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The Misappropriation Theory in Light of Carpenter and the Insider Trading and Securities Fraud Enforcement Act of 1988

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I. INTRODUCTION

Insider trading is the financial touchstone of the late 1980's. It represents Wall Street's greed run rampant.[1] Insider trading epitomizes "yuppie fever"—the creation of excessive wealth by young Wall Street professionals. The extent and pervasiveness of insider trading is self-evident; it has been an extensive subject of the popular press and has even been the subject of a major motion picture.[2] Yet, behind the scenes, the Securities and Exchange Commission (SEC), Congress, and the courts are taking affirmative steps to stop the latest form of insider trading—that undertaken by nontraditional insiders or outsiders to the corporation. This comment addresses measures designed to prevent illegal trading on material nonpublic information by individuals who are not traditional insiders.[3]

In November 1988, then President Reagan signed the Insider Trading and Securities Fraud Enforcement Act of 1988 (the Act).[4] The

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1. *See* Nathans & Smart, *A Backlash Against Business?*, BUS. WK., Feb. 6, 1989, at 30.

2. *Wall Street* (20th Century Fox 1987).

3. Traditional insiders are directors, officers, or shareholders with at least a ten percent ownership. *See* Securities and Exchange Act of 1934, § 16(a), 15 U.S.C. § 78p(a) (1982). These three groups are considered agents of the corporation and owe it a fiduciary duty. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947) (rule 10b-5 applies to officers and directors who trade in their corporation's stock while possessing material inside information).

4. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (to be codified as amended in scattered sections of 15 U.S.C.) (signed by former President Reagan on November 19, 1988); *see also* H.R. REP. NO. 910, 100th Cong., 2d Sess. (1988), *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 6043 [hereinafter REPORT].

Act expressly codified the misappropriation theory as a means to establish liability under the insider trading laws. Under the misappropriation theory, liability arises when an individual trades on the basis of information acquired in violation of a fiduciary duty of confidentiality owed to another, whether it be a corporation, an employer, or an individual.[5] Part II of this comment will address the evolution of section 10(b) and rule 10b-5. Part III will detail the misappropriation theory's development, the Second Circuit's application of the theory, and the United States Supreme Court's position on the theory. For the practitioner, Part IV delineates the parameters of the misappropriation theory and the theory's effect on a section 10(b) cause of action. Part V will address the Act. Finally, Part VI will provide a critique of the misappropriation theory and the Act.

II. THE EVOLUTION OF SECTION 10(B) AND RULE 10B-5

Section 10(b) of the Securities Exchange Act of 1934[6] was designed "to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's."[7] The purpose of section 10(b) is to maintain a fair and honest market by requiring full disclosure of information,[8] thus protecting public investors.[9] The Supreme Court

5. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984). The author contends that the misappropriation theory should support Rule 10b-5 violations when "[outsiders] trade on the basis of nonpublic information that has been entrusted to them with the expectation that they will hold it in confidence and refrain from acting upon it . . . ." *Id.* at 102.

6. 15 U.S.C. § 78j(b) (1982). Section 10(b) prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . ." *Id.*

7. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (footnote omitted).

8. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858-59 (2d Cir. 1968) (en banc), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969) (citing H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934)).

9. Commentators have sharply criticized the SEC's position on the evils of insider trading. *See* Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1056-57 (1977). Market efficiency results from two factors:

> vigorous competitive securities analysis and trading by corporate insiders with superior ability to forecast future performance by their firms. Each of these processes may account in part for market efficiency, but in any case the SEC should no longer ignore the overwhelming evidence of securities market efficiency in formulating its regulatory policy.

Id.; *see also* Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) (footnote omitted) (insider trading is "an efficient way to compensate corporate managers"); M. Moran, Insider Trading In The Stock Market: An Empirical Test Of The Damage to Outsiders (Center for the Study of American Business, Working Paper No. 89, Wash. U., July 1984) (unpublished manuscript). The empirical results suggest that "insider trading harms no one and improves the performance of the has noted that section 10(b), when implemented by rule 10b-5,[10] is an all-inclusive provision designed to prevent any fraudulent activity.[11]

Rule 10b-5[12] was similarly enacted to protect investors against fraudulent practices.[13] During its development, litigation primarily focused on corporate officers and directors who traded in their company's securities based upon undisclosed material information.[14] Ultimately, the courts have been responsible for the development of rule 10b-5.[15] Chief Justice Rehnquist has noted that this rule has become a "judicial oak which has grown from little more than a legislative acorn."[16]

The seminal case of *In re Cady, Roberts & Co.*[17] established the dis-

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stock market. Therefore, the insiders' profits are not outsiders' losses but evidence of more efficient resource allocation." *Id.* at 1. *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 25-35 (1988) (discussion concerning the philosophies behind the development of the federal securities statutes).

10. 17 C.F.R. § 240.10b-5 (1988). See *infra* note 12 for the text of this regulation.

11. Chiarella v. United States, 445 U.S. 222, 226 (1980) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202, 206 (1976)).

12. 17 C.F.R. § 240.10b-5 (1988) states:

> 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 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.

Id.

13. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

14. *See, e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946); *see also* Comment, *A New Concept of Fraud on the Securities Exchange—A Comment on* In Re Cady, Roberts & Co., 15 S.C.L. REV. 557, 565 (1963) [hereinafter *New Concept*] (noting that before *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961), "the courts and even the Commission unjustifiably restricted the application of Rule 10b-5 to include only those insiders as defined by [section] 16b (officers, directors, and 10% controlling shareholders)"); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1144-46 (1950) (details who insiders are, to whom the duty to disclose is owed, and when the duty exists).

15. *See generally* L. LOSS, *supra* note 9, at 726-29. As section 10(b) and rule 10b-5 are "virtually as vague as the Due Process Clause, the law is surely as much judge-made as is the classic common law of the states." *Id.* at 728.

16. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

17. 40 S.E.C. 907 (1961). The SEC initiated administrative proceedings against Cady, Roberts & Co., a brokerage firm and Mr. Gintel, a broker-dealer, for violations of section 10(b) and rule 10b-5. Mr. Cowdin, a registered representative of Cady, Roberts & Co. and a director of Curtiss-Wright Corporation, notified Gintel of a dividend reduction by Curtiss-Wright. Prior to public dissemination of this information, Gintel sold 7,000 shares of Curtiss-Wright stock. *Id.* at 908-10.

close or abstain doctrine. The SEC held the brokerage firm of Cady, Roberts & Co. and Mr. Gintel, a Cady, Robert's broker-dealer, in violation of rule 10b-5.[18] The Commission held that a corporate insider has a fiduciary duty to either abstain from trading in his corporation's securities or disclose all material information prior to any trading.[19] The SEC based the disclose or abstain doctrine on two principles: (1) the existence of a relationship which provides access to information intended only for a corporate purpose; and (2) the inherent unfairness of using the information for personal advantage.[20] The significance of *Cady, Roberts* stems from the analytical framework provided in applying rule 10b-5 to individuals who do not fit within the classification of traditional insiders.[21]

SEC v. Texas Gulf Sulphur Co.[22] was the first court of appeals case to apply rule 10b-5 to nontraditional corporate insiders while addressing the duty to disclose material information under rule 10b-5.[23] The

18. *Id.* at 913.

19. *Id.* at 911. Ultimately, because of the common law duty owed to the corporation, the directors' only viable option under the "disclose or abstain" rule is to abstain from trading. *See* Oliver v. Oliver, 118 Ga. 362, 368, 45 S.E. 232, 234 (1934).

> It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock.

Id.; *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). Any person possessing material inside information "must either disclose it . . . or, if disabled from disclosing it in order to protect a corporate confidence, . . . abstain from trading" in the securities. *Id.*

20. *Cady, Roberts*, 40 S.E.C. at 912.

21. *New Concept*, *supra* note 14, at 565-70. "Thus in *Cady, Roberts*, the Commission finally has an opportunity to administer the spirit of the act, which is to expand the concept of fraud so that the investing public may rely without detriment on the honesty and integrity of the securities market and those who deal therein." *Id.* at 570. *See* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The* Cady, Roberts *Doctrine*, 30 U. CHI. L. REV. 121, 122 (1962). The *Cady, Roberts* decision establishes three principles: nondisclosure operates as fraud or deceit, rule 10b-5 reaches noninsiders, and the duty to disclose is owed in the impersonal securities market. *Id.*

22. 401 F.2d at 833. The defendant company issued a press release in response to rumors of a substantial mineral discovery. The press release stated that the rumors regarding the extent of the discovery were unsubstantiated. Four days later, the company issued a second press release concerning the exact magnitude of the mineral field. During the interim, a Texas Gulf Sulphur director, two officers, and several other employees purchased shares in the company. *Id.* at 843-47.

23. *See* Bromberg, *Corporate Information:* Texas Gulf Sulphur *and Its Implications*, 22 SW. L.J. 731, 732 (1968). *Texas Gulf Sulphur* additionally established three tests to determine materiality of the nondisclosure or misrepresentation: "the reasonable investor test," whether the information would affect a reasonable investor's investment decision; "the probability factor," materiality depends upon the balance of the probability that the event will occur and the total effect the event would have on the company; and the "cut-your-own-throat element," evidence of materiality exists whenever an insider trades. *Id.* at 740-42; *see also* Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771, 1773 (1984) (judicial focus changed from examining fiduciary duties to the concept of inherent unfairness when permitting informational advantages among market investors); Fleischer, *Securities Trading and*

Second Circuit, sitting en banc, held that certain officers, directors, and geologist employees of Texas Gulf Sulphur possessed material nonpublic information regarding exploratory drilling activities and, although some of these individuals were not traditional corporate insiders, they were nevertheless under a duty to disclose the information concerning the magnitude of the mineral discovery or to refrain from trading.[24] Their failure to abstain from trading in the stock during the exploration period resulted in a rule 10b-5 violation.[25] The court expanded the holding of *Cady, Roberts* by stating that "[a]nyone in possession of material inside information must either disclose it to the investing public, or . . . [if unwilling to disclose or, if due to a corporate confidence, is unable to disclose, to] . . . abstain from trading or in recommending the securities . . . ."[26]

In *Chiarella v. United States*,[27] the Supreme Court examined the duty of an individual to disclose material nonpublic information in light of rule 10b-5 when the individual was unconnected to the subject corporations. Chiarella failed to disclose information concerning takeover target corporations acquired through his job. Instead, he purchased each company's stock, which he sold as soon as the news of the takeover had been publicly disseminated.[28] He consequently earned $30,000 over a fourteen month period.[29] Although the Second Circuit affirmed his conviction under section 10(b) and rule 10b-5,[30] the Supreme Court reversed, holding that Chiarella's trading without disclosure did not violate section 10(b) or rule 10b-5.[31]

Corporate Information Practices: The Implications of Texas Gulf Sulphur *Proceedings*, 51 VA. L. REV. 1271, 1272 (1965) (noting that *Texas Gulf Sulphur* is not a radical departure from securities law; rather, it is a consistent development of the federal securities law).

24. *Texas Gulf Sulfur*, 401 F.2d at 848.

25. *Id.*

26. *Id.* However, in General Time Corp. v. Talley Indus., 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969), the Second Circuit retreated from the disclose or abstain rule in *Texas Gulf Sulpher* and stated, "[w]e know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relationship to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.* at 164.

27. 445 U.S. 222 (1980). Chiarella was employed by a financial printing firm. His capacity as a markup man included handling five separate documents concerning corporate takeovers. Although the name of the takeover targets were concealed, Chiarella could ascertain the target companies through other information that was provided in the document. *Id.* at 224.

28. *Id.*

29. *Id.*

30. *Id.* at 225.

31. *Id.* at 237.

Chiarella is significant because of the limitation placed on rule 10b-5.[32] The Court noted that past rule 10b-5 violations involved individuals who owed a preexisting duty of care to the party trading on the information.[33] Chiarella was not a corporate insider, and therefore owed no preexisting duty to disclose the information he acquired to the opposite party to the transaction.[34] Thus, a duty to disclose information exists *only* when the party trading on the information has a preexisting duty or relationship of trust and confidence.[35] The Court's opinion displays a strict statutory construction, and a narrow interpretation of section 10(b)'s reach.[36]

In *Dirks v. SEC*,[37] Dirks, as an officer of a brokerage house, received information from a former officer of Equity Funding of America (Equity Funding) that Equity Funding's assets were vastly overstated. While investigating, Dirks discussed the alleged fraud with individuals who subsequently sold their Equity Funding holdings. The SEC found Dirks liable for violating the anti-fraud provisions of section 10(b) and rule 10b-5.[38] The Circuit Court of Appeals for the District of Columbia entered judgment against Dirks, basing its decision on the SEC's opinion.[39] However, the Supreme Court reversed, stating that Dirks had no duty to abstain from using the ma-

32. Note, *Rule 10b-5 and Non-Traditional Insiders: The Supreme Court Continues Its Retrenchment Trend,* Chiarella v. United States, 30 DE PAUL L. REV. 181, 200-201 (1980). By narrowly interpretating rule 10b-5, the Court created a gap that allows a nontraditional insider to trade on material inside information without the threat of prosecution. *See* Note, *Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief,* 55 ST. JOHN'S L. REV. 93, 112-15 (1980). The *Chiarella* opinion is flawed because it restricted the liability of potential defendants through its requirement of a duty of trust and confidence between the buyer and seller, and it decreased the SEC's power to control insider trading by declining to rule on the misappropriation theory as an alternative theory of liability. *Id.*

33. *Chiarella,* 445 U.S. at 229-30; *see also* Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972) (bank officers were charged with responsibility to their shareholders and could not act as market makers and induce individuals to sell without first disclosing the existence of second market); Frigitemp Corp. v. Financial Dynamics Funds, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (held "[t]he party charged with failing to disclose market information must be under a duty to disclose it to the plaintiffs"); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1168-70 (2d Cir. 1970) (failure of brokerage firm to disclose to its clients that the brokerage firm was making a market in the stock was a failure to disclose a material fact under, inter alia, rule 10b-5); General Time Corp. v. Talley Indus., 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969) (purchaser has no obligation to reveal material facts to potential seller, unless he is either an insider or a fiduciary).

34. *Chiarella,* 445 U.S. at 231-33. To hold otherwise, the Court would be forced to recognize a broad duty among all market participants, and this would be contrary to the doctrine requiring a specific relationship between the parties. *Id.* at 233.

35. *Id.* at 228.

36. *Id.* at 233-34. *But see* 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 7.5(511), at 7.233 (1979). A majority of the justices of the *Chiarella* Court accepted some version of the misappropriation theory. *Id.*

37. 463 U.S. 646 (1983).

38. *Id.* at 652.

39. *Id.*

terial nonpublic information.[40]

Dirks is significant for establishing the tipper/tippee liability standard[41] and the Court's emphasis on market efficiency as a function of the anti-fraud provisions of the securities laws.[42] The Court reiterated that a duty to disclose or abstain from trading is dependent upon a relationship of trust and confidence vis-à-vis a corporation's shareholders.[43] This duty is predicated upon a preexisting fiduciary relationship.[44] Although Dirks received his information from a corporate insider, the Court held that a tippee[45] must refrain from trading only when an insider has breached his fiduciary duty.[46] A breach occurs when the insider/tipper discloses material nonpublic information to the outsider/tippee.[47] "[T]he 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. Absent a breach by the insider, there has been no derivative breach."[48] Dirks' tipper did not benefit from his disclosure.[49] Thus, there was no breach by the insider and Dirks could not have committed a derivative breach.[50]

40. *Id.* at 667.

41. *See generally* Note, Dirks v. SEC: *Delineating the Scope of Insider Trading Liability Under Rule 10b-5*, 4 N. ILL. U.L. REV. 329 (1984) [hereinafter Note, *Delineating*]; Note, Dirks v. SEC: *Tippee Liability After* Chiarella v. United States, 59 TUL. L. REV. 502 (1984).

42. Note, *The Supreme Court's Highwire Act: Balancing SEC Enforcement and Market Efficiency in* Dirks v. SEC, 45 U. PITT. L. REV. 923, 944-47 (1984).

43. *Dirks*, 463 U.S. at 654.

44. *Id.* at 654-55; *see also* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986). The duty of disclosure must exist from a fiduciary relationship which is not established by the securities laws. *Id.* at 495-96.

45. "[T]hose who receive material nonpublic information from insiders . . . ." Note, *Delineating*, *supra* note 41, at 330.

46. *Dirks*, 463 U.S. at 660.

47. *Id.*

48. *Id.* at 662; *see* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984). In *Switzer*, a director of Phoenix Resources informed his wife at a track meet of the possibility of liquidating Phoenix (which the court considered material information), so that the wife would know his business schedule, and thus enable her to make child care arrangements. Defendants overheard this information. The court held that the director did not breach a fiduciary duty to shareholders of Phoenix because disclosure was not for an "improper purpose," which is either a direct or indirect benefit to the insider, and thus the first prong of *Dirks* was not established. *Id.* at 766. The second prong of *Dirks* was not satisfied either, as the SEC failed to establish that the defendants knew the information was material, nonpublic, and disseminated by insiders for an improper purpose. *Id.*

49. *Dirks*, 463 U.S. at 666-67.

50. *Id.* at 667. *But see* 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 66.02[a][iii][C], at 3-494.9 (2d ed. 1989 revision). Six justices of the majority ap-

III. THE MISAPPROPRIATION THEORY

A. *The Development of the Misappropriation Theory*

As an alternative avenue to establishing liability, then Chief Justice Burger first raised the misappropriation theory in his dissenting opinion in *Chiarella*.[51] Under section 10(b) and rule 10b-5 "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[52] As a general rule, there is no duty to make disclosure to the opposing party in an arms-length business transaction. However, Chief Justice Burger contended "the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."[53] Thus, the failure to disclose the misappropriated information constitutes the necessary fraud element for a rule 10b-5 action. Although criticized,[54] Chief Justice Burger's dissenting opinion stimulated the development of the misappropriation theory.

Commentators have suggested that, by building upon the dissenting opinion in *Chiarella*[55] and the dictum in *Dirks*, implicit acceptance of the misappropriation theory is possible.[56] The Court stated that Dirks did not "misappropriate or illegally obtain the information . . . ."[57] This statement is unnecessary to the holding in *Dirks*.[58] Nonetheless, it indicates the Court would have reached a different

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proved the misappropriation theory as evidenced by Justice Powell's dictum that Dirks did not misappropriate the information about Equity Funding. *Id.*

51. Chiarella v. United States, 445 U.S. 222, 239-45 (1979) (Burger, C.J., dissenting); *see* 5A A. JACOBS, *supra* note 50, § 66.02[a][iii][C][II], at 3-494.7 to .8. Chief Justice Burger's opinion is unclear as to what specific activity violated rule 10b-5. Perhaps it was: (a) the acquiring of the information through illegal avenues; (b) the use of the information; or (c) the acquisition of the information, without consent of the entity which created the information, and the subsequent use of the information for personal benefit. Jacobs opts for the latter activity because it fits within rule 10b-5, and satisfies Chief Justice Burger's language. *Id.*

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

53. *Id.*

54. Aldave, *supra* note 5, at 114-17. Former Chief Justice Burger's interpretation of the misappropriation theory is inconsistent with the majority opinions in *Chiarella* and *Dirks*. Both the Supreme Court and the Second Circuit rejected former Chief Justice Burger's view that the misappropriator of nonpublic information has an absolute duty to disclose or abstain from trading. *Id. See generally* Note, *The SEC's Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory*, 52 BROOKLYN L. REV. 43, 63-74 (1986) (general criticisms of the misappropriation theory). However, "[t]he continued application of the theory may deter outsiders from using material nonpublic information, and the image of a more rigorous enforcement program may assuage the fears of the investing public . . . ." *Id.* at 73-74 (citation omitted).

55. *See supra* notes 51-53 and accompanying text.

56. *See infra* note 95.

57. Dirks v. SEC, 463 U.S. 646, 665 (1983).

58. According to Donald Schwartz, professor at Georgetown University Law Center, the "most important thing" about *Dirks* "was the survival of the misappropriation theory of inside trading—'a Phoenix rising out of the ashes of *Chiarella*.'" *Special*

result had Dirks misappropriated the information, thus implicitly accepting the misappropriation theory.[59] However, in light of subsequent cases and the enactment of the Act, the debate over the validity of this argument is purely academic.

B. *The Second Circuit's Application of the Misappropriation Theory*

The Second Circuit[60] addressed the misappropriation theory for the first time in *United States v. Newman*.[61] The court reasoned that the misappropriation of confidential information concerning merger and acquisition proposals by a securities trader constituted sufficient fraud upon the defendants' employers.[62] The Second Circuit rejected the district court's statement that the defendants' fraud must be exacted upon the purchasers or sellers of the security.[63] Rather, the purchase or sale requirement had been satisfied as the defendants' "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares in the target companies . . . ."[64] Thus, the alleged fraudulent acts constituted a rule 10b-5

Report: Hostile Takeout Theme Pervades Fifth Garrett Securities Conference, 17 Sec. Reg. & L. Rep. (BNA) No. 20, at 899 (May 17, 1985).

59. Note, *supra* note 42, at 937.

60. Due to the geographic location of the stock exchanges within the Second Circuit, this Court of Appeals has had extensive experience with federal securities regulation cases. Consequently, other circuits look to the Second Circuit for guidance concerning securities-related issues. Bromberg, *supra* note 23, at 732.

61. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983). Newman, a securities trader, received confidential material information from employees of Morgan Stanley & Co., Inc. and Kuhn Loeb & Co., both investment banking firms. The information concerned merger and acquisition proposals entrusted to Morgan Stanley and Kuhn Loeb. Newman then passed the information along to two foreign investors, and all three purchased stock in the companies involved. The district court dismissed the indictment, but the court of appeals reversed. *Id.* at 14.

62. *Id.* at 17.

63. *Id.*; *see* O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (D.N.Y. 1981). The *O'Connor* court noted that even though insiders of Amax, Inc. and Standard Oil of California, Inc. and their tippees owed no duty to the writers of call options, "under the *Newman* rationale, because their trading or tipping breached fiduciary duties owed to other parties [their respective corporations], the alleged conduct constituted a fraudulent practice within the meaning of the securities laws." *Id.* at 1185; *see also* M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 3.04, at 3-16.2 (1988). *O'Connor* "can be read more narrowly as applying only to the duties of insiders and their tippees when trading on information derived from the issuer." *Id.* A broader reading would contradict the *Chiarella* holding that a duty to disclose results from a relationship between the parties to the transaction. *Id.* at 3-16.2 to .3.

64. *Newman*, 664 F.2d at 18; *see* Chemical Bank v. Arthur Andersen & Co., 552 F.

violation.[65]

In *SEC v. Materia*,[66] the Second Circuit faced facts virtually identical to those in *Chiarella*. Materia misappropriated information from the financial printing firm where he was employed. Prior to public disclosure, he traded on the illicitly acquired information for his financial benefit. The court relied upon *Newman*, holding that misappropriation came within the anti-fraud section of the securities law and, therefore, Materia's subsequent trading violated section 10(b) and rule 10b-5.[67] The misappropriation of the employer's property constituted sufficient fraud "upon any person."[68] Furthermore, because the misappropriation was part of the plan to trade on the information, the fraud was committed "in connection with" the purchase and sale of securities as required by rule 10b-5.[69]

In *Moss v. Morgan Stanley, Inc.*,[70] the Second Circuit addressed for

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Supp. 439 (D.N.Y. 1982), *cert. denied*, 469 U.S. 884 (1984). The *Chemical Bank* court stated:

> *Superintendent of Insurance* and its progeny require a nexus, albeit not a direct or close relationship, between the allegedly fraudulent conduct and the sale of the securities. Stated otherwise, the fraudulent conduct must 'touch upon' the securities transaction. This has been called the 'de minimis touch test,' primarily because it does not take much of a 'touch' to satisfy the test.

Id. at 451-52 (citations omitted); *see also* 1 A. BROMBERG & L. LOWENFELS, *supra* note 36, § 4.7(574), at 88.32 to .37 (judicial interpretations of "connection" have been very expansive).

65. *Newman*, 664 F.2d at 19; *see* Note, *Rule 10b-5 Developments—Theories of Liability*, 39 WASH. & LEE L. REV. 969, 984 (1982).

> The effect of *Newman* is to shift the focus for establishing liability under rule 10b-5 from a duty to the other party to a securities transaction to a duty to the source of nonpublic information. To trade on confidential information is to defraud the source of that information. After *Newman*, mere possession of confidential information can impose a duty to abstain from trading.

Id. (footnote omitted).

66. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

67. *Id.* at 201.

68. *Id.* at 201-03; *see* United States v. Winans, 612 F. Supp. 827 (D.N.Y. 1985). "Once again, the facts [in *Materia*] included some harm to a third party, but the language . . . [in *Materia*] in no way implies that the misappropriation theory requires anyone outside the employer/employee relationship to have been affected." *Id.* at 840-41. To require otherwise would result in a "view that a securities fraud can only be perpetrated against a buyer or seller of securities, a view clearly rejected in *Newman*." *Id.* at 841.

69. *Materia*, 745 F.2d at 203; *see* SEC v. Tome, 638 F. Supp. 596 (D.N.Y. 1986). Tome exploited a confidential relationship with the Chief Executive Officer of Joseph E. Seagram & Co. to obtain nonpublic information. The "in connection with" requirement was easily satisfied as "[t]he sole purpose of Tome's theft of confidential information regarding Seagram's tender offer plans 'was to reap instant no-risk profits in the stock market.' " *Id.* at 622 (quoting *Materia*, 745 F.2d at 203).

70. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). Warner-Lambert Co. retained Morgan Stanley to evaluate the acquisition of Deseret Pharmaceutical Company. Courtois, an employee of Morgan Stanley, informed Antoniu, an employee of Kuhn Loeb & Co., of the proposed acquisitions. Antoniu subsequently informed Newman. Based upon the confidential information concerning the potential takeover of Deseret by Warner-Lambert, all three agreed to purchase Deseret stock. Plaintiff

the first time whether an individual may rely on the misappropriation theory when bringing a private cause of action. Moss brought suit to recover damages for alleged violations of, inter alia, section 10(b) and rule 10b-5 after the defendants had purchased stock with knowledge of an upcoming tender offer that should have been disclosed to the tender offeree's shareholders.[71] The court rejected the use of the misappropriation theory in a private cause of action as being contrary to the holdings in *Chiarella* and *Dirks*[72] because the "defendants owed no duty of disclosure to plaintiff Moss, they committed no 'fraud' in purchasing shares of Deseret stock."[73] This holding affirmed the lower court's judgment dismissing the complaint for failure to state a valid section 10(b) or rule 10b-5 cause of action.[74] Commentators have argued, however, that the *Moss* court did not bar the use of the misappropriation theory in a private cause of action, but rather held only that the defendants owed no fiduciary duty to the sellers of the target company's stock.[75]

The Second Circuit last addressed the misappropriation theory in *United States v. Carpenter*.[76] Winans, a reporter for the *Wall Street Journal* (the *Journal*), wrote for the *Journal*'s "Heard on the Street" column.[77] The column did not contain any corporate inside

Moss sold his stock in Deseret the same day the defendants purchased their stock. When the information became public, Deseret stock appreciated by over 30%. *Id.* at 8.

71. Plaintiffs also sought treble damages under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68 (1976 & Supp. III 1979), alleging damage by an unlawful enterprise conducting a pattern of racketeering activity through securities fraud. The court of appeals affirmed the district court's holding that the plaintiff failed to state a valid cause of action under RICO. *Moss*, 719 F.2d at 8. For a discussion of the elements in a RICO cause of action, see R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 1493-1508 (6th ed. 1987). For a discussion of "pattern of racketeering activity," see Black, *Racketeer Influenced and Corrupt Organizations (RICO)—Securities and Commercial Fraud as Racketeering Crime After* Sedima*: What Is a "Pattern of Racketeering Activity"?*, 6 PACE L. REV. 365 (1986). *See generally* Note, *A Day of Reckoning Is Near: RICO, Treble Damages, and Securities Fraud*, 41 WASH. & LEE L. REV. 1089 (1984).

72. *Moss*, 719 F.2d at 16. *But see infra* notes 182-184 and accompanying text.

73. *Moss*, 719 F.2d at 16.

74. *Id.*

75. Note, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 GEO. WASH. L. REV. 600, 618 (1988).

76. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

77. The "Heard on the Street" column discusses selected stocks and analyzes market movements. The column provides both positive and negative information concerning the stocks featured in the column and expresses "a point of view with respect to investment in the stocks that it reviews." United States v. Winans, 612 F. Supp. 827, 830 (D.N.Y. 1985).

information, but the articles did impact the stock prices of corporations featured in the column.[78] Carpenter was a news clerk at the *Journal*. Both Winans and Carpenter knew of the *Journal*'s policy that all news information was the *Journal*'s property and that employees must treat it as confidential.[79] Carpenter, acting as Winans' messenger, provided Felis, a stockbroker at Kidder Peabody, with information to be used in future "Heard on the Street" columns. The three traded approximately twenty-seven times based on the information Winans supplied, earning net profits of $690,000.[80]

The issue before the Second Circuit was whether the employee's misappropriation of the employer's material nonpublic information was a violation of the federal securities law.[81] In affirming the defendants' criminal conviction,[82] the Second Circuit rejected the defendants' reliance upon *Newman* and *Materia*, reasoning that the purpose of the misappropriation theory was to prohibit the conversion of confidential information.[83] Therefore, the fact that an individual was not a corporate insider, and would not otherwise owe a duty to the corporation, was irrelevant.[84] The court held that Winans, as a *Journal* employee, had breached a duty of confidentiality by misappropriating the *Journal*'s publication schedule.[85] An individual cannot personally benefit from utilizing misappropriated infor-

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78. *See Study Says Impact of Journal Column Fell After Scandal*, Wall St. J., Nov. 30, 1988, at C-26, col. 4 [hereinafter *Study*].

> A new academic study concludes that the impact on stock prices of the Wall Street Journal's Heard on the Street column declined after the disclosure in 1984 that one of the column's writers had taken part in an insider-trading scheme. The study concludes that this reduced impact indicates that the column's credibility was hurt by that scandal.

Id.

79. *Carpenter*, 791 F.2d at 1026.

80. *Id.* at 1027.

81. *Id.* at 1027-28. *But see* Note, *Financial Reporters, The Securities Laws and the First Amendment: Where to Draw the Line*, 53 FORDHAM L. REV. 1035, 1046 (1985). Without an existing fiduciary duty between the newspaper and the corporation being reported on, an essential element of the misappropriation theory is lacking. Thus, reporters escape liability under the misappropriation theory. *Id.* However, *Carpenter* focused on the duty owed between the reporter and the newspaper, as opposed to a general duty owed between the reporter and his or her readers. *See infra* note 86 and accompanying text.

82. *Carpenter*, 791 F.2d at 1026. *But see* Comment, United States v. Carpenter: *Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 DEL. J. CORP. L. 605, 606 (1987) (*Carpenter* decision is incorrect in allowing criminal liability under the misappropriation theory to be dependent upon the employer's policy concerning information the employee acquires within his employment).

83. *Carpenter*, 791 F.2d at 1028-29. The defendants contended that the misappropriation theory applies only when the employee has breached a duty owed to the employer and to the corporation whose securities were involved. *See also* Note, *supra* note 81, at 1046.

84. *Carpenter*, 791 F.2d at 1029.

85. *Id.* at 1028.

mation acquired in breach of an employee's fiduciary duty of confidentiality.[86] Misappropriation of the *Journal*'s information was sufficient to establish fraud under section 10(b) and rule 10b-5.[87] Furthermore, a sufficient nexus existed between the duty and the fraudulent scheme. The publication schedule was worthless except "in connection with" the trading of the securities.[88]

The dissent contended that the misappropriation theory did not encompass the defendants' actions.[89] The *Journal*'s publication schedule was not securities-related information.[90] Further, the potential damage to the *Journal*'s reputation[91] was not sufficiently harmful to the securities markets or investors, and therefore was not within the redress of section 10(b) and rule 10b-5.[92]

C. *The Supreme Court's Application of the Misappropriation Theory*

Although the misappropriation theory was presented in *Chiarella*, the majority refused to address the issue because it was improperly submitted to the jury.[93] Nevertheless, four of the *Chiarella* justices endorsed some form of the misappropriation theory.[94] Moreover, commentators have argued that the *Dirks* court implicitly accepted the misappropriation theory.[95] However, prior to *Carpenter*, the Court had not directly addressed the misappropriation theory. Thus, while these commentators asserted that the Court had already adopted the misappropriation theory,[96] it was desired that the Court would directly rule on the merits of the theory when it granted certi-

86. *Id.* at 1031.
87. *Id.* at 1032.
88. *Id.* at 1033.
89. *Id.* at 1036 (Miner, J., dissenting).
90. *Id.* at 1036-37 (Miner, J., dissenting).
91. *See generally Study, supra* note 78, at C-26, col. 4.
92. *Carpenter*, 791 F.2d at 1037 (Miner, J., dissenting).
93. Chiarella v. United States, 445 U.S. 222, 236-37 (1980).
94. 5A A. JACOBS, *supra* note 50, § 66.02[a][iii][B], at 3-484.
95. Note, *The Supreme Court's Highwire Act: Balancing SEC Enforcement and Market Efficiency in* Dirks v. SEC, 45 U. PITT. L. REV. 923, 937 (1984) (*Dirks* majority accepted the misappropriation theory by stating Dirks did not misappropriate the information, thus inferring that a different result might have occurred had Dirks misappropriated the information); *accord* 5A A. JACOBS, *supra* note 50, § 66.02[a][iii][C], at 3-494.9. According to Jacobs, in light of *Dirks* and Bateman, Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 313 n.22 (1985), which reiterated that Dirks did not misappropriate the information, the Supreme Court has accepted the misappropriation theory. 5A A. JACOBS, *supra* note 50, § 66.02[a][iii][c], at 3-494.9.
96. *See supra* note 95.

orari in *Carpenter v. United States.*[97]

Although the *Carpenter* Court unanimously affirmed the convictions on the basis of the mail and wire fraud statutes,[98] it failed to address the merits of the misappropriation theory and the section 10(b) violations.[99] The Court stated only that it "is evenly divided with respect to the convictions under the securities law and for that reason affirms the judgment below on those counts."[100] Consequently, the question remains whether the four unnamed dissenters who favored the reversal of the securities law convictions disapproved the misappropriation theory or, rather, the application of the theory to the particular facts in *Carpenter.*[101]

IV. THE MISAPPROPRIATION THEORY AND A SECTION 10(B) CAUSE OF ACTION

In light of the Insider Trading and Securities Fraud Enforcement Act's adoption of the misappropriation theory as an avenue to establish a private cause of action for a section 10(b) violation,[102] this sec-

97. 484 U.S. 19 (1987).

98. *Id.* at 24. "We have little trouble in holding that the conspiracy here to trade on the Journal's confidential information is not outside the reach of the mail and wire fraud statutes. . . . The Journal's business information that it intended to be kept confidential [the publication schedule and the content of the "Heard on the Street" column] was its property . . . ." *Id.* at 28. The requirement that the mail and wire medium be used to execute the scheme was satisfied because, had the Journal not been distributed to the public, there would be no possibility to profit from the misappropriated information. *Id.*; *see also* Sontag, *Misappropriation Theory in Limbo, an SEC Victory—or Not?*, Nat'l L.J., Dec. 7, 1987, at 3, col. 2.

> Even without affirming the securities theory, the justices' decision to broaden the scope of mail and wire fraud statutes left the prosecutors' officers in good shape. They could use those laws to prosecute insider traders even if the high court overturns the misappropriation theory. . . . But the high court's broad reading of the fraud statutes does not help the SEC, which can only press civil cases; mail and wire fraud is a criminal offense.

Id.

99. *Carpenter*, 484 U.S. at 24; *see* Aldave, *The Misappropriation Theory:* Carpenter *and Its Aftermath*, 49 OHIO ST. L.J. 373, 375 (1988).

100. *Carpenter*, 484 U.S. at 24.

101. *See* Aldave, *supra* note 99, at 375-78 (discussion of the *Carpenter* deadlock); Sontag, *supra* note 98, at 10, col. 1.

102. Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680 (1988) (to be codified at 15 U.S.C. § 78t-1).

> Any person who violates any provision of this title . . . by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

Id.

For a discussion of an option trading private cause of action under rule 10b-5, see Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056 (1988) (asserting that a private cause of action exists under The tion will examine the parameters of the misappropriation theory and its application to a section 10(b) private cause of action.

A. *The Misappropriation Theory*

The misappropriation theory is rapidly becoming the most utilized means of establishing liability under rule 10b-5.[103] This theory incorporates the concept of an agent's fiduciary duty of confidentiality[104] with federal securities regulations. Generally stated, liability exists when an individual acquires nonpublic material information in violation of a fiduciary or similar duty of trust or confidence, and then trades based upon that information.[105] The illegal acquisition of the information may be viewed as fraud upon the person who controls the information or as fraud upon the market participants in the securities.[106] Fraud does not exist simply from trading on an informational advantage. Rather, the trading becomes fraudulent when the individual obtains the informational advantage by violating a fiduciary, contractual, or similar duty owed to the rightful controller of the information.[107]

The misappropriation theory is utilized only when a duty exists be-

Insider Trading Sanctions Act of 1984, and that the restrictive interpretation of this Act by the following *Harvard Law Review* note was incorrect); Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959 (1987) (implied rights of action for option investors, the duty requirement and the causation element; supports granting private rights of action under rule 10b-5); Note, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 YALE L.J. 623 (1988) (noting that if the courts improve their understanding of derivative securities, the federal statutes can adequately deal with the relationships created by derivative securities). For a discussion of commodities trading based upon nonpublic information, see Note, *Trading in Commodity Futures Using Nonpublic Information*, 73 GEO. L.J. 127 (1984).

103. Hagen, *Insider Trading Under Rule 10b-5: The Theoretical Bases for Liability*, 44 BUS. LAW. 13, 23 (1988); *see also Misappropriation Theory Adopted*, Legal Times, Oct. 1984, at 4, col. 3 (according to Daniel L. Goelzer, SEC's General Counsel, one-half of the SEC's insider trading suits are based on the misappropriation theory).

104. RESTATEMENT (SECOND) OF AGENCY § 395 (1958) states:

> Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

Id.

105. Aldave, *supra* note 5, at 114.

106. 3 A. BROMBERG & L. LOWENFELS, *supra* note 36, § 7.5(510), at 7.232.

107. Aldave, *supra* note 5, at 121.

tween individuals. This duty may result from a fiduciary relationship, a contractual relationship, or a similar obligation between the misappropriator and the controller of the information.[108] It must be established that the trading is based on the confidential information that was acquired by breaching the fiduciary duty or obligation. However, the person to whom the duty is owed and breached need not be a purchaser or seller of the securities.[109] Under the misappropriation theory, liability does not depend upon a breach of a fiduciary duty owed to a corporation, or its shareholders, in whose stock the misappropriator trades.[110] Instead, liability turns on the misappropriation and the subsequent trading as a violation of a fiduciary duty or relationship between the misappropriator and the rightful controller of the information.[111] In sum, the misappropriation theory forbids individuals trading on information acquired in violation of a fiduciary duty that is owed to the information controller.

Liability under the misappropriation theory extends beyond traditional insiders[112] to include other individuals as well. These "outsiders" acquire material confidential information in violation of a duty owed to an individual or a corporation controlling the information. Under the traditional requirement, the misappropriator would have to violate a duty directly owed to the shareholders of the corporation in which the misappropriator trades. The misappropriation theory establishes the requisite fiduciary relationship as also being between an outsider and another entity, typically the outsider's employer to whom the misappropriator owes a fiduciary duty.[113]

Under an alternative analysis of the misappropriation theory,[114] the relevant issues are whether the defendant created the informa-

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108. *Id.* at 122.

109. *See, e.g.*, United States v. Newman, 664 F.2d 12, 16 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983); *see supra* notes 63-65 and accompanying text.

110. Note, *supra* note 54, at 54-55. The following hypothetical is offered to illustrate that the fiduciary duty established under the misappropriation theory differs from the duty established under *Cady, Roberts*. Employee steals confidential information from Employer. This information was entrusted to the Employer by Corporation for whom the Employer works or represents. If Employee was a traditional insider, he would have breached a duty to Corporation and, according to *Cady, Roberts*, Employee would have to either disclose the information to the public, or abstain from trading while the information remained nonpublic. Yet, using the misappropriation theory, Employee owes no duty to Corporation. She owes a duty only to Employer. Employee, consequently, has no duty nor right to disclose the confidential information she has stolen. She must, however, abstain from trading until Corporation publicly discloses the information. Employee is an outsider with no duty or relationship to Corporation and, therefore, cannot speak on behalf of Corporation. The first duty of disclosure under *Cady, Roberts* does not exist, and Employee must therefore abstain from trading until the information becomes public. *Id.* at 55-56.

111. *Id.* at 55.

112. For the definition of "traditional insiders," see *supra* note 3.

113. *See* Note, *supra* note 54, at 55-56.

114. *See* 5A A. JACOBS, *supra* note 50, at 3-494.8.

tion and whether the creator of the information intended the information to be used by the defendant for trading or tipping.[115] Liability exists only if *both* issues are answered in the negative. Under this analysis, the defendant escapes liability if the defendant either created the information or if the information's creator intended the information to be the basis of the defendant's trading.[116]

If the defendant did create the information, the misappropriation theory does not prohibit the defendant from trading on the information.[117] Naturally, in this situation, there is no one from whom the information could be misappropriated. This element protects market analysts, specialists, arbitrageurs, investment advisors, and others who properly discover and analyze corporate information. It permits an individual "to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting."[118]

In deciding whether the information was intended as a basis for the defendant's trading or tipping, the intention of the information's creator is determinative.[119] First, the creator of the information must be identified.[120] For example, a corporation, as an entity, creates information when it proposes a takeover. While the chief executive officer (CEO), as the corporation's agent, may ultimately decide that the corporation should pursue the takeover, the CEO is acting only on the corporation's behalf and is therefore not the creator of the information.[121] The misappropriation theory applies to employees of an information source, usually high level officers or directors, who receive information during the course of their employment. As individuals, these employees did not create the information, and they may not personally trade on it.[122]

If the information creator consents to insider trading, no liability

115. *Id.*

116. *Id.* at 3-494.11 to .12.

117. *Id.* at 3-494.10.

118. Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger C.J., dissenting); *see also The 2 A.M. Wall Street Raid*, Wall St. J., Oct. 25, 1988, at A-26, col. 1.

119. Dasho v. Susquehanna Corp., 461 F.2d 11, 26 n.36 (7th Cir. 1972), *cert. denied*, 408 U.S. 925 (1972). Conflict of interest regulations may be analogized to rule 10b-5 mismanagement cases, in which a director has an interest which either "was of sufficient importance to influence his action as a director," or "conflict[ed] with [his] status as a shareholder[ ] or director[ ]." *Id. See generally* 5B A. JACOBS, *supra* note 50, § 118.01, at 5.90 to .105.

120. 5A A. JACOBS, *supra* note 50, at 3-494.10.

121. *Id.*

122. *Id.* at 3-494.11.

exists under the misappropriation theory[123] because, with consent, no breach of a fiduciary duty can exist.[124] Under the misappropriation theory, a defendant has no duty to other market participants resulting from his duty owed to the information creator,[125] and is therefore free to trade on the information after receiving consent. However, if the information source consents through its officers, and the individual receiving the consent is closely connected to the information source, perhaps as an officer or director, this consent would be subject to conflict of interest concerns.[126]

The following hypothetical is offered to assist in understanding this interpretation of the misappropriation theory.[127] Corporation A is preparing for a tender offer of Target Corporation B. Thus, Corporation A, as the offerer in proposing a takeover, creates the information. Pursuant to its tender offer, Corporation A purchases stock in Target Corporation B prior to publicly disclosing the tender offer. Thereafter, Corporation A informs its corporate allies of the takeover prior to public announcement. The purpose in disclosing the information is that its allies would purchase stock in Target Corporation B and, eventually, tender it or provide support to Corporation A in its acquisition of Target Corporation B.

Neither Corporation A, nor its allies, have violated the misappropriation theory. Corporation A has not violated the misappropriation theory because it is the creator of the information. The allies also have not violated the misappropriation theory because Corporation A provided the information and intended the information to be a basis for the allies' trading. Although the allies of Corporation A did not create the information, liability still would exist if the allies lacked consent from the information source to trade on the information. Nevertheless, in this hypothetical, Corporation A, as the information creator, provided the information and intended the allies to use it when trading. Consequently, there is no liability, even though the allies did not create the information, because the allies received consent from the information source to trade on the information.

As an alternative example, liability also would exist when applying the facts of *Chiarella* to this two-step test. First, Chiarella, as the printing firm's employee, did not create the information concerning the corporate takeovers.[128] Instead, the information was created by

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123. *Id.* at 3-494.13.

124. *Id.* at 3-494.12.

125. *Id.* at 3-494.13.

126. *Id.* For example, an inherent conflict of interest exists where the CEO of a corporation authorizes his own use of material nonpublic information in his role as corporate decision maker.

127. *Id.* at 3-494.12. *See generally* Chiarella v. United States, 445 U.S. 222, 234 (1980) (discussing the "warehousing" of stocks).

128. *Chiarella*, 445 U.S. at 224. As an employee of a financial printer, Chiarella did

the corporations which proposed the tender offers. Second, none of the involved corporations consented to Chiarella's use of the information.[129] Under the facts of *Chiarella*, both elements of the two-part test would be answered negatively, resulting in liability against the financial printing firm's employee.

B. Elements For a Section 10(b) Private Right of Action

An expressed private right of action now exists under the Insider Trading and Securities Fraud Enforcement Act of 1988.[130] To bring an action against an individual trading on inside information, the plaintiff must have "contemporaneously" traded in the same class of the security as the insider, albeit on the opposite side of the market from the insider.[131] To establish a section 10(b) cause of action,[132] six general elements are required. There must be a misrepresentation, omission, or fraudulent device[133] which is "in connection with"[134] a purchase or sale of securities.[135] The defendant must have acted with scienter or intent to defraud.[136] The misrepresentation must also be

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not create any of the information concerning the corporate takeovers because he merely prepared the information for printing. *Id.*

129. *Id.* at 224-25. The corporations, by concealing the identities of the companies involved in the takeover bids, implicitly did not provide Chiarella the necessary consent to trade on the information. *Id.*

130. *See supra* note 102.

131. REPORT, *supra* note 4, at 26. *See generally* 5A A. JACOBS, *supra* note 50, § 66.02[a][iii][D], at 3-494.16 to .19.

132. 15 U.S.C. § 78j(b) (1982). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national 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.

Id.

133. *See generally* Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (instances of corporate mismanagement held not to be a fraudulent device).

134. For impact of the Act on this element, see *supra* note 132 and *infra* notes 209-15.

135. *See generally* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). A section 10(b) or rule 10b-5 private cause of action is limited to actual purchasers or sellers of securities. *Id.* at 731-55.

136. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In *Ernst*, the Supreme Court defined scienter as the "intent to deceive, manipulate or defraud." *Id.* at 193. Recent cases have incorporated a defendant's knowledge of his duty of confidentiality in determining whether there was a sufficient level of scienter. *See* SEC v. Musella,

material.[137] In addition, the plaintiff must have justifiably relied[138] on the misrepresentation or omission and suffered damages as a result.[139]

This comment will focus only on the effect of the misappropriation theory on the misrepresentation, omission, or fraudulent device element of a section 10(b) cause of action. The remaining elements of a section 10(b) cause of action have been extensively covered elsewhere[140] and, therefore, a recitation of these elements would be of marginal value.

Under the misappropriation theory, the acquisition of nonpublic information, and subsequent trading on such information, creates the misrepresentation, omission, or fraudulent device. The inside information must be material and acquired in violation of a fiduciary duty owed, as an example, to an employer, a corporate client, or someone similarly situated.[141] Yet, the person to whom the duty is owed need

578 F. Supp. 425, 440-43 (D.N.Y. 1984), and United States v. Carpenter, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

137. *See generally* TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976). The Court in *TSC* held that an omitted fact in a proxy statement is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449. In Basic Inc. v. Levinson, 108 S. Ct. 978, 983 (1988) (Blackmun, J., plurality), the Supreme Court adopted the *TSC* standard for materiality in section 10(b) and rule 10b-5 actions. *Id.* at 983 (Blackmun, J., plurality). In *Basic*, the court analyzed materiality in the context of preliminary merger discussions. For lower court cases that have applied the *TSC* materiality standard to section 10(b) and rule 10b-5 actions, see Lockspeiser v. Western Maryland Co., 768 F.2d 558, 561 (4th Cir. 1985); Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 647 (3d Cir. 1980); SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 15 (2d Cir. 1977).

138. See *infra* notes 216-25 for the Act's impact on this element. In *Basic*, the Supreme Court, in a plurality opinion, accepted the concept of a rebuttable presumption of reliance that the open market price of a stock is established free of fraud. *Basic*, 108 S. Ct. at 988-92 (Blackmun, J., plurality).

139. *See* Elkind v. Ligget & Myers, Inc., 635 F.2d 156 (2d Cir. 1980). In *Elkind*, the Second Circuit permitted an action for damages equal to the difference between the actual purchase (or sale) price and the price at which the individual would have purchased (or sold), had the omitted information been disclosed. Thus, the maximum damage award is the amount gained by the insider or tippee as a result of the trading. *See* Friedman, *Efficient Market Theory and Rule 10b-5 Nondisclosure Claims: A Proposal for Reconciliation*, 47 MO. L. REV. 745, 762 (1982). Friedman asserts that *Elkind*'s measure of damages is incorrect because when a corporation is the defendant, all market participants in the stock should be entitled to recover. *Id.*

140. *See* Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 264-71 (1981); Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 230-46 (1985) [hereinafter *Report of Task Force*]; Conrad, *Securities Regulation in the Burger Court*, 56 U. COLO. L. REV. 193, 199-201 (1985); Note, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 GEO. WASH. L. REV. 600, 621-31 (1988) (corporate acquirer has a private cause of action against the employees of its investment banker).

141. *See Report of Task Force*, *supra* note 140, at 236 nn.40-41. The task force cites a case regarding the duty between father and son: United States v. Reed, 601 F. Supp.

not be the purchaser nor seller of the securities.[142] The mere acquisition of the information is insufficient to maintain a cause of action.[143] The defendant must also trade on the information or tip others about the information in violation of *Dirks*.[144]

V. THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

The Act[145] is a response by the House Committee to the insider trading scandals that have occurred on Wall Street since 1986.[146] The Act's purposes are delineated in the accompanying Report of the House Committee on Energy and Commerce.[147] By providing for greater deterrence, detection, and punishment, the Act will enhance the enforcement of the securities law.[148] Finally, the Act attempts to

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685 (D.N.Y. 1985), *rev'd as to venue*, 773 F.2d 477 (2d Cir. 1985). The court upheld the sufficiency of an indictment for insider trading on the theory that the son had misappropriated from his father confidential information concerning a forthcoming merger. Additionally, according to members of the SEC and its staff, a duty could exist between a newspaper reporter and his or her readers. *Report of Task Force*, *supra* note 140, at 236 n.41. *But see* Note, *supra* note 81, at 1045-46 (journalists cannot be liable under section 10(b) because reliance by a reader on reporters and newspapers does not equate to a fiduciary relationship).

142. *Id.*; *see Report of Task Force*, *supra* note 140, at 236. *But see* Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983). It is important to note, however, that the Insider Trading and Securities Fraud Enforcement Act expressly overturned cases such as *Moss*, which prevented recovery by the plaintiff under the misappropriation theory. *See infra* notes 211-215 and accompanying text.

143. Note, *supra* note 75, at 616.

144. *See supra* notes 37-50 and accompanying text.

145. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified at 15 U.S.C. § 78(a)).

146. REPORT, note 4, at 11-14. The Report noted the following: The "Yuppie Five," an insider trading group, traded in stocks and options of companies based upon information Michael David misappropriated from his New York law firm. David Levine, a managing director of Drexel Burnham Lambert, Inc. (Drexel), made $12.6 million by trading on material nonpublic information regarding tender offers and mergers. The Levine investigation uncovered Ivan Boesky, who made $50 million by trading on nonpublic information provided by Levine. Martin Siegel, co-head of mergers and acquisitions at Drexel, also had provided Boesky with confidential information about possible takeover deals. Siegel's settlement with the government exceeded $9 million. William Dillon, a stock broker, acquired advance copies of "Inside Wall Street," a column found in *Business Week*, from a pressman employed by the printer of *Business Week*. He subsequently traded in the stock, based upon the column, prior to the magazine's publication. Similar to the *Wall Street Journal*'s "Heard on the Street" column, prices of the stocks featured in the "Inside Wall Street" column were affected the same day the column became public. *Id.*

147. *Id.* at 7.

148. *Id.*; *see* Miller, *Every Market Player Deserves To Be An Insider*, Wall St. J., Nov. 29, 1988, at A22, col. 3 (to prevent insiders from trading, the law should demand instant disclosure).

rebuild public confidence in the integrity of the securities market, especially in light of the stock market crash of October 1987.[149] The House Committee emphasized that despite the self-policing measures observed by various security organizations, "there is a clear need for institutional, rather than individual, response to this problem."[150]

While the drafters of the Act realized the continuing concern regarding the development of an insider trading definition,[151] the Committee determined the Act should not provide a statutory definition of insider trading for two reasons.[152] First, courts have established clear guidelines which are applicable in all but a few cases of insider trading. Consequently, any statutory definition "could potentially be narrowing, and in an unintended manner facilitate a scheme to evade the law."[153] Second, establishing a definition of insider trading would have delayed the enactment of the legislation due to the lack of consensus concerning the appropriate parameters of the definition of insider trading.[154] Having established the underlying congressional purpose and policy of the Act, the various sections of the Act must be examined.

A. Civil Penalties

The Act provides for civil penalties against insider trading violators

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149. REPORT, *supra* note 4, at 7; *see also* The October 1987 Market Break, SEC Staff Report, Fed. Sec. L. Rep. (CCH) No. 1271, Special Report, xii, (Feb. 9, 1988) (an increase in the market volatility can negatively affect investor's confidence in the stock market and in the long run, impact the ability of corporations to efficiently raise capital); Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988). "Public confidence in the nation's securities markets is the function of a number of interrelated variables. Although Congress and the SEC have recently placed great weight on a vigorous insider trading enforcement program, factors such as market stability are also important elements in the calculus of investor confidence." *Id.* at 704 (citations omitted).

150. REPORT, *supra* note 4, at 14-15.

151. *See* Note, *Logical Inconsistencies in the SEC's Enforcement of Insider Trading: Guidelines for a Definition*, 44 WASH. & LEE L. REV 935 (1987). This note argues that Congress's definition of insider trading should be based on *Cady, Roberts* and thus:

> impose 10b-5 liability on outsiders who undermine the integrity of the securities markets by trading on illegally obtained information. Congressional reliance on the *Cady, Roberts* analysis would bolster confidence in the marketplace without impairing legitimate investment activities. Finally, an insider trading definition based on the SEC's analysis in *Cady, Roberts* would offer outsiders guidance concerning the types of activities that constitute insider trading and also would provide adequate deterrence against outsiders who trade fraudulently on inside information.

Id. at 953-54 (footnotes omitted); *see also* Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377 (1989). "Under the efficiency analysis conducted in this note, only insider activity that results in harm to society beyond direct wealth transfers should be prohibited." *Id.* at 399.

152. REPORT, *supra* note 4, at 10-11.

153. *Id.*

154. *Id.*

and those who control the violators.[155] For a person who trades " 'while in possession of material nonpublic information' or 'by communicating such information in connection with a transaction,' "[156] the maximum civil penalty would be treble the profit gained, or the loss avoided, due to the unlawful trading.[157] Controlling persons include broker-dealers, investment advisors, employers, and other individuals "with power to influence or control the direction of the management, policies, or activities of another person."[158] The determination of who is a controlling person is a question of fact and therefore is made on a case-by-case basis.[159] A controlling person is liable when he or she knows, or recklessly disregards, facts that indicate a controlled person was trading on inside information or was engaging in a tipping violation.[160] Before liability will exist, the inadequacy of the controlling person's supervision and surveillance must also relate to the controlled person's violation.[161] If the controlling person is found liable, the minimum civil penalty is $1 million, with a maximum ceiling of three times the profit earned, or loss avoided, by the controlled person.[162] If the controlled person is a tipper,[163] the profit or loss provision is determined by those individuals with whom the tipper communicated and who subsequently traded on the information.[164]

The Act places two additional limitations on the liability of a controlling person. The controlling person's liability may not be predi-

155. *See* Pub. L. No. 100-704, § 3, 102 Stat. 4677, 4677-80 (1988) (codified as U.S.C. 78(a)). Additionally, according to former SEC Enforcement Director Gary Lynch, the SEC will ask Congress, pursuant to the Act, for power to impose civil penalties for all federal securities laws violations. For example, this authority would permit the SEC to impose a civil penalty any time it commences an injunctive action. *Lynch Says SEC Will Ask Congress for Civil Monetary Fine Authority*, 21 Sec. Reg. & L. Rep. (BNA) No. 2, at 64-65 (Jan. 13, 1989).

156. REPORT, *supra* note 4, at 36.

157. *Id.*

158. *Id.* at 17.

159. *Id.*

160. *Id.* The actions by a control person must constitute "a gross deviation from the standard of care that a reasonable person would exercise in such a situation." *Id.* at 18 (citation omitted).

161. *Id.* at 36.

162. *Id.*

163. A tipper is an insider, either corporate or noncorporate, who provides material nonpublic information to outsiders. Note, *The Misappropriation Theory: Rule 10b-5 Insider Liability for Nonfiduciary Breach*, 15 FORDHAM URB. L.J. 1049, 1062 (1987); *see* Dirks v. SEC, 463 U.S. 646, 647-49 (1983).

164. REPORT, *supra* note 4, at 36. The Act does not alter the tipper/tippee liability standard.

cated solely upon the principle of *respondeat superior*.[165] Additionally, liability is determined by the specific standards contained in the Act, rather than section 20(a) of the Securities Exchange Act of 1934, which addresses the general responsibility of controlling persons towards controlled persons.[166]

In addition to the requirements stated above, the Act also places further responsibility on broker-dealers and investment advisors. Broker-dealers and investment advisors must "establish, maintain and enforce written [supervisory] policies and procedures 'reasonably designed to prevent the misuse of material nonpublic information' in violation of the Exchange Act . . . ."[167]

B. *Bounty Provision*

The Securities and Exchange Commission, at its discretion and without judicial review, has the authority to award a bounty payment to those individuals who provide information concerning insider trading violations.[168] The bounty provision provides an incentive for individuals to supply information concerning possible insider trading violations that the Commission or the United States Attorney might not otherwise receive.[169] The maximum possible bounty is ten percent of either the penalty imposed or the settlement reached.[170] The provision expressly excludes those individuals who have a responsibility to enforce the securities laws.[171]

C. *Criminal Penalties*

During the House subcommittee hearings, witnesses advocated that the strongest deterrent for white-collar criminals is a jail term.[172] Consequently, the Act revises the criminal penalties contained in the Securities Exchange Act of 1934, section 32, as follows: the maximum jail sentence is increased from five years to ten years; the maximum

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165. *Id.*

166. *Id.*

167. *Id.* at 21. For example, the Committee stated that a firm's policies and procedures should restrict the communication of confidential information and monitor its dissemination by restricting access to files containing confidential information. Firms should also initiate educational programs addressing insider trading and monitor their employees' stock market trading activity. *Id.* at 22.

168. *Id.*; *see also SEC Soon to Propose Rules Implementing Insider Trading Act's Bounty Provision*, 21 Sec. Reg. & L. Rep. (BNA) No. 14, at 515-16 (Apr. 7, 1989); *Insider Trading Tipsters: SEC Lets Your Fingers Do the Finking*, L.A. Times, June 29, 1989, Part IV, at 1, col. 1 (tipsters may call their local SEC office in order to turn in inside traders and possibly collect "bounty" money).

169. *See generally* Roberts, *Securities Lawyers Fear Abuse of New Insider-Trading Bill*, L.A. Daily J., Oct. 27, 1988 at 1, col. 2.

170. REPORT, *supra* note 4, at 22.

171. *Id.* at 22-23.

172. *Id.* at 16, 23.

criminal fine for individuals is increased from $100,000 to $1 million; and the maximum criminal fines for non-natural persons is increased from $500,000 to $2.5 million.[173]

D. Expressed Private Right of Action

The Act codifies an express right of action against insider traders and tippers[174] for the benefit of market participants who "contemporaneously" trade in the same security, but on the opposite side of the market from the insider trader.[175] Although the Report uses the term "insider traders and tippers,"[176] the actual language of the Act does not limit the right of action to insiders only.[177] Rather, "[a]ny person who violates [the Exchange Act of 1934 or any rule thereunder] by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action" brought by an individual who traded contemporaneously in the security, but on the opposite side.[178] The Act does not define "contemporaneous" because it relies on the developed case law definition.[179] A tipper shall be jointly and severally liable with, and to the same extent as, the person to whom the tipper directly communicates.[180] This direct communication provision limits the tipper's liability. If the tipper was held liable for all communication that resulted from his or her original communication, it would expose the communicator to tremendous liability which, in turn, could possibly chill legitimate business communications.[181]

173. *Id.*; *see* Pub. L. No. 100-704, § 4, 102 Stat. 4677, 4680 (1988) (to be codified at 15 U.S.C. § 78ff).

174. For the definition of "tipper," see *supra* note 163.

175. REPORT, *supra* note 4, at 26. To be on the opposite side of the market, one individual must purchases the stock while another contemporaneously sells it, or vice-versa.

176. REPORT, *supra* note 4, at 26.

177. *Id.* at 4.

178. *Id.*

179. *See id.* at 27 n.22. The cases cited within the Report are Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 95 (2d Cir. 1981) (plaintiffs purchased stock one month after defendant sold it; therefore, plaintiffs did not contemporaneously trade with the insiders); Shapiro v. Merrill, Lynch, Pierce, Fenner and Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (duty owed to all persons "who during the same period [trade in the security] without knowledge of the material inside information" which defendant possessed); O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 805 n.5 (D.N.Y. 1983) (defendant's trading occurred only over a seven day period; therefore, the "trades clearly were sufficiently contemporaneous" to establish a conclusion of liability under *Wilson*).

180. REPORT, *supra* note 4, at 27.

181. *Id.* at 39.

Significantly, the Act's codification and acceptance of the misappropriation theory[182] is demonstrated by the express right of action which "is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory."[183] The Committee further expressed that "the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful."[184]

E. SEC Authority to Cooperate with Foreign Governments

The SEC has attempted to cultivate cooperation with foreign governments because insider trading violations occurring outside the United States[185] have increased through such practices as offshore banking.[186] Consequently, the Act increases the SEC's authority to investigate and assist foreign authorities in establishing whether a violation has occurred under the foreign laws.[187] While the Commission has discretion to assist foreign governments, it should also consider: (1) whether the foreign government has a reciprocal agreement to assist the Commission when the Commission investigates United States security matters; and (2) whether the assistance would be contrary to the public interest of the United States.[188] The full range of SEC procedures and remedies are available in the investigation.[189]

182. *See* Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680 (1988) (to be codified at 15 U.S.C. § 78t-1). The House report states, "the misappropriation theory clearly remains valid in the Second Circuit, [which was] the lower [c]ourt in the *Winans* case, but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within section 10(b) and Rule 10b-5." REPORT, *supra* note 4, at 10.

183. REPORT, *supra* note 4, at 26 (citing Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984)); *see supra* notes 70-75 and accompanying text.

184. REPORT, *supra* note 4, at 26-27. For a broader discussion of the adoption of the misappropriation theory and its implications, see *infra* notes 190-225 and accompanying text.

185. REPORT, *supra* note 4, at 28.

186. For example, Dennis Levine, a managing director of Drexel, used a Bahamian broker and bank to effectuate his trading on inside information. Eventually the Bahamian broker correlated Levine's success with the takeover targets that Levine had traded in. As a result, the broker began to personally copy Levine's trades, without Levine's knowledge. *Id.* at 12.

187. *See* Pub. L. No. 100-704, § 6, 102 Stat. 4677, 4681-82 (1988) (to be codified at 15 U.S.C. §§ 78(c), (u)); REPORT, *supra* note 4, at 29.

188. REPORT, *supra* note 4, at 39.

189. *Id.*; *see SEC, DOJ Set Up Framework to Review Foreign Requests For Investigative Help*, 4 Corp. Couns. Weekly (BNA) No. 9, at 2-3 (Mar. 1, 1989). *See generally* Note, *International Cooperation in Insider Trading Cases*, 40 WASH. & LEE L. REV. 1149 (1983) (international participation and resulting conflicts in security trading investigations).

VI. CRITIQUE

A. *The Misappropriation Theory*

The misappropriation theory represents a valid approach to establish liability in today's complex securities markets. As previously stated, fraud is established by an individual's "deceitful exploitation of information rightfully belonging to a third person."[190] When one trades on information entrusted to him or her, and damage to other investors results, a rule 10b-5 cause of action may exist.[191] However, the failure to disclose the information or to trade on material nonpublic information alone does not create sufficient fraud for a rule 10b-5 violation.[192] Rather, the fraud exists because of the recipient's use of an "informational advantage" acquired through deceit or through an abuse of a confidential or trust relationship.[193]

The misappropriation theory has a broad and generalized scope. It arises from the misappropriator's duty to the information creator, and not from any fictional relationship between a misappropriator and an individual on the opposing side of a transaction.[194] The theory creates no distinction between corporate insiders or outsiders, nor between insiders who buy or sell the securities. However, the theory is relevant to tipper and tippee liability.[195] Finally, the theory is applicable to "trading in options, or in debt securities, as well as those who trade in stock."[196]

The misappropriation theory is also consistent with the general concept that trading on confidential information is unfair.[197] If a trader creates information through diligence, foresight, and superior analytical ability, most people would not find trading on such information morally wrong, as the information results from an individual's own efforts.[198] Conversely, acquiring information in breach of a duty owed to another seems improper because an obligation of confidence should not be broken for personal benefit.[199]

190. Aldave, *supra* note 5, at 121.
191. *Id.*
192. *Id.*
193. *Id.*; *see supra* note 105 and accompanying text.
194. *See supra* note 108 and accompanying text.
195. Aldave, *supra* note 5, at 121.
196. *Id.*
197. *Id.* at 122.
198. *See generally* Chiarella v. United States, 445 U.S. 222, 239-40 (1980) (Burger, C.J., dissenting).
199. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L.

However, the misappropriation theory does not prohibit all trading on nonpublic information; it only prevents trading on information acquired in breach of a fiduciary duty.[200] Thus, the misappropriation theory does not bar those who create or possess information with the consent of the information source from trading on the information.[201] Contrary to Chief Justice Burger's position in *Chiarella*,[202] the misappropriation theory does not reach those who steal or misappropriate the information from a stranger.[203] Further, the misappropriation theory does not prohibit subsequent trading on information inadvertently discovered, for example, by overhearing a conversation.[204] Simply stated, the misappropriation theory only prevents trading based upon information acquired from the rightful owner through a breach of a fiduciary duty.[205]

B. *The Insider Trading and Securities Fraud Enforcement Act of 1988*

Due to the recent passage of the Act, no authorities exist addressing the Act's eventual impact. The following analysis is based upon a logical reading of the Act in conjunction with past insider trading cases.

The Act should affect two elements of the section 10(b) cause of action,[206] namely the "in connection with" requirement and the reliance element. Generally stated, the "in connection with" element requires that the alleged misrepresentation be in connection with the purchase or sale of the security.[207] The reliance element requires that the plaintiff's decision to trade in the security be causally connected to the defendant's conduct.[208]

The Act should liberalize the "in connection with" requirement. The Second Circuit has approached the "in connection with" test differently, depending upon whether a criminal or private cause of ac-

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REV. 1217, 1248 (1981). "[T]he average American . . . probably has a visceral reaction that inside trading definitely harms someone else in the market and may harm the issuer. This reaction is absolutely correct. In short, any public antipathy toward inside trading has a valid foundation." *Id.*

200. Aldave, *supra* note 5, at 121.

201. *Id.* at 121-22; *see supra* notes 123-26 and accompanying text.

202. Chief Justice Burger expressed that the misappropriation theory would prohibit thieves from profiting by trading on stolen information. *Chiarella*, 445 U.S. at 241-42 (Burger, C.J., dissenting).

203. Aldave, *supra* note 5, at 122. For these individuals, a common law theft or fraud cause of action may be utilized to establish liability.

204. *See supra* note 48. *See generally* SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

205. Aldave, *supra* note 5, at 122.

206. See *supra* notes 132-44 and accompanying text for the elements of a section 10(b) cause of action.

207. *See generally* Sec. & Fed. Corp. L. Rep. (Clark Boardman), at 3-4 (Jan. 1985).

208. *Report of Task Force*, *supra* note 140, at 243.

tion is involved. In *Carpenter*, *Materia*, and *Newman*, all criminal actions, the Second Circuit determined that the defendants had violated section 10(b) when the purpose for misappropriating the information was only to purchase securities.[209] Thus, the "in connection with" test was therefore satisfied, even though the defendants did not violate a duty to the purchasers or sellers of the securities.[210] However, in *Moss*, the court limited the private cause of action under section 10(b) and rule 10b-5 to only those plaintiffs to whom the defendant owed a duty.[211]

However, as noted above, the Act has expressly overturned cases such as *Moss* which prohibit a plaintiff from maintaining a private cause of action because the defendant owed no duty to the plaintiff.[212] Given the House Report's vast and expansive reading of the misappropriation theory for a private cause of action and the unacceptability of the *Moss* result,[213] it is reasonable to postulate that the "in connection with" test for a private cause of action will be the same as that applied in criminal actions.[214]

Presumably, a duty between the plaintiff and the defendant will no longer be required. Rather, the fraud will be "in connection with" the purchase or sale of securities whenever the information would be considered of "no value whatsoever except 'in connection with' [the] subsequent purchase of securities."[215]

The Act should also reduce the plaintiff's burden of proving reliance in a private cause of action. The plaintiff must act with justifi-

209. United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984); United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).

210. *Carpenter*, 791 F.2d at 1033.

211. Moss v. Morgan Stanley, Inc., 719 F.2d 5, 16 (2d Cir. 1983); *see Materia*, 745 F.2d at 203.

212. *See supra* notes 182-84 and accompanying text.

213. "The Committee believes that [the result in *Moss*] is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communication or trading while in possession of material nonpublic information is unlawful." REPORT, *supra* note 4, at 26-27.

214. If it were otherwise, a benefit conferred to the private plaintiff by the adoption of the misappropriation theory would be taken away by requiring, as the court did in *Moss*, an existing duty between the plaintiff and the defendant. If the *Moss* duty requirement still exists after the Act's enactment, then the express private right of action would not benefit private individuals, rendering that section of the Act superfluous. If this were the case, the express private right of action would never have been codified in the Act.

215. *Materia*, 745 F.2d at 203; *see* United States v. Carpenter, 791 F.2d 1024, 1033 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

able reliance on the defendant's fraudulent actions,[216] which only requires a connection between the defendant's actions and the plaintiff's decision to purchase or sell securities. One view, followed only in the Sixth Circuit,[217] precludes private plaintiffs from recovering when "defendant's act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider."[218] The other view established by the Second Circuit, in *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*,[219] created a two-part analysis for determining reliance. First, reliance is established by alleging that the plaintiff would have altered his stock purchase or sale if the information held by the defendant had been known to the plaintiff.[220] Second, a presumption of reliance exists once the plaintiff has established a duty to disclose and the materiality of the information involved.[221] In *Basic Inc. v. Levinson*,[222] the Supreme Court's plurality opinion followed the Second Circuit by accepting a rebuttable presumption of reliance that the market price of a security was established free of fraud.[223]

Arguably, the Act accepts the Second Circuit's presumption of reliance since an individual must only establish a contemporaneous trade on the opposite side of the market from the defendant-insider trader.[224] By requiring only contemporaneous trading, the Act does not appear to require the plaintiff's direct reliance on the defendant's activities. Thus, given the expansive language of the Report accompanying the Act,[225] the Act arguably endorses the Second Circuit's

216. *See Report of Task Force*, *supra* note 140, at 243-44.

217. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977). The plaintiffs brought an action under rule 10b-5 alleging that the defendants traded while possessing material inside information concerning a possible acquisition of the company with which defendants were closely associated. The plaintiffs asserted they would not have sold their stock had they been aware of the possible merger agreement. *Id.* at 311.

218. *Id.* at 318-19.

219. 495 F.2d 228 (2d Cir. 1974). Defendant, potential underwriter for Douglas debentures, received information from Douglas management concerning unfavorable earnings. The defendant then disclosed this information to a few of the defendant's clients before it was publically announced. Due to such a large selling volume, the stock dropped dramatically. During this period and prior to the public disclosure of the earnings information, the plaintiffs had bought stock and sustained a substantial loss because of the vast selling of those informed by the defendant of the unfavorable earnings of Douglas. *Id.*

220. *Id.* at 239-40.

221. *Id.* at 240.

222. 108 S. Ct. 978 (1988) (Blackmun, J., plurality).

223. *Id.* at 990 (Blackmun, J., plurality) (stating that "[r]equiring a plaintiff to show a speculative state of facts . . . would place an unnecessarily unrealistic evidentiary burden on the rule 10b-5 plaintiff").

224. *See supra* notes 174-81 and accompanying text.

225. REPORT, *supra* note 4, at 7 (need to curtail insider trading to restore public trust in the integrity of the stock market), 10 (acceptance of the misappropriation the-

presumption of reliance for a rule 10b-5 action.

VII. CONCLUSION

What the Court left unresolved in *Carpenter*, Congress has seen fit to settle. The misappropriation theory has been codified into an express private right of action. In light of the expanding securities market, the theory correctly premises liability on an individual's deceptive use of information, rather than upon a fiduciary relationship between market participants. The misappropriation of material nonpublic information harms the rightful controller of the information, as well as those who trade with the misappropriator, and properly constitutes a violation of section 10(b) and rule 10b-5.

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ory as within section 10(b) and rule 10b-5), 26-28 (discussion of the express private right of action).