

1984

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Frank P. Luberti, Jr.

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Recommended Citation

Frank P. Luberti, Jr., *An Outsider Looks at Insider Trading: Chiarella, Dirks and the Duty to Disclose Material NonPublic Information*, 12 Fordham Urb. L.J. 777 (1984).

Available at: <https://ir.lawnet.fordham.edu/ulj/vol12/iss4/9>

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AN OUTSIDER LOOKS AT INSIDER TRADING: CHIARELLA, DIRKS AND THE DUTY TO DISCLOSE MATERIAL NONPUBLIC INFORMATION

I. Introduction

The prohibition against "insider trading"¹ is an acknowledged policy under the federal securities laws.² While many sources have contributed to this prohibition,³ much of the law on insider trading has

1. "Insider trading" refers to the practice of trading securities on both organized stock exchanges and the over-the-counter market based upon material nonpublic information. Wang, *Trading On Material Nonpublic Information On Impersonal Stock Markets: Who Is Harmed, And Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1219 n.2 (1981). See also Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1 (1982).

"Material" and "nonpublic" are also terms of art which have specific meaning. "Material" information has been defined as that information to which "a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965) (emphasis added). Such a test also includes information "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities." *Id.* at 462 (emphasis added). See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963). For a further discussion of material nonpublic information, see Fleischer, Mundheim & Murphy, *An Initial Inquiry Into The Responsibility To Disclose Market Information*, 121 U. PA. L. REV. 798, 803 (1973); Kripke, *Rule 10b-5 Liability and "Material Facts"*, 46 N.Y.U. L. REV. 1061 (1971); Note, *The Reliance Requirement In Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 593 (1975).

"Nonpublic" information "refers to information that investors may not lawfully acquire without the consent of the source. It also includes information which, although it may lawfully be disseminated, is not yet generally available." Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 n.2 (1979). See *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

"Information" refers generally to two categories: "corporate" information and "market" information. Corporate information concerns "information relating to the intrinsic value of the issuer, primarily its business and operations," while market information encompasses "a residual category of noncorporate information," such as information on a potential tender offer. Langevoort, *supra*, at 42. See Heller, Chiarella, *SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 BUS. LAW. 517, 526-32 (1982).

2. Langevoort, *supra* note 1, at 1.

3. The development of the law of insider trading has been influenced by common law cases, specifically those dealing with the tort of misrepresentation. See W.

developed under section 10(b) of the Securities Exchange Act of 1934⁴ and Rule 10b-5 promulgated thereunder.⁵ These antifraud provisions of the federal securities laws, often described as "catchall" sections,⁶ have served as the primary bulwarks against insider trading, even though neither provision specifically addresses the issue of insider trading.⁷ Nevertheless, the fundamental prohibition against insider trading has been accepted by the business and legal communities.⁸

At the heart of the prohibition against insider trading is the concept known as the "abstain or disclose" rule,⁹ which states that persons in

CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 713-18 (5th ed. 1980). Also, certain well-known cases have added to the prohibitions on insider trading by developing state corporation laws. *See, e.g.*, *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (insider held liable to his corporation for trading on material nonpublic information based upon common law agency principles). *See also* RESTATEMENT (SECOND) OF AGENCY § 388 & comment c (1957).

4. Section 10(b) of the 1934 Act reads:

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—

...
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78(j) (1982) [hereinafter cited as Section 10(b)].

5. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in 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.

17 C.F.R. § 240.10b-5 (1982).

6. *See Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201-06 (1976) (discussing legislative history of Section 10(b)).

7. *Langevoort*, *supra* note 1, at 2-3.

8. *Id.* at 1 n.2.

9. This is also known as the "disclose or refrain" rule. *See Brudney*, *supra* note 1, at 1-2. For the development of the rule, see *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (D. Del. 1951), discussed in W. CAREY & M. EISENBERG, *supra* note 3, at 730-32.

possession of material nonpublic information must either disclose that information or refrain from trading on such information.¹⁰ In light of the requirement to read Rule 10b-5 in a flexible manner,¹¹ the abstain or disclose rule is in keeping with the broad remedial purposes attributed to federal securities legislation.¹² Administrative and judicial application of the abstain or disclose rule in cases of insider trading leads to a variety of sanctions being applied against a violator, ranging from restitution to criminal penalties.¹³

Despite the existence of this elaborate legal system designed to prevent insider trading, the public and private opprobrium associated with such conduct, and the risk of civil or criminal prosecution for violations of the federal securities laws, cases of insider trading continue to arise with troublesome frequency.¹⁴ Nor are these cases limited to one type of individual. From printers¹⁵ to paralegals,¹⁶ cabinet-

10. Langevoort, *supra* note 1, at 1.

11. See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). For a discussion of the purpose and policy behind the 1934 Act and Section 10(b), see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (“[t]he 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges”); *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974) (“[t]he basic intent of section 10(b) and rule 10b-5 and indeed, of the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings”); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974).

12. See, e.g., *Capital Gains Research Bureau, Inc.*, 375 U.S. at 186 (“[a] fundamental purpose, common to these [securities regulation] statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry”).

13. See, e.g., Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); *Stalking Stock Trading Abuses*, N.Y. Times, Mar. 6, 1981, at D1, col. 3.

14. Dooley, *supra* note 13, at 10. See Hudson, *With Shad as Chief, SEC Eases Many Rules And Stirs a Big Outcry*, Wall St. J., Jan. 12, 1984, at 1, col. 6; Blumstein, *Insider Trading Hard to Measure*, N.Y. Times, Jan. 9, 1984, at D1, col. 4; Hudson, *SEC's Enforcer Runs Tight Ship, but Critics Charge He's Too Soft*, Wall St. J., June 28, 1983, at 1, col. 1; Blumstein, *SEC Cracks Down on Insider Trades, But Violations Are Difficult to Prove*, Wall St. J., Nov. 12, 1980, at 37, col. 4. *But see* Branson, *Discourse on The Supreme Court Approach to SEC Rule 10b-5 And Insider Trading*, 30 EMORY L.J. 263, 293-95 (1981). See generally Wolfson, *The Need for Empirical Research in Securities Laws*, 49 S. CAL. L. REV. 286 (1976).

15. See *Chiarella v. United States*, 445 U.S. 222 (1980).

16. Kaplan, *Firms Alert To Insider Trade Peril*, NAT'L L. J., Jan. 23, 1984, at 1, col. 4.

level officers¹⁷ to corporate directors,¹⁸ instances of insider trading have presented some of the most complex and colorful cases of any area of the law.

This Note examines recent developments in the law of insider trading. Part II reviews the information and individuals involved in such cases, with emphasis on the arguments for and against insider trading. Part III traces the development of the duty to disclose material non-public information. Part IV discusses two leading decisions in the area of insider trading, *Chiarella v. United States*¹⁹ and *Dirks v. S.E.C.*²⁰ Part V examines potential legislative reform of the statutes currently regulating insider trading. Part VI discusses future problems in coping with insider trading. Finally, this Note concludes with the recommendation that a more serious attitude toward such abuses is required by all parties in conjunction with greater penalties to combat instances of insider trading. These actions are necessary to achieve the purposes of the federal securities laws and to promote greater investor confidence in the securities markets.

II. Information, Actors and the Arguments For and Against Insider Trading

A. The Nature of the Information

The information involved in insider trading cases may vary as to both source²¹ and content.²² This section will discuss the nature of the information involved in insider trading and the term "material non-public information."²³

17. See, e.g., "Inside Traders" Are on the Spot, U.S. NEWS & WORLD REP., Jan. 16, 1984, at 9, col. 1 (discussing action against former Deputy Defense Secretary Paul Thayer); Hudson, *With Shad as Chief, SEC Eases Many Rules And Stirs a Big Outcry*, supra note 14, at 1 (discussing Thayer case); *New Crackdown on Insider Traders*, NEWSWEEK, Dec. 5, 1983, at 89, col. 1; Block & Hoff, *Life After 'Dirks': Can Outsider Trading Constitute Fraud?*, NAT'L L. J., Sept. 19, 1983, at 1, cols. 3-4 (discussing case of Special Presidential Assistant Thomas C. Reed); Blumstein, *Insider Trading Hard to Measure*, supra note 14, at D1 (discussing Thayer and Reed cases).

18. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (tip from member of board of directors of Curtiss-Wright Corporation regarding reduction in company dividends to broker-dealer who sold Curtiss-Wright stock on basis of tip).

19. 445 U.S. 222 (1980).

20. 103 S. Ct. 3255 (1983).

21. *Id.*

22. *Id.*

23.

Generally, the law has been concerned with two types of undisclosed material information. "Inside information" is a legal term commonly used

1. *Corporate and Market Information*

An analytical distinction has been drawn between two types of material nonpublic information—corporate information and market information.²⁴ Corporate information is defined as “information relating to the intrinsic value of the issuer, primarily its business and operations.”²⁵ A closer look at corporate information indicates that the information at issue is often a function of the particular corporation and its directors, officers and employees.²⁶

Corporate information may concern the report of decreased earnings for a particular period,²⁷ the imminent reduction of corporate dividends,²⁸ or the discovery of a new mineral deposit.²⁹ These examples reflect how traditional instances of corporate information may form the basis for insider trading. Such examples are not exhaustive, as the nature of the information will vary with the uniqueness of the corporation.³⁰

to describe information concerning a particular corporation and its securities which is known to the directors, officers and employees and others associated with the corporation and their “tippees,” which is intended to be available only for “corporate purposes and not for the benefit of any one” (especially such directors, officers or employees), and which, if disclosed, would significantly affect market values. Any other type of undisclosed information is commonly described as “market information.”

Heller, *supra* note 1, at 522-23; accord Herman, *Equity Funding, Inside Information and the Regulators*, 21 UCLA L. REV. 1, 5-12 (1973) (discussing information involved in *Dirks* case); Langevoort, *supra* note 1, at 42-44.

24. See *supra* note 1.

25. Langevoort, *supra* note 1, at 42. See also Brudney, *supra* note 1, at 329 (“corporate information . . . is information which comes from within the corporation or affects the price of corporate stock because of its reflection of a corporation’s expected earnings or assets”) (footnotes omitted).

26. Heller, *supra* note 1, at 522-23.

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

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

29. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). See generally Bromberg, *Corporate Information: Texas Gulf Sulphur and its Implications*, 22 Sw. L.J. 731 (1968); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceedings*, 51 VA. L. REV. 1271 (1965); Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U. L. REV. 423 (1968).

30.

Examples of corporate information include knowledge of a significant discovery of natural resources, a research and development breakthrough, a rush of new orders, or a potential merger, any of which can be expected to cause a rise in the price of a corporation’s stock upon public disclosure. Corporate information can also be adverse, such as knowledge of can-

The other general category of inside information is "market information."³¹ While some commentators have defined this category more broadly than others,³² market information generally refers to information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power.³³

As with corporate information, market information exists in a variety of forms.³⁴ For example, "[i]nformation coming from the bidder in a planned tender offer is a classic example of market information relating to the subject company's securities."³⁵ This example indicates how market information is often unknown to corporate sources,³⁶ thereby illustrating the distinction between corporate and market information.

celled orders, nonacceptance of new products, a newly computed decline in earnings, the passing of a dividend, or the writeoff of a failed venture. In the latter cases, the corporation's stock price can be expected to decline once the news reaches the market.

Brudney, *supra* note 1, at 329 n.31.

31. See *supra* note 1.

32. Compare Fleischer, Mundheim & Murphy, *supra* note 1, at 799 and Brudney, *supra* note 1, at 329 ("[m]arket information concerns transactions in a corporation's securities that will have an impact on their future price quite apart from expected changes in the corporation's earnings or assets") with Heller, *supra* note 1, at 523 ("[a]ny other type of undisclosed material information is commonly described as 'market information' ") and Langevoort, *supra* note 1, at 42 (" 'market' information (a residual category of noncorporate information)").

33. Fleischer, Mundheim & Murphy, *supra* note 1, at 799.

34. "Situations involving market information abound. Knowledge that mutual funds experienced net redemptions over a recent period has affected market prices generally. In other cases market information affects only the stock of a particular company." Fleischer, Mundheim & Murphy, *supra* note 1, at 799. See, e.g., *Rogen v. Iikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966); *Reed v. Riddle Airlines*, 266 F.2d 314, 319 (5th Cir. 1959).

Typically such market information is generated by investment advisers, brokers, authors of market letters, or financial columnists, and is relevant to transactions anticipating public recommendations or reports by them. Another kind of market information is that possessed by a person engaged in the buying and selling of stocks. Thus a broker-dealer who is making a market, or a floor trader or specialist on an exchange, have information about supply and demand for shares that is not generally available.

Brudney, *supra* note 1, at 330 n.32. For a further discussion of such market professionals and the types of securities in which they deal, see Brudney, *supra* note 1, at 349; Fleischer, Mundheim & Murphy, *supra* note 1, at 845-58; Langevoort, *supra* note 1, at 39-42.

35. Langevoort, *supra* note 1, at 42.

36. "Market information need not come from, or indeed be known at all to, sources 'inside' the enterprise; nor need it reflect knowledge about the company's

In many cases, market information is also "outside" information emanating from noncorporate sources.³⁷ This information may take the form of a positive or negative recommendation by a broker-dealer³⁸ or a financial columnist.³⁹ Whatever the form, "[o]utside information, like inside information, can give one group of market participants an advantage over other participants to whom the information is not available."⁴⁰

One commentator has suggested a third category of information in addition to corporate and market information.⁴¹ This category includes information of a more general nature which may nevertheless have an impact upon a specific corporation or the market as a whole.⁴² However, the federal securities laws do not distinguish between various types of information.⁴³ The major requirement under the antifraud provisions of the federal securities laws is that the information be material.⁴⁴

worth apart from the short term market effects of a tender offer or a delisting or an unloading of a block of its stock." Brudney, *supra* note 1, at 330.

37. Fleischer, Mundheim & Murphy, *supra* note 1, at 807.

38. *Id.*

39. See, e.g., *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1264 (9th Cir. 1979) (financial columnist violated Section 10(b) and Rule 10b-5 when he failed to reveal to his readers that he had purchased shares of corporation which he recommended in his column and that he expected to profit if readers followed his advice).

40. Brudney, *supra* note 1, at 331.

41. See Brudney, *supra* note 1, at 331.

42.

[Examples of] still other kinds of information [include] . . . knowledge of an impending diplomatic shift, war among remote countries, an imminent scientific discovery, or a research breakthrough by another corporation. Such information may be external to a particular firm, or indeed have nothing to do with either the firm's operations or transactions in its securities and may be acquired legitimately by outsiders.

Brudney, *supra* note 1, at 331.

43. See Brudney, *supra* note 1, at 331-32 ("[t]he antifraud provisions by their terms and by their history do not distinguish between noncorporate and corporate information or outsiders and insiders") (footnotes omitted); *Langevoort*, *supra* note 1, at 42-43 ("[e]ven if there were a bright line distinguishing the two types of information, nothing in *Chiarella* suggests that such a distinction should be determinative in establishing the liability of insiders and tippees") (footnotes omitted).

44. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 (1976); *Harkavy v. Apparel Indus., Inc.*, 571 F.2d 737, 740-41 (2d Cir. 1978); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 15 (2d Cir. 1977); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-53 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). See also *Langevoort*, *supra* note 1, at 43 (sole question is whether information is material; that is, whether it is likely that reasonable investor's decision to trade at prevailing market price would be affected by disclosure of such information).

2. Materiality

Rule 10b-5⁴⁵ requires that the information in question be "material."⁴⁶ The cases defining materiality⁴⁷ have utilized the test of "whether 'a reasonable man would attach importance [to the information] . . . in determining his choice of action in the transaction in question.'"⁴⁸ Applying this test, courts have required that the information be accurate, specific and of such a nature that it would have a significant impact upon prices if disclosed.⁴⁹ Once the materiality of the information is shown, reliance on it is generally presumed.⁵⁰

B. Insiders, Outsiders and the Duty to Disclose

The antifraud provisions of the federal securities laws⁵¹ make it unlawful for "any person" to perpetrate a fraud or to make an affirmative misrepresentation concerning securities traded on the capital markets.⁵² Although the reach of the "any person" language would appear to be clear, a distinction has been drawn between "insiders" with an express fiduciary relationship to their corporations and "out-

45. See *supra* note 5.

46. *Id.*

47. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977); *SEC v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co., Inc.*, 44 S.E.C. 633 (1971).

48. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965), *quoted in Texas Gulf Sulphur Co.*, 401 F.2d at 849.

49. *Heller*, *supra* note 1, at 526 (footnotes omitted).

50. See *Langevoort*, *supra* note 1, at 43 ("[u]sually the information is sufficiently material that the insider's reliance can be presumed") (footnote omitted); Note, *The Fraud-On-The-Market Theory*, 95 HARV. L. REV. 1143, 1144 (1982); Note, *The Reliance Requirement In Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 587 (1975).

However, whether the information is specific or general in nature is important because

it directly bears upon the level of risk taken by an investor. Certainly the ability of a court to find a violation of the securities laws diminishes in proportion to the extent that the disclosed information is so general that the recipient thereof is still "undertaking a substantial economic risk that his tempting target will prove to be a 'white elephant.'" "

Monarch Fund, 608 F.2d at 942 (quoting *United States v. Chiarella*, 588 F.2d 1358, 1366-67 (2d Cir. 1978), *rev'd*, *Chiarella v. United States*, 445 U.S. 222 (1980)). For a further discussion of materiality, see *Fleischer, Mundheim & Murphy*, *supra* note 1, at 803-04; *Heller*, *supra* note 1, at 526-32; *Herman*, *supra* note 4, at 9-11.

51. See *supra* notes 4-5.

52. *Id.*

siders"⁵³ who are not directly associated with the corporation in question.⁵⁴

The existence of a duty to disclose material nonpublic information under the abstain or disclose rule⁵⁵ is dependent upon the classification of the party in question. The first category of individuals governed by the duty is corporate insiders.⁵⁶ Insiders such as corporate directors, officers and employees are barred from trading on material nonpublic information based upon their fiduciary duty⁵⁷ to the corporation which they serve and to its stockholders.⁵⁸ Allowing such individuals to profit as a result of their fiduciary duty would be both inequitable⁵⁹ and unfair.⁶⁰

53. Outsider trading has been defined as "trading by persons not associated with the corporation, based on inside information . . ." Block & Hoff, *supra* note 17, at 1.

54. See Brudney, *supra* note 1, at 339-53; Langevoort, *supra* note 1, at 18-35.

55. See *supra* note 9 and accompanying text.

56. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) ("a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders"). See also Brudney, *supra* note 1, at 343 ("[p]lainly, one group subject to the duties imposed by those [antifraud] provisions, both as a matter of legislative history and as a matter of traditional law, consists of corporate insiders—directors, officers, and executive employees") (footnotes omitted).

57. See, e.g., *Diamond*, 24 N.Y.2d at 497-98; *Brophy v. Cities Serv. Co.*, 70 A.2d 5 (Del. Ch. 1949). See also Langevoort, *supra* note 1, at 21 n.78 ("fiduciary" is not subject to precise definition requiring court to determine whether there is expectation of trust and confidence arising from relationship or whether law should assume such expectation to prevent overreaching).

58. See *Diamond*, 24 N.Y.2d at 497-98. See also Langevoort, *supra* note 1, at 20 (insiders acting in agency or quasi-agency capacity with corporate entity as principal owe fiduciary duties of loyalty and care to corporation and derivatively to its shareholders).

59.

Here, the basis in equity for the open-market abstain-or-disclose rule is plain. When an insider buys immediately before the announcement of good news or sells just before bad, his profit arises by virtue of his fiduciary status and the resulting access to the nonpublic information that created the opportunity for low-risk wealth. Requiring public disclosure by the insider in the open-market situation furthers a significant objective underlying the fiduciary disclosure rule—that of preventing unjust enrichment.

Langevoort, *supra* note 1, at 19.

60.

The insider has acquired from the corporation relevant and material corporate information and those with whom he deals cannot acquire it from the corporation lawfully, at least without the corporation's consent, which the insider has reason to know has not been given and will not be given. Allowing the insider the informational advantage in dealing with outsiders is thought to be "unfair," in the language of *Cady, Roberts*,

The reasoning behind the restraints imposed upon corporate insiders was expressed in the leading case of *In re Cady, Roberts & Co.*⁶¹ The Securities and Exchange Commission (Commission) reasoned that the disclosure obligations were based upon two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.⁶² Fine distinctions and rigid classifications should be avoided when considering these elements under the broad language of the antifraud provisions.⁶³ Rather, the provisions restrict those persons who have a special relationship with a company and have access to its internal affairs.⁶⁴ These persons are subject to correlative duties when trading in the company's securities.⁶⁵ The restraints are justified as necessary to protect the uninformed from exploitation.⁶⁶ Thus, the corporate insider is prohibited from exploiting his position of trust and confidence through trading on corporate information at the expense of unknowing shareholders.⁶⁷

In addition to corporate insiders, the corporation itself has been identified by some commentators as a specific entity to which the duty of disclosure applies.⁶⁸ The rationale for prohibiting the corporation from trading in its own securities based upon inside information is that "the application of the disclose-or-refrain rule to corporate transactions follows from the same exclusivity of access to the information which underpins the 'unfairness' of which *Cady, Roberts* spoke."⁶⁹

Closely related to those groups with direct ties to the corporation are individuals serving the corporation in a position of loyalty and

presumably because he has a lawful monopoly on access to the information involved. The unfairness is not a function merely of possessing more information—outsiders may possess more information than other outsiders by reason of their diligence or zeal—but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access.

Brudney, *supra* note 1, at 346 (referring to *Cady, Roberts*, discussed *infra* at notes 63-74 and accompanying text.

61. 40 S.E.C. 907 (1961).

62. *Id.* at 912.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. Langevoort, *supra* note 1, at 21.

68. Brudney, *supra* note 1, at 346-47.

69. *Id.* at 347 (footnote omitted).

fideliy, such as lawyers, accountants and financial advisers.⁷⁰ "While the delineation of the category 'insider' may be fuzzy at the edges, there is no doubt that it includes all those normally considered as having a confidential relationship in the conduct of the business of the enterprise."⁷¹ Thus, in the gray area between insiders and outsiders there may exist a category of specialists who will have fiduciary responsibilities imposed upon them under certain circumstances.⁷²

Finally, certain individuals are "tippees" of insiders, a category defined as "persons who receive confidential corporate information from an insider."⁷³ The tipper-tippee relationship has been a source of continued discussion⁷⁴ and litigation.⁷⁵ Much of the difficulty stems from the fact that "[u]nlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. In view of this absence, it has been unclear how a tippee acquires the *Cady, Roberts* duty to refrain from trading on inside information."⁷⁶ The current position is that the tippee is under no such duty unless he knew or should have known of the insider's breach of his fiduciary relationship.⁷⁷

70. See Brudney, *supra* note 1, at 347-48; Langevoort, *supra* note 1, at 20-21 (same result should apply to other persons who are serving issuer in capacity that creates relationship of trust and confidence with company).

71. Brudney, *supra* note 1, at 348.

72.

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.

Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983) (footnotes omitted). See Obermaier, *Insiders, Outsiders, Tipsters and Tippees*, N.Y.L.J., Sept. 6, 1983, at 2, col. 3.

73. Langevoort, *supra* note 1, at 24.

74. See, e.g., Langevoort, *supra* note 1, at 24-35; Comment, *Investors Management Company and Rule 10b-5—The Tippee At Bay*, 72 COLUM. L. REV. 545, 548 (1972); Note, *Investors Management: Institutional Investors as Tippees*, 119 U. PA. L. REV. 502, 506 (1971); Block & Hoff, *supra* note 17, at 18.

75. See, e.g., *SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2d Cir. 1974); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973); *In re Investors Management Co.*, 44 S.E.C. 633 (1971); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

76. *Dirks*, 103 S. Ct. at 3261 (footnote omitted).

77. "Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached

C. The Debate Over Insider Trading

The prohibition against insider trading is an accepted rule in the legal and business communities.⁷⁸ Notwithstanding this acceptance, debate continues regarding the alleged societal benefits and harms from insider trading.⁷⁹ This section will discuss the traditional position against insider trading and examine the leading critiques of this position.

1. *The Traditional View of Insider Trading*

The policy behind the antifraud provisions of the 1934 Act is "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in the over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."⁸⁰ The rationale for this policy is both pragmatic and equitable. From a pragmatic viewpoint, investors may be deterred from participating in the market if they know that others are trading on nonpublic information—the average investor would feel that the odds are stacked against him.⁸¹ In terms of equity, the insider is barred from profiting from his position of trust and confidence.⁸² The resulting system is intended to encourage individual investor participation in the secur-

his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Id.* at 3264 (footnote omitted). See also *In re Investors Management Co.*, 44 S.E.C. 633, 651 (1971) (tippee responsibility must be related back to insider responsibility by necessary finding that tippee knew information was given to him in breach of duty by person having special relationship to issuer not to disclose information and that information must be shown not only to have been material and nonpublic but also to have substantially contributed to trading that resulted).

78. See *supra* note 1 and accompanying text.

79. See, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Hetherington, *Insider Trading and the Logic of the Law*, 1967 WIS. L. REV. 720; Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967); Longstreth, *Halting Insider Trading*, N.Y. Times, April 12, 1984, at A27, col. 1; Bonner, *A Kind Word For Insiders*, N.Y. Times, Mar. 21, 1984, at D2, col. 1; SEC, *Professor Split on Insider Trades*, Wall St. J., Mar. 2, 1984, at 12, col. 3; Kaplan, *And Now, a Word in Favor of Insider Trading*, NAT'L L.J., Jan. 23, 1984, at 26, col. 1.

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

81. Wang, *supra* note 1, at 1227.

82. See, e.g., Langevoort, *supra* note 1, at 18-24; Brudney, *supra* note 1, at 343-46.

ities markets and to prosecute trading abuses based upon inside information.⁸³

2. *The Case for Insider Trading*

The arguments in favor of allowing insider trading may be roughly divided into two categories: first, those which maintain that there are inherent benefits to insider trading, or at the very least that no one is harmed by such activity, and second, those which assert that the inadequacy of the present structure prohibiting insider trading mandates that the current system be reorganized.

In the first category, the argument is made that removing prohibitions against insider trading would act as an incentive for corporate executives to create favorable conditions for their corporation's securities which they would then be able to exploit as investors.⁸⁴ Under this theory, insider trading becomes both an incentive and an alternate form of compensation for corporate entrepreneurs.⁸⁵

Alternatively, the argument is advanced that "[i]n anonymous stock trading, insider trading probably directly harms no one *individual*."⁸⁶ If an individual investor would have participated in a particular trade regardless of the insider's activity, then it is argued that no causal relationship exists between the outside investor's loss and the insider's gain.⁸⁷

Insider trading is also advocated as a mechanism to increase the efficiency of the capital markets in determining the most accurate price for a given corporation's securities.⁸⁸ "Presumably, by allowing

83.

Those executives, or securities industry professionals or others in a position to act on inside information, can and should owe allegiance to the securities marketplace. The priority that the removal of insider trading restrictions would give them would impugn investor confidence in their ability to participate in the markets. Maintenance of broad participation in capital markets gives corporate enterprise, corporate officials, securities professionals, institutional investors, and, indeed, financial printers both the ability to provide goods and services to earn livelihoods. Allowing insiders to trade would provide them with short run benefits at a potentially much greater long term personal cost.

Branson, *supra* note 14, at 292.

84. *Id.* at 291-92.

85. *Id.*

86. *Id.* at 295. See also Dooley, *supra* note 13, at 33 (insider trading does not induce outsider's trades nor does it mislead him or affect his expectations in any way).

87. Branson, *supra* note 14, at 295.

88. See, e.g., Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Heller, *supra* note 1, at 520-26; Note, *The Efficient Capital Market*

insider trading, securities laws will ensure that insiders will quickly move prices to the proper levels."⁸⁹ The resolution of this particular argument requires a determination of whether market efficiency or investor protection should be the underlying goal of securities regulation.⁹⁰ For example, a corporation developing a new product which is subject to governmental approval may receive advance notice that such approval will be denied, a decision that would adversely affect the price of the corporation's securities when made public. By permitting corporate insiders to sell their stock based on such information, the securities markets would begin to incorporate the adverse decision by setting a lower, more accurate stock price. Potential investors in the corporation may be dissuaded from purchasing the stock as a result of the price movement initiated by the insider trading.⁹¹

In the second category of arguments favoring insider trading, commentators have observed that attempts to regulate insider trading have proven to be ineffective.⁹² One commentator has stated that "enforcement by any means of insider trading restrictions is a bankrupt idea because enforcement attempts to curb an incurable element of human nature."⁹³ While such observations concerning human nature may have validity,⁹⁴ disagreement over both the extent of insider trading and the efficacy of enforcement provisions is expected to continue.⁹⁵

III. The Development of the Duty to Disclose

Much of the law of insider trading is an outgrowth of the Securities and Exchange Commission's analysis in the case of *In re Cady, Roberts & Co.*⁹⁶ Between the decision in *Cady, Roberts* and the more recent cases of *Chiarella*⁹⁷ and *Dirks*,⁹⁸ however, a number of signifi-

Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031 (1977).

89. Branson, *supra* note 14, at 292.

90. See Brudney, *supra* note 1, at 336.

91. Cf. Bonner, *Searle Stock Query Held 'Smokescreen'*, N.Y. Times, Feb. 29, 1984, at D5, col. 1 (scientist traded on company's stock expecting price decrease to result from negative reports concerning company's new artificial sweetener which scientist had criticized).

92. See, e.g., Branson, *supra* note 14, at 293; Dooley, *supra* note 13, at 72.

93. Branson, *supra* note 14, at 293.

94. See *infra* note 218 and accompanying text.

95. See *supra* notes 14-18 and accompanying text.

96. 40 S.E.C. 907 (1961). See *supra* notes 61-77 and accompanying text.

97. 445 U.S. 222 (1980).

98. 103 S. Ct. 3255 (1983).

cant decisions intervened. These intervening cases illustrate the development of the duty to disclose material nonpublic information. They also provide indispensable perspective for the decisions in *Chiarella* and *Dirks*.

Although much commentary on the subject begins with the *Cady, Roberts* decision, note should be taken of early common law cases which dealt with insider trading.⁹⁹ In these cases, the plaintiff usually attempted to extend the tort of misrepresentation to reach material nondisclosures of corporate information in transactions involving an official of the corporation.¹⁰⁰ Where a duty was imposed on the corporate official either on a fiduciary duty¹⁰¹ or special facts¹⁰² basis, courts often granted rescission of the transaction as the appropriate remedy.¹⁰³ The early common law decisions helped to establish the fiduciary relationship between the corporate insider and the corporation's stockholders.¹⁰⁴

The Commission's decision in *Cady, Roberts*¹⁰⁵ relied on statutory provisions rather than common law in declaring that insider trading violated section 10(b)¹⁰⁶ and Rule 10b-5.¹⁰⁷ The case involved a tip from a director of the Curtiss-Wright Corporation concerning a dividend reduction by the board of directors which was given to a partner of a securities firm.¹⁰⁸ Based on the corporate information, the partner sold Curtiss-Wright stock for the benefit of his clients.¹⁰⁹ The Commis-

99. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); *Hotchkiss v. Fischer*, 136 Kans. 530, 16 P.2d 531 (1932). For discussions of these cases, see Brudney, *Insider Securities Dealings During Corporate Crises*, 61 MICH. L. REV. 1 (1962); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950).

100. Langevoort, *supra* note 1, at 4-5.

101. *Strong v. Repide*, 213 U.S. 419 (1909).

102. See *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903).

103. *Strong v. Repide*, 213 U.S. 419 (1909).

104. "While these holdings were not universally accepted, they clearly indicated a trend . . . toward treating the insider as a fiduciary for the shareholders as well as for the company." Langevoort, *supra* note 1, at 5 (footnotes omitted). See W. CARY & M. EISENBERG, *supra* note 3, at 713-18; Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956).

105. 40 S.E.C. 907 (1961). By its own language, the Commission recognized *Cady, Roberts* as "a case of first impression and one of signal importance in our administration of the Federal securities acts." *Id.*

106. See *supra* note 4.

107. See *supra* note 5.

108. 40 S.E.C. at 908-10.

109. See *supra* notes 51-64 and accompanying text.

sion's analysis was based on "first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."¹¹⁰ Thus, *Cady, Roberts* went beyond the fiduciary rationale and the special facts doctrine expressed in the common law decisions¹¹¹ and established a broader approach under Rule 10b-5 for dealing with cases of insider trading.¹¹²

Following the *Cady, Roberts* decision, the Court of Appeals for the Second Circuit recognized the Commission's reasoning in *Cady, Roberts* as the "essence" of Rule 10b-5.¹¹³ In *SEC v. Texas Gulf Sulphur Co.*,¹¹⁴ the Second Circuit reviewed the history of the antifraud provisions and concluded that "[w]hether predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine, . . . the Rule 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."¹¹⁵ As a result, anyone

110. 40 S.E.C. at 912 (footnote omitted).

111. See *supra* notes 99-103.

112. 40 S.E.C. at 913-14.

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

Id. (footnote omitted). See Langevoort, *supra* note 1, at 7-9; Note, *Whistle Blowing as a Rule 10b-5 Violation: Dirks v. SEC*, 36 U. MIAMI L. REV. 987, 992 (1982); Comment, *The Dutiful Relationships of Section 10(b): The Chiarella Decisions*, 42 U. PITT. L. REV. 637, 640-41 (1981).

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

The essence of the Rule 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 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. The case involved the purchase of corporate stock by company officials based upon material information, specifically the discovery of copper deposits not yet disclosed to the public. See also *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969); *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

114. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

115. *Id.* at 848. For more on the "access to information" approach, see *supra* note 60 and Brudney, *supra* note 1, at 353-55.

possessing material nonpublic information would be required either to disclose the information or to abstain from trading on the information while it remained nonpublic.¹¹⁶

After establishing the basis for insider liability in the *Cady, Roberts* and *Texas Gulf Sulphur* decisions, courts were increasingly faced with the tipper—tippee relationship and the problem of outsider liability.¹¹⁷ In the case of *In re Investors Management Co.*,¹¹⁸ the Commission determined that the antifraud provisions of Rule 10b-5 applied to the tippees of corporate insiders.¹¹⁹ In such cases, the SEC concluded that “the appropriate test in that regard is whether the recipient knew or had reason to know that the information was non-public and had been obtained improperly by selective revelation or otherwise.”¹²⁰

In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹²¹ the Second Circuit held that the tippee defendants were liable in money

116. 401 F.2d at 848. *See also* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971); Langevoort, *supra* note 1, at 9; Note, *supra* note 112, at 992; Comment, *supra* note 112, at 642-43.

117. *See supra* notes 73-77 and accompanying text.

118. 44 S.E.C. 633 (1971). *Investors Management* involved the sale of shares in Douglas Aircraft Company based upon a report of substantially reduced earnings not yet public. *See also* Fleischer, Mundheim & Murphy, *supra* note 1, at 806-07; Note, *supra* note 112, at 933.

119.

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions. Both elements are here present as they were in the *Cady, Roberts* case. When a recipient of such corporate information, knowing or having reason to know that the corporate information is non-public, nevertheless uses it to effect a transaction in the corporation's securities for his own benefit, we think his conduct cannot be viewed as free of culpability under any sound interpretation or application of the antifraud provisions.

44 S.E.C. at 644.

120. 44 S.E.C. at 643. Concurring in the result, Commissioner Smith would have framed the . . . test in terms of the respondents knowing or having reason to know that the material non-public information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes. Such knowledge, in effect, renders the tippee a participant in the breach of duty when he acts on the basis of the information received.

Id. at 650 (footnote omitted).

121. 495 F.2d 228 (2d Cir. 1974). *Shapiro* involved the disclosure of material nonpublic information regarding an expected decrease in earnings for the Douglas Aircraft Company. While preparing an underwriting of Douglas debentures, Merrill Lynch disclosed the information to a preferred group of institutional clients (the

damages for violating the abstain-or-disclose rule.¹²² The case imposed liability on tippees in the same manner as insiders had earlier been held liable under the antifraud provisions.¹²³ In addition, *Shapiro* determined the proper class of investors who could recover in such actions. The proper plaintiffs were those individuals who purchased securities between the time of defendants' trading on the inside information and the time of disclosure of the material information.¹²⁴

These cases are indicative of the early decisions on insider trading. By applying the antifraud provisions of the federal securities laws to different factual situations involving insiders, outsiders, tippers and tippees, the lower courts began to develop a body of law dealing uniquely with insider trading. This early progression of the law of insider trading would soon undergo a major transformation as a result of the Supreme Court's decision in *Chiarella v. United States*.¹²⁵

IV. *Chiarella* and *Dirks*: The Twin Pillars of the Law of Insider Trading

A. *Chiarella v. United States*

Vincent Chiarella, an employee of a financial printer which produced confidential documents relating to corporate takeover bids, purchased shares of stock in companies about to be acquired through

selling defendants) who knew or should have known that the information had not been publicly announced. Based on this information, the selling defendants then sold Douglas stock prior to Douglas' public disclosure of the revised earnings estimates. *Id.* at 231-34.

122. *Id.* at 237.

123. 495 F.2d at 237-38.

We are not persuaded by the selling defendants' argument that as tippees they were not able to make effective public disclosure of information about a company with which they were not associated; for the duty imposed is not a naked one to disclose, but a duty to abstain from trading unless they do disclose. Since upon the admitted facts before us the selling defendants knew or should have known of the confidential corporate source of the revised earnings information and they knew of its non-public nature, they were under a duty not to trade in Douglas stock without publicly disclosing such information.

Id.

124. *Id.* at 241. *But see* *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) (measure of damages in tipper liability case limited to tippee's profits); *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (plaintiff class may not recover damages without showing of actual injury caused by defendant's conduct).

125. 445 U.S. 222 (1980).

tender offers prior to public announcement of the offers.¹²⁶ Chiarella acquired this material nonpublic information by deciphering the codes used by his employer to mask the identity of the corporations involved in the takeover proceedings.¹²⁷ Such conduct was prohibited by his employer,¹²⁸ and Chiarella knew of the restrictions.¹²⁹ After purchasing shares in the target companies without disclosing the material information, Chiarella waited for the announcement of the takeover attempts and sold immediately thereafter, reaping a substantial profit.¹³⁰

Chiarella was convicted on seventeen counts¹³¹ of violating section 10(b) of the 1934 Act¹³² and SEC Rule 10b-5.¹³³ His criminal conviction was affirmed by the Court of Appeals for the Second Circuit,¹³⁴ which reasoned that the abstain-or-disclose rule¹³⁵ barred Chiarella from trading on material nonpublic information obtained in the course of his employment as a financial printer.¹³⁶ The court of appeals based this position on the test of whether an individual regularly received or had access¹³⁷ to material nonpublic information,¹³⁸ regard-

126. *Id.* at 224.

127. *Id.*

128. *United States v. Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

129. 445 U.S. at 224.

130. In the course of five transactions (four tender offers and one merger) covering a fourteen month period, Chiarella's profits amounted to just over \$30,000, which he agreed to return to the sellers of the shares. *Id.* See *Langevoort*, *supra* note 1, at 11-12; *Heller*, *supra* note 1, at 532-35; *Branson*, *supra* note 14, at 271-75; Comment, *supra* note 112, at 638-40.

131. *SEC v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1977).

132. See *supra* note 4 and accompanying text.

133. See *supra* note 5 and accompanying text.

134. *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

135. See *supra* notes 9-13 and accompanying text.

136. 588 F.2d at 1368. See *Langevoort*, *supra* note 1, at 12; Note, *Rule 10b-5: Birth of the Concept of Market Insider and Its Application in a Criminal Case—United States v. Chiarella*, 8 *FORDHAM URB. L.J.* 467 (1980); Note, *Nontraditional Corporate Insiders in Possession of Material Inside Information Have a Duty Either to Disclose the Inside Information or to Abstain From Trading in the Corporation's Stock: United States v. Chiarella*, 47 *GEO. WASH. L. REV.* 965 (1979); Comment, *Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and United States v. Chiarella*, 1980 *WIS. L. REV.* 162.

137. 588 F.2d at 1365. "Anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling." *Id.* (footnote omitted) (emphasis in original). For a further discussion of "access to information," see *supra* note 60 and accompanying text.

less of whether the individual was a corporate insider.¹³⁹ Although Chiarella was not an insider of the companies whose securities he traded, his employment gave him regular access to confidential information.¹⁴⁰ This access formed the basis for the finding of liability by the Second Circuit.¹⁴¹

The Supreme Court reversed Chiarella's conviction,¹⁴² rejecting the "access to information" approach and instead requiring that liability under section 10(b) be "premised upon a duty to disclose [material nonpublic information] arising from a relationship of trust and confidence between parties to a transaction."¹⁴³ Given that Chiarella was not a corporate insider¹⁴⁴ and was not acting in a position of trust and confidence toward the sellers of the securities,¹⁴⁵ his use of the confidential information could not have constituted a fraud under section 10(b).¹⁴⁶ While Chiarella's conduct may have been unfair in relation to other shareholders, the Court concluded that "not every instance of financial unfairness constitutes fraudulent activity under [Section] 10 (b)."¹⁴⁷

While the Court in *Chiarella* reaffirmed that section 10(b) is a "catchall" provision,¹⁴⁸ it emphasized that "what it catches must be

138. 588 F.2d at 1365.

139. *Id.*

140. 588 F.2d at 1364. For more on the "market insider" concept, see *supra* note 137 and accompanying text.

141. 588 F.2d at 1365-68. See Langevoort, *supra* note 1, at 11-12.

142. 445 U.S. 222 (1980).

143. *Id.* at 230. See Langevoort, *supra* note 1, at 12-13; Comment, *supra* note 112, at 639-40.

144. 445 U.S. at 231.

145. *Id.* at 232-33.

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. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Id.

146. *Id.* at 233.

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forego actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent.

Id.

147. *Id.* at 232.

148. *Id.* at 226.

fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."¹⁴⁹ Consequently, Chiarella's conviction could not be upheld based on his mere acquisition of nonpublic information.¹⁵⁰

B. *Dirks v. S.E.C.*

In *Dirks v. S.E.C.*,¹⁵¹ the Supreme Court reaffirmed the position taken in *Chiarella* that the duty to disclose material nonpublic information arises from the existence of a relationship between the parties to the transaction, not from the ability to acquire confidential information based on the position one occupies.¹⁵² The case involved the disclosure of material nonpublic information in the form of fraudulent corporate practices within Equity Funding of America, a corporation engaged in selling life insurance and mutual funds.¹⁵³ The disclosures were made by Ronald Secrist, a former officer of Equity Funding,¹⁵⁴ to Raymond Dirks, a broker-dealer who provided investment analysis of the securities of insurance companies to institutional investors.¹⁵⁵

Based on this information, Dirks conducted an investigation of Equity Funding¹⁵⁶ and discovered that its corporate assets were vastly

149. *Id.* at 235.

150. *Id.* at 235.

We hold that a duty to disclose under [section 10(b)] does not arise from the mere possession of nonpublic information. The contrary result is without support in the legislative history of [section 10(b)] and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

Id. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-79 (1977).

In Part IV of the opinion, the Court refused to consider Chiarella's liability under a "misappropriation" theory, namely that Chiarella had breached a duty to the acquiring corporation when he traded upon information obtained as an employee of a financial printer retained by the corporation. This refusal was based upon the failure to submit this theory to the jury in the lower court proceeding. 445 U.S. at 235-37. See Langevoort, *supra* note 1, at 14-16; Comment, *supra* note 112, at 639-40.

151. 103 S. Ct. 3255 (1983). See Block & Hoff, *supra* note 17, at 18; Note, *supra* note 112, at 987-90. For the prior history of the case, see *Dirks v. S.E.C.*, 681 F.2d 824, 828 (D.C. Cir. 1982); *In re Boston Co. Inst'l Investors, Inc.*, 1978 FED. SEC. L. REP. (CCH) ¶ 81,705.

152. 103 S. Ct. at 3263.

153. *Id.* at 3258.

154. *Id.*

155. *Id.*

156. 103 S. Ct. 3259. Dirks' investigation included an attempt to persuade the *Wall Street Journal* to publish an article on the fraud allegations. Such an article was eventually published based upon the information gathered by Dirks, but only after the SEC filed a complaint against Equity Funding. *Id.*

overstated.¹⁵⁷ During Dirks' investigation the price of Equity Funding stock began to fall,¹⁵⁸ ultimately causing the New York Stock Exchange to suspend trading in the stock.¹⁵⁹ The corporation soon went into receivership.¹⁶⁰ Prior to this occurrence, however, some of Dirks' clients and other institutional investors sold their shares of Equity Funding based on their discussions with Dirks regarding the corporate improprieties, thereby avoiding further financial loss.¹⁶¹

The Supreme Court began its analysis in *Dirks*¹⁶² by restating the traditional view first expressed in *Cady, Roberts*¹⁶³ and later adopted in *Chiarella*.¹⁶⁴ The Court stated that a Rule 10b-5 violation is predicated upon a showing of the existence of a relationship affording access to information intended to be available only for a corporate purpose and the unfairness of allowing a corporate insider to take advantage of such information without public disclosure.¹⁶⁵ In addition, a Rule 10b-5 violation requires some form of "manipulation or deception," which in an insider trading case derives from the inherent unfairness of permitting an insider to trade in corporate information for his own personal benefit.¹⁶⁶

Unlike corporate insiders, however, the typical "tippee" lacks any specific relationship with or fiduciary obligation to the corporation or its shareholders.¹⁶⁷ In consideration of *Chiarella's* finding that a duty to disclose is the basis for liability under section 10(b),¹⁶⁸ it has been unclear how a tippee acquires a duty to abstain from trading on inside information absent a fiduciary or other special relationship.¹⁶⁹

157. *Id.* at 3258-59.

158. *Id.* at 3258.

159. *Id.*

160. *Id.* at 3259.

161. *Id.* See Block & Hoff, *supra* note 17, at 18. For his role in the proceedings, Dirks was censured by the SEC for aiding and abetting violations of Rule 10b-5 by repeating the information he had discovered to investors who were likely to sell their shares of Equity Funding based upon such information. His petition for review of the SEC's action was dismissed by the Court of Appeals for the District of Columbia. 103 S. Ct. at 3259-60.

162. 103 S. Ct. 3255 (1983).

163. 40 S.E.C. 907 (1961).

164. 445 U.S. 222 (1980).

165. 103 S. Ct. at 3260.

166. *Id.* at 3261 (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1973)).

167. *Id.*

168. *Id.*

169. *Id.*

The Court resolved this issue by stating that "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."¹⁷⁰ The disclosure by the insider to the tippee is improper only where it would violate the insider's duty under *Cady, Roberts*.¹⁷¹ "Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."¹⁷²

Finally, the Court examined those circumstances under which an insider's tip would breach his fiduciary duty, thereby forming the basis for the tippee's derivative breach.¹⁷³ The Court stated that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure."¹⁷⁴ Under such a standard, the Court concluded that Dirks did not violate the antifraud provisions of the federal securities laws given his lack of a fiduciary relationship with Equity Funding and its shareholders.¹⁷⁵ Furthermore, those corporate officials who disclosed the scandal to Dirks did not violate their *Cady, Roberts* duty¹⁷⁶ because they were motivated by a desire to expose the fraud and received no personal benefit in return for their disclosure of the information.¹⁷⁷

170. *Id.* at 3264 (emphasis in original).

171. *Id.*

172. *Id.*

173. *Id.* at 3265.

174. *Id.* "Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.* (footnote omitted).

175. *Id.* at 3266-67.

176. *Id.* at 3267-68.

177. *Id.* For other recent developments in the law of insider trading, see, e.g., *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 52 U.S.L.W. 3266 (U.S. Oct. 3, 1983) (No. 82-1653); *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983); *Walton v. Morgan Stanley & Co., Inc.*, 623 F.2d 796 (2d Cir. 1980); *SEC v. Thayer*, 84 Civ. 66 (CES) (S.D.N.Y. 1984); *SEC v. Musella*, 83 Civ. 342 (CSH) (S.D.N.Y. 1984); *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983); *SEC v. Platt*, 565 F. Supp. 1244 (W.D. Okla. 1983); *Moss v. Morgan Stanley*, 553 F. Supp. 1347 (S.D.N.Y. 1983); *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179 (S.D.N.Y. 1981).

V. Proposals For Reform

Several commentators have criticized the current system of preventing insider trading¹⁷⁸ and have called for a legislative augmentation of current statutory provisions regulating trading abuses in the securities markets.¹⁷⁹ This process has been accelerated as a result of the *Dirks* decision¹⁸⁰ and the recent increase in the number of allegations filed by the SEC against public figures for insider trading activities.¹⁸¹

One suggested reform is the Insider Trading Sanctions Act of 1983,¹⁸² approved by the House of Representatives in September,

178.

A review of the current regulatory scheme indicates that to be effective, enforcement must be quiet, swift and sure. Furthermore, it must be substantial and real, universal in application, and based upon principles more definite than the duty to the marketplace. The current scheme is noisy, random, slow-moving, and vague, thus resulting in a lack of sufficient deterrence. Furthermore, it is counterproductive and promotes a lack of investor confidence.

Branson, *supra* note 14, at 301. See also *Illegal Insider Trading Seems to Be on Rise; Ethics Issues Muddled*, Wall St. J., Mar. 2, 1984, at 1, col. 6.

179. See, e.g., FED. SEC. CODE § 1603 (1980); Block & Hoff, *supra* note 17, at 23-24; Branson, *supra* note 14, at 301-03; Langevoort, *supra* note 1, at 52-53 (perhaps best solution is legislative revision along lines of Federal Securities Code to remove prohibition from its uneasy fraud base); Wang, *supra* note 1, at 1320-21.

180. See Obermaier, *Insiders, Outsiders, Tippers and Tippees*, N.Y.L.J., Sept. 6, 1983, at 1, col. 1; Karmel, *The Efficient Market and "Dirks v. SEC."*, N.Y.L.J., Aug. 18, 1983, at 1, col. 1; Brodsky, *Trading on Inside Information*, N.Y.L.J., Aug. 17, 1983, at 1, col. 1.

181. See *supra* note 17. See also Metz, *Use of Inside Data in the Takeover Game Is Pervasive and Can Lead to Huge Profit*, Wall St. J., Mar. 2, 1984, at 12, col. 6. *Media Policies Vary on Preventing Employees and Others From Profiting on Knowledge of Future Business Stories*, Wall St. J., Mar. 2, 1984, at 12, col. 1.

182. The provisions of the bill relevant to insider trading read as follows:

A bill to amend the Securities Exchange Act of 1934 to increase the sanctions against trading in securities while in possession of material non-public information.

SECTION 1. This Act may be cited as "The Insider Trading Sanctions Act of 1983."

SECTION 2. Section 21 of the Securities Exchange Act of 1934 is amended by redesignating subsection (d) as subsection (d)(1), and adding at the end thereof the following new paragraph:

(2)(A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (A)(i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (B)(ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring action in a United States District Court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such a person, or any person aiding or abetting

1983.¹⁸³ In its present form, the Act would substantially increase both civil¹⁸⁴ and criminal¹⁸⁵ penalties for insider trading.¹⁸⁶ To the extent

the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who may recover such penalty by action in the appropriate United States District Court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of Section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

(B) No person shall be subject to a sanction under this subsection (d)(2) solely because that person aided and abetted a transaction covered by it in a manner other than by communicating material nonpublic information. Section 20 of this title shall not apply to actions brought under this subsection (d)(2). No person shall be liable under this subsection (d)(2) solely by reason of employing another person who is liable under such a subsection.

(C) For the purposes of this subsection (d)(2), "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

(D) No action may be brought under this subsection (d)(2) more than five years after the purchase or sale. This provision shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties imposed in an action commenced within five years of such transaction.

SECTION 3. Section 32 of the Securities Exchange Act of 1934 is amended by striking "\$10,000" from subsection (a) and inserting in lieu thereof "\$100,000".

SECTION 4. The amendments made by this Act shall become effective immediately upon enactment of this Act.

H.R. 559, 98th Cong., 1st Sess. (1983).

For a discussion of the Act, see *Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. (1983); Middleton, *Insider Trading*, 69 A.B.A.J. 1613 (1983); Obermaier, *supra* note 180, at 2.

183. *House Approves Bill to Increase Penalty For Insider Trading*, Wall St. J., Sept. 20, 1983, at 3, col. 2.

184. *Id.* More specifically, the language of the Act states that the Commission may bring action in a United States District Court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid

that the legislation goes beyond present remedies which merely require restitution of gains made as a result of trading on inside information, the Act is a significant contribution toward making insider trading a much more perilous activity.¹⁸⁷

Although the Act would provide enhanced sanctions both to deter and to prosecute insider traders,¹⁸⁸ the legislation has been subjected to a variety of criticisms.¹⁸⁹ One objection is that in its current form the Act does not contain any specific definition of precisely what activities constitute insider trading.¹⁹⁰ In fact, the SEC was opposed to incorporating any such definition into the legislation.¹⁹¹ The Commission's reasoning for this position was based upon the difficulties involved in drafting a comprehensive definition of insider trading.¹⁹²

Critics argue that the Act is fundamentally misdirected to the extent that it fails to deal with the unfair use of material information by outsiders.¹⁹³ In their view, the problem of outsider trading requires its

by such a person, or any person aiding or abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or the loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States.

See supra note 182. The Act defines "profit gained or loss avoided" as "the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information." *Id.* But *see* SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983) (price a reasonable time after dissemination of information defined profit to be disgorged for insider trading).

185. The Act would increase criminal fines for insider trading violations from \$10,000 to \$100,000. *See supra* note 182.

186. Middleton, *supra* note 182, at 1613.

187. "The rationale for that legislation, which provides for treble civil penalties, is valid because under current law the only sanctions are disgorgement of profits and an injunction. Accordingly, there is no downside to violating the insider trading prohibitions." Block & Hoff, *supra* note 17, at 23. *See* Block, *Insider Trading Bill Raises Difficult Questions*, N.Y.L.J., June 6, 1983, at 25, col. 1.

188. *See supra* notes 183-86.

189. *See, e.g.*, Middleton, *supra* note 182, at 1613; Obermaier, *supra* note 180, at 2.

190. Obermaier, *supra* note 180, at 2.

191. 15 SEC. REG. & L. REP. 1337 (BNA) (July 15, 1983). *See* Obermaier, *supra* note 180, at 2.

192. 15 SEC. REG. & L. REP. 1563 (BNA) (Aug. 12, 1983). *See* Obermaier, *supra* note 180, at 2.

193. "[L]egislation dealing with outsider trading is necessary, but . . . it should be defined as such and not come under the catchall 'insider trading,' which the SEC calls fraud under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5." Middleton, *supra* note 182, at 1613.

own independent legislative remedy.¹⁹⁴ In addition, commentators have observed that the result of *Chiarella*¹⁹⁵ and *Dirks*¹⁹⁶ may be to move away from section 10 (b) as the traditional remedy for securities laws violations.¹⁹⁷ The ultimate conclusion may be the further limitation of present regulatory provisions through judicial restrictions¹⁹⁸ without legislative development of sufficient alternatives to augment or replace the existing statutory framework.¹⁹⁹

Furthermore, critics charge that to use legislation entitled the "Insider Trading Sanctions Act" to prosecute cases of outsider trading would result in either a mislabeling of the Act²⁰⁰ or in its misapplication to a theoretically different problem, which is based on unfairness rather than fraud.²⁰¹ Increasing the penalties for insider trading and then attempting to apply such legislation to the problem of outsider trading, critics argue, would only prescribe the wrong remedy for a related, yet distinct, problem. In order to avoid such confusion, one suggested approach to the problems raised by outsider trading is "not simply sanctions, because sanctions cannot be imposed where there is

194. *Id.*

195.

The likely effect of *Dirks* will be to undermine the use of [Section] 10(b) and Rule 10b-5 as effective vehicles to combat outsider trading on inside information. Both *Chiarella* and *Dirks* now demonstrate that [Section] 10(b) may not be the appropriate statutory predicate to combat trading on inside information by outsiders.

Block & Hoff, *supra* note 17, at 23 (footnotes omitted). See Sporkin, *Setback to SEC's Enforcement Drive*, N.Y. Times, July 17, 1983, at F2, col. 3; Pitt & Aim, '*Dirks*' Deals Blow to Insider Trading Program, LEGAL TIMES OF WASH., July 11, 1983, at 13.

196. See Block & Barton, *Securities Litigation*, 10 SEC. REG. L.J. 350 (1983).

197. Block & Hoff, *supra* note 17, at 23.

198. See, e.g., Block & Barton, *supra* note 197, at 371-73 (discussing proposed legislation based upon regulation of unfair trading).

199. Middleton, *supra* note 182, at 1613.

200.

[W]hile increased sanctions are a potent response, the legislation fails to go to the root of the problem. The courts have interpreted [Section] 10(b) as proscribing fraud by corporate insiders and those who knowingly trade on the information received from insiders who have breached their duty to their corporation and its shareholders. Outsider trading on inside information, however, is not fraud because the traditional elements of fraud—e.g., duty, misrepresentation and deception—are absent. The prohibition on outsider trading based on inside information is rather a judicially created concept grounded more on notions of fairness than on the specific activities outlawed by [Section] 10(b) and Rule 10b-5.

Block & Hoff, *supra* note 17, at 24.

201. *Id.*

no liability. . . . What is needed, therefore, is legislation that specifically addresses the issue of outsider trading.”²⁰²

Such legislation would add to the remedies already proposed in the Insider Trading Sanctions Act, yet it would be specifically designed to cope with the problem of outsider trading. “The legislation should clarify the policy to be vindicated and should set forth who is precluded and the conduct from which they are precluded.”²⁰³ The policy behind such legislation should be to maintain investor confidence in the securities markets²⁰⁴ and to remove the impression that “some people play the market with marked cards and deal bad hands to honest investors.”²⁰⁵

VI. Present Issues and Future Prospects

Securities trading violations based upon the fraudulent or unfair use of material nonpublic information have confronted the legal and business communities with serious legal and ethical questions. Given the increasing variety of securities available²⁰⁶ and the new methods by which they may be traded,²⁰⁷ the potential for violations, if not

202. *Id.*

203. *Id.*

204.

Congress should expressly articulate that the underlying policies of such legislation [are] that it is unfair to trade on inside information and that the integrity of the capital markets must be protected. The legislation should make it unlawful to trade based on material non-public information. The legislation should also articulate an intent standard and should provide express exceptions to liability to reflect, among other things, the Supreme Court's proper rejection of the notion that there should be equal access to investment information as undesirable and impractical. Thus, the focus of the legislation would not be on fraud, but rather on unfair trading.

Id.

205. Middleton, *supra* note 182, at 1613.

206.

The S.E.C.'s headaches do not end with [stock or] stock options. Trading in futures and options on “subindexes” of just a few stocks is on the verge of taking off, providing new opportunities for insider trading. Various exchanges have made proposals to the S.E.C. to trade some 60 options on subindexes. Meanwhile, the commission has opposed futures on four stock subindexes proposed by the Chicago Mercantile Exchange, in part out of the fear of insider trading.

Blumstein, *Insider Trading Hard to Measure*, *supra* note 14, at D5.

207. “Taming insider trading is increasingly difficult because of the growing ways to trade on private information. Not only can people buy and sell stock, but in many

actual cases of abuse, is almost certain to increase in the future.²⁰⁸

In response to these developments, the legal and business communities will be faced with a number of important choices. The most fundamental is whether to continue to prohibit insider trading,²⁰⁹ or instead to follow the course advocated by certain commentators²¹⁰ and allow trading on material nonpublic information as a device to increase the efficiency of the capital markets.²¹¹ While many arguments have been made in favor of the efficiency approach,²¹² the underlying purposes of the federal securities laws²¹³ preclude sacrificing the integrity of the securities markets and the faith of the individual investor in those markets on the basis of efficiency alone.²¹⁴

Presuming that the prohibitions on insider trading will remain, the legal and business communities, working in conjunction, should adopt a two-part approach to keep trading abuses at the lowest possible level. On one level, greater legal sanctions are necessary to deter and, if the need arises, to prosecute those who use their positions of trust and confidence for personal profit. On this level, legislation such as the Insider Trading Sanctions Act²¹⁵ and proposals for further legislation dealing with the problem of outsider trading²¹⁶ are indispensable weapons in the arsenal of those charged with the enforcement of the federal securities laws. Such enactments, however, will be unsuccessful unless those charged with their enforcement maintain a high degree of vigilance in identifying and prosecuting transgressors.

cases, they can sell options on stock, whose prices tend to move even more dramatically than the underlying shares." *Id.*

208. *Id.*

209. See Heller, *supra* note 1, at 520-26; Note, *The Efficient Capital Market Hypothesis, Economic Theory, and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1034 (1977).

210. See Heller, *supra* note 1, at 522.

211. *Id.*

212. See *supra* note 209.

213. See *supra* notes 11-12 and accompanying text.

214.

ECMH (Efficient Capital Market Hypothesis) theory implies that trading by those with nonpublic information—insider trading—increases the information flow to the market and thereby improves efficiency. Thus, economic considerations do not justify restrictions on insider trading. *However, insider trading presents difficult moral questions that have been debated widely by both legal scholars and economists.*

Note, *supra* note 209, at 1073-74 (emphasis added).

215. See notes 182-206.

216. *Id.*

On a more fundamental level, greater disapproval of abuses involving securities transactions is necessary, not only within the legal and business communities but throughout the entire investing public. Trading on material nonpublic information is difficult to discover.²¹⁷ Even when such cases are disclosed, however, the public reaction often falls far short of the condemnation engendered by other forms of illegal activity. Indeed, insider traders may be often secretly envied by other members of the investing community, a reaction which can only decrease faith in the integrity of the capital markets and the securities laws. The standard of ethical behavior required must be substantially higher than the mere morality of the marketplace.

This Note does not argue that the total elimination of unfair securities trading based upon confidential information—whether by insiders or outsiders—will occur in the foreseeable future. Given the potential for financial gain, such an expectation would be either too naive or too utopian to be credible. The more realistic goal of limiting instances of insider trading recognizes human nature and accepts the fact that there will always be certain individuals who will violate the securities laws by trading on inside information.²¹⁸ By developing a coherent body of legal doctrine to address these inevitable excesses, the securities markets will be protected from becoming forums of fraudulent and unfair activity.

VII. Conclusion

This Note has examined the subject of insider trading and the development of the duty to disclose material nonpublic information. While the antifraud provisions of the federal securities laws have traditionally been the remedy for insider trading violations, new legislative approaches have been offered as alternative solutions for lowering the level of insider trading activity. Because they would enhance present sanctions, such proposals should be supported as valuable additions to the law on insider trading.

Frank P. Luberti, Jr.

217. See *supra* note 14 and accompanying text. See also Noble, *How the S.E.C. Watches Stocks*, N.Y. Times, Apr. 13, 1984, at D1, col. 4; Blumstein, *Wall St. Columns Get Wide Scrutiny*, N.Y. Times, Apr. 6, 1984, at D5, col. 1; Jones, *Profits for Lawyer Reported*, N.Y. Times, Apr. 6, 1984, at D5, col. 4; *SEC's Inquiry Widens As It Questions Broker, Others in Journal Case*, Wall St. J., Apr. 2, 1984, at 1, col. 6; Jones, *Journal Says a Reporter Is Under S.E.C. Inquiry*, N.Y. Times, Mar. 30, 1984, at D1, col. 1; *SEC Investigates Charges of Traders Profiting on Leaks by Journal Reporter*, Wall St. J., Mar. 29, 1984, at 3, col. 2.

218. "The question is are we going to abolish human nature? I would say not likely." Blumstein, *supra* note 14, at D5 (quoting James Balog, Senior Executive Vice President, Drexel Burnham Lambert).