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[M]isappropriation of information as the basis for insider trading liability is a theory in search of a rationalization.[1]

I. Introduction

Generally, insider trading occurs when a party to a securities transaction uses material nonpublic information in connection with a securities trade.[2] Congress has never codified an explicit definition of insider trading.[3] Rather, the Securities and Exchange Commission (SEC) uses the general antifraud provisions in Section 10(b) of the Securities Exchange

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1. HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 874 (1996).

2. *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1193 (1995) (providing overview of insider trading).

3. *See* Barbara B. Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALB. L. REV. 893, 897-900 (1988) (describing lack of any definition of insider trading in Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CAL. L. REV. 1, 2-3 (1982) (discussing insider trading and lack of statutory definition). Section 16(b) of the Securities Exchange Act of 1934, sometimes called the short-swing profit rule, precludes officers, directors, and ten-percent shareholders from profiting from securities transactions performed within six months of each other. Securities Exchange Act of 1934, ch. 404, § 16(b), 48 Stat. 881, 896 (current version at 15 U.S.C. § 78p(b) (1994)). However, § 16(b) is not comprehensive enough to prevent many fraudulent transactions. *See* Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 71-72 (1984) (criticizing § 16(b) as ineffective because it only covers officers, directors, and ten-percent shareholders and only applies to trades occurring within six months of each other).

Act of 1934[4] and Rule 10b-5[5] to enforce the prohibition against insider trading.[6]

Under the Section and the Rule, two methods of enforcement have developed: classical insider trading and the misappropriation theory.[7] A violation of classical insider trading is based on the relationship between the parties to the transaction.[8] A typical example of classical insider trading involves a corporate official[9] who trades in the corporation's shares on the

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4. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j(b) (1994)). Section 10(b) provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
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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 or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

5. 17 C.F.R. § 240.10b-5 (1995). Rule 10b-5 states that:

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

6. *See* Langevoort, *supra* note 3, at 2-3 (discussing how SEC enforces prohibition of insider trading by use of § 10(b) and Rule 10b-5). Professor Langevoort stated that because there is no explicit statutory prohibition against insider trading except for § 16(b), the use of § 10(b) and Rule 10b-5 for insider trading enforcement is of judicial and administrative origin. *Id.*

7. *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 187 (1991) (stating that there are two distinct bases of liability under antifraud provisions: (1) classical or traditional theory; and (2) misappropriation theory).

8. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980) (discussing fraud violation premised on relationship between parties to securities transaction). In *Chiarella*, the Supreme Court concluded that silence may be actionable under § 10(b) as a fraud. *Id.* However, liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.*

9. For purposes of this Note, a corporate official is an officer, director, or employee privy to confidential information because of her position with the corporation.

basis of material nonpublic information.[10] The corporate official owes a fiduciary duty both to the corporation and to the shareholders.[11] When the official obtains material confidential information because of her position and then trades in the shares of the company without disclosing that information, she has breached the fiduciary obligation owed to the shareholders.[12] Therefore, the explicit fraud requirements of Section 10(b) and Rule 10b-5 are satisfied because the corporate official owed a duty to disclose the confidential information or to abstain from trading in the shares of the corporation.[13]

Under the misappropriation theory of insider trading, however, a person may violate Section 10(b) regardless of the relationship between the parties to the securities transaction.[14] The misappropriation theory permits an individual to violate the antifraud provisions even though he does not owe a fiduciary duty to the other participant in the securities transaction.[15] The requisite fraud occurs when the violator misappropriates confidential information entrusted to him and he subsequently trades on the basis of that information.[16] The violator needs only to breach a relationship of trust in

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10. *See infra* text accompanying notes 134-52 (discussing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)). *Texas Gulf Sulphur* is a prime example of classic insider trading.

11. *See* ROBERT C. CLARK, CORPORATE LAW § 4.1, at 141 (1986) (discussing fiduciary duty owed by corporate officials). Clark stated that "[d]irectors, officers, and, in some situations, controlling shareholders owe their corporations, and sometimes other shareholders and investors, a fiduciary duty of loyalty. This duty prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions." *Id.*

12. *See Chiarella*, 445 U.S. at 227-30 (discussing breach of fiduciary duty between corporate officials and shareholders when officials trade on material nonpublic information).

13. *See* Fisch, *supra* note 7, at 187-89 (examining classical insider trading and companion disclose or abstain rule).

14. *See* SEC v. Clark, 915 F.2d 439, 443-44 (9th Cir. 1990) (discussing elements of misappropriation theory). The Ninth Circuit stated that:

> Generally speaking, the theory provides that Rule 10b-5 is violated when a person (1) misappropriates material non-public information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.

Id. at 443; *see also* David C. Bayne, *The Insider's Natural-Law Duty:* Chestman *and the 'Misappropriation Theory,'* 43 KAN. L. REV. 79, 87-88 (1994) (discussing how focus has shifted from relationship between parties to securities transaction to source of information under misappropriation theory).

15. *See Clark*, 915 F.2d at 443 (stating that existence of fiduciary duty between parties to securities transaction is not element of misappropriation theory).

16. *See* Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading*

obtaining the information to trigger a violation of the antifraud provisions.[17] For example, consider a corporate official who purchases shares of a second corporation knowing that his company recently awarded a large manufacturing contract to the second corporation. The official owes no duty of disclosure to the shareholders from whom he purchased the stock.[18] Therefore, the official would not violate Section 10(b) under classical insider trading because an affirmative duty to disclose did not exist between the parties.[19] However, under the misappropriation theory, the corporate official is guilty under Section 10(b) because the requisite fraud is found when the official misappropriates confidential information regarding the manufacturing contract and trades in the shares of the second company.[20]

Classical insider trading is a traditional and universally accepted method of enforcing the antifraud provisions of the Securities Exchange Act.[21] The misappropriation theory does not hold nearly as much esteem.[22] The

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on Nonpublic Information, 13 HOFSTRA L. REV. 101, 121 (1984) (discussing that requisite fraud for Rule 10b-5 violation occurs when violator improperly uses confidential information entrusted to him).

17. *See id.* (noting that violation occurs when perpetrator breaches duty of confidentiality in obtaining information).

18. *See* Fisch, *supra* note 7, at 200 (stating that fraud recognized under misappropriation theory is not based on duty to disclose or to abstain).

19. *See* SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984) (stating that question of affirmative duty of disclosure between parties to securities transaction is relevant only to private actions under Rule 10b-5 and is not relevant when determining contravention of Rule under misappropriation theory), *cert. denied*, 471 U.S. 1053 (1985).

20. *See* DONALD C. LANGEVOORT, INSIDER TRADING REGULATION 159 (1991) (stating that fraud occurs under misappropriation theory when violator uses confidential information entrusted to her).

21. *See* Chiarella v. United States, 445 U.S. 222, 226-30 (1980) (recognizing legitimacy of enforcement of § 10(b) and Rule 10b-5 premised on fiduciary obligation and relationship between parties to securities transaction); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-53 (2d Cir. 1968) (en banc) (finding that corporate officials using material nonpublic information violated antifraud provisions by breaching fiduciary duty when trading in corporation's stock), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 910-17 (1961) (finding that broker violated Rule 10b-5 by trading on material inside information given to him by member of company's board).

22. *See* Bayne, *supra* note 14, at 140-61 (criticizing misappropriation theory for, among other reasons, contorting precedent and distorting relationship between fraud and injury); Fisch, *supra* note 7, at 184 (criticizing entire doctrine of insider trading because it has developed on "ad hoc" basis); Phillips & Zutz, *supra* note 3, at 90-93 (stating that misappropriation theory has multiple problems including: (1) its emphasis on protecting employers, not investors; (2) its inconsistency with Dirks v. SEC, 463 U.S. 646 (1983); and (3) its inapplicability to private actions); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y

United States Court of Appeals for the Second Circuit and the SEC developed the misappropriation theory in the early 1980s[23] in response to the Burger Court's retraction of Section 10(b) securities fraud enforcement actions during the 1970s.[24] The relatively recent creation of the theory has gained acceptance only in the Second, Seventh, and Ninth Circuits.[25] In *United States v. Bryan*,[26] the Fourth Circuit Court of Appeals rejected the misappropriation theory outright.[27] This decision created a split in the courts of appeals and seriously questioned the validity of the misappropriation theory.

This Note analyzes the development of insider trading law culminating with *United States v. Bryan* and determines whether the misappropriation theory is a valid enforcement mechanism for Section 10(b) and Rule 10b-5. Part II discusses common-law fraud and its relationship to insider trading

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223, 233-53 (1992) (declaring misappropriation theory flawed under legal, economic, and ethical analysis). *But see* Aldave, *supra* note 16, at 102 (declaring that misappropriation provides convincing argument for finding violation of Rule 10b-5).

23. *See* SEC v. Materia, 745 F.2d 197, 201-02 (2d Cir. 1984) (affirming application of misappropriation theory), *cert. denied*, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12, 16-17 (2d Cir. 1981) (declaring that day had come for court to address violation of Rule 10b-5 for misappropriated information and subsequently adopting misappropriation theory), *cert. denied*, 464 U.S. 863 (1983).

24. *See* Carlos J. Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. CORP. L. 793, 807-08 (1988) (discussing Burger Court's retraction of use of § 10(b) and subsequent development of misappropriation theory).

25. *See* SEC v. Cherif, 933 F.2d 403, 408-10 (7th Cir. 1991) (stating that Rule 10b-5 can accommodate misappropriation theory and subsequently adopting theory), *cert. denied*, 502 U.S. 1071 (1992); SEC v. Clark, 915 F.2d 439, 449-53 (9th Cir. 1990) (stating that misappropriation theory fits comfortably within Rule 10b-5 and subsequently adopting theory); United States v. Newman, 664 F.2d 12, 16-19 (2d Cir. 1981) (adopting use of misappropriation theory), *cert. denied*, 464 U.S. 863 (1983). There is some question whether the Third Circuit has also adopted the theory. *See* Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985). The Third Circuit stated that a person violates Rule 10b-5 when he breaches a duty of confidentiality to a corporation. *Id.* However, the court did not directly adopt the misappropriation theory nor explicitly call it by name. *Id.*

26. 58 F.3d 933 (4th Cir. 1995).

27. *See* United States v. Bryan, 58 F.3d 933, 952 (4th Cir. 1995) (rejecting use of misappropriation theory). Elton Bryan worked for the State of West Virginia as the Director of the West Virginia Lottery (Lottery). *Id.* at 936. Bryan manipulated two contracts granted by the Lottery, one for advertising and one for the purchase of video lottery machines. *Id.* at 937-39. Using information entrusted to him, Bryan purchased shares in companies doing business with the Lottery before the public announcement of the contracts. *Id.* at 939. The United States District Court for the Southern District of West Virginia convicted Bryan on two counts of mail fraud, one count of wire fraud, one count of securities fraud, and one count of perjury. *Id.* at 936. The Fourth Circuit, rejecting the use of the misappropriation theory, affirmed all but the securities fraud conviction. *Id.* at 939-60.

enforcement.[28] Part III examines the Securities Act of 1933 and the Securities Exchange Act of 1934 and discusses the promulgation of Rule 10b-5 and subsequent judicial interpretation.[29] Part IV evaluates the expansion of SEC interpretation and application of Section 10(b) and Rule 10b-5.[30] Part V analyzes the Burger Court's retraction of the application of Section 10(b) and Rule 10b-5 as a reaction to the SEC's expansion.[31] Part VI explains the development of the misappropriation theory in the Second Circuit as a response to Supreme Court decisions.[32] Part VII studies the Fourth Circuit's rejection of the misappropriation theory in *United States v. Bryan*.[33] In conclusion, Part VIII advocates rejecting the use of the misappropriation theory.[34]

II. Insider Trading at Common Law

Before passage of the Securities Act of 1933[35] and the Securities Exchange Act of 1934,[36] actions for fraudulent nondisclosure were based on the common-law action of deceit.[37] However, an action in common-law deceit for fraudulent nondisclosure required a breach of an affirmative duty

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28. *See infra* notes 35-63 and accompanying text (discussing insider trading enforcement using common-law action of deceit).

29. *See infra* notes 64-99 and accompanying text (examining Securities Act of 1933, Securities Exchange Act of 1934, and Rule 10b-5).

30. *See infra* notes 100-59 and accompanying text (evaluating interpretation and expansion of § 10(b) and Rule 10b-5).

31. *See infra* notes 160-289 and accompanying text (analyzing Burger Court's interpretation of § 10(b) and Rule 10b-5 as retraction of application).

32. *See infra* notes 290-453 and accompanying text (explaining creation of misappropriation theory as response to Burger Court's retraction).

33. *See infra* notes 454-530 and accompanying text (studying rejection of misappropriation theory in United States v. Bryan, 58 F.3d 933 (4th Cir. 1995)).

34. *See infra* note 531 and accompanying text (advocating rejection of misappropriation theory for § 10(b) enforcement).

35. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

36. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1994)).

37. *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 106, at 737-38 (5th ed. 1984) (discussing fraudulent nondisclosure and its relationship to common-law deceit). The elements of common-law deceit are: (1) a false representation of a material fact, (2) made with scienter, (3) intended to cause reliance, (4) producing justifiable reliance that (5) causes damages. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977) (stating elements of common-law deceit).

to disclose.[38] A very limited number of circumstances created an affirmative duty to disclose.[39] For instance, a fiduciary obligation between the parties to a securities transaction created a duty to disclose.[40] Yet, courts had difficulty agreeing whether a fiduciary obligation existed between a corporation's officers and shareholders.[41] Three theories developed: the majority view, the minority view, and the "special facts" doctrine.[42]

The jurisdictions that subscribed to the majority view determined that corporate officials owed a fiduciary obligation to the corporation and to the shareholders only in the official's dealings with the corporation.[43] Corporate officials owed no fiduciary duty to shareholders involving transactions on an individual level.[44] The majority view assumed that shareholders had access to the corporate books.[45] This access gave the shareholders constructive knowledge of the corporation's inside information.[46] Therefore, corporate officials using material nonpublic information could trade freely in the shares of the corporation without any obligation to disclose the infor-

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38. *See* RESTATEMENT (SECOND) OF TORTS, *supra* note 37, § 551(1) (discussing liability for nondisclosure); KEETON ET AL., *supra* note 37, § 106, at 738-39 (discussing how breach of affirmative duty to disclose might trigger deceit action).

39. *See* W. Page Keeton, *Fraud — Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 11 (1936) (discussing exceptions to general rule of no duty to disclose).

40. *See* RESTATEMENT (SECOND) OF TORTS, *supra* note 37, § 551(2)(a) (stating that fiduciary relationship creates duty to disclose between parties to business transaction); KEETON ET AL., *supra* note 37, § 106, at 738-39 (same).

41. *See* 5 ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 2.01[b], at 1.12 (2d ed. 1991) (evaluating conflict in jurisdictions over whether fiduciary obligation existed between corporate officials and shareholders).

42. *See* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 768-70 (3d ed. 1995) (discussing majority view, minority view, and "special facts" doctrine that developed in various jurisdictions).

43. *See* Chenery Corp. v. SEC, 128 F.2d 303, 307-08 (D.C. Cir. 1942) (stating that officer is fiduciary to corporation but may still trade in shares of company). The court declared that "while directors occupy a trust relation to the corporation, the same relation does not exist as to stockholders — at least in the sale and purchase of their stock." *Id.* at 307.

44. *See* Goodwin v. Agassiz, 186 N.E. 659, 660-61 (Mass. 1933) (stating that no fiduciary duty existed between directors and shareholders in securities transactions); Crowell v. Jackson, 23 A. 426, 427 (N.J. 1891) (stating that prior to securities transaction, director is not bound to disclose to individual shareholder information that may affect value of shares).

45. *See* HOWARD H. SPELLMAN, PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS § 247, at 615 (1931) (stating that books are open to shareholders for inspection and noting that shareholders may form their own opinions regarding proper value of corporation's shares).

46. *See id.* (discussing opportunity for shareholders to examine corporate books).

mation to the shareholders.[47]

The minority view developed in response to the majority view in those jurisdictions that disagreed with the majority view's willingness to allow corporate officials to use material nonpublic information in securities trades.[48] The minority view courts determined that officers and directors were "quasi-trustees" of the shareholders' interests.[49] Under the minority view, a fiduciary obligation existed between the corporate officers and the shareholders.[50] Therefore, the minority view jurisdictions required corporate officials to disclose all material information prior to trading in the shares of the corporation with a present shareholder.[51]

In *Strong v. Repide*,[52] the Supreme Court developed a third view: the special facts doctrine.[53] This theory occupied a middle ground between the

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47. *See* LOSS, *supra* note 42, at 768 (stating that directors were free to trade in corporation's shares without disclosure in those jurisdictions adopting majority view).

48. *See* HENRY W. BALLANTINE, BALLANTINE ON CORPORATIONS § 80, at 212-13 (rev. ed. 1946) (discussing how minority of courts considered majority theory lax because majority theory did not protect trading public). Ballantine stated that the majority rule "may be criticized as a rule of unconscionable laxity." *Id.* at 213.

49. *See* Hotchkiss v. Fischer, 16 P.2d 531, 534-35 (Kan. 1932) (comparing corporate directors to trustees). The court noted that "[i]t is commonly said that directors of a corporation are 'trustees' for stockholders." *Id.* at 535; *see also* Oliver v. Oliver, 45 S.E. 232, 233-34 (Ga. 1903) (comparing corporate directors to trustees). The court stated that "the director is, in a most important and legitimate sense, trustee for the stockholder. Not a strict trustee, . . . but a quasi trustee as to the shareholder's interest in the shares." *Id.* (citation omitted).

50. *See Hotchkiss*, 16 P.2d at 535 (stating that corporate officers are fiduciaries). The court declared that "[d]irectors act in a fiduciary capacity in management of corporate affairs, and a director negotiating with a shareholder for purchase of shares acts in a relation of scrupulous trust and confidence." *Id.*

51. *See* BALLANTINE, *supra* note 48, § 80, at 213 (discussing minority view and fiduciary obligation that existed between officers and shareholders); Langevoort, *supra* note 3, at 5 (discussing existence of fiduciary obligation between officers and shareholders that created affirmative duty to disclose).

52. 213 U.S. 419 (1909).

53. *See* Strong v. Repide, 213 U.S. 419, 431 (1909) (stating that corporate director has duty to disclose prior to securities transactions if certain special facts exist). In *Strong*, the Supreme Court considered a fraud claim concerning a corporate director who purchased shares of the same company. *Id.* at 428-35. The plaintiff, Eleanor Erica Strong, owned 800 shares of the Philippine Sugar Estates Development Company (Philippine Sugar Estates). *Id.* at 421. The defendant, Repide, controlled three-quarters of the stock and was also one of the five directors of the company. *Id.* The board elected Repide the agent and administrator general of the company, granting him "exclusive intervention in the management" of the corporation. *Id.* In 1903, Repide, as administrator general of Philippine Sugar Estates, entered into negotiations with the United States to sell land the company owned in the Philippines for a considerable sum. *Id.* at 424. Repide did not inform the other

limited disclosure of the majority view and the full disclosure of the minority view.[54] The existence of certain special facts not discernible from the company's books created an affirmative duty between corporate officials and shareholders to disclose material nonpublic information prior to stock transactions.[55] Such special facts might include a merger, an acquisition, or any other important activity involving the corporation.[56] The catalyst of the securities transaction — the special facts — created the affirmative duty to disclose.[57]

Eventually, the application of the three theories blurred.[58] Jurisdictions that claimed to follow the majority view began to follow the special facts

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shareholders about the negotiations. *Id.* The property in the Philippines was the company's only asset of substantial value. *Id.* at 425. In September 1903, Repide, through an agent, approached Strong concerning the availability of her 800 shares for purchase. *Id.* Repide's agent and Strong's agent reached an agreement on October 10, 1903. *Id.* at 426. Repide's agent never mentioned the prospective land sale to the United States. *Id.* The purchase price for the 800 shares was $16,000 in Mexican currency. *Id.* On December 21, 1903, Repide and the United States agreed to terms for the land owned by Philippine Sugar Estates. *Id.* at 424. Repide obtained the 800 shares from Strong at one-tenth the price the shares were worth after the consummation of the land sale. *Id.* at 426. The Court found that Repide committed fraud by failing to disclose the land negotiations prior to the purchase of Strong's stock. *Id.* at 433-34. The Court stated that there are certain special facts regarding the value of the shares that create a duty to disclose before a director purchases shares from a stockholder. *Id.* at 431. The possible land sale to the United States constituted a special fact that might affect the value of the shares, and therefore, Repide acted fraudulently in his failure to disclose this information to Strong prior to the securities transaction. *Id.* at 431-34. The Court stated that "[i]f under all these facts he purchased the stock from the plaintiff, the law would indeed be impotent if the sale could not be set aside or the defendant cast in damages for his fraud." *Id.* at 433.

54. *See* LOSS, *supra* note 42, at 769-70 (discussing special facts doctrine as intermediate position between majority and minority views).

55. *See Strong*, 213 U.S. at 431-32 (discussing certain special facts that create obligation to disclose). The Supreme Court stated that:

> If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists.

Id. at 431.

56. *See* BALLANTINE, *supra* note 48, § 80, at 213 (discussing special circumstances that created fiduciary obligation between officers and shareholders).

57. *See Strong*, 213 U.S. at 431 (discussing special facts that created affirmative duty to disclose between officer and shareholder).

58. *See* LOSS, *supra* note 42, at 770 (discussing merging of majority, minority, and special facts doctrines).

doctrine.[59] Courts increasingly began to describe the special facts doctrine in terms indistinguishable from the minority view.[60] Yet, a few salient requirements remained constant. First, if a cognizable claim in deceit for fraudulent nondisclosure involving a securities transaction existed, it required the breach of a fiduciary obligation between the corporate official and the shareholder.[61] Second, regardless of which view the jurisdiction applied, the corporate official was under no obligation to disclose if the transaction occurred on a stock exchange.[62] Finally, the corporate official owed no duty, regardless of the jurisdiction, to the opposite party of the transaction if that party was not a shareholder.[63]

III. The Securities Act of 1933, Securities Exchange Act of 1934, and Rule 10b-5

Congress enacted the Securities Act of 1933[64] (Securities Act) and the Securities Exchange Act of 1934[65] (Exchange Act) in the wake of the disastrous 1929 stock market crash.[66] The insufficient protection that the common

59. *See id.* (discussing how courts that had previously adopted majority view started using part of special facts doctrine).

60. *See id.* (stating that original special facts doctrine became very similar to minority view as courts expanded circumstances that created special facts causing companion duty to disclose).

61. *See* Keeton, *supra* note 39, at 11 (discussing requirement of fiduciary duty for cognizable action in deceit for fraudulent nondisclosure).

62. *See* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (stating that heavy burdens might discourage people from taking corporate office). The court stated that:

> Purchases and sales of stock dealt in on the stock exchanges are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules.

Id.; JACOBS, *supra* note 41, § 2.01[b], at 1.14 (discussing unavailability of action for fraudulent nondisclosure if transaction occurred on securities exchange).

63. *See* 3 LOUIS LOSS, SECURITIES REGULATION 1455 (2d ed. 1961) (discussing absence of duty to disclose if party opposite corporate official is not already shareholder).

64. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

65. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1994)).

66. *See* S. REP. NO. 792, 73d Cong., 2d Sess. 3-5 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 17 (J. Ellenberger & E. Maher comp. 1973) (discussing necessity of legislative action

law provided to investors necessitated federal legislation.[67] The Securities Act concerns the registration of publicly distributed securities,[68] while the Exchange Act regulates postdistribution securities market transactions.[69] Congress designed the statutes to promote market integrity and to increase market participant confidence.[70] The Supreme Court has stated that "[a] fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[71] Consistent with these objectives, Congress included antifraud provisions both in the Securities Act and in the Exchange Act.[72] The sections relevant to

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because of margin accounts, insider trading, failure of corporations to publish true nature of financial condition, and rampant speculation prior to October 1929 crash). The Senate report stated that:

> By the development of the margin account, a great many people have been induced to embark upon speculative ventures in which they were doomed to certain loss. The unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs, and the failure of corporations to publish full and fair reports of their financial conditions, have also been contributing causes of losses to investors.

Id. at 3.

67. *See* Cuevas, *supra* note 24, at 795 (noting unsuitability of common-law fraud as adequate remedy for insider trading on impersonal markets).

68. *See* LOSS, *supra* note 42, at 34 (stating that Securities Act requires registration with SEC of distributions of securities).

69. *See id.* (stating that Exchange Act targeted postdistribution trading). Professor Loss also stated additional goals of the Exchange Act:

> [T]he 1934 Act from the beginning has had three other themes: (1) regulation of the exchange and over-the-counter markets; (2) prevention of fraud and market manipulation; and (3) control of securities credit by the Board of Governors of the Federal Reserve System as part of its authority over the Nation's credit generally.

Id.

70. *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 2-5 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 18 (J. Ellenberger & E. Maher comp. 1973) (discussing need to regulate securities exchanges to cure defects that caused 1929 crash and to keep pace with modern trends).

71. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

72. Securities Act of 1933, ch. 38, § 11, 48 Stat. 74, 82 (current version at 15 U.S.C. § 77k (1994)); Securities Act of 1933, ch. 38, § 12, 48 Stat. 74, 84 (current version at 15 U.S.C. § 77*l* (1994)); Securities Act of 1933, ch. 38, § 17(a), 48 Stat. 74, 84 (current version at 15 U.S.C. § 77q(a) (1994)); Securities Exchange Act of 1934, ch. 404, § 9, 48 Stat. 881, 889 (current version at 15 U.S.C. § 78i (1994)); Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j(b) (1994)); Securities Exchange Act of 1934, ch. 404, § 15, 48 Stat. 881, 895 (current version at 15 U.S.C. § 78o

insider trading are Section 17(a)[73] of the Securities Act and Sections 10(b)[74] and 16(b)[75] of the Exchange Act. Section 17(a) affects only the seller of securities and, therefore, has a limited application.[76] Section 16(b)'s reach is also limited because it affects only officers, directors, or majority shareholders that profit from short-swing trades.[77] Because of its broad language, Section 10(b) of the Exchange Act therefore became the primary enforcement mechanism to enforce the prohibition against insider trading.[78]

Congress included an important provision in Section 10(b) as a corollary to the antifraud language. This provision authorizes the SEC to promulgate rules in the public interest or for the protection of investors.[79] Pursuant to this power, the SEC promulgated Rule 10b-5[80] in 1942.[81] The SEC modeled

(1994)); Securities Exchange Act of 1934, ch. 404, § 16(b), 48 Stat. 881, 896 (current version at 15 U.S.C. § 78p(b) (1994)).

73. Securities Act of 1933, ch. 38, § 17(a), 48 Stat. at 84 (current version at 15 U.S.C. § 77q(a) (1994)).

74. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. at 891 (codified at 15 U.S.C. § 78j(b) (1994)).

75. Securities Exchange Act of 1934, ch. 404, § 16(b), 48 Stat. at 896 (current version at 15 U.S.C. § 78p(b) (1994)).

76. *See* Securities Act of 1933, ch. 38, § 17(a), 48 Stat. at 84 (current version at 15 U.S.C. § 77q(a) (1994)) (limiting prohibition of fraud to sellers of securities, not purchasers).

77. *See* Securities Exchange Act of 1934, ch. 404 § 16(b), 48 Stat. at 896 (current version at 15 U.S.C. § 78j(b) (1994)) (prohibiting officers, directors, and majority shareholders from profiting on short-swing trades). A short-swing trade is a buy/sell or sell/buy occurring within six months of each other. An individual may violate this section in two ways: First, if the violator purchases shares and then sells the stock within six months at a profit, a violation occurs because of the actual profit. Second, if the violator sells shares prior to a decrease in price and then the violator buys the stock back within six months, a violation occurs because the violator owns the same stock but he has obtained a residual profit.

78. *See* Langevoort, *supra* note 3, at 2-3 (stating that modern law of insider trading developed under § 10(b) and Rule 10b-5).

79. *See supra* note 4 (providing text of § 10(b)).

80. 17 C.F.R. § 240.10b-5 (1995); *see supra* note 5 (providing text of rule 10b-5).

81. *See* SEC Release No. 3230 (May 21, 1942). Milton Freeman, present at the promulgation of Rule 10b-5, tells of the Rule's inception:

> It was one day in the year [1942], 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 Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the SEC 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

Rule 10b-5 after Section 17(a) of the Securities Act but extended Section 17(a)'s prohibition of fraud beyond "sellers" of securities to "purchasers,"[82] thereby curing Section 17(a)'s deficiency in coverage.[83] The SEC wrote Rule 10b-5 in very broad terms, and like the enabling statute, the Rule does not expressly prohibit insider trading.[84] Rather, the SEC uses the Rule's general antifraud provisions to enforce the prohibition against insider trading.[85]

Early decisions interpreting Rule 10b-5 did little to clarify the confusion surrounding actions based on fraudulent nondisclosure.[86] However, two

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> for this coming year. Is there anything we can do about it?" So he came upstairs and I called 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 calender, 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?" That is how it happened.

A.B.A. Sec. of Corp., Banking & Bus. Law, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 921-23 (1967), *reprinted in* LOSS, *supra* note 42, at 777.

82. *See* Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952) (stating that SEC attempted, by promulgating Rule 10b-5, to make prohibitions in § 17(a) of Securities Act applicable to purchasers). The *Birnbaum* court explained that "the Commission's adoption of Rule X-10B-5, shows that the Commission was attempting only to make the same prohibitions contained in Section 17(a) of the 1933 Act applicable to purchasers as well as to sellers." *Id.*

83. *See id.* (discussing extension of "sellers" requirement to "purchasers"). The court stated that "the SEC adopted Rule X-10B-5 to close this 'loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.'" *Id.* (quoting SEC Release No. 3230 (May 21, 1942)).

84. *See supra* note 5 (providing text of Rule 10b-5).

85. *See* Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465, 466-67 (1990) (stating that Rule 10b-5 became predominant tool for use against insider trading).

86. *See* Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 201 (5th Cir. 1960) (stating that common law does not limit Rule 10b-5), *cert. denied*, 365 U.S. 814 (1961). The court stated that the Rule "greatly expands the protection frequently so hemmed in by the traditional concepts of common-law misrepresentation and deceit . . . ." *Id.*; *see also* Connelly v. Balkwill, 174 F. Supp. 49, 59 (N.D. Ohio 1959) (stating that common law does not limit Rule 10b-5), *aff'd*, 279 F.2d 685 (6th Cir. 1960) (per curiam). The *Connelly* court noted that:

> It is not inconsistent with the view that Rule X-10b-5 cannot be limited by common-law standards of deceit to say that the duty to speak which is imposed

important cases demonstrated the continued prevalence of fraudulent nondisclosure based on the breach of a fiduciary relationship.[87] In *Kardon v. National Gypsum Co.*,[88] the United States District Court for the Eastern District of Pennsylvania found that directors violated Rule 10b-5 when they purchased shares of the corporation without disclosing material nonpublic information.[89] In finding for the plaintiffs, the court determined that "the broad terms of the [Exchange] Act are to be made effective in a case like the present one through application of well known and well established equitable principles governing fiduciary relationships."[90] The court found that the defendants breached this fiduciary relationship, thereby committing Rule

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> by the rule derives from those principles of equity which have enlarged the area of recovery for fraudulent conduct beyond the narrow limits and rigid requirements of the old common-law action of deceit.

Id.; *see also* Tobacco and Allied Stocks, Inc. v. Transamerica Corp., 143 F. Supp. 323, 327 (D. Del. 1956) (stating that Rule 10b-5 is founded on common-law fraud), *aff'd*, 244 F.2d 902 (3d Cir. 1957); Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del.) (extending Rule 10b-5 to cover majority shareholders by using principles of equity, fiduciary obligation, and "special circumstances"), *supplemented*, 100 F. Supp. 461 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, 803 (E.D. Pa.) (discussing how application of traditional principles of fiduciary relationships aid in enforcement of Exchange Act), *modified*, 83 F. Supp. 613 (E.D. Pa. 1947).

87. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del.) (discussing existence of fiduciary duty creating duty to disclose), *supplemented*, 100 F. Supp. 461 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, 803 (E.D. Pa.) (stating that breach of fiduciary relationship in securities context violates Exchange Act), *modified*, 83 F. Supp. 613 (E.D. Pa. 1947).

88. 73 F. Supp. 798 (E.D. Pa. 1947).

89. *See Kardon*, 73 F. Supp. at 803 (discussing how breach of affirmative duty to disclose is violation of Exchange Act). In *Kardon*, the court found a violation of Rule 10b-5 when two directors of a closely held corporation purchased the outstanding shares from the other shareholders without disclosing a prearranged sale of the company's assets. *Id.* at 800-02. The plaintiffs, Morris and Eugene Kardon, and the defendants, Leon and William Slavin, were equal co-owners in Western Board and Paper Company. *Id.* at 800. All sat on the board of directors and were officers of the company. *Id.* On March 18, 1946, the Slavins purchased the Kardons' shares for $504,000. *Id.* at 801. Prior to the consummation of the stock sale, Leon Slavin had covertly arranged to sell Western Board and Paper Company's plant and equipment to National Gypsum Company for $1,500,000. *Id.* at 800. Slavin never mentioned the proposed asset sale to National Gypsum during negotiations for the purchase of the Kardons' stock. *Id.* at 801. The court found that the defendants violated Rule 10b-5 and explained that "[u]nder any reasonable liberal construction, these provisions [of Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction." *Id.* at 800.

90. *Id.* at 803.

10b-5 fraud by purchasing the shares without disclosing information regarding the sale of the company.[91]

In *Speed v. Transamerica Corp.*,[92] the United States District Court for the District of Delaware examined a Rule 10b-5 claim involving a majority shareholder who purchased a minority stockholder's shares without disclosing material nonpublic information known only because of majority status.[93] In deciding for the minority stockholder, the court relied both on a breach of fiduciary obligation and on principles of equity.[94] The district court

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91. *See id.* at 802 (finding violation of Rule 10b-5). The court stated that:

> The plaintiffs' case was established when the defendants' duty and its breach were proved. This was done by showing that the defendants were officers and directors of Western and that they disposed of the bulk of the corporate assets to an outsider, for their own benefit, without disclosing the transaction to the plaintiffs or giving them an opportunity to participate in it.

Id.

92. 99 F. Supp. 808 (D. Del. 1951).

93. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 828-33 (D. Del.) (evaluating minority shareholder Rule 10b-5 claim against majority), *supplemented*, 100 F. Supp. 461 (D. Del. 1951). In *Speed*, the court considered a Rule 10b-5 claim against majority shareholders who purchased shares of the minority without disclosing information affecting the value of the shares known only to the majority by virtue of their position. *Id.* at 816-32. The plaintiff, William S. Speed, was a minority shareholder in Axton-Fisher Tobacco Company (Axton). *Id.* at 812. Transamerica, the defendant, was the majority shareholder of Axton. *Id.* On November 12, 1942, Transamerica offered to purchase Class A shares of Axton for $40 and Class B shares for $12. *Id.* Speed subsequently sold his shares to Transamerica. *Id.* Transamerica offered to purchase the shares knowing that Axton's inventory was significantly undervalued. *Id.* Transamerica gained this information by its position as majority shareholder. *Id.* The true value of the shares was more than $200 for Class A shares and over $100 for Class B shares. *Id.* Transamerica desired to profit from the stock purchase by eventually merging with Axton or dissolving the corporate assets for their true value. *Id.* The court found that Transamerica violated Rule 10b-5 by purchasing the minority's shares without disclosing the true value of the stock. *Id.* at 828-29. The court wrote that:

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.

Id.

94. *See id.* at 829 (relying on principles of fiduciary duty and fairness). The court stated that:

> The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority shareholders. It is an attempt to provide some degree of equalization in bargaining position in order that the minority may exercise an informed judgment in any such

extended fiduciary obligations beyond the traditional scope of directors and corporate officials to include majority stockholders.[95] Although the court found that the majority shareholder had a duty to disclose and partially based its decision on principles of fairness, fraudulent nondisclosure based on the existence of a fiduciary relationship still formed the foundation of its finding a Rule 10b-5 violation.[96]

Although courts interpreted the scope and limitations of Rule 10b-5 differently, the concept of a fraudulent nondisclosure violation based on a fiduciary relationship remained somewhat consistent.[97] Absent the breach of an affirmative duty to disclose based on a fiduciary duty, courts were unlikely to find a Rule 10b-5 violation.[98] If the SEC wanted to fully effectuate the "any person" prohibition described in Rule 10b-5,[99] then an expansion of insider trading law was necessary.

IV. Expansion of Rule 10b-5 Interpretation

The first significant expansion of Section 10(b) and Rule 10b-5 application occurred in the seminal case of *In re Cady, Roberts & Co.*[100] Robert M. Gintel was a partner and a selling broker of the firm Cady, Roberts & Co.[101] From early November 1959 through November 23, 1959, Gintel purchased approximately eleven thousand shares of Curtis-Wright Corporation stock for accounts Gintel represented.[102] On November 24, 1959, press reports circulated concerning a new type of internal-combustion engine developed by Curtis-Wright.[103] On the same day, the stock closed three and one-

> transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the "special circumstances." One of the primary purposes of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78a et seq., was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders.

Id.

95. *See id.* (stating that Rule 10b-5 violation occurs when majority shareholders purchase shares from minority stockholders without disclosing material facts).

96. *See id.* (discussing how fiduciary duty creates affirmative duty to disclose).

97. *See* Phillips & Zutz, *supra* note 3, at 74 (stating that early cases relied on fiduciary duty to create affirmative duty to disclose).

98. *See id.* (finding that fiduciary duty requirement remained important).

99. *See supra* note 5 (providing text of Rule 10b-5).

100. 40 S.E.C. 907 (1961); *see* Bayne, *supra* note 14, at 93 (stating that "*Cady, Roberts* is undoubtedly the bellwether of the modern law of Insider Trading").

101. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 908 (1961).

102. *Id.*

103. *Id.*

quarter points higher, at 35 1/4.[104] Slowly, Gintel began to sell off some of the Curtis-Wright shares.[105] While Gintel proceeded to sell, the stock price continued to increase, and the stock reached a high of 40 3/4 on the morning of November 25th.[106] Also on November 25th, the Curtis-Wright board of directors met to discuss the declaration of a quarterly dividend.[107] In the first three quarters of 1959, Curtis-Wright had paid a dividend of $0.625 per share.[108] Nevertheless, the board decided to pay a dividend of only $0.375 for the fourth quarter.[109] J. Cheever Cowdin was a director of Curtis-Wright and also a representative of Cady, Roberts & Co.[110] After the board decided on the fourth quarter dividend and prior to the public announcement of the reduction, Cowdin telephoned Cady, Roberts & Co. and left Gintel a message informing him of the reduced dividend.[111] Gintel discovered the message prior to the public announcement of the dividend cut and entered a sell order of two thousand shares and a short-sell order of five thousand shares of Curtis-Wright stock.[112] Curtis-Wright shares closed at 34 7/8 on November 25, 1959.[113]

Chairman Cary began the SEC opinion by stating that the antifraud provisions "are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common-law action for fraud and deceit."[114] The Commissioner found that, regarding misrepresentations, Rule 10b-5 applied to "any person," as the Section and Rule state, regardless of the identity of the perpetrator.[115] Cary continued, however, by stating that corporate insiders,

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104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 909.
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.* at 910.
114. *Id.*
115. *See id.* at 911 (stating that "any person" may violate antifraud provisions if based on actual misrepresentation). The Commission stated that:

> Section 17 and Rule 10b-5 apply to securities transactions by "any person." Misrepresentations will lie within their ambit, no matter who the speaker may be. An affirmative duty to disclose material information has been traditionally imposed on corporate "insiders," particularly officers, directors, or controlling shareholders. We, and the courts have consistently held that insiders must disclose material facts

"particularly officers, directors, or controlling shareholders,"[116] traditionally possessed an affirmative duty of disclosure.[117] This affirmative duty was a "special obligation" of corporate insiders.[118] However, these three groups of corporate insiders were not the only individuals with this special obligation of disclosure.[119] A two-element analysis determined whether this heightened duty applied to other parties.[120] The first element examined the existence of a relationship granting access to corporate information, and the second element studied the inherent unfairness of informational disadvantage.[121]

The SEC concluded that Gintel violated Rule 10b-5 and Sections 10(b) and 17(a) when he sold Curtis-Wright shares prior to the public announcement of the dividend cut.[122] Cary determined that Gintel possessed characteristics similar to individuals classified as corporate insiders.[123] The SEC stated that Cowdin's status as a board member clearly prohibited him from selling Curtis-Wright shares prior to the announcement of the dividend cut.[124] By extension, the SEC reasoned that Gintel gained insider status because of a relationship providing him with confidential information, and accordingly, this relationship precluded Gintel from selling Curtis-Wright shares.[125]

> which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the antifraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

Id.

116. *Id.*

117. *See id.* (discussing heightened duty of affirmative disclosure for corporate insiders).

118. *See id.* at 912 (evaluating "special obligation" of corporate insiders).

119. *See id.* (discussing others who possess special obligation of disclosure).

120. *See id.* (stating two-element evaluation for special obligation status).

121. *See id.* (describing two-element evaluation). Chairman Cary stated that:

> [T]he 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.

Id.

122. *Id.* at 911.

123. *Id.* at 912.

124. *Id.*

125. *Id.*

In re Cady, Roberts & Co. produced several developments in Section 10(b) interpretation and its relation to insider trading enforcement. The SEC expanded the group of persons who possess an affirmative duty to disclose confidential information.[126] Traditionally, only corporate insiders possessed this special obligation.[127] After the *Cady, Roberts* decision, individuals normally not considered insiders who satisfied the two-part analysis possessed an affirmative duty of disclosure.[128] This idea was progressive for two reasons: First, the two-part analysis contained a fairness component.[129] The SEC's decision to partly base an affirmative obligation to disclose on concepts of fairness had a tremendous impact on subsequent insider trading enforcement actions.[130] Second, the SEC found a violation of the antifraud provisions despite the absence of a fiduciary relationship between Gintel and the Curtis-Wright stock purchasers.[131] The determination that a violation of the antifraud provisions had occurred notwithstanding the lack of a fiduciary duty was a departure from prior Rule 10b-5 decisions.[132] *In re Cady, Roberts & Co.* was a revolutionary case for securities fraud enforcement and provided the framework for further expansion of the insider trading doctrine.[133]

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126. *See id.* (discussing expansion of class of individuals possessing special obligation).

127. *See id.* (stating that corporate insiders traditionally possess special obligation).

128. *See id.* (providing how non-insider may possess special obligation).

129. *See id.* (stating that second element of special obligation analysis examines fairness).

130. *See* Bayne, *supra* note 14, at 105 (stating that fairness element of *Cady, Roberts* had tremendous impact on insider trading law); Cuevas, *supra* note 24, at 800 (noting that *Cady, Roberts* was first case to extend Rule 10b-5 to non-insiders).

131. *See* Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 794 (1988) (discussing lack of fiduciary duty between Gintel and purchasers). In *Cady, Roberts*, the SEC rejected arguments that Gintel did not owe a duty of disclosure because of a lack of fiduciary duty. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911-13 (1961). Chairman Cary determined that Gintel possessed the special obligation of an insider because he satisfied the two-part analysis. *Id.* at 911. It did not matter that Gintel defrauded purchasers instead of present shareholders of Curtis-Wright. *Id.* at 913. The SEC stated that:

> Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader antifraud concepts embodied in the securities acts.

Id. at 913-14.

132. *See* Mitchell, *supra* note 131, at 794 (claiming that violation without companion breach of fiduciary duty is substantial break with past interpretations of Rule 10b-5).

133. *See id.* at 789 (stating importance of *Cady, Roberts*). Mitchell stated that "[t]he

In *SEC v. Texas Gulf Sulphur Co.*,[134] the United States Court of Appeals for the Second Circuit expanded the policies and guidelines delineated in *Cady, Roberts*.[135] Texas Gulf Sulphur Co. (TGS) performed mineral exploration in eastern Canada beginning in 1957.[136] In March 1959, aerial geophysical surveys detected unusual conductivity in a tract of land near Timmins, Ontario (the Kidd 55 segment).[137] On November 8, 1963, exploratory drilling of the Kidd 55 segment began at drill hole K-55-1.[138] The extraordinary mineral results of K-55-1 convinced TGS executives to acquire the entire Kidd 55 tract and to keep the information confidential, even from other TGS employees, officers, and directors.[139] After the acquisition of the entire tract in March 1964, TGS completed several more exploratory holes, all with similarly outstanding results.[140] Finally, on April 16, 1964, TGS publicly disclosed the discovery of a mineral strike of at least twenty-five million tons of ore — a very substantial amount — on the Kidd 55 tract.[141]

During the period between the mineral discovery on the Kidd 55 tract and the public announcement of the ore strike, several TGS directors purchased TGS shares or stock call options without disclosing the ore strike to the seller.[142] TGS officials also relayed information about the Kidd 55 strike to third parties, who subsequently traded on the basis of that information.[143] The price of TGS shares rose from 18 points on Friday, November 15, 1963,

importance of this opinion cannot be underestimated, because it served as the keystone for the development of both the Supreme Court's and the Second Circuit's jurisprudential approaches." *Id.*

134. 401 F.2d 833 (2d Cir. 1968) (en banc).

135. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (expanding on *Cady, Roberts*), *cert. denied*, 394 U.S. 976 (1969); John F. Olson et al., *Recent Insider Trading Developments: The Search for Clarity*, 85 NW. U. L. REV. 715, 720 (1991) (stating that *Texas Gulf Sulphur* expanded on SEC's analysis in *Cady, Roberts*); Phillips & Zutz, *supra* note 3, at 75 (stating that Second Circuit adopted and expanded on *Cady, Roberts* approach).

136. *Texas Gulf Sulphur*, 401 F.2d at 843.

137. *Id.*

138. *Id.*

139. *Id.* The court stated that "[t]hese results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit." *Id.*

140. *Id.* at 844.

141. *Id.* at 846.

142. *Id.* at 840-46. A call option is a contract in which the bearer may purchase a fixed number of particular shares from the seller at a set price on or before a certain date. *Id.* at 841 n.3.

143. *Id.* at 840-44.

to 36 3/8 points on April 16, 1964, the day of the Kidd 55 mineral deposit announcement.[144] The share price reached 58 1/4 points by May 15, 1964.[145]

The SEC claimed multiple violations of Section 10(b) and Rule 10b-5, and brought an action against TGS and several of its officers, directors, and employees.[146] The Second Circuit evaluated the complaint, expanded on the SEC's interpretation given in *Cady, Roberts*, and found several violations of Rule 10b-5.[147] According to the court, the proposition that all investors should have "relatively equal access to material information" formed Rule 10b-5's foundation.[148] The appellate court based a substantial amount of its reasoning on *Cady, Roberts*, but went beyond the SEC's definition of an insider and expanded the SEC's application of the Rule.[149] Under the Second Circuit's analysis, Rule 10b-5 required *anyone* possessing material inside information, regardless of its origin, to disclose that information or to refrain from trading.[150] The court determined that the *Cady, Roberts* "disclose or abstain" rule[151] did not go far enough, and consequently, the court of appeals

144. *Id.* at 847.

145. *Id.*

146. *Id.* at 839.

147. *See id.* at 848 (discussing and expanding on interpretation of § 10(b) and Rule 10b-5 given by Chairman Cary in *Cady, Roberts*).

148. *See id.* (evaluating policy behind Rule 10b-5). The court stated that:

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

Id. (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).

149. *Compare* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (stating that group covered by Rule 10b-5 extends beyond traditional group of insiders to anyone possessing material inside information), *cert. denied*, 394 U.S. 976 (1969) *with In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (stating that insiders are composed of group of traditional insiders, i.e., officers, directors, controlling shareholders, and individuals with relationships granting them access to material confidential corporate information).

150. *See Texas Gulf Sulphur*, 401 F.2d at 848 (analyzing application of Rule 10b-5). The court stated that, under the Rule:

> [*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.

Id. (emphasis added).

151. *See Cady, Roberts*, 40 S.E.C. at 911 (stating that insiders must disclose material

extended the Rule's application to anyone who possessed material inside information.[152]

After *Cady, Roberts* and *Texas Gulf Sulphur*, the application of Rule 10b-5 evolved from determining how the violator obtained the information to an analysis of the information itself.[153] If the perpetrator possessed material nonpublic information and did not disclose or abstain from trading, a Rule 10b-5 violation would occur regardless of the source of the information, whether it occurred on an exchange, or whether it occurred in the absence of a fiduciary duty.[154] The Second Circuit's progressive rule is commonly termed the "parity of information" or "equal access" theory.[155] The impetus behind this approach was "the plight of the buying public — wholly unprotected from the misuse of special information."[156] This theory radically departed from the common law and was a substantial evolution from the pre-*Cady, Roberts* interpretation of Rule 10b-5.[157] Subsequent cases affirmed this new interpretation.[158] However, this novel approach lasted only until the Supreme Court established that a breach of an affirmative duty to disclose between parties to a securities transaction must occur prior to finding a Rule 10b-5 violation based on fraudulent nondisclosure.[159]

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information or abstain from trading).

152. *See Texas Gulf Sulphur*, 401 F.2d at 848 (stating that anyone, not just someone strictly termed "insider," must disclose material inside information or abstain from trading); Cuevas, *supra* note 24, at 801 (naming *Texas Gulf Sulphur* as landmark case because it applied Rule 10b-5 to nontraditional insiders).

153. *See* Mitchell, *supra* note 131, at 778 (discussing competing approaches to Rule 10b-5 interpretation and concluding that *Texas Gulf Sulphur* epitomizes possession approach).

154. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (extending duty to disclose or to abstain to anyone, not just insiders), *cert. denied*, 394 U.S. 976 (1969).

155. *See* Bainbridge, *supra* note 2, at 1194 (claiming that "*Texas Gulf Sulphur* rested on a policy of equality of access to information"); Bayne, *supra* note 14, at 111 (stating that *Texas Gulf Sulphur* rule "has now become the somewhat pejorative 'parity of information theory'").

156. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961); *see supra* notes 129-33 and accompanying text (discussing fairness element of *Cady, Roberts* analysis).

157. *See* Phillips & Zutz, *supra* note 3, at 78 (claiming that Second Circuit tremendously broadened scope of insider trading enforcement).

158. *See generally, e.g.*, United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978) (supporting disclose or abstain requirement delineated in *Texas Gulf Sulphur*), *rev'd*, 445 U.S. 222 (1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (same); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972) (same).

159. *See* Chiarella v. United States, 445 U.S. 222, 228-36 (1980) (establishing breach

V. Retraction of Rule 10b-5 Application

Beginning in the mid-1970s, the Supreme Court limited the scope of Section 10(b) and Rule 10b-5 liability created by the broad interpretation of the SEC and the Second Circuit.[160] In each of the following cases, the Court reverted back to the statutory language and consistently held that fraud, determined by the language of Section 10(b),[161] must exist before a violation of Rule 10b-5 occurs.[162] The Court repeatedly refused to consider vague notions of fairness or ethics, and stated that Section 10(b) was not a regulatory mandate to enforce the SEC's interpretation of fairness in business transactions.[163]

A. Blue Chip Stamps v. Manor Drug Stores

In *Blue Chip Stamps v. Manor Drug Stores*,[164] the Supreme Court held that only actual purchasers or sellers had standing to bring a private damages action under Rule 10b-5.[165] Justice Rehnquist, writing for the majority,

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of fiduciary duty between parties to securities transaction as requisite for Rule 10b-5 violation for nondisclosure).

160. *See* Cuevas, note 24, at 801-03 (discussing how Supreme Court limited application of Rule 10b-5).

161. *See supra* note 4 (providing text of § 10(b)).

162. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 153 (1995) (stating that Court consistently required showing of fraud for § 10(b) violation).

163. *See id.* at 152 (claiming that Court refused to apply "business ethics" to circumvent statutory mandate).

164. 421 U.S. 723 (1975).

165. *See* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (holding that only purchasers or sellers had standing to bring private action under Rule 10b-5). In *Blue Chip Stamps*, the Supreme Court considered whether a private plaintiff possessed standing to bring a Rule 10b-5 action against a seller even though the plaintiff did not purchase any stock. *Id.* at 727. Blue Chip Stamp Company (Blue Chip) sold trading stamps wholesale to retailers. *Id.* at 725. Pursuant to a consent decree reached after the United States filed a civil antitrust complaint against Blue Chip, the company offered a substantial amount of its shares to retailers who did not own stock prior to the antitrust action. *Id.* at 726. Prior to the offering, Blue Chip prepared and distributed a prospectus to all offerees. *Id.* Manor Drug Stores (Manor Drug), a stamp retailer, received a prospectus but did not purchase any Blue Chip stock. *Id.* at 727. Two years after the offering, Manor Drug brought a Rule 10b-5 action against Blue Chip claiming that the prospectus contained material misleading information about the future of Blue Chip. *Id.* at 726. Manor Drug alleged that Blue Chip intentionally deceived stamp retailers in hopes that they would not purchase Blue Chip stock so that Blue Chip could later sell the shares on the open market for a premium. *Id.* The Supreme Court held that only purchasers or sellers may maintain a private

noted that Rule 10b-5 was "a judicial oak which has grown from little more than a legislative acorn."[166] The importance of *Blue Chip Stamps* stems from the Court's restrictive approach to Rule 10b-5 interpretation. The Court granted standing for a Rule 10b-5 civil action only to purchasers or sellers and thereby eliminated three groups of potential plaintiffs.[167] The Court removed these plaintiffs from Rule 10b-5 civil actions notwithstanding the inherent unfairness of denying them a remedy and concluded that considerations of statutory interpretation, legislative choices, precedent, and policy dictated this restrictive ruling.[168] Although *Blue Chip Stamps* primarily concerned questions of standing, it is an important decision because of its restrictive ruling and its rejection of fairness as a principal consideration.[169]

B. Ernst & Ernst v. Hochfelder

In *Ernst & Ernst v. Hochfelder*,[170] the Supreme Court considered whether a plaintiff could bring a private cause of action under Section 10(b) and Rule 10b-5 for negligent nonfeasance rather than fraud.[171] Finding it

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Rule 10b-5 action. *Id.* at 749. The Court relied on and accepted the rule of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), which states that only actual purchasers or sellers can bring a private Rule 10b-5 action (*Birnbaum* rule). *Id.* at 730-49. The Court also considered: (1) historical interpretations that Rule 10b-5 does not have an explicit private right of action; (2) that when Congress desired to give others besides purchasers and sellers a right to action it did so expressly; and (3) the concern over vexatious litigation. *Id.* at 728-49.

166. *Id.* at 737.

167. *See id.* at 737-38 (discussing possible plaintiffs excluded from bringing Rule 10b-5 action because of Court's acceptance of *Birnbaum* rule). The three groups excluded from bringing a private Rule 10b-5 action include: (1) potential purchasers of shares who are dissuaded because of a gloomy prospectus; (2) actual shareholders who do not sell; and (3) shareholders or creditors who lost value due to activities that violate Rule 10b-5. *Id.*

168. *See id.* at 728-54 (discussing reasons why Court applied *Birnbaum* rule).

169. *See id.* at 732-35 (stating that specific wording of § 10(b) and language of other sections of Securities Act and Exchange Act require rule that Rule 10b-5 plaintiffs be actual purchasers or sellers because Congress explicitly provided same right to others in different situations).

170. 425 U.S. 185 (1976).

171. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (discussing whether negligence is proper basis for Rule 10b-5 action). In *Hochfelder*, the Supreme Court considered a Rule 10b-5 claim against an accounting firm that represented a brokerage house which defrauded investors. *Id.* at 188-214. Ernst & Ernst, an accounting firm, represented the brokerage firm of First Securities Company of Chicago (First Securities). *Id.* at 188. Leston B. Nay, the owner of 92% of First Securities stock, perpetrated a fraud on investors by inducing them to invest in high-yield accounts. *Id.* at 189. In reality, the accounts did not exist and Nay purloined the funds for his own use. *Id.* Nay committed the fraud

important to determine the meaning of "any manipulative or deceptive device,"[172] the Court began its analysis with an evaluation of the language of Section 10(b).[173] The Court stated that the particular language of the statute "strongly suggest[s] that [Section] 10(b) was intended to proscribe knowing or intentional misconduct."[174] After rejecting the SEC's arguments, the Court determined that the language of Section 10(b) "clearly connotes intentional misconduct."[175] Concluding its statutory analysis, the Court then considered the statute's legislative history to determine whether support existed for predicating a Rule 10b-5 action on negligence.[176] Finding no support in the legislative history for such a claim, the Court determined that only willful or intentional misconduct could form the basis of a Rule 10b-5 action.[177]

Hochfelder is an important decision for Section 10(b) analysis. The Court rejected an "effects" oriented approach.[178] The SEC, in an amicus curiae brief, argued that the Court should allow a Rule 10b-5 action to proceed based on negligence because of the *effect* that negligence has on investors.[179] The SEC claimed that the Rule's purpose was to protect the public, regardless of whether the conduct was intentional or negligent, because of the similar effect both had on the public.[180] Finding the SEC's

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between 1942 and 1966. *Id.* Final discovery occurred in 1968, after Nay's suicide. *Id.* The investors brought a Rule 10b-5 action against Ernst & Ernst and claimed that the accounting firm aided and abetted Nay's fraud by its failure to perform proper audits. *Id.* The plaintiffs' cause of action rested on negligent nonfeasance. *Id.* The Supreme Court, in an opinion authored by Justice Powell, held that Rule 10b-5 and § 10(b) require a showing of willful or intentional conduct. *Id.* at 199-201. The Court relied on the plain language of the statute and the lack of any legislative history granting relief based on negligence. *Id.* at 197-214. The Supreme Court determined that Congress fully intended that a § 10(b) violation requires willful or intentional conduct and concluded that Rule 10b-5 could not exceed the statutory mandate. *Id.*

172. *See id.* at 197 (discussing meaning of "manipulative or deceptive device").

173. *Id.* (stating that "[t]he starting point in every case involving construction of a statute is the language itself" (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring))); *see supra* note 4 (providing text of § 10(b)).

174. *Hochfelder*, 425 U.S. at 197.

175. *Id.* at 201.

176. *See id.* at 201-14 (analyzing legislative histories of Securities Act and Exchange Act).

177. *See id.* (finding no support for plaintiff's claim and holding that Rule 10b-5 action requires willful or intentional misconduct).

178. *See id.* at 197-99 (rejecting Commission's "effects" approach).

179. *See id.* at 198 (discussing effects approach).

180. *See id.* (claiming purpose of effects approach was to protect public). The Court

argument illogical and stretched beyond the statute's plain meaning, the Court completely rejected the effects approach.[181]

The importance of the Court's rejection of the effects oriented approach cannot be overstated. First, concern over the effects of trading on material nonpublic information drove the fairness element in *Cady, Roberts*[182] and resulted in Rule 10b-5's expansion in *Texas Gulf Sulphur* to include "anyone," not simply corporate insiders.[183] Second, the Court's refusal to stray from the statutory underpinnings gives *Hochfelder* additional importance.[184] The Court began its analysis with the statute[185] and refused to grant Rule 10b-5 an application beyond the organic statute's scope.[186] The refusal to accept the SEC's effects approach and the Court's consistent statutory interpretation provided important precedent for later decisions interpreting the Rule and its application.

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stated that "[t]he Commission then reasons [in its amicus curiae brief] that since the 'effect' upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally." *Id.*

181. *See id.* 198-99 (rejecting effects approach). The Court asserted that:

> The logic of the effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.

Id.

182. *See supra* notes 129-33 and accompanying text (discussing fairness element of *Cady, Roberts* decision).

183. *See supra* notes 148-52 and accompanying text (discussing expansion of Rule 10b-5 in *Texas Gulf Sulphur* to include persons not normally considered traditional insiders).

184. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-201 (1976) (basing decision primarily on statutory interpretation).

185. *See supra* note 173 and accompanying text (noting that Court begins analysis with statute).

186. *See Hochfelder*, 425 U.S. at 213-14 (confining Rule 10b-5 application to limits of § 10(b)). The Court stated that:

> The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute." Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).

Id. at 214 (quoting Dixon v. United States, 381 U.S. 68, 74 (1965)).

C. *Santa Fe Industries v. Green*

In *Santa Fe Industries v. Green*,[187] the Supreme Court considered the scope of Section 10(b) and Rule 10b-5 in the context of a corporation that performed a Delaware short-form merger intended to eliminate the minority shareholders.[188] The Court did not find Santa Fe Industries (Santa Fe) liable under Rule 10b-5 because Santa Fe did not engage in any manipulative or deceptive practices.[189] Even assuming the truth of the minority shareholders' allegations concerning the grossly undervalued share price, the Court refused to find a Rule 10b-5 violation based on Santa Fe's conduct.[190] A detailed statutory analysis, similar to *Hochfelder*'s analysis, formed the basis of the opinion.[191] The Court began by stating that the language of Section 10(b) determines the meaning of fraud under Rule 10b-5.[192] The underlying statute, Section 10(b), requires a "manipulative or deceptive device or contrivance in contravention"[193] of SEC rules.[194]

187. 430 U.S. 462 (1977).

188. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 464-65 (1977) (presenting question of application of Rule 10b-5 in context of Delaware short-form merger). In *Santa Fe Industries*, the Supreme Court held that absent a specific showing of intentional misconduct, minority shareholders had no recourse under Rule 10b-5 when majority shareholders executed a proper Delaware short-form merger. *Id.* at 474-77. Santa Fe Industries (Santa Fe) acquired 95% ownership of Kirby Lumber Corp. (Kirby), a Delaware corporation, by 1973. *Id.* at 465. In 1974, Santa Fe, wishing to own all of Kirby's stock, performed a short-form merger. *Id.* A Delaware short-form merger allows a company owning at least 90% of a subsidiary company to merge the subsidiary into the first company. *Id.* The short-form merger requires neither the notice nor the approval of the minority shareholders. *Id.* However, the majority must notify the minority within 10 days and offer to buy the minority's shares. *Id.* If the minority is dissatisfied with the offer, they may petition the Delaware Court of Chancery for review. *Id.* Santa Fe offered $150 per share to the minority after an appraisal valued the stock at $125 per share. *Id.* at 466. The minority believed that the proper value was $772 per share. *Id.* at 467. However, they did not ask for review in Delaware but brought an action under Rule 10b-5 in federal district court. *Id.* The complaint asserted that Santa Fe wanted to freeze out minority shareholders, to obtain a fraudulent appraisal of Kirby's worth, and to mislead minority shareholders. *Id.* The Supreme Court found that Santa Fe did not violate Rule 10b-5. *Id.* at 480. The Court relied on a statutory analysis and determined that the short-form merger was neither deceptive nor manipulative. *Id.* at 473-74. See § 253 of Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 253 (1974 & Supp. 1982), for the short-form merger procedure.

189. *See Santa Fe*, 430 U.S. at 473-74 (finding Santa Fe not liable under Rule 10b-5).

190. *See id.* (noting Santa Fe's conduct did not violate Rule 10b-5).

191. *See id.* at 471-77 (analyzing § 10(b) in detail).

192. *See id.* at 472 (stating that § 10(b) language, particularly words "manipulative" and "deceptive," defines fraud under Rule 10b-5).

193. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified

Therefore, a fraudulent act within Rule 10b-5 requires manipulation or deception.[195] The Court did not find that Santa Fe's behavior established a Rule 10b-5 violation because Santa Fe did not engage in any manipulative or deceptive practices.[196]

The *Santa Fe* decision continued the Burger Court's restrictive interpretation of Rule 10b-5.[197] The Court again performed a detailed statutory analysis, and the limited interpretation of fraud under the Rule — defined as "manipulative or deceptive" — formed the basis of the decision.[198] Concerns for marketplace fairness and business ethics were again subordinate to the statutory language of Section 10(b).[199]

D. Chiarella v. United States

In the watershed case of *Chiarella v. United States*,[200] the Supreme Court considered the application of Rule 10b-5 and Section 10(b) to a financial printer who used material nonpublic information obtained through his employment to trade in the shares of companies that were targets of tender offers.[201] Vincent Chiarella worked for Pandick Press, a printer of financial documents.[202] Chiarella processed documents relating to corporate takeover bids.[203] These documents had blank spaces where the company names were to later appear, but Chiarella discerned the applicable companies

at 15 U.S.C. § 78j(b) (1994)); *see supra* note 4 (providing text of § 10(b)).

194. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1976) (stating that "the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute").

195. *See id.* (defining fraud under Rule 10b-5 as manipulation or deception).

196. *See id.* at 474 (stating that Santa Fe did not commit violation of Rule 10b-5).

197. *See* Kenny & Thebaut, *supra* note 162, at 154-55 (stating that Court once again refused to stray from statutory language of Rule 10b-5 and did not want to creatively adjudicate where Congress did not legislate).

198. *See Santa Fe*, 430 U.S. at 474 (finding no manipulative or deceptive behavior and concluding that no violation of Rule 10b-5 occurred).

199. *See id.* at 473 (analyzing statute and congressional intent). The Court stated that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception. Nor have we cited any evidence in the legislative history that would support a departure from the language of the statute." *Id.*

200. 445 U.S. 222 (1980).

201. *See* Chiarella v. United States, 445 U.S. 222, 224-38 (1980) (considering whether Rule 10b-5 applied to employee who obtained information regarding tender offers of other corporations through his employment).

202. *Id.* at 224.

203. *Id.*

from other information.[204] After determining the target company, Chiarella then purchased shares of that company and subsequently sold the stock after the takeover offer became public.[205] The transactions produced a profit of over $30,000 in fourteen months.[206] The SEC initiated an investigation and Chiarella agreed to a consent decree in May 1977.[207] In January 1978, the United States indicted Chiarella on seventeen counts of violating Rule 10b-5 and Section 10(b).[208] The district court convicted Chiarella on all counts and the Second Circuit affirmed the decision.[209]

Justice Powell, writing for the Supreme Court, began the analysis with the language of the statute.[210] However, Justice Powell noted that the statutory language did not explicitly address the situation presented.[211] The difficulty arose because the statute did not address "whether silence may constitute a manipulative or deceptive device."[212] Lacking any reliable guidance from legislative history,[213] Justice Powell proceeded to examine precedent and the common law.[214]

Justice Powell recognized that the SEC took an important step in *Cady, Roberts* when it declared that a corporate insider must disclose material nonpublic information or refrain from trading.[215] According to the Court's interpretation of *Cady, Roberts*, the relationship that grants access to special nonpublic information creates the affirmative duty of disclosure.[216] The Court

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204. *Id.*

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.* Section 32(a) authorizes criminal penalties for violations of the Exchange Act. Securities Exchange Act of 1934, ch. 404, § 32(a), 48 Stat. 881, 904 (current version at 15 U.S.C. § 78ff(a) (1994)).

209. Chiarella v. United States, 445 U.S. 222, 225 (1980).

210. *See id.* at 225-26 (beginning analysis with language of § 10(b)).

211. *See id.* at 226 (noting that statute did not expressly cover whether silence constitutes violation of § 10(b) and Rule 10b-5).

212. *See id.* (stating that § 10(b) fails to mention silence as manipulative or deceptive device).

213. *See id.* (noting failure of legislative history to provide assistance in evaluating silence as manipulative or deceptive device).

214. *See id.* (using prior case law and common law to answer question whether silence may be fraud).

215. *See id.* at 226-27 (recognizing *Cady, Roberts* decision as important and discussing disclose or abstain rule).

216. *See id.* at 227-28 (claiming special relationship created affirmative obligation in *Cady, Roberts*). The Court stated that "[i]n its *Cady, Roberts* decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation

then compared the *Cady, Roberts* interpretation with the common law and decided that each comported with the other.[217] Finding common-law fraud for nondisclosure required a breach of an affirmative duty to speak.[218] A fiduciary relationship or other relationship of trust creates an affirmative duty to disclose.[219] The Court then asserted that, in *Cady, Roberts*, the SEC found such a relationship of trust between a company's shareholders and insiders who possessed material nonpublic information, and that the SEC subsequently declared that this relationship created an affirmative duty of disclosure.[220] Justice Powell briefly discussed federal precedent and concluded that past decisions required a similar finding that a claim of fraudulent nondisclosure could exist only upon a breach of an affirmative duty to disclose.[221] Finally, the Court stated that a cognizable claim for Section 10(b) fraudulent nondisclosure required the breach of an affirmative duty of disclosure arising from a relationship of trust and confidence between the securities transaction's participants.[222]

The Court applied this analysis to Chiarella's actions and reversed the conviction.[223] Chiarella did not possess an affirmative duty to disclose the

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and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose . . . ." *Id.* at 228.

217. *See id.* at 227-28 (discussing common-law rule and how special relationship creates affirmative duty to disclose material information).

218. *See id.* (evaluating affirmative duty of disclosure at common law). The Court stated that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." *Id.* at 228; *see also supra* notes 35-63 and accompanying text (discussing fraudulent nondisclosure at common law).

219. *See* Chiarella v. United States, 445 U.S. 222, 228 (1980) (stating that fiduciary relationship or other relationship of trust creates obligation to disclose); *supra* notes 35-63 and accompanying text (discussing creation of affirmative duty of disclosure at common law).

220. *See Chiarella*, 445 U.S. at 228 (asserting that SEC found special relationship between shareholders and insiders that created duty to disclose).

221. *See id.* at 229-30 (discussing federal precedent and concluding that party must possess affirmative duty of disclosure for valid claim of fraudulent nondisclosure to exist).

222. *See id.* at 230 (stating test for actionable fraudulent nondisclosure claim under § 10(b)). The Court delineated the test, and stated that:

> [A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between* parties to a transaction.

Id. (emphasis added).

223. *See id.* at 231-35 (reversing Chiarella's conviction).

tender offer information to the sellers of the securities.[224] There was a complete lack of a fiduciary relationship or other relationship arising from trust and confidence between Chiarella and the sellers that would have created an affirmative duty of disclosure.[225] The Court determined that it could not affirm Chiarella's conviction without creating a general duty for all market participants to refrain from trading on material nonpublic information.[226] Concluding its discussion, the Court summarized its important holding that Section 10(b) actions for fraudulent nondisclosure require a breach of an affirmative duty to disclose created by a fiduciary relationship or another relationship of trust and confidence.[227]

In reversing Chiarella's conviction, the Court rejected the Second Circuit's analysis[228] for two reasons.[229] First, the Court noted that "not every instance of financial unfairness constitutes fraudulent activity under [Section] 10(b)."[230] This statement repudiates the second element of the *Cady, Roberts* analysis and the policies underlying the equal access theory in *Texas Gulf Sulphur*.[231] Further, the Court stated that "neither the Congress nor the Commission has ever adopted a parity-of-information rule"[232] and that to do so would impose a general duty on all market participants to disclose or to abstain.[233] The second deficiency in the Second Circuit's analysis stemmed from the absence of any relationship between Chiarella and the sellers that required an affirmative duty to

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224. *See id.* at 232 (noting absence of duty to disclose nonpublic information).

225. *See id.* (finding that Chiarella was not fiduciary, agent, or other person who obtained trust and confidence of sellers).

226. *See id.* at 233 (refusing to adopt general duty of disclosure for all market participants).

227. *See id.* at 234-35 (summarizing Court's holding). The Court concluded that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.*

228. *See id.* at 231-33 (rejecting reasoning of Second Circuit). The Second Circuit, in affirming the conviction, held that "*[a]nyone* — corporate insider or not — who regularly receives material inside information may not use that information to trade in securities without incurring an affirmative duty to disclose." *Id.* (quoting United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980)).

229. *See id.* at 232 (stating that Second Circuit's analysis suffered for two reasons).

230. *Id.*

231. *See supra* notes 126-59 and accompanying text (discussing *Cady, Roberts* and *Texas Gulf Sulphur*).

232. Chiarella v. United States, 445 U.S. 222, 233 (1980).

233. *See id.* (discussing how affirming Second Circuit would require general duty to disclose).

disclose.[234] The Court reiterated its finding that Rule 10b-5 fraud occurs only from a breach of an affirmative duty of disclosure and stated that Chiarella did not commit fraud because he had no duty to disclose.[235] Because the Second Circuit based its decision on the equal access theory and principles of fairness, rather than on a breach of an affirmative duty between securities transaction parties, the Supreme Court reversed Chiarella's conviction.[236]

Chiarella is an extremely important decision in the development of insider trading enforcement law under Rule 10b-5.[237] The Supreme Court repudiated the Second Circuit's equal access theory[238] and established that a Rule 10b-5 violation cannot occur unless a party to a securities transaction breaches an affirmative duty to disclose created by a fiduciary relationship or by another relationship of trust and confidence.[239] After *Chiarella*, the development and application of insider trading enforcement has come full circle, returning to the common-law principle of a securities fraud claim for nondisclosure based on the breach of an affirmative duty between parties to a securities transaction.[240]

Chiarella is also an important decision because the misappropriation theory has its genesis in Chief Justice Burger's dissenting opinion.[241] The Government offered the Supreme Court an alternative and original theory — later named the "misappropriation theory" — that Chiarella violated Rule 10b-5 when he breached a duty that he owed to his employer and to the

234. *See id.* at 232 (noting that Chiarella's conviction was incorrect even though no duty to disclose existed).

235. *See id.* at 232-33 (stating that Chiarella could not have committed fraud because he had no relationship with sellers creating affirmative duty to disclose).

236. *See id.* at 232 (stating that Second Circuit decision "rested solely upon its belief that the federal securities laws have 'created a system providing equal access to information necessary for reasoned and intelligent investment'" and then overruling Second Circuit (quoting United States v. Chiarella, 588 F.2d 1358, 1362 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980))). As a result of the Court's decision in *Chiarella*, the SEC promulgated Rule 14e-3, which prohibits certain conduct in relation to tender offers. 17 C.F.R. § 14e-3 (1995) (prohibiting certain behavior relating to tender offers).

237. *See* Cuevas, *supra* note 24, at 804 (describing *Chiarella* as "landmark decision").

238. *See* Chiarella v. United States, 445 U.S. 222, 232 (1980) (discussing and rejecting Second Circuit's parity of information analysis).

239. *See id.* at 230 (discussing requirement that party breach affirmative duty of disclosure for actionable Rule 10b-5 claim based on fraudulent nondisclosure).

240. *See* Aldave, *supra* note 16, at 104 (stating that Court considers fraud under Rule 10b-5 identical to fraud under common law); Phillips & Zutz, *supra* note 3, at 86 (noting that insider trading doctrine has come full circle).

241. *See Chiarella*, 445 U.S. at 239-45 (Burger, C.J., dissenting) (advocating upholding Chiarella's conviction under Rule 10b-5 on theory that he defrauded his employer).

acquiring company.[242] Because the district court did not present this new theory to the jury, the Court refused to consider whether the theory would support a conviction.[243] However, the Court made a special point to note that it did not accept, reject, or pass judgment on the merits of this new theory.[244]

Chief Justice Burger did, however, support a conviction of Chiarella under the Government's alternative theory.[245] Chief Justice Burger took an expansive view of Section 10(b) and Rule 10b-5, and stated that a "person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[246] Regardless of any duty between the parties to the transaction, Chief Justice Burger found that "these provisions reach *any* person engaged in *any* fraudulent scheme."[247] It is not clear where this blanket duty originates. Chief Justice Burger based his interpretation of Rule 10b-5 on principles of fairness[248] and the assertion that misappropriated information grants an undue trading advantage serving no useful purpose.[249] Chief Justice Burger did not explain how a breach of a duty to disclose arising from the source of the information — such as a breach to an employer — becomes an act of fraud committed *between* parties to a securities transaction.[250] This omission notwithstanding, Chief Justice

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242. *See id.* at 235-37 (discussing alternative theory offered as basis of Chiarella's conviction). The Government argued that Chiarella:

> [B]reached 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. The breach of this duty is said to support a conviction under § 10(b) for fraud perpetrated upon both the acquiring corporation and the sellers.

Id. at 235-36.

243. *See id.* at 235-37 (refusing to uphold conviction under new theory because jury did not consider it).

244. *See id.* at 236-37 (reserving judgment on new theory). The Court stated that it would "not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)." *Id.*

245. *See id.* at 239-45 (Burger, C.J., dissenting) (discussing how application of new theory would support conviction of Chiarella).

246. *Id.* at 240 (Burger, C.J., dissenting).

247. *Id.* (Burger, C.J., dissenting).

248. *See id.* at 241-42 (Burger, C.J., dissenting) (stating that purpose of antifraud provision is to assure fair dealing and citing *Cady, Roberts* for its two-element analysis partly based on fairness).

249. *See id.* at 241 (Burger C.J., dissenting) (stating that undue trading advantage serves no useful function).

250. *See id.* at 239-45 (Burger, C.J., dissenting) (omitting explanation of origin of duty to disclose between parties to securities trade).

Burger supported Chiarella's conviction under Rule 10b-5 and stated that Chiarella "misappropriated — stole, to put it bluntly — valuable nonpublic information entrusted to him in the utmost confidence"[251] and subsequently traded on that information.[252]

E. Dirks v. SEC

In *Dirks v. SEC*,[253] the Supreme Court considered tippee[254] liability under Section 10(b) and Rule 10b-5.[255] Raymond L. Dirks specialized in analyzing and providing information to institutional investors concerning insurance company securities.[256] On March 6, 1973, a former employee of Equity Funding of America (Equity Funding), a large insurance company, informed Dirks of the company's fraudulent corporate practices.[257] Dirks began an investigation of Equity Funding and contacted several members of senior management and subordinate employees.[258] The senior employees denied any fraud, but the subordinate employees corroborated the former employee's allegations.[259] While performing the investigation, Dirks discussed the fraud allegations with clients and investors.[260] Several investors liquidated their holdings in Equity Funding.[261] During the two-week investigation, the stock price fell from $26 per share to less than $15 per share, causing the New York Stock Exchange to stop trading in that stock on March 27th.[262] California authorities discovered the fraud, and the SEC subsequently filed a complaint against Equity Funding.[263] However, the SEC also examined Dirks's role in exposing the fraud and, after an administrative hearing, found that Dirks aided and abetted violations of Section 17(a) of

251. *Id.* at 245 (Burger, C.J., dissenting).

252. *See id.* (Burger, C.J., dissenting) (supporting conviction of Chiarella for violating Rule 10b-5).

253. 463 U.S. 646 (1983).

254. A tippee is an individual who receives material inside information from another person, the tipper.

255. *See* Dirks v. SEC, 463 U.S. 646, 648-68 (1983) (evaluating tippee liability under Rule 10b-5).

256. *Id.* at 648.

257. *Id.* at 649.

258. *Id.*

259. *Id.*

260. *Id.*

261. *Id.*

262. *Id.* at 650.

263. *Id.*

the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.[264] The SEC posited a theory of tippee liability in which Dirks received and then repeated inside information about the fraud to investors who subsequently traded on that information.[265] Dirks appealed to the United States Court of Appeals for the District of Columbia Circuit, which also ruled against him.[266] However, the Supreme Court granted a petition for certiorari and reversed the court of appeals.[267]

The Court began its analysis by discussing and strongly affirming the *Chiarella* holding:[268] Only a breach of a duty to disclose arising from a relationship between parties to a securities transaction violates Rule 10b-5's prohibition against fraudulent nondisclosure.[269] However, the SEC, finding that Dirks violated Rule 10b-5, had primarily relied on the equal access theory repudiated in *Chiarella*.[270] The Court found that the SEC had acted incorrectly by relying on the theory and refused to lend any merit to the equal access theory.[271] Noting that the SEC had difficulty in applying the *Chiarella* analysis to tippees,[272] the Court created a test for tippee liability under Rule 10b-5.[273]

The Court stated that the "tippee's duty to disclose or abstain is derivative from that of the insider's duty."[274] Therefore, the Court found that a tippee does not always possess a duty to disclose simply because he receives inside information from a corporate official.[275] However, there are some instances when a tippee acquires a duty to disclose or to abstain.[276] Under such circumstances, the first inquiry is whether the insider has breached his fiduciary duty to the corporation in passing the information to the tippee and

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264. *Id.* at 650-51.

265. *Id.* at 651.

266. *Id.*

267. *Id.*

268. *See id.* at 653-58 (discussing and affirming *Chiarella* holding).

269. *See id.* (restating *Chiarella* holding).

270. *See id.* at 655-57 (stating that SEC followed discredited equal access or parity of information theory rejected in *Chiarella*).

271. *See id.* (refusing to follow SEC interpretation).

272. *See id.* at 655 (noting that SEC had difficulty applying *Chiarella* relationship requirement to tippee liability).

273. *See id.* at 659-64 (creating test for tippee liability under Rule 10b-5).

274. *Id.* at 659.

275. *See id.* at 658-59 (stating that information passed to tippee does not always pass derivative duty to disclose or to abstain).

276. *See id.* at 659 (deciding that some instances trigger duty of disclosure for tippee).

whether the tippee knew of the breach.[277] A tippee will possess "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 there has been a breach."[278] The next inquiry analyzes what behavior by the tipper demonstrates a breach of the tipper's fiduciary duty.[279] The Court found that a tipper breaches his fiduciary duty when he personally benefits from the disclosure to the tippee.[280] Many events, however, might result in personal gain to the tipper, including pecuniary gains, advancements to personal reputation, or making an informational gift to a friend or to a relative.[281]

The Court applied this new test to Dirks and found that none of the Equity Funding insiders violated their fiduciary duty by advancing information about the fraud to Dirks.[282] The employees received no personal benefit, either monetary or to their reputation, by divulging the information to Dirks.[283] Quite the contrary, the tippers were motivated solely to expose the fraud.[284] The Court held that Dirks could not have violated a derivative fiduciary duty because the insiders did not violate their own fiduciary duty, and therefore, Dirks owed no duty to abstain from the use of the information.[285]

F. Summary

As a result of a decade of decisions that concluded with *Dirks*, the Court had severely restricted the application of Rule 10b-5.[286] The Court, using a

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277. *See id.* at 660 (stating that tippees have duty of disclosure when tippers violate fiduciary duty and tippees are aware of breach).

278. *Id.*

279. *See id.* at 662-64 (discussing events that denote breach of fiduciary duty).

280. *See id.* at 662 (stating that tipper breaches fiduciary duty when tipper receives personal gain). The Court stated that the "test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.*

281. *See id.* at 663-64 (discussing events that might result in tippee's personal gain).

282. *See id.* at 666-67 (analyzing reason why Dirks did not violate Rule 10b-5).

283. *See id.* at 667 (noting that insiders did not receive any benefit from discussing inside information with Dirks).

284. *See id.* (stating exposure of fraud as reason for tipper disclosure).

285. *See id.* (concluding that Dirks did not violate Rule 10b-5). The Court stated that "[i]n the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks." *Id.*

286. *See* Cuevas, *supra* note 24, at 807 (stating that Court substantially narrowed appli-

strict statutory analysis, completely rejected the Second Circuit's parity of information or equal access theory, and strongly asserted that a Rule 10b-5 violation for nondisclosure could only occur when there was a breach of a fiduciary duty between parties to a securities transaction.[287] The important focus for a Rule 10b-5 action was neither the nature nor the type of information used, but the participant's conduct in using the information.[288] However, the SEC and the Second Circuit, though bruised, were not defeated. In the early 1980s, both the SEC and the Second Circuit latched onto Chief Justice Burger's *Chiarella* dissent and created a new theory of liability under Rule 10b-5: the misappropriation theory.[289]

VI. The Development of the Misappropriation Theory

As a reaction to the Supreme Court's restriction of Rule 10b-5 application and in response to gaps thereby created, the SEC and the Second Circuit developed and applied the misappropriation theory to certain Rule 10b-5 actions not covered by classical insider trading enforcement.[290] The misappropriation theory differs from classical insider trading in that the requisite fraud does not occur between the parties to the securities transaction, but between the violator and the source of the information.[291] A person may violate Rule 10b-5 under the misappropriation theory even though she owes no duty to the opposite party in the securities transaction.[292] The fraud occurs when the violator improperly obtains the material inside information in breach of a fiduciary relationship or another relationship of trust and confidence.[293] This fraud

cation of Rule 10b-5 and § 10(b)).

287. *See* Bainbridge, *supra* note 2, at 1194 (noting that Court rejected equal access or parity of information theory and that liability under Rule 10b-5 now requires breach of duty to disclose).

288. *See* Mitchell, *supra* note 131, at 778 (stating that *Chiarella* is epitome of conduct approach under Rule 10b-5); Phillips & Zutz, *supra* note 3, at 86 (claiming that insider trading law monitors conduct, not informational equality).

289. *See* Bainbridge, *supra* note 2, at 1196 (claiming that misappropriation theory developed from Chief Justice Burger's dissent in *Chiarella*); *infra* notes 290-453 (discussing development of misappropriation theory).

290. *See* LANGEVOORT, *supra* note 20, at 160-61 (stating that misappropriation theory developed to fill gaps in insider trading enforcement created by *Chiarella*).

291. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc) (stating that under misappropriation theory, fraud may occur between violator and source of information), *cert. denied*, 503 U.S. 1004 (1992).

292. *See id.* (noting that "the misappropriation theory does not require that the buyer or seller of securities be defrauded").

293. *See id.* (finding fraud under misappropriation theory when violator breaches fiduciary duty or some other relationship of trust and confidence); LANGEVOORT, *supra* note 20,

is then transferred onto the securities transaction, thereby satisfying the requirements of Section 10(b) and Rule 10b-5.[294] Under the misappropriation theory, the victim of the fraud usually does not suffer any pecuniary loss, and the person with the monetary loss — the party trading opposite the violator — is not the victim of the fraud.[295] In this sense, the misappropriation theory is a hybrid that, by combining the victim of the fraud with the actual securities transaction, allows a finding of a Rule 10b-5 violation. The following discussion of Second Circuit cases explains the development of the theory and its application.

A. Early Development

In *United States v. Newman,*[296] decided after *Chiarella* and before *Dirks*, the Second Circuit applied the misappropriation theory mentioned in *Chiarella.*[297] James M. Newman worked in the over-the-counter department of a New York brokerage firm.[298] Between 1973 and 1978, Newman received confidential information concerning corporate takeovers from employees of Morgan Stanley & Co. (Morgan Stanley) and Kuhn Loeb & Co. (Kuhn Loeb), two investment banking firms.[299] The employees misappropriated their employer's confidential information regarding the takeovers.[300] Newman purchased shares of target corporations prior to public disclosure and subsequently sold the stock for a large profit after the public announcement.[301] Newman shared the proceeds with the Morgan Stanley and Kuhn Loeb employees.[302] The United States indicted Newman and his co-conspirators, charging violations of Rule 10b-5, Section 10(b), mail fraud, and conspiracy to commit securities and mail fraud.[303] The United States District

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at 159 (stating that victim of fraud is person who entrusted information to fiduciary).

294. *See* Fisch, *supra* note 7, at 200 (noting that misappropriation theory satisfies requirement of Rule 10b-5 that "any person" suffer fraud).

295. *See* Bayne, *supra* note 14, at 144-47 (discussing elements of misappropriation theory and noting that focus is on taking of information, not on traders with monetary loss who are not victims of fraud).

296. 664 F.2d 12 (2d Cir. 1981).

297. *See* United States v. Newman, 664 F.2d 12, 14-19 (2d Cir. 1981) (applying misappropriation theory for first time), *cert. denied*, 464 U.S. 863 (1983).

298. *Id.* at 15.

299. *Id.*

300. *Id.*

301. *Id.*

302. *Id.*

303. *Id.* at 14.

Court for the Southern District of New York dismissed all of the allegations.[304]

On appeal, the Second Circuit reversed the district court's decision and reinstated the indictment.[305] The court decided that the case could proceed even though the victims of the fraud — the investment firms — did not participate in a trade with Newman.[306] The court of appeals reasoned that such concerns were relevant only in civil actions — because determining the victim of the fraud is a standing question — and stated that a Rule 10b-5 criminal action does not require an actual purchaser or seller to be the victim of the fraud.[307] The Second Circuit noted that Rule 10b-5 "contains no specific requirement that fraud be perpetrated upon the seller or buyer of securities."[308]

The court then addressed the actual fraud committed by Newman.[309] Declaring that "we need spend little time on the issue of fraud and deceit,"[310] the court found the employees' misappropriation of information for personal gain in breach of their fiduciary duty to be fraudulent.[311] The only basis for the finding of fraud was the theft of inside information in breach of an employer/employee relationship.[312] The appellate court determined that "[b]y sullying the reputations of [the investment banks] as safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money."[313]

After the Second Circuit found the requisite fraud, it still needed to find a connection between the fraud and the securities transaction.[314] Examining the behavior of Newman, the court determined that profiting from the quick sale of securities purchased on misappropriated information satisfied the "in

304. *Id.*

305. *Id.* at 16.

306. *See id.* at 16-17 (stating that criminal action could proceed despite fact that defrauded party did not trade with defendant).

307. *See id.* at 17 (claiming that victim of fraud need not be purchaser or seller for criminal violation of Rule 10b-5 to occur).

308. *Id.*

309. *Id.* at 17-18.

310. *Id.*

311. *See id.* (stating that using insider information for personal gain was fraudulent).

312. *See id.* at 17 (comparing employees' actions as similar to stealing cash or securities and stating that such behavior formed basis for fraud).

313. *Id.*

314. Rule 10b-5 requires that the fraud be "in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1995); *see supra* note 5 (providing text of Rule 10b-5).

connection" requirement.[315] The fraud need only "touch" the securities sale to satisfy the in connection requirement.[316] This nexus is a very tenuous relationship.[317] Finding that Newman committed fraud in connection with the purchase or sale of securities, the Second Circuit reversed the dismissal of the indictment.[318]

Although it did not explicitly name the theory, the Second Circuit established the misappropriation theory when it found that Newman violated Rule 10b-5 by perpetrating a fraud on the source of the information — the investment banks — and then traded on that information.[319] The traders opposite Newman were not the victims of a fraudulent act, and no fraud occurred in the actual securities transaction, yet the Second Circuit still found *securities* fraud.[320] This result and the *Newman* opinion are problematic for several reasons: First, the Second Circuit simply disregarded Supreme Court precedent when it transformed the purchaser or seller requirement into a standing question for civil suits and concluded that the purchaser or seller requirement had no application in criminal actions.[321] By eliminating the purchaser or seller requirement, the Second Circuit dramatically expanded Rule 10b-5's applicability.[322] Second, the court offered only a very brief analysis of the actionable fraud. The court of appeals found the theft of inside information in breach of a fiduciary duty to be fraudulent.[323] The potential damage to the investment banks from the theft included the sullying

315. *See* United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981) (finding little merit in Newman's argument that his behavior did not have connection with securities transaction), *cert. denied*, 464 U.S. 863 (1983).

316. *See id.* (citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1972), as precedent for flexible interpretation of "in connection" requirement that included behavior merely touching transaction).

317. *See id.* (stating that commentators have called this relationship "very tenuous indeed" (quoting 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD, § 4.7(574)(3), at 88.34 (1979))).

318. *Id.* at 19.

319. *See id.* at 17-19 (finding that Newman violated Rule 10b-5 by defrauding source of information, not opposite party to transaction).

320. *See id.* (stating that investment banks, not trading partners, were victims of fraud but still finding Rule 10b-5 violation).

321. *See* Kenny & Thebaut, *supra* note 162, at 187-88 (stating that Second Circuit ignored Court's precedent and incorrectly assumed that purchaser or seller requirement is relevant only in civil action).

322. *See id.* at 188 (claiming that Second Circuit greatly expanded coverage of Rule 10b-5).

323. *See* United States v. Newman, 664 F.2d 12, 17-18 (2d Cir. 1981) (finding fraud in theft of information), *cert. denied*, 464 U.S. 863 (1983).

of the banks' reputation.[324] Additionally, the court cited "other areas of the law, [in which] deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has been held to be unlawful."[325] "Unlawful" perhaps, but where is the fraud? The appellate court never explains how theft — not necessarily a fraudulent activity — or how a simple breach of a fiduciary relationship without deception transforms the inside employees' behavior into a fraudulent activity.[326] Such an expansive and vague view of Rule 10b-5's fraud requirement runs counter to the Supreme Court's interpretation of the Rule.[327] Finally, the Second Circuit's liberal interpretation of the in connection requirement fails to provide clear guidelines.[328] The court's decision that fraud need not occur between parties to the transaction expanded the Rule's application and did not comport with Supreme Court precedent.[329]

In *SEC v. Materia*,[330] the Second Circuit reaffirmed the misappropriation theory for enforcement of Rule 10b-5.[331] The court evaluated Materia's

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324. *See id.* at 17 (asserting loss of reputation as basis for investment bank's damages).

325. *Id.* at 18.

326. *See id.* at 17-18 (omitting detailed analysis of fraudulent behavior).

327. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) (delineating specific requirements for fraud under Rule 10b-5 in tipper/tippee context); Chiarella v. United States, 445 U.S. 222, 230 (1980) (stating express requirements for Rule 10b-5 action premised on fraudulent nondisclosure); Santa Fe Indus. v. Green, 430 U.S. 462, 472-73 (1977) (stating that mere breach of fiduciary duty is not sufficient to support Rule 10b-5 action; instead, manipulation or deception must be involved).

328. *See* United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981) (stating that fraud need only "touch" securities transaction), *cert. denied*, 464 U.S. 863 (1983).

329. *See Chiarella*, 445 U.S. at 228-35 (stating that Rule 10b-5 action for nondisclosure requires breach of fiduciary relationship between parties to securities transaction); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (requiring that purchaser or seller be subject to fraud for private right of action under Rule 10b-5).

330. 745 F.2d 197 (2d Cir. 1984).

331. *See* SEC v. Materia, 745 F.2d 197, 198-203 (2d Cir. 1984) (reaffirming misappropriation theory), *cert. denied*, 471 U.S. 1053 (1985). In *Materia*, the Second Circuit considered the application of § 10(b) and Rule 10b-5 to an employee of a financial printer. *Id.* Materia worked for Bowne, Inc. (Bowne), a printing firm specializing in financial documents, especially tender offers. *Id.* at 199. Materia read financial documents aloud to a proofreader who compared the information to the correct copy received from the client. *Id.* Blanks were normally used in place of the sensitive information, but Materia ascertained the target and acquiring companies. *Id.* Using this information, Materia purchased stock in four, separate target companies prior to public disclosure and sold the shares after the public announcement for a profit of over $99,000. *Id.* The SEC filed an enforcement action against Materia, claiming violations of Rule 10b-5, § 10(b), and other securities violations. *Id.* The United States District Court for the Southern

actions under Rule 10b-5 using a three-part inquiry.[332] First, the court found that Materia's misappropriation of inside information from his employer constituted fraud:[333] "Materia's theft of information was indeed as fraudulent as if he had converted corporate funds for his personal benefit."[334] Second, the appellate court repeated that the proper question in a non-civil action is the scope of the Rule, and not an analysis of to whom the particular duty is owed.[335] Because the *Newman* court concluded that the victim of the fraud need not be a purchaser or seller, it was not important that Materia owed no duty to the other parties to the securities transactions.[336] Third, the court found that Materia's fraud easily satisfied the in connection portion of the analysis.[337] Because Materia took the information for the purpose of trading on it for instant gain, the court of appeals concluded that the fraud perpetrated on the employer satisfied the in connection requirement.[338] Therefore, the Second Circuit determined that Materia violated Rule 10b-5 and reaffirmed the misappropriation theory.[339]

B. *Expansion of the Misappropriation Theory*

In *United States v. Carpenter*,[340] the Second Circuit dramatically expanded the application of the misappropriation theory to include a breach of confidentiality outside securities-related transactions or even a securities-

District of New York found that Materia violated Rule 10b-5. *Id.* at 200. The district court determined that Materia breached a fiduciary duty to his employer and the employer's clients by trading on nonpublic information stolen from his employer. *Id.* On appeal, the Second Circuit affirmed the conclusions of the district court. *Id.* at 203-04. The court applied the misappropriation theory developed in *Newman*. *Id.* at 200-04. Finding that Materia breached a duty owed to his employer and to its clients, the court determined that the fraud satisfied the in connection requirement of Rule 10b-5. *Id.* Therefore, the court held that Materia violated Rule 10b-5. *Id.* at 203-04.

332. *See id.* at 201-04 (applying three-part inquiry).

333. *See id.* at 201-02 (finding Materia's behavior fraudulent).

334. *Id.*

335. *See id.* at 202-03 (stating that fraud need not be perpetrated on purchaser or seller).

336. *See id.* (stating that requirement that purchaser or seller be victim of fraud is important only for civil actions).

337. *See id.* at 203 (finding in connection inquiry satisfied).

338. *See id.* (evaluating fraud committed on employer in larger context of making instant profits and concluding that profit motivations satisfied in connection requirement).

339. *See id.* (concluding that Materia violated Rule 10b-5 under misappropriation theory).

340. 791 F.2d 1024 (2d Cir. 1986).

related institution.[341] R. Foster Winans wrote the influential *Heard on the Street* column (*Heard* column) for the *Wall Street Journal* (*Journal*).[342] Co-conspirator David Carpenter, a news clerk, also worked at the *Journal*.[343] Winans and Carpenter participated in a scheme with Kenneth P. Felis and Peter Brant, both stockbrokers, to trade on *Heard* column information prior to the column's publication.[344] Usually the day before publication, Winans and Carpenter would supply the two stockbrokers with the *Heard* column information, and the stockbrokers would execute trades based on the information.[345] This process occurred on twenty-seven different occasions, netting profits near $690,000.[346] Winans and Carpenter delivered this information despite *Journal* policy deeming all news material created by employees *Journal* property and all nonpublic information as confidential.[347] After an SEC investigation, Brant became the Government's key witness, and the United States District Court for the Southern District of New York convicted Felis and Winans of Rule 10b-5 violations, Section 10(b) violations, mail fraud, wire fraud, and several conspiracy counts.[348] The district court also convicted Carpenter of aiding and abetting in the commission of securities fraud, mail fraud, and wire fraud.[349]

On appeal, the Second Circuit affirmed all securities fraud convictions under the misappropriation theory.[350] Finding the securities fraud issue one of first impression,[351] the court inquired whether Winans's breach of his duty of confidentiality would support a securities fraud conviction.[352] The court

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341. *See* United States v. Carpenter, 791 F.2d 1024, 1027-34 (2d Cir. 1986) (expanding misappropriation theory), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

342. *Id.* at 1026.

343. *Id.*

344. *Id.* at 1026-27.

345. *Id.*

346. *Id.* at 1027.

347. *Id.* at 1026.

348. *Id.*

349. *Id.*

350. *See id.* at 1027-34 (convicting defendants under misappropriation theory).

351. *Id.* at 1027.

352. *See id.* at 1027-28 (noting primary issue on appeal). The court stated that:

> This case requires us to decide whether . . . [the defendants] violated or conspired to violate or aided and abetted in the violation of federal securities laws by misappropriating material, nonpublic information in the form of the timing and content of the *Wall Street Journal*'s confidential schedule of columns of acknowledged influence in the securities market, in contravention of the established policy of the newspaper, for their own profit . . . .

determined that Winans breached a duty of confidentiality owed to the *Journal* when he used information concerning the *Heard* column's timing and content.[353] The important question was whether Winans's breach of confidentiality could support a Rule 10b-5 action.[354] The court concluded that, under the misappropriation theory, the facts would support a conviction under Rule 10b-5:[355] "The misappropriation theory . . . broadly proscribes the conversion by 'insiders' *or others* of material non-public information in connection with the purchase or sale of securities."[356] Accordingly, the court of appeals found that Winans converted the *Heard* column information for his own use and that this conversion satisfied the "fraud or deceit" requirement of the antifraud provisions.[357] After the fraud finding, the Second Circuit noted that it was immaterial that the victim of the fraud was not a party to the transaction.[358] The court summarily asserted that "[i]t is sufficient that the fraud was committed upon Winans'[s] employer."[359] Finally, the court experienced no difficulty satisfying the in connection requirement.[360] Finding that the securities transactions supplied the only purpose for misappropriating the information, the court concluded that the scheme satisfied the in connection requirement of Section 10(b) and Rule 10b-5.[361] Therefore, the Second Circuit affirmed the securities convictions of all defendants under the misappropriation theory.[362]

Id. at 1027.

353. *See id.* at 1028 (determining that Winans breached duty of confidentiality to *Journal* when he used material nonpublic information about *Heard* column).

354. *See id.* (reducing case to whether breach of confidentiality could support securities fraud allegation). The court stated that "we address specifically whether an employee's use of such information in breach of a duty of confidentiality to an employer serves as an adequate predicate for a securities violation." *Id.* at 1031.

355. *See id.* at 1028-34 (stating that breach of duty of confidentiality would support Rule 10b-5 action).

356. *Id.* at 1029.

357. *See id.* at 1031 (finding that Winans's behavior amounted to "fraud and deceit" under antifraud provisions). The court stated that "Winans 'misappropriated — stole, to put it bluntly — valuable nonpublic information entrusted to him in the utmost confidence.'" *Id.* (quoting Chiarella v. United States, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting)).

358. *See id.* at 1032 (evaluating relevancy of victim of fraud to misappropriation theory and concluding that victim need not be purchaser or seller).

359. *Id.*

360. *See id.* at 1032-33 (satisfying in connection requirement).

361. *See id.* (finding that scheme of misappropriating information for purpose of trading on it satisfied in connection requirement).

362. *See id.* at 1034 (affirming convictions). The court stated that:

The defendants appealed the Second Circuit's decision to the Supreme Court.[363] In its decision, the Court was divided four to four on the validity and application of the misappropriation theory.[364] Justice White, who wrote the Court's opinion, included no substantive comment and simply stated that "[t]he Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts."[365]

In *Carpenter*, the Second Circuit determined that Winans violated Rule 10b-5 under the misappropriation theory because he breached an employment duty of confidentiality, even though the transactions did not involve *Journal* stock and the *Journal* did not participate in the securities transactions.[366] This conclusion greatly expanded the application of the misappropriation theory and is disturbing for several reasons. First, the court based its finding of a Rule 10b-5 violation on the breach of a duty owed to an employer, not to a market participant nor to a corporation whose shares were traded.[367] This position dramatically departs from *Newman* and *Materia*. In *Newman*, the stockbrokers breached a duty to their employers, but the inside information came from the same corporate clients whose shares Newman subsequently purchased.[368] Therefore, the court reasoned that the brokers also wronged the investment banks' clients.[369] Similarly, in *Materia*, the defen-

> [B]ecause of his duty of confidentiality to the *Journal*, defendant Winans — and Felis and Carpenter, who knowingly participated with him — had a corollary duty, which they breached, under Section 10(b) and Rule 10b-5, to abstain from trading in securities on the basis of misappropriated information or to do so only upon making adequate disclosure to those with whom they traded.

Id.

363. Carpenter v. United States, 484 U.S. 19 (1987).

364. *See id.* at 24 (stating that securities fraud question evenly split Court). Only eight members of the Court heard *Carpenter* because of Justice Kennedy's confirmation process.

365. *Id.*

366. *See* United States v. Carpenter, 791 F.2d 1025, 1027-34 (2d Cir. 1986) (finding defendants violated Rule 10b-5 under misappropriation theory notwithstanding facts that *Journal* did not participate in transactions and that defendants did not trade in *Journal* stock), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

367. *See id.* at 1031 (finding fraud in breach of employer-created duty of confidentiality).

368. *See* United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981) (noting that brokers obtained information concerning mergers from employers who received it from clients), *cert. denied*, 464 U.S. 863 (1983).

369. *See id.* at 17 (stating that defendants harmed clients of investment banks). The court stated that "[a]ppellee and his cohorts also wronged Morgan Stanley's and Kuhn Loeb's clients . . . ." *Id.*

dant misappropriated tender offer information from Bowne, the defendant's employer, but Bowne had received the inside information from its clients.[370] Both Newman and Materia misappropriated information given to their employers by clients and then traded in the clients' stock.[371] The situations presented in *Newman* and *Materia* significantly differ from the scenario presented in *Carpenter*. In *Carpenter*, the information taken from the *Journal* was neither derived from nor had any relation to the inside workings of the corporations whose shares the defendants purchased or sold.[372] Interestingly, Winans wrote most of the *Heard* columns and analyzed data freely available to the public.[373] Winans did not even take any substantive information — he could not, because he created it — he took only the *Journal*'s publication schedule.[374] Surprisingly, the Second Circuit based a securities fraud conviction on the defendant's use of a nonmarket participant's publication schedule regarding information that the defendant actually compiled from public information.[375] This result contradicts the Supreme Court's finding in *Santa Fe*.[376] In *Santa Fe*, the Court refused to find a Rule 10b-5 violation for a mere breach of fiduciary duty without some affirmative manipulation or deception.[377] Clearly, the Rule does not support all breaches

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370. *See* SEC v. Materia, 745 F.2d 197, 199 (2d Cir. 1984) (finding that Materia misappropriated tender offer information from financial documents of Bowne's clients), *cert. denied*, 471 U.S. 1053 (1985).

371. *See id.* at 201-03 (finding that Materia took information entrusted to employers from client and then traded in client's shares); *Newman*, 664 F.2d at 17-18 (determining that brokers misappropriated information and then traded in shares of investment bank's clients).

372. *See* United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986) (finding that misappropriated information only included information about timing and content of articles, not information obtained from other corporations), *aff'd by an equally divided court*, 484 U.S. 19 (1987). The court noted that "[t]he information misappropriated here was the *Journal*'s own confidential schedule of forthcoming publications. It was the advance knowledge of the timing and content of these publications" that the defendants used to trade. *Id.*

373. *See id.* at 1037 (Miner, J., concurring) (stating that Winans compiled information and wrote *Heard* column).

374. *See id.* (Miner, J., concurring) (noting that Winans only took publication schedule).

375. *See id.* at 1027-34 (finding defendants violated Rule 10b-5).

376. *See supra* notes 187-99 and accompanying text (discussing *Santa Fe*).

377. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 472-76 (1977) (determining that Rule 10b-5 requires deception or manipulation and that mere breach of fiduciary duty is insufficient). The Court stated that "the cases do not support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule." *Id.* at 476.

of a fiduciary obligation.[378] A Section 10(b) violation requires deception and does "not seek to regulate transactions which constitute no more than corporate mismanagement."[379] The Court did not wish to develop and to apply a "federal fiduciary standard" in Rule 10b-5 cases[380] because the Rule does not "cover the corporate universe."[381] Winans's behavior, however, closely resembles the situation that the Supreme Court chose not to regulate using Rule 10b-5 in *Santa Fe*.[382] Winans breached a fiduciary duty of confidentiality without any manipulation or deception because his position granted him access to the *Heard* column's content and to the publishing schedule.[383] The Second Circuit directly conflicted with the holding of *Santa Fe* when it used Rule 10b-5 to convict Winans.[384]

The *Carpenter* holding also conflicts with the Supreme Court's *Chiarella* decision.[385] In *Chiarella*, the Court determined that a Rule 10b-5 violation predicated on nondisclosure is valid only when there is an affirmative duty to disclose arising from a fiduciary duty or another relationship of trust and confidence between the parties to the transaction.[386] The *Carpenter* court contradicted the *Chiarella* holding when it determined that the defendants' duty of disclosure was derived from the breach of a duty of confidentiality

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378. *See id.* (stating that all breaches of fiduciary obligation are not supported by Rule). The Court found that using fraud within "Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction . . . would . . . 'add a gloss to the operative language of the statute quite different from its commonly accepted meaning.'" *Id.* at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

379. *Id.* at 479 (quoting Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971)).

380. *See id.* at 477-80 (discussing reluctance to federalize fiduciary standard).

381. *Id.* at 480 (quoting William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974)).

382. *Compare* Santa Fe Indus. v. Green, 430 U.S. 462, 472-81 (1977) (refusing to apply Rule 10b-5 to mere breach of fiduciary duty) *with* United States v. Carpenter, 791 F.2d 1024, 1031-32 (2d Cir. 1986) (noting that Winans breached employer-created fiduciary duty of confidentiality), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

383. *See id.* at 1028 (stating that Winans learned *Heard* column content and schedule in course of employment, but not mentioning any manipulation or deception).

384. *Compare Santa Fe Indus.*, 430 U.S. at 472-81 (holding that mere fiduciary breach without deception or manipulation is insufficient to find Rule 10b-5 violation) *with Carpenter*, 791 F.2d at 1031-32 (finding that Winans committed fraud under Rule 10b-5 by breaching fiduciary duty of confidentiality owed to *Journal*).

385. *See supra* notes 200-52 and accompanying text (discussing *Chiarella*).

386. *See* Chiarella v. United States, 445 U.S. 222, 228-30 (1980) (requiring affirmative duty to disclose arising from relationship of trust and confidence between parties to transaction).

and not from any fiduciary duty or another relationship of trust and confidence with the opposite party to the securities transaction.[387] The idea that a prior breach of a duty of confidentiality to an outside party creates a corollary duty of disclosure does not comport with *Chiarella*'s conclusion that the affirmative duty to disclose is derived from the relationship between the parties to the transaction.[388] Winans and his co-defendants did not have a fiduciary relationship or another relationship of trust and confidence with the opposite parties to the transactions, and therefore, they should not have possessed an affirmative obligation to disclose.

The *Carpenter* decision is also problematic for what it does not properly address. According to the Second Circuit's reasoning, if the *Journal* did not have a confidentiality requirement or if the *Journal* had freely encouraged its employees to trade on *Heard* column information, then securities fraud would not have occurred.[389] Because the gravamen of the Rule 10b-5 violation in *Carpenter* was the breach of a duty of confidentiality, no breach should mean no Rule 10b-5 violation. Similarly, if the *Journal* itself had traded on the *Heard* column information, there would have been no breach of confidentiality — and presumably, no Rule 10b-5 violation — because it is absurd to say that the newspaper owed a duty to itself.[390] Although the *Carpenter* defendants presented this argument to the court, the court of appeals rejected it, stated that it was unlikely that the *Journal* would ruin its own reputation, and again asserted that even if the *Journal* could trade lawfully,[391] the defendants could not trade lawfully because of their duty of confidentiality.[392] Strangely, if the *Journal* traded or if the employees could

387. *See* United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986) (stating that Winans had duty to disclose or to abstain created by breach of duty of confidentiality), *aff'd by an equally divided court*, 484 U.S. 19 (1987). The court stated that "because of his duty of confidentiality to the *Journal*, . . . [the defendants] . . . had a corollary duty, which they breached under Section 10(b) and Rule 10b-5, to abstain from trading in securities on the basis of the misappropriated information or to do so only upon making adequate disclosure to those with whom they traded." *Id.*

388. *Compare Carpenter*, 791 F.2d at 1034 (stating that duty to disclose is derived from prior breach of confidentiality) *with Chiarella*, 444 U.S. at 228-30 (holding that duty to disclose arises only from relationship between parties to securities transaction).

389. *See Carpenter*, 791 F.2d at 1027-34 (basing Rule 10b-5 violation on breach of confidentiality owed to *Journal*).

390. *See id.* at 1033 (stating that *Journal* possibly could trade legally on *Heard* column information).

391. The Second Circuit reserved judgment on whether the *Journal* could trade lawfully on the information in the *Heard* column. *Id.* at 1033 n.10.

392. *See id.* at 1033-34 (rejecting defendants' argument that it was improper to hold defendants liable for something their employer could legally do).

trade without breaching a duty, the investors would still have had the same loss whether or not it amounted to a Rule 10b-5 violation. Both problems are inadequately answered in *Carpenter* and exist because the Second Circuit, by using the misappropriation theory, shifted the focus of the securities fraud provisions away from the securities transaction to some antecedent duty between the violator and the source of the information.[393] Supreme Court precedent demonstrates that the purpose of the securities laws is to protect investors.[394] By applying the misappropriation theory, the Second Circuit protected corporations — not investors — when it found a breach of duty in violation of trust and confidence. Yet, as evidenced by the possible situations above, investors still may suffer the same loss. By using the misappropriation theory of Rule 10b-5, the Second Circuit attempted to apply the federal fiduciary standard rejected in *Santa Fe*.[395]

Not only does the misappropriation theory, as applied in *Carpenter*, contradict Supreme Court precedent, it also fails to provide guidelines for prospective enforcement. Both the *Chiarella* and *Dirks* decisions provided clear procedures for analyzing an alleged Rule 10b-5 violation.[396] Because the misappropriation theory is not based on the relationship between the parties to a securities transaction, but instead on the relationship from which a person derives the information, it is not clear what types of relationships will support a Rule 10b-5 conviction under the misappropriation theory. This confusion creates enforcement difficulties and leaves traders at the whim

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393. *See id.* at 1031 (finding requisite fraud in employees' breach of confidentiality); SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (finding requisite fraud when Materia took information entrusted to him in course of employment), *cert. denied*, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (finding requisite fraud when brokers took information from their employers), *cert. denied*, 464 U.S. 863 (1983).

394. *See* Dirks v. SEC, 463 U.S. 646, 657-58 (1983) (discussing how duty to disclose arises from relationship *between* parties to securities transaction and not simply from possession of material nonpublic information); Chiarella v. United States, 445 U.S. 222, 228-30 (1980) (stating that duty to disclose arises from relationship *between* members of securities transaction); Santa Fe Indus. v. Green, 430 U.S. 462, 478-80 (1977) (noting that Rule 10b-5 neither supplies federal fiduciary standard nor protects against simple corporate mismanagement); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976) (finding that purpose of federal securities regulations is to protect investors); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (allowing only actual purchasers or sellers to bring private Rule 10b-5 action).

395. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 478-80 (1977) (stating that Rule 10b-5 should not be used to apply federal fiduciary standard).

396. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) (predicating tippee liability on breach of fiduciary duty between tipper and shareholders); Chiarella v. United States, 445 U.S. 222, 230 (1980) (stating that affirmative duty to disclose stems from relationship of trust and confidence between parties to securities trade).

of the SEC — a dangerous situation that does not sufficiently warn investors that their behavior may be criminal.[397]

In *United States v. Chestman*,[398] the Second Circuit again evaluated the misappropriation theory, but this time the alleged breach occurred in the context of the trust relationship between husband and wife.[399] On November 21, 1986, Ira Waldbaum, president and controlling shareholder of Waldbaum, Inc., a large, publicly traded supermarket chain, agreed to sell the company to Great Atlantic and Pacific Tea Company.[400] Ira informed certain members of his family — including his sister, Shirley Watkin — about the sale and admonished them to remain silent.[401] Shirley Watkin, however, told her daughter, Susan Loeb, about the transaction and asked Susan to refrain from discussing the sale with anyone except her husband, Keith Loeb.[402] On November 24th, Susan informed Keith about the sale of the company and explicitly told him to remain silent.[403] On the next day, November 25th, Keith called his stockbroker, Robert Chestman, and conveyed the tender offer information to Chestman.[404] Chestman purchased three thousand Waldbaum shares at $24.65 per share for his personal account and eight thousand shares at approximately $26.00 per share for client discretionary accounts.[405] After again speaking with Chestman on the 25th, Loeb also purchased one thousand Waldbaum shares for himself.[406] On the evening of November 26th, the public announcement of the tender offer for Waldbaum occurred.[407] Waldbaum stock closed at $49 per share the next business day.[408]

397. *See Dirks*, 463 U.S. at 664 n.24 (noting that reliance on SEC discretion is potentially dangerous). Justice Powell stated that "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous . . . ." *Id.*

398. 947 F.2d 551 (2d Cir. 1991).

399. *See* United States v. Chestman, 947 F.2d 551, 564 (2d Cir. 1991) (stating that breach of family relationship supplied basis for misappropriation theory), *cert. denied*, 503 U.S. 1004 (1992).

400. *Id.* at 555.

401. *Id.*

402. *Id.*

403. *Id.*

404. *Id.* Surprisingly, Chestman denied ever having spoken with Keith Loeb about Waldbaum shares on November 25th and stated that he purchased the shares using information he obtained on his own initiative. *Id.*

405. *Id.*

406. *Id.*

407. *Id.*

408. *Id.*

After an SEC investigation, Loeb agreed to assist the Government, disgorge his $25,000 profit, and pay a $25,000 fine.[409] A grand jury indicted Chestman on ten counts of violating Rule 14e-3(a) (addressing tender offers), ten counts of violating Rule 10b-5, ten counts of mail fraud, and one count of perjury.[410] A jury convicted Chestman on all counts.[411] Chestman appealed, and the Second Circuit reversed the convictions.[412] The court of appeals voted to rehear the case en banc for all convictions except the perjury conviction.[413]

On rehearing, the Second Circuit reinstated the Rule 14e-3 convictions, but dismissed the Rule 10b-5 and mail fraud convictions.[414] Because the district court had found that Chestman both aided and abetted Loeb and received a tip from him, the misappropriation theory formed the basis of the original Rule 10b-5 convictions.[415] The court of appeals concluded that, although Chestman was the defendant, Keith Loeb performed the actual misappropriation.[416] Therefore, the relevant inquiry for determining whether the defendants violated Rule 10b-5 under the misappropriation theory involved examining Keith and Susan Loeb's relationship and deciding if any breach of duty had occurred.[417]

The Second Circuit began with a discussion of the two predominant theories of Rule 10b-5 enforcement: the traditional theory and the misappropriation theory.[418] Finding that the traditional theory developed mainly from *Chiarella*, the court stated that the traditional theory contrasts with the misappropriation theory because the buyer or seller need not suffer any fraud under the misappropriation theory.[419] The court noted that, under the misappropriation theory, "a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities

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409. *Id.* at 556.

410. *Id.*

411. *Id.*

412. *Id.*

413. *Id.*

414. *Id.*

415. *See id.* at 564 (stating that aiding, abetting, and tippee liability formed basis of misappropriation theory under Rule 10b-5).

416. *See id.* (concluding that Keith Loeb's actions, not Chestman's behavior, amounted to alleged misappropriation).

417. *See id.* (determining that Keith and Susan Loeb's relationship was proper relationship for study to determine if there was Rule 10b-5 violation).

418. *Id.* at 565-66.

419. *See id.* (analyzing classic and misappropriation theories and noting differences).

transaction."[420] The appellate court then examined fiduciary duty concepts and other relationships of trust and confidence to determine whether Keith Loeb violated such a duty when he used the tender offer information.[421]

The Second Circuit stated that, after the extremely broad *Carpenter* holding, "the fiduciary relationship question takes on special importance."[422] The *Carpenter* decision presented problems because the misappropriation theory scrutinizes not only fiduciary breaches between shareholders and corporate officials but also fiduciary breaches of any sort.[423] The court expressed concern over the *Carpenter* holding because fiduciary relationships outside of the shareholder/fiduciary context lack clear definition.[424] Existing precedent also failed to provide clear guidelines for determining the existence of a fiduciary duty, a particularly disturbing absence given the broad holding in *Carpenter*.[425] Therefore, the Second Circuit noted that "we tread cautiously in extending the misappropriation theory to new relationships, lest our efforts to construe Rule 10b-5 lose method and predictability, taking over the 'whole corporate universe.'"[426]

The court then attempted to define both the scope of a fiduciary relationship and a relationship of trust and confidence.[427] Initially, the court of appeals eliminated two situations that do not automatically establish a fiduciary relationship: the unilateral entrusting of information and the bond of marriage alone.[428] Receipt of confidential information, without more, does

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420. *Id.* at 566.

421. *See id.* at 566-71 (analyzing scope and characteristics of fiduciary duties).

422. *Id.* at 567.

423. *See id.* (stating that examining fiduciary duty under misappropriation theory is important because *Carpenter* holding is very broad). The court stated that the "fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a 'similar relationship of trust and confidence,' is construed liberally." *Id.*

424. *See id.* (noting ease of determining fiduciary duty in shareholder/corporate official context and difficulty in determining fiduciary duties in other situations). The court noted that in relationships other than shareholder relationships, "[t]he existence of fiduciary duties . . . is anything but clear." *Id.*

425. *See id.* (finding no precedent of value because prior misappropriation cases occurred in context of employer/employee relationships).

426. *Id.* (citations omitted).

427. *See id.* at 567-70 (attempting to define application of fiduciary relationship or other relationship of trust and confidence in context of misappropriation theory).

428. *See id.* (eliminating unilateral granting of information and marriage as per se fiduciary relationships).

not create a fiduciary duty of confidentiality.[429] Similarly, a spousal relationship does not create a fiduciary obligation when one spouse simply makes a disclosure of confidential information.[430] The Second Circuit, however, listed relationships that are fiduciary in nature, including "attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder."[431] Finding that neither the relationship between Keith and Susan Loeb nor the relationship between Keith and Susan's family possessed characteristics similar to these relationships, the court concluded that Keith did not stand in a fiduciary relationship with either Susan or Susan's family.[432]

However, the Second Circuit continued its inquiry because the misappropriation theory also requires an examination of "whether there exists a 'similar relationship of trust and confidence.'"[433] The court determined that a similar relationship of trust and confidence is the essential equivalent of a fiduciary relationship.[434] The Second Circuit discussed characteristics that make a relationship fiduciary in nature: discretionary authority, reliance, custodial possession of property, a prohibition on self-dealing, and serving the best interests of the principal.[435] A similar relationship of trust and confidence, therefore, must possess essentially the same qualities as a fiduciary relationship.[436]

To determine that Chestman violated Rule 10b-5 under the misappropriation theory the court had to find that Keith breached a fiduciary relationship owed to his family and that Chestman knew about the breach.[437] The appellate court concluded that Keith had neither a fiduciary relationship nor another relationship of trust and confidence sufficient to establish a breach

429. *See id.* (stating that disclosing confidential information, by itself, does not create fiduciary duty).

430. *See id.* at 568 (finding that family relationship alone does not create fiduciary obligation). The court stated that "more than a gratuitous reposal of a secret to another who happens to be a family member is required to establish a fiduciary or similar relationship of trust and confidence." *Id.*

431. *Id.* (citations omitted).

432. *See id.* at 568-71 (finding that Keith Loeb was neither fiduciary of Susan nor fiduciary of Waldbaum family).

433. *Id.* at 568 (citations omitted).

434. *See id.* (concluding that "[a] similar relationship of trust and confidence, therefore, must be the functional equivalent of a fiduciary relationship").

435. *See id.* at 569 (discussing characteristics of fiduciary relationship).

436. *See id.* (concluding that similar relationship of trust and confidence must share qualities of fiduciary relationship).

437. *See id.* at 570 (stating requirements for conviction of Chestman).

under the misappropriation theory.[438] Familial relationships alone are not enough, and the Government presented no additional evidence to convert Keith's relationship into one of fiduciary stature or a similar relationship of trust.[439] Absent any fraud committed by Keith, Chestman could not have derivatively violated Rule 10b-5 under the misappropriation theory, and therefore, the court reversed the securities fraud convictions.[440]

Chestman is an important decision for understanding the misappropriation theory. The Second Circuit recognized the extremely broad holding of *Carpenter* and the problems the decision created.[441] The vague language in *Carpenter* suggests a limitless application of the theory because of the numerous types of relationships in which confidential information is discussed.[442] The Second Circuit recognized this problem and declined to extend the misappropriation theory to family relationships without a clear showing of a fiduciary relationship between family members.[443] The court, however, should have overruled *Carpenter* and eliminated the misappropriation theory. Instead, it tried to define the scope of the predicate relationship,[444] albeit unconvincingly because of the many relationships in which confidential information is discussed. The *Chestman* decision fails to provide clear notice to those individuals who must determine whether their relationship is fiduciary in nature prior to trading on material nonpublic information. Evaluating the relationship is of paramount importance because "a duty to disclose does not arise from the mere possession of nonpublic market information."[445] Considering that *Chestman* involved a six-to-five split of an en banc court,[446] it is questionable whether this limited view of a relationship will survive through the next misappropriation decision. As Judge Miner quoted in his concurrence: "Prosecutors can often claim that some confiden-

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438. *See id.* (finding that Keith Loeb did not breach relevant relationship). The court had "little trouble finding the evidence insufficient to establish a fiduciary relationship or its functional equivalent between Keith Loeb and the Waldbaum family." *Id.*

439. *See id.* at 570-71 (discussing lack of evidence to support conviction).

440. *See id.* at 571 (reversing Rule 10b-5 convictions).

441. *See id.* at 567 (noting broad holding of *Carpenter).*

442. *See id.* (stating that fiduciary relationships outside fiduciary/shareholder context lack clear definition).

443. *See id.* at 568-71 (refusing to apply misappropriation theory to Keith Loeb's actions).

444. *See id.* at 567-70 (discussing qualities of fiduciary relationship or similar relationship of trust).

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

446. *See* United States v. Chestman, 947 F.2d 551, 551-52 (2d Cir. 1991) (en banc) (noting vote of each judge), *cert. denied*, 503 U.S. 1004 (1992).

tial relationship was abused — whether between lovers, family members, longtime friends, or simply that well known confidential relationship between a bartender and drunk. Such a test inherently creates legal uncertainty and invites selective prosecutions."[447] As Justice Powell warned in *Dirks*: "Without legal limitations, market participants are forced to rely on the reasonableness of the SEC's strategy, but that can be hazardous . . . ."[448]

In *Chestman*, the Second Circuit also attempted to define "a similar relationship of trust and confidence."[449] Defining this statement is important because of the expansive interpretation that the phrase imputes to the application of the misappropriation theory. The court, however, simply concluded that a similar relationship of trust and confidence is essentially the equivalent of a fiduciary relationship.[450] This "clarification" appears after the Second Circuit admitted that fiduciary duties outside the context of shareholder/fiduciary relationships lack definition and are anything but clear.[451] Thus, the court defined "a similar relationship of trust and confidence" using fiduciary duty concepts that the court itself admitted are ambiguous.[452] This definition is subject to the same problems as determining the existence of a fiduciary relationship, and therefore, is of little assistance.

Chestman is a disappointing decision by the en banc Second Circuit that just barely — because of the six-to-five split — recognized that the misappropriation theory, as delineated in *Carpenter*, presented serious problems of application and understanding. Determining the existence of a fiduciary relationship outside of traditional relationships is a difficult task at best. Yet, considering some of the individuals convicted under the misappropriation theory for violating this relationship,[453] it is important to establish some

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447. *Id.* at 583 (Miner, J., concurring) (quoting John C. Coffee, *Outsider Trading, That New Crime*, WALL ST. J., Nov. 14, 1990, at 16).

448. Dirks v. SEC, 463 U.S. 646, 664 n.24 (1983).

449. *See Chestman*, 947 F.2d at 567-70 (attempting to define similar relationship of trust and confidence).

450. *See id.* at 568 (asserting that similar relationship of trust and confidence possesses qualities of fiduciary relationship).

451. *See id.* at 567 (noting that fiduciary duties outside shareholder/fiduciary relationship are not clear).

452. *See id.* at 567-69 (stating that similar relationship of trust and confidence has qualities of fiduciary relationship, but also admitting difficulty of determining existence of fiduciary relationship outside shareholder/fiduciary relationship).

453. *See generally, e.g.*, SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) (finding fiduciary duty between individual and *former* employer); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990) (finding fiduciary duty between employee and employer); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986) (finding fiduciary duty between newspaper and columnist), *aff'd by an equally divided court*, 484 U.S. 19 (1987); United States v. Willis, 737

definitions. Elimination of the misappropriation theory would yield a more equitable and desirable result and would reinstate the clear guidelines of *Chiarella* and *Dirks*.

VII. The Fourth Circuit Rejects the Misappropriation Theory

In *United States v. Bryan*,[454] the United States Court of Appeals for the Fourth Circuit completely rejected the misappropriation theory.[455] Elton Bryan worked for West Virginia as the Director of the West Virginia Lottery.[456] Bryan manipulated two government contracts involving the Lottery, one for an advertising campaign and the other involving the purchase of interactive video lottery machines.[457] In each case, Bryan rigged the selection process to insure that a desired company received the contract.[458] During Bryan's tenure as Lottery Director, he also engaged in securities transactions with shares of companies that did business with the West Virginia Lottery.[459] Bryan used material nonpublic information obtained through his position as Lottery Director for the securities transactions.[460] The United States charged Bryan with two counts of mail fraud stemming from the manipulated contracts, one count of violating Rule 10b-5 and Section 10(b), one count of wire fraud arising from the securities trades, and one count of perjury. The United States District Court for the Southern District of West Virginia convicted Bryan on all counts.[461]

On appeal, the Fourth Circuit affirmed the two mail fraud convictions, the wire fraud conviction, and the perjury conviction.[462] However, the court reversed the securities fraud conviction because Bryan's Rule 10b-5 conviction rested on the misappropriation theory, which the Fourth Circuit

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F. Supp. 269 (S.D.N.Y. 1990) (finding fiduciary duty between psychiatrist and patient); United States v. Chestman, 704 F. Supp. 451 (S.D.N.Y. 1989) (finding fiduciary duty between husband and wife), *rev'd in part*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.) (finding fiduciary duty between father and son), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

454. 58 F.3d 933 (4th Cir. 1995).

455. *See* United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995) (rejecting use of misappropriation theory for Rule 10b-5 enforcement).

456. *Id.* at 936.

457. *Id.* at 936-39.

458. *Id.*

459. *Id.* at 939.

460. *Id.*

461. *Id.* at 936.

462. *Id.*

refused to adopt.[463] The court of appeals attacked the theory on two fronts: First, because the theory contradicted the language of Section 10(b) as interpreted by the Supreme Court; and second, because the court determined that policy considerations demanded rejection of the theory.[464]

The Fourth Circuit began its analysis by discussing the elements and the applicability of the misappropriation theory to Bryan's actions.[465] Reviewing the theory, the court found that the fraud required for a Rule 10b-5 action under the misappropriation theory occurs when a person "misappropriates material nonpublic information in breach of a fiduciary duty or some other relationship of trust and confidence."[466] The appellate court noted that the victim of the fraud need not be a purchaser or a seller, be in any way affiliated with the securities transaction, nor have any interest in the transaction.[467] Finally, the fraud satisfies the in connection requirement because the violator subsequently uses the information in a stock transaction.[468] The court of appeals concluded that Bryan's conduct clearly violated Section 10(b) under the misappropriation theory because Bryan used information entrusted to him by the nature of his position and then traded on it.[469] However, the Fourth Circuit decided that the relevant inquiry was not Bryan's behavior, but whether the misappropriation theory is a valid enforcement mechanism for Section 10(b) and Rule 10b-5.[470]

Following the Supreme Court's consistent admonition not to expand the concept of fraud beyond the statute, the appellate court stated that "manipulation and deception are the touchstones of Section 10(b) liability . . . ."[471] Because manipulation is "virtually a term of art,"[472] the interpretation of

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463. *See id.* at 944-59 (discussing and refusing to adopt misappropriation theory for § 10(b) and Rule 10b-5 enforcement).

464. *See id.* at 943-53 (rejecting misappropriation theory (1) because it does not comply with § 10(b) and (2) because of policy considerations).

465. *See id.* at 944-45 (delineating misappropriation theory and discussing application to Bryan's actions).

466. *Id.* at 944 (quoting United States v. Chestman, 947 F.2d 551, 556 (2d Cir. 1991) (en banc), *cert. denied,* 503 U.S. 1004 (1992)).

467. *See id.* (stating that source of information need not be associated with stock transaction).

468. *See id.* (discussing in connection requirement).

469. *See id.* at 945 (concluding that Bryan's conduct violated misappropriation theory).

470. *See id.* (stating that relevant inquiry should not focus on Bryan's conduct but on validity of misappropriation theory).

471. *See id.* (following Supreme Court's advice and precedent by concluding that manipulation and deception formed bases of § 10(b) violations).

472. *Id.* (citations omitted).

"deception" in Section 10(b) limits the interpretation and application of fraud under Rule 10b-5.[473] The ultimate question, then, is whether the fraud committed under the misappropriation theory — a breach of a fiduciary duty to the source of the information who is not connected to the securities transaction — is deception under Section 10(b).[474]

The Fourth Circuit stated that the *Santa Fe* Court defined deception in the context of Section 10(b) either as a material misrepresentation or as a breach of an affirmative duty to disclose.[475] In deciding *Santa Fe*, the Supreme Court rejected the notion that Section 10(b) applied to breaches of fiduciary duties without deception.[476] The Fourth Circuit noted that the Court, in *Central Bank v. First Interstate Bank*,[477] recently reaffirmed this conclusion[478] and stated that "Section 10(b) does not 'reach[ ] breaches of

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473. *See id.* (stating that Rule cannot exceed language of statute).

474. *See id.* at 946 (determining focus of analysis). The court stated that the:

> [S]pecific concern is whether the Rule's prohibition of "fraud" "in connection with the purchase or sale of any security," which can be read no more broadly than the statutory prohibition of "deception" "in connection with the purchase or sale of any security," . . . may extend to breaches of fiduciary duty involving the misappropriation of confidential information from one who is neither a purchaser nor seller of securities, or otherwise connected with a securities transaction.

Id.

475. *See id.* (noting that Supreme Court defined "deception" in *Santa Fe*).

476. *Id.* (interpreting *Santa Fe* and stating that § 10(b) does not cover mere breaches of fiduciary duty). In *Santa Fe*, the Court stated that "the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977).

477. 114 S. Ct. 1439 (1994).

478. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446-48 (1994) (reaffirming that Rule 10b-5 violation requires manipulation or deception). In *Central Bank*, the Supreme Court eliminated aiding and abetting liability under § 10(b) for private civil actions. *Id.* at 1448. The Colorado Springs-Stetson Hills Public Building Authority (the Authority) issued $26 million worth of bonds in 1986 and 1988 to finance public improvements. *Id.* at 1443. Landowner assessment liens secured the bonds and the bond covenants required that the value of the land equal at least 160% of the outstanding principal and interest. *Id.* Central Bank of Denver (Central Bank) served as indenture trustee for the issues. *Id.* AmWest Development (AmWest), the developer of Stetson Hills, gave Central Bank an annual report comparing the land values with the 160% requirement. *Id.* Prior to the June 1988 issue, Central Bank received information that the land values had declined and that they did not meet the 160% test mandated by the covenants. *Id.* However, Central Bank chose to postpone a thorough analysis of the land values until the end of 1988, six months after the bond issue. *Id.* After the 1988 issue and prior to the completion of the land value appraisal, the Authority defaulted on the 1988 bonds. *Id.* First Interstate Bank of Denver (First Interstate Bank) and Jack Naber purchased more than $2 million of 1988

fiduciary duty . . . without any charge of misrepresentation or lack of disclosure.'"[479] In eliminating aiding and abetting liability, the Court agreed that although this behavior is improper in some instances, fairness considerations could not alter the holding dictated by the language of Section 10(b).[480]

The Fourth Circuit then analyzed who must suffer the deception in a Section 10(b) action.[481] The appellate court noted that the Supreme Court has consistently stated that Section 10(b) is concerned only with deception performed on purchasers or sellers of securities or, at most, other parties with a vested interest in the transaction.[482] The court stated that the Supreme Court "has left no doubt that the principle concern of Section 10(b) is the protection of purchasers and sellers of securities."[483] This protection of investors supplied the premise for both *Chiarella* and *Dirks*.[484] The Fourth Circuit also interpreted an aspect of the *Central Bank* decision to support the purchaser or seller limitation of Section 10(b).[485]

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bonds. *Id.* They brought suit against the Authority, an AmWest official, Central Bank, and two underwriters, claiming various violations of § 10(b). *Id.* The United States District Court for the District of Colorado granted summary judgment to Central Bank but the Tenth Circuit reversed. *Id.* The Supreme Court reversed the court of appeals and eliminated aiding and abetting liability for private actions under § 10(b). *Id.* at 1445-50. The Court primarily relied on the language of § 10(b) and concluded that the statutory language did not provide liability for aiding and abetting. *Id.* at 1445-48. The Court stated that "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *Id.* at 1448. The statutory language of § 10(b) simply did not preclude aiding and abetting. *Id.*

See Carrie E. Goodwin, Note, Central Bank v. First Interstate Bank: *Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV. 1387 (1995), for a discussion of *Central Bank* and its ramifications.

479. United States v. Bryan, 58 F.3d 933, 946 (4th Cir. 1995) (quoting *Central Bank*, 114 S. Ct. at 1446). Later in *Central Bank*, the Supreme Court reaffirmed this conclusion and stated that "[a]s in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Central Bank*, 114 S. Ct. at 1448.

480. *See Central Bank*, 114 S. Ct. at 1448 (refusing to consider policy issues because statute is explicit on its face). The Court stated that "[t]he issue, however, is not whether imposing private civil liability on aiders and abetters is good policy but whether aiding and abetting is covered by the statute." *Id.*

481. *See Bryan*, 58 F.3d at 946-48 (analyzing purchaser or seller requirement).

482. *See id.* at 946 (stating that victim must be purchaser, seller, or other person closely connected with transaction for actionable § 10(b) claim).

483. *Id.* at 946-47.

484. *See id.* at 947 (stating that investor protection is basis of *Chiarella* and *Dirks* decisions).

485. *See id.* (citing *Central Bank* as supporting purchaser or seller limitation).

After establishing that, in the context of fraudulent nondisclosure, the scope of Section 10(b) only addresses deception performed on actual purchasers or sellers, or on others with a vested interest in the transaction,[486] the Fourth Circuit analyzed the misappropriation theory under the purview of Section 10(b).[487] First, the court noted that the misappropriation theory requires only a breach of a fiduciary duty or some other relationship of trust and confidence, and not an affirmative act of deception.[488] Such a breach is not necessarily deceptive as defined by the Supreme Court.[489] Second, under the misappropriation theory, the victim of the deception need not be the party trading opposite to the violator nor a market participant at all.[490] The appellate court determined that this particular result conflicted with precedent by eliminating the requirement that a market participant suffer the deception.[491] The court stated that by eliminating the requirement that a market participant suffer the fraud, the misappropriation theory converted the securities laws into "a federal common law governing and protecting any and all trust relationships."[492] The court of appeals noted that the protection of fiduciary or trust relationships is not the purpose of the securities laws.[493] Therefore, under the Fourth Circuit's analysis, the misappropriation theory is faulty for two reasons: First, the fraud under the theory is broader than the deception defined by Section 10(b) as construed by the Supreme Court; and second, the victim of the fraud is not necessarily connected in any manner to the securities transaction.[494]

486. *See id.* at 946-48 (discussing scope of § 10(b) and concluding that it applied to deception performed on actual purchasers or sellers).

487. *See id.* at 949-50 (analyzing misappropriation theory under limits of § 10(b)).

488. *See id.* at 949 (finding that misappropriation theory does not require deception). The court stated that "by its own terms, the misappropriation theory does not even require deception, but rather allows the imposition of liability upon the mere breach of a fiduciary relationship or similar relationship of trust and confidence." *Id.*

489. *See id.* (noting that misappropriation theory only requires breach of fiduciary duty that is not necessarily deceptive).

490. *See id.* at 949-50 (stating that victim of deception need not be purchaser or seller). The court noted that "the theory still does not require deception violative of a duty of fair representation or disclosure owed to a market participant, i.e., deception in connection with a purchase or sale of securities." *Id.* at 949.

491. *See id.* at 949-50 (finding that misappropriation theory contradicts precedent by eliminating requirement that market participant suffer fraud).

492. *Id.* at 950.

493. *See id.* (finding that Congress did not intend for securities laws to protect non-securities relationships).

494. *See id.* (concluding that misappropriation theory is faulty because it does not require deception and because victim is neither purchaser nor seller). The court stated that:

Despite the Fourth Circuit's determination that precedent and textual analysis were sufficient to reject the misappropriation theory, the court discussed various policy reasons behind its rebuff.[495] The court noted that the Supreme Court has stated that securities laws demand predictability.[496] Moreover, market participants need guidance, and absent clear laws and interpretations, investors might find themselves victims of the SEC's spontaneous decisionmaking and enforcement strategy.[497] With this axiomatic premise in mind, the court of appeals noted the extreme uncertainty that the misappropriation theory introduced into securities fraud enforcement.[498] The culprit of this uncertainty is the theory's crux — the simple breach of a fiduciary duty.[499] Basing the theory on a breach of a fiduciary duty is problematic because the duty is difficult to define. As the court noted: "[A]lthough fifteen years have passed since the theory's inception, no court adopting the misappropriation theory has offered a principled basis for distinguishing which types of fiduciary or similar relationships of trust and confidence can give rise to Rule 10b-5 liability and which cannot."[500] The appellate court declared that the absence of clear guidelines for determining the nature of relationships presents a formidable problem because the definition and the regulation of relationships varies widely from state to state, from family to family, and from employer to employer.[501] Basing the *federal* securities laws on such dramatic variations of relationships traditionally regulated by states presents fairness and enforcement problems between jurisdictions and

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> In essence, the misappropriation theory disregards the specific statutory requirement of deception, in favor of a requirement of a mere fiduciary breach, and then artificially divides into two discrete requirements — *a* fiduciary breach and *a* purchase or sale of securities — the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction. In doing so, the theory effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived, allowing conviction not only where the "defrauded" person has no connection with a securities transaction, but where no investor or market participant has been deceived.

Id.

495. *See id.* at 950-53 (discussing policy reasons for rejection of theory).

496. *See id.* at 950 (noting that Supreme Court has declared that securities laws need predictability and certainty).

497. *See id.* at 950-51 (discussing importance of having clear rules).

498. *See id.* at 951 (stating that misappropriation theory introduced unpredictability into securities laws).

499. *See id.* (claiming that breach of fiduciary duty is theory's "linchpin").

500. *Id.*

501. *See id.* (finding that relationships vary tremendously between different entities).

would eventually lead to the "effective federalization of relationships historically regulated by the states."[502] This, the Fourth Circuit stated, would clearly violate *Santa Fe*'s admonition not to use the federal securities laws to regulate behavior traditionally left to the states.[503]

For all of the above reasons, the Fourth Circuit rejected the use of the misappropriation theory.[504] Certainly, the court did not condone Bryan's behavior, but commented that "in securities law, as in all areas of the law, our perceptions of what is wise or fair are ultimately of no relevance."[505] Notwithstanding a desire to punish Bryan for perceptibly unfair behavior in trading on the material nonpublic information, the court concluded that "it simply was not conduct that is prohibited by Section 10(b) of the Securities Exchange Act of 1934."[506] The court of appeals noted, however, that Bryan's behavior surrounding the securities transactions would not go totally unpunished: It sustained Bryan's conviction for the wire fraud stemming from the securities transactions.[507]

United States v. Bryan and its repudiation of the misappropriation theory is a sound decision that is based on precedent and policy. The Fourth Circuit rejected any abstract ideas concerning fairness and, instead, remained consistently guided by precedent.[508] Such precedent mandated the rejection of the misappropriation theory.[509] The court focused on two elements of the misappropriation theory that precedent dictates as inappropriate: First, the

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502. *Id.*

503. *See id.* at 951-52 (stating that eventual result of misappropriation theory would lead to federal fiduciary principle in contradiction of *Santa Fe*).

504. *See id.* at 952 (rejecting misappropriation theory). The court stated its holding:

> Accordingly, we hold that criminal liability under Section 10(b) cannot be predicated upon the mere misappropriation of information in breach of a fiduciary duty owed to one who is neither a purchaser nor seller of securities, or in any other way connected with, or financially interested in, an actual or proposed purchase or sale of securities, even when such a breach is followed by the purchase or sale of securities. Such conduct simply does not constitute fraud in connection with the purchase or sale of securities, within the meaning of Section 10(b).

Id.

505. *Id.* at 959.

506. *Id.*

507. *Id.* at 943.

508. *See id.* at 943-50 (using Supreme Court precedent to reject misappropriation theory).

509. *See id.* at 950 (noting that text of § 10(b), as interpreted by Supreme Court, was sufficient to reject misappropriation theory). The court noted, however, that "[a]bsent guidance from the Supreme Court, the language of the Rule, if not of the statute, could plausibly accommodate the misappropriation theory." *Id.* at 945.

lack of any deception in using the confidential information; and second, the commission of the fraud on the source of the information, not on the opposite party to the securities transaction.[510]

The Fourth Circuit began its thorough analysis of precedent by properly interpreting *Santa Fe* to define fraud under Rule 10b-5 by the "manipulative or deceptive" language of Section 10(b).[511] The mere breach of a fiduciary duty, without more, is not deceptive under the statute.[512] Applying this to the misappropriation theory, the appellate court noted that the theory only requires that the violator breach some type of a fiduciary duty in using the entrusted information — deception is not an element.[513] The court rightly concluded that this result clearly contradicts the holding of *Santa Fe*.[514] Misappropriation without deception simply does not violate Rule 10b-5.

The Fourth Circuit then properly determined that Supreme Court precedent focused on investors and not on the source of confidential information.[515] Section 10(b) requires that the fraud occur "in connection with the purchase or sale of any security."[516] The court correctly stated that Rule 10b-5 applies only to purchasers, sellers, or others with a vested interest in the securities transaction.[517] Otherwise, "the statutory requirement that the

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510. *See id.* at 945-50 (focusing on definition of fraud and victim of fraud).

511. *See id.* at 945-46 (interpreting *Santa Fe*); *see also* Santa Fe Indus. v. Green, 430 U.S. 462, 473-76 (1977) (requiring manipulation or deception for finding of fraud under Rule 10b-5).

512. *See* United States v. Bryan, 58 F.3d 933, 946 (4th Cir. 1995) (noting that *Santa Fe* stated that § 10(b) does not prohibit mere breaches of fiduciary duty); *see also Santa Fe*, 430 U.S. at 472 (refusing to extend § 10(b) to all breaches of fiduciary duty).

513. *See Bryan*, 58 F.3d at 949 (finding that misappropriation theory does not require any deception, only breach of fiduciary duty).

514. *See id.* (concluding that misappropriation theory does not comply with *Santa Fe* holding).

515. *See id.* at 946-50 (finding that Supreme Court's precedent primarily concerned investors); *see also* Dirks v. SEC, 463 U.S. 646, 657-58 (1983) (discussing how duty to disclose arises from relationship *between* parties to securities transaction and not simply from possession of material nonpublic information); Chiarella v. United States, 445 U.S. 222, 228-30 (1980) (finding that duty to disclose arises from relationship *between* members of securities transaction); *Santa Fe*, 430 U.S. at 478-80 (noting that Rule 10b-5 neither supplies federal fiduciary standard nor protects against simple corporate mismanagement); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976) (finding that purpose of federal securities regulations is to protect investors); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975) (allowing only actual purchasers or sellers to bring private Rule 10b-5 actions).

516. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j(b) (1994)); *see supra* note 4 (providing text of § 10(b)).

517. *See* United States v. Bryan, 58 F.3d 933, 946 (4th Cir. 1995) (stating limits of

fraud be in connection with the purchase or sale of securities . . . [will] be rendered meaningless."[518] The holdings of *Dirks*, *Chiarella*, and *Blue Chip Stamps* assisted the Fourth Circuit with its reasoning.[519] Finding that both *Dirks* and *Chiarella* required that the duty to disclose arise from the relationship between the parties to a transaction, the Fourth Circuit determined that the primary purpose of Section 10(b) is the protection of purchasers and sellers of securities.[520] The court noted that the relationship between the parties — not mere possession of confidential information — creates the duty to disclose and that Section 10(b) protects against violations of that relationship.[521] The *Blue Chip Stamps* decision also supplied persuasive precedent in its limitation that a person must be an actual purchaser or seller before bringing a civil action under Section 10(b).[522] Although *Blue Chip Stamps* did not specifically apply, the court noted the soundness of the decision's statutory interpretation and asserted that the case provided additional support.[523] The appellate court's conclusion limiting Section 10(b) to purchasers, sellers, or others with a vested interest in the transaction is commendable and correct. Because the misappropriation theory lacks any requirement of deception and does not require that a participant to the securities transaction suffer the fraud, the Fourth Circuit properly rejected the theory's application for Rule 10b-5 enforcement.

The court's policy arguments also provided impressive support for the theory's repudiation.[524] The concern that the securities laws might provide insufficient guidance to investors primarily troubled the court.[525] Without clearly defined rules, investors could unknowingly subject themselves to discretionary enforcement by the SEC.[526] The court correctly noted that the

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Rule 10b-5).

518. *Id.*

519. *See id.* at 946-48 (discussing purchaser or seller requirement for Rule 10b-5 and citing precedent).

520. *See id.* at 946-47 (stating that primary purpose of § 10(b) is to protect investors).

521. *See id.* (interpreting *Chiarella* and *Dirks* and asserting that purpose of § 10(b) is to protect purchasers and sellers).

522. *See id.* at 947-48 (relying on *Blue Chip Stamps* to support conclusion limiting § 10(b) to purchaser or sellers); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-49 (1975) (limiting private actions under § 10(b) to actual purchasers or sellers).

523. *See* United States v. Bryan, 58 F.3d 933, 947-48 (4th Cir. 1995) (discussing *Blue Chip Stamps*).

524. *See id.* at 950-53 (discussing policy reasons for rejection of misappropriation theory).

525. *See id.* at 950-51 (noting that securities laws should provide clear rules).

526. *See id.* (demonstrating concern for investors in absence of clear guidelines).

misappropriation theory conflicted with these goals of providing clear securities laws.[527] The Fourth Circuit properly recognized that the theory introduces tremendous uncertainty into the securities laws because of its vague requirement that a violator breach a fiduciary duty or some other relationship of trust and confidence.[528] This uncertainty leads to selective enforcement, and eventually, would require a federal fiduciary standard because of the varying fiduciary duties.[529] The court persuasively stated that federal enforcement of a fiduciary standard conflicts with the Supreme Court's refusal in *Santa Fe* to extend Rule 10b-5 over areas traditionally left to state law.[530] The Fourth Circuit's decision in *United States v. Bryan* correctly interprets the text of Section 10(b) and Rule 10b-5, properly analyzes Supreme Court precedent, and provides significant policy arguments for rejection of the misappropriation theory.

VIII. Conclusion

A former SEC Commissioner suggested that the misappropriation theory "is merely a pretext for enforcing equal opportunity in information."[531] This observation appears to be correct. Since *Texas Gulf Sulphur* the Second Circuit has attempted to implement the discredited parity of information theory. The Second Circuit, along with the SEC, attempted to apply nebulous concerns of fairness and consistently read Rule 10b-5 more expansively than the statutory language of Section 10(b) allowed. The misappropriation theory is simply the most recent device intended to establish parity of information. The theory is pretextual — a hidden motivation lies in the Second Circuit's and the SEC's infatuation with ridding the securities markets of behavior that they deem unfair, regardless of whether the conduct violates Section 10(b). This rationale is seductive. Who can argue against fairness? However, as the Fourth Circuit noted and as the Supreme Court has consistently expressed, concerns of fairness are not only subordinate to Section 10(b), but completely irrelevant. This is not to say that the behavior

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527. *See id.* at 951 (finding that misappropriation theory introduced uncertainty into securities laws).

528. *See id.* (stating that misappropriation theory's requirement of breach of fiduciary duty introduced uncertainty into securities laws).

529. *See id.* at 951-52 (discussing ramifications of misappropriation theory).

530. *See id.* (evaluating possible response to securities laws enforcement based on wide array of fiduciary duties); *see also* Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) (refusing to extend Rule 10b-5 to areas traditionally regulated by state law).

531. Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 366 (1988).

of Newman, Materia, Carpenter, Chestman, or Bryan is admirable. Quite the contrary, most were scoundrels who acted out of pure greed. They were not, however, perpetrators of Section 10(b) violations. Their conduct simply did not constitute *securities* fraud as the statute is written. If Congress concludes that their behavior should be illegal, then Congress should enact legislation to clarify federal insider trading enforcement law. Regardless, the misappropriation theory contradicts precedent, protects relationships instead of investors, requires the evaluation of vague concepts of fiduciary duties, and does not provide clear guidelines for prospective enforcement. The elimination of the misappropriation theory of insider trading enforcement is, in actuality, the *fair* result and should occur immediately.

TRIBUTE

Edmund Douglas Campbell