of another person" any act made unlawful by the federal securities laws)).

94. *Dirks*, 463 U.S. at 662.

95. *Id.*

96. The Court emphasized the difficulty in determining whether an insider personally benefits from a particular disclosure. *Id.* at 664.

97. *Id.* at 663-64 (emphasis in original) (citation omitted). In applying the facts, the Court found:

In holding that there must be a breach of the insider's fiduciary duty to the corporation's shareholders before the tippee inherits a derivative duty to disclose or abstain,[98] and in premising the existence of a breach on whether the insider will personally benefit from disclosing the information to the tippee,[99] the Court has made it significantly more difficult to hold tippees liable under Rule 10b-5.

C. *Criticism and Implications of* Chiarella *and* Dirks

In addition to the mass of legal commentary analyzing *Chiarella* and *Dirks*,[100] the dissenting opinions provide sound overall criticism of the decisions. In *Chiarella*, Chief Justice Burger's dissenting view was that an individual has a duty of disclosure under Rule 10b-5 when his informational advantage is "obtained, not by superior experience, foresight, or industry, but by some unlawful means."[101] The Chief Justice argued that the evidence showed beyond all doubt that Chiarella's informational advantage was obtained unlawfully.[102]

The Chief Justice's argument respects the fundamental principles that were expressed prior to *Chiarella* and *Dirks*.[103] He stated that the language of Section 10(b) and Rule 10b-5 is sufficiently broad to "reach *any* person engaged in *any* fraudulent scheme."[104]

> It is clear that neither Secrist nor the other Equity Funding employees violated their . . . duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. [citation omitted] In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. [citation omitted] Dirks therefore could not have been "a participant after the fact in [an] insider's breach of fiduciary duty."

Id. at 665-67 (quoting Chiarella v. United States, 445 U.S. 22, 230 n.12 (1980)).

98. *See supra* text accompanying notes 92-93 for a discussion of the requisite breach of an insider's duty.

99. *See supra* text accompanying notes 94-95 for a discussion of the test for benefit to the insider.

100. *See supra* note 62 for a list of articles written about *Chiarella* and *Dirks*.

101. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

102. Chiarella admitted that the information that he traded on was confidential and not to be used for personal gain. *Id.* at 244. In addition, counsel conceded that "[w]e do not dispute the proposition that Chiarella violated his duty as an agent of the offeror corporations not to use their confidential information for personal profit." *Id.* at 245 (quoting Reply Brief for Petitioner at 4). The Chief Justice concluded that "[t]hese statements are tantamount to a formal stipulation that Chiarella's informational advantage was obtained unlawfully." *Id.*

103. For a discussion of the fundamental principles that emerged from the traditional analysis of Rule 10b-5 violations, particularly in *Cady Roberts, Texas Gulf Sulphur Co., Investors Management*, and *Shapiro*, see *supra* notes 28-59 and accompanying text.

104. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting) (emphasis in original). Burger also cited Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972), for the proposition that the "repeated use of the word 'any' was obviously

Thus, by exploiting his ill-gotten informational advantage by purchasing securities in the market, Chiarella plainly violated Rule 10b-5. Burger does, however, exclude from the reach of 10b-5 anyone who obtains information from superior knowledge and foresight; thus "experts" in the securities marketplace may trade without having the duty to disclose the material information that they possess. Justice Burger also stressed that rule 10b-5 was designed primarily to assure fairness and equal opportunity for all investors.[105] This argument is precisely within the fundamental principle explained in *Texas Gulf Sulphur*, "that all investors trading on impersonal exchanges [should] have relatively equal access to material information."[106]

Justice Blackmun's dissent[107] in *Chiarella* considered the Congressional intent behind Rule 10b-5 to promote fairness in the securities markets[108]—the same fundamental principle espoused in *Cady, Roberts*.[109] In criticizing the majority, Justice Blackmun wrote:

> By its narrow construction of Section 10(b) and Rule 10b-5, the Court placed the federal securities laws in the rear guard of this movement [to promote fairness], a position opposite to the expectations of Congress at the time the securities laws were enacted. I cannot agree that the statute and Rule are so limited. The Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate. As Congress itself has recognized, it is integral to this purpose "to assure that dealing in securities is fair and without undue preferences or advantages among investors."[110]

Thus, the dissents in *Chiarella* argued that Congress intended Rule 10b-5 to offer greater protection than that provided by state law concepts based on a fiduciary duty.[111]

Justice Blackmun also wrote a stinging dissent in Dirks.[112] There, he criticized the majority's requirement that the tipper be motivated by personal gain.[113] He stated that such a requirement

meant to be inclusive." *See supra* text accompanying notes 24-27 (looking at the language of the antifraud provisions).

105. *Chiarella*, 445 U.S. at 241.

106. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 845 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

107. Justice Marshall joined in Justice Blackmun's dissent. *Chiarella*, 445 U.S. at 245-252.

108. *Id.* at 248.

109. *See supra* notes 33-34 and accompanying text (two-element fairness test announced in *Cady, Roberts*).

110. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting) (citation omitted).

111. For authorities refuting the contention that rule 10b-5 encompasses a fiduciary duty, see *supra* note 50.

112. Justices Brennan and Marshall joined in Justice Blackmun's dissent. Dirks v. SEC, 463 U.S. 646, 667-679 (1983).

113. *Id.* at 668. For a discussion of the motivational requirement announced by

"excuses a knowing and intentional violation of an insider's duty to shareholders if the insider does not act from a motive of personal gain."[114] This benefit, in most cases, apparently must enrich the insider monetarily. Other types of benefits, such as an enhanced reputation, appear to be insufficient if the do not translate into future earnings.[115] In addition, proving such a personal motive will frequently be troublesome.[116]

Insiders often divulge information without any motive of personal gain. One common fact pattern concerns the "loose-lipped" insider: the director or officer who divulges confidential corporate information to friends, relatives or golfing companions without any intention to personally benefit.[117] If, in fact, the insider derives no benefit and does not divulge the confidential information as a gift,[118] it appears that such tippees may trade on the basis of the information without risking any liability. Thus, the *Dirks* decision has both facilitated such tippee trading and made it more difficult to prove.

Another serious implication of *Chiarella* and *Dirks* is their rejection of the "parity of information" and "parity of access to information" theories.[119] In general, these theories preclude anyone from trading on the basis of material nonpublic information before such

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the majority, see *supra* text accompanying notes 94-95.

114. *Dirks*, 463 U.S. at 668 (Blackmun, J., dissenting).

115. *Id.* at 676 n.13. The motivational requirement adds an administrative and judicial burden to Rule 10b-5 cases. Generally, the SEC has presumed that the insider gains from tipping. The Court, however, eliminated such a presumption by requiring a case-by-case determination of whether the insider derived any "gain." *Id.*

116. The majority conceded that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." *Id.* at 664.

117. *See* M. STEINBERG, *supra* note 63, § 3-6.

118. The majority conceded that the insider receives the requisite benefit when he "makes a gift of confidential information to a trading relative or friend." *Dirks*, 463 U.S. at 663-64.

119. The most significant articulation of the "parity of information" theory appeared in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969):

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

The "parity of access to information theory" appeared in the court of appeals decision in United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980): "[A]nyone —corporate insider or not—who regularly receives material nonpublic information may not use this information to trade in securities without incurring an affirmative duty to disclose." *See also* Brudney, *supra* note 9, at 354 ("the essential . . . element which makes an informational advantage unusable by those who possess it in dealing with those who do not is the inability of the latter to overcome it lawfully, no matter how great may be their diligence or large their resources").

information is effectively disseminated to the investing public.[120] The Commission in *Cady, Roberts* stressed the unfairness of allowing anyone to trade on inside information which he knows is unavailable to those with whom he is dealing.[121] Rule 10b-5 is grounded on the notion of fairness,[122] an objective which should be the underpinning for every theory of Rule 10b-5 liability.

III. THEORIES OF TIPPEE AND QUASI-INSIDER LIABILITY

The reasoning of *Chiarella* and *Dirks* reaches cases of illegal trading by "traditional insiders."[123] However, a great deal of trading on nonpublic information, particularly in connection with tender offers, is done by quasi-insiders who do not obtain their information, directly or indirectly, from the issuers of the securities they trade.[124] In order to hold these quasi-insiders liable under Rule 10b-5, it is necessary to identify some "fraud" that the quasi-insider has committed.[125] As *Chiarella* and *Dirks* command, the requisite fraud is found where there is a breach of some fiduciary duty. Generally, tippees and quasi-insiders have no fiduciary duty to those with whom they trade and thus often avoid liability.[126] Courts have therefore adopted various theories whereby tippees and quasi-insiders could be held liable under the antifraud provisions of the securities laws.

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120. *Id.*

121. *See supra* text accompanying notes 33-34 (*Cady, Roberts* two-element fairness test).

122. *See supra* note 9 for a general explanation of the origins of insider trading prohibitions.

123. *See supra* note 16 for the American Law Institute's definition of "insider."

124. It is generally believed that the amount of trading on nonpublic information has been increasing. The House report accompanying the 1984 Insider Trading Sanctions Act attributed this increase to the growth in the number of mergers and tender offers and the growth in the option markets "where a small investment in options can yield enormous profits if the underlying stock increases in value as a result of a tender offer announcement or other news." H.R. REP. No. 355, 98th Cong. 2nd Sess. 5 (1984). *See also* Freeman, *The Insider Trading Sanctions Bill—A Neglected Opportunity*, 4 PACE L. REV. 221, 228 (1984) (outsider trading has become a significant problem because of the "proliferation of tender offers by outsiders and the creation of an option market in which the traders are not insiders"). For different reasons, the Commodity Futures Trading Commission also made a major study of trading while in possession of material nonpublic information. *See* COMMODITY FUTURE TRADING COMMISSION, A STUDY OF THE NATURE, EXTENT AND EFFECTS OF FUTURES TRADING BY PERSONS POSSESSING MATERIAL, NONPUBLIC INFORMATION (1984).

125. *See supra* notes 11-12 (describing Section 10(b) and Rule 10b-5 as federal "antifraud" provisions).

126. *See supra* notes 70-75 and accompanying text (explaining the *Chiarella* Court's requirement of a fiduciary relationship and holding that Chiarella, a possible quasi-insider, did not owe any fiduciary duty) and 90-95 and accompanying text (explaining the *Dirks* Court's affirmation of the fiduciary relationship requirement and holding that tippees do not have such relationships).

A. *The Misappropriation Theory*

The misappropriation theory suggests that the requisite fraud for 10b-5 liability occurs when the quasi-insider "misappropriates" information that has been entrusted to him by his employer or another person, and he or his tippee trades on the basis of that information. The fraud is on the person or persons who entrusted the information to the quasi-insider. The theory is thus separate and independent from the disclose-or-abstain rule.[127]

The Supreme Court first discussed the misappropriation theory in *Chiarella,* although it refused to fully address the issue because it had not been submitted to the jury.[128] The SEC quickly embraced the misappropriation theory in its post-*Chiarella* enforcement program.[129] Shortly thereafter, the second circuit discussed the theory in *United States v. Newman,*[130] a case similar to *Chiarella.* The *Newman* decision established the misappropriation theory as a judicially viable weapon against insider trading by tippees and quasi-insiders.

Newman involved two employees of investment banking firms who conveyed to some associates confidential information about proposed mergers and acquisitions. The associates bought stock in the target companies and then sold at a gain when the takeovers were announced. The second circuit held that the members of the conspiracy had defrauded the investment banking firms and their clients by converting their highly sensitive information for personal use.[131] The court concluded that such a misappropriation of information was inherently fraudulent.[132] In addition, it ruled that this

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127. For a complete discussion of the origins and implications of the misappropriation theory, see Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information,* 13 HOFSTRA L. REV. 101, 112-25 (1984-1985).

128. In applying the misappropriation theory, the United States argued that Chiarella deceived his employer (the financial printing company) and his employer's clients (the tender offerors) by converting the highly sensitive information for his own use. Brief for United States at 28-42, Chiarella v. United States, 445 U.S. 222 (1980) (No. 78-1202). As noted earlier, the Supreme Court did not even address the issue because it had not been submitted to the jury. *See supra* text accompanying note 79. *See also Chiarella,* 445 U.S. at 237-238 (leaving consideration of the misappropriation theory "for another day"). *Cf. Id.* at 238 (Steven, J., concurring) (with regard to the validity of the misappropriation theory, respectable arguments could be made in support of either position); *Id.* at 240-42 (Burger, J., dissenting) (endorsing the misappropriation theory offered by the government that an affirmative duty of disclosure to marketplace traders arises when trading on misappropriated information).

129. *See, e.g.,* SEC v. Wyman, SEC Litigation Release No. 9311, 22 S.E.C. Docket 391 (S.D.N.Y., Feb. 20, 1981) (misappropriation theory argument led to consent judgment).

130. 664 F.2d 12 (2d Cir.), *aff'd on remand,* 722 F.2d 729 (1981), *cert. denied,* 464 U.S. 863 (1983).

131. *Id.* at 17.

132. *Id.*

fraud was "in connection with the purchase or sale of a security"—namely, the defendants' own trading.[133] Thus, the court did not consider whether the persons allegedly defrauded were engaged in any securities trading. The misappropriation theory adopted in *Newman* has been reaffirmed and elaborated upon in later cases.[134]

In the recent Supreme Court decision of *Carpenter v. United States*,[135] the Court was equally divided on the issue of a quasi-insider's liability under a misappropriation theory. Foster Winans was co-author of a Wall Street Journal investment advice column which, because of its perceived quality and integrity, had an impact on the market prices of the stocks it discussed. Winans entered into a scheme with conspirators to buy and sell stocks based on the column's probable impact on the market. Nearly $700,000 in profits accumulated through the scheme.[136] The Court's split decision left intact the judgment of the second circuit which found the defendants guilty under the misappropriation theory.[137] Except for Justice

133. *Id.* at 18.

134. *See, e.g.*, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (upholding SEC injunction against employee of financial printing company), *cert. denied*, 471 U.S. 1053 (1985); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (granting preliminary injunction against tippees accused of trading on nonpublic information misappropriated by law firm employee); SEC v. Wallis, [Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 91,562 (S.D.N.Y. May 31, 1984) (granting preliminary injunction against taxi driver who allegedly traded on nonpublic information tipped to him by law firm employees). The misappropriation theory received an indirect endorsement from the third circuit in Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985). In *Rothberg*, the court concluded that the *in pari delicto* defense barred recovery by the principal financier of an investment joint venture because he was an unlawful tippee of information from one of his co-venturers. *Id.* at 822. In determining that the tip was unlawful, the court found that the tipper had breached a duty to the corporation on whose board he sat when he profited by trading and tipping on the basis of information received from a principal of the issuer, a company that the tipper's corporation was interested in acquiring. *Id.* The majority considered the information to have been received by the tipper in the course of acting as a director. *Id.* In his concurrence, Judge Higgenbotham disagreed that the information was received in the course of activity as a director, and hence found the misappropriation theory inapplicable. *Id.* at 825. He would have based liability on a tipper-tippee theory, assuming that the insider of the issuer was acting improperly in passing on the information to the tipper. *Id.* at 825-26. The Supreme Court made an apparently favorable reference to the misappropriation theory in Bateman Eichler, Hill Richards, Inc. v. Berner, 472, U.S. 299, 313 n.22 (1985) (" a tippee may be liable if he . . . misappropriates or illegally obtains the information").

135. No. 86-422, slip op. (Nov. 16, 1987).

136. *Id.* at 2.

137. The district court found, United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), and the court of appeals agreed, United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *rev'd*, No. 86-422, slip op. (Nov. 16, 1987), that Winans knowingly breached a duty of confidentiality by misappropriating prepublication information that he gained in the course of employment under the understanding that it would not be revealed. Although the Journal was not a buyer or seller of the securities traded or otherwise a market participant, the fraud was nevertheless found to be "in connection with" a purchase or sale of securities within the meaning of Rule 10b-5. *Id.*

White, there was no indication of how the individual justices voted on the misappropriation theory issue.[138]

The misappropriation theory is a logical extension of the continually developing law of trading on nonpublic information by tippees and quasi-insiders. Prior to *Chiarella*, the disclose-or-abstain rule was flexible enough to encompass the full range of then-perceived insider trading abuses.[139] Now, however, the Court's strict limitations on the use of that rule has excluded tippees and quasi-insiders from liability. The limitations could be avoided by premising liability on the tippee's or quasi-insider's deception of those who have given him privileged access to confidential information. In addition, adoption of the misappropriation theory would be consistent with fundamental principles of fairness and would bolster public confidence in the integrity of the securities markets.

B. *The Equal Access Theory*

The equal access theory is the lower federal courts' version of the disclose-or-abstain rule.[140] This theory holds that those persons who regularly receive or are tipped material nonpublic information, and who have reason to know that such information was derived from a corporate source,[141] must disclose the information to the marketplace as a whole or refrain from trading and tipping.[142] Under this theory, tippees stand "in the shoes" of their tippers, and if the tipper cannot trade on the information, then neither can the tippee.[143]

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138. Justice White, writing the opinion of the Court, stated that "Winans violated his fiduciary responsibility to protect his employer's confidential information by exploiting that information for his personal benefit, all the while pretending to perform his duty of safeguarding it." *Id.*

139. For a discussion of the gaps in the disclose-or-abstain framework that the misappropriation theory was intended to fill, see D. LANGEVOORT, *supra* note 1, at 176-77.

140. *See supra* text accompanying note 10 (development of the disclose-or-abstain rule).

141. In In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961), the Commission stated the criteria for determining whether the tippee has the requisite "reason to know":

> [T]he question of whether the recipient had the requisite 'reason to know' is properly determinable by an examination of all the surrounding circumstances, including the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relations to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts.

Id. at 918.

142. For cases employing the equal access theory, see *supra* note 10 and *infra* text accompanying notes 144-46.

143. *See, e.g.*, Elkind v. Liggett & Meyers, Inc., 635 F.2d 156 (2d Cir. 1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). The equal access theory's well established foundation prompted the authors of one

The equal access theory emerged principally from *Texas Gulf Sulphur,*[144] which recognized that the primary purpose of Rule 10b-5 is to ensure that the investing public equal has access to material information and thereby equal access to the rewards of participating in the securities market.[145] The second circuit emphasized that "all members of the investing public should be subject to identical market risks . . . [and] inequities based upon unequal access to knowledge should not be shrugged off as inevitable . . . or . . . remain uncorrected."[146]

The equal access theory, which is plainly grounded on notions of fairness, was widely accepted by the courts until the Supreme Court's decision in *Chiarella.* In rejecting the theory, the Court opted for a rationale based on state law notions of fiduciary duty. However, the equal-access theory and its fundamental principles provide an excellent basis for future legislation.

C. *The Employer-Employee Theory*

The majority in *Chiarella* left open the possibility that Chiarella "breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation."[147] Since *Chiarella,* employees of law firms,[148] a financial printing company[149] and an investment banking firm[150] have all been found to have violated Rule 10b-5. The employer-employee theory recognizes that the employee owes a fiduciary duty to the corporation employing him.

In *Dirks,*[151] the Court pointed out that underwriters, accountants, attorneys and consultants engaged by a corporation assume a fiduciary duty to the shareholders when they legitimately receive

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textbook to state that the "prohibition [against trading on material nonpublic information] almost certainly extends to the immediate 'tippees' of the insiders who, by trading on such information, participate in the wrong committed in the giving of the tip." *See* SOLOMON, STEVENSON, & SCHWARTZ, CORPORATIONS: LAW AND POLICY 908 (1982).

144. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969).

145. The *Texas Gulf Sulphur* Court further stated that "[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions." *Id.* at 851-52.

146. *Id.* at 852.

147. Chiarella v. United States, 445 U.S. 222, 235 (1980).

148. *See, e.g.,* SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (employee of law firm); SEC v. Wallis, [1984 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 91,562 (S.D.N.Y. May 31, 1984) (taxi driver who received tip from employee of law firm).

149. *See, e.g.,* SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (employee of financial printer).

150. *See, e.g.,* United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (employees of investment banking firm), *cert. denied,* 464 U.S. 863 (1983).

151. SEC v. Dirks, 463 U.S. 646 (1983).

material nonpublic information.[152] This fiduciary duty does not arise simply because the person acquires nonpublic corporate information, but rather it arises because "they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."[153] Thus, there is no logical reason for attaching liability only to the accountant who negotiates an employment agreement with a corporation, and not to staff accountants who might misuse inside information. The corporation does not enter the agreement with the accountant as an individual but, rather, it employs the entire accounting firm with the expectation that any confidential information will be kept secret by everyone in the firm. Employees of the accounting firm also have a "special confidential relationship" with the corporation because they have been "given access to information solely for corporate purposes." Therefore, employees should be held to the same fiduciary duty as their employers.[154]

D. *Family Members, Friends and the Temporary Insider Rationale*

The largest category of unlawful tipping probably involves instances where a traditional insider reveals confidential corporate information to friends and relatives.[155] In the typical case where the insider expects or encourages the friend to trade, there is clearly a violation of the disclose-or-abstain rule. Here, courts consider the information to be a gift. The *Dirks* court established that the insider who gives a tip as a gift receives an adequate benefit to conclude that he breached a fiduciary duty, thereby exposing the tippee to liability.[156] Under circumstances where the tippee is a family member of the insider, the tip often results in pecuniary gain to the insider as well, making the case for imposing liability even stronger.[157]

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152. *Id.* at 655 n.14.

153. *Id. See also supra* note 91 (under certain circumstances, even outsiders may become fiduciaries of a corporation's shareholders).

154. *See* Note, *Securities—Rule 10b-5—Corporate Outsider May Be Liable For Failure to Disclose or Abstain Under Rule 10b-5 Based on Employer-Employee Fiduciary Relationship*—United States v. Newman, *664 F.2d 12 (2d Cir. 1981)*, 12 SETON HALL L.J. 178 (1982) (analysis of the employer-employee theory but criticizing the *Newman* result as being inconsistent with *Chiarella's* logic).

155. One of the earliest insider trading cases under Rule 10b-5 involved this situation. *See* Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967). For a recently-settled proceeding involving tipping within the family, see SEC v. Newton, noted in 18 Sec. Reg. & L. Rep. (BNA) 712 (E.D. Va., May 14, 1986).

156. *See supra* notes 94-97 and accompanying text for a discussion of the *Dirks* tipper-benefit requirement. The Court stated that a tip and subsequent trade by the tippee resembles trading by the insider himself followed by a gift of the profits to the tippee. *Dirks*, 463 U.S. at 664.

157. When a tip results in a pecuniary gain, the tipper-benefit requirement is clearly met. *See supra* text accompanying note 97.

In *United States v. Reed*,[158] government prosecutors suggested an alternative hybrid approach upon which to base the liability of an insider's family member. In *Reed*, a son received confidential information from his father, a company insider, regarding a corporate merger. The son then purchased options on the company's stock and realized a large profit.[159] The prosecution conceded that the father had not breached a duty to the company by merely discussing the matter with his son because the father did not have any intention of gaining a direct or indirect personal benefit from the disclosure.[160] Thus, the disclose-or-abstain theory was not an available basis for liability.

The prosecution instead argued a misappropriation theory, contending that the son defrauded the father by violating the confidence that the father had placed in him not to misuse the information that was often part of their conversations.[161] The court held that the prosecution's misappropriation argument alleged facts that, if proved, would establish a Rule 10b-5 violation.[162] Reed was acquitted in his jury trial, but the SEC has continued to base Rule 10b-5 claims on this type of familial misappropriation theory.[163]

In *SEC v. Lund*,[164] the District Court for the Central District of California interpreted the concept of an "insider" flexibly to include a friend and business associate of a corporate director. A corporate director telephoned Lund, a long time friend and business associate, to tell him that the director's company was entering into a lucrative joint venture, and to ask Lund if he would be interested in investing. Soon thereafter, Lund traded in shares of the insider-director's company and realized a $12,500 profit.[165]

The disclose-or-abstain theory was unavailable because the insider did not breach a fiduciary duty in disclosing the information. The insider conveyed the information only as a means of seeking investors for the joint venture and he did not intend to personally gain from the disclosure. The court found Lund liable on the theory that he was a "temporary insider" of the director's company.[166] Thus, the *Lund* court did not follow the *Dirks* requirement that

158. 601 F. Supp. 685 (S.D.N.Y. 1985).
159. *Id.* at 689.
160. *Id.* at 698-99.
161. *Id.* at 699-700. For a discussion of the merits of the misappropriation theory, see *supra* notes 127-139 and accompanying text.
162. United States v. Reed, 601 F. Supp. at 737.
163. *See* SEC v. Lewis, 18 Sec. Reg. & L. Rep. (BNA) 1159 (D.D.C., Aug. 4, 1986) (consent decree). For an extensive discussion of *Reed*, see Hiler, *The Judiciary Considers the Nature of Confidential Relationships in Insider Trading Cases - A Look at* United States v. Reed, 13 SEC. REG. L.J. 128 (1985).
164. 570 F. Supp. 1397 (C.D. Cal. 1983).
165. *Id.* at 1400.
166. *Id.* at 1403.

there be an express or implied fiduciary relationship between the insider, temporary or not, and the issuer.[167] Under *Lund*, anytime a person is given information by an issuer with an expectation of confidentiality or limited use, he becomes an insider of the issuer and cannot trade on the basis of that information.[168]

E. *Eavesdropper Liability*

A vexing question of liability arises when an individual inadvertently obtains material nonpublic corporate information: for example, the individual who just happens to be riding the same train as a corporate president who is discussing material information with an associate might obtain such information. In *SEC v. Switzer*,[169] the football coach of the University of Oklahoma, while sitting in the stands at a track meet, overheard a business executive tell his wife about the liquidation of a certain corporation. Thereafter, Switzer (and others whom he, in turn, tipped) traded on the information. The court applied the principles of *Dirks* to exonerate all defendants[170] because the corporate insider "received no direct or indirect personal benefit from the disclosure."[171] The court concluded that Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider.[172]

One commentator has argued that "this type of windfall" should not stand.[173] He believes that investor confidence in the securities markets requires that *no* person be allowed to trade on the basis of material nonpublic information.[174] "Few rules are so likely to encourage perjury as one that allows an 'innocent' eavesdropper to retain profits."[175] This commentator's fear is that individuals questioned about an apparent tip would be tempted to perjure themselves by inventing an innocent story that would justify their possession of the nonpublic information.

167. *See* SEC v. Dirks, 463 U.S. 646 (1983). Note that *Lund* was decided two months after *Dirks*.

168. *Lund* is one of the cases cited explicitly by the House Committee on Energy and Commerce in its report on the Insider Trading Sanctions Act of 1984 for the conclusion that the current law is sufficiently broad and flexible to deal with basic "outsider" trading abuses. H.R. REP. No. 355, 98th Cong. 1st Sess. 13 n.20 (1983).

169. 590 F. Supp. 756 (W.D. Okla. 1984).

170. *Id.* at 768.

171. *Id.* at 766 (quoting *Dirks*, 463 U.S. at 663).

172. *Id.*

173. *See* Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1136 (1985).

174. *Id.*

175. *Id.*

IV. Possible Legislation

A. *The Need For Legislation*

The case law that has developed since the Supreme Court's *Chiarella* and *Dirks* decisions leaves substantial doubt as to the liability of tippees and quasi-insiders under Rule 10b-5. These decisions exemplify the complex balance between common law fiduciary principles and the current federal securities laws. The common law principle that the duty to disclose depends on the existence of a fiduciary or special relationship[176] limits the reach of Rule 10b-5 with respect to tippees and quasi-insiders.[177]

Under current law, then, the only weapon available for holding tippees and quasi-insiders liable is a flexible interpretation of fiduciary concepts and their underlying notions of fairness. Although various courts have accepted some creative interpretations of fiduciary concepts,[178] thereby allowing this area of law to further develop, the dangers of insider trading are too great for the legislature to ignore. An addition to the federal securities laws would replace confusing common law principles with explicit insider trading prohibitions. The result would be an effective deterrent, a reduction in litigation, and increased public confidence in the nation's securities markets.[179]

B. *A Legislative Proposal*

An amendment to the federal securities laws must be created with several considerations in mind. First, an amendment should be created with reference to the fundamental principles of insider trading liability, as established prior to *Chiarella* and *Dirks*.[180] Second, the statute should begin by prohibiting *all* trading on the basis of material, nonpublic information. Third, the legislature should enumerate exceptions which, under certain limited circumstances, would allow individuals to trade on material nonpublic information. Finally, the statute must not be drafted so as to discourage legitimate investment analysis. By incorporating these considerations

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176. *See supra* notes 70-75 and accompanying text (discussing the common law fiduciary principles in *Chiarella*) and notes 89-99 and accompanying text (discussing the common law fiduciary principles in *Dirks*).

177. *See supra* notes 101-122 and accompanying text (discussing the criticism and implications of *Chiarella* and *Dirks*).

178. For examples of cases employing various theories of liability for tippees and quasi-insiders, see *supra* notes 127-175 and accompanying text.

179. One commentator believes that "[b]uilding confidence in the securities marketplace is the overriding objective of the federal securities laws." D. Langevoort, *supra* note 1, at 12.

180. For a discussion of the fundamental principles that were established prior to *Chiarella* and *Dirks*, see *supra* text accompanying notes 54-59.

into a new insider trading statute, Congress would be giving courts a tool with which they could effectively determine the insider trading liability of tippees and quasi-insiders.

Most importantly, an insider trading statute must be grounded on notions of fairness.[181] Many large corporations have thousands of shareholder-investors who know nothing about the company or about the securities markets. These individuals buy the securities on the advice of stock brokers as "good investments." These are the individuals that insider trading laws must seek to protect. Investors must be confident that they have the same access to information regarding their investment as any other investor or prospective investor.[182] This fundamental principle, articulated in *Texas Gulf Sulphur*,[183] is the basis for the parity of information theory which prohibits any person from trading while in possession of material nonpublic information.[184]

The parity of information theory provides the perfect rationale upon which Congress could base an amendment to the federal securities laws. Prohibiting *all* trading on the basis of material nonpublic information,[185] but including certain enumerated exceptions for situations in which Congress determines trading on nonpublic information to be "fair," would satisfy the overall fairness objective of the statute without requiring courts to decide what is "fair" in a given situation. In contrast, one recent proposal would declare illegal the "unfair use of material nonpublic information."[186] This approach, however, would place the burden squarely on the courts to determine which uses of material nonpublic information are "unfair" and which are not. Although this would also satisfy an overall objective of fairness, Congress is in a better position than the courts to interpret such malleable terms as "unfair." Allowing the courts to make such *ad hoc* determinations would require extensive, costly litigation and would inevitably result in unpredictable decisions.[187] The courts

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181. For a summary of the fairness objective, see *supra* notes 34, 36 & 44 and accompanying text.

182. This principle, known as the integrity of the market theory, was first announced in S.E.C. v. Texas Gulf Sulphur, 401 F.2d 833 (1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). For an explanation of the *Texas Gulf Sulphur* decision, see *supra* notes 40-45 and accompanying text.

183. SEC. v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

184. For the language of the "parity of information" theory as expressed in *Texas Gulf Sulphur Co.*, see *supra* note 119.

185. Other commentators have agreed that there should be a broad prohibition on all insider trading. *See, e.g.*, Seligman, *supra* note 173, at 1139 (broad approach is mandated by the parity of information theory adopted in *Texas Gulf Sulphur*).

186. *See Report of the Task Force on Regulation of Insider Trading*, 1984 A.B.A. Sec. Corp. Bank and Bus. L. 69-76 (discussion draft).

187. *See* Seligman, *supra* note 173, at 1139. Professor Seligman notes that the initial judicial constructions of the Sherman Act exemplify the risk of employing the

can more realistically interpret the applicability of exceptions by using concrete guidelines set forth by Congress.

Another suggested insider trading statute would simply list what types of persons violate the law.[188] The list might include traditional insiders (officers, directors, employees, agents, and outside consultants), misappropriators of information, securities analysts, securities journalists, tippers, tippees, government officials or employees, eavesdroppers, friends, relatives or business associates of insiders, stockbrokers, temporary insiders, fiduciaries, and any outsiders or tippees of any of the above types of persons. The courts would then only have to categorize defendants into one of the classes enumerated by the legislature. This proposal, however, would narrow the applicability of the new statute with respect to quasi-insiders.[189] "Quasi-insider" is a generic term for a person who has unusual access to material nonpublic information.[190] Because there is no limit to the different types of persons who may be quasi-insiders, it is impossible to create a list that includes every possible category of securities trader who might violate prohibitions against insider trading.

Thus, the new statutory section should begin with a general, broad-based prohibition on all insider trading: Any person in possession of material nonpublic information which he knows or has reason to know emanates from a corporate source is prohibited from trading on the basis of that information, whether he is trading on the impersonal securities markets or face to face . . .[191]

The legislative exceptions to this insider trading prohibition should be based on fairness. In addition, certain exceptions are necessary to prevent any conflict with other federal securities laws. First, the statute should be consistent with the disclose-or-abstain rule announced by the SEC in *Cady, Roberts*.[192] Therefore, a person should be allowed to trade with material nonpublic information after he effectively discloses that information to the trading public.[193]

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term "unfair" in the language of a statute.

188. *See Report of the Task Force on Regulation of Insider Trading*, *supra* note 186, at 69-76.

189. *See* Seligman, *supra* note 173, at 1139 (explicitly naming the types of persons who can violate the law runs risk that list will be underinclusive).

190. For a summary of who is a quasi-insider for purposes of this Comment, see *supra* note 20.

191. This language is from the author's summary of the fundamental principles which existed prior to *Chiarella* and *Dirks*. *See supra* text accompanying notes 54-59.

192. 40 S.E.C. 907 (1961). For a complete discussion of the disclose-or-abstain rule and the SEC's decision in *Cady, Roberts*, see *supra* notes 10 & 28-39 and accompanying text.

193. This exception is rather circular because, after disclosure, the information no longer retains its status as "nonpublic" as required by the suggested statute. The exception, however, will provide an express warning for courts to determine whether

Second, anybody who trades on the basis of information from another person (i.e., a tip) with the honest benefit that such information was merely an opinion or a "hunch" should not be liable under the statute, even if it turns out that the information was, in fact, material nonpublic corporate information. Either the statute itself or an accompanying legislative report should include "considerations" for courts to weigh in determining whether the individual knew or should have known that the information derived from a corporate source. Such considerations might include, for example, the tipper's relationship, if any, to the corporation or employees of the corporation in which the shares were traded.

Third, the statute should exempt potential takeover bidders who possess less than five percent of the shares of a target corporation. Under the Williams Act,[194] any person who has acquired five percent or less of the corporate stock of a company need not publicly disclose either his ownership interest or his ultimate takeover plan.[195]

Fourth, the statute should permit stock or options exchange specialists and floor traders to trade while in possession of material nonpublic information about trading activity on the floor of an exchange to the extent that such trading is permitted by other federal securities laws or stock exchange rules.[196]

Finally, an insider trading statute should not discourage legitimate investment analysis.[197] Therefore, those who obtain material nonpublic corporate information as a result of superior knowledge, intelligence, skill or technical judgment should be exempted from the statute's coverage.

CONCLUSION

The public confidence in the securities markets has declined in recent years due to the government's inability to successfully prosecute insider traders. This inability is due in part to the Supreme

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the information was effectively disclosed to the investing public. For a discussion of the "nonpublic" status of information resulting from an effective disclosure, see *supra* note 15.

194. Securities Exchange Act of 1934, §§ 13(d), 14(d); 15 U.S.C. §§ 78m(d), 78n(d) (1982).

195. The material nonpublic information that a person could trade on is that person's own proposed takeover attempt. If the potential takeover bidder was required to disclose the takeover plan, the price of the target company's stock would likely increase, making any takeover uneconomical, or at least much more expensive. For further discussion of this exception, see Seligman, *supra* note 173, at 175.

196. *Id.*

197. The discovery of information and its assimilation into the marketplace serves a valuable public service. *See* Investors Management Co., 44 S.E.C. 633, 648-49 (1971) (Commissioner Smith, concurring).

Court's decisions in *Chiarella* and *Dirks*, which limited the scope of Rule 10b-5 with respect to tippees and quasi-insiders. Courts have been forced to creatively interpret common law principles in order to avoid exonerating tippees and quasi-insiders who have traded on inside information. A new insider trading statute would forthrightly prohibit trading by tippees and quasi-insiders who are currently profiting at the expense of the investing public.

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