NETTING THE OUTSIDER: THE NEED FOR A BROADER RESTATEMENT OF INSIDER TRADING DOCTRINE

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INTRODUCTION

For the better part of forty years, federal courts have employed the broad general language of Rule 10b-5 to circumscribe the use for trading of material nonpublic information concerning a corporation.

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1. Rule 10b-5 provides as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,  
(a) To employ any device, scheme, or artifice to defraud,  
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or  
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


2. In this article, we employ the term “inside” or material, nonpublic information to cover both true “inside information,” i.e., nonpublic information originating from within and concerning the issuer of the securities involved, and “market information,” i.e., information from external sources but which may affect the value of the issuer's securities as traded.

See, e.g., the discussion of “market information” in Fleischer, Mundheim and Murphy, An Initial Inquiry Into the Responsibility to Disclose Market Information, 121 U. Pa.
by “insiders” of that corporation. The ripples of liability gradually have spread outward from the center—from true insiders\(^3\) to temporary or “quasi” insiders\(^4\) to true outsiders such as “tippees”\(^5\) and even “subtippees.”\(^6\) The United States Supreme Court set out, in *United States v. Chiarella*,\(^7\) limitations regarding the circumstances in which liability under Rule 10b-5 can be imposed. The Court followed up its *Chiarella* ruling with a decision three years later in *SEC v. Dirks*,\(^8\) a decision intended to specify similar limits to the liability under Rule 10b-5 of tippees trading on material nonpublic information.

The central holding of *Chiarella* is that an insider will be obligated to “abstain or disclose” under Rule 10b-5 only where the insider has a preexisting duty, arising out of a fiduciary or similar relationship of trust or confidence, to the party injured by the insider’s trading transactions.\(^9\) In the absence of any such relationship, the insider is not liable for injuries or damages suffered by a person buying or selling securities without access to the same information as the insider, nor is the insider subject to criminal or administrative sanctions. *Dirks* represents the related proposition that an outsider, e.g., a tippee, buying

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1. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). In this context, insiders include directors, officers, and employees of an issuer of securities who have access to information regarding that issuer by virtue of their position with the issuer.

2. Ross v. Licht, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967); SEC v. Lund, 570 F. Supp. 1397, 1402-03 (C.D. Cal. 1983). Such terms include persons (for example, business associates, independent contractors) who are not traditional insiders but assume the duties of such on a temporary basis by virtue of a special relationship with the issuer. Id. at 1403.

3. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 237-38 (2d Cir. 1974). The term “tippee” customarily is used to refer to a person who has no preexisting relationship with an issuer but who obtains nonpublic information concerning that issuer directly or indirectly from an insider.

4. *See, e.g.*, SEC v. Musella, 578 F. Supp. 425, 438-39 (1984). A subtippee is a person who receives material, nonpublic information from a tippee rather than a tipper. In many of the principal cases involving the liability of a tippee, the Securities and Exchange Commission also has brought civil or criminal proceedings against persons receiving information from the principal tippees. Thus, for example, many of the persons charged in SEC v. Musella received the inside information concerning pending acquisitions from Alan Ihne, the service manager at the Sullivan & Cromwell law firm, through a former stockbroker. Other examples of more well known subtippees would include the various institutional clients of Raymond Dirks, the girl friend of the stockbroker tipped by Paul Thayer, and certain clients of the stockbrokers tipped by R. Foster Winans. *See* notes 58-59 and 80-85 and accompanying text.


or selling securities upon material, nonpublic information from an insider is liable only if the insider has breached a fiduciary relationship in disclosing the information to the tippee, and the tippee knows or should have known that the insider has committed such a breach. In other words, a tippee's liability is totally derivative from, and dependent upon, a breach of duty by the insider.

A flood of articles and commentary from both the academic community and members of the practicing bar has followed the Chiarella and Dirks decisions. Many commentators have bemoaned the narrowness of the fiduciary duty standard articulated in those decisions. Some have urged greater use of an alternative ground for liability, such as the misappropriation theory or some other concept, and still others have proposed new legislative proscriptions. Most agree that some standards in addition to or in lieu of the fiduciary duty tests used by the Supreme Court in Chiarella and Dirks are appropriate if additional troublesome conduct involving securities trading by persons with access to material, nonpublic information is to be deterred. Of particular concern is trading by persons other than (1) traditional int-

10. 463 U.S. at 660-64.
13. Several lower courts have formulated an alternative basis for dealing with insider trading under Rule 10b-5 in the form of the so-called "misappropriation theory," the outlines of which first were suggested in Chief Justice Burger's dissenting opinion in Chiarella, 445 U.S. at 240-41. See infra notes 53-95 and accompanying text.
14. Congress has enacted the Insider Trading Sanctions Act, intended to strengthen the enforcement efforts of the Securities and Exchange Commission regarding insider trading. That legislation introduces additional twists to the plot, insofar as it purports, on one hand, to leave the existing case law under Rule 10b-5 undisturbed and yet, on the other hand, clearly is premised upon policy bases broader than those accepted or articulated by the Supreme Court in Chiarella or Dirks. See infra notes 95-110 and accompanying text. And, not to be outdone, an American Bar Association Task Force has come up with specific recommendations for legislative and/or administrative rulemaking proposals to further clarify the applicable standards governing insider trading. Task Force, supra note 11, at 253-64.
siders, that is, persons who have a preexisting relationship to the is­
suer, or (2) tippees of such insiders, but who nevertheless trade on
inside information. Indeed, the obstacles to imposing liability on such
traders (whom we label “outsiders” for ease of reference) under the
present framework is our main criticism of that framework.

While it no doubt would be helpful were Congress to enact legis­
lation explicitly defining what we mean by “insider” and/or “outsider
trading” and proscribing specific conduct as unlawful thereunder, it
seems unlikely that any such legislation will be forthcoming in the
near future. For the meantime, we are left with an unfinished judi­
cial formulation on our hands derived from Rule 10b-5. This formula­
tion performs adequately in certain conditions but has significant
limitations in other circumstances. Our effort here, therefore, is to see
if we can chart out a broader acceptable hypothesis by which insider
and outsider trading can be prohibited.

We propose to start with an unfettered look at the underlying
bases for prohibiting insider trading, that is, to identify the possible
interests which might be affected in any particular transaction where
someone possesses and uses an informational advantage in the
purchase or sale of securities. We then briefly consider the principal
concerns which have caused the Supreme Court to prescribe limita­
tions to the existing theories of liability.

In a subsequent part, we undertake a brief review of the develop­
ment of the existing jurisprudence under Rule 10b-5—the common
law roots; the “possession” theory espoused in Matter of Cady, Rob­
erts & Co. and SEC v. Texas Gulf Sulphur; the fiduciary principle
limitation announced in Chiarella; and the misappropriation theory
States v. Winans, among others. Finally, we attempt to describe an
alternative formulation which we believe is both simpler and more

15. At the hearings on the proposed Insider Trading Sanctions Act, various wit­
tesses suggested that Congress add specific language defining what constitutes insider trad­ing. The Senate and House Committees ultimately concluded that such a provision might
“reduce flexibility” and “create new ambiguities” and thus chose not to attempt any statu­tory definition. See Insider Trading Sanctions Act of 1933. H.R. REP., 98th Cong. 1st
16. 40 S.E.C. 907, 911 (1961). See supra notes 47-50 for a discussion of the posses­sion theory developed from the Cady Roberts decision by the courts in Texas Gulf Sulphur
and subsequent decisions.
consistent with the underlying policy reasons for prohibiting insider trading, and yet at the same time addresses the concerns which have motivated the Supreme Court's search for limiting principles.

I. IDENTIFYING THE INTERESTS

We believe that there are at least four interests protected by adopting a regulatory scheme which imposes liability for engaging in securities transactions on the basis of material, nonpublic information:

1. prevention of injury to a shareholder who buys or sells a security without lawful access to comparable information possessed by another person engaged in a contemporaneous transaction ("injury to shareholder");
2. protection to the owner of proprietary or confidential information against the misuse of that information ("injury to property right");
3. assurance of the integrity of and confidence in the public markets for various corporations' securities ("injury to market"); and
4. prevention of unjust enrichment of a person using an informational advantage not obtained through lawful means.

The first interest focuses on a person who engages in a purchase or sales transaction but would not have done so on the same terms had that person possessed the same information as was available to other persons engaged in opposite transactions at the very same time. Such a shareholder was operating upon assumptions as to the existing circumstances which are, in fact, mistaken. We deem it unfair that others who know the real circumstances by a means other than by their own effort and diligence should be able to take advantage of the former. Such unfairness or injury can arise irrespective of either the precise method of trading (direct dealings or impersonal market transactions) or the status of the wrongdoer (insider, quasi-insider, or outsider).

The second interest concerns the protection of information which is valuable in the hands of the owner because the owner has expended resources to develop the information and/or has the opportunity now to realize value from its own use of that information. A trader's improper use of that information may injure that owner either (1) by depriving the owner of the opportunity to realize full value,21 (2) by

21. Assume, for example, that an institutional investor has expended considerable sums on research regarding the probable outcome of major pending litigation between two parties. Based upon the results of that research, the institutional investor proposes to buy
increasing acquisition costs,\textsuperscript{22} or (3) by injury to the owner's reputation and goodwill.\textsuperscript{23} While the injury may be just as real as an injury to shareholders discussed above, the causal linkage or relationship between the injury and the insider's wrongful gain may be more attenuated.

The third interest concerns the protection of the market generally. Among the crucial differences between direct dealing transactions and impersonal market transactions are that in the latter, one party generally will not know what person is on the opposite side of the transaction, and thus will be unable, as a practical matter, to assess the likelihood that the other person possesses any informational advantage. In a face-to-face transaction, on the other hand, a selling shareholder knows the identity of the person with whom he or she is dealing and has the opportunity, whether or not used, to inquire as to the state of any special facts or circumstances that may be known to that person. That opportunity generally is absent in an impersonal or remote market transaction. Accordingly, if shareholders perceive that others are trading in the impersonal trading markets with significant informational advantages which the former will be unable to obtain through their own efforts, they may be reluctant to trade at all. Thus, prohibitions on insider trading are intended to give assurances to sellers and buyers that they are not assuming, in addition to ordinary

\begin{itemize}
\item the shares of one of the litigants and sell shares of the other. Before the investor is able to do so, various employees with access to the information buy and sell (short) shares of the companies, which has the effect of driving up the market price of the prevailing litigant and driving down the market price of the losing litigant and, in both cases, reducing the profits otherwise attainable by the institutional investor.

\textsuperscript{22} Obviously, had Texas Gulf Sulphur's test result information been disclosed to the public or others prior to the time it completed acquisition of additional land and mining rights in the Kidd Creek area, the costs of such acquisition would have been substantially higher. Similarly, purchases in the marketplace by individuals such as Messrs. Chiarella or Materia, using information theoretically known only to the prospective bidder, could have the effect of driving up the price of the target companies' stocks (either directly or by "signaling" to others the interest of the acquirer). Indeed, Anheuser-Busch, Inc., has commenced a damages action in United States District Court for Northern Texas against Paul Thayer, a former Busch director, and other defendants accused of trading on "misappropriated" inside information, alleging that the purchase of shares of Campbell Taggart, Inc., the target company, by Anheuser-Busch, Inc., cost substantially more as a result of the improper tipping and trading which occurred. \textsc{17 Sec. Reg. & L. Rep. (BNA) No. 45}, at 2010 (Nov. 15, 1985).

\textsuperscript{23} The misuse of confidential information by an employee of a financial printing firm or a newspaper publisher obviously can cause injury to the reputation of those firms with their clients. \textit{See, e.g.}, the discussion in \textit{Materia}, \textsc{745 F.2d} at 202 ("Among a financial printer's most valuable assets is its reputation as a safe repository for client secrets.") and \textit{Winans}, \textsc{612 F. Supp.} at 845 ("[T]he \textit{Wall Street Journal's} reputation for journalistic integrity was sullied.").
market risks, a risk of dealing with persons possessing unfair informational advantages.\(^\text{24}\)

This particular type of injury, however, is not one where damages are suffered by an identifiable participant in an ascertainable amount; the harm which can result is more in the nature of injury to the value of a public good or service generally.\(^\text{25}\)

The first three interests concern one or more specific types of injury suffered by some party as a result of insider trading. The fourth, on the other hand, concerns the benefit or advantage obtained or realized by the wrongdoer. It is important to note that this fourth interest does not necessarily extend to every person who trades using an informational advantage. Thus, traditional concepts of restitution or unjust enrichment require that one person has by “some unconscientious act or breach of good faith . . . obtained an undue advantage over another.”\(^\text{26}\) In this regard, it is useful to distinguish, as did Professor Page Keeton almost fifty years ago, among three alternative means by which a person obtains material, nonpublic information: (1) by chance, (2) by effort, or (3) by unlawful or improper means.\(^\text{27}\)

As to the third of these classifications, we have little difficulty arguing that it is unjust for a person to profit from an informational advantage unlawfully or improperly obtained. On the other hand, we rarely begrudge persons the opportunity to trade upon informational advantages devel-

\(^{24}\) See, e.g., Texas Gulf Sulphur Co., 401 F.2d at 852 (“It was the intent of Congress that all members of the investing public should be subject to identical market risks. . . .”). See also Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 355-56 (1979).

\(^{25}\) We refer to confidence in the integrity of the market as a public good or service because investors in the marketplace cannot assess in advance the risk, with respect to any particular security, that insider trading is likely to occur, and thus the risk cannot simply be factored into the “costs” any particular investor chooses to pay. See, e.g., Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 39-41 (1980):

[I]nvestors cannot before the fact distinguish those companies whose insiders trade on confidential information from those whose insiders do not. This distinction is impossible not only because insider trading is difficult to detect but also because the opportunities for insider trading are dependent on the fortuitous occurrence of significant events and are therefore distributed randomly throughout the market.


\(^{26}\) J. Pomeroy, Equity Jurisprudence, § 873 (5th ed. 1941).

\(^{27}\) See Keeton, Fraud—Concealment and Non-Disclosure, 15 Tex. L. Rev. 1, 35 (1936).
oped through their own lawful industry and effort; indeed, in the absence of any incentive to develop informational advantages, the securities markets might not function efficiently. Access obtained by chance rather than by effort is a more difficult circumstance to judge. While our society generally views windfalls resulting from events of chance as not unfair, the line between luck and breach of good faith sometimes may be hard to ascertain.

In any given instance of insider trading, the trader will realize a substantial benefit, and one or more of the injuries described above ordinarily will occur as well. Consider, for example, the case where an officer of Texas Gulf Sulphur bought shares of Texas Gulf Sulphur on the undisclosed news of the Canadian test drilling site results. There was little question that the corporate officer benefited directly when the value of the shares acquired appreciated following the dissemination of the favorable news. We can identify as among the injured in that instance the following: (1) injury to shareholders, that is, those persons who sold their shares but would not have had the test results previously been disclosed publicly; and (2) to a rather unquantifiable extent, the integrity of the trading markets, that is, investors will be hesitant to participate in the market for Texas Gulf sulphur securities specifically, and for other securities generally, if and when they believe there is a substantial likelihood that others have significant improper or unfair informational advantages.

In other insider trading situations, different interests may be affected. Assume, for example, that a genetic engineering firm has achieved a significant research breakthrough which when announced will generate substantial market interest in the firm’s shares. The firm wishes to hold back on a public announcement until it can both file necessary patent applications to protect its proprietary interest and lock up certain sources of supply for critical raw materials. A key employee buys shares of the firm’s stock on the basis of the material,

28. See Brudney, supra note 24, at 361-62.

29. Professor Aldave cites the story given at a congressional hearing of a motorist driving on a deserted road when he observes a huge explosion in the XYZ plant. The motorist, who owns XYZ stock, immediately calls his broker and instructs the sale of the XYZ stock before the disaster becomes publicly known. The witness concluded that the average investor would not bar the motorist from selling securities. See Aldave, supra note 11, at 123, n.119.

30. Indeed, we have a difficult time being clear as to the proper distinction. Is a person who overhears a conversation in which inside information is disclosed and then acts upon it simply lucky (to be in such a place at such a time so as to hear that information), or are they acting in bad faith when they proceed to reap profits in securities transactions based on that information? Under our formulation, the individual probably will be liable for any profits obtained. See supra notes 119-123 and accompanying text.
nonpublic information to which he has access. Again, the insider benefits directly when the value of the shares acquired appreciates following the announcement of the favorable development. In addition, however, the firm itself may be injured if the insider's trading activities necessitate or result in earlier disclosure of the development before the firm is able to obtain proprietary protection or negotiate its raw materials requirements contracts.31

II. COUNTERVAILING CONCERNS

While protection of the foregoing interests generally supports the imposition of liability for insider trading transactions, there are countervailing concerns. First is the concern for a clear linkage between the interests being protected and the particular transaction alleged to have caused injury. For example, the general prohibitions against insider trading probably can be applied in transactions involving direct dealing between two parties without untoward consequences. When one of two shareholders in XYZ Corporation, individual L, buys the XYZ shares of the other shareholder K without telling K of material developments which will enhance the value of the XYZ shares significantly, we can identify a measurable loss to shareholder K and link it to an identifiable corresponding unjust gain to shareholder L.32 On the other hand, when we move from direct dealing transactions to impersonal transactions effected over a national securities exchange or in the over-the-counter market, that corresponding linkage usually is lost. Even though there may well be identifiable losses suffered by shareholders operating at an informational disadvantage and identifiable gains improperly realized by persons trading with an informational advantage, the "linkage" between the two may be exceedingly difficult to establish. If there is no verifiable connection between the two identifiable amounts, we confront substantial complications in setting the appropriate measure of damages.33

Second is a concern that investors have adequate guidance or no-

31. In this instance, the interests of the selling shareholders conflict with those of the firm. In other words, while the firm will have a bona fide business reason to delay disclosure of the material development, that will adversely affect persons selling shares of the firm who would not have done so had they known of the development.


33. Thus, for example, in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 232-33 (2d Cir. 1974), the plaintiffs proved that the defendants had sold 165,000 shares of Douglas Aircraft stock over a period of four days. During the comparable time period approximately 605,300 shares were traded on the New York Stock Ex-
tice as to what may or may not be an unlawful transaction. Without some guiding or limiting principles or framework, it is difficult for an investor to determine whether or not he or she has violated insider trading prohibitions. The very nature of the marketplace puts a premium on investors' obtaining all information relevant to their investment decisions. Furthermore, how is an individual to prove that he or she did not act on material, nonpublic information not available to another trading at approximately the same time? To state the matter in another way, how can there be certainty and predictability of consequences for market traders unless the attaching conditions and limits of liability are known?

Last is a concern that broad prohibitions on insider trading may stifle market efficiency. When one moves from direct dealing transactions where we can easily allocate responsibilities to impersonal national market and exchange transactions, how can we avoid adopting rules or prohibitions which may have a significant adverse impact upon lawful efforts to gain informational advantage? When participants and markets are dispersed, the process by which an individual investor can obtain the greatest amount of useful information preliminary to a sale or purchase of stock decision may be enhanced best by contracting with an intermediary or professional (for example, a financial analyst) to obtain the information. Presumably, we do not want to deny that or any other investor the opportunity to acquire such information if he or she is willing to pay for such services and if those services are available to any other person willing to pay to acquire the same. In other words, whatever prohibitions we adopt should not unreasonably interfere with lawful efforts, theoretically available to all, to obtain a temporary informational advantage. A general prohibition against any person seeking an informational advantage would destroy the functions and significance assumed in the marketplace by intermediaries such as financial analysts. Would the financial markets then have any incentive at all to be efficient, to reward diligence and effort for ferreting out information so that securities will reflect their intrinsic values?

These three concerns clearly were the major considerations shaping the Supreme Court's decisions in Chiarella and Dirks to limit the scope of various persons' liability under rule 10b-5. After reviewing the general development of the Rule 10b-5 jurisprudence up until the change. Are the defendants liable for the damages suffered by the purchasers of 165,000 shares or 605,300 shares?

34. See Brudney, supra note 24, at 339-43.
present time, we will return to attempt to address these concerns through our alternative formulation.

III. ORIGINS OF INSIDER TRADING DOCTRINES

In tracing the development of the doctrinal law of Rule 10b-5, it is appropriate to start with the theories at common law which traditionally applied to bipartite, direct dealing transactions. These cases reveal two separate theories justifying private recoveries for insider trading transactions.

The first theory developed out of fraud concepts, beginning with the tort of active misrepresentation and eventually extending liability to nondisclosure situations as well. The focus there, of course, was on the injury suffered by the person who bought or sold securities as a result of the misrepresentation or nondisclosure. Affirmative or active misrepresentation cases in which a person misrepresents the true state of affairs to the other party to the purchase or sale long have been recognized as supporting the imposition of liability. While a different rule initially applied with respect to those who traded in silence, liability often could be established under a "special facts" doctrine. Furthermore, a separate basis for recovery in bipartite transactions was available through the application of the equitable concept of unjust enrichment. Unlike the misrepresentation or constructive fraud cases which look to the injury suffered by the victim, the principal goal of the law of unjust enrichment or restitution is to punish the wrongdoer, that is, to prevent unjust enrichment of a person who has benefited from the infringement of another person's interest or by another's loss.

In several of the common law cases most often cited by the fed-

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36. E.g., Goodwin v. Agassis, 283 Mass. 358, 186 N.E. 659 (1933). See also the numerous cases cited in 84 A.L.R. 615, 616-18 to the effect that an insider generally does not have a fiduciary obligation to disclose to individual shareholders any inside information when purchasing from or selling to such shareholders.


eral courts applying Rule 10b-5, both the misrepresentation and unjust enrichment theories are invoked. Thus in Strong v. Repide, the Supreme Court was influenced both by the substantial injury suffered by the plaintiff in selling shares at a price substantially below their true value and by the unjust benefit obtained by the defendant through "a studied and intentional omission . . . as part of the deceitful machinations to obtain [the stock] . . . at a lower price." In Diamond v. Oreamuno, Chief Judge Fuld noted that the function of a claim based upon breach of fiduciary duty through wrongful use of corporate information was "not merely to compensate the plaintiff for wrongs committed by the defendant but . . . to prevent them, by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others . . . ."

Because two distinct theories or concepts concerning the interests and parties involved have supported a finding of liability under the common law, it should not be surprising that reference was made to a number of active misrepresentation, nondisclosure, or concealment and unjust enrichment cases when Rule 10b-5 later came to be applied to insider trading situations. In Cady, Roberts & Co., the Securities and Exchange Commission traced the common law development from Strong, Hotchkiss v. Fischer and other common law cases in laying out the bases upon which liability could be imposed. However, the Commission went even further in holding that the application of Rule 10b-5 was not confined to the limits of such common law principles but rather that the separate statutory scheme of the federal securities laws created an independent basis for prohibiting insider trading. In the Commission's view, authority derived from the Securities Exchange Act of 1934 enabled the Commission to extend protection to persons not protected under the common law. Thus in Cady, Roberts & Co. the Commission dismissed the argument that a Curtiss-Wright director owed no fiduciary duty, and thus was not liable, to persons not yet shareholders who had bought the shares of Curtiss-Wright without access to the same information he had. The Commis-

40. Id. at 433.
41. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). Courts in at least two other states have declined to follow the ruling of the New York Court of Appeals in Diamond v. Oreamuno. See, e.g., Schein v. Chasen, 313 So. 2d 739 (Fla. 1975) and Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978).
42. Diamond, 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.
44. Id. at 913-14.
sion held that the purposes underlying the federal securities laws necessitated an obligation to disclose or refrain from trading on the part of insiders even with respect to persons and investors not presently shareholders. The Commission set out what it believed to be the appropriate elements for establishing violation of Rule 10b-5 with respect to insider trading:

We have already noted that the anti-fraud provisions are phrased in terms of 'any person' and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.

The principles crafted in Cady, Roberts first were embraced judicially in Texas Gulf Sulphur. In its introductory discussion of Rule 10b-5, the Second Circuit also took note of the Strong and Hotchkiss precedents at common law and then restated the general principle articulated in Cady, Roberts, that is, that liability is premised upon the access to material, nonpublic information not generally available. However, while the Cady, Roberts formulation had definite overtones relating to the wrongful use by and unjust enrichment of the insider having access to material, nonpublic information, the Texas Gulf Sulphur opinion recast the prohibition to turn on the possession of such information:

Thus, anyone in [the] 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

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45. Id. at 913.
46. Id. at 912 (emphasis added).
47. 401 F.2d at 848.
48. Id.
chooses not to do so, must abstain from trading in or recom-
mending the securities concerned while such inside information re-
 mains undisclosed.49

This viewpoint, which came to be characterized as the "possession" theory of Rule 10b-5, was followed in a number of subsequent federal court cases,50 including, of course, the lower court decision in the Chiarella case which was reversed by the Supreme Court in 1980. The standard generally applied in those cases was that any person—"corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."51 In other words, the mere possession of material, nonpublic information gave rise to the duty to disclose or abstain.

The Supreme Court in Chiarella rejected this theory, holding that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."52 In the Court's view, the insider with access to such information must have a preexisting duty to disclose arising out of some relationship with the other participants in the securities transactions. Justice Powell, writing on behalf of the majority, cites three examples of such a relationship: (1) agency, (2) a fiduciary relationship, or (3) some other arrangement pursuant to which "the sellers had placed their trust and confidence" in the defendant.53 In support of such a requirement, the Court noted the distinction sometimes made at common law between affirmative misrepresentation and nondisclosure cases wherein liability attached to the latter only if the defendant breached a duty to the other parties through its silence.54 Citing the Restatement (Second) of Torts, the Court observed that a duty to disclose ordinarily arises "when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.'"55

As others have noted, the actual holding of the court in Chiarella is quite narrow, namely, that the mere possession of material, nonpub-

49. Id.
51. Chiarella, 588 F.2d at 1365.
52. 445 U.S. at 235.
53. Id. at 232.
54. Id. at 228.
55. Id. (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).
lic information is insufficient to create a duty to disclose or to refrain from trading.\textsuperscript{56} In the context of the objectives or interests underlying prohibitions on insider trading, such a holding is equivalent to saying that the mere fact that shareholders (existing or future) are injured by being at an informational disadvantage, without more, does not establish or constitute a violation of Rule 10b-5. Regrettably, the majority opinion of the Court addresses neither the significance of the other interests such as possible injury to property rights or injury to the market, nor the relevance of issues of unjust enrichment.\textsuperscript{57}

In \textit{Dirks}, the Supreme Court took some pains to reemphasize its rejection of the parity of information theory previously espoused by the Securities and Exchange Commission, reaffirming its position in \textit{Chiarella} that a duty to disclose can only arise from "a specific relationship between two parties."\textsuperscript{58} In the Court's view, a tippee could be liable only if the insider from whom the tippee receives the information has violated such a duty to disclose:

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them \textit{improperly}. . . . Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.\textsuperscript{59}

After \textit{Chiarella} and \textit{Dirks}, persons seeking to impose liability upon others for insider trading activities—whether the Securities and Exchange Commission or private claimants—thus have three principal alternatives open to them:

1. establish that the person trading had some relationship with the other participants that creates a duty to disclose;
2. pursue an alternative theory for breach of duty, such as misappropriation; or
3. distinguish \textit{Chiarella} and \textit{Dirks} on the grounds of the nar-

\textsuperscript{56} Justice Burger was careful to emphasize in his dissent that the actual holding of the majority was thus so limited. \textit{See} 445 U.S. at 243, n.4. \textit{See also} Note, \textit{supra} note 12, at 507.

\textsuperscript{57} The majority opinion noted the alternative theory offered by the government to find a breach of duty based upon Chiarella's wrongful appropriation of the information. The Court did not reach that issue on the ground that it had not been submitted to the jury. 445 U.S. at 235-36.

\textsuperscript{58} 463 U.S. at 654-55.

\textsuperscript{59} \textit{Id.} at 660.
row holdings relating to the mere possession of inside information and establish presence of additional factors supporting a basis for relief.

For the great majority of insider trading cases, there will be a relationship (for example, director or officer status, independent contractor or agent) which can be identified. In those situations the Chiarella and Dirks holdings allow for the imposition of liability. In outsider trading situations, however, where there is no specific relationship, troublesome transactions or conduct still may occur, and it is as to these that we now turn our attention.

IV. THE MISAPPROPRIATION THEORY

Given the groundwork laid in both Justice Stevens' concurring opinion60 and Chief Justice Burger's dissenting opinion61 in Chiarella, it has not taken the lower federal courts much time to develop a misappropriation theory to cover many of those situations where a fiduciary duty cannot easily be established.

Under the current formulation of the misappropriation theory, 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.62 The misappropriation theory represents a potentially significant advance toward catching the outsider trader in two respects. First, it eliminates the requirement that an insider breach a fiduciary duty to shareholders prior to finding a violation.63 Secondly, it does not make any distinction between persons (that is, tippees) who directly obtain inside information from an insider who breaches a duty in disclosing that information and persons who otherwise obtain inside information unlawfully or improperly.64 Under the theory, traders violate section 10(b) when they obtain nonpublic information illegitimately.65

This is not to say that under the misappropriation theory there is no inquiry into the relationship between various of the parties in-

61. Id. at 239-45.
62. Materia, 745 F.2d at 201; Newman, 664 F.2d at 16-17.
63. See infra notes 66-67 and accompanying text.
65. Chiarella, 445 U.S. at 230 (Burger, C.J., dissenting). "A person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." Id.
volved. Indeed, the first step in the analysis remains a determination
that some of the parties "stand in some confidential or fiduciary rela-
tion." 66 However, the important distinction is that the field of rele-
vant relationships is not limited to that between the trader and the
shareholders with whom he trades. Rather, the field is opened to rela-
tionships including parties who, while injured by the violation, are
neither purchasers nor sellers of the securities in question. 67

The misappropriation theory was applied for the first time and
upheld by the Second Circuit in Newman, 68 a case decided under the
shadow of Chiarella. In Newman, a brokerage firm manager was
found criminally liable for purchasing the stock of companies that
soon thereafter became takeover targets. Newman learned of the im-
pending takeovers through employees of investment banking firms
whose clients "engaged in corporate mergers, acquisitions, tender of-
fers, and other takeovers." 69 The government did not allege, nor did
the court hold, that the shareholders who sold their stock to Newman
had been defrauded. Having no fiduciary relationship with those
shareholders, temporary or otherwise, Newman had no duty under
Chiarella to disclose to the sellers. 70 No insider had breached a fiduci-
ary duty; the corporate insiders had revealed the information legiti-
ately and in confidence to the investment banking firms. Thus,
under the reasoning of Dirks, Newman would have no liability for the
transactions affected. Nevertheless, the court held that Newman was
criminally liable for violation of Rule 10b-5 in that he had participated
in a breach of trust and confidence shared between the investment
banking firm and its corporate clients. The breach, according to the
opinion, sullied the reputation of the investment banking firms "as safe
repositories of client confidences." 71 In addition, the purchases "artifi-
cially inflated" the stock prices of the target companies, thereby injur-

66. Id. at 239-40 (Burger, C.J., dissenting).
67. As might be anticipated, this raises a right of standing issue because of the nar-
row limits to a private right of action under the securities laws. See 445 U.S. at 238 (Ste-
vens, J., concurring). This has not proven, however, to be a serious obstacle to application
of the misappropriation theory. See infra note 79. But see Moss v. Morgan Stanley Inc.,
719 F.2d 5 (2d Cir. 1983).
69. Id. at 15.
70. Id. at 15. Indeed, because there was no fiduciary relationship, the Second Circuit
affirmed the dismissal, for lack of standing, of subsequent suits by shareholders who had
In Newman, the court held that the standing issue was not relevant to a criminal action.
664 F.2d at 17.
ing the corporate clients.72

The Second Circuit reaffirmed the principles of the misappropriation theory in *Materia.*73 The facts of the case were strikingly similar to the *Chiarella* circumstances. The defendant, Materia, was a copy reader for Bowne of New York City, Inc., a financial printing firm. Among the printing services performed for clients by Bowne was the preparation of proposed tender offer filings. Bowne made every effort to keep such corporate information confidential, using both blanks and code names for companies that were attempting takeovers and/or were the subject of takeover attempts. In addition, Bowne had posted notices visible to its employees that warned against trading on information discovered in the course of their work. In spite of these efforts and disregarding the warnings, Materia ascertained from information at the printing firm the names of at least four companies that were soon to be takeover targets. In each case, Materia purchased stock in the target before the announcement of a tender offer. Upon the stock's increasing in value after the announcements, Materia sold his shares.74

The Securities and Exchange Commission charged Materia with violations of sections 10(b) and 14(e) of the Securities Exchange Act, as well as Rules 10b-5 and 14e-3. The Commission's theory was that Materia had traded "on the basis of material nonpublic information he had misappropriated from his employer and its clients."75 Materia argued that under the *Chiarella* holding his actions were not illegal.76 The Commission argued, and the Second Circuit agreed, that Materia had perpetrated a fraud against his employer. The employer, in turn, enjoyed a confidential relationship with those companies who had shared confidential information with Bowne for the purpose of preparing the tender offer materials. By "trading on confidences," Materia "undermined" the relationship between the printing firm and its clients.77

Importantly, the fact that Materia did not learn of the information in question from insiders of the issuer is irrelevant under the misappropriation theory. The information need only be improperly obtained.78 It is similarly irrelevant that neither the employer nor its clients were the persons who traded with or at the same time as

72. *Id.* at 17-18.
73. 745 F.2d at 201.
74. *Id.* at 199.
75. *Id.* at 199-200.
76. *Id.* at 201.
77. *Id.* at 202.
78. See *supra* note 64 and accompanying text.
Materia. In other words, if a confidential relationship with another party has been breached by the misappropriator, and the misappropriation relates to information regarding the securities of an issuer, that is sufficient to constitute being “in connection with” a purchase or sale of securities. 79

A more recent application of the theory occurred in Winans. 80 There, R. Foster Winans, formerly one of the authors of the “Heard on the Street” column of the Wall Street Journal, was charged with violating section 10(b) by disclosing to others the timing, content, and tenor of market-sensitive stories about various companies. The other individuals proceeded to trade in the securities of the issuer in question in advance of the story’s publication, realizing a profit when the market value of the securities went up or down after the column appeared. 81 The government’s principal theory was that since Winans knew, pursuant to the Wall Street Journal’s policies, that “he was not supposed to leak the timing or contents of his articles or trade on that knowledge,” his appropriation of the confidential information regarding the nature and timing of those articles for the personal benefit of himself and the co-conspirators operated as a fraud upon his employer. 82

Winans argued that application of the misappropriation theory was inconsistent with the Supreme Court’s holding in Chiarella and Dirks that a duty to disclose exists only if a “specific relationship [exists] between the shareholders and the individual trading on inside information.” 83 Federal District Judge Stewart distinguished Chiarella and Dirks simply by classifying those decisions as “one chapter [of the book on insider or outsider trading] with respect to one type of fraudulent trading. That type is not before us.” 84 Winans also contended that applying the misappropriation theory essentially was equivalent to adopting the “parity of information” doctrine expressly rejected in Chiarella. Judge Stewart disagreed, responding:

The Chiarella majority also did not accept the view that an informational advantage which is not ‘legally available to others,’ known as the access to information theory, should be the basis for drawing the line. 445 U.S. at 235 n.20, 100 S. Ct. at 1118 n.20, see also

79. The court characterized Materia’s argument that his actions were not “in connection with” a purchase or sale as “spurious.” 745 F.2d at 203.
81. Id. at 829-38.
82. Id. at 842.
83. Id. at 841.
84. Id. at 842.
Dirks, supra, 463 U.S. at 672, 103 S. Ct. at 327. But we do not agree that the misappropriation theory is in conflict. The focus of the approach before us is not on whether the defendant had an informational advantage that others could not legally obtain, but on how the defendant gained the advantage, which must be fraudulently.85

While various federal courts, particularly in the Second Circuit, thus have succeeded, through use of the misappropriation theory, in imposing liability in unique situations left unprotected by the fiduciary duty standard of Chiarella, there are several conceptual problems involved with the use of such a theory. As has been noted elsewhere,86 there is concern whether the theory is consistent with Santa Fe Industries, Inc. v. Green.87 Under the reasoning of the latter case, no action lies under Rule 10b-5 for claims based upon mismanagement or breach of fiduciary duty unless the alleged conduct involved some deception or misrepresentation regarding either the purchase or sale of securities.88 The conduct which constitutes a breach of duty in cases such as Newman, Materia, or Winans sounds more like breach of contract than a deception or misrepresentation regarding the purchase or sale of securities. On the other hand, one can point to approving comments in the legislative history of the Insider Trading Sanctions Act as indicative of Congress' tacit endorsement of the misappropriation theory and its intent that prohibitions of Rule 10b-5 encompass such activities.89

A more difficult conceptual issue is when and how to delineate the relevant relationships which will or will not support a misappropriation claim under Rule 10b-5. The reasoning and approach used by a number of the federal courts to find a relationship which has been breached often seems artificial or strained. In Newman, it was undisputed that the investment banking firms shared a confidential relationship with their clients who were the issuers of the securities in question. There was, however, no relationship between Newman and the investment banking firms or between Newman and the issuers. Why did Newman owe a duty to the investment banking firms to "abstain or disclose"? He was not their agent. The investment banking firms' own employees had committed the breach. Was their duty to their employer transferred to Newman upon their disclosure of the

85. Id. (emphasis added).
86. See, e.g., Langevoort, supra note 11, at 46-49; Note, supra note 12, at 523; Phillips and Zutz, supra note 12, at 91-92.
88. Id. at 474-477.
89. See supra notes 100-109 and accompanying text.
information? If this was the court’s reasoning, it is no less circuitous and artificial than that used to find derivative fiduciary duties for tippees.90 Where does the transfer of the duty to disclose stop? Are persons who learn from Newman and trade also liable? What about traders who receive the information fifth-hand and sixth-hand?

The application of the misappropriation theory in the cited cases raises questions as to the appropriate guidelines for determining when confidential relationships exist that are subsequently breached by trading activities. While in Materia and Winans the employee-employer relationship created a presumption of confidentiality between Materia and Bowne and between Winans and the Wall Street Journal, other relationships may not give rise to such a presumption. Persons may trade on material, nonpublic information from sources who are merely business associates. In other cases, the relationship of the source of the information may range from a family member to a passing acquaintance.91 Yet in these latter situations the prospects for the per-

90. See supra notes 58-59 and accompanying text.

One of the more interesting recent insider trading cases initiated by the Securities & Exchange Commission concerned the alleged breach of trust arising out of a psychiatrist-patient relationship. A psychiatrist who treated the spouse of an official of Posi-Seal International, Inc., was alleged to have engaged in trading transactions based upon information disclosed to the psychiatrist in the course of the treatment. The Commission alleged violations of the insider trading provisions, claiming among other matters that the information had been disclosed to the psychiatrist under the expectation that all information would be kept confidential. The charges were settled without admission or denial by agreement of the psychiatrist to disgorge profits made and by payment of a civil penalty. Wall St. J., March 4, 1986, at 10, col. 4.

91. Some of the difficulties involved with a determination of confidentiality are illustrated in the recent case of United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985). The relevant facts were that the Standard Oil Company of California intended to purchase all of the outstanding shares of Amax, Inc., at a price that was approximately twice the market value. Thomas Reed allegedly learned of this offer from his father, Gordon Reed, who was a member of the Amax board of directors. Thomas Reed had no relationship with Amax or Standard Oil. His father’s disclosure of the impending offer, it was alleged, was made in confidence “and on the expectation that the son would not trade....” Id. at 698-99. Thomas Reed purchased call options at a total cost of slightly more than $3,000 prior to public announcement of the offer. After the announcement, he realized total profits exceeding $400,000.

Thomas Reed moved to dismiss the charges, contending that he did not have the requisite relationship of trust and confidence to enable an action to be sustained against him. The court, in an extensive review of both federal securities case law and common law principles of confidentiality, attempted to provide some guidelines for a legal determination of the requisite confidential relationship. Id. at 703-18. It ultimately held that the government would prevail if it could show at trial that Reed and his father were bound by an understanding of confidentiality, express or implied, or that some regular pattern of behavior by Reed and his father generated a justifiable expression of confidentiality and fidelity. Id. at 718. While noting that three elements are generally recognized as aspects to a confidential relationship, i.e., “disparity of position,” reliance, and “controlling influence,” the
son trading to obtain unjust gains and for others to be injured thereby are equally as great as they were in *Materia* and *Winans*.

Thus we question both the utility and appropriateness of such an alternative relationship inquiry. Aside from the difficulties inherent in such a determination, a confidential relationship requirement suffers from the same drawback as the fiduciary duty standard of *Chiarella*—it fails to focus on the central issue of the purposes and objectives underlying prohibitions against insider trading generally.

To be sure, injuries to various property rights have been sustained in the misappropriation cases decided to date. In *Newman*, the injury concerned the reputation of the investment banking firms and the fact that their clients might have had to pay more in the tender offers being effected. In *Materia*, the reputation of the printing firm was at risk; in *Winans*, the injury sustained was to the *Wall Street Journal* and its reputation. However, those are not the core interests or objectives involved; they are cited only because the lower federal courts have been unsure what otherwise to rely upon in light of the narrow and restrictive holdings of *Chiarella* and *Dirks*. The issues really involved include (1) the unjust enrichment of Newman, Materia, and Winans through the use of information not even intended to be available for their personal benefit; (2) the losses suffered by persons selling or buying securities on the opposite end of these trading transactions without access to the same information; and (3) the injury to the integrity of the securities markets themselves. While the misappropriation cases add an interesting chapter and a formula which occasionally will be useful in covering transactions not strictly within the fiduciary duty standard of *Chiarella*, we might well ask whether it is not time to conclude that a broader hypothesis is needed than that articulated in either *Chiarella*, *Dirks*, or the misappropriation cases.

V. IMPLICATIONS OF THE INSIDER TRADING SANCTIONS ACT

In formulating a broader hypothesis, we need to factor in the enactment of the Insider Trading Sanctions Act of 1984 (ITSA). At court conceded that there is a "lack of universality and uniformity of practice among courts and commentators in their analysis." Generally whether a confidential relationship exists is an issue of fact to be determined by the trier of the facts. *Id.* at 717.

Reed ultimately was acquitted of criminal charges after a jury trial. 17 SEC. REG. & L. REP. (BNA) No. 50, at 2179 (Dec. 20, 1985).

92. See *supra* notes 71-72 and accompanying text.
93. See *supra* note 77 and accompanying text.
94. See *supra* note 82 and accompanying text.
the time the Securities and Exchange Commission first pressed for ITSA, the Commission represented that it merely sought additional enforcement remedies and that it was satisfied with the existing substantive law under Rule 10b-5. Thus, ITSA theoretically merely (1) added authority for the Commission to seek civil penalties against persons engaged in unlawful insider trading of up to three times the amount of profits made or losses avoided by the person trading,96 and (2) extended insider trading prohibitions to option and other derivative instruments.97

However, several factors suggest that, in approving ITSA, Congress intended that Rule 10b-5 be given a more expansive application with respect to insider trading transactions than the Supreme Court has in Chiarella and Dirks. Indeed, one can assert with considerable force four points in support of the proposition that Congress intended that the courts follow principles closer in philosophy to the equal access/possession theories of pre-Chiarella cases98 than to the fiduciary type standard of Chiarella.99

The first point to be noted is the language of ITSA itself. The conduct which triggers the civil penalty provision of ITSA, now section 21(d)(2)(A) of the 1934 Act, is the purchase or sale of "a security while in the possession of material nonpublic information. . . ."100 There is no reference to any preexisting duty or fiduciary obligation, but merely to "possession" as the jurisdictional nexus. The extension of liability to purchasers or sellers of options or other derivative instruments also raises an inference that no preexisting duty or relationship is necessary to establish liability, since no fiduciary duty traditionally has been owed by corporate officers and directors to option and similar security holders.101

Secondly, the legislative history of ITSA makes little mention of fiduciary or other relationships; rather, it is replete with references to informational advantages and differences improperly obtained. The House Report quotes favorably from Brudney's masterful article:

The inability of a public investor with whom an insider trans­acts on inside information ever lawfully to erode the insider's infor-

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98. See supra notes 43-50 and accompanying text.
99. See supra notes 52-55 and accompanying text.
ational advantage generates a sense of unfairness. . . . The unfairness is not a function merely of possessing more information—outsiders may possess more information than other outsiders by reason of their diligence or zeal—but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which [other investors] cannot acquire access.¹⁰²

The comments of Representatives Wirth and Dingell on the floor of the House of Representatives stressed the importance of general public confidence in the securities markets and the "fundamental expectations of fairness and honesty," and characterized the conduct of those acting on inside information as "thieves."¹⁰³ Senator D'Amato argued in a similar vein on the Senate floor in support of ITSA:

Some commentators have called insider trading a victimless crime, however, I strongly disagree. The investor who trades with a person possessing nonpublic inside information is clearly at a severe informational disadvantage. In addition, the integrity of the market is violated, which results in a loss of investor confidence. John Fedders, the Director of the Securities and Exchange Commission's Division of Enforcement, has stated publicly that he believes that those who engage in insider trading are thieves, I concur wholeheartedly with Mr. Fedders.¹⁰⁴

The emphasis in the legislative deliberation thus was on the unjustness of the trader's profits and on the injuries suffered, both by shareholders directly and with respect to the integrity of and public confidence in the securities markets when insider trading occurs.

Thirdly, the circumstances existing at the time of ITSA's enactment suggest that both the Securities and Exchange Commission, which initially requested the legislation, and Congress anticipated that the Commission should not be restricted by the limitations imposed by the Supreme Court in the *Chiarella* and *Dirks* decisions. On one hand, *Chiarella* had been rendered moot by the Securities and Exchange Commission's subsequent promulgation of Rule 14e-3 under the more specific authority of the Williams Act provisions.¹⁰⁵ Conduct by persons in positions similar to *Chiarella* and *Materia* thus was in violation

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¹⁰⁵. The language of Rule 14e-3 is nearly identical to that of Rule 10b-5 except that the former applies specifically to misrepresentations, omissions, and other fraudulent practices in connection with tender offers. See 17 C.F.R. 240 14e 3.
of Rule 14e-3, and criminal and administrative sanctions could be im­
posed as a result of any such violations. Technically, therefore, Rule
10b-5 was not needed in order to impose appropriate sanctions on
traders such as Vincent Chiarella or Anthony Materia. On the other
hand, the Supreme Court's decision in Dirks, which was issued after
the initial hearings in ITSA but before its final enactment, initially did
raise concerns in the congressional committees. Thus, the House
Committee was prompted to request that the Commission make a fol­
low-up report to Congress on the impact, if any, of Dirks on the Com­
mission's subsequent enforcement activities.

Finally, several of the cases cited approvingly in the House and
Senate Reports as illustrative of the then current state of Rule 10b-5
are based upon broader concepts than the Supreme Court espoused in
Chiarella and Dirks. Thus the House Report cites several examples of
"the legal principles governing the smaller number of cases that in­
volve trading on market information that originates from sources
other than the company." These include Rule 14e-3, Newman (a
clear articulation of the misappropriation theory), and SEC v. Lund109
("temporary insider" liable for transaction based upon nonpublic in­
formation even though no preexisting duty).

The legislative history of ITSA suggests that the crucial inquiry is
one similar to that noted by Judge Stewart in Winans—was the infor­
mational advantage improperly obtained, that is, one which others
cannot obtain through lawful means or competition.110

VI. A RESTATE STANDARD

From the foregoing, we propose the following standard for the
imposition of insider or outsider trading liability: Whether a trader
realizes profits or avoids losses whenever trading on an informational
advantage that the trader knows others cannot obtain through lawful
means or competition. The objectives and interests to be served should
be clear from our prior discussion. The relevant questions remaining
at this point are: (1) Will this standard pass muster with the Supreme
Court? (2) Does such a standard address any more effectively the con­
cerns which spawned the limiting principles of Chiarella and Dirks?
(3) Is there really any need for such a refurbished standard?

We turn first to the question of whether our standard would pass muster with the Supreme Court. One might expect that a future defendant being subjected to this standard would claim, as did Winans, that the formulation is essentially the same as the parity of information standard rejected in Chiarella and Dirks. There are three appropriate responses to that argument. First, as Judge Stewart noted in his Winans decision, the focus is not on the disparity of informational advantage, but rather on how the defendant obtained such, that is, through wrongful conduct. Where a defendant obtains an informational advantage by his own effort and initiative and without acting wrongfully, that defendant will have no liability. Second, our standard is consistent with what the common law long has recognized as proper bases for an unjust enrichment claim, namely, where a person unfairly or in bad faith benefits from the infringement of another person's interest. Third, in its enactment of ITSA, Congress expressed specific views with respect to the policies underlying prohibitions on insider trading, indicating support and approval of doctrines and cases broader than those articulated in Chiarella and Dirks.

Another argument might utilize that concern which caused the Supreme Court to fashion the limiting principles articulated in Chiarella and Dirks, namely, the problem of linkage between the wrongful insider trading and the ascertainable amount of injuries suffered by others. Indeed, that problem is present even in the most traditional of insider-trading-type cases, that is, when a corporate officer or director trades on inside corporate information. It is a problem inherent in the fact that from a particular trading transaction three possible types of injuries may result, someone wrongfully will receive an unjust benefit, and none of these is necessarily mathematically related to any other. Two solutions suggest themselves, and neither is novel. In the first instance, where ascertainable damages are not claimed and/or cannot be shown, as, for example, in the Newman or Winans situations, we may continue not to recognize private actions but rely instead upon criminal and administrative sanctions to protect and carry out the intended objectives. Secondly, we can choose to

111. Id.
112. See supra note 38 and accompanying text.
113. See supra note 108 and accompanying text.
114. See supra text at notes 21-25.
115. This has been the approach followed generally with respect to cases brought under the misappropriation theory where the principal injury established was to the owner
measure damages in a manner consistent with the fourth interest under­lying insider trading prohibitions, namely, by restitution from the wrongdoer of the amount by which he has been unjustly enriched.

Reference to the principles of unjust enrichment and the law of restitution also may serve us well with respect to the Supreme Court’s concern for certainty and guidance to persons engaged in securities transactions as to when liability may attach. The concepts of unjust enrichment are not foreign or difficult to grasp; indeed, there is a great deal of legal doctrine developed from contract law which may help differentiate between persons acting properly and in good faith and persons knowingly exploiting an advantage improperly obtained. Furthermore, it seems to us that the emphasis on the propriety of the trader’s use and whether or not others have comparable opportunity to obtain the information should assure that the activities of financial analysis and other lawful market intermediaries will not be foreclosed or unfairly impinged upon.

Lastly, we come to the question of whether we need a reformu­lated standard. If the fiduciary standard of Chiarella works for most traditional insider cases, if Rule 14e-3 will cover most tender offer situations, and if the misappropriation theory can be applied in many other unique settings, why bother with any other standard? We suggest three brief responses. First, we submit that the alternative formulation proposed more directly reflects both the interest served by insider trading prohibitions and the historical common law remedies available to injured parties. By this we mean that an appropriate standard should focus as much on the improper conduct of the trader and the benefits unjustly received by him as it does on the parties and interests seeking to be protected. The fiduciary principle espoused in Chiarella, on the other hand, ignores both if the court can find no preexisting duty or relationship between the parties. Second, such a standard obviates the necessity for creating or rationalizing the existence of a relationship which has been breached as in some of the misappropriation cases. Finally, our standard may enable the

of the confidential information. See, e.g., Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983); contra the pending action instituted by Anheuser-Busch, Inc., against Paul Thayer supra note 22.

116. See supra text at notes 26-27.
118. Brudney discussed this matter at length in his 1979 article. While other issues raised by him were cited by the Supreme Court in the Chiarella and Dirks decisions, this part of his analysis was overlooked or disregarded. See Brudney, supra note 24, at 360-64.
Commission or a court to reach troublesome conduct which under either the fiduciary duty standard or the misappropriation theory would not be viewed as unlawful.

To illustrate this last point, we would recall the case decided two years ago of Barry Switzer, the University of Oklahoma head football coach.\textsuperscript{119} Switzer overheard, at a track meet, inside information about a corporation which was not intended for his use.\textsuperscript{120} Switzer recognized the information as material, nonpublic information and not only bought shares to profit personally on the information, but spread the tip to other business associates so they also could share in inside profits.\textsuperscript{121}

The information concerned the proposed liquidation of a publicly traded company engaged in oil and gas exploration. Prior to the dissemination of that information, the company's common stock was trading in the $39-$42 range; after the public announcement of the Board of Directors' intentions, the value of the stock increased first to $61 per share and subsequently to as high as $79 7/8. Switzer and the other persons who traded on the basis of the information realized aggregate profits of approximately $591,000.\textsuperscript{122}

The Oklahoma federal district court judge, applying the \textit{Chiarella} and \textit{Dirks} analysis, found no breach of duty by the insider who had been discussing the nonpublic information which Switzer overheard and concluded that none of the persons involved in the trading activities thus could be liable as tippees.\textsuperscript{123} That outcome is a classic example of the limitations and deficiencies of the fiduciary duty standard of \textit{Chiarella} and \textit{Dirks}.

Under the standard we propose above, persons in those circumstances would be found liable if and when they trade on information they know is material, nonpublic, and not intended for their own benefit. In other words, once a person is aware that he has an informa-

\textsuperscript{120} \textit{Id.} at 762. The Securities and Exchange Commission, the complaining party in the proceeding, obviously believed that Switzer's overhearing the information was not all that accidental, but rather that the information had been expressed aloud by the insider for Switzer's benefit. The Commission, however, was unable to support that belief with sufficient independent evidence. \textit{Id.} at 768.

Professor Aldave cites this case as an example of fortuitious discovery of insider information for which no sanctions would apply under existing theories of 10b-5 liability. Aldave, \textit{supra} note 11 at 122, n.115. We disagree and believe it represents an example of troublesome conduct that a broader formulation as to trading liability should cover.

\textsuperscript{121} \textit{Switzer}, 590 F. Supp. at 766. Court said that the plaintiffs had not proven that the defendant knew the information was material.
\textsuperscript{122} \textit{Id.}
\textsuperscript{123} \textit{Id.} at 766.
tional advantage which no other person then participating in the marketplace can duplicate through research or other lawful means, that person will be liable under the standard we propose.124

Evaluating Switzer's and similar outside traders' conduct in the context of the interests we have identified in this article, imposition of liability appears a most appropriate result. In the first instance, we can identify a known class of shareholders injured by the Switzer group's improper use of the inside information, that is, those persons on the opposite sides of the market transactions without either access to such information or any comparable opportunity to obtain the same. We know that those persons lost possible profits at least equal to those obtained by the quickly formed Switzer trading group, that is, at least $591,000. Secondly, we know that use of inside information in such a manner will tend to undermine public confidence in the integrity of the marketplace. Thirdly, and perhaps most significant in this instance, is the substantial enrichment of those trading on the inside information, the possession of which was not a result of their own effort, skill, or diligence, but, at best, of fortuitous circumstances or, at worst, of lack of care or intentional favoritism by an insider. The imposition of liability in such a circumstance thus would further the interests underlying prohibition on insider trading and still avoid impinging upon the activities of persons lawfully engaged in research, trading, or investment activities. It is regrettable that some lower courts, such as in the Switzer case, have chosen not to explore beyond the limits of the Chiarella and Dirks fiduciary duty standard. We hope that this article has laid out a logical and historically based means for doing so—with the ultimate objective that the outer limits of insider trading liability reach to all improper conduct.

124. As a practical matter, that probably means that a claim of "fortuitous discovery" of the information will afford no defense, so long as the person then traded with knowledge that the information was nonpublic, material, and afforded them a very distinct trading advantage over others.