The Insider Trading Rules after Chiarella: Are They Consistent with Statutory Policy

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By Richard J. Morgan*

Developed in the United States over the past four decades, the federal insider trading rules prohibit certain persons from trading in the securities of a corporation or other issuer about which they have material information that has not been disclosed. The Securities and Exchange Commission (SEC) began the development of the insider trading rules in 1942, when it adopted rule 10b-5. This rule, promulgated pursuant to authority granted to the SEC by Congress in section 10(b) of the Securities Exchange Act of 1934, has formed the basis for the proscriptions on insider trading, which have been primarily developed by the SEC and the federal courts.

This development culminated in 1980 in Chiarella v. United States, in which the United States Supreme Court refused to impose

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1. 17 C.F.R. § 240.10b-5 (1980): “It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or any facility of any National Securities Exchange, (a) To employ any device, scheme or artifice to defraud, (b) To make any untrue statement of 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.” For a discussion of the circumstances under which the rule was adopted, see note 31 infra.

2. 15 U.S.C. § 78j (1976). 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 . . .”

criminal liability for insider trading on a defendant who had no relationship to the issuer and its shareholders, implying that only those in such a relationship of trust and confidence are precluded from trading on material inside information. 4 In Chiarella, the Supreme Court clearly recognized the existence of restraints on insider trading, although thoughtful and scholarly commentaries had questioned their usefulness and validity. 5 The Court, however, limited those restraints


"The duty to disclose arises only when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'” Id. at 228.

"Thus administrative and judicial interpretations have established that silence . . . may operate as a fraud actionable under Section 10(b) . . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to the transaction . . . .” Id. at 230.

"No duty could arise from petitioner’s relationship with the sellers of the target company’s securities for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence . . . .” Id. at 232.

While the Court’s statements refer to a requisite relationship of trust and confidence between the parties to the transaction, when one of those parties is a security holder of a publicly held company, such a relationship usually would arise through a relationship with the corporate issuer. For example, a corporate officer or director owes a fiduciary duty to the corporation and that duty also extends to its shareholders.

In addition, while the majority opinion strongly suggests that one without a fiduciary or confidential relationship with the trading security holders has no disclosure obligation to the market or to trading market participants, the Court left open the possibility that such a disclosure obligation might arise from a fiduciary relationship with a person other than the issuer or its security holders. See note 100 infra.

For a discussion of the breadth of the Court’s actual holding in Chiarella, see text accompanying notes 70-80 infra.

The Court indicated in Chiarella that tippees of persons who were precluded from trading would share that preclusion. See id. at 230 n.12.


This Article, like the Court, assumes that there are and will continue to be restraints on insider trading and that the abolition of such restraints by legislative or administrative action will not occur in the foreseeable future, if at all. See ALI SECURITIES CODE § 1603.

and their application to insiders and other fiduciaries.6

This Article discusses the statutory policy considerations that should underlie any judicial or administrative development of the insider trading rules, and examines the development of the rules prior to Chiarella. The Article then describes the Chiarella decision and the state of insider trading law after Chiarella, demonstrating that Chiarella has developed insider trading rules not fully consistent with statutory policy. Finally, the Article proposes an insider trading standard that better serves the congressional purpose of promoting fair and honest securities markets.

The Policy and Purpose Underlying the Insider Trading Proscriptions

Although the Securities Exchange Act of 1934 (the Act)7 specifically addressed a number of unfair and dishonest market practices that were common at the time of its enactment, such as market manipulation8 and short-swing trading by officers, directors, and ten-percent shareholders,9 it addressed other evils only through section 10(b).10 Section 10(b) was intended to be a general, "catch-all" provision11 to permit the SEC to impose sanctions upon deceptive and manipulative conduct arising in connection with future securities transactions.

Perhaps because of the general nature of this section, Congress failed to provide any legislative history to guide the section’s application to insider trading transactions.12 In fact, the Supreme Court determined in Chiarella that neither the language nor the legislative history of section 10(b) afforded guidance on the application of this section and rule 10b-5 to cases in which the alleged violation is based upon a failure to disclose.13

The absence of useful legislative history, however, should not compel the conclusion that the purpose of section 10(b) cannot be de-

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6. See text accompanying notes 70-80 infra.
12. For a discussion of the legislative history of the Act, see Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627 (1963) [hereinafter cited as Ruder].
termined, because a number of the Act's major purposes are set forth in section 2 of the Act. Although these congressional purposes are recited in general terms, they should allow the courts to follow the usual practice of interpreting a statute to further the perceived congressional intent, as determined from the statute and its legislative history. Therefore, because one of the Act's purposes, as set forth in section 2, is to ensure the maintenance of fair and honest markets, any insider trading proscription under the Act should have as its underlying purpose the maximization of both market honesty and market fairness.

To achieve maximum honesty in the securities markets, the courts and the Commission should require absolute informational equality of market participants. Anyone with a material informational advantage would be prohibited from trading until the informational advantage had been dissipated by disclosure. While a requirement of absolute informational equality would further the purpose of providing honest markets, because, at least in theory, all participants would have equal informational strength, it would not result in fair markets.

Many informational advantages, for example, are derived from legitimate activities of potential investors, such as detailed analysis of the publicly available information regarding a firm. If such an effort

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14. 15 U.S.C. § 78b (1976); “For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.” Section 2 was last amended in 1975. Pub. L. No. 94-29, § 2, 89 Stat. 97.


16. This approach was embraced by the court in dictum in the celebrated case, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). See notes 38-42 & accompanying text infra. This approach was also followed, apparently, by the district court in Chiarella. See text accompanying notes 64-67 infra.

17. See text accompanying notes 43-51 infra.

18. See Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798 (1973) [hereinafter cited as Fleischer, Mundheim & Murphy]; see also Barry, supra note 3, at 1318, 1353; Heller, supra note 3, at
leads the analyst to the conclusion that a firm's securities are undervalued by the market and are therefore a good investment, it seems unfair to force the potential investor to disclose the fruits of this endeavor to the public. Requiring disclosure would destroy the value of the information ascertained because the investor's knowledge would be no greater than the general public's. Thus, such a legitimate analysis could not benefit any investor, and no investor would have the incentive to pursue such effort in the future.\textsuperscript{19}

This stifling of analytical incentive is unfair both to such potential investors and to present investors in firms that might be analyzed but for the hypothetical informational equality requirement. Securities are often undervalued because of imperfections in the market, but such a situation often is rectified when an analyst discovers the undervaluation and buys, or recommends that others buy, the security. This increased demand for the security usually will continue until the market value of the securities reflects the value of the company.\textsuperscript{20}

If an analyst cannot profit from this discovery, however, there is no incentive to undertake the analysis. If full informational equality is required, thereby compelling an analyst to disclose his or her view of a security's true value prior to trading in the security, then no one who has gained such a legitimate informational advantage ever will profit; upon such disclosure, any undervaluation will quickly disappear as the increased demand for the security forces the price up. Therefore, if full informational equality is required, present investors will receive less frequently, if at all, the benefit of price adjustments triggered by analysis, because analysts will have no incentive to examine any firm. Absolute informational equality, which promotes market honesty, is thus not necessarily consistent with market fairness.

The antifraud rules, the legislative history of section 10(b), and the administrative history of rule 10b-5 do not suggest that full informational equality is required.\textsuperscript{21} When faced with situations in which the alleged inside information is the product of the defendant's own efforts, lower courts have permitted the potential investor to benefit from those

\textsuperscript{529; cf. In re Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961): "[The inside information] was not arrived at as a result of perceptive analysis of generally known facts but was obtained from a director (and associate) during the time when respondents should have known that [it was undisclosed]."}

\textsuperscript{19. See Barry, supra note 3, at 1318, 1353; Brudney, Insiders, Outsiders and Informational Advantages under the Federal Securities Laws, 93 Harv. L. Rev. 322, 339-43 (1979) [hereinafter cited as Brudney]; Fleischer, Mundheim & Murphy, supra note 18, at 817.}

\textsuperscript{20. See Fleischer, Mundheim & Murphy, supra note 18, at 830-31.}

\textsuperscript{21. See Brudney, supra note 19, at 339-40; see generally Ruder, supra note 12.}
efforts by trading prior to disclosure. Furthermore, it is possible to formulate a simple rule—that all traders who have misappropriated material, nonpublic information must disclose it or refrain from trading—that seems to maximize public access to information generally, while permitting the use of certain informational advantages to preserve necessary incentives. Such a rule would further the congressional goal of market honesty by requiring disclosure by all who have not earned their informational advantage, and would further the congressional goal of market fairness by permitting analysts and others to profit from their legitimate efforts by exploiting their informational advantages.

Development of the Insider Trading Rules Under Rule 10b-5

The SEC began to develop the insider trading proscription of rule 10b-5 in a 1943 administrative proceeding, In re Ward LaFrance Truck Co. The SEC held that officers, directors, and controlling shareholders of a closely-held corporation had violated rule 10b-5 by failing to disclose a number of material facts prior to purchasing stock from their fellow shareholders.

A few years later, the courts addressed the application of section 10(b) and rule 10b-5 in Kardon v. National Gypsum Co. and Speed v. Transamerica Corp. Like Ward LaFrance, these cases involved officers, directors, and controlling shareholders of closely-held corporations who had purchased securities of the corporation without disclosing allegedly material information known to them but unknown to the sellers of the securities. The defendants’ relationship to the corporation permitted them to make beneficial acquisitions of the corporation's securities.

22. See, e.g., General Time Corp. v. Talley Industries, Inc., 403 F.2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 545 (2d Cir. 1967); Brascon, Ltd. v. Edper Equities Ltd., 477 F. Supp. 773, 786 n.6 (S.D.N.Y. 1979); Mills v. Sarjem Corp., 133 F. Supp. 753, 764-65 (D.N.J. 1955); see also Polinsky v. MCA, Inc., 14 SEC. REG. & L. REP. (BNA) 1289 (9th Cir. 1982); Rothschild v. Teledyne, Inc. [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,076, at 90,965 (N.D. Ill. 1971). However, the recent case of Dirks v. SEC, 14 SEC. REG. & L. REP. (BNA) 983 (D.C. Cir. 1982), holding that a tippee of material inside information (provided by corporate insiders) aided and abetted a violation of rule 10b-5 when he passed that information on to others who traded on it, also indicates that an analyst who is a broker-dealer and who discovers securities fraud on the part of an issuer has a duty to refrain from trading in that issuer’s securities (or tipping others to do so) until he has notified the SEC of his her discovery.

23. See text accompanying notes 129-33 infra.


25. Id. at 381. Among the facts undisclosed was that the corporation’s financial condition and future prospects recently had improved dramatically. Id. at 374.


porate issuers in whose securities they traded formed the basis for the courts' decisions. In *National Gypsum*, the court found that rule 10b-5 should "apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a [material] fact coming to their knowledge by reason of their position . . . ."28 Similarly, in *Transamerica*, the court stated: "It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position . . . ."29

*Ward LaFrance*, *National Gypsum*, and *Transamerica* typify the situations in which rule 10b-5 first was applied to parties with unequal informational strength. Most of the early cases were brought against officers, directors, and controlling shareholders who traded in securities of corporations in face-to-face transactions, rather than in impersonal transactions on an exchange or in the over-the-counter market.30 In most of these cases the courts, or the Commission, applied rule 10b-5 without an elaborate discussion of underlying policy and without determining the limits of rule 10b-5, simply because the defendants clearly were both insiders and fiduciaries.31

28. 73 F. Supp. at 800.

Because face-to-face transactions almost always involve some statement or representation by the parties, most of the early cases could have been resolved on the basis of rule 10b-5(b) as incomplete statements or half-truths. JENNINGS & MARSH, supra, at 1043. When incomplete or misleading representations are made, they are actionable by the aggrieved party regardless of who the speaker is and whether there is a duty to disclose. *See In re Cady*, Roberts & Co., 40 S.E.C. 907 (1961).

31. That rule 10b-5 could be applied in cases such as *Ward LaFrance*, *National Gypsum*, and *Transamerica* without a great deal of analysis is not surprising, because the rule was adopted to resolve precisely these types of cases, in which an insider-buyer takes advantage of uninformed sellers. *See JENNINGS & MARSH*, supra note 30, at 1043; *see also* R. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 778 (2d ed. 1981).

The administrative history of the adoption of rule 10b-5 has been described as follows: "It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor, who was then the Director of the Trading and Exchange Division. He said, 'I have just been on the telephone with Paul Rowen,' who was then the S.E.C. Regional Administrator in Boston, 'and he has told me
While the opinions in some of these early cases do suggest that a breach by the defendant of a fiduciary duty underlies rule 10b-5 liability, none of the early cases predicated a violation of the insider trading proscriptions of rule 10b-5 on a finding that the defendant's nondisclosure constituted a breach of a common law fiduciary duty to disclose the material, nonpublic information. Thus, although the early decisions sometimes contained references to the concept of fiduciary duty and may have been based on this duty and the common law disclosure obligation arising under it, the courts never expressly held that only fiduciaries are subject to the insider trading proscriptions of the rule.

That the insider trading proscriptions of rule 10b-5 could be applied to those who were not traditional insiders, such as officers, directors, or controlling shareholders of the issuer, was made clear by the SEC in In re Cady, Roberts & Co. This administrative proceeding was brought against a broker-dealer and one of its registered represent-

about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it? So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where 'in connection with the purchase or sale' should be, and we decided it should be at the end.

"We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike, who said, 'Well,' he said, 'we are against fraud, aren't we? That is how it happened." Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967) (comments of Milton V. Freeman).


33. At common law, a failure to disclose is fraudulent only in the face of a duty to disclose; such a duty arises from a fiduciary relationship. Restatement (Second) of Torts § 551(2)(a) (1977); see Chiarella v. United States, 445 U.S. 222, 228 n.9 (1980); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932); see also Strong v. Repide, 213 U.S. 419 (1909) (duty to disclose "special facts" arises from a fiduciary relationship); Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir. 1959).

34. Commentators have taken the position that the disclosure obligation that the courts found to exist in these early cases, and later ones, is based upon the fiduciary relationship of the defendant to the plaintiff. See, e.g., Jennings & Marsh, supra note 30, at 946; Brudney, supra note 19, at 326; Fleischer, Mundheim & Murphy, supra note 18, at 804; Ruder, supra note 12, at 641. Professor Brudney, however, notes that there is nothing in the language or legislative history of section 10(b) and rule 10b-5 that confines their coverage to "insiders." Brudney, supra note 19, at 329.

atives who received confidential information regarding an issuer's planned dividend reduction. The information had been obtained from a fellow registered representative who was also a member of the board of directors of the issuer. The defendant representative traded in the securities of that issuer for the accounts of various clients while the information remained undisclosed to the public. Finding that the individual defendant had violated rule 10b-5, the SEC held that

Section 17 [of the Securities Act of 1933] and Rule 10b-5 apply to securities transactions by 'any person.' Misrepresentations will lie within their ambit, no matter who the speaker may be. An affirmative duty to disclose material information has been traditionally imposed upon corporate insiders, particularly officers, directors or controlling stockholders. We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosures in these circumstances constitutes a violation of the antifraud provisions.36

The SEC rejected the defendant's argument that only officers, directors, and controlling shareholders are subject to the insider trading proscription of rule 10b-5, finding that such proscriptions can apply to persons other than these traditional insiders. The SEC based this determination on its belief that the obligation to disclose or to refrain from trading arises from (1) the existence of a relationship affording access to information intended to be available only for a corporate purpose, and (2) the unfairness of allowing a person to take advantage of that information by trading without disclosure.37 Under this analytical framework, the Commission demonstrated that the defendant should be subject to the insider trading proscriptions. In establishing that these rules were not limited to officers, directors, and controlling shareholders, however, the Commission did not address the outer limits of the rule.

Seven years after the SEC decision in Cady, Roberts, the Second Circuit decided SEC v. Texas Gulf Sulphur Co.,38 in which it eliminated any doubt regarding the applicability of the insider trading proscriptions of rule 10b-5 to persons other than officers, directors, and control-

36. Id. at 911.
37. Id. at 912 & n.15; see also Chiarella v. United States, 445 U.S. 222, 227 (1980).
ling shareholders of an issuer. In holding that the lower court had improperly denied the injunctive relief sought by the SEC against corporate officers, directors, and employees who had traded in the securities of the corporation while in possession of nonpublic information concerning a major ore discovery in Ontario, Canada, the Second Circuit endorsed the rule adopted by the SEC in *Cady, Roberts*, and in dictum broadly extended that test:

> [T]he Rule is also applicable to one possessing the information who may not be strictly termed an ‘insider’ within the meaning of sec. 16(b) of the Act . . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.

Although, under the facts of *Texas Gulf Sulphur*, the court could have limited its discussion to persons who could easily be characterized as "corporate insiders" or their tippees, and although there is some suggestion in the court's opinion that the basis for the application of the insider trading proscriptions was a breach of fiduciary duty by the defendant, the court did not do so.

Not all informational advantages, however, were proscribed by *Texas Gulf Sulphur*, as illustrated by three cases decided by the Second Circuit within a few months of *Texas Gulf Sulphur*: *Mutual Shares Corp. v. Genesco, Inc.*, *General Time Corp. v. Talley Industries*, and *SEC v. Great American Industries*. In *Genesco* and *General Time*, it was alleged that rule 10b-5 was violated by a tender offeror's failure to disclose the anticipated tender offer to persons with whom it dealt prior to the public announcement of the offer. In both cases, the court held

39. 401 F.2d at 863-64.
40. "The essence of rule 10b-5 is that anyone who, trading for his own account in the securities of a corporation, has 'access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone' may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public." *Id.* at 848 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)).
41. *Id.*
42. "Whether predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine, [rule 10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." *Id.* The individual defendants were all officers, directors, or employees of the issuer, or tippees of such persons.
43. 384 F.2d 540 (2d Cir. 1967).
that the rule did not require disclosure under these circumstances. As the court stated in General Time, "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demand and thus abort the sale."47

In Great American Industries, the SEC alleged that rule 10b-5 had been violated by a purchaser of securities who traded property for shares of a corporation without disclosing to the selling corporation the enormity of the finder's fee paid to his agent. Holding that neither the buyer nor his agent had any obligation to disclose, the court refused to interpret rule 10b-5 as imposing a duty of disclosure on those who do not occupy a "special relationship" to a trader in securities. "[T]o read Rule 10b-5 as placing an affirmative duty of disclosure on persons who, in contrast to 'insiders' or broker dealers, did not occupy a special relationship to a seller or buyer of securities would be occupying new ground and would require most careful consideration."48

Because these cases were decided by the court that decided Texas Gulf Sulphur, they should have cast some doubt on the viability of the sweeping dictum of that case that "anyone in the possession of material inside information must either disclose it . . . or . . . abstain from trading. . . ."49 These decisions, however, did not eliminate the possibility that any person in possession of inside information might be deemed an insider,50 and thus become subject to the proscription on insiders.

Furthermore, in none of these cases did the defendants possess information misappropriated from the corporation or relating to the internal affairs of the corporation or "market"51 information about the

46. General Time, 403 F.2d at 164-65; Genesco, 384 F.2d at 545-46; see also Polinsky v. MCA, Inc., 14 Sec. Reg. & L. Rep. (BNA) (9th Cir. 1982).

47. 403 F.2d at 164. The Williams Act, Pub. L. No. 90-439, § 2, 82 Stat. 454 (1968), which added § 13(d) to the Act, 15 U.S.C. § 78m(d) (1976 & Supp. III 1979), was enacted shortly before the General Time opinion was rendered, but was not in effect at the time of the transaction involved in that case.

48. 407 F.2d at 460.

49. 401 F.2d at 848 (emphasis added).

50. See text accompanying note 41 supra. See also Chiarella v. United States, 445 U.S. 222, 250 (1980) (Blackmun, J., dissenting): "The concept of the insider, itself has been flexible; wherever confidential information has been abused, prophylaxis has followed."

51. Commentators have sometimes distinguished between "corporate" and "market" information, the former generally referring to inside information regarding the corporation's assets, operations, and business, and the latter generally referring to information about the supply of and demand for the corporation's securities. See, e.g., Jennings & Marsh, supra
anticipated activities of third parties. Rather, the defendants possessed information about their own acquisition plans, based on their analysis and evaluation of the company and its securities.52

The results in these cases suggested that, despite the dictum of Texas Gulf Sulphur, the insider trading proscriptions of rule 10b-5 generally would be applied only to insiders, fiduciaries, and broker-dealers. Many subsequent cases addressed the issue whether to characterize as corporate insiders those persons who had traded upon or tipped inside information but who were not officers, directors, substantial shareholders, or employees of the issuer. Among those characterized as insiders were underwriters,53 market makers,54 financial columnists,55 friendly tender offerors,56 friends of corporate officers, directors, and controlling shareholders,57 and finders or merger negotiators.58

After Texas Gulf Sulphur, the SEC began a campaign to prevent financial printers and their employees from trading in the securities of corporations about which they obtained information by virtue of their printing activities. This campaign resulted in several cases involving employees of financial printers who, after learning valuable nonpublic information in the course of their employment, went into the market and purchased the stock of various corporations that were likely to be the targets of acquisition efforts.59 The SEC had many successes and only one failure60 in this program before addressing the conduct of

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53. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).


60. SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) 95,034 (S.D.N.Y. 1975) (printing company not held liable for unlawful actions of its employees, when it had taken steps to safeguard against improper use of nonpublic information).
Vincent Chiarella, the employee of a financial printer, and determining that it was sufficiently egregious to merit criminal prosecution as well as civil sanctions.

Insider Trading Proscriptions Under the Chiarella Rule

In 1978, Vincent Chiarella, formerly an employee of a major financial printer, was tried in federal court on seventeen counts of willfully violating section 10(b) and rule 10b-5. Chiarella was convicted on all seventeen counts following a jury trial during which he admitted that he had purchased securities of five different companies in open market transactions, in each case shortly prior to the announcement by a corporate suitor of its intention to attempt to acquire control of the company whose securities Chiarella had just purchased; that he resold those shares for an aggregate profit of approximately $30,000 shortly after the public announcement of the respective takeover proposals; that he had learned of the proposed takeovers and had deciphered the identities of the five target companies from confidential proofs of the disclosure documents which his employer was printing for use by the acquiring company in its takeover effort; and that the information which he had thus obtained was material information that had not been publicly disclosed at the time of his purchases.

The trial court in essence adopted the dictum of Texas Gulf Sulphur in instructing the jury that anyone in possession of material inside information has a duty to disclose or to refrain from trading.

61. Section 32(a) of the Act, 15 U.S.C. § 78ff(a) (1976 & Supp. III 1979), provides in pertinent part: "Any person who willfully violates any provision of this chapter... or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter... shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both..." Chiarella was the first person subjected to criminal liability for nondisclosure under § 10(b). See Chiarella v. United States, 445 U.S. at 235 n.20.

62. Four of the takeover attempts were to be by tender offer, while the other involved a merger. Neither the government nor Chiarella treated the difference in structure as significant at the trial or on appeal. Id. at 224 n.1; United States v. Chiarella, 588 F.2d 1358, 1363 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980).

63. The actual names of the target companies were not inserted in the proofs of the disclosure documents pertaining to these transactions until shortly before the commencement of the production of the final documents. Until that time, blanks or a fictitious name was inserted in lieu of the true name of the target. Chiarella was able to determine the true identity of each target from the number of spaces and characters reserved for its actual name and from the description of its business contained in the proofs. Chiarella v. United States, 445 U.S. at 224.

64. 588 F.2d at 1363-64 n.5.

65. See notes 40-41 & accompanying text supra.

66. See id. at 1364 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848). Chiarell-
Chiarella stipulated that he possessed material, undisclosed information at the time of his purchases, and was subsequently convicted.\textsuperscript{67} On appeal, the Second Circuit rejected his argument that the duty to disclose material, nonpublic information or to refrain from trading applies only to insiders of, and those in a fiduciary relation with, the issuer of the securities traded. Affirming Chiarella's conviction, the court found that the insider trading proscriptions are designed to ensure market integrity, and are not limited to the enforcement of fiduciary duties.\textsuperscript{68} The court therefore held that the insider trading rules apply to those who regularly receive material, nonpublic information.\textsuperscript{69}

In 1980, in \textit{Chiarella v. United States},\textsuperscript{70} the United States Supreme Court reversed Chiarella's conviction, holding that the jury had been improperly instructed.\textsuperscript{71} Contrary to the trial court's instructions, the Supreme Court held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."\textsuperscript{72} In

\textsuperscript{67} The jury instructions were summarized by the Supreme Court at 445 U.S. at 236.

\textsuperscript{68} \textit{Id.} at 1365.

\textsuperscript{69} In dissent, Judge Meskill strongly argued that it was improper to impose criminal liability on Chiarella because no case had ever imposed civil liability for insider trading "on anyone other than an insider, the tippee of an insider, or one standing in a special relationship with other traders." \textit{Id.} at 1373. He further argued that existing case law required disclosure under rule 10b-5 only when a fiduciary or special relationship existed, \textit{id.} at 1373-75, and that, in light of the case law, Chiarella had not been given fair warning that his conduct was criminal. \textit{Id.} at 1377-78.

\textsuperscript{70} 445 U.S. 222 (1980).

\textsuperscript{71} Justice Powell's opinion for the majority was joined by Justices Stewart, White, Rehnquist, and Stevens, although Justice Stevens wrote a separate opinion to emphasize that the Court did not approve of the defendant's conduct and to discuss alternate theories of liability that the government might have advanced. Concurring in the result, Justice Brennan gave his approval to the summary of the law presented by the Chief Justice's dissent. See note 73 \textit{infra}.

\textsuperscript{72} 445 U.S. at 235. "The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-public information to sellers from whom he bought the stock of the target corporation . . . ." \textit{Id.} The trial judge had instructed the jury that conviction could be based on conduct that operated "as a fraud or deceit upon any person." \textit{Id.} at 236. The jury then was instructed that "failure by Chiarella to disclose material, non-public information in connection with his purchase of stock would constitute deceit."
the process of reaching this narrow holding, the majority examined a number of cases, from which it concluded that "the established doctrine" is that a duty to disclose arises from a "specific relationship" between two parties, and that "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them.'" 

At least three Justices of the Supreme Court interpreted the majority opinion to hold that a person in possession of material, nonpublic information must disclose or refrain from trading only if there is a duty to disclose arising from a relationship of trust and confidence. While this interpretation of the Court's holding has not been unanimously accepted, the majority opinion strongly suggests that the duty to disclose or refrain from trading applies only to those who have a confidential or fiduciary relationship to the issuer and its security holders. On the other hand, persons who have no such relationship but who possess

73. The scope of the majority's holding was the subject of some confusion among members of the Court. Justice Stevens, concurring, agreed "with the Court's determination that petitioner owed no duty of disclosure to the sellers . . . ." Id. at 237 (Stevens, J., concurring). In dissent, Justice Blackmun, joined by Justice Marshall, interpreted the majority opinion to hold that "a failure to disclose violates the Rule only when the responsibilities of a [fiduciary] relationship . . . have been breached." Id. at 247 (Blackmun, J., dissenting).

On the other hand, Chief Justice Burger believed that "[t]he Court's holding, however, is much more limited, namely, that mere possession of material nonpublic information is insufficient to create a duty to disclose . . . ." Id. at 243 n.4 (Burger, C.J., dissenting). Accordingly, he interpreted the majority opinion to indicate "that the Court has not rejected the view . . . that an absolute duty to disclose or refrain [from trading] arises from the very act of misappropriating nonpublic information." Id.; cf. SEC Exchange Act Release No. 17,120 (Sept. 4, 1980), promulgating Rule 14e-3, 17 C.F.R. § 240.14e-3 (1980), discussed in notes 108-10 & accompanying text infra.

Decisions subsequent to Chiarella indicate that the lower courts have embraced the views of Justices Stevens and Blackmun regarding the scope and meaning of the Court's determination in Chiarella. See notes 81-91 & accompanying text infra.


75. 445 U.S. at 233.

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

77. See note 73 supra.


79. See note 4 supra. Chiarella had no relationship to the target companies in whose securities he traded. His employer had been engaged by the acquiring companies, and not by the target companies. See 445 U.S. at 224, 232. The Court, however, left open the possi-
material, nonpublic information regarding it may trade in the issuer's securities and profit from their informational advantage, unless such trade is in breach of a duty to someone else.\textsuperscript{80}

**Lower Court Application of the Chiarella Rule**

Subsequent lower court decisions have mostly ignored \textit{Chiarella}'s narrow holding, while embracing the interpretation that the duty to disclose or refrain from trading arises only from a fiduciary or other confidential relationship. For example, in \textit{Elkind v. Liggett & Myers, Inc.},\textsuperscript{81} the Second Circuit considered the potential liability under rule 10b-5 of a corporation and its officers for tipping others about allegedly material inside information respecting the corporation.\textsuperscript{82} Holding that corporate insiders must refrain from tipping, the court observed: \textquote{The Supreme Court ruled in \textit{Chiarella} that there can be no violation of § 10(b) unless the party so charged has violated a duty arising out of a relationship of trust. A corporate insider who tips confidential information clearly violates a fiduciary obligation.}\textsuperscript{83}

Thus, the Second Circuit appeared to interpret \textit{Chiarella} as holding that only those in a relationship of trust and confidence can violate rule 10b-5.\textsuperscript{84}

The Second Circuit again set forth this view in \textit{Walton v. Morgan Stanley & Co.},\textsuperscript{85} in which a derivative suit was brought on behalf of Olinkraft Corp., a Delaware corporation, for breach of fiduciary duty owed to that corporation.\textsuperscript{86} The plaintiff alleged that Morgan Stanley & Co., as investment banker for Kennecott Copper Corp., had been given confidential information respecting Olinkraft in connection with a contemplated acquisition of Olinkraft by Kennecott. After the acquisition had been abandoned, Morgan Stanley allegedly used the confidential information for its own benefit. The court affirmed the dismissal of the suit because it could find no fiduciary relationship between Morgan Stanley and Olinkraft. Morgan Stanley was Kenne-

\textsuperscript{80} For a discussion of the possibility that insider trading may be precluded by a duty to someone other than the security holders of the issuer, see note 100 \textit{infra}.

\textsuperscript{81} 635 F.2d 156 (2d Cir. 1980).

\textsuperscript{82} The court found that some of the information involved was immaterial. \textit{Id.} at 166.

\textsuperscript{83} \textit{Id.} at 165 n.14 (citation omitted).

\textsuperscript{84} See also United States v. Newman, 664 F.2d 12 (2d Cir. 1981), discussed in note 100 \textit{infra}.

\textsuperscript{85} 623 F.2d 796 (2d Cir. 1980).

\textsuperscript{86} Federal jurisdiction was based on diversity; Delaware law governed the case. \textit{Id.} at 798.
cott’s agent, not Olinkraft’s. Absent a fiduciary relationship, there was no breach of fiduciary duty under Delaware law. In determining that no fiduciary relationship existed, the court cited Chiarella for the proposition that “[t]he doctrine that a duty to disclose or refrain from trading arises from a specific relationship between two parties—and not simply from the fact that some investors have more information than others—is now established in both state and federal law.”

Several district courts have relied on Chiarella in finding that defendants had no duty to disclose. In Kirshner v. Goldberg, a beneficiary of the New York City Teachers Retirement System sought to impose rule 10b-5 liability upon Morgan Guaranty Trust Co. and others. The Retirement System, along with a number of other pension trusts, had entered into an agreement, to which Morgan was a party, obligating the pension funds to buy securities to be issued by New York City or by its Municipal Assistance Corporation. The plaintiff alleged that Morgan had violated rule 10b-5 by failing to disclose to the pension trusts that it was reducing its own holdings of the securities. The court stated: “Holding that a purchaser-seller relationship alone is not enough to create a duty to disclose under § 10(b), the [Chiarella] Court stated that a fiduciary relationship must exist as a prerequisite for a finding of liability.” The court accordingly dismissed part of the complaint against Morgan, because no such fiduciary relationship was alleged.

Thus, the lower federal courts seem to interpret Chiarella as did several of the Justices: a duty of disclosure under rule 10b-5 can be predicated only upon a fiduciary or confidential relationship.

87. Id. at 799 n.6. The Ninth Circuit appears to agree with the Second Circuit’s interpretation of Chiarella. In SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980), the Ninth Circuit discussed “Chiarella’s establishment of a ‘duty’ requirement” and noted: “The Court held [in Chiarella] that § 10(b) liability for silence in connection with the purchase or sale of securities ‘is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction.’” Id. at 652 n.23 (quoting Chiarella v. United States, 445 U.S. at 230).
89. Id. at 458 (citations omitted).
90. See also Staffin v. Greenberg, 509 F. Supp. 825 (E.D. Pa. 1981) (tender offeror had no duty to disclose tender offer plans before commencing market purchases based either on pre-Chiarella law regarding tender offerors or on Chiarella rule that duty to disclose arises only from confidential or fiduciary relationship); Feldman v. Simkins Indus., 429 F. Supp. 839 (N.D. Cal. 1980) (one of three large shareholders of a publicly held company had no duty to disclose material inside information regarding the company before selling his shares in the market under the Chiarella rule that a duty to disclose arises from a relationship of trust and confidence).
91. See also United States v. Newman, 664 F.2d 12 (2d Cir. 1981); O’Connor & Assoc.
Chiarella and subsequent cases have developed a rule that prohibits the use of material inside information by some, but not by others.

Criticism of the Chiarella Rule

If the Chiarella rule had been formulated in response to policy considerations, its disparate treatment of fiduciaries and nonfiduciaries might be justified. Chiarella, however, was not grounded on such considerations; rather, the decision was based on the Court's view of certain precedents in the law of insider trading developed by the lower courts and by the SEC. These precedents, in turn, generally had been decided without regard to the underlying policies or purposes that insider trading proscriptions ought to serve. Thus, Chiarella and its progeny represent the culmination of four decades of ad hoc judicial development of insider trading rules. These rules are not tied to any policy other than those underlying common law fraud.

If the insider trading rules are to be based on a policy, one source of such a policy would be congressional intent. Congressional intent suggests that the insider trading proscriptions should attempt to maximize disclosure of material inside information and at the same time permit fair treatment of those who derive informational advantages.

v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981); Benoay v. Decker, 517 F. Supp. 490, 495 n.3 (E.D. Mich. 1981); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 886 (S.D. Fla. 1981); E.D. Warde & Sons v. Colorado Nat'l Bank, 502 F. Supp. 461, 463-64 (D. Colo. 1980); Marrero v. Banco di Roma (Chicago), 487 F. Supp. 568, 574 (E.D. La. 1980). But cf. State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278 (S.D.N.Y. 1980), aff'd in part, rev'd in part, 654 F.2d 843 (2d Cir. 1981). One issue before the district court in Fluor was whether the defendant corporation had an obligation to disclose to the market place the existence of an important contract, recently awarded to the defendant, when the market was ripe with rumors of material developments respecting the company. Holding that "[e]ven in the absence of insider trading or prior inaccurate disclosures [by the company] . . ., a violation of Rule 10b-5(c) may arise from a failure to disclose where, as here, rumors are rampant, the price of stock is shooting upward and the defendants are in possession of all material facts but refrain from disclosing them," 500 F. Supp. at 292, the district court clearly viewed Chiarella as setting forth a nonexclusive test for the determination of when a duty to disclose arises. See id. at 291-92.

The Second Circuit, however, rejected the district court's conclusions regarding the company's duty to disclose under rule 10b-5. Without discussing the exclusivity or nonexclusivity of the Chiarella disclosure duty, the Second Circuit held that a company "has no duty to correct or verify rumors in the marketplace unless these rumors can be attributed to the company." State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850 (2d Cir. 1981). The District of Columbia Circuit, however, clearly reads Chiarella as setting forth a nonexclusive test for when the duty to disclose arises. See Dirks v. SEC, 14 SEC. REG. & L. REP. 983, 990 (D.C. Cir. 1982).

92. See 445 U.S. at 226-35.
93. See notes 24-58 & accompanying text supra.
94. See notes 7-15 & accompanying text supra.
through legitimate efforts.\textsuperscript{95}

Two issues thus are raised by the \textit{Chiarella} decision and subsequent cases developing the \textit{Chiarella} rule. The first is whether the rule that only those in a fiduciary or confidential relationship are precluded from trading on material inside information is consistent with this congressional purpose. The second issue is why, if \textit{Chiarella} is inconsistent with this congressional purpose, the Court adopted this rule instead of one more consistent with the congressional goal of fair and honest markets.

Arguably, the honesty and fairness of markets are lessened by the conduct of market participants who profit from the use of inside information without providing to the market the benefits that flow from the effort and analysis invested in creating an informational advantage.\textsuperscript{96} The SEC has long assumed that investors expect that material inside information will not be used to their detriment in market transactions.\textsuperscript{97} For this reason, the SEC continues to give priority to the prevention of insider trading.\textsuperscript{98}

If liability for insider trading is dependent on a relationship with the issuer and its security holders, a person lacking such a relationship will be permitted to use inside information regardless of whether that person developed or misappropriated the informational advantage. By indicating that one without such a relationship has no disclosure obligation to the market or to the market participants with whom he or she deals, \textit{Chiarella} and its progeny have lessened the possibility that such a person may be liable to such participants under section 10(b) and rule...
In theory, a trader who has no relationship to the issuer and its security holders could be liable under section 10(b) and rule 10b-5 if the use of inside information violates a duty to persons other than the issuer and its shareholders. Nevertheless, reducing the risk of suits

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99. In certain situations, such a person may violate rule 14e-3, 17 C.F.R. § 240.14e-3 (1980). See text accompanying notes 108-10 infra. It may also be possible for such a person to be liable under section 10(b) and rule 10b-5 to persons other than the trading shareholders for breach of some fiduciary duty. See note 100 infra.

100. In *Chiarella*, the government argued that Mr. Chiarella owed a duty to his employer and its clients, the acquiring companies, to refrain from using confidential information entrusted to the employer and that his breach of this duty furnished a basis for finding that a fraud had been perpetrated on those clients and on the selling shareholders in violation of rule 10b-5. Although the majority refused to consider this argument, because it had not been properly presented to the jury, Justice Stevens discussed the argument in his concurring opinion as follows: “Arguably, when petitioner bought securities in the open market, he violated . . . a duty of silence owed to the acquiring companies. . . . The court correctly does not address the second question: whether petitioner’s breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer’s customers—could give rise to criminal liability under Rule 10b-5. Respectable arguments could be made in support of either position. On the one hand, if we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his activities constituted a ‘fraud or deceit’ upon those companies ‘in connection with the purchase or sale of any security.’ On the other hand, inasmuch as those companies would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, . . . it could also be argued that no actionable violation of Rule 10b-5 had occurred. I think the court wisely leaves the resolution of this issue for another day.”

Subsequent to *Chiarella*, in United States v. Newman, 664 F.2d 12 (2d Cir. 1981), the Second Circuit reversed a district court’s dismissal of an indictment that charged the defendants with criminal violations of rule 10b-5. The theory of the indictment was that those defendants who were employees of an investment banking firm breached a fiduciary duty to their employer and their employer’s clients when they assisted in trading, without disclosure, in target company securities, knowing that clients of their employer were about to tender for target company securities.

The conduct at issue was similar to that in *Chiarella*, so the government, in an attempt to overcome the defect in its *Chiarella* case, based its indictment on the theory that the defendants owed a duty of trust and confidence to their employer and its clients, rather than to the trading shareholders, and that in using confidential information for their own benefit and without disclosure they violated this duty and rule 10b-5. Thus, the indictment used the theory that the Supreme Court had discussed but not decided in *Chiarella*.

The Second Circuit concluded that the defendants’ alleged conduct, if proved at trial, would constitute a fraud on the employer and on the employer’s clients in connection with the purchase or sale of securities, and therefore was actionable under rule 10b-5. Because *Newman* involved a criminal indictment, the court did not address the question, raised by Justice Stevens in *Chiarella*, whether the employer or its clients, who had neither sold nor purchased securities, would have standing to sue under rule 10b-5.

In upholding the indictment based on this theory, it can be argued that the Second Circuit acted consistently with *Chiarella*, because the duty of the defendants to disclose or refrain from trading arose from a fiduciary or confidential relationship. The majority opinion in that case, however, stressed the importance of a relationship between the parties to the
by market participants against persons who trade on inside information lessens the deterrence against the use of such information.

In O'Connor and Associates v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981), the district court applied Newman to find that a rule 10b-5 cause of action had been stated by an options trader, which alleged that insiders of two corporations, one of which was about to tender for outstanding securities of the other, had tipped material, inside information to persons who then purchased call options on the stock of the target corporation from the options trader. The tippees moved to dismiss, arguing that, after Chiarella, no cause of action could be stated against them because neither they nor their tippers owed any fiduciary duty to the options trader. The court agreed that no fiduciary duty was owed to such a trader by these people, distinguishing the position of an options trader from that of a corporate stockholder.

The court went on to hold, however, that the options trader had stated a cause of action under rule 10b-5 because the insider-tippers owed a fiduciary duty to their respective corporations to avoid tipping or trading on inside information. Because of this duty, such insiders and their tippees could not trade or tip, absent disclosure of the material inside information "to the investing public," and when they did so, a violation of rule 10b-5 occurred. The court determined that the options trader, who was a seller of securities by virtue of his sale of the call options, had standing to assert this rule 10b-5 violation, although the fiduciary duty that was breached by the insiders was not owed to him.

These cases demonstrate that the lower courts, having interpreted Chiarella as eliminating the direct use of rule 10b-5 by persons without a fiduciary relationship with a non-disclosing trader or tipper, will go to some lengths to protect such persons indirectly by finding other fiduciary relations and their breach on which to base the 10b-5 claim. Whether the Supreme Court will ultimately approve this expansive use of the alternate theory which the Court refused to consider in Chiarella remains to be seen.

Even if the Supreme Court were to adopt this expansion of the views that it set forth in Chiarella, the rule still would not provide a strong deterrent against the use of inside information in circumstances in which its use is destructive of market honesty and fairness. Obviously, there will be no deterrence unless there is a reasonable prospect of a lawsuit being brought against the insider trader by someone.

If the insider trader has no fiduciary or confidential relationship with the issuer, its shareholders, or anyone else involved in the transaction, there can be no possibility of such a lawsuit. In such circumstances there is no duty to disclose, even under Newman and O'Connor, and, therefore, there will be no rule 10b-5 violation. Thus, a suit by private litigants, by the SEC, or by the Justice Department is not possible.

If the insider trader has a fiduciary or confidential relationship with someone other than the issuer and its security holders, as in Newman, it is possible that a duty to disclose or to refrain from trading can arise out of that relationship. Even if that relationship can support a rule 10b-5 violation, however, that does not answer the questions of who can sue to redress such violations and how likely it is that such a suit will be brought.

If a rule 10b-5 violation has occurred as a result of a breach of the "disclose or refrain" duty arising out of a relationship with someone other than the issuer and its security holders, the SEC can seek injunctive relief or can refer the matter to the Department of Justice for criminal prosecution. United States v. Newman, 664 F.2d 12 (2d Cir. 1981). Although suit by the government is thus possible in such circumstances, it is doubtful that this will provide a real deterrent, because such a suit is not likely. As the SEC is fond of saying, it has precious few resources and really must rely to a large extent on private practitioners and litigants to bring about compliance with the securities laws.

It may be unlikely that a private litigant would sue to redress a rule 10b-5 violation that
It would be unnecessary to deter the use of material, nonpublic information if the use of such information were consistent with market fairness and honesty, as it is when the person profiting from its use has developed the informational advantage from legitimate efforts and analysis.\textsuperscript{101} Many people, however, after coming into possession of material, nonpublic information regarding an issuer with whom they have no fiduciary or confidential relationship, use that information in an unauthorized way for their personal benefit. This use of information adversely affects market fairness\textsuperscript{102} and honesty and, just as importantly, public perceptions of the market. Furthermore, this use of inside information now is deterred significantly only when the user has a special relationship to the issuer and its security holders.\textsuperscript{103}

For example, an employee of a financial printer often receives, while working for the acquiring company, information respecting the target company in a proposed tender offer. After \textit{Chiarella} and its progeny, the employee may purchase the securities of the target company in a proposed tender offer. After \textit{Chiarella} and its progeny, the employee may purchase the securities of the target company, which arises from a breach of fiduciary duty to someone other than the issuer and its shareholders. First, the person to whom the fiduciary duty ran will lack standing to sue, if he or she is neither a purchaser nor a seller of securities. \textit{See Chiarella v. United States}, 445 U.S. at 238 (Stevens, J., concurring). Second, even if such a person has standing, he or she may lack incentive to sue the insider trader. For example, in an acquisition situation such as those involved in \textit{Chiarella} and \textit{Newman}, it may be difficult for the acquiring company—the party to whom the fiduciary duty ran—to establish the amount of damages, which presumably would reflect the increased cost to it resulting from the market rise caused by the insider trader's conduct. On the other hand, those damages may be insignificant in comparison with the total amount involved in the transaction. For either reason, the acquiring company might be expected to decline to sue the insider trader.

Even if the person to whom the fiduciary duty ran cannot be expected to sue, it is possible that someone else might have standing to sue. Standing was conferred in \textit{O'Connor}, where such person was a purchaser and seller of securities, because the court found that a fiduciary duty of the insiders to the corporation gave rise to a disclosure duty to the market. The effect of this was to confer standing to sue in such a case on all trading market participants. Allowing trading market participants to sue is precisely what is needed to deter insider trading; but it is doubtful that there will be many cases like \textit{O'Connor} in which the court will be able to achieve this result, since in \textit{O'Connor}, unlike \textit{Newman} and \textit{Chiarella}, the insider had a relationship with the corporation.

Unless market participants have standing to sue the insider trader, deterrence of insider trading will be lessened. While it may be possible to construct a theory in some cases, such as \textit{O'Connor}, by which market participants gain standing to sue as a result of a breach of a confidential or fiduciary duty to someone else, such attempts to circumvent \textit{Chiarella} seem a less preferable alternative to a straightforward rule under which market participants who lack a fiduciary relationship with the insider trader could sue in appropriate circumstances.\textit{See text accompanying notes 127-39 infra.}

\textsuperscript{101} \textit{See notes 18-20 & accompanying text supra.}

\textsuperscript{102} \textit{See Fleischer, Mundheim & Murphy, supra note 18, at 816-17; see also Barry, supra note 3, at 1352; Langevoort, supra note 3, at 2; Marsh, Book Review, 66 Mich. L. Rev. 1317, 1320 (1968).}

\textsuperscript{103} \textit{See note 100 supra.}
pany without fear of liability to the selling shareholders under section 10(b) and rule 10b-5.\textsuperscript{104} If, however, the transaction were structured as a merger or other “friendly” acquisition, in connection with which the printer had been employed by both companies to print a joint proxy statement or press release, a trading employee of that printer might be liable to the selling shareholders of the acquired company because he or she would now have an agency and, accordingly, a fiduciary relationship to that company.\textsuperscript{105}

Other examples of parties shielded by the \textit{Chiarella} rule from liability to market participants include one who overhears a conversation between a potential tender offeror and one of its advisors regarding a proposed tender offer, a visitor to the offices of a potential tender offeror who happens to see a “confidential” proposal respecting a tender, or a burglar who breaks into the tender offeror’s office and steals a copy of such a confidential proposal.\textsuperscript{106} In none of these cases does the person who learns of the confidential information have any relationship to the target company, to its security holders, or to the tender offeror.\textsuperscript{107} Under \textit{Chiarella} and its progeny, therefore, these people may trade with impunity under section 10(b) and rule 10b-5 although each has knowingly benefitted from the intentional misappropriation of confidential information. This result does not seem to be in accord with Congress’s intent in passing section 10(b), and seems unreasonable and patently unjust.

Recognizing this, the SEC promulgated rule 14e-3\textsuperscript{108} pursuant to section 14(e) of the Act\textsuperscript{109} shortly after the decision in \textit{Chiarella}. This

\textsuperscript{104} There may be liability under rule 14e-3. See text accompanying notes 108-10 infra.

\textsuperscript{105} In fact, one of the five takeover proposals in \textit{Chiarella} involved a merger. The parties, however, did not regard as significant the difference between a merger and a tender offer. See note 62 supra.

\textsuperscript{106} Scienter must be proved in order for a violation of rule 10b-5 to be established. Aaron v. SEC, 446 U.S. 680, 701 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976). Therefore, if the miscreant does not know that the information is confidential, he or she will not be liable for trading on that information, unless scienter could be established through recklessness. See \textit{Chiarella} v. United States, 445 U.S. 222, 230 n.12 (1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 237 (2d Cir. 1974); see also Ernst & Ernst v. Hochfelder, 425 U.S. at 193 n.12 (reserving the question whether recklessness constitutes scienter).

\textsuperscript{107} For further illustrations of such situations, see R. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 841 (2d ed. 1981); ALI FEDERAL SECURITIES CODE § 1603, comment 3(d) (Proposed Official Draft 1980).


\textsuperscript{109} 15 U.S.C. § 78n(c) (1976) prohibits false and misleading statements “in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.”
rule attempts to prohibit virtually all who possess material inside information concerning tender offer transactions from trading on that information.\footnote{110} This rule, however, can extend only to tender offer situations because section 14(e) is limited to such situations.\footnote{111} The possibilities for the unauthorized trading use of inside information, on the other hand, extend beyond those situations.

For example, a lawyer who has been retained by an individual to file suit against a publicly-held company may take advantage of that knowledge by selling stock of that company because he or she lacks the requisite relationship to the issuer or its stockholders. An employee who knows that his or her firm is about to award a lucrative contract to a publicly-owned issuer may take advantage of this knowledge to purchase securities of that issuer because he or she has no fiduciary relationship to that company.\footnote{112} In these situations, the person who is profiting has knowingly used information that has been misappropriated. The trader has not created or developed the information, and its use was not authorized by a person who legitimately created it.

While it has been argued that improper trading on inside informa-

\footnote{110} Rule 14e-3 provides: "If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from: (1) The offering person, (2) The issuer of the securities sought or to be sought by such tender offer, or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise."

\footnote{111} One commentator has questioned whether rule 14e-3 is a valid exercise of the SEC's rulemaking power. See Heller, supra note 3, at 541-45.

\footnote{112} See JENNINGS & MARSH, supra note 30, at 952-53. If the employee is permitted to trade on the inside information, the corporate employer should be able to trade on it because it also lacked any confidential or fiduciary relationship with the other corporation or its shareholders. Thus, the employee may have breached a fiduciary duty owed to the employer by appropriating a corporate opportunity. The trading employee, therefore, might be subject to suit by the employer for breach of fiduciary duty, but under Chiarella could not be sued by market traders unless a disclosure obligation to the market somehow arose from this breach. See O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1187 (S.D.N.Y. 1981).

For a discussion of "corporate opportunities," see generally H. HENN, THE LAW OF CORPORATIONS § 237 (2d ed. 1970); N. LATTIN, THE LAW OF CORPORATIONS § 79 (2d ed. 1971). For a discussion of the ability of a corporation to trade in the securities of another corporation on the basis of information received in the course of arm's-length contract negotiations, see Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975).
tion does not harm the market participants who trade, because they presumably would have traded even if the "insider" were not in the market, there is at least a strong possibility that such conduct causes harm to the markets by casting doubt upon their fairness and honesty. Because of this, such conduct should be deterred.

Because the rule of Chiarella and its progeny does not accomplish this deterrence to the fullest extent possible, as would be consistent with congressional policy, it must be asked why the Supreme Court adopted the rule. The Supreme Court adopted the Chiarella rule because, among other things, it determined that the "established doctrine" of precedent compelled this result.

No decision relied on by the Court in Chiarella actually held that only those with a fiduciary or other confidential relationship to the issuer and its security holders are subject to the insider trading proscription. The Chiarella Court's apparent conclusion that the application of the insider trading proscription of rule 10b-5 is so limited cannot, therefore, have been compelled by precedent. Although the Court indicated that its view of the application of the insider trading proscription was consistent with and based on the "established doctrine" of these precedents, the assertion that the Chiarella doctrine was "established" by the lower courts is unconvincing. Better reasons justify the Court's result in Chiarella.

The Chiarella rule is supported, for example, by the language of rule 10b-5, which prohibits fraud or deceit in connection with purchases and sales of securities, and the language of section 10(b), the statutory authority for rule 10b-5, which authorizes the SEC to prohibit the use of manipulative and deceptive devices or contrivances in connection with the purchase or sale of securities. Arguably, the statute and the rule cannot be interpreted to proscribe conduct that does not

115. See notes 99-112 & accompanying text supra.
117. See note 74 & accompanying text supra.
118. Although SEC v. Great American Indus., 407 F.2d 453 (2d Cir. 1968), cert. denied, 395 U.S. 920 (1969), discussed in text accompanying notes 43-52 supra, comes close to such a holding, that case did not define the ambit of the term "insiders." See notes 53-58 & accompanying text supra.
120. See note 1 supra.
121. See note 2 supra.
amount to fraud and deception, because they focus principally on fraudulent and deceptive conduct.\textsuperscript{122} Under common law principles, nondisclosure is fraudulent or deceptive only when it occurs in the face of a duty to disclose, and a duty to disclose arises when there is a fiduciary or confidential relationship between the buyer and the seller of the securities.\textsuperscript{123} The majority of the Court accepted this argument in \textit{Chiarella}.

This argument, not the compelling and "established doctrine" of the precedents, probably led the Court to the \textit{Chiarella} result.

Although this argument is plausible, it is not the only possible interpretation of the scope of rule 10b-5 or section 10(b). The lower courts and the SEC, whose precedents the Court found attractive and compelling in \textit{Chiarella}, had also established the doctrine that rule 10b-5 and common law fraud are not identical and that their elements need not be coextensive.\textsuperscript{125} Thus, the Court could have interpreted "deceit" and "fraud" without the limitations of the common law meaning of these terms.\textsuperscript{126}

The Misappropriation Theory for Insider Trading Rules

If the insider trading proscriptions under section 10(b) and rule


\textsuperscript{123} See note 33 supra. A duty to disclose may, however, arise in some nonfiduciary relationships. See \textit{Restatement (Second) of Torts} § 551 (1976); Barry, supra note 3, at 1363-65; Langevoort, supra note 3, at 12 n.44.

\textsuperscript{124} See 445 U.S. at 227-28.

\textsuperscript{125} See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), \textit{carn. denied}, 394 U.S. 976 (1969), discussed in notes 38-42 & accompanying text supra. In \textit{Texas Gulf Sulphur}, the court indicated that under rule 10b-5 anyone in possession of inside information had a duty to disclose it or refrain from trading, \textit{id.} at 848, whereas common law fraud principles would have applied this obligation only to fiduciaries. See note 33 supra. In addition, the court suggested that the standard of culpability under rule 10b-5 could be negligence in some circumstances, whereas under common law fraud principles scienter was required. \textit{Id.} at 854-55.

Although the \textit{Texas Gulf Sulphur} court's views on both of these points have since been rejected by the Supreme Court, see Aaron v. SEC, 446 U.S. 680 (1980), \textit{Chiarella} v. United States, 445 U.S. 222 (1980), and Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the case demonstrates that lower courts were willing to view rule 10b-5 as extending beyond common law fraud.

\textsuperscript{126} The Supreme Court itself has on occasion interpreted "fraud" broadly. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), has been characterized as holding that "just plain stealing" is "fraud" for purposes of rule 10b-5. Jennings & Marsh, supra note 30, at 997-98. In SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963), the Court construed "fraud" and "deceit" within the meaning of the Investment Advisers Act, 15 U.S.C. §§ 806-1 to 806-21 (1976), broadly and remedially rather than in their "technical" sense.
10b-5 seek to maximize market honesty, while enhancing market fairness by preserving incentives for legitimate analysis, the following insider trading proscription, proposed by Chief Justice Burger in his Chiarella dissent, is appropriate: "[A] person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." Such a rule strikes a proper balance between market fairness and market honesty and is consistent with the results of the judicial and SEC decisions that the Court relied on in Chiarella.

Promotion of Market Fairness and Honesty

If the proposed rule replaces the rule embraced by the majority in Chiarella, the balance between market fairness and market honesty would be enhanced. Unlike the Chiarella rule, which permits trading on inside information by those who have not furthered market fairness, the proposed rule would permit insider trading only by those who have contributed to the goal of market fairness by developing their own informational advantage. The proposed rule would limit lawful insider trading to those who have contributed to market fairness, because most "inside information," other than that which is the product of a person's own effort, analysis, and thoughts, is misappropriated.

Financial printers, eavesdroppers, office visitors, and burglars who learn of a proposed tender offer, whether from their printing activities, by overhearing a conversation, by glancing through a confidential document, or by theft, have clearly misappropriated the information, be-

127. See text accompanying notes 18-23 supra.
129. In In re Investors' Management Co., 44 S.E.C. 633 (1971), the SEC appeared to embrace a "misappropriation" test for determining who is an "insider" or a tippee of an insider. Among the elements the SEC considered requisite for rule 10b-5 liability in the proceeding against tippees was that they "know or have reason to know that [the information] was non-public and had been obtained improperly by selective revelation or otherwise." Id. at 641. The opinion noted: "Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like.... Our test would not attach responsibility with respect to information which is obtained by general observation or analysis." Id. at 641 n.18.
130. See notes 78-80 & accompanying text supra.
131. Presumably, one who has developed an informational advantage could choose to share the benefits to be derived from that advantage with others. Therefore, authorized "tippees" of one who could trade under the proposed rule should also be able to trade. See Fleischer, Mundheim & Murphy, supra note 18, at 811-12; see also Barry, supra note 3, at 1373.
132. Tippees of persons who are proscribed from trading must disclose or refrain from trading. See Chiarella v. United States, 445 U.S. at 230 n.12.
cause in each case it was not intended for their use and benefit.\(^{133}\) Similarly, the lawyer and the company employee who trade on information received in the course of their employment have misappropriated that information, because it was intended to be used by them only for the benefit of their employer and not for their own personal benefit. Yet, in each of these hypothetical cases, the Chiarella rule will permit the malefactor to trade on this inside information without fear of suit by market traders under section 10(b) and rule 10b-5.\(^{134}\)

The proposed rule, on the other hand, would subject these types of insiders to the “disclose or refrain” rule of section 10(b) and rule 10b-5. Their hypothetical conduct is destructive of market honesty and not conducive to the enhancement of market fairness, so it seems proper that this type of conduct be deterred by the possibility of liability to market traders.

**Harmonization with Prior Law**

The lower courts often have addressed situations in which the issuer or an officer, director, or substantial shareholder trades on inside information. In such cases, the courts have found that the insider can be sued by market participants under rule 10b-5.\(^{135}\)

If the proposed rule were adopted, the result in these cases would be the same. Information received by an officer, director, or controlling stockholder in the course of the insider’s relationship with the corporation is held for the benefit of the corporation, and not for personal benefit; information received by the corporation is held for the benefit of all shareholders.\(^{136}\) Therefore, it should be possible to view corporate

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\(^{133}\) See Barry, supra note 3, at 1370-72.

\(^{134}\) The possibility of liability to others, however, remains. See note 100 supra.

\(^{135}\) See text accompanying notes 26-34 supra.

\(^{136}\) This is true whether or not inside information is viewed as a corporate asset for purposes of determining when, if ever, a nontrading shareholder may bring a derivative suit under state law against an officer or director who trades on inside information. In Diamond v. Oreamuno, 24 N.Y.2d 494, 298 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the New York Court of Appeals held that inside information is a corporate asset and that a derivative suit could be maintained on behalf of the corporation by a nontrading shareholder against the officer who misappropriated that asset. Id. at 498-99, 298 N.E. 2d at 912, 301 N.Y.S.2d at 81. The Second Circuit Court of Appeals in Schein v. Chasen, 478 F.2d 817, 821-22 (2d Cir. 1973), determined that the Florida courts would, if presented with the question, embrace the Diamond rule and extend it to third parties who are involved in a common enterprise with officers and directors to misuse corporate funds. The Florida Supreme Court, however, flatly rejected the Diamond rule in Schein v. Chasen, 313 So. 2d 739, 746 (Fla. 1975), after the United States Supreme Court vacated the Second Circuit decision and certified the case to the Florida Supreme Court. Lehman Brothers v. Schein, 416 U.S. 386, 391-92 (1974). The Diamond approach was also rejected in Freeman v. Decio, 584 F.2d 186, 196 (7th Cir.
information that is used for the personal benefit of an officer, a director, or some of the shareholders' as having been “misappropriated” and, if such is the case, the results in the traditional “insider” cases are consistent with the misappropriation theory set forth in the proposed rule.

The courts have also treated as insiders a number of other categories of persons, such as underwriters, finders, and friendly acquisition partners, so that such persons are subject to the “disclose or refrain” rule of section 10(b) and rule 10b-5. In such cases, the results should be the same if the proposed rule were adopted. In each case the person has knowingly traded, or caused others to trade, for personal gain on information that was held for the benefit of another; thus, the malefactor should be viewed as a misappropriator.

In addition, the courts have absolved from liability a number of persons whose alleged transgression was trading upon an informational

1978), in which the Seventh Circuit determined that the Indiana courts would not follow Diamond.

It seems that the rejection of Diamond is the proper result, because neither a nontrading shareholder nor the corporation which he or she claims to represent in the derivative suit is harmed by the nondisclosure of material, inside information. Once the inside information is disclosed, the corporation and its remaining, nontrading shareholders get the benefit of it. Only those who have sold during the period prior to the announcement of the information have been harmed and only they should be able to sue, which they can do under rule 10b-5.

137. This would occur if a corporation possessing material inside information repurchased its own shares from some of its shareholders at a “bargain” price, thereby benefitting the remaining shareholders. In American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 743 (E.D. Va. 1980), the court held that corporate officers had no personal liability under rule 10b-5 for failing to disclose material facts to the sellers from whom they repurchased shares on behalf of the corporate issuer. The court noted that insiders and fiduciaries have a duty to disclose under Chiarella, but limited that duty to situations in which the insider or fiduciary is trading for his or her own account. Id. at 741-44. The court did, however, find the officers liable under § 10(b) and rule 10b-5 for making affirmative misrepresentations to the sellers. Id. at 744-47.

This result is consistent with the misappropriation theory previously discussed, because the corporate officers had not appropriated the inside information for their own benefit. The officers were using that information to benefit the corporation. The corporation itself, however, could be liable under rule 10b-5 for insider trading, even though its officers were not. This result also would be consistent with the misappropriation theory. Because the information on which the corporation traded was held for the benefit of all corporate shareholders, the corporation, acting through its officers, misappropriated that information when it used it to the disadvantage of the selling shareholders and to the advantage of the remaining ones.

138. See notes 53-58 & accompanying text supra.

139. Cf. Frigiemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975), in which a defendant was absolved of liability to the corporate plaintiff under rule 10b-5 when the “inside” information on which the defendant had traded was voluntarily disclosed by the corporate plaintiff, without restriction on its use or confidentiality, in the course of arm’s-length negotiations between the defendant and the plaintiff. The result in Frigiemp would be the same under the proposed rule because the inside information there involved was given to the defendant without restriction on its use; it was not misappropriated.
advantage consisting of their own plans for a company after its acquisition or their own analyses and views of a company's value. These results also are consistent with the "misappropriation" theory, although the cases have been decided on the ground that the defendant is not an insider rather than on the ground that the informational advantage was not misappropriated. In these cases, the defendant's efforts or thoughts, rather than misappropriation, produced the informational advantage, and so the information may legitimately be employed under the proposed rule without the threat of liability under section 10(b) and rule 10b-5.

**Implementation of the Proposed Rules**

Several possible means of adopting the proposed rule should be examined. First, the Court might overrule Chiarella and expressly adopt the proposed rule. This is not likely, however, in light of the fact that a majority of the Court declined the Chief Justice's proposal to adopt this rule in Chiarella. Furthermore, the majority's basis for

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140. See text accompanying notes 43-51 supra.

141. The misappropriation theory is also consistent with the application of the insider trading proscription of rule 10b-5 to brokers, dealers, and investment advisers. The cases usually have held that these persons, because of their fiduciary relationship to their clients, must disclose to their clients any material information which they may have regarding the securities that they are proposing to buy, sell, or recommend for the client. See, e.g., SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); Lewelling v. First Cal. Co., 564 F.2d 1277 (9th Cir. 1977); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Barthe v. Rizzo, 384 F. Supp. 1063 (S.D.N.Y. 1974). Such information could be information regarding the corporate issuer, which the broker-dealer or advisor might have developed through its research department, or information regarding market conditions for the security. See Brudney, supra note 19, at 349.

The requirement that brokers, dealers, and investment advisors disclose such information to their clients is consistent with the misappropriation theory because information respecting an issuer that is developed or received by a broker, dealer, or investment advisor in the course of its business, can be viewed as having been received for the benefit of its client. Thus, if a broker or advisor uses the information for its own benefit, rather than disclosing it to the client, the information arguably has been misappropriated.

142. Technically, any such action by the Court might not constitute an overruling, because of the narrow holding in Chiarella. See notes 71-80 & accompanying text supra.


Of course, the Court could abandon the "established doctrine" embraced by it in Chiarella in favor of the misappropriation theory espoused here. The Court's actual holding was limited and neither accepted nor rejected the misappropriation theory. See notes 70-80 & accompanying text supra. In addition, Superintendent of Ins. v. Bankers Life & Casualty
the Chiarella rule indicates that the Court views section 10(b) and rule 10b-5 as being limited by common law fraud principles.144 Thus, the Court would probably not adopt the proposed rule.

Second, the SEC may revise rule 10b-5 or enact a new rule under section 10(b), expressly prohibiting insider trading by misappropriators of information. While the SEC appears disposed to take all reasonable steps to combat this type of trading,145 the question remains whether section 10(b) authorizes the SEC to prohibit conduct that would not amount to fraud or deceit at common law. Chiarella and other authorities cast doubt on the SEC's authority to do so.146 The SEC's response to Chiarella—rule 14e-3—was grounded not on section 10(b) but on section 14(e); the SEC felt that its rulemaking authority in this area was clearer under section 14(e) than under section 10(b).147 Accordingly, the power of the SEC to enact the proposed rule under section 10(b) is in doubt, and as the present rule is not broad enough to cover misappropriators who trade on inside information but who lack a fiduciary or confidential relationship, the only proper avenue for enactment of the proposed rule is through the Congress.

In an effort to end the uneven and unprincipled application of the insider trading proscription, it is suggested that the following subsection (c) be added to section 10 of the Act:

Section 10. 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—

... (c) To purchase or sell or recommend the purchase or sale of securities while in possession of material, undisclosed information regarding such securities or their issuer or affiliates of such issuer, 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. Any rules adopted pursuant to this subsection (c) shall attempt to balance and bring about the objectives, set forth in Section 2 of this Act, of fair and honest markets.

Under such clear statutory authority, the SEC could adopt the pro-

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144. See notes 120-25 & accompanying text supra.
146. See note 142 supra. For an argument that there is a common law duty to disclose misappropriated information, see Barry, supra note 3, at 1362-63.
posed rule, which would then apply to all transactions, and not just to those in the tender offer area now covered by rule 14e-3.148

Under the authority of this new statute, the SEC could adopt a rule more restrictive than that proposed here.149 For this reason, the last sentence of the proposed statute and its legislative history should establish that only the use of misappropriated informational advantages should be proscribed. Those informational advantages legitimately derived from analysis of publicly available information may be used by their creators and by authorized users.

Conclusion

For the past forty years, courts have applied rule 10b-5 to insider trading transactions without considering the statutory policy behind the rule. The Supreme Court has continued this approach in Chiarella. The lower courts appear to be following Chiarella and determining the scope of the insider trading rules on the basis of specified relationships rather than statutory principles.


149. The possibility that the SEC might by rule preclude the use of informational advantages to a degree greater than that advocated by this Article is suggested by rule 14e-3, which the Commission adopted in the wake of the Chiarella decision. See notes 108-11 & accompanying text supra. This rule precludes the use by certain persons, prior to disclosure, of material information respecting tender offers. While the rule does not preclude the use of such information by the tender offeror itself, it does preclude the use of such information by, among others, users who have been authorized by the tender offeror. See note 110 supra. Furthermore, the SEC has suggested in the past that it may adopt a rule prohibiting the tender offeror itself from commencing pre-tender, market purchases without disclosing its intent to make a tender offer. See SEC Exchange Act Release No. 15,548 (Feb. 5, 1979) (proposed rule 14e-2(c)). Such a rule would go well beyond existing case law. See notes 43-52 & accompanying text supra.

One of the incentives to spur investment analysis, which ultimately enhances market fairness, is the possibility that the analyst, its clients, and other authorized users will reap the benefits of that analysis by trading in the market before the results of the analysis generally are known. See notes 18-22 & accompanying text supra. It seems inappropriate to prevent the tender offeror or authorized users from trading until they have disclosed their information respecting the tender. After all, the decision to launch the tender is the result of the tender offeror's analysis of the current market situation and conclusion that the target company is undervalued. The offeror should be able to reap the benefits of this legitimate analysis, enhancing the fairness of the market, without impairing its integrity or honesty, because the information in question has not been misappropriated.

Thus, if section 10(b) is amended as proposed, the Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976 & Supp. III 1979), should also be amended appropriately to withdraw the SEC's authority to prohibit preannouncement purchases by tender offerors and those authorized by the tender offeror to make such purchases. Such developments would return the insider trading proscriptions to an evenhanded approach, consistent with the objectives of Congress as set forth in section 2 of the Act.
This approach leads to results inconsistent with the statutory purpose of ensuring fair and honest markets. To achieve this statutory purpose, Congress should augment the existing antifraud structure by expressly authorizing the SEC to prohibit trading on "misappropriated" information.